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FOREIGN INVESTMENT

SIR ARTHUR SALTER

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS AND SOCIAL INSTITUTIONS
PRINCETON UNIVERSITY
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This is the twelfth number in the series ESSAYS IN INTERNATIONAL FINANCE *published by the International Finance Section of the Department of Economics and Social Institutions in Princeton University.*

The writer of this essay, the Right Hon. Sir Arthur Salter, G.B.E., K.C.B., was Member of Parliament (Independent) for Oxford University from 1937-1950; Parliamentary Secretary of the Ministry of Shipping (later of War Transport) 1939-1943; Senior Deputy Director General of UNRRA in 1944; Chancellor of the Duchy of Lancaster, with special responsibility for questions of European relief in the brief "Caretaker" Government of 1945; and Chairman of the Advisory Council of the International Bank for Reconstruction and Development in 1948 and 1949.

Among previous appointments relevant to the subject of this essay, he was Chairman of the Allied Maritime Transport Executive from 1917 to 1919; Secretary of the Supreme Economic Council in 1919; General Secretary of the Reparation Commission 1920-1922; Director of the Economic and Finance Section of the League of Nations from 1922 to 1931.

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GARDNER PATTERSON, *Director*
International Finance Section

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 £1,300

* 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
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 striking 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 reinvestment 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.