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FOREIGN INVESTMENT

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GARDNER PATTERSON, *Director*  
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# FOREIGN INVESTMENT

SIR ARTHUR SALTER\*

## PART I

### BRITAIN'S EXPERIENCE AS A CREDITOR COUNTRY

#### I. INTRODUCTION

PART I of this essay discusses what there was in Britain's experience, when she was the principal overseas investor, which may be relevant to America's problems now that she has succeeded to that position. This will be followed by Part II which discusses the problem of foreign investment in present conditions.

\*AUTHOR'S NOTE. In the early months of 1950, at the suggestion of Mr. Winthrop Aldrich (Chairman of the President's Committee for Financing Foreign Trade), I wrote a memorandum on Britain's experience as a creditor country, and added comments on the special circumstances now affecting foreign investment. In preparing this I had the advantage of consultation with the responsible authorities of the City of London (The Bank of England, the Joint Stock Banks and the accepting and issuing houses), who not only gave me oral advice but sent me detailed written comments and suggestions which I embodied in my text. Some of those who saw this memorandum expressed the opinion that it should be given a wider circulation, and in October 1950 I received and accepted an invitation from the International Finance Section of the Department of Economics in Princeton University to prepare a revised text for inclusion in its series *ESSAYS IN INTERNATIONAL FINANCE*.

I had contemplated personal consultations with officials in the British administration and international organizations such as the Organization for European Economic Cooperation (OEEC), of the same kind as those which I had already had in the City of London. In the meantime, however, OEEC had arranged for a study, covering much the same field, through an international committee presided over by Sir Mark Turner. This Report (published in November 1950) reflects fully the official point of view on the questions which I had been studying independently and made unnecessary the personal consultations with officials which I had contemplated. For the present text I have here and there quoted some figures from this Report; but no changes of substance have been made. The Report has of course a collective authority which my memorandum cannot claim, and is fortified by fuller statistical and factual information. Any general similarity of the conclusions is the reflection of two completely independent studies.

In the present text I have had the advantage of consultation during October with economists, certain officers of the Chase National Bank, those associated with the International Bank for Reconstruction and Development (IBRD), and others in America; and the principal additions to my earlier, and privately circulated, text are due to these. I wish to express my sincere gratitude to all who have helped me in this way.

Apart from personal help of this kind I have drawn upon (a) official publications issued by national governments and international organizations, (b) certain standard books, and (c) private memoranda prepared for internal use by banks, including the IBRD.

I append a note at the end of this essay on source material covering (a) and (b), but not (c), as the latter is not publicly available. In view of this general note I have only rarely thought it necessary to append footnotes to particular passages.

Britain's great creditor period was from about 1880 to 1913, which lasted, it is interesting to note, only a third of a century. The nature of her achievement in that period can, however, be seen more clearly if it is compared with her own subsequent experience and that of other countries. It will be convenient therefore to sketch in bare outline the significant features of foreign investment over the last 70 years.

It is well, however, at the outset, to note the more important differences between Britain's position and that of America.

1. During her great creditor period Britain, a small island with no important domestic raw materials and minerals except coal, had a population which expanded rapidly till it consumed twice as much food as has ever been produced on her own soil. She was the pioneer in industrial development, and when her overseas investments first began to develop on a great scale industrialization in other countries was only at an early stage.

2. Britain's trade with customer and borrowing countries was for the most part therefore essentially complementary. Typically she exported railway equipment to the Argentine, which did not manufacture it, and bought maize which she did not produce. She had also in her colonies primary producing areas with which trade was similarly complementary; and in these British rule gave the competent administration and the political security required to ensure that economic development would not be impeded or its rewards lost.

3. Even in underdeveloped areas outside the British Empire political conditions were much more favourable for foreign investment in the half century preceding the first world war than they have been since or are now.

4. Foreign investment during this period offered greater rewards than most investment by the British investor in enterprise at home, and the difference was more than enough to compensate for any moderate extra risk. Domestic industrial expansion was mainly financed by ploughing back profits (then of course facilitated by the lower level of taxation) rather than by issues in the London market, and the general home investor was for the most part confined to Government bonds etc., of which the yield was substantially less than that promised by overseas investment. One consequence was that the machinery for promoting foreign investment was much more developed than any available for home investment.

5. In Britain's great period the world's currencies were anchored to a metallic basis, usually gold. Exchange rates were stable within the narrow limits of the gold points. There were, except in rare cases, no transfer difficulties or exchange controls.

6. Aided by these circumstances Britain's policy, and the practices of

her traders and financiers, were ideally suited to a "creditor" country. She had no tariffs or quotas or other impediments to equal trade. She both imported and re-invested freely. Her foreign loans were not during this period "tied" to expenditure on British products. Her imports amounted at the peak to between a third and a quarter of her whole national income and throughout the whole period, 1880-1913, considerably exceeded her exports. In that period her annual earnings from foreign investments were, on the average, about £100 million of which about £60 million were used to finance imports in excess of current exports and £40 million were re-invested. In the last ten years of the period (in spite of a continuing import surplus) new foreign investment averaged over £150 million, and in the last year, 1913, it almost reached £200 million (\$1 billion at the rate of exchange of the time), equivalent at present prices to about £600 million, an astonishing figure for a small island with a population of some 40 million.

There was, therefore, no "sterling" gap in the sense in which there has since the war been a "dollar" gap.

7. In all these respects America's problem as a creditor country is different and such as to make a "creditor policy" more difficult. It is true that, partly as a result of the depletion of certain resources during the second world war, she is likely to be more dependent upon imports for certain essential materials including iron ore, copper, and oil. Except, however, for these and a few articles of luxury (which together cannot be expected in themselves to maintain her balance of trade at anything like the present level) she produces and makes all she needs as well as or better than others, and in terms of man-hours more economically. Any great expansion of imports from other countries must consist largely of goods which enter into direct competition with her own manufacturers and are only able to compete successfully because of the advantage of lower wage costs, with perhaps "devaluation" as well, which from the point of view of the domestic manufacturer seems "exchange dumping." This makes it much more difficult for her than it was for Great Britain to abolish tariffs. The differences in regard to foreign investment are no less important. The absence of stable currencies is one obstacle, the less favourable political conditions in most parts of the world a second, the opportunities for highly remunerative home investment a third. These differences will be discussed more fully later. But it is well that they should be stated at once in broad outline in order that the comparison with the British experience may be seen in its proper perspective.

8. These differences, however, while important, must not be exaggerated. For example, Britain's foreign trade in her creditor period was not wholly complementary, and its development to the point it reached

was only made possible by a deliberate policy which subordinated to it the interests of the home producer and manufacturer.

British agriculture, for instance, denied either subsidy or protection during this period, became unprofitable in the 1880's; and the land under wheat was reduced by half, from 3.6 million to 1.8 million acres, between 1874 and 1900. Moreover a quarter of British imports were of manufactured goods which competed directly, without tariff handicap and often with the advantage to the foreign exporter of lower wage-costs, with domestic industry. For the British Empire, and other primary producing countries in which British capital had been invested, produced more raw materials than could be sold to Britain alone; they exported the remainder to Europe and the U.S.A., which in turn sent manufactured goods to Britain. Only in this way could the international accounts have been balanced at so high a level of foreign trade. Britain's creditor policy, therefore, though favoured by circumstances, was only pursued as far as it was with difficulty and against the protests, unsuccessful throughout the period which ended with the first war, of the interests which suffered from a free trade policy.

9. It is obvious that America cannot so far expand her imports that they would occupy a place in her economy comparable with that of Britain's imports in her creditor period. But nothing approaching that, of course, would be required to enable any probable dollar gap to be closed without a reduction of America's exports. The imports needed for that purpose would absorb only a small fraction of the home market of the manufacturers affected; and any resulting loss or difficulty would be compensated by a fully equal gain in external markets to the same or other American industries. The problem of achieving an appropriate creditor policy, therefore, though in some respects more difficult, is in other respects proportionately a smaller one for America than it was for Great Britain.

When every allowance is made for differences there remains much that is interesting and relevant in the British experience.

## II. BRITAIN'S RECORD 1880-1913\*

Britain's period as a great foreign investor reached its peak and its conclusion on the eve of the 1914 war. It may be said to have begun half a century, or its very large-scale development a third of a century, before then. In 1854 the total of British investment was only about £200 million. In 1880 the total of British investment was £1300

\* NOTE: In this part of the Essay I have drawn freely on *The Problem of Foreign Investment* published by the Royal Institute of International Affairs in 1937. In order to avoid numerous footnotes I content myself with this general acknowledgment.

million, in 1905 £2000 million and in 1913 over £3700 million; with an allowance for investments not represented by negotiable securities, which are not included in the above figures, the 1913 total was about £4000 million, equivalent to about £12,000 million at current prices.

It is this period, from 1880 to 1913, that will now be examined.

During this expanding third of a century Britain's investments and the income from them increased at a much greater rate than the total wealth and income of the country. Between 1880 and 1913 the national income was not quite doubled (it rose from £1200 million to £2250 million). While at the earlier date, however, the income derived from overseas investment was about £50 million, in 1913 it reached £200 million, a fourfold increase. This income was 4% of the total national income in 1880, 7% in 1903 and 9% in 1913. As the British national income (with increased population and depreciated purchasing power of the pound) is now estimated at over £10,000 million, a maintenance of the 1913 proportion of foreign investment (without any continuation of the rate of increase) would have brought the total up to £16,000 million and the income up to £900 million. In fact Britain is now, on balance, a debtor and capital importing country.

The actual yield on overseas investments shows the motive force behind this great expansion. In the decade 1870-1880 the average yield on all foreign bonds was 5.5% and on other foreign securities nearly 7%. The average yield on Consols during this period was 3.8%. In the first decade of the present century there was still a large margin in favour of foreign investments, which gave an average yield of 5.2% as compared with about 3% on Consols and 3.5% on home securities generally. On the other hand there was little or no margin in the case of Colonial investments. Indian Government Loans were issued at a rate which yielded only 3.2%, Indian Railways 3.87% and Colonial and provincial loans 3.7%. Dominion and Colonial governments could indeed borrow more cheaply in London, just before the first war, than those home borrowers whose bonds were not trustee securities. This favourable rate of borrowing was helped by the fact that the Colonial Stock Acts gave trustee status to Empire Bonds—almost the only instance of government intervention favouring overseas investment. It also well illustrates, however, the confidence of the British investor in overseas areas under British administration and the special importance which the Empire thus had as a field of expansion for British overseas investment.

The geographical distribution of the investments is equally interesting. In the early 19th Century the main British investments had been in Europe, where they served to accelerate industrial development. In the period now under consideration, however, they had been switched

to countries which were largely or mainly primary producers. By the end of our period (the outbreak of the first world war) the distribution was as follows:

AREA	PERCENTAGE
U.S.A.	20
Canada	14
Australia and New Zealand	11
India	10
Argentine	9
Europe	6
Rest of the World	30
	<hr/>
Total	100

Not less important is the distribution of the investments between different classes of borrowers and enterprises.

Mr. Herbert Feis\* has given a detailed classification of British investments in December 1913 from which the general pattern can be clearly seen. The total value was about £4000 million divided as shown in the above table between the Empire and foreign countries.

Railway securities take the first place, since in the period in which the investments were being made railway construction was the most important development taking place in the world. They account for 40% of the total. Loans to governmental authorities, central, state or municipal, come next with 30%. Four other main groups, raw materials, banks and finance, commerce and industry, and public utilities together account for the remaining 30%. The great bulk of the capital raised was in the form of securities yielding a fixed rate of return, though in South Africa in particular the general investor invested substantially in equity stock. In many cases, however, the bonds subscribed to by the general public in this way were issued by a British Company whose investment was "direct," in the sense that it controlled the actual enterprise—e.g. railways in the Argentine and in China.

Some four-fifths of the British investment in Governmental and railway securities was in countries dependent upon the profitability of agriculture as an export industry.

The other most notable features of the system of foreign investment were these:

A large, and increasing, proportion of the earnings and dividends was absorbed in the form of an excess of imports into the United Kingdom over exports. At the same time enough was re-invested to increase total investments at the rate already indicated. This re-investment was

\* *Europe the World's Banker 1870-1914*, Yale University Press, 1930.



an essential part of the system from the point of view of the borrower, as well as the lender; for repayments, particularly of Government borrowing, were normally made out of the proceeds of new loans, and the prospect of further borrowing was the best incentive to a debtor to keep up service payments.

British loans during this period were not "tied." The borrowers could freely use them to buy from foreign countries as well as from Britain. The bulk of the business doubtless went in fact to British industrialists, but the fact that the borrower was free to go elsewhere was a protection against exploitation and a help to the development of multilateral trade.

The machinery through which these investments were arranged was highly developed and efficient. In the early years of Britain's export of capital, for a quarter of a century after 1850, the machinery and methods were in several respects unsatisfactory. A select Committee\* of the House of Commons in 1875 had revealed weaknesses and abuses in the system by which loans had been issued to several countries in South America, as the Senate's investigation did in the American system about half a century later. But by 1880 the British system had been reformed and throughout the period which is now being discussed, in which Britain was the greatest lending country, London was the best equipped centre for the purpose; and it retained its superiority after that period ended. The British issuing houses developed traditions and rules of practice which attracted and safeguarded the investor. In a well known passage the Macmillan Committee† described the position in 1931:

"When he (the investor) is investing abroad he has the assistance of long-established issuing houses, whose reputation is world-wide. When subscriptions to a foreign issue are invited by means of a public prospectus, it is almost certain that that issue will be vouched for by one of these issuing houses whose name will be evidence that it has been thoroughly examined and the interests of the investors protected as far as possible. For the issuing house's issuing credit, which can easily be affected, is involved, and it is very highly to its own interest to make sure that the issue is sound. If, as must from time to time happen, something goes wrong with the loan or the borrower, the issuing house regards it as its duty to do everything it can to put matters straight, and, indeed, to watch continuously the actions of the borrower to see that the security remains unimpaired. These duties are sometimes very onerous and involve a great deal of labour and expense, as well as judgment, skill and experience."

In addition to arranging long-term investment of this kind by the

\* Select Committee on Loans to Foreign States *Report*, 29th July, 1875.

† Committee on Finance and Industry *Report*, Cmd. 3897, 1931 (henceforth referred to as *Macmillan*), paragraph 387.

public, London developed an elaborate and extensive system of short-term financing of international trade through the acceptance houses and the discount market, which is described at length in the Macmillan Report. Until the first war the claims in respect of acceptances were roughly matched by bills and deposits held in London on foreign account. These short-term operations yielded profits which were a substantial addition to Britain's "invisible exports"; and since the acceptances were directly linked to the actual movements of goods, the system was safe as well as profitable, so long as there was an approximate balance between them and the obligations in respect of the foreign deposits and short-term credits. In the inter-war period, as we shall see, this balance was no longer maintained, and short-term foreign deposits made London very vulnerable in a world financial crisis. When the Macmillan Committee wrote its report (in 1931) the absence of any institutions for financing domestic enterprise had become a serious defect in the British financial system. But up to the first war there was little need of capital from the general investor or of institutions in London to encourage and collect it. Overseas investment during this period profited from this fact.

Till at least late in the 19th Century the development of home industry was financed mainly out of profits, or by direct personal arrangements between individuals. Of total national savings (including profits ploughed back) of nearly £400 million a year, rather more than half went to home industry, a little less than half abroad; but of the former only a small fraction was obtained from the general investor through the mechanism of the London market. The great bulk of home investment came from those who had personal knowledge of the particular businesses. One consequence was that capital was in a form which made the return vary with changing fortunes. Either the business was individually owned, or its capital was mainly in the form of share-capital (equities), whether "ordinary" or "preference," of a joint stock company. There was no undue weight of fixed debt involving an annual charge independent of profits. The capital structure was thus such as to afford an elastic buffer against bankruptcy in a period of depression. A further result was that the savings of the general investor who had no personal knowledge of a promising home enterprise were not required for industrial development at home and were therefore available for foreign investment and were attracted to it by the specialized and responsible issuing houses.

As we shall see, these conditions changed after the first war; but in the period 1880-1913 they constituted a very favourable environment for the expansion of overseas investment.

America's situation and system in the same period presented a strik-

ing contrast. Her domestic industry was before the first war expanding rapidly enough to absorb all, and more, of the capital available for investment. She was a net importer, not exporter, of capital. Her financial system was as clearly better fitted than the British to attract the general investor's savings to home investment as it was less well fitted to guide them towards foreign investment. All important industrial issues in the United States were sponsored by some responsible issuing institution, whose name appeared prominently on the prospectus. The banks or issuing houses engaged their credit in the eyes of the public for the soundness of the issues, and accordingly maintained a close and intimate association with the industries concerned. They gave the public real guidance of a kind not available to the British home investor.

These distinctive features of the British and American systems were still of importance, as we shall see, in the later inter-war period which preceded the financial crash of 1931. In the earlier period now under examination both the domestic capital needs and the credit system of America combined to increase British supremacy in overseas investment.

The relation of Britain's foreign investments to her balance of payments is often misunderstood. Throughout the whole of the period now under consideration, 1880-1913, the increase in her foreign assets was not due to any investment of a surplus of current earnings from an excess of exports of goods and services over payments for imports; for there was no such surplus, but a deficit. It was wholly due to the re-investment of a part of the income derived from earlier investments. It was only in an earlier period, which terminated soon after 1870, that the resources for foreign investment came from an excess of current exports over imports. In the whole period from 1870-1913, when total foreign investments increased from about £1000 million to nearly £4000 million, the total new investments made were only about 40% of the income from past investments during the same period. The relevant statistics are given in Mr. C. K. Hobson's *Export of Capital*\* of which Mr. Devons has analyzed the significance†. He summarizes the record in the following striking table:

PERIOD	AVERAGE ANNUAL INCOME FROM OVERSEAS INVESTMENT	AVERAGE ANNUAL CAPITAL EXPORTS
	[£millions]	
1870-1875	48	55
1876-1880	48	-1
1881-1893	75	48
1894-1904	100	24
1905-1913	155	143

\* C. K. Hobson, *Export of Capital*, Constable, 1914.

† *Manchester Guardian*, January 18th and 19th, 1950.

He comments justly "This British experience merely illustrates the essential point, which is so often overlooked, that a capital-exporting country soon finds itself in the position of being able to maintain its investment by re-investing income."

("Re-investment" must of course be understood in the national, not the individual, sense. To the individual investor the annual return from his foreign investments was a part of his income, which he would spend or invest at home or abroad as he might decide on personal grounds. But his foreign earnings however spent contributed to a surplus in the national balance of payments available for new foreign investments.)

### III. FOREIGN INVESTMENT IN THE INTER-WAR PERIOD

The significance of earlier investing experience becomes clearer after consideration of what happened later.

The new factors in the situation at the end of the first world war need only be mentioned briefly: the new régime in Russia (which had repudiated the pre-war Russian debts); the war debts; the reconstruction needs of Europe, and the disorder of its finances and currencies; the deterioration in Britain's balance of payments and capital resources; the availability of American capital for export; the attraction of America's finance to Europe (in addition to its more customary outlets in the Western Hemisphere) through the reconstruction and reparation schemes (first the earlier League loans and then the Dawes and Young loans).

Britain was prevented from taking the principal share in supplying the capital needs of Europe by her own weakened external capital position; by changes in her internal credit system and in the capital available for home industry; and to some extent also by the unsuitability and inadaptability of her overseas investment system (built up on the needs of primary producing countries) for the new requirements of Europe. This change was mainly due to the war, but partly also to developments which had begun, on a smaller scale, before.

Profound changes indeed had been taking place in the methods by which British home industries secured the capital they needed for their development. Increased taxation, including death duties, had reduced the extent to which new capital could be furnished by the earlier investing class, the rich; and had above all dried up the main source of equity capital. The larger scale of modern industry required more capital, and it could no longer be found in the form of ploughed back profits or transactions between a few individuals. Capital for home industry had

to come either from the general investor or from the banks. For the first there were, as the Macmillan Committee pointed out in the passage already quoted, no institutions which could compare in efficiency either with those available in America for similar purposes or with the British foreign issuing houses. Issues were floated on the initiative of the industries concerned with the aid of agents in London. But, except in rare cases, the general investor could not look for help or guidance to substantial issuing houses (as distinct from the actual industries requiring the capital) with a continuing responsibility and a reputation to preserve. In some cases irresponsible issuing houses tempted the small investor to put his savings into hazardous, and in the event unsuccessful, enterprises. Many of the older industries which needed adaptation had too poor a profit record to issue new equities but were able to obtain fixed-charge capital. There was a natural tendency too for the general investor, neither knowing himself about the particular industries nor having the help of experienced and responsible institutions, to prefer to limit his risk and to acquire a right to a fixed annual payment rather than more expansive but more precarious profits. A larger proportion of the capital structure of British industry thus came to be in the form of debentures or fixed-charge loans and a smaller proportion in the form of either reserves built up from profits or share capital. Industry then no longer had to the same extent the cushion given by an equity structure against depression and lower prices—and therefore against default and bankruptcy.

The joint-stock banks were not adapted to correcting this tendency or filling the gap in home investment institutions. They supplied industry with working capital in the form of overdrafts, which were legally recallable at fixed short terms and of course included no "equity" element of returns varying with the success of the business. The difficulty of obtaining long-term capital soon led to such overdrafts being largely used not only as working capital but for longer-term requirements. During the depression these overdraft credits ceased to be really liquid, since the banks could not recall them without causing bankruptcy. In effect such overdrafts became a substantial part of the long-term capital structure of British industries with a prior claim over other forms of such capital. But as the banks had a primary responsibility to their depositors, and were concerned in principle only to provide working capital, they relied upon an increasingly fallacious liquidity, rather than upon any intimate knowledge of the borrowing industries, as their security against loss.

The consequences were unfortunate. Once an industry was living on recallable overdrafts which it could not repay, its mastery necessarily passed to the banks. These, however, were neither equipped, nor did

they desire, to direct and control businesses. They usually did what they could to restore their clients to a position in which long-term issues would again be possible, if only to enable the bond indebtedness to be repaid; and they were often ready to put in more money themselves as part of an appropriate scheme. Naturally, however, reconstructive efforts of this kind were financial rather than technical in conception. The problem was approached as one of the balance sheet rather than of technical equipment, and in too little relation to the general condition of the industry of which the particular business in difficulty was one unit.

Often, therefore, the bank's nominally liquid interests in a business became frozen. Meantime the known existence of these frozen overdrafts (which at least retained a prior claim over new capital otherwise obtained) made long term issues more difficult.

The investor's experience, in a period of depression and lower prices, was discouraging, indeed disastrous. In the year 1928, for example, the total amount subscribed in Great Britain, in shares and debentures of 284 companies, was £117 million; and in May 1931 the total market value of these shares was only £66 million, a loss of 47%. Moreover, of the 284 companies 70 were already wound up and the capital of 36 others had no ascertainable value.\* It will be noted that, though by May 1931 there had been between two or three years of general depression, this was before the world financial crisis of June 1931 and before the period of the deeper depression. Even if there had been no world depression in 1929 it seems likely that there would have been an intolerable proportion of losses.

Foreign investments at the same date, May 1931, i.e. before the financial crisis, had a much better showing. The half that were in the form of sterling debentures, bonds and mortgages were still for the moment substantially intact, though the remainder, in equities, of course showed losses in the case of countries producing raw materials of which the prices had fallen abnormally. Disaster was indeed soon to follow, through causes which will be discussed. But it is instructive to note that as late as May 1931 the fate of British overseas investments, like the prospects to the investors in the preceding years, compared very favourably with home investment.

In the years preceding the general crash of June 1931 Britain's own financial position in the world had become much more vulnerable. Before the war, as we have seen, there was an approximate balance between acceptances and foreign deposits recallable at short notice. After the war, however, the short-term money in the London market increased out of all proportion. Very large French deposits were placed in Lon-

\* *Macmillan*—paragraph 349.

don, and there was a growing practice on the part of central banks and other banks abroad of holding a large part of their liquid resources in this way. It may be said that during these years London became the centre of international deposit banking. The consequence was that London had large funds available for investment, which were recallable on short-term basis, in excess of what was required for the acceptance business. These formed a precarious basis for lending abroad in other forms. Large credits, for example, (apart from long-term loans) were made on a nominally short-term basis in Germany during the years 1924-1928. When Germany ran into difficulties these credits became necessarily frozen and were in effect converted into a long-term investment, as similar short-term credits from the banks to home industry had become frozen. Meantime the foreign deposits were recallable—and were recalled. It was this process of "borrowing short and lending long" that formed the background to the fall of sterling from gold in September 1931.

It should be remarked that British loans in the inter-war period, unlike the earlier loans, tended, in many cases, to be for practical purposes "tied."

The defects of the British home investment system, although real, as the Macmillan Committee pointed out, must not be exaggerated, and must not be regarded as responsible to any important extent for the difficulties of the depression period. It is true that British industries would have done better in some cases if they had raised their capital through responsible issuing houses. The investor too would have been saved from losing his money in some of the more risky ventures into which he was tempted. But after all, in the inter-war period, a good deal of useful new development in Britain was successfully financed, and it was the uncertainty of the economic opportunities rather than difficulty in obtaining capital which set the limit. And under the general world conditions of the later '20's and '30's investors must have been involved in disastrous losses whatever the system of industrial financing. The closer association of the banks with industry for example, in Germany and—in a somewhat different form—in America, which had before helped industrial development, now involved banks as well as industries in a common ruin.

The advantage of British foreign over home investments in the early months of 1931 could not after all be maintained. It was only on the surface that the foreign investments seemed then in a comparatively satisfactory position. The underlying factors were such as to lead necessarily to the disaster which soon followed, after the financial crash of June 1931.

The losses sustained, first on domestic and soon afterwards on foreign

investments, show indeed the great difficulties under which all institutions concerned with investment worked in the inter-war period. The world depression, of unprecedented range and intensity, was accompanied by a sudden fall of prices to about half the previous level. This doubled the burden of all bond indebtedness.

It is scarcely possible to exaggerate the importance of the "fixed-charge" capital structure (industrial, governmental and inter-governmental) in precipitating and exaggerating the financial crisis. In the case of one important obligation, that of Germany for reparation, an attempt had been made in the Dawes plan of 1924 to provide a corrective for a change in the value of money by making the obligation vary with the general level of prices. Even in this special case of reparation, however, this corrective was unhappily omitted from the subsequent Young plan of 1929. And there was no relief whatever for the doubling of the real weight of the great mass of fixed-charge obligations on borrowing governments and upon productive enterprise whose capital was on a bond basis. In these circumstances the financial crisis of 1931 was the inevitable sequel of the depression of 1929, which in turn it deepened and prolonged.

It has been worth while to emphasize these features of the inter-war experience because the success of future investment will again depend partly on the respective proportions of fixed-charge and equity capital, and on the extent to which changes in the general price level modify the real weight of the former.

The distinctive features of the American system were in the inter-war period of greater importance than those of the British system. The need for American capital abroad after the first war, and America's capacity to supply it, suddenly opened an opportunity for American issuing houses. Their rapid growth, in successful competition with British issuing houses, was largely due to the fact that there was now more American than British capital available for investment. It was further accelerated, however, by the fact that the British bearer bonds were subject to a 2% stamp which had no counterpart in America. British investors were still for the time more "foreign-bond minded" than America, and in these circumstances many bonds issued by American houses were taken by British investors. Issues by American houses, for example, of Argentine Government bonds and, in 1926, of Hamburg City bonds were largely placed in London. There was until after 1920 no mechanism to evoke the interest of the American investor in foreign bonds. In the later 1920's, however, a new mechanism was rapidly developed. It was based, to an extent not known elsewhere, upon thousands of local agents working on commission throughout the country



on behalf of a small number of large issuing houses, mostly operating from New York and Chicago.

These agents for the first time induced the small investor in provincial towns and the countryside of the Middle and Far West to link his fortunes with the governments and enterprises of distant lands. It was a remarkable achievement in organization, and very successful in its first purpose of inducing the investor to lend his money and making it available for the continents needing capital. It was at the other end of the operation, that of the examination of the character and purposes of the loan, the capacity of the borrower and the likelihood of the money being used productively, that the system was defective. There was too much competition and too little caution in negotiating the loans. The more prudent bankers were embarrassed by the competing offers of less responsible issuing houses, who were content to sell the bonds, take their substantial commissions, and leave the consequences to be borne by the investors. And too often the competition was in the form of laxer conditions rather than lower rates.

In an official publication the United States Department of Commerce made the following comment:\*

“ . . . American investment brokers had their agents ‘sitting on the doorsteps’ of prospective borrowers, . . . offering them money and many times persuading them to borrow more than they actually needed. The bonds were widely distributed, in turn, to the American investing public, which were attracted by the high yields obtainable and apparently willing to rely on the judgment of the selling bankers as to the safety of the loans. This uncontrolled and extremely competitive method of foreign lending led almost inevitably to unwise, and frequently to wasteful, use of loan proceeds and to overborrowing by many countries.”

It was an important factor in extending this process that in the period in which America was a great long-term lender through the issue of foreign bonds, and also a short-term lender to the German banks, she was also simultaneously (in 1928 and 1929) a short-term borrower from Europe under dangerous conditions. The operation of her banking system made her short-term money rates more volatile than the corresponding rates in London and elsewhere. During the Stock Exchange boom of 1928 and early 1929 the demand for money with which to speculate drove up short-term money rates to extraordinary heights and made them a dangerous magnet for European liquid funds, with a consequent drain on European currency reserves. There were, therefore, during this period a large and simultaneous import from Europe of

\* *The United States in the World Economy*, 1943, p. 96.

short-term capital, and an export to Europe of both long-term and short-term capital.

The general pattern of American investment at this time must be borne in mind in order to see the defects of the system which have just been indicated in a proper perspective. Of a total of some \$15,000 million, about half were represented by "direct investment" (in foreign branches and subsidiaries of United States companies, etc.) in which the investors controlled, wholly or to an important extent, the enterprises financed. The remaining half consisted of dollar bond issues, four-fifths of which were to governments or carried a government guarantee. Of these a third were in Canada. There remained \$1200 million in Germany, \$2300 in the rest of Europe and \$1600 in Latin America.

The dangers of the new bond promotion system were especially conspicuous in the case of Germany and Latin America. Here, however, they had important consequences. It cannot be denied that in a high proportion the loans to these countries were reckless, extravagant, and wasteful. The lenders were private investors (who bore the risk for they had no guarantee except from the borrowers) and the borrowers were governments. There are very special dangers in such loans. An individual company usually borrows with a careful consideration of the consequences which must fall directly on those who direct it. The lender is also more cautious because his security depends on the limited and calculable resources and prospects of the borrower. Moreover, if the transaction proves a bad one, the consequences are restricted in both range and time. The individual borrower dies and the heir is not saddled with a net liability; or a borrowing company goes bankrupt and its insolvency does not affect the credit of others. But when the borrower is a government, default affects the credit of the whole nation and all individual concerns within it. There is, moreover, a curious combination of the dangers of both a short and a long expectation of life. The contracting Minister may well think largely in terms of his own probable tenure of office, which is usually short, rather than that of the loan—so that a high rate of interest for a loan which offers a large amount of ready cash is no deterrent. But if political life is shorter than personal life, the nation bearing the burden is immortal and the charges of a rashly negotiated loan may extend over generations.

The records of the loans of this period afford many examples of these dangers. For example, Brazil's borrowing culminated in a moratorium after the financial crash of 1931. Behind this was the fact that since the war Brazilian public authorities had issued long-term bonds abroad amounting, with some refunding and self-liquidating loans, to about

\$800 million. These included \$8 million in 1922 for electrifying the Central Railway, which was still not electrified ten years later, and \$20 million for a Rio Aero water supply scheme which was in effect abandoned. Colombia's record was even more instructive. Between 1924 and 1928 it borrowed over \$150 million. A large part of this was devoted to constructing a railway to connect two valleys separated by a range of mountains 9000 feet high, for which there was no economic justification since both valleys had their own outlet to the sea. A very expensive tunnel through the mountain range was begun and then abandoned; and while the Federal Government was driving a tunnel through the mountains the local authorities were making a costly road over them.

Many of these extravagant futilities were due to the fact that the normal relation between a borrower who finds that he wants capital and a lender who cautiously and critically examines his proposals disappeared. On both sides the negotiating individuals reaped quick and substantial profits, and left the consequences to others. Often there was something like actual corruption in the negotiations, as was revealed in the evidence before the Finance Committee of the American Senate. Apart from that, however, the possession of a large sum of cash often tempted the borrowing Government to speculation or wasteful expenditure, or military extravagance or adventures; or an unconstitutional adventurer might be confirmed in power. On the lending side the loan agent, tempting the borrower Ministers with offers, got his commission and was no longer concerned. And, as the evidence produced to the Senate Committee disclosed, the issuing house which employed him recognized no greater or continuing responsibility. It was only an intermediary between the borrowing country and the investing public, and having taken its own commission left both to suffer the consequences.

Another notable feature of the extravagant lending of this period was that the good lender became involved with the bad. There were of course responsible and prudent issuing houses in every financial centre. But they were liable not only to be blacklegged in negotiating their business by irresponsible houses offering temptingly lax conditions but also to have their own originally sound transactions made unsound by subsequent extravagance. A modest and useful loan might for example have been issued to a particular country and used for productive purposes; and then the subscriber might lose because later wasteful loans disorganized the borrower's public finances and compelled default. The inflated scale of borrowing in this period in fact undermined all foreign investment.

## I. THE PEAK OF INTER-WAR INVESTMENT—1930

The peak of the world's overseas investment, in the inter-war period, was about 1930. New investments had then only just begun to fall off (after the depression of 1929), and the great financial crisis of 1931 was just ahead. It will be convenient, therefore, to look at the situation at that date.

The three principal creditor countries were the United States, Great Britain and France, but Holland and Switzerland were important participants in foreign lending, and Sweden also took part in many international issues, though on a smaller scale. The total investments of the three principal countries, excluding both debts owed to the Governments of these three countries and short-term debts, were about:

Great Britain	£3,700 million
United States	\$15,600 million
France	Fr. 72,000 million

Allowing for investments of each of these three in the other two the total investments of the three in the rest of the world somewhat exceeded £7,000 million.

The distribution of these 1930 investments was approximately as follows:

*Creditors:* Great Britain: 60% in the Commonwealth, 22% in Latin America, 8% in Europe.

United States: 30% in Europe and the great bulk of the remainder on the American Continent.

France: at least 60% in Europe.

*Debtors:* The greatest European debtor was Germany. (Russia had had a greater debt, about £1,000 million, but after the Revolution the Bolshevik Government had repudiated debts contracted under the Czarist government.) Her long-term foreign debt amounting in 1930 to R.m. 18 milliard (£880 million). Of this over 50% was owed to the United States alone, the rest being divided between the United Kingdom, France, Holland and Switzerland.

The great bulk of British investment, in 1930 as in 1913, was in primary producing countries, and the main purpose was the development of "public utilities" (roads, railways, power plants, harbours), which while not actually part of the primary producing industries were an important adjunct to them. Such loans enabled exports to be increased to an extent which more than covered the service of the loans, so that there was a sound economic basis for the transactions. It will be

noted that a much larger proportion of British investment was now in the Commonwealth and less in foreign countries.

Investments in Europe, which is not essentially an exporter of either raw materials or food, were of a different character. Britain in 1930 only had a total investment in this continent of about £300 million as compared with United States investments of \$4,248 million, of which \$2,420 million were in government securities, and \$968 million in the form of "direct" investments in subsidiaries or branches of American firms. Computations of long-term capital at this period are, however, complicated by a fact that was to become of great significance in the following years, viz; that nominally short-term credits were continually renewed and used for expenditure of a kind which is more appropriately financed by a long-term loan; they were therefore in reality, though not in form, a part of long-term investment.

Europe's inter-war borrowing falls into three classes:

- (a) stabilization and relief loans
- (b) post stabilization borrowing for capital projects
- (c) re-armament loans

It is the character of this inter-war lending which explains the financial crisis of 1931, and a few further comments are therefore desirable.

A foreign loan is only permanently sound if it causes not only increased production in the borrowing country but also (directly or indirectly) extra exports (or a substitute for imports) equal to or exceeding the service of the loan.

This fundamental condition was not satisfied by the bulk of the new lending in Europe (as also in several South American countries) in the 1924-1928 period.

Taking the three classes distinguished above:

(a) The Dawes and Young loans to Germany (£117 million), the League loans (£81 million), and further loans of the same general character to Poland, Roumania and Czechoslovakia fall mainly into this category, though a substantial part of the two reparations loans was intended to make reparation payments possible.

On the whole, however, with this exception, the loans in this category were genuinely reconstructive and well worth while; they would have been sound and of permanent value had subsequent developments in the world (peaceful international relations and the expansion of world trade) been such as had been hoped at the time.

The League loans to Austria and Hungary, for example, as we shall see, enabled the currencies to be stabilized, brought back fugitive money, and established the balance of payments in a sound position. Within two or three years both countries experienced a substantial revival, were

reasonably prosperous, and were easily able to meet the service of the loan out of current foreign earnings. It was only the impact of the general world depression which ended this recovery and led to collapse and default.

(b) The very success of the first stabilization loans, however, encouraged a reckless form of lending and borrowing, which in 1931 brought general collapse. In addition to the Dawes and Young loans Germany had borrowed by 1930 a further £763 million on long-term, and a further £877 million on short-term (the greater part coming from the United States, though a substantial part of the short-term credits came from Britain) a total of £1,640 million. Of the long-term borrowing about £300 million was represented by purchases by foreigners of German securities and mortgages, £117 million by the Dawes and Young loans, £100 million borrowings by states and municipalities, £80 million by various forms of private borrowing. The fatal features of these operations were that a substantial part of the newly imported capital was used for unproductive expenditure (on municipal buildings and amenities for example) and as a whole it did comparatively little to increase the export-earning capacity required to meet the service payments as they became due. Moreover most of Germany's potential exports competed directly with the domestic or exporting industries of her principal creditors with the result that she encountered formidable tariff or other obstructions to her foreign sales.

The resulting difficulties, which in any case would have been serious, were aggravated by the fact that much of the nominally short-term credits assumed the character of long-term loans. They were used to finance projects which at the best could not give an early return. It became necessary to renew them automatically to avoid open default. The crisis was postponed for a time in this way but the whole financial structure came to depend upon a continuing flow of new credits as well as the freezing of past ones; and when the American depression of 1929-31 stopped this process, a general crash became inevitable. It started with the default of the Credit Anstalt at Vienna, and quickly spread throughout the world.

(c) Re-armament loans, a substantial feature of overseas lending both before the first war and in the inter-war period, had still less the character of productive lending in the economist's sense. France, with the natural political purpose of strengthening resistance against the danger of German aggression, was especially active in promoting such loans. But though political in purpose they were not guaranteed by the Government which recommended them. The risk was borne by the French investors, very largely small peasant producers who toiled and

lived sparsely and then hopefully lent their savings to Russia or the Balkans.

## 2. THE LEAGUE LOANS

The League loans of this period\* are specially instructive, and a rather fuller account of them may be of interest. The earlier, and more important, were for the purposes of "stabilization," the later for relief and refugee settlement.

The first loan was devoted to the reconstruction of Austria and was of a type which was without precedent at the time. The country was in 1922 *in extremis*. She could not live without large imports of food. She had no resources with which to pay for them. Her currency had fallen to a fifteen-thousandth part of its value and, as the Government was meeting its current expenditure by printing new notes, was still falling rapidly. Some £30 million of public money and, in the form of charity or speculative investment in the crown, even more private money had been poured in, with no improvement to show at the end. The Supreme Council of the Allies in the summer of 1922 referred the problem to the League of Nations with no real hope of any useful result. The League, however, in addition to the members of its regular staff, had the assistance of a very able Financial Committee composed of members of the Treasuries or leading banks of the principal countries. This Committee came to the conclusion that a composite scheme which would provide for the cessation of note printing and a control of budget expenditure would attract back fugitive money, and establish the conditions under which Austrian exports (visible or, still more, invisible) could be restored. But a large loan of some £27 million was necessary to cover the interval between the cessation of note-printing and the successful attainment of these results. It was obvious that no loan could be raised on the security of a country in dissolution for a completely novel experiment in reconstruction. Governmental guarantees were therefore indispensable. Fortunately it was easier to secure these because several countries feared the political consequences of chaos in Austria; Czechoslovakia and Italy for example each suspecting what action the other would take. In the end varying proportions were guaranteed (totalling 100%, but the guarantees were "several" not "joint and several"); the loan was launched and the Financial Committee's plan met with immediate and dramatic success. Within two years Austria was enjoying a moderate boom, and a standard of living which compared not unfavourably with that of her neighbours or even of her

\* NOTE: I was head of the League's Financial Section at this period, and closely associated with all the loans, both at Geneva and in the respective capitals, and I was in charge for a time of the League's administration in Vienna, and prepared the scheme for Hungary in Budapest.

own past. It was only the impact of external developments, in the world depression of 1929 and the world financial crisis of 1931, that ultimately had the effect of plunging Austria, like other countries, back into impoverishment.

Meantime the success in Austria led to a similar reconstruction scheme for Hungary. In this case the League's reputation enabled the loan to be issued without governmental guarantees, though it was necessary to offer a high rate of interest ( $7\frac{1}{2}\%$ ). The success was equally striking, and Hungary also achieved a recovery and moderate prosperity, again to be interrupted by the impact of external events.

In both these cases a control of Budget expenditure through a League Commissioner responsible to the League was an essential feature. The restoration of confidence had, however, such rapid and important results on the whole financial position of the two countries that this control did not in fact need to impose severe sacrifices. The revenues from taxation were enough both to meet the service of the loan and to finance all essential services. Everything possible was done to establish the required internal conditions. The League's object was to bring each particular country up to the level of its neighbours, and to eradicate the defects of its own internal position. And this purpose was achieved. But of course nothing in the League action could protect the country against the impact on its external trade and on its capacity to attract foreign capital of the major world depression and financial crash.

Following upon these successes the League was able, by similar schemes or sometimes only by sending technical advice and assistance, to assist a number of countries to stabilize their finances and return to gold, or gold exchange, currencies. It also undertook refugee settlement, with the aid of foreign loans, in Greece and in Bulgaria. In the former case over a million destitute refugees from Asia Minor were settled in Greece, mainly in Macedonia, so successfully that within a few years their production of wheat and other products made them an asset, instead of a burden, to the country.

Several conclusions are suggested by the League's experiences.

No internal help to a weak country can immunize it against the results of a great world depression. And under the best conditions the rate of interest required to attract private capital (if there are no governmental guarantees) is high. The investor is likely to lose his money, and to be very unwilling to risk more after one such experience. The question therefore naturally suggests itself whether loans of this kind (involving a risk of failure from causes beyond the control of the borrowing government, still more of the private lender), are suitable for private (unguaranteed) investment.

In a suitable external environment, however, and if neither political



conditions nor external developments are adverse, the recuperative consequences of currency stabilization are rapid and remarkable.

### 3. FATE OF INTER-WAR INVESTMENTS—1934

After 1930 overseas lending declined sharply, and practically ceased in 1932; and after the financial crisis of 1931 there was widespread default especially by Latin America and some European countries.

#### *British Investments*

Of £1,206 million of sterling securities issued by South American borrowers outstanding in 1934, £708 million or nearly 60% were receiving no interest whatever.

In Europe at this date the Dawes and Young loans, and three of the League loans, were still meeting their service payments in full, and others in part. About a half of the £120 million of British holdings of European Government's bonds were in default.

It is however notable at this time, after the financial crisis but before the second war, that the defaulted bonds of Russia, Germany, the Succession States, Greece and Roumania formed 93% of the total European default. Over a dozen European countries had a clean record. In the countries of the British Empire there was no default except on a few municipal and private obligations and many borrowers there and elsewhere met their obligations by heroic efforts.

The following table shows the record between January 1930 and March 1934 for privately subscribed sterling bonds to governments.

#### DEFAULT (PARTIAL OR TOTAL)

Brazil	Ecuador	Peru
Bulgaria	Germany (states)	Roumania
Chile	Greece	Salvador
Colombia	Hungary	Turkey
China	Mexico	Uruguay
Costa Rica	Paraguay	Yugoslavia

#### NO DEFAULT

Argentina	Finland	Persia
Austria	France	Poland
Belgium	Holland	Portugal
Cuba	Honduras	Siam
Czechoslovakia	Iceland	Spain
Denmark	Italy	Sweden
Egypt	Japan	Switzerland
Estonia	Norway	Venezuela

### *American Investments*

The American investor had of course a similar experience. Of a total, in 1934, of \$1,866 million dollar issues in Latin America some \$1,500 were in 1935 in complete or partial default; Canadian bonds were practically intact; of \$2,376 million of dollar bonds in Europe \$1,223 million were in default (distributed as indicated in the above table of sterling bonds).

It may indeed be said with truth that, taking all foreign bond issues together, the American investor lost less in capital depreciation after the defaults had begun than he had received in the meantime in income. In evidence before a committee of the House of Representatives in 1945, Mr. Wayne Taylor, Under Secretary of Commerce, estimated that, up to 1940, United States investors had "put in" to new foreign issues \$11,077 million and "got out" \$12,600 million (\$4,900 million income receipts, \$4,900 million amortization receipts with \$2,800 million as the estimated market value of the outstanding investments at that date). The showing for the earlier date, 1934, would have been more favourable than this.

It might also doubtless be shown that most United States investors in home equities in the boom period which ended in the autumn of 1924 subsequently suffered comparable or greater losses.

If, however, we are trying to assess or explain the attitude of the American investor to new dollar bond issues no such comments on the past will help us. Mr. Wayne Taylor's basis of calculation gives too favourable a picture, as it obscures the losses of original investors through earlier resale at lower prices; it also obscures the great losses in the new type of issues to Germany and Latin America by merging them with the more conventional loans to a country like Canada. An investor moreover in a bond, whose annual return is limited to a specified rate (unlike the buyer of an equity) expects to be assured that that return is secure. The memory of defaults by foreign governments on so wide a scale, and of the irresponsible attitude of the issuing houses concerned, was bound to remain.

#### 4. GENERAL REFLECTIONS ON INTER-WAR LENDINGS

I. In the inter-war period, investments of the earlier type, designed to increase the output of primary producing countries, still continued. In Europe the bulk of the new loans were devoted to professedly "reconstruction" purposes. Some of these were, however, misused. Elsewhere too they went, with little discrimination, to borrowing Governments which often used them wastefully and unproductively.

On the whole the older investments, and the new ones of the same type, stood up better than the loans of the later types, in spite of the

very severe impact on prices of raw materials and food during the depression.

Stabilization loans, however, proved to have very great recuperative effect so long as external conditions in other countries were favourable.

2. The new lending of 1924-1928 was in total on much too great a scale for the annual service to be permanently possible under the conditions of restricted international trade in those and in subsequent years.

A very large proportion of it was irresponsibly negotiated and wastefully expended.

In a survey in 1932\* I wrote:

"I venture to challenge a denial of any responsible person acquainted with the public borrowings of the years 1926-1928 of the assertion that, with the exception of loans recommended by the League of Nations and the central banks, the *bulk* of the foreign loans in these years to public authorities in debtor countries would better not have been made."

This comment was made before the special causes already mentioned had involved loans which were essentially reconstructive, and beneficial to the borrowing countries, as well as the intrinsically bad loans, in widespread default. The *bulk* (though not all) of the loans made at this period, except those recommended by the League and the central banks, were in fact intrinsically undesirable and would have damaged the economies of the borrowing countries even if their other resources had enabled them to avoid the later defaults. This opinion was endorsed by the book prepared five years later for the Royal Institute of International Affairs by an able group of members under the Chairmanship of Mr. (now Sir) Hubert Henderson, which made this comment:

"No one, we think, has attempted to take up Sir Arthur Salter's challenge. It is now generally accepted that the international lending of the period in question only eased the difficulties of the moment at the expense of greatly aggravating them in subsequent years."

3. This lending, in its bulk and character, did not cause the depression of 1929. Added, however, to all that restricted international trade (in which the Smoot-Hawley tariff has a notable place), it led to the financial crash of 1931, which deepened and prolonged the depression and contributed largely to the forces which resulted in the second world war.

4. Among the principal causes of this unfortunate lending we must include the hastily improvised new foreign bond issuing system in America, and the neglect of the careful investigation and precautions which had been customary with the older institutions concerned with foreign investment, in Britain and elsewhere.

5. Quite apart from the advent of a second world war the memories of losses in 1931 and the subsequent consequences would (even if con-

\* *Recovery*, Reynal and Hitchcock, 1932.

ditions had been otherwise favourable) have been an insuperable obstacle to new private investment of the inter-war type and through the credit system which had arranged it.

It would have been a prior condition to any substantial revival of overseas investment that the defects in that system should be removed.

6. This would have been made less difficult by the fact that the institutions concerned were a manageable number—some half a dozen great issuing houses with the Federal Reserve authorities in America, the Bank of England leading a few great houses in Britain, in France a few issuing houses with the Bank of France.

These could, if they had agreed, have controlled the situation. Once they had decided under what rules, and with what precautions, foreign issues should be made, they could, each group in its own country, by its collective authority and influence, have secured that the rules would be observed and the precautions taken. They could have made it impossible for any less responsible issuing house to tempt money from a recently bitten public for less cautious loans.

7. The loans which had led to disastrous consequences (and might again if repeated in the same form) were those borrowed by governments and subscribed by private investors, who bore the risk. They were unilaterally governmental.

Some of the loans were "recommended" or encouraged by governments severally or jointly, but they were neither subscribed by these governments nor guaranteed by them. This general statement applies also to the Dawes and Young loans and to the League loans except for the first Austrian one.

Subscribers were undoubtedly encouraged to subscribe by the belief that the governments which had recommended the issue would take effective measures to secure that the service payments were duly made. This belief was not wholly illusory, for governmental influence was exerted and the recommended loans had in practice a priority over loans not so recommended. But under the strains resulting from the financial crisis, and the increase in the burden of fixed-charge obligations which resulted from lower prices, this proved insufficient. It was usually not unwillingness but sheer incapacity which accounted for the failure of so many borrowing governments to meet their obligations. And in the 20th century there were in any case narrower limits than in the 19th to the enforcing action that creditor countries could take with the support of public opinion. A debtor country could not be occupied or cowed by a naval visit.

8. There was, however, more than one possible course in these circumstances. Governmental influence, especially if it was exercised in

common by several governments, could at least very greatly reduce the risk of default.

This was, however, unlikely to be always effective or even justifiable unless the responsibility of governments were engaged at the time of the negotiation of the loan and appropriate precautions were then taken to ensure that its purpose was sound, the amount and charges not excessive, and the safeguards against later wasteful or improper expenditure adequate. In the 19th century Egypt had been occupied to protect investors against loss on loans which had largely been spent unproductively by royal extravagance. Such action was in the 20th century neither practicable nor justifiable.

But even when milder influence is exerted by governments to protect the investor from the consequences of making loans which they have not approved in the first instance, the results must be to encourage imprudent investment, to make the attempts of the good lending houses to maintain standards more difficult, and to diminish the prestige of the governments who thus exercise influence which is neither selective nor responsible. In respect of future loans to governments therefore creditors ought surely to know that they will be left to their fate, without being able to call on their governments to help them in case of default, unless the loans either (a) have had governmental—or intergovernmental—approval at the time of issue, as the Dawes and Young and League loans did, but many subsequent ones did not, or (b) at least are shown to have conformed to rules and principles authoritatively defined.

The formulation of such rules and principles, and their adoption by the principal issuing houses, seemed in any case to be a necessary preliminary to the resumption of private lending to governments.

Obviously too there were advantages, for loans to governments, in the official approbation being given, or code of rules laid down, by an international institution. At the time now under discussion (the early 1930's) the Financial Committee of the League of Nations and the Bank for International Settlements might in co-operation have served this purpose.

A kind of Charter of Public Loans laying down the general conditions which make the difference between bad loans and good, and the appropriate precautions in each class of cases might thus have been drawn up; and if conditions had thereafter become favourable for the resumption of foreign lending (as of course with the approach of the second war they did not) the results might have been of great value.

(It will be discussed later whether now, in 1950, the International Bank could not usefully serve this purpose.)

9. Already, however, the experience of the inter-war loans was sug-

gesting at least to some minds a more fundamental question which has since become more insistent.

Some of the most important foreign bond issues to governments were of such political importance that the governments of the lending countries, or official institutions representing them, collectively recommended them—but without themselves (except in the one notable case of Austria) giving any guarantee. The Dawes and Young loans for example were designed partly to make reparations possible, and partly to re-establish stable political and financial conditions in central Europe. The League loans were designed similarly to re-establish stability in South-eastern Europe. Is it desirable, and in later cases would it be practicable, that in such cases the risk should be borne by the private investor? If the governments of the lending countries are sufficiently interested to recommend, should they not also guarantee, at least in part? In other words, were not the Dawes and Young loans, and all the League loans except the Austrian, on the wrong basis?

There are, of course, difficulties, which will be discussed later, in the association of governments with lending operations. One of the great advantages of private loans, without the governmental responsibility of the creditor countries being engaged, is that the system is elastic and flexible. The conditions and rates charged can vary with the credit-worthiness of the borrowing government, the character of the proposed expenditure and with the safeguards adopted to prevent waste or abuse. It is obviously more difficult, politically, if it is not a private issuing house but the government of a creditor country that has to distinguish in this way between the credit-worthiness of different borrowing governments. It is still more difficult if the negotiation authority is an international institution of which the borrowing governments are equal members. Nevertheless this difficulty was not found to be insuperable in the League of Nations. Each of the borrowing governments was not only a member of the League. It was also an *ad hoc* member of the League's supreme authority, the Council, when the proposed loan scheme was under discussion. Nevertheless the rates, and the conditions, of the different loans were varied according to the credit of each country, its internal situation, and the character of the particular loan project.

## PART II.

### FOREIGN INVESTMENT IN THE PRESENT PERIOD

#### I. INTRODUCTION

The purpose of Part II of this essay is to discuss, against the background of the earlier experience described in Part I, the problems of foreign investment in present circumstances, the impediments which now obstruct private investment and the practicable steps by which its resumption might be encouraged and accelerated.

The environment of facts and events and fears is exceedingly complex; the statistical information available embarrassing in its amplitude. No attempt will now be made to present a detailed factual analysis which indeed has become less necessary with the publication of the *Report on International Investment* by the Organization for European Economic Cooperation (OEEC). What follows is only a sketch in outline of the present situation, with tentative suggestions as to policy.

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Current problems can only be seen in due perspective in relation to developments during the first five years after the end of hostilities.

During the second world war much more elaborate provision was made than in the first for the tasks of restoring a stable world economy after the end of hostilities.

Behind the decisions at Bretton Woods and elsewhere there was a conception of policy which was consistent and designed to be comprehensive. The immediate needs of relief and rehabilitation were to be met by the United Nations Relief and Rehabilitation Administration (UNRRA), whose resources were furnished by subscriptions from the governments of countries which had not been devastated. The International Monetary Fund (IMF), also deriving its resources from governments, was to re-establish the stability of the foreign exchanges on which both world trade and private investment would depend. Thirdly the long-term needs of reconstruction and development were to be served by the International Bank for Reconstruction and Development (IBRD). This Bank was to obtain its funds partly from contributions from governments and partly from bond issues in the market carrying government guarantees. It was to conduct its operations as a prudent financial institution, selecting its projects and fixing its terms so as to avoid loss and thus convert its original resources into a continuing revolving fund. In this process the Bank and the borrowers would of course benefit from the cheap terms upon which the governmental guarantee enabled its bonds to be issued, but with this help the Bank

was intended to pay its way. The control was vested in a Board constituted from the subscribing countries, with a voting power varying with the amount of their prescribed subscriptions.

In all these institutions, and in the furtherance of this policy, there would be a partnership in which the United States would take the principal but by no means an exclusive (or even majority and controlling) part. It was apparently contemplated that these institutions together would cover a transition period to "normalcy" and that thereafter private investment and enterprise, with no more governmental assistance than before the war, could be left to promote further progress.

These expectations soon proved to be illusory; UNRRA met the first urgent need of "relief," but scarcely touched "rehabilitation." It quickly appeared that the IBRD, while it could help "development" in other cases, was inappropriate for the "reconstruction" needs of countries whose economies had been disrupted by the war. As constituted, its resources were inadequate, its methods unsuitable, its terms too exacting, for what had originally been conceived as its first and most urgent task. Currency disorder too proved to be too deeply rooted for the IMF to fulfill the role for which it had been designed; and the major changes in exchange ratios were made without its effective control. It became clear too that the share of responsibility falling upon America, and the American Government, was bound to be much greater than had been originally contemplated. With negligible exceptions the funds at the disposal of the Bank were provided either by called-up United States Government subscriptions or by bond issues floated in the United States market fully guaranteed by the Government. And much more was soon found necessary.

In 1945 and 1946, therefore, large American Government credits and loans to the United Kingdom and France were arranged, on easier terms and a larger scale than was possible for the IBRD. These were quickly exhausted and in 1947 the Marshall Plan was inaugurated, with its large grants supplemented by some loans on terms which were easier than those of either the IBRD or the earlier governmental loans. The Marshall Plan achieved striking results in reviving production in Europe, but when it had run two years the administering authorities announced that its goal of making the recipient nations self-supporting by 1952 would not be attained by that date. In the meantime the worsening relations with Russia opened the prospect of the American taxpayer assuming the burden of military aid on a large scale to countries associated in the struggle against communism. Nor was this all. The progress of underdeveloped countries could not, it appeared, be left solely to the operations of the IBRD; and the President announced the "Point 4" programme. This was designed, with the aid of United States govern-



mental subsidies, to promote technical assistance and training; and as first announced it was limited to these purposes. But almost immediately methods of providing further United States governmental resources for actual development through the Export-Import Bank (and not only the IBRD), were devised.

All these developments have one feature in common. Each reflects a recognition that governmental, and United States governmental, assistance to the capital needs of other countries, must be greater, and that the time at which genuinely private investment would take its place was more remote, than had previously been believed. The course taken in the evolution of policy is clear—and the process not yet complete.

#### POSTSCRIPT AFTER THE OUTBREAK OF WAR IN KOREA

This essay was originally written on the assumption, always precarious but the only practicable one in the early part of 1950, of a continuance of the cold war without actual hostilities. This may again become the international environment, and most of what follows will be related to such an assumption. But in the meantime the Korean war has transformed the whole situation to an extent which cannot now be exactly assessed. It would be absurd, however, to publish a study at this time without a note as to the main changes required if we take the alternative assumption of localized hostilities, perhaps repeated in other regions. This assumption is obviously less favourable to the prospects of private foreign investment than the one on which this study was originally based. It is no less obviously not the worst of the possibilities which confront us. If, however, there should be general war with Russia, the problem of capital export would of course be so completely transformed that it would be inappropriate to discuss it in this essay.

What then are likely to be the special features of a period of localized hostilities and intensive rearmament? I suggest these:

1. The general "non-commercial" risks of investment will be increased and, save in very exceptional cases, will be prohibitive outside the American continent.

2. The financial consequences of rearmament will be of various kinds. Increased taxation will, *ceteris paribus*, reduce the money that would otherwise be available for saving.

Increased prices will have a similar effect upon those whose incomes are not increased by war orders or employment, or the consequences of inflation.

War orders, the creation of new war plants, and the effect of inflation on equities will increase the attraction to domestic investment.

The precise effects will of course depend on the extent to which extra

government expenditure is covered by new taxation or financed by inflationary methods.

3. Investment in subsidiaries or branches of present United States companies for the production of oil will doubtless continue.

4. The development in undeveloped countries of minerals for which the demand is increased by rearmament is likely to continue, and even perhaps increase, the investment being either wholly "direct" (i.e. with control vested in the United States company) or with some local participation.

5. In brief, the impediments to genuine private foreign investment are on the whole increased and the date on which its revival will be possible on a considerable scale postponed.

6. One reason for which such investment has been considered of great importance, viz. that it would narrow the dollar gap, will temporarily be less important. This is because (a) the greater purchases by the United States of strategic materials in non-dollar areas, and their high prices, will diminish the gap; (b) expenditure by the United States on "military aid," on its troops stationed abroad, on Point 4 development, to say nothing of any continuance in some form (as envisaged by Mr. Gordon Gray) of ECA, will have a similar effect; (c) inflation may well go further in America than in most sterling countries. This will greatly assist the latter's exports, not so much to America as to neutral markets in which the United States is a principal competitor.

These factors are already reflected in increased dollar-reserves in the sterling area, in an outflow of gold from the United States and in a strengthening of non-dollar currencies at their recently reduced ratios.

The extent, and the duration, of this movement will of course depend on the development of the international situation and of re-armament or military expenditure, on the place and extent of any localized hostilities, and on the character of both the domestic and international financial arrangements.

7. In general, throughout the period of localized hostilities and general tension, it is to be expected that, with the comparatively small exceptions noted, United States capital export will be governmental, in the form of governmental loans, military aid and other grants, Point 4 development through the Export-Import Bank or otherwise, supplemented in some cases by semi-private investment carrying governmental guarantees (whether from Export-Import Bank or IBRD), and by loans or guarantees from the predominantly United States-financed IBRD. The *risk* in all these cases is wholly, or almost wholly, that of the United States taxpayer.

It is against this background that we must consider the opportunities of foreign investment and of action to encourage it. What follows will be related to the possibility of an international situation not less favourable than that of the pre-Korean period, and will need to be discounted as suggested above if such an improvement is not realized. It will be divided into the following main sections: the advantages of foreign investment; present impediments; extent of United States private investment; possible action to remove impediments; coordination of official policy; the role of the International Bank; and possible forms of investment.

## II. THE ADVANTAGES OF FOREIGN INVESTMENT

The purpose of all investment, domestic and foreign, is of course to create sources of continuing additional wealth. The advantages, both to exporters and importers of capital, of foreign investment are illustrated in the British record already summarized and the special need for such investment in underdeveloped countries has been fully described in official United States publications on Point 4. It is unnecessary to traverse this familiar ground again now. Since the war, however, special attention has been directed to the effect of United States foreign investment in narrowing the "dollar gap," and on this a few comments may now be convenient.

As recently as the early months of 1950 the OEEC, supported by other responsible experts, estimated that at the end of Marshall Aid in 1952 there would still be a substantial gap, amounting perhaps to \$2 billion a year, in the sense that the non-dollar countries will wish to buy, and the United States to sell, something like that amount of goods in excess of what the importing countries will have the dollars to pay for. Recent events, including the consequences of the devaluations of 1949, the new rearmament programmes, the increased American purchases (at higher prices) of strategic raw materials, have made a dramatic change in the immediate position and prospects. These recent causes are, however, in their nature temporary (at least on their present scale); and a consideration of long-term developments in the balance of the world's economy suggests that, if and when the international situation improves, there will still be a substantial "dollar gap" in the sense defined, though perhaps of smaller dimensions. It is well to consider therefore the effect of foreign investment, especially by the United States, on such a gap.

The *immediate* effect would undoubtedly be beneficial, as it would *pro tanto* reduce any gap during the transition period as Marshall Aid ends. Any such gap would be narrowed by either increased American

imports or the export of American capital. What remained would compel an exactly equal reduction of American exports. This might inflict serious loss on the would-be importing countries, and coming suddenly might initiate or aggravate a depression in America. Obviously an adjustment through an increase of United States imports would be most advantageous both for the American economy as a whole and that of other countries. It is not to be expected that any practicable increase of American imports will bridge the gap, though it may narrow it. Any net export of capital will therefore have the effect of permitting an exactly equal amount of exports, which would otherwise be cut off, to be continued. When capital export in the form of governmental *gifts* ceases, if the flow is to continue it can only take the form of investment (governmental or private, with or without some kind of government guarantee).

Foreign investment, however, only gives a very temporary relief to a balance of payments disequilibrium and may soon aggravate it. The British experience summarized above is illuminating in this respect. British foreign investment had other advantages, especially that of developing production in underdeveloped areas, with mutual benefit. But, except for a brief period and on a small scale, it did not serve the purpose of reducing what would otherwise have been a gap in the balance of payments and of enabling the capital exporting country to export more than it imported.

A surplus country investing a balance from current trade quickly reaches this position. United States foreign investment will *postpone* an adjustment through the balance of imports and exports. But it will within a few years increase the adjustment that must be made in this way; and it will make it then more difficult, unless the capital is used not only productively but also in such a way as to increase the dollar-earning (or dollar-saving) production of the deficit countries. This is a hard condition; and it is much harder than in Britain's creditor period since most of the underdeveloped countries now have large, and rapidly expanding, populations in relation to their natural resources, and are also insistent upon rising standards of consumption.

United States foreign investment must therefore be thought of rather as continuing the transitional purpose aimed at in Marshall Aid, and as facilitating a restoration or expansion of productive capacity, than as a means of enabling America, except for a period of a few years, to export more than she imports. It is no solution, or even partial solution, of the long-term dollar problem, for if the investment is genuine, and not a disguised gift, the annual returns will in a few years exceed current investment at the original rate.

Nevertheless, foreign investment may bring such benefits in the years

following Marshall Aid as to make it highly desirable in spite of these later consequences. For some time the major part will doubtless be through some form of *Governmental* capital export, or export of which the United States Government bears the risk through existing institutions. It is obviously desirable, however, that a proportion, and in time an increasing proportion, of the investment should come from private investors who bear the risk, or at least a part of it.

The problem, therefore, which will now be discussed is how to encourage the resumption of genuine private investment, and in particular what the United States Government and such institutions as the IBRD, can do to help in this.

### III. PRESENT IMPEDIMENTS TO PRIVATE FOREIGN INVESTMENT

It will be convenient first to note the chief impediments before considering the measures by which they might be removed or reduced.

1. There are the memories of past losses, and the defects of the machinery available for foreign investment, as described in Part I. If all other impediments were removed, and there are many, this would still be important.

2. The absence of transport or power facilities etc. in underdeveloped countries, the provision of which under present conditions is not attractive to private capital, sometimes impedes a private enterprise that would otherwise be attractive.

There is also the general absence in such areas of adequate knowledge of real development opportunities, which can only be obtained by new surveys, and of local personnel with technical training, still more of highly qualified specialists.

3. Satisfactory political conditions, as well as opportunities of economic development, are essential if foreign investment is to be reasonably safe and attractive. The investor needs to feel assured that the economic opportunities will not be frustrated, or the rewards of his enterprise taken from him, by civil disorder, administrative incompetence or confiscation.

The areas in which *both* conditions are sufficiently satisfied to win the merited confidence of the private investor are very restricted. Political conditions are much less favourable to foreign investment than they were in the last century—or were thought to be in the inter-war period.

The purely *economic* opportunities, for example, would doubtless be great in Russia and China—but their systems of government make foreign investment impossible; and in India—but the new governments of the now divided country have still to prove themselves; and in South

America—but the political factor varies from time to time and from country to country. In Africa, indeed, the colonial territories offer some cases of credit-worthy countries, and these areas will merit special consideration below.

There are of course cases in which, though the political conditions are dubious, political motives may induce creditor *governments* to take a risk. But the private investor, without such a motive, will be more cautious.

4. Exchange controls and inconvertibility of currencies are (apart from political risks) the most serious of all obstacles in the case of such countries as those covered by Marshall Aid, in which some forms of private investment might otherwise be possible on a considerable scale.

5. Even if other difficulties were removed American foreign investment would be restricted by the present opportunities of highly remunerative investment, especially in industrial equities, at home. The precisely opposite situation in Britain, during the period of greatest expansion, was as we have seen an important factor in British overseas enterprise.

The American investor can now get about 6% return from good industrial equities. To tempt him to take extra risks abroad he might want some 4% more. But few overseas borrowers, and only certain special classes of foreign enterprises, can afford anything like 10% for their capital.

The high yield of equities in America is partly due to special causes. There is a real shortage, not of capital, but of capital seeking equity investment. This is partly due to the taxation on capital gains; it is partly due to State laws restricting to fixed interest bonds the investments of such institutions as insurance companies, who absorb a large proportion of the savings of the general public. "Tax-exempt" bonds aggravate the situation, for they are more valuable to those in the higher, than the lower, brackets of income tax payers. They therefore tend to draw into bond investment precisely the form of surplus capital which is most appropriate for equity risks. The Federal Government has long ceased to issue such bonds itself, but the States still exercise the right to issue bonds which give exemption from federal as well as state taxation. The total of such bonds now stands at some \$17 billion, and they are likely to increase as the States are able to attract in this way what is in effect a concealed federal subsidy. Even more important are State laws which impose severe restrictions on the security investments of insurance companies in domestic securities, as well as prohibiting investment abroad. The proportion of the total capital available for investment which is in the hands of insurance companies and the trustees of pension funds is now very great, and so long as they are for

the most part kept out of equity investment, the shortage of capital available for such investment is likely to continue during any period of expansion. Any release of more resources for equity investment by a change of existing laws (or of course by a reduction of taxation, if that were possible, as it obviously is not at present) would tend to reduce the earning rates in such investment, and would thus help to pave the way for foreign investment by making it comparatively more attractive if and when other conditions are favourable. But the effect would be indirect, for it is perhaps hardly to be expected that insurance companies, even if allowed to invest freely in domestic securities, would be able to lend abroad.

The cumulative effect of the obstacles mentioned above is so great as to set comparatively narrow limits at present to all foreign investment.

It has been estimated that something like \$2 billion a year of American private capital might be available for investment.\* It is not, however, the amount potentially available but the existence of suitable and attractive projects which will determine the actual amount of investment.

This point can scarcely be overemphasized. It is illustrated by the experience of the IBRD. That Bank has a very special advantage, and a very strong motive, for extending its loans as compared with private investors. It can obtain funds for investment by the issue of bonds fully guaranteed by the American as well as other governments. It is, however, far from having fully used its means of obtaining funds under these favourable conditions. It can, and does, lend under conditions which would not attract private investment. But the limit to its actual loan operations is set by the difficulty of finding suitable loan projects, even under these less exacting conditions.

Lending by the IBRD is of course not really private investment since the investor in its bonds does not bear the risk of the loan operation. He is as fully assured as the investor in a United States Government bond. Genuine private investment only begins when the investor bears the risk, or at least a part of it—when for example a creditor country gives a guarantee of convertibility against “non-commercial” risks, but no more.

#### IV. EXTENT OF PRESENT UNITED STATES PRIVATE FOREIGN INVESTMENT

In order to see the above considerations in due perspective, and to measure the obstacles which any new action to encourage private invest-

\* National Association of Manufacturers, *Capital Export Potentialities after 1952*, March 1949.

ment has to surmount, it is well to bear in mind both the dimensions and the character of such investments in recent years.

In the four years 1946-1949\* inclusive, the United States exported, in goods and services, \$67.4 billion and imported \$35.9 billion, the surplus thus being \$31.5 billion. This surplus was financed (apart from net movements of gold and minor contributions from the IMF and IBRD) to the extent of \$21 billion from United States Government sources and less than \$5 billion from United States private sources; and of the latter nearly half were gifts and ten percent were short-term loans.

The composition of this contribution of private long-term capital was equally significant. Private *portfolio* investment, if one excludes private purchases of debentures sold or guaranteed by the IBRD, made no contribution at all; it was indeed actually negative, the amounts paid in redemption exceeding the new sales of foreign bonds to private investors.

The only form of net private long-term investment in the period 1946 through 1948 (details for 1949 are not yet available) was "direct" investment, i.e. in the extension of foreign subsidiaries and branches. The value of these investments increased in the period by about \$3 billion. This was stimulated by very high earnings reaching, in 1948, 15.6%† on the average, and 25.6% in the case of petroleum investments. Of the total new investment of this kind, some 40% went to Latin America, and a further 23% to Canada. In all countries the *net new* capital amounted to only about \$1,600 million during the three years, of which some \$1,200 million was in petroleum. It is also significant that the bulk of such new capital as was invested came, not from the general investor, but from the undistributed domestic profits of parent companies which had foreign subsidiaries.

Taking into account the reinvestment of foreign earnings, the purpose and geographical distribution of new investment, and the source of such new capital as was supplied from United States domestic sources, the position can be simply summarized. A few American companies with foreign subsidiaries and branches abroad (though less than ½% of such companies) have invested \$2-\$3 billion in them from their internal resources, the great bulk coming from oil companies, and some ⅔ of the total being on the American continent. Private foreign investment (in which the general investor risks his money) either in portfolio or in direct investment has been practically non-existent.

All efforts to encourage genuine foreign private investment therefore start almost from scratch.

\*Princeton University, International Finance Section, *Survey of United States International Finance—1949*, Princeton University Press, 1950, page 174.

† *Ibid.*, page 104.



## V. POSSIBLE MEASURES TO ENCOURAGE PRIVATE FOREIGN INVESTMENT

The preceding pages have indicated what are the principal impediments, and how formidable they are collectively. The following note on possible measures to surmount them will in general follow the same sequence.

1. If conditions were otherwise favourable it should not be difficult to remedy any of the remaining defects in the machinery of investment which were revealed by the loans of the 1924-1928 period. The general line of action required has been suggested above.

The Charter of Public Loans proposed earlier could perhaps, in present circumstances, most suitably be prepared by the IBRD, in consultation with the principal issuing houses.

In the course of its own work the Bank must be developing certain principles and rules, which it would find it convenient to formulate from time to time even for its own purposes. These would not in all respects be appropriate for use in connection with issues by private institutions for specific loan projects. They would, however, be a useful basis for a Charter suitably modified in consultation with the investing houses concerned; and the Bank's official (and international) status and its current responsible operations would qualify it to initiate the necessary consultations.

There is adequate time as unguaranteed issues for loan projects in the general market are in any case unlikely on any considerable scale for some time to come. Some forms of private foreign investment may, however, be possible (see below); and even before any elaborate Charter for general loan schemes is possible or needed, a clear exposition of the principles on which the Bank is finding it best to base its own loans would be valuable.

This would help to prepare the way for developments in the future even if this is distant.

2. The absence of adequate "public utilities" etc., of knowledge of real economic opportunities, and of technical skill etc., in under-developed countries has been recognized both by the IBRD and the Point 4 policy as requiring loans from public sources before the way can be cleared for private investment.

The IBRD has given special attention to loans of this kind, and has sent special missions to different countries to survey the situation as a step to such loans.

The Point 4 policy (given statutory authority by Congress in the 1950 "Act for International Development") was designed to provide on a grant basis technical assistance and specialist training, not actual

development capital, and was furnished with \$35 million for this purpose. It has also been recognized, however, that this will not in itself be sufficient to attract adequate capital, and that more will be needed than even the IBRD is likely to provide. Proposals have therefore been submitted to Congress for the enlargement of the scope, though not the resources, of the United States Export-Import Bank.

The Administration sought cooperation on Point 4 action (as distinct from action by the IBRD) from the technical organs of UN who in response published in May 1949 an elaborate series of proposals for "Technical Assistance for Economic Development."

There are, I suggest, certain inherent dangers in some of these proposals. UN for example would itself send a number of investigating missions. These might easily do more harm than good. The composition might be largely determined by political pressures which would result in many members being appointed without adequate technical qualifications. Above all, missions composed of persons who have no responsibility for subsequent loan operations are likely to produce over-ambitious schemes, based not on practical possibilities, but upon unrealistic ideas of "human needs." There is a great difference in this respect between a mission sent by UN (which has no resources for development loans or responsibility for organizing them), and those sent by the Financial Committee of the League of Nations (which *did* organize such loans and always, in sending a mission, had the prospect of doing so in mind), or those sent by the IBRD, whose representatives are conscious that what they say will be used as the basis of a loan application to the Bank itself. It is significant that the Bank, though technically connected with UN, preferred to stand out of UN's proposals and organize its own surveys out of its own resources.

It is not unlikely that UN missions, without a comparable responsibility, will rouse extravagant ideas in the under-developed countries which will be a serious obstacle to the more limited operations which could otherwise have been arranged through the Bank or otherwise.

The President has now, however, in addition to the National Advisory Council appointed the advisory "Board of International Development" contemplated in the Act of 1950; and it is to be presumed that he will look to either this Board or the earlier Committee for Financing Foreign Trade for advice in the provision of United States Point 4 money. These bodies, appointed by the Government which is providing the money, may be expected to have a corresponding sense of responsibility.

Outside the sphere of United States action it should be noted that British Commonwealth conferences have been taking place (on the original initiative of Australia) about economic development in South

and Southeast Asia. Plans contemplating an investment of nearly £2,000 million in the next six years, most of it with capital from outside the areas of development, made in this way may overlap those made by the United States and may require both cooperation and coordination.

Among the under-developed countries colonies are, at least in some instances, among the comparatively few where both the economic and political conditions may be favourable for productive investment on a great scale. The uncertainties that attach to most under-developed countries are in a large measure removed so long as their government is in the hands of metropolitan countries with which reliable engagements can be contracted—though there are of course some cases in which this advantage is now precarious. At the same time their products, food and raw materials, are better assured of dollar-earning markets than those of industrial countries. United States investment in them helps to narrow a dollar gap just as much as if it was made in the metropolitan countries. The colonies themselves would benefit by securing a more rapid and more extensive development than would be possible from the restricted capital resources of the metropolitan countries, and the latter would benefit from a reduction in the strain on those resources. Point 4 assistance, or complementary loans from the Export-Import Bank, may therefore find a useful field of operation in some colonial areas. In particular, however, there are special advantages in the IBRD entering such areas; there are also certain (perhaps temporary) difficulties; both will be discussed in the later special section on the IBRD.

3. The action so far suggested would help to "pave the way" for private investors. There remain, however, certain non-commercial risks which would still be in most cases prohibitive—the political risks described in paragraph 3 of the preceding section and those of inconvertibility described in paragraph 4. The question therefore arises whether (as an alternative to the limitation of foreign investment, except for a few special categories, to governmental loans) these obstacles can be surmounted by specific governmental guarantees from the capital importing or exporting country or both, or by such intergovernmental institutions as the IBRD.

#### a. Guarantees by the Capital-importing Country

In case of a dollar-bond loan, whether from the United States Government or the IBRD, the government of the capital-importing country is of course pledged to the maintenance of the service. It could of course also give its guarantee in respect of loans to private borrowers if it thought the loan projects of sufficient national interest: and, indeed, under appropriate conditions, could guarantee convertibility at a stated rate of exchange in respect of other forms of investment. It could also

give guarantees against expropriation, etc. The attractiveness of such guarantees would of course be limited to the investors' belief in both the willingness and the ability of the government giving the guarantees to make them good. A "deficit" country might be unable to find the dollars required except at the expense of essential dollar imports which, in the event, it would be unwilling to forego. It might be succeeded by a new régime (after a revolution) or (in some cases) by another government which had obtained power without a revolution, which would refuse to honour the engagements of its predecessors.

Guarantees of direct investment against increases in taxation or new controls applying to all enterprises could hardly be given or, if given, relied upon. Moreover no government could give reliable guarantees against war or its consequences.

The most useful action by a capital importing country is of a different kind. It can simplify and publicize the procedure for authorizing foreign investment; it can reduce exchange controls and enlarge the facilities for "switching" investments, and taking out both profits and capital; it can modify any requirements as to foreign control of companies operating in its territory; it can negotiate treaties to avoid double taxation. Above all of course any strengthening of the general national economy and its balance of payments will reduce the doubts of the foreign investor. Most of these forms of action call for no discussion at this moment; but on two of them comments may be useful.

The deterrent resulting from the requirements of some countries that the majority of shares (carrying control) in any company operating in their territory must be in the hands of nationals can in some cases be removed by suitable "management" contracts.

More important are the arrangements now being made by some countries (notably Great Britain) for assuring transfer and convertibility in respect of approved undertakings for both capital and profits. This may give real encouragement to the only form of foreign investment which is at all likely at the present time, namely in subsidiaries or branches of United States companies or equity participation in foreign enterprises.

As such arrangements are necessarily technical and complex and are still in course of development, they will not be discussed further in the present essay.

#### b. Guarantees by the Capital-exporting Country

It is obvious that under present conditions guarantees from the capital-importing country alone are unlikely, except in rare and special cases, to attract the foreign investor.

If the capital-exporting country thinks that the encouragement of

foreign investment (as an alternative to relying solely upon straight governmental loans for the maintenance of the required outflow of goods) is sufficiently important, there are various ways in which its government could relieve the investor of the risks which deter him.

The IBRD, apart from its straight loans, is permitted by its statutes to participate in foreign investment or (charging a commission) to guarantee private loans or other forms of investment.

The discretionary power has not so far been used, partly because the commission makes the operation too expensive to the borrower, partly because some methods of sharing risk with the public are precluded by other provisions in the Articles of Agreement. For example, the Bank cannot participate in a direct investment of a United States corporation unless a guarantee is given by the government or central bank of the capital-importing country. In some otherwise promising cases such a guarantee may be unacceptable both to the investing company, which fears control and interference, and by the government concerned, which prefers to limit its guarantees to loans made directly to itself.

Apart from such participation it would be possible for the IBRD to give guarantees of the different kinds which are referred to below in the discussion of direct United States Government guarantees. In view of the financial structure of the Bank there is indeed no substantial difference, from any point of view, between a guarantee by it and by the Government.

Under the 1948 Act, ECA was empowered to give government guarantees against certain non-commercial risks in new investments in OEEC countries. The precise scope of such guarantees has been enlarged from time to time, but it has at no time included the risk of currency devaluation. Up to date the guarantees have only amounted to some \$20 million and the provision is interesting rather as a precedent for other forms of United States Government guarantees than as an indication that ECA guarantees are likely to be of importance. To have any substantial importance United States Government guarantees would of course have to be of a much wider scope and on an altogether larger scale. They might be made either through the intermediary of the IBRD (where the guarantees though formally international are in effect United States), or through the Export-Import Bank (for which the required extension of powers is being sought from Congress), or through any other agency the Government might choose.

It would be possible to combine governmental and private risks through the guarantees of a particular part of the risk; or the arrangement could be in the form of "insurance" with the United States Government against defined risks or default of the borrower. Many combinations can be conceived in which the investment would be really

private, though only in part, since some part of the risk would be left with the investor.

In no case of course could convertibility of full equity earnings be guaranteed at the original exchange rate, since earnings in local currency would, other things being equal, be automatically increased by any depreciation or devaluation. But it would be possible to guarantee convertibility into dollars up to the amount of the original United States capital invested (or a prescribed proportion of it) or similarly the fixed annual return of a bond issue, or, up to a limited amount, of equity earnings.

In any case the following comments seem appropriate.

1. If a guarantee is given in respect of a particular class of investment the result will be to make it even less likely than it would otherwise be that capital will be forthcoming for other *similar* investment without such a guarantee. It is therefore desirable that the class of investments for which guarantees will be given should be strictly defined and that no financial limit on the extent of the guarantees should be imposed which is substantially narrower than the total capital potentially available for such investments.

2. Since the purpose of encouraging investment by guarantee is to enable countries to buy American exports which they would otherwise not be able to buy (or to buy up to the same amounts) i.e. to bridge or reduce the "dollar gap," it would be well to guarantee investments only in countries whose dollar balance is adverse.

3. Similarly it would be well that governmental loans should not be "tied" for the reasons given elsewhere.

4. Whether guarantees (as distinct from governmental investment) are worth while will depend upon whether there is, under the conditions of the time, a substantial amount of private capital available for foreign investment if the *special* risks attaching to such investment are covered—i.e. the private investor is prepared to take *some* risk.

There are precedents for guarantees by governments of all non-commercial risks including war; some European governments for example are operating credit guarantee schemes carrying the risks up to a prescribed proportion.

A State Department publication of 1950 (*Point Four*) recognizes the reasons for government guarantees:

"Risks of confiscation or seizure cannot be fully eliminated through treaties so long as the possibility exists of a change in government in the foreign country through revolution or war. . . . The extension of guarantees by the U.S. Government against risks peculiar to investment in foreign countries is a means of attacking these difficulties and should thus contribute importantly to this objective."

Greater significance is of course given to this statement by the fact that the Administration is seeking from Congress (in a Bill introduced in July 1949) additional powers for the Export-Import Bank to enable it to give such guarantees.

5. If foreign investment were made more attractive to the general investor by such action, the shortage and high earnings of equity capital at home would still be a restraining factor. The most effective action to meet this would be the amendment of the State laws restricting the investment of insurance companies. As separate legislation by the States would be required the process of amendment might be slow. But if New York, Massachusetts, Connecticut, New Jersey and Illinois changed their laws the great bulk of the insurance funds would be covered.

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As regards other positive encouragement of foreign investment, the President in his message to Congress of January 23rd 1950 suggested action along three lines: (1) postponing the tax on corporate income earned abroad until the income is brought home, (2) extending and generalizing the present credit for taxes paid abroad and (3) liberalizing the foreign residence requirements for exemption of income earned abroad. In this connection it is appropriate to call attention to the very exceptional tax relief given in respect of the development of oil and mineral resources abroad. This in effect relieves the concerns affected of the major part of the risks involved. It may perhaps be thought to go too far in encouraging "wild cat" schemes, but it has undoubtedly resulted in the discovery and exploitation of important new resources. The extension, perhaps in a modified form, of similar relief outside the sphere of oil and mineral development within which the present concession is restricted, might have important effects.

## VI. CO-ORDINATION OF OFFICIAL POLICY

Whatever the specific action decided upon there is now an urgent need for coordinating official (and especially United States) policies. In response to successive needs one institution after the other has been hastily improvised, and several of these now operate in the same areas and impinge upon each other's policy. There is, apart from UN, the IBRD, the Export-Import Bank and ECA (which has made loans as well as grants). Their spheres of operations do not coincide, but they overlap. They make separate investigations, and offer different terms and conditions to borrowers. They are under different authorities, the IBRD being international, and the responsibility of the American institutions being partly to the Administration and partly to Congress.

The consequent difficulties are obvious. If for example the IBRD is negotiating a loan to a country like Yugoslavia, it must, in addition to examining the particular projects to be financed, consider also the maximum loan obligations which it is prudent for the country to assume. Having determined its policy accordingly it may find that its estimates are upset by the separate grant of a loan by the Export-Import Bank. Similarly one institution may be played off against the other in negotiations as to terms and conditions.

Improvisation to meet successive needs was the only practicable method of action if fatal delays were to be avoided. But the time has clearly now come for an attempt to secure unity of policy. In principle the problem is international, and ultimately some form of general development advisory body should doubtless be established. But the urgent problem is in regard to institutions in which the United States has either an exclusive or a predominant authority. Among present bodies either the National Advisory Council, or the International Development Board (Point 4) or the President's Committee for Financing Foreign Trade, might be given the task of defining and coordinating United States policy. But, to be effective, internal administrative arrangements would of course be necessary to insure that its advice was followed by the separate American authorities and the American representatives in such an institution as the IBRD.

## VII. ROLE OF THE INTERNATIONAL BANK

It is only possible now to mention a few of the special characteristics of the Bank as affecting the theme of this essay.

The Bank is of course international. But the United States, partly by virtue of its voting power, but more as a consequence of the dependence of the Bank on United States financial resources, naturally exercises a decisive influence on its policy.

The Bank has hitherto made loans amounting to about \$1 billion. The funds for this purpose, except for a very small fraction, have been obtained either from the 18% call up of the American subscription or from funds raised in the United States market on the basis of a United States Government guarantee (apart from the guarantees of other countries). Without going in detail into the Bank's financial structure it is enough to say that, until the Bank's obligations exceed about \$2.5 billion, subscribers to bonds enjoy 100% United States Government guarantee.

The Bank is required by its Articles of Agreement to conduct its operations so as to pave the way for genuine private investment and to make its loans free, or "untied."



Until the Marshall Aid was effective the Bank made substantial loans to European countries and is likely perhaps to do so again as Marshall Aid tapers off and ends. In the meantime, however, its sphere of operation has been mainly in under-developed countries.

Certain aspects of these have been discussed elsewhere. But a special comment may be desirable as to "colonial" loans. Some of the special features of these have already been noted, but one further reason may be mentioned why even limited Bank operations in colonial areas may in time be important. Metropolitan governments control the entry of external capital, in order to protect the native inhabitants from exploitation and sometimes in the interest of their own investors or enterprises. Foreign enterprises therefore are confronted with the necessity of negotiating with the metropolitan country before they embark on a new venture. If all such enterprises have to start from scratch, and to negotiate separately and successively without initial knowledge of the conditions they may have to satisfy, this may prove a fatal obstacle. The Bank, however, having for its own limited operations carried through such negotiations, will incidentally have established a framework of general conditions which will then be available—or at least be a very useful guide—for subsequent private investors.

Some useful light is thrown on the problems likely to be involved in the failure of the first negotiations between the Bank and the British Colonial Development Corporation. The Bank apparently made demands for information and rights of criticism and control of the kind which the Corporation was unwilling to accept. It may well be that the Corporation was unduly sensitive; a lender's psychology does not easily change to that of a borrower. But the negotiations also raised the question as to whether the Bank's requirements are not in some respects regrettably inflexible.

It is easy to understand the pressures which make the Bank, operating under an international authority, consider that it must have a uniform contract which all borrowers are required to sign. But this should not be an insuperable difficulty in cases in which some elasticity is desirable. The contract gives "rights" to the Bank. But there must in the nature of the case be subsequent and supplementary correspondence as to the special characteristics of the particular scheme. It would surely be possible for this to specify, and set limits to, the exercise of its "contract" rights by the Bank, where either the nature of the operation or the character of the borrower makes that reasonable. There may of course be differences of opinion as to the rights of supervision etc., which the Bank should require in a particular case. But at least the matter should surely not be regarded as excluded from consideration by the presumed necessity of uniformity. Any such subsequent cor-

response would in the first instance not be published but be confidential as between the Bank and the borrower, though both parties would have to be prepared for the possibility of its becoming public in case of a subsequent dispute. This suggestion of course assumes that the Bank can conduct correspondence of this kind without its being subject to inspection by all the Executive Directors, and possible opposition by any of them.

I have subsequently learned that the Bank's action in these particular negotiations was in fact less rigid than the first reports had suggested. I do not wish to express any opinion on the particular case, which in any event was of minor importance. But the general question raised has a bearing on the extent to which the Bank will be able to develop its operations and so to conduct them as to pave the way for genuinely private investment. Control by an inter-governmental Board has led to a general rule that all loans shall be at the same rate and subject to certain uniform conditions. But a lending institution which cannot adjust its rates and conditions to borrowers of different degrees of credit-worthiness or to varying degrees of risk in the actual loan project is obviously under a most serious disability. It is likely to be excluded from the marginal loans where the risk is either considerably less or greater than the average; for in the former cases the rates and conditions seem too onerous to the borrower and in the latter the Bank's extra risk is inadequately compensated. No successful lending institution has been so rigid and inflexible. It is indeed the essential function of such an institution to assess risk and adjust the conditions of any loan to it. If there were no escape from this rule of uniformity the Bank's utility would be narrowly restricted. I suggest, however, that though the structure of the Bank makes a more flexible policy difficult it does not make it impossible.

Another disadvantage of the methods by which the Bank obtains its resources and lends them is that they do nothing to enlist the interest of the private investor in particular borrowing countries and to help the latter to establish themselves in the capital markets. The subscriber to the Bank's bonds does not know where the resources he provides will go. He is not concerned with the credit-worthiness of any actual borrower. It is enough for him if the Bank's credit remains good. Indeed even that affects his investment very little for he has 100% guarantee of the United States Government for the payment of his interest, and the realizable capital value of his bonds is bound to be very near to, though not identical with, that of ordinary United States Government bond issues.

The contrast between the Bank's methods and those adopted for the German reparation loans and the League loans is very striking. The

League, for example, did not issue loans of its own and then subsequently lend the proceeds to different countries. It collaborated with a particular country, like Austria or Hungary, in preparing a reconstruction scheme; and publicly endorsed the scheme as sound. The loan required was then raised as an Austrian loan (with guarantees from other governments arranged by the League) or a Hungarian loan (without such guarantees), and was recommended by the League. This system gave three advantages. First, the rate of interest varied with the markets' opinion of the credit-worthiness of the particular borrower; second, the other conditions of the loan project (for example the character of any external control) varied with the opinion of the League's Financial Committee as to the needs of the particular case; third, investors were directly interested in a particular country to whose loan they had subscribed, and the future credit-worthiness of that country (its ability to obtain fresh capital from abroad and the terms on which it would be able to do so) would depend on the progress made as judged by vigilant investors.

The world financial crisis, as elsewhere explained, led ultimately to a failure in the service of the League loans. But the method adopted, when it is practicable, is both more flexible in relation to varying credit-worthiness and also paves the way, to an extent to which the Bank's present system does not, for the restoration of genuine private investment.

With private foreign investment paralyzed as it has been since the war, the Bank has perhaps so far had no alternative to acting as it has done. Alternative methods are however possible under the Articles of Agreement. The Bank is able under its statutes to "guarantee" or "participate" in loan operations for which the primary responsibility lies with investors and borrowers.

So long as the individual investor is fully guaranteed and bears no share of the risk of a loan project, genuine private investment has not of course begun. This is true whether it is a general bond issue or a specific loan to a particular country that has been guaranteed. It may well be true that apart from a few special cases discussed below, genuine risk-bearing private foreign investment is not yet possible. But the Bank would be preparing the way for such investment, as it is not now, if instead of lending its own funds it guaranteed an issue made in the name of a particular country—even if that guarantee had for the first issues to be 100%.

A different question arises as to limitations on the expenditure of loaned money. It has been suggested that in some cases the prohibition in the Articles of Agreement of "tied" loans, if observed in the letter, has to some extent been evaded by the Bank's administrative arrange-

ments. I am not in a position to judge what, if any, truth there is in such suggestions. It is worth while, however, to emphasize the importance of leaving the borrower to buy where he finds it most advantageous. Britain's practice in her great creditor period, and its relation to the development of multilateral trade, has already been described. If, in addition to the "tied" export of United States capital through the Export-Import Bank, the International Bank's loans were also in practice linked to American exports, the results must be unfortunate. "Tied" loans tend to favour just those classes of the lending country's exports which deficit importing countries would have been disposed to dispense with, and, therefore, while aggravating the dollar shortage in the long run, they do not, even in the short run, relieve it as much as untied loans.

Some recent operations of the Bank are worth special mention as suggesting future possibilities of considerable importance.

In the first place, it has (in Turkey and in Brazil) participated in the financing of a local consortium designed to attract and make available for local development local capital resources which no existing machinery was adequate to handle. In some cases potential local capital of this kind is considerable, and participation by the IBRD with domestic banks can give just the support and confidence that is needed. Secondly, the policy of making a series of small loans, instead of a single large one, is calculated to assure a most valuable form of continuous help and advice from the Bank. In the third place, the grant of loans in a number of currencies, adjusted to the expenditure contemplated on the particular projects, instead of a "dollar" loan, may lead to important results. A main defect of the Bank as an international institution has been that non-dollar countries have, with negligible exceptions, been unwilling to give the required assent to the call up of the contemplated 18% of their subscriptions. This has been due to their fear of the adverse effect on their own currencies and reserves of conversion. The same countries have often preferred to make bilateral trade and currency arrangements outside the Bank. It should be possible, if the Bank develops composite currency loans of the kind described, to induce non-dollar countries to replace their bilateral loan agreements by allowing a larger proportion of their 18% to be called up and lent through the Bank.

The potential resources of the IBRD are much greater than what is likely to be required for a long time to come for such development as satisfies the necessarily strict and prudent criteria which govern the Bank's operations. In the near future further capital export (e.g. through the Export-Import Bank or Point 4 arrangements) will be required more because it is politically desirable to finance types of ex-

penditure which would not satisfy the Bank's criteria than because the Bank's own potential resources are insufficient.

### VIII. POSSIBLE FORMS OF PRIVATE FOREIGN INVESTMENT

The recital of the long list of impediments to private foreign investment may have left the impression that the prospect of any such investment is remote and doubtful. To any generalization of this kind, however, there are even now some substantial exceptions; and, with some improvement in the international situation and the aid of the government action suggested, these exceptions would quickly assume a wide scope.

The following most promising forms of investment may be briefly noted:

1. Most important of all, as has already appeared, are the "direct" investment of industries interested in the development of new oil and mineral resources in foreign countries. These have been helped by the special tax concessions allowed under United States legislation. Development of this kind in underdeveloped countries (whether colonies or not) is likely to be secured more quickly and more efficiently by private enterprise than by governmental action. The more suitable role of the latter (whether through Point 4 machinery, the Export-Import Bank, the IBRD, or such bodies as the British Colonial Development Corporation) will be to establish basic public utilities (power and transport), and develop essential social services (health, education and training etc.). For work of this kind governments have appropriate experience and can find experts. For the development of new resources private enterprise is usually able to find better experts and to direct the work more efficiently, as the contrast between the British Government's "groundnuts" scheme and the private enterprise development of copper mines etc. in colonies has illustrated.

2. Next are to be noted the establishment by large American industries of branches or subsidiaries abroad. The inducements are to secure a foreign market from which the enterprise might otherwise be excluded by a high tariff or import restrictions; or to secure the advantage of cheaper labour. In some cases the differences of taxation further encourage such investment; in other cases the foreign taxation is higher but not to a sufficient extent to offset the other inducements.

Further development of this kind is encouraged by the recent concessions in exchange regulations permitting not only current earnings but also new capital invested to be re-exported.

The Ford establishment at Dagenham, England, is a typical instance.

Many more examples of the "Dagenham" type, or extensions of those which already exist, are probable.

3. Purchases of shares in enterprises by individual American investors (and without any attempt to secure a controlling interest) are possible. They are not likely, however, to develop on any great scale, while the comparative attractions of domestic equities remain as they are. In any case they are of little value to the country or enterprise concerned as they may be thrown again on the market at any time.

4. More important and promising is the participation of United States capital with local interests, on an equity basis but on a scale which does not give actual foreign control. This may take many forms, and may either create a new enterprise or expand one which already exists. It may be applied to both developed and underdeveloped countries. I will cite one personal experience to illustrate the circumstances in which it may be suitable. I went to China in 1931 and again in 1933 and 1934 as financial advisor to the Government. At that time there was substantial local capital available for investment. At the same time there was a strong nationalist sentiment and much suspicion of foreign enterprises of the old form—the foreign ownership and management of railways and public utilities. Neither local capital nor local management and technical ability was however sufficient in itself to convert or replace these enterprises. Moreover, with the pressures upon government policy, local capital felt less secure if it was not associated with foreign capital; where there was such an association the local investor felt more secure against confiscatory government action because it would injure foreign interests as well and foreign influence would be exerted against it. Foreign capital in turn, however, was more secure if it was associated with local capital because the influence of the local capitalists (not strong enough to be decisive but still powerful) would be added to foreign representations to resist any threat of confiscatory measures which would be equally damaging to all interests involved in the enterprise. I therefore advised this as a promising form of future association of foreign capital with China's development. Japanese aggression and civil war soon of course constituted political conditions unfavourable to all new capital development. But, apart from that, the circumstances in China in the period I refer to were, I believe, such as to make equity participation of this kind highly promising.

So far as China herself is concerned of course the political situation now makes this, or any other form of foreign investment, impossible. Conditions similar to those which then existed in China may well, however, be found elsewhere, and this form of investment may there be found practicable. An illustration of this may be found in the operations of the International Basic Economy Corporation, in Venezuela,

Brazil and Ecuador. It should be noted that the political risks involved in the relations with Russia do not constitute the same impediment to investment in the Western Hemisphere as they do elsewhere.

5. Bond issues in the United States market by foreign governments are, for the reasons given, not usually practicable; certainly they cannot reach anything like the same dimensions as in the 1924-1928 period. Nevertheless some loans have been arranged by American banks e.g. to South Africa; and there are several countries in Europe and some in Latin America whose credit is very nearly, if not quite, good enough for modest long-term loans, to say nothing of those of medium or short term. Some improvement in political relations, and skilful participation and encouragement by the IBRD might lead to substantial, though discriminating, private investment of this kind.

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Nevertheless, in spite of these limited possibilities, it must of course be expected that the great bulk of the capital exported in present circumstances and in the near future will be through governmental institutions and in a form which leaves the whole or the main risk with the taxpayers of the capital-exporting country. Overhanging, and dominating, all the prospects of the future, is the general political situation, with the risk of war which it involves. All the specific suggestions in this essay are not only dependent upon each other but upon this major factor which is within the responsibility not of financial, but political, authorities.

## IX. SUMMARY OF CONCLUSIONS

The points of special relevance to the practical problems of to-day are perhaps these:

1. Throughout her great expansion period, from 1880-1913 when her overseas investments rose from £1,300 million to £4,000, Britain had a large *import* surplus. Foreign investment, if sound and successful, does not enable a country to sell more than it buys except for a very brief period. A great creditor country, if it is to retain that position, is bound to buy more than it sells; a high level of exports will only be possible if imports are still higher.

United States foreign investment, therefore, while bringing other great advantages, would only temporarily relieve any "dollar-shortage" as Marshall Aid ends. It is not a solution for a long-term disequilibrium.

2. Britain's "creditor policy" in her expansion period was based on (a) *no* tariffs or quota restrictions (b) a large import surplus (c) re-investment abroad of any balance of payments surplus resulting from dividends on earlier investments (d) free or "untied" lending. Much

of Britain's foreign trade was complementary; and this helped the "creditor policy." But much was not; her policy definitely subordinated the interests of home agriculture and of industries catering for the home market to those of the consumer and the export trade.

3. The obstacles to an early and substantial resumption of genuine United States private foreign investment are formidable, including the memories of past losses, a shortage of United States "equity" capital and highly remunerative opportunities of investment in domestic equities, political uncertainties in the capital-needing countries with dangers of inconvertibility and confiscation.

4. The possible ways in which the foreigner can obtain dollars through United States private foreign investment are:

(a) Direct borrowing of dollars by foreign governments, municipalities, industries etc., through the issue in New York of dollar bonds. The foreign borrower would in this case have to take the dollar risk—i.e. he has to find the service in dollars. There are two reasons why this cannot happen now. The foreign borrower would normally, unless he could get money from the IBRD or the Export-Import Bank, neither be ready to take the dollar risk nor be allowed to do so. The second reason is that the United States investor would not buy the bonds for the reasons already given. The customary method by which the London market used to invest money abroad is now therefore usually impossible.

(b) Purchase by the United States private investors or institutions, such as investment trusts etc., through the ordinary machinery of the stock exchanges, of foreign bonds expressed in foreign currencies, not dollars, or foreign preference or ordinary shares. They might buy them in London, Paris, Johannesburg, Melbourne, Berlin etc. This was the way in which the United Kingdom and other investors bought billions worth of American securities. But now against this method are the political risk, the currency risk, and the nationalization risk. A little of this form of investment is taking place, e.g. in South African gold mines, but it will not go far until there is political peace and convertibility.

(c) Participation in, or expansion of, American industrial and commercial concerns abroad (Dagenham's etc.), either alone or in partnership with British, French, German, Latin American, etc., interests. Even now this is happening on a small scale. It might be increased by guarantees; with political peace and convertibility it might become very large.

Considerable investments are being made by United States oil companies in oil producing countries, and by industries interested in new mineral resources. This is by far the largest class of genuine foreign investments at present.



5. Recent concessions by the United Kingdom Treasury providing for guaranteed transfer in respect of new United States capital in approved undertakings of the type described in 4(c) above, and similar action by other countries, may lead to a substantial increase in investment of this kind.

6. In these circumstances the great bulk of capital export will be governmental (the funds being either provided or guaranteed by the governments of the exporting countries), through such institutions as IBRD or the Export-Import Bank.

7. The IBRD would do well to adjust its rates and conditions more than it does at present to varying credit-worthiness of borrowers and the varying risks of particular projects. It would help to prepare the way for genuine private investment if, in suitable cases, it guaranteed private ventures against such non-commercial risks as confiscation and inconvertibility instead of lending direct from its own funds. It would also assist the development of multilateral trade by removing all suspicions that loans may in effect be "tied" by administrative provisions.

Such recent developments of the Bank's policy as the issue of composite currency loans and the association with a local consortium for attracting and investing local capital are to be welcomed.

Colonial areas offer a specially favourable field of operations, and an appropriate association with the British Commonwealth plans for development in South and South East Asia is desirable.

8. The United States could increase the private capital available for investment by the amendment of State laws restricting the investment of insurance funds, and by the extension of tax relief for American enterprise abroad.

9. As private investment becomes possible on a greater scale, and over a wider range, the association of United States institutions with British houses which have had long experience of overseas investment might prove very useful. The institutions through which foreign investment was arranged when the flow of capital was westward from the United Kingdom are still available for a flow in the opposite direction; and the traditional skill and know-how developed from nearly a century ago can be utilized, in appropriate association, by those who now inherit the creditor role. The possible forms of association will of course vary with the particular operations. They are too numerous and too complex for detailed discussion here.

10. Where there is an important political advantage in the export of capital to particular countries (as there was in the case of the Dawes and Young loans to Germany and the League loans to Central Europe) it will usually not be enough for governments to recommend such loans to the public; they will need to provide or guarantee them.

11. Some co-ordinating machinery, primarily between United States official lending institutions and ultimately between them and those of other countries, is now urgently required.

12. Political conditions (international unrest and unreliability of national régimes) are the principal impediment to any wide extension of private foreign investment. In a period of localized hostilities and intensive rearmament this impediment is more formidable than it was in the state of "cold war" which preceded hostilities in Korea. The timing and practical value of the proposals in this essay will therefore depend upon the development of the international situation. Their purpose has been to suggest, in the light of earlier experience as well as more recent events, the ways in which, when an improvement of political conditions gives the opportunity, the resumption of genuine private foreign investment may be facilitated and accelerated.

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