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It is apparent that a knowledge of world-affairs was never of more importance to Americans than today. The spirit of distrust which pervades the Old World is not without its effect upon our own country. How to combat this disintegrating tendency is a problem worthy of the most serious thought. Perhaps one of the best methods is the promotion of a better understanding of other nations through wisely directed educational effort.

The purpose of the foundation shall be the promotion of a better understanding on the part of American citizens of the other peoples of the world, thus establishing a basis for improved international relations and a more enlightened world-order. The aim shall always be to give accurate information, not to propagate opinion.

Annual Institutes have been held at the University of Chicago since the summer of 1924. This series of volumes includes the lectures there delivered, in essentially their original form.

## FOREIGN INVESTMENTS

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# FOREIGN INVEST- MENTS

[LECTURES ON THE HARRIS FOUNDATION 1928]

By

GUSTAV CASSEL, *Professor of Economics,  
Stockholms Högskola, Stockholm, Sweden;*  
THEODOR E. GREGORY, *Professor of Bank-  
ing and Currency, London School of Eco-  
nomics and Political Science, University of  
London, England;* ROBERT E. KUCZYNSKI,  
*Council Member, Institute of Economics,  
Washington, D.C.;* HENRY KITTREDGE  
NORTON, *Publicist and Author.*



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## FOREWORD

The first four institutes on the Harris Foundation dealt respectively with European, Far Eastern, Mexican, and British Empire affairs. The fifth institute from June 18 to June 28, instead of limiting itself to a particular region or state, dealt with the topic of foreign investments in both its theoretical and practical aspects and with the varied problems to which it has given rise in different parts of the world. While due attention is given in the lectures to the general economic and political consequences of the international movements of capital, especial attention is devoted to the recent problems arising in relation to the extensive American investments abroad, and to the inter-allied debt and reparation settlements resulting from the World War. The lectures are all printed substantially as delivered during the institute.

The qualifications of the authors to speak authoritatively on the subjects with which they deal are in part indicated on the title-page. Professor Cassel has long been recognized on the continent of Europe and throughout the world as a leading economist and since the war as the originator of the Purchasing Power Parity theory of interna-

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tional exchanges. He has written extensively in English, German, and Swedish on economics and finance and has served as expert on financial problems at various international conferences. His memoranda for the Brussels Financial Conference, 1920, and for the League of Nations Financial Committee, 1921, had a profound influence on the policies adopted for the rehabilitation of European currencies since the war. Professor Gregory is the author of many books on foreign exchange, tariff, and banking and has been a keen observer at close range of the financial operations in the city which has long been and still is the chief money market of the world. Dr. Kuczynski was formerly director of the Municipal Statistical Office at Berlin-Schoenberg and professor of economics, at the Berliner Handelshochschule. He has written many books on labor and financial problems. Mr. Norton has been a keen observer of economic and political developments in many parts of the world, especially the less-developed regions of Asia and Latin America. He is a well-known writer on topics related to world-politics and was attached to the American delegation at the sixth Conference of American States at Habana, Cuba, in 1928.

QUINCY WRIGHT, *Executive Secretary*

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**THE INTERNATIONAL MOVEMENTS  
OF CAPITAL**

*By* **GUSTAV CASSEL**

# I

## INTERNATIONAL TRADE, CAPITAL MOVEMENTS, AND EXCHANGES<sup>1</sup>

The problem of foreign investments, or more generally of international movements of capital, has come very much to the fore during the last few years. Financial and general economic interests of the widest bearing are intimately connected with this problem, its intricacies are continually followed with the keenest attention by banking and investment circles, and the whole subject is more and more drawn both into the internal political controversies of the various countries and into the sphere of international discussion. It is obviously of the highest importance that such a subject should not be treated in a loose and confused manner and without a clear conception of the fundamental economic realities that are at the bottom of it. Hence it is natural, and in fact inevitable, that we should devote some time and some serious efforts to clearing up the elementary

<sup>1</sup> These three lectures delivered by Professor Cassel at the University of Chicago were included in a series of six given at Columbia University. The other three lectures of the series appear in a volume entitled *Post-War Monetary Stabilization*, published by the Columbia University Press.

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theory of international capital movements. But for this purpose it is obviously necessary to start from a clear analysis of the nature of international trade.

What, then, is the characteristic feature that distinguishes international trade from the internal trade carried on within a particular country? Ultimately this question is of course the same as the question: What constitutes a nation? Fundamentally this is the conception of a people of itself as a unit with common interests and the corresponding recognition of a certain responsibility of this unit for the well-being of its members. In the economic sphere the national interest may manifest itself in a policy framed to give to the economic life of the country a most favorable development. For this purpose a series of measures may be adopted and, particularly in relation to other countries, a more or less comprehensive program may be entered upon for an international trade policy, perhaps including protective tariffs and other means of preferential treatment of national interests. The conditions of international trade will obviously be very much influenced by such measures. But it is impossible to represent them as essential characteristics of international trade. Radical free-traders would like to see most of these measures abol-

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ished, and even trade carried on between two nations on the most complete free-trade basis would without hesitation be called international trade.

What from an economic point of view characterizes two trading communities as different nations and their trade as an international trade is first of all the fact that each of them possesses a monetary system of its own. A policy aiming at a certain stabilization of the currency of the country must always form a part of its economic policy, and this function is essentially a national one. The trade between two countries must also ultimately be valued in their respective currencies, and the problem of keeping these currencies themselves and their rate of exchange at a stable value is in its turn always intimately connected with the movements of international trade. At the very first step of the study of international trade we meet the question of how payments are possible between two countries with independent monetary standards. This leads to a discussion of the rate of exchange between the two currencies and the way in which this rate is fixed. To answer this latter question is, in fact, to clear up the fundamental principles of the theory of international trade. A scientific theory of international trade can, therefore, with the greatest advantage start from the

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definition of international trade as a trade carried on between two countries with independent monetary standards. Choosing this way we are immediately confronted with the natural and essential task of laying a common foundation to the theory of international trade and to that of international exchanges.

New York and Illinois have the same currency, regulated in the last instance by a central authority, the Federal Reserve Board. We therefore do not regard the trade between these states as international. No doubt the real problem of the trade between these states is fundamentally the same as that of the trade between different nations. We may regard the trade between the American states as a special case of international trade, viz., a case when the currencies of the countries are regulated so as to be identical and always exchangeable at par. But we most easily arrive at a thorough understanding of this special case if we first begin by studying the general case of international trade when the rate of exchange is liable to fluctuations. This method of procedure has the particular advantage that it makes us realize that the parity between the New York dollar and the Illinois dollar is not an automatic and self-evident thing, but is the result of a deliberate and consistent mone-

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tary policy carried on under the auspices of a central authority, always directing its attention toward the prevention of possible fluctuations in the rate of exchange.

Now, in order to examine international trade in its simplest form, let us suppose we have two countries, A and B, trading with one another without any artificial hindrances and without any considerable capital movements in either direction. Let us also suppose that the two countries have each an independent monetary system which the authorities regulate so as to keep the general level of prices invariable. Under these circumstances a certain rate of exchange must obviously establish itself between the two currencies, and in a state of equilibrium, when A sells as much to B as it buys from B, this rate must remain invariable. The first and indeed fundamental question which we have to face is then how this rate is determined.

Obviously, in the state of equilibrium a certain sum of money must have about the same purchasing power if converted into the one currency or into the other. For as long as it had a manifestly greater purchasing power, say in currency A, it would be advantageous to convert currency B into currency A, buy goods in country A and export them to country B, and the assumed equilibrium

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in the international trade of both countries could not exist. We have, however, no exact basis for comparing the purchasing power of the one currency with that of the other. To say, in an exact sense, that two currencies have the same purchasing power is possible only when the prices of all goods are precisely the same in both countries. In this case the rate of exchange would of course be 100 per cent. But then no international trade could take place. The fundamental condition of international trade is that relative prices in the countries are different. A certain sum of money will then in country A buy more of some goods and less of other goods than is the case in B; and this is the very motive for international trade.

The fact that relative prices are different in the two countries certainly prevents us from getting any exact measure of the relative purchasing power of their currencies. But it would be false to conclude from this that even an approximate comparison between the purchasing power of the one currency and the other is impossible. If prices generally are about ten times as high in A as in B, we do not hesitate to say that the purchasing power of currency B is about ten times as high as that of A. And everybody is ready to draw the practical conclusion of this situation by paying

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about ten units of currency A for one unit of currency B.

Of course, even in this case prices in A are not all exactly ten times as high as in B. They are dispersed round an average that cannot be exactly stated, but which is about ten times as high as the B level. If then about ten units of A are paid for one unit of B, the trade between the two countries can come to an equilibrium. When equilibrium is established in the trade between the two countries, the rate of exchange between their currencies must stand at a level which about equalizes the general level of prices in both countries and which therefore gives to a certain sum of money approximately the same purchasing power when converted into the one currency or the other.

This equilibrium rate of exchange may therefore rightly be called the Purchasing Power Parity between the two currencies.

If an inflation takes place in A, the rate of exchange, as measured by the price of currency A in currency B, will fall in the same proportion as the general level of prices in A has risen, and if an inflation takes place in B, the same rate of exchange will rise in proportion to the rise of the general level of prices in B. The new rate will correspond to the new purchasing power of the currency and



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will keep the trade between the two countries in the same equilibrium as before the inflation. The new rate, therefore, represents the natural parity between the currencies.

. When I introduced for the first time—it was in 1918—the conception of the Purchasing Power Parity, the chief interest was concentrated on the comparison between the fluctuating values of the currencies at that time and their pre-war values. Thus it was natural to study the Purchasing Power Parity between two currencies *in relation to* its pre-war height which could be regarded as an expression for the pre-war equilibrium in international trade. The question of how this pre-war rate of exchange was determined could for the moment be left aside. For the elementary theory of international trade, however, the question at what absolute rate of exchange an equilibrium in the trade between two countries is brought about is of fundamental importance.

The volume of goods that can move in either direction between our two countries will obviously depend on the rate of exchange between them. Taking the rate of exchange to be the quotation of currency A in terms of currency B, it is evident that a very low rate of exchange must greatly handicap export from B to A, and at the same

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time facilitate export from A to B. Country A is then bound to have a surplus balance of trade. On the other hand, if the rate of exchange is very high A must show a deficit in its balance of trade. Equilibrium in the international balance of trade can evidently only be reached at a rate of exchange which will enable A to sell as much to B as B to A. This condition may serve as the exact definition of the rate of exchange that represents the Purchasing Power Parity. Obviously, at this rate of exchange the purchasing power of the one currency is as nearly equal to that of the corresponding amount of the other currency as it is possible to ascertain.

From these considerations we can immediately draw a conclusion of great importance. A country can never in its trade with another country possess a general superiority. Neither can its position be so weak that it is incapable of selling any products to the other country. On the whole, we can never speak of such a thing as an absolute superiority in the sense that the one country is generally able to produce cheaper than the other. A comparison can only be made when a certain rate of exchange has established itself. A country may be very backward in relation to another country with regard to technical development and economic organization,

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it may have a scantier supply of land, capital, and skilled labor; there will nevertheless always exist a rate of exchange at which it can sell just as much goods to the wealthier country as it buys from it, and at this rate of exchange an equilibrium in the trade between the two countries will be attained. There will always be some branches of production in which the poorer country has a relative advantage, and this country will necessarily be able to compete in such branches if only the rate of exchange has adjusted itself to the situation. The cost of production is a conception that refers itself to the prices on the internal market of the country and a comparison between the costs of production of two different countries is only possible at a definite rate of exchange. Now, this rate must stabilize itself at just such a level as will allow an equalization of weakness and strength with regard to cost of production and bring the balance of trade into equilibrium.

With this quite elementary examination of the problem the whole classical theory of "Comparative Costs" is exposed in its most simple, and at the same time most general, form. At the same time, this theory of international exchanges makes it possible for us to give a clear answer to a series of questions which usually play a great rôle in dis-

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cussions on international trade. The widespread idea that an undeveloped country is in need of a tariff protection in order to be able to stand the competition with a more highly developed country now stands out as a misconception of the elementary conditions of international trade. The same naturally holds true in respect of the idea that a wealthy country that has high costs of production as a consequence of a high standard of living should necessarily be handicapped in competition with other countries where a lower standard of living prevails.

The equilibrium rate of exchange is determined by a co-operation of all the factors that influence the prices of goods in the different countries. Among these factors we have particularly to note the supply of elementary agents of production, such as land, raw materials and labor of different kinds, taken together with the demand for these agents and the technical costs of production.

As long as a country forms a closed unit for itself these factors determine relative prices according to the system of equations which I have given in my "Theory of Social Economy." When two countries are brought into connection with one another all prices are affected and a new system of prices is established. These prices are determined

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by a new system of equations, comprising all the elements of the two systems that determined prices when the countries were isolated. But in this new system of equations a new unknown quantity enters, and that is the rate of exchange between the countries. On the other hand, a new equation is added to the system, expressing the equilibrium of the balance of trade that A buys as much from B as it sells to B. Thus, the system is complete all prices are determined, and among them particularly the rate of exchange.

Perhaps this reasoning may be felt by some of you as somewhat hard to follow. But it is enough to show that the rate of exchange is determined at the same time and by the same system of conditions as all prices in the two countries. The rate of exchange is therefore dependent upon all factors entering into the general price problem. However usual fluctuations in these factors have doubtless very little influence on the rate of exchange, which can only be materially affected by very thorough alterations in these factors. For instance, if new and very rich natural resources are discovered in one country or if radical revolutions take place in its methods of production and in its facilities for transport, it is probable that the rate of exchange would thereby be affected. After such revolutions,

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however, it is obviously very difficult to state whether our fundamental condition is fulfilled that the general level of prices should be kept constant.

The rate of exchange which corresponds to the Purchasing Power Parity between our two countries generally possesses a high degree of stability. Particularly is this the case if the economic life in both countries has reached a state of all-round development and if the countries are in intimate commercial relations with one another. For then even a small deviation of the rate of exchange from the Purchasing Power Parity will encourage the export of the one country and at the same time hamper previously existing possibilities of import, while the effect on the other country will of course be the reverse. These changes will dislocate the balance in such a way that powerful forces will be set in motion to restore the rate of exchange to the Purchasing Power Parity. A fall in the price of the A currency in terms of the B currency will not only stimulate the export from A of such kinds of goods as have already formed part of the export trade and increase the volume of this export, but it will also make possible an export of goods that have not previously been able to compete on the B market. At the same time, the imports from B will not only generally fall off in quantity, but will

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be restricted to a narrower group of goods, some kinds of B goods being entirely excluded from competition on the A market. We see from this that the balance is determined not only by the goods actually taking part in international trade, but also by goods which potentially could enter into that trade if the rate of exchange moved in a direction favorable to an increased export.

Thus it is clear that international trade must offer a very strong reaction against any deviation in the rate of exchange from the Purchasing Power Parity. The total volume of a country's foreign trade is generally so large that even an increase of some few per cent in its exports and a similar decrease in its imports mean a very considerable surplus in the balance of trade, i.e., a very considerable deviation from the state of equilibrium.

The fact that the rate of exchange corresponding to the Purchasing Power Parity possesses such a remarkable stability is a sufficient reason for regarding the Purchasing Power Parity as the fundamental factor determining the rate of exchange and for classifying all other factors that may influence the rate and perhaps make it deviate from the Purchasing Power Parity as factors of secondary importance, most suitably grouped under the

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head of "disturbances." There are three main groups of such disturbances. The first comprises the monetary disturbances caused by processes of inflation or deflation. The second is formed by all sorts of artificial hindrances to international trade. The third group contains those disturbances that may be caused by international movements of capital. When the currencies concerned are kept at an invariable purchasing power on their internal markets, when the trade between the countries is not hampered by artificial hindrances, and when no capital movements in either direction take place, the rate of exchange must stand at the equilibrium level represented by the Purchasing Power Parity and cannot show more than small and quite temporary deviations from this level.

For the subject of the present lectures the possible influence of international capital movements as a factor deviating the rate of exchange from the Purchasing Power Parity has a primary interest. Let us examine this question more closely under the assumption that we have to do with two countries A and B with stable currencies and on a free-trade basis. What influence, then, will a loan from A to B have on the situation? The answer is that a real transfer of capital will not affect the equilibrium of the rate of exchange, which will con-



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tinue to be determined by the Purchasing Power Parity.

In order to make this clear, it will be useful first to examine a very simple case. Let us suppose that country A grants a loan to country B, and that for this money B at the same time purchases a ship from A. Such a transaction is, of course, quite outside normal commercial relations, and will not in any way affect the balance of trade or the rate of exchange between the countries. B now has indeed an excess of imports, but this excess is paid by the loan granted by A to B and therefore will not affect the balance of trade. A in its turn has, it is true, placed a sum in its currency at the disposal of B, but this supply of exchange is immediately used for the purchase of the vessel, and will thus not in any way affect the exchange market. The transfer of capital which consists in A granting a loan to B is completed in this case by A at the same time transferring to B material capital goods of corresponding value. This is a typical instance of a complete process of capital transfer.

Let us imagine that B issues a bond loan and "exports" bonds to a value corresponding to the amount of the loan. If these securities are included in the balance of trade in the same way as goods, it may be said that B continues to export to A as

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much as it imports from A. The condition for equilibrium will then be, formally speaking, the same as it was when a transfer of capital was excluded.

The problem of transfer of capital may, however, be far more complex. Let us suppose that country B desires to build a railway and for that purpose raises a loan in country A. If the loan is used for the purchase of railway engines from A, the result will be quite the same as in the preceding case. But the borrowers may spend the money within the country, e.g., for the actual construction of the railway. In that case materials and labor will be withdrawn from other uses. Let it be assumed that the country would otherwise have exported these materials and that the labor would have found employment in some export industry. In that case the construction of the railway leads to a reduction in the export from the country, and thus to a deficit in the balance of trade. This deficit, however, is covered by the loan, and equilibrium is restored. The borrowed capital in this case has served to pay for that part of the normal imports from A which B cannot pay with its reduced exports. The material side of the transfer of capital is thus a transfer of goods consisting of a certain part of the usual exports from country A to

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country B. The construction of the railway, however, may lead to a reduction in B's production for domestic purposes. If, for example, workers are withdrawn from agriculture to employment on the construction of the railway, the production of cereals in country B will be diminished and B will be obliged to import cereals from A. The transfer of capital from A to B then serves to pay for this new importation. In all circumstances the rate of exchange will remain at its normal equilibrium; and the balance of trade will also retain its equilibrium, if the export of bonds from B is included in the balance.

It will be seen from these examples that an export of capital is always counterbalanced by an export of goods to the same value. Goods may, of course, be replaced by services, such as freightage, the services of banks and insurance companies, etc. The actual export of goods may also be replaced by people from country B going over to country A to consume goods and services there. But in all cases the transfer of capital must be supplemented by some kind of transfer of utilities from A to B. No doubt we can discuss the export of capital as a transaction by itself and we may endeavor to form an opinion as to the merits and drawbacks of this transaction. But it would be very false and

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lead to grave mistakes were we, in doing so, to forget that the transaction must necessarily have another side in a corresponding export of goods or services. The idea of an isolated transfer of capital in the abstract, which seems to be the basis of widespread popular misconceptions regarding questions of commercial policy, has nothing to do with economic reality. True, A can simply grant a loan to B, but B cannot transfer the money to itself except by an import of utilities. This, of course, does not prevent a private borrower in country B from transferring to B and converting into its currency money borrowed in A, without at the same time importing any goods from A. But he may sell the A currency that he has acquired to others, who will then either use it for the import of goods or simply leave the currency in country A as a more or less permanent investment of capital. In the former case the necessary transfer of goods from A to B has been effected. In the latter case the borrowed money has really been left in A, and there has been no transfer of capital from A to B.

It is, of course, also conceivable that B may raise what may be called a "loan of consumption" in A. The result may then be a corresponding increase in the import of consumers' goods from A into B. The previously existing equilibrium in the

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balance of trade and in the rate of exchange is not affected in this case either.

The fact which we have now established, that a real transfer of capital from one country to another has no influence on the rate of exchange between them, gives strong support and a much widened applicability to the Purchasing Power Parity theory. For we must remember that according to this theory the normal rate of exchange is determined by a Purchasing Power Parity calculated on the assumption that imports and exports have to balance one another without the aid of any capital movements. When we now find that the existence of capital movements connected with corresponding movements of goods does not in any way affect the rate of exchange, the Purchasing Power Parity is proved to represent the normal rate even in the more general case when capital transfers enter into the trade relations between the two countries.

It sometimes occurs that a large loan places so much A currency at the disposal of borrowers in B that the borrowers will not immediately be able to use all this A currency for their purchases or other expenses in A. If they then try to sell it, they may thereby force down the exchange value of the A currency. In such circumstances some

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fall of the rate of exchange beneath the Purchasing Power Parity is possible, but this fall will be merely of an incidental character and will last only so long as the temporary surplus of currency A has not found an outlet. The fall of the rate of exchange can obviously not be ascribed to any actual transfer of capital, which in this case does not occur, but is precisely due to the difficulties which for the moment stand in the way of such a transfer. There are two typical ways in which it is possible to utilize currency A: either for the import of goods from A, or for a more or less transitory investment of capital in A. Both these uses will be stimulated by a fall of the rate of exchange and will act as a powerful check against this fall. Such a fall will in particular lead to the intervention of speculators who, anticipating a profit on the restoration of the currency to its normal value, find it to their advantage to leave their holdings of A currency in country A, whether as deposit with a bank or in some other form. Such a speculation is also a strong factor counteracting the downward movement of the rate of exchange. If the borrowers are unable to find buyers for their A currency at an acceptable price, they will be obliged for the present to keep it themselves in country A. In that case the fall of the rate of exchange for currency

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A has led to a shrinkage in the offers of that currency.

All these factors combine to check the depressing influence of the temporary superfluity of currency A, which will therefore only have a limited and passing effect on the rate of exchange.

A similar case is when country A has large debts to pay to country B. The money for payment is then first accumulated in A and put at the disposal of the creditors in B. Thus the exchange market is loaded with a superfluity of currency A, with the same depressing effect on the rate of exchange as we have observed in the former case. Only the effect may become much more serious, for whereas fresh loans are usually not granted to any larger extent than the exchange market can absorb with comparative ease, debts may run up to huge sums and claim to be paid without respect to the situation of the exchange market. Our experience of the war debts gives to this case a very actual interest.

Everybody would agree, however, that deviations from the Purchasing Power Parity that are brought about by such causes have the character of disturbances of the normal exchange market. They have to be studied as such, but their existence does not in the least alter the fact that the Pur-

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chasing Power Parity represents the normal equilibrium of the rate of exchange.

In our discussion of this equilibrium we have started from the assumption that the currencies of the two countries are kept invariable in the sense that the purchasing power of the monetary unit in each country remains constant. Theoretically at least this would be possible if each country possessed a rationally regulated paper standard. The Purchasing Power Parity will in this case also remain constant and disturbances of the exchange market will appear in the form of a tendency of the rate of exchange to rise above or fall below the Purchasing Power Parity.

Let us now suppose that both countries have a gold standard. Let us also, for the sake of simplicity, suppose that it is possible to keep the general level of prices in B constant and nevertheless maintain the redeemability of currency B in gold. Currency A will then be so regulated as to keep the rate of exchange at the theoretical gold par or at least very near that par. We know that this is possible and that with an effective gold standard the fluctuations of the exchange can be restrained within the narrow limits that we usually denote as the gold-points. But this regulation of currency A will not be possible without abandon-



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ing the stability of the general level of prices in A. The monetary problems we have here studied under the assumption of stabilized paper standards naturally remain the same under these new conditions, but they assume a new formal appearance. A factor which in the former case would tend to depress the rate of exchange of currency A in terms of currency B below the Purchasing Power Parity is in a gold-standard system prevented from doing so. But instead the effect of this factor will appear as a fall of the general level of prices in country A. In fact, the monetary authorities in A will find themselves obliged deliberately to force down prices in order to increase the exchange value of their currency so much as to counteract the tendency to a depression of this value and thus to keep their currency at its gold parity. The fall in prices in A will result in a new Purchasing Power Parity which is higher than the former one. As the rate of exchange remains constant, the ultimate effect is the same as in the former case in so far as the rate of exchange will come to stand below the Purchasing Power Parity and that in consequence thereof strong forces will be set in motion for restoring the normal equilibrium of the exchange market.

This case is by no means a theoretical exampl

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constructed for the exercise of students. Its great practical import will stand out in full clearness when we come to treat the problem of Germany's indemnity payments and of their transfer to the countries which have to receive indemnity.

Some authors have advanced the opinion that a country which is importing capital in the form of big foreign loans is thereby exposed to a rise of its own general level of prices. The explanation should be that large amounts of foreign currency are offered for sale on the home market and that the banks of the country would therefore be induced to increase the supply of means of payment in order to be able to buy all foreign currency coming on the market. This increased supply of means of payment would naturally tend to raise the general level of prices.

This theory, however, cannot be accepted. It seems to involve some confusion caused by lack of sufficient exactness in the assumption on which it has to be based in regard to the character of the monetary systems of the countries concerned. Theoretically, the simplest case is when our borrowing country has a paper standard. The question before us can then only be discussed if we make distinct assumptions as to the principles according to which this paper standard is regulated.

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The most natural and at any rate simplest assumption is that the stabilization of a certain price-level is chosen as the aim of monetary policy. In this case a rise of the general level of prices is excluded *ex hypothesis*. The effect of huge foreign loans can then only manifest itself in a depression of the rates of exchange upon other countries. But even this effect would, as we have seen, necessarily be confined within rather narrow limits.

Let us now assume instead that our country puts the stability of the rate of exchange on the lending country as the aim of its monetary policy; and let us further assume that this country is able to keep its general level of prices invariable. This assumption would most nearly correspond to the present situation when the United States are able to maintain their gold standard in an invariable purchasing power, while other countries regulate their currencies so as to keep them at a definite par with the dollar. The huge loans will result then no doubt for the borrowing country in a certain rise of the general level of home prices. For in this case the monetary authorities are bound to supply means of payment more liberally in order to call forth a tendency to a rise of the rate of exchange on the lending country sufficient to balance the depressing influence of the superfluous supply of

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that country's currency. But even in this case the effect is confined within narrow limits. Prices cannot at any rate rise so much as to depress the actual rate of exchange below its gold parity. This would indeed be contrary to our hypothesis.

No doubt cases may be quoted in which countries, particularly colonial countries, have contracted huge foreign loans and afterward seen their internal prices undergo a violent rise. But we have here not to do with any direct connection between cause and effect. The effect is in such cases simply the result of a common inflation, an inflation which has nothing to do with the importation of capital except in so far as the new abundance of capital may have had a psychological influence causing the authorities to abandon all sound principles of monetary policy. But such a hypnosis is a fact by itself which cannot be said to stand in any necessary connection with the import of capital. In some cases the rise in prices which the statistical figures seem to indicate is doubtless to a certain extent only apparent. The import of capital into an undeveloped country is accompanied by more intimate trade relations with the outside world involving perhaps a complete revolution of the country's whole system of prices. Under such circumstances it is almost impossible

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to give a reliable expression for the idea of an invariable price-level. Of course, some prices of natural products are bound to rise very much, but on the other hand, many foreign products are supplied to the country at a very much lower price than before. It is impossible from such cases to draw any conclusions in regard to the effects of capital import on the general level of prices.

Never has the import of foreign capital reached such extraordinary dimensions as has been the case in Germany ever since the Dawes Plan came into force. An examination of the effects of this import of capital must therefore naturally be of particular interest. The theory that capital imports on a grand scale must tend to cause a rise in prices has in this case found representative advocates and has played a not unimportant part in the world-wide discussion of the problem of Germany's foreign loans. The reasoning which is brought forward is the following. When industrial concerns or municipalities in Germany borrow big sums in New York, they offer their dollar assets to the central bank, the German Reichsbank, and expect this bank to exchange the dollars for German marks. In this way the bank may be forced to increase the supply of German marks almost without limits and thus the bank loses all efficient control over

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the internal supply of means of payment and consequently also over the general level of prices. It has been concluded from this reasoning that the practice of having recourse to the foreign capital market must be severely restricted in order that the German currency may be protected against a threatening inflation. This conclusion is obviously false, and it is important that it should not be allowed to play any part in the discussions on German borrowing abroad. This question is already complicated enough and it is highly desirable that no confusion should be allowed to exist with regard to its bearing on the German currency problem.

The central bank of a gold standard country has the duty of keeping its currency in a certain parity with gold. To this end the bank is usually obliged to buy and to sell gold or foreign gold money at prices in the neighborhood of the theoretical par. It would clearly be impossible for the bank to do so to an unlimited extent if the bank were not allowed to make a small profit on the transactions. For this purpose the bank is usually authorized to buy gold and gold currency at a price somewhat below par and to sell it at a price somewhat above par. Central banks do not always take advantage of the whole margin thus put at

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their disposal. If they are eager to acquire gold, they may pay the full parity price for it. But if a central bank makes use of its right to keep its buying price some few pro mille below par, no import of capital can bring about an inflation of the currency of the country. For such inflation would obviously manifest itself in an internal rise in prices and in a consequent rise in the exchange values of foreign gold currencies. But as soon as these currencies began to rise above par, the offering of foreign currencies to the bank would immediately cease and the cause of inflation would have disappeared.

A central bank can therefore always buy all gold currency that is offered to it, provided the price is kept a little below par, without running the risk of the currency being inflated by a superabundant import of foreign capital. Such an import of capital can, as we have seen, cause a rise of the internal price level only to the limited extent that this may be needed for counteracting an actual undervaluation of foreign gold currencies.

The situation may be much more difficult of course for the central bank when the loans are to be repaid. The tendency to a fall in the exchange value of the currency may then be counteracted by greater stringency in the supply of means of

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payment calculated to cause a slight lowering of the general level of prices. On the basis of these low prices exports should be possible sufficient for meeting the obligations. Of course, the receiving countries may hinder the exports by exorbitant tariffs or other similar means, but that is a separate question, to which I shall revert in my third lecture.



## II

### THE UTILITY OF FOREIGN INVESTMENTS

When we now come to discuss the practical advantages and disadvantages of foreign investments, the theoretical examination of our last lecture will prove to be of great use to us. A discussion of foreign investments is necessarily a discussion of a transfer of capital. But, as we have seen, such a transfer of capital can be carried out in reality only when it is supported by an actual export of goods. These goods may be material goods, as ordinary merchandise, but they may also be services of various kinds, such as transport insurance, etc. It is usual to distinguish between visible and invisible goods. For our purposes, however, this distinction is of secondary importance and we have only to concentrate our attention upon the fact that an export of goods must always be the basis of an export of capital.

In order to see this clearly we should do well to examine the balance of payments of a country. In its simplest form such a balance contains a credit item: export of goods, say \$3,000,000,000; and a debit item: import of goods, say \$2,000,000,000

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In order to establish a balance between credit and debit it is in this case necessary that the country should export capital to the amount of one billion dollars. If this is done, we have a new debit item of one billion dollars and credit and debit will in their total sums balance one another. In this case the export of capital is counterbalanced by an excess export of goods. These two factors are mutually dependent upon one another. It is impossible to export capital without a corresponding net export of goods; and it is impossible to have such an excess in the balance of trade without covering it by a corresponding export of capital.

The balance of payments is of course usually much more complicated. The goods that are exported or imported consist, as already said, not only of material goods, but also of services of many kinds. Among these services should also be reckoned the right to disposal of capital. We may regard interest as the price paid for "waiting," as Marshall used to say, or as the price for "disposal of capital," which is the term I use in my exposition of the theory of interest. If a country has to receive on balance a certain sum of interest, this sum should therefore be regarded as the payment for a specific service rendered during the year to the outside world and this service ought to be included

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among the other services that enter under the big item "export of goods." On the other hand, "capital movements" contain not only loans granted to the outside world but also repayments of such loans, variations in the mutual accounts of foreign and domestic banks, private commercial credits, etc. But in all these complications our main result remains valid: a net export of capital must always be balanced by a net export of goods.

It is curious to find how long a time it has taken for the world to come to a clear understanding as to what a balance of payments really means. The idea that the balance ought to show a surplus, but could under unfavorable conditions result in a deficit, has been adhered to with tenacious conservatism. It is only the modern improvement of the balance sheet for a country's international payments that has made it clear that credit and debit must in principle balance, and that if the statistical figures do show a surplus or a deficit, even when all conceivable items are taken into consideration, such balance must be taken to represent "errors and omissions," which it is naturally not possible entirely to avoid in such statistics. The United States have taken the lead in this reform of the practice of drawing up the balance of payments and the American statisticians have done

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much to make the balance as complete as possible. However, with all due respect to this progress, it is perhaps not out of place here to utter a warning against the tendency of statisticians in several countries to lay heavy burdens on the commercial world and even to sacrifice freedom of movement merely for the sake of getting statistical knowledge about international transactions.

The object of the present lecture is now to discuss the merits and drawbacks, or more generally the economic effects of an export of capital. It follows from what has been said that it is impossible to do so without having regard to the corresponding movements of goods that form the real basis of the movements of capital. The necessity of this observation is best understood if we observe how much public opinion is usually influenced by sheer confusion as to the real nature of international economic transactions. We find nowadays plenty of people strongly opposed to the export of capital. Still, many of these people would find it only natural that every endeavor should be made to create a surplus in their country's balance of payments. They keep to the mercantilistic idea of a "favorable balance" and they regard such a balance as representing an essential national interest. At the same time they do not hesitate to preach that an

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export of the nation's capital is an act of an unpatriotic mind, not to say an act of treachery against one's own country! Obviously it is fruitless to discuss such a complicated matter as the international movements of capital as long as opinions are formed on the basis of such logical contradictions. In our whole examination of the international movements of capital we must always take care not to lose sight of the real movements of goods and services that are behind and indeed form only the other side of the capital movements.

A capital export has three phases: the moment when the export takes place; the period in which the capital remains abroad; and the moment when it is repaid. The economic effects of the transaction must be examined separately for each of the phases. Let us begin with the first phase.

As an export of capital is always accompanied by an excess export of goods, it furnishes occupation for the export trades, the products of which are for the moment paid by the capital exporter. From the point of view of the possibility of employing labor, this capital performs the same service as any purchasing power that is retained home and is used for buying goods on the domestic market.

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It is sometimes thought that it is necessary for a capital-exporting country to see to it that the exported capital is used directly for buying the products of that country. This is to take a short-sighted view of the matter. The entire capital exported from the capital-exporting countries of the world must be used for buying the combined total excess export of these countries and it does not matter whether the relations between the countries' export of goods and export of capital are more or less indirect. Of course, a country must be able to compete on the world's market if it is to succeed in establishing an excess export of goods. But unless it is able to do so it will no longer find itself in a position to export capital. Thus, the trouble generally taken to induce or force the borrowers to use the funds put at their disposal to buy the products of the capital-exporting country is superfluous and only apt to hinder the natural flow of international trade. We laugh at the corresponding petty measures of the mercantilists of the seventeenth century, but we should draw more real advantage from educating ourselves to laugh at our own short-sighted measures in matters of international economy.

A long term capital investment abroad is mainly used for buildings and constructions and for

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equipping the borrowing country with all kinds of machinery and tools. The exported capital therefore will to a great extent serve as a buying power for all sorts of capital goods. Thus a market is created for those industries that produce capital goods. The most important of these industries are the iron and steel industry, the engineering industry and some similar industries. These industries are mostly concentrated in countries with the highest industrial development and the flourishing of these industries is the determining factor in the general prosperity of the world. A sufficient export of capital is therefore always a precondition not only for the success of some enterprises producing capital goods, but for the economic welfare of the world as a whole. We shall presently have opportunity of examining this interesting connection in the light of an actual case.

Modern export trade is generally very much dependent upon credit facilities. Most buyers are in pressing need of advances and keen competition between the sellers makes it necessary for them to extend credit over longer and longer periods. For such credits a very considerable capital must be continually employed. The individual credits may be paid back within a comparatively short time, but the export trade incessantly re-

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quires fresh credits and for a country with a growing export this means that a continually increasing capital is required for carrying the trade. The whole of this capital is at every moment to be regarded as exported and, in fact, plays a very great part in the export of capital of some countries. A country that wants to build up a new export trade is therefore in need of huge amounts of capital to be used as advances for this trade. The most illuminating case is that of Germany after the war. The country, having lost practically the whole of its earlier foreign trade, had to spend very considerable sums for furnishing the new export trade with the necessary advances. This need explains to a certain extent Germany's enormous absorption of capital in the years after the adoption of the Dawes Plan.

When public opinion is hostile to the investment of money in foreign countries, it is very often ignorant of the fact that the advances for the export trade in reality represent an export of capital. If they knew the whole connection between capital exports and foreign trade, they would certainly take a very different view of the question of foreign investments.

Let us now consider the effects of the capital export for the period during which the capital re-



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mains invested abroad. Naturally this effect will essentially consist in an increased capacity of production in the borrowing countries. They perhaps possess vast national resources and a numerous population, but want the third great factor of production, viz., the disposal of capital. This factor now being supplied, the economic life of the countries in question reaches a new efficiency and the advantage derived is in many cases incomparably greater than the amount of interest that has to be paid for the disposal of capital required. As to the existence of this advantage, certainly no serious difference of opinion will be found.

However, a widespread opinion is hostile to the export of capital for the very reason of the great advantages that the disposal of this capital gives to the borrowing country. It is said that the exported capital will only strengthen foreign competition and make it still more difficult for our own export industries to find a market for their products and perhaps also for our home industries to defend their home market against foreign invaders. This again is the same line of thought as followed by the old mercantilists when they tried to prohibit exports of good-quality raw materials or of machinery which they feared would promote the development of foreign production. According to the

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genuine mercantilist faith, a country could become rich only at the cost of other countries and it was therefore equally important to suppress other countries and, as far as possible, to hold them back, as it was to work directly for the development of one's own country. Officially, of course, we have long ago left these ideas behind us as old-fashioned and extremely backward. But without being aware of it, people may still keep to lines of thought which at the bottom are identical with these antiquated ideas. It still requires much enlightenment to get the public generally to accept without reserve the truth that the welfare of one country is dependent upon the welfare of the whole world.

This truth has a particular importance in the case before us. The export of capital to countries that have badly wanted it has given rise to an extraordinary increase in the productive capacity of these countries. Thus the general supply of goods on the world's market has increased and the world has become so much the richer. The variety of goods that can be put at our disposal is in this way continually increasing and the qualities are incessantly improving. At the same time the division of labor makes production cheaper and we are supplied with the goods we want at incomparably low-

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er prices than would have been possible without the beneficent effects of the export of capital. Of vital importance for the industrial countries is the increased supply of food and raw materials that has only been made possible by the export of capital to agricultural and colonial countries. I shall presently come back to this question and for the moment I only want to draw your attention to the sheer impossibility of feeding our great industrial districts and supplying them with the necessary raw materials without a continual export of capital to areas capable of supplying these wants. Taking only a narrow and selfish view, we may in any particular case find it more advantageous to keep capital at home than to send it away to distant countries in whose development we have very little direct interest. But if we only imagine such a policy to have been followed, say during the last century—what would the present world look like now?—the moment's reflection on this question should be enough to make it clear how futile the idea of keeping capital at home in order to let the home country enjoy alone the whole economic development to which an abundant supply of capital can give rise. Indeed, we have here an opportunity of learning how necessary it is to take broad views of international economic problems and to survene

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long periods and world-wide connections before we form a judgment on economic questions of paramount importance for the common life of humanity.

In the next instance we have to take into account the advantage for the lending country of having to receive interest and dividends during the whole period in which capital is invested abroad. This advantage is most conspicuous in the case of Great Britain. In 1925 Great Britain, according to official estimates, had a net income from overseas investments of 250 million pounds, which is over 1,200 million dollars. This was by far the largest item of the so-called invisible exports. The item was used to a minor extent for new overseas investments, but chiefly for paying the huge excess of imports of merchandise. As this excess of imports largely consists of raw materials and food, we find that the annual income from overseas investments is not merely a concern of some wealthy classes, but indeed a vital interest for the whole people.

Naturally the export of capital must involve some disadvantages. It is in the nature of economy that no want can be satisfied without a sacrifice of other wants, and we have only to make sure that what we sacrifice is of less importance than

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what we gain. When capital is exported, it is of course withdrawn from the home market. The adversaries of capital exports try to show that the diminished supply of capital on the domestic market reduces employment, causes higher rates of interest, and tends to lower wages. Theoretically, no doubt, it has to be admitted that the diminished supply of an important agent of production such as the disposal of capital places the other agents of production in a less advantageous position. Thus far the export of capital represents a certain sacrifice. But the important question is whether these effects are of any practical bearing. To answer this question we have first to observe that the domestic capital market is as a rule very much favored by the investors of the country, who indeed show no particular bias for foreign investments. We shall generally find very considerable differences in the rates of interest charged for foreign and domestic investments of types which from an international point of view would be regarded as belonging to the same class. This is a common experience in European countries and as far as I can judge, the situation is the same in the United States.

As long as the domestic capital market enjoys such a considerable preference it is a weak argu-

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ment against the capital exports that the preference would be still more marked if capital were to be retained at home. The productive efficiency of the exported capital is on an average much higher than that of the capital invested in the home country and, as we have seen, the return of foreign investments does not merely represent an increased income for the wealthy classes, but serves very materially to improve the conditions of the whole people. As the export of capital also gives rise to increased employment for the country's export industries, there can hardly be any doubt that the advantages of capital exports by far outweigh the disadvantages. That this holds true even if we have regard solely to the interests of labor becomes clear enough as soon as we begin to survey sufficiently long periods. For, as we have seen, the capital-exporting countries, which are mostly the same as the highly industrialized countries, would be absolutely unable to feed and clothe their industrial populations without the assistance of foreign countries developed by aid of the capital exports.

The problems connected with the repayment of capital invested abroad have usually not much of immediate practical importance for the capital-exporting country. A wealthy country exporting capital generally continues to do so year after year

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and even on a growing scale. Such a country therefore never reckons with a repayment of the capital in the sense that the total sum invested abroad should be seriously diminished. Even if the borrowing countries could pay, such a repayment would be impossible because no profitable employment could be found at home for such a mass of capital. Of course, it sometimes happens that a borrowing country pays back its debts and even itself develops into a capital-exporting country. But then the capital repaid immediately finds employment in other undeveloped countries, and the countries from which the capital has originally been exported cannot only easily find employment for their old capital, but can invariably reckon with an insatiable demand for all the fresh capital they may have to export. This situation is quite sound as long as the capital exported is really used for productive purposes. For, as long as this is the case, the growing demand for capital is only a sign of a healthy development of the world's economy.

A repayment of capital exported can, however, under certain circumstances come to play a part in a country's economy. Particularly in cases of emergency, and first of all, of course, in cases of war, it might prove to be of very great advantage

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to be able to withdraw capital from other countries. But even the usual fluctuations of trade may cause situations when this would be desirable. In a rising tide of industrial development, the country can have an extraordinary need for capital that is impossible to supply solely by aid of current savings. On the other hand, in slack times it may be a great advantage to be able to export capital which can find no profitable employment at home. For the whole economy of the country it is obviously very desirable that the supply of capital should have such elasticity. The alternating in- and outflow of capital has an equalizing influence on the rate of interest and prevents a reckless squandering of capital in lean times; at the same time it secures to the country the means for a full use of the opportunities that offer themselves in good times.

Turning now to the political side of the matter, we are faced with the question whether the state ought to take any measures in order to regulate the export of capital. People who after a perhaps very loose examination of this phenomenon are ready to condemn the export of capital as contrary to the national interest are usually also immediately ready with the conclusion that the state ought to step in and prohibit such export, or at



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least subject it to severe control. This tendency makes it necessary to discuss state intervention in this sphere as a separate problem. The effects of official restrictions on the export of capital may be studied from different points of view.

The first result of such restrictions is that capital is given an uneconomic use at home. When no really profitable employment can be found, all sorts of unsound prospectus-making will be encouraged, with the result that much capital is lost. In extreme cases a superfluity of capital called forth by artificial restrictions of export may stimulate wild speculation, with consequent great destruction of capital. At any rate we can by no means be sure that the capital retained at home by government interference will in reality be conserved to the country. The risks are indeed only too great that it will vanish altogether.

In the next place we have to consider the effects of the restrictions in question on the saving of the country. We certainly cannot regard this saving as a given quantity which will be supplied independently of how the capitalists are treated. People who have saved a part of their income naturally look upon this money as their own property and they think—not without a certain right—that they are entitled to invest it wherever they like.

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If they are prevented from doing so, they may prefer to consume it. To lay a severe control on the use of savings while consumption is left free to take any direction it likes, and particularly while the spending of money for a luxurious life abroad is not subject to any restrictions, is certainly a very curious attitude of state legislation.

In the third instance, the effect which an artificial superfluity of capital on the domestic market is likely to have on state and municipal expenditure must be taken into consideration. The risk that an excessive supply of capital will lead to a certain recklessness in the use of capital for public enterprises is patent enough. Even under normal circumstances public bodies are able to attract capital to the realization of their programs to an extent which is hardly quite compatible with strict economy. This tendency must obviously develop into a serious danger if by State regulation capital is kept at home which under normal circumstances would have found an outlet in foreign investments.

Finally, it is impossible to repress the remark that the whole question of foreign investments is far too complicated to be a suitable object for the judgments and decisions of the average politician. The fact that entirely contradictory views in regard to the export of capital are very often con-

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fused in one and the same political program—that, for instance, hostility to capital export can be combined with enthusiasm for a surplus balance of trade—seems to be a sufficient proof of the great risks of drawing this matter into the common political controversy.

We know that since the war extraordinary obstacles have been put in the way of free communication between the nations, and we also know that these obstacles are to a large extent responsible for the great sufferings that some people have had to go through, as well as for the general setback in the world's economic development. In this dark picture the only illuminating point is the relative freedom that has been given to the international movement of capital. In fact, the amount of reconstruction that has been accomplished is in an essential degree due to the liberal supply of capital from the better situated countries to those nations that were in urgent need of it. This experience ought to stand out as a good lesson demonstrating for all future generations the utility, not to say the absolute necessity, of the free movement of capital as an agent of economic progress, particularly in cases of great distress. The International Chamber of Commerce at its meeting in Stockholm last year also indorsed this conclusion and

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most strongly recommended a liberal policy with regard to the international movement of capital.

Post-war experience, however, also makes it clear that the supply of capital has by no means been sufficient and that economic recovery has been very much retarded by the fact that important parts of the world have been insufficiently provided with capital.

A particularly interesting case is that of the colonial world. Before the war the colonial countries used to supply the industrial part of the world with the food and the raw materials it was in need of. On the other hand, the industrial countries supplied the capital required for the continual development of the colonial world and in consequence always had a large export of iron and steel, machinery, and other capital goods. Since the war the supply of capital to the colonial world has been very much curtailed. The consequence has been a considerable slowing down in the economic development of these countries, which have, therefore, no longer been the good customers to Europe and the United States as they used to be. The capital-producing industries have particularly suffered from the reduced demand of the colonial world. It is by no means mere chance that the depression in Europe has made itself most strongly felt in the

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capital-producing industries, especially the iron and steel and the engineering industries, or that those countries which used to stand in the first rank as exporters of real capital to the colonial world, viz., England and Germany, are now those to suffer most seriously from unemployment. It is worth while to give closer attention to this situation.

Let us first look at the export of capital. For Great Britain we have statistical figures showing long-term overseas investments not only for the last few years but also for 1913. In millions of dollars, the figure for 1913 is 963. This figure, however, has fallen very considerably since the war, and, for the years 1923-25, the figures are respectively 622, 592, and 425 million dollars. In the case of loans from the United Kingdom to British colonies, calculations made by the *Statist* show a marked decrease, viz., from 485 million dollars in 1913 to 393 million dollars in 1923, 312 million dollars in 1924, 337 million dollars in 1925, and 280 million dollars in 1926.

If due account is taken of the reduced value of money, it appears that these figures disclose in reality a falling-off of the export of capital to appreciably less than half in the said period. We have here a striking indication of the insufficient capital supply to the colonial world after the war.

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In studying the figures for new British loans, it should be observed that these are gross figures and must be diminished by the presumably not unimportant and, as a rule, probably increasing regular amortization of earlier loans. The net export of capital from the United Kingdom, therefore, is likely to have suffered a still heavier decline than is indicated by the figures for new loans.

Since the war, the United States have appeared as lenders on a large scale. The situation has, of course, been considerably improved thereby as compared with what it would otherwise have been. One should be careful, however, not to form exaggerated ideas as to the importance of the American capital export. It is true that, in the years immediately following the war, the net export of capital from the United States was very important. Since then, however, a change has taken place. For the year 1923, reverse capital payments actually exceeded new loans, so that capital movements including movements of the United States' currency showed a net import of 159 million dollars. For the years 1924 and 1925, the American net export of capital is stated to have been 572 and 494 million dollars respectively. In 1926 it had risen to 569 million dollars. If British gross and American net figures for investments

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abroad in 1925 are taken together, we arrive at the sum of 857 million dollars. This seems to show that the capital export of the United States and England combined does not nearly amount to the sum attained in 1913 by England alone. The comparison will, of course, give a still more unfavorable result if the fall in the value of money is taken into consideration.

If we take account of the obligation of the colonial countries to pay interest and dividends, we often find that these payments exceed the amounts of fresh capital exported to them. For the United States these reverse payments for the two years 1924 and 1925 taken together very considerably exceed the net export of capital. It also has to be observed that the amounts representing the American export of capital have in reality not been at the borrowers' disposal to their full extent, as very important sums have remained in the United States as bank deposits. For 1926 the "change in foreigners' bank deposits" is given as an inward movement of capital of \$359,000,000, which covers the greater part of the estimated capital export for that year, \$569,000,000. It is further to be considered that the borrowing countries have used a considerable part of their loans for procuring gold and bills on gold countries as securities

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for their note circulation. That portion of the American loans which has actually been available to the borrowers for buying fresh real capital has consequently been confined within rather narrow limits.

As, moreover, France and Germany, which before the war used to be lenders on a large scale, have since the war themselves been in urgent need of capital, it is evident that the capital supply to the colonial world must have been more or less neglected.

The consequence has been that the purchasing power of the colonial world for European products in general has become insufficient. Especially must the deficiency in the capital supply have impeded the progressive development of the colonial world and hampered its equipment with fresh real capital, whereby Europe's export of real capital and of materials for all kinds of construction must naturally have suffered too. A most obvious and conspicuous result is the general depression prevailing in the iron and steel and engineering industries.

Great Britain's export of locomotives, which amounted (in thousands of English tons) to 47.1 for 1913, decreased in the years 1924 and 1925 to 23.6 and 29.3 respectively. During the same period, the locomotive export of Germany (in thou-



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sands of metric tons) fell from 54.4 to 17.2 and 22.6. The colonial world, i.e., the world outside Europe and the United States, received in 1913 from Germany and Great Britain together 63.9, but in 1924 only 28.4 thousands of tons of locomotives. As there has been at the same time a considerable decline in the corresponding import from the United States, it is clear that colonial railway traffic has been very much hampered in its normal progress. Of course, automobilism has afforded fresh transport facilities. Still, it cannot be doubted that the falling-off in the import of locomotives signifies a rather serious interruption in the normal economic development of the colonial world.

Other groups of machinery of particular importance for this development are agricultural machinery, general tool machines, and power-producing machines. The export of machinery of these three groups from the three leading countries, viz., England, Germany, and the United States, shows a considerable decrease from 1913. Reduced to the money value of pre-war times, the index numbers for the export of the three groups of machinery are approximately, for 1925, 84, 74, and 70 respectively, as compared with 100 for 1913. In 1923 and 1924, the corresponding figures were even very much lower.

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For Great Britain, the decline in the export of machinery must for some groups be described as catastrophic. If we reckon in thousands of tons, the export of power-machinery, which in 1913 reached 94.6, had in 1923 gone down to 41.8, from which figure it again rose to 56.8 in 1925. Still more violent is the decline in the export of agricultural machinery, which went down from 73.5 in 1913 to 13.2 in 1923 and 22.0 in 1925. In Germany, the export of power-machinery fell from 100.3 in 1913 to 31.5 in 1924 and 50.0 in 1925, and the export of agricultural machinery from 80.8 in 1913 to 40.2 in 1924 and 73.4 in 1925.

Clearly, the movements disclosed by these figures must form an essential element in the extraordinary amount of unemployment that has prevailed in Germany and Great Britain.

The practical conclusions to be drawn from these experiences are clear. If the future of the capital-producing industries of Europe depends so much upon the capacity of the industrial countries to place fresh savings at the disposal of the colonial world, it becomes a matter of the utmost importance that the surplus of savings that can be disposed of in this way should be increased as much as possible and that, at the same time, no obstacles should be placed in the way of the natural flow of

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savings from Europe and the United States to the colonial world. Further, it is a matter of great weight that the political and monetary conditions of the colonial world should become stabilized and that confidence in colonial investment in general be brought up to the level already enjoyed by the most highly developed colonial countries.

What has been said here about the importance of a continual capital supply to the colonial world obviously holds good also with regard to most European countries. Europe is itself still in urgent need of funds for reparation and for the filling-up of accumulated deficiency in agriculture, in building, and other lines of production as well as for purposes of normal development, and the capital-producing industries of Europe must inevitably suffer from a congested market as long as this need is not sufficiently catered for.

Thus it is essential for a sound development of the world's economy that saving and accumulation of capital—if they cannot be directly stimulated—should at least be given fair conditions. Undoubtedly the present difficulties are to a considerable extent due to the decline in European saving consequent upon the war. In post-war times, ideas hostile to the accumulation of capital have gained a deplorable influence over a demo-

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cratic policy supposed to be molded in accordance with the interests of the masses. Such ideas have particularly influenced taxation, which has been developed in a direction extremely unfavorable to the accumulation of fresh capital. A general scarcity of capital is, however, diametrically opposed to the interests of the working classes, whose needs can be satisfied only by the most extensive use of capital and who are absolutely dependent for their welfare—particularly in a world with a steadily growing population—upon a continual supply of fresh savings. A curtailment of the capital supply must also have the effect of reducing the amount of employment that can be offered in the very important industries of Europe that produce materials for construction and other capital goods. At the same time, the inevitable retardation of the development of the colonial world will restrict the supply of colonial goods which is of such paramount and steadily growing importance to the broad masses of European consumers. That labor stands to suffer from such a development seems clear enough.

A survey of the economic development of the last two years serves to show that a considerable improvement has taken place in the situation of important basic industries. It can hardly be doubt-

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ed that this improvement is due to a more liberal supply of capital to the colonial and agricultural world, a supply which has only been rendered possible by increased savings in wealthier countries and by a relative freedom of the export of capital. The conclusion is clear enough: A better satisfaction of human needs will only be possible under a financial policy which avoids placing unreasonable obstacles in the way of the natural forces tending to an incessant formation of fresh capital and to such a distribution of this capital as will best serve the productivity of the world's economy.

### III

## THE WAR DEBTS

The greatest problem the world has ever been confronted with in regard to international movements of capital is that connected with the inter-governmental debts inherited from the war. Not only are the sums to be paid incomparably larger than anything the world has known before, but the complexity of the problem and the world-wide extension of the interests involved in it are equally unprecedented.

If we wish to get a bird's-eye view of the situation, we are bound to simplify it as far as possible. The problem, then, is this. Germany has huge sums to pay to the Allied countries as war indemnity. The Allied countries in their turn have very large sums to pay to the United States on account of loans contracted during the war. It is easy to say that these different obligations have nothing to do with one another but are independent problems which ought to be solved each separately. Adopting simply a lawyer's point of view, the United States might say: we have nothing to do with the German indemnity; we have advanced loans to the European Allies in the war and we simply

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insist upon these loans being repaid. This standpoint is unobjectionable. A debtor is obliged to pay and he has no right to tell his creditor that he is going to pay only if the debts owed to him are duly paid and that he would like to cancel his own debt by transferring to his creditor his more or less doubtful claims against a third party. If victorious countries refuse to pay their debts on account of war loans until they have got an indemnity from the conquered, the creditor will be placed in a disagreeable situation. But he will generally have very small possibilities of enforcing his claims. The ultimate effect, however, is bound to be that it will become almost impossible for a country involved in war to get loans from other countries: if it loses the war it is presumably incapable of paying and if it wins the war, it can refer to the precedent established when victorious countries in the World War tried to nullify their obligations and tell their creditor to get himself paid out of the proceeds of the indemnity they had laid upon their former enemy. If this experience should make the financing of future wars more difficult and thus contribute to prevent them, or at least to keep them within narrower limits, it might indeed be regarded as satisfactory enough.

All such considerations, however, have nothing

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to do with the great *economic* problem of war debt payments for which the present world has to find a solution. Economically it cannot be doubted that the Allied countries have to pay the United States chiefly by means of the indemnity payments they receive from Germany. I wish particularly to point out that I do not mean to say that this necessity arises out of any incapacity of the Allied countries to find means for paying their war debts. Under reasonably favorable conditions they are probably able to do so even if they should get no indemnity payments from Germany. The necessity to which I have alluded is a necessity of the international balance of trade. Take for instance the case of France. France is entitled to receive an annual sum from Germany. But the balance of trade between France and Germany is usually favorable to France, French exports to Germany exceeding German exports to France. As long as this is the case, it is obviously impossible for France directly to receive German indemnity payments. But if France at the same time has to pay an annual sum on account of war debts to the United States, she must naturally do that by transferring to the United States the sum she has received from Germany. Thus the United States acquire a claim on Germany and are faced with the problem of



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how the payment shall ultimately be effected. This problem is obviously identical with the one we have discussed in our previous lectures, viz., the problem of a real transfer of capital from one country to another. The problem cannot be evaded as long as the present international indebtedness is maintained and payment of the debts is insisted upon. The United States must necessarily be confronted with Germany as their ultimate payer and with German exports as the ultimate means of payment. Thus, irrespective of all political and legal considerations, the United States inevitably acquire a very prominent interest in the German indemnity question. The clue to the whole situation created by the war is the question of how it shall be possible for the world, and ultimately for the United States, to receive German indemnity payments. Under these circumstances it is obviously of the highest importance that we should first of all get a clear insight into the whole problem of German indemnity payments.

If Pompeius or Julius Caesar or anyone else of the great Roman conquerors awoke to see our World War and its consequences, nothing would certainly surprise them more than the fact that the victors had no sooner succeeded in annihilating their adversary than they hastened to supply him

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to the most liberal extent with capital for building up his economic life and making his country again a prosperous and progressive one. On this point the modern world obviously differs radically from the ancient world. Here for once we have a very patent exception from the old but somewhat cheap proverb that there is nothing new under the sun.

The desire to destroy, however, and to retard the economic development of the vanquished has not therefore been definitely abandoned. In fact, very contradictory endeavors are confused with one another, and at the side of one another we find efforts to ruin and to build up, to prevent a too rapid recovery and to co-operate in promoting the highest possible development of the country's productive powers. In the Peace of Versailles, the desire of the Allied countries to hinder Germany from gaining an advantage in the start for post-war recovery has left very manifest traces, and even in the Dawes Plan such tendencies have obviously had a considerable influence.

The framers of the Peace Treaty as well as those of the Dawes Plan were of the opinion that Germany was well equipped with capital for all long-term investments and that the need she actually had for capital was only for supplementing her circulating capital and was no larger than that it

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could be satisfied comparatively easily. This proved to be a great fallacy. Since the acceptance of the Dawes Plan Germany has year after year imported capital on a scale never before known in the world's economic history. In reality, Germany needed huge sums of capital for increasing the permanent equipment of her industries. The extension of works undertaken during the war was mostly not in accordance with the requirements of the situation created by the peace. Thus, works had to be rebuilt and new extensions and new equipments of all descriptions were needed. In addition, post-war technical progress, which in many lines, particularly in regard to automatic machinery, amounted to nothing less than a revolution, proved to be a source of almost unlimited demands for fresh capital. A similar need was that caused by the reorganization of industry in big concerns and cartels. The Germans felt that if they were to pay huge sums to the outside world, they had first of all to bring their whole productive apparatus up to the highest degree of efficiency. To the same end an improvement in agriculture was needed requiring vast amounts of capital. At the same time, an important part of the inflowing capital stream had to be directed to the long-neglected building industry for supplying the grow-

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ing population with necessary housing accommodation.

The politicians had insisted upon reparation payments, which meant that capital should flow from Germany to the outside world. Economic realities, here as in all similar cases, proved infinitely stronger than politics, and the capital stream in reality went in the opposite direction. The capital imported into Germany was partly used for the purposes here indicated. The result was that Germany was rapidly reconstructed and, at least in some important branches of industry, attained a high efficiency. Thus the financial system of the country was brought on to a sound basis and taxes could be paid sufficient for the reparation claims of the Dawes Plan. As a nation, however, Germany remained just as incapable of making large outward payments. In fact, the reparations that have been paid in the years since the acceptance of the Dawes Plan have been paid entirely by means of foreign loans. Part of the capital nominally imported into Germany has never reached Germany but gone to pay reparations to the Allied countries. As the United States have been by far the greatest lender to Germany, we may sum up the situation by saying that the United States have paid the reparations to the Allied countries and as

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compensation for this service have received bonds representing claims on Germany's future productive capacity. By thus advancing reparation payments and transforming political claims into general business claims, the United States have acquired a very material interest in the whole reparations question. Obviously this transformation cannot go on indefinitely. The sound mortgaging of German property has its limits and American lenders will perhaps prove wise enough not to go beyond these limits. When once they are reached, the period in which reparations could be paid by means of foreign loans will have come to an end, and the world will then be faced with the real problem of reparation payments.

Let us, however, examine a little more closely the machinery by aid of which the present reparation payments are carried out. The German taxpayers and the German industries and railways pay the sums required by the Dawes Plan to the account of the Reparations Agent with the German Reichsbank. Thus he has a sum of German marks at his disposal. He sells these German marks to German business concerns or municipalities that have contracted loans in dollars and desire to exchange their dollars for marks to be used at home. The Agent, again, uses the dollars he has acquired in this way

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for transferring reparation payments to the various countries entitled to receive them. This is the typical procedure. It can of course be modified by payments in kind and several other devices. But this does not alter the fundamental principle on which reparation payments are carried out.

Now the Dawes Plan was conceived with a view to gaining experience as to the practical possibility of transferring reparation payments. Thus far the Plan has proved a failure. Nobody has ever doubted that reparation payments would be possible as long as foreign countries were found willing to lend Germany money for the purpose. To prove this possibility no particular plan was required. The real difficulty of reparation payments will appear in full daylight only when payments have to be made without any assistance of foreign loans. Hitherto the capital stream toward Germany has had such an overwhelming strength that it has quite thrust aside the machinery by which the Dawes Plan intended to test the practical possibility of reparation payments.

Last year I published some critical remarks on these lines with regard to the experience we could expect to gain or not to gain from the working of the Dawes Plan. Under the Dawes Plan, I said, the transfers are only to go on as long as the process

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can continue without disturbing the stability of the foreign exchange market. The originators of the Plan evidently believed that this would be a sufficient safeguard against the reparation payments being continued when they no longer have a concrete basis in the capacity of Germany to make payments to foreign countries. This is obviously incorrect. So long as it is possible to go on taking up foreign credits, the real transfer difficulties will be pushed into the background, and the transfers can go on amid an ever increasing indebtedness on the part of Germany, even though there exists no real capacity to pay in the form of an export surplus. To a certain extent, it is even incumbent upon the Reichsbank to stimulate, if necessary, a continued influx of foreign capital by raising the bank rate, and also, should occasion arise, to force down the internal price-level so as to facilitate the transfers. Under such circumstances, the transfers can of course go on until Germany is unable to obtain any more foreign credits, and a wholly untenable position will have been created.

This criticism was replied to by Sir Josiah Stamp, one of originators of the Dawes Plan, and undoubtedly one of the best economic authorities on it. He said that there are no grounds for assuming "that the Transfer Committee in dis-

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charging their duties will be so foolish as to pay regard only to *one* index of the German financial position, and that they will proceed to pump goods out of Germany by compelling a continually ascending bank rate in Germany and low prices." Stamp thinks that this would inevitably cause a depression which would destroy the confidence of the foreign investors. He continues: "It is difficult to believe that the Transfer Committee would be so easily misled, and naturally they would be paying close regard to the true export position, even if the political transfers were thereby disappointing."

This authoritative interpretation of the Dawes Plan is very valuable. According to this interpretation the Reparations Agent may not permanently make use of the influx of foreign loans in order to accomplish transfers which have no concrete basis in the exchange of goods between Germany and foreign countries. But everyone knows that it is only in this way that the transfers have hitherto been possible. The much criticized public foreign loans which, unlike the industrial loans, have not been used primarily to pay for the importation of raw materials, have particularly been an important source of funds out of which the Reparations Agent has so far been able to make his transfers. When, therefore, is the Agent to stop this procedure,



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which in principle is unjustifiable? This is no question for the distant future; it is a very acute question of the immediate present, and an answer to it is becoming more and more urgent. The Allies have, on the basis of the Dawes Plan, no right to expect Germany to burden herself with foreign debts for the sake of present transfers, when such debts only mean a postponement of the Dawes payments. But on the other hand, so long as German industrialists and public bodies take up foreign loans and exchange them for marks out of the Reparations Agent's balance, the latter has no reason to complain of the future charges with which the German capital market must become overloaded by this procedure, for these charges are only the reverse side of an extraordinary service which is being rendered to him in the present.

As long as the present practice of paying reparations by means of foreign loans is continued, there is an obvious danger that people will accustom themselves to this procedure and begin to regard it as a normal and natural way of accomplishing reparation payments. It will presumably take a long time to free the political leaders of the Allied countries from this belief. And it is therefore urgent that we should do our utmost to clear up the essential unsoundness of the present pro-

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cedure and its character as a transitory emergency method, necessarily to be terminated within the shortest possible time.

Last autumn some newspapers began to discuss the question of whether, and to what extent, reparation payments have priority over other German financial liabilities. This discussion caused much trouble and for some time depressed the quotations of German securities on international stock exchanges. It also succeeded in bringing further German borrowing to a relative standstill.

The whole discussion seems, however, to have been quite superfluous. For under the Dawes Plan the Agent for reparations possesses definitely specified securities to meet his demands. For the financial liability of the German Reich, these securities consist of the customs duties and certain taxes on consumption. In addition there are first mortgages on the German railways and on all German industrial plants. The aggregate income from these sources is not only sufficient to cover the Dawes payments in full, but also yields a very substantial surplus, which is at the disposal of the German government. As far as one can see, a similar surplus will continue to be available in the future. This is not doubted by anyone. Furthermore, when, in his letter to the German government

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of October, 1927, the Agent for Reparation Payments subjected the financial policy of the German government to severe criticism, he did not advance the argument that the taxes pledged did not afford adequate security. In their reply the German government emphasized the fact that there is no reason at all to fear any threat to the balancing of the national budget, for "the reparations charges can be more than met by the revenues pledged for that purpose."

This being so, it is obvious that any discussion of priority of the reparations demands is purposeless, in so far, at least, as Germany's liabilities to the reparation account are concerned. The commercial liabilities of Germany cannot in any way be imperiled by the payments made for reparation account. The foreign investors know exactly where they stand, and the security provided remains undiminished, being precisely the same as at the time when the loan agreement was made. In the case of industrial loans, an exact statement has always been furnished showing the Dawes payments chargeable upon the industry in question. And as for the public loans negotiated for the purpose of specific productive enterprise, they are guaranteed by the productivity of these enterprises. Furthermore, behind the public loans is the whole tax-

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ation capacity of the population, in so far as this is not already requisitioned for the Dawes payments. On this basis the fullest security is guaranteed for investors in German loans, the issuing houses having as a rule made the most careful investigations into all factors exerting any influence on capacity to pay. In this respect, therefore, there is absolutely no cause for uneasiness.

The second stage of the Dawes payments consists in the transfer of sums in German marks from the Reparations Agent to the parties entitled to them. Here, too, there have been the loosest and most ambiguous comments concerning priority, and this priority has been the chief point on which the international discussion of German payments has turned. First of all, therefore, it must be made quite clear that the idea of "priority" has absolutely no meaning in this connection. The whole of this priority dispute is only another manifestation of the extreme haziness which prevails as to the real nature of the foreign exchange market. Those who have brought up this priority question into the discussions obviously imagine that foreign exchanges are sold in Germany by a national authority, and that this authority is in a position to classify claims and to give certain of these claims priority over others. This of course

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is not the case. The exchange between German marks and foreign currencies takes place on the open market, and the open market comprises not merely the whole of Germany but the whole world. Business in this market is concentrated in the exchanges, where German currency is quoted in terms of various foreign currencies, these quotations taking place not merely on the German exchanges, but on all the important exchanges of the world. The chief characteristic of this exchange market is the fact that it is absolutely free, and that therefore its quotations are a true reflection of conditions of exchange under which the German mark can be turned by anyone into any foreign currency to any extent that is desired. To say that the German mark maintains its gold parity is equivalent to saying that, in such a free international market, the German mark can be bought and sold at a rate which is in the immediate neighborhood of the theoretical parity.

An important object of the Dawes Plan is the stabilization of the German currency, and the Plan also explicitly lays it down that the transfer of the German mark credits of the Agent for Reparation Payments may only take place as far as "the foreign exchange market will permit," i.e., so far as is possible "without threatening the stability of the

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German currency." The first fact to be deduced from this is that the Dawes Plan assumes the existence of a foreign-exchange market. This is indeed the decisive point in the question, for every attempt to restrict the freedom of this market means nothing more nor less than the destruction of the market itself. And every attempt to classify the demand for foreign currency and to subordinate commercial claims to the claims of the Reparations Agent would have the immediate effect of forcing the disfavored buyers to pay higher prices for foreign exchanges, and the mark would be quoted below par. Thus there can obviously be no question of a priority for the transfer of reparation funds. Every owner of German marks must be absolutely free to exchange them for foreign currencies, without restriction and without control. The only person upon whom certain restrictions must be imposed in his demand for foreign exchange is the Reparations Agent: he must not push his claims so far as to imperil the parity of the German currency. This is a fundamental feature of the Dawes Plan. For this is the very point on which the Plan seeks to test the economic possibility of transfers being made to an extent corresponding to the internal German payments. Any limitation of the freedom of the foreign-exchange

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market would obviously make this test illusory; and must for this reason alone be condemned as precluded in advance.

The clause in the Dawes Plan that makes it compulsory for the German government and the Reichsbank to facilitate transfers by such measures "as will aid in the control of foreign exchange" has been interpreted in certain quarters to mean that, in virtue of this passage, the Plan contemplates some restrictive control of the market by the authorities. Such an interpretation will not commend itself to anyone conversant with English phrasing in such matters. The sentence immediately following in the original text, which speaks of the importance of the bank rate as a factor in the foreign-exchange market, would appear to indicate what the English text really means by the words "control of foreign exchanges." All doubt on the point is removed by the corresponding passage in the French text, which speaks of compulsory means "pour aider au maintien de la stabilité des changes." The decisive factor in determining the significance of this passage is, however, as already pointed out, the fact that all control which seeks, no matter how, to restrict the freedom of the market, would imperil the existence

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of the market, and, in like measure, the stability of the German currency.

It has been argued that if the Agent for Reparation Payments is not given a more privileged position, the reparation claims will drop into so unsatisfactory a situation that they will ultimately vanish into thin air; and from this premise an attempt has been made to draw the conclusion that the Plan cannot be thus interpreted. The conclusion is, as we have seen, false. The interpretation is perfectly clear. But it will not be out of place to inquire what difficulties really do hamper the transfers, where the responsibility for these difficulties lie and what can be done to eliminate them. These are, in fact, the main questions from which any discussion of the reparations problem on practical economic lines should begin.

It must first of all be made clear that the Reparations Agent, as soon as he has in hand German mark credits, has in reality at his command a certain amount of German goods and services which, within very wide limits, he can select at pleasure, but which make up an aggregate value equivalent to that of the German mark credits. The only question is, therefore, how these goods can be transferred abroad, and what special difficulties result from such transfer. This way of stating



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the problem is important, for many people imagine that the German mark credits of the Reparations Agent are nothing more than a purely abstract value, the conversion of which into foreign currencies has to be effected by some semi-magical process. In opposition to this view, it must be made quite clear that the actual goods for the reparation payments are really in concrete existence, the whole question being merely one of the transfer of these goods to the countries entitled to them.

The actual transfer of goods is not in any way hampered by Germany. This might of course happen if Germany were to introduce export duties or even export prohibitions with the intention of limiting export to the Allies. But there is no question of anything of the kind, so that this possibility may be left outside the discussion. It is sometimes imagined that the transfer of goods might be hampered by German costs of production and generally by the German price-level being kept too high. This is obviously a fallacy. For if the German price-level were really so high, this circumstance would inevitably be reflected in the international quotations of the German mark. The purchasing power parity of the mark would sink below gold parity and it would be impossible to

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maintain the mark at par for any length of time. As soon, therefore, as the Reparations Agent comes into possession of a certain amount of marks, it thereby becomes possible for him to select reasonably priced goods, which he may export to the parties on behalf of whom he acts.

The only question, therefore, is whether the claimant countries are willing to receive these goods. In fact, the Allies are themselves putting the greatest stumbling-blocks in the way of transfers by their reluctance to admit German goods because these compete with their own goods in their home markets. The possibility of transfers without the aid of new foreign loans is contingent upon the amount of German exports. The Reparations Agent has the utmost interest in its being as large as possible. If, hitherto, the increase in German exports has not satisfied him, those on whose behalf he acts undoubtedly have chiefly themselves to thank for it. No one doubts that the German export figures would go up considerably if the countries that have to receive reparations were to admit all the goods necessary for such payments duty-free. And such exemption from duty would indeed be no more than reasonable. If anyone owes me money and is ready to pay me, it is rather singular behavior on my

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part if I impose certain dues on his deliveries, and in this one-sided way increase the burden of his liabilities as a debtor. The least that can be asked of the recipient countries is that at any rate they shall not raise their customs duties or other protective measures above the level at which these stood at the time when the debts were contracted.

If by their strongly protectionist policy the countries which insist on Germany's paying reparations put such obstacles in the way of German export that the transfer of the goods that have been placed by Germany at the disposal of the Reparations Agent is thereby hampered, they cannot possibly make any valid claim for priority in reparation payments. They have created the difficulties themselves and they are themselves to blame if the Reparations Agent has to restrict or stop his transfers under the Dawes Plan. From this point of view there would be grave objections to putting an end to the protection provided by the Plan against a misuse of transfers, a suggestion which has recently been made in certain quarters and particularly by the Reparations Agent himself in his report for last year. For but for those clauses of the Dawes Plan that regulate the transfers, the recipient countries would be quite free to frame:

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their commercial policy on lines which would be even more unfavorable to German export. The chief importance of this regulation of the transfers is that the recipient countries are given an interest in the transferring process. It is very desirable that the responsibility of the recipient countries in this respect should be clearly understood, and it is therefore very disquieting that anyone should begin to obscure the sense of this responsibility by indicating the largeness of Germany's foreign credits as the factor really responsible for the difficulty in payment which is apprehended in the future.

The transfer of the reparations goods involves certain unavoidable difficulties, inasmuch as these goods are being withdrawn from German economic life. As long as the goods that are at the disposal of the Reparations Agent remain in Germany, they form a part of the real capital serving German production; and they therefore play an important rôle in German industry, even though they belong to foreigners. The transfers deprive Germany of this capital and thus have the effect of making her short of capital. This shortage is of course primarily an internal matter; it only affects the recipient countries in so far as it impairs the future economic capacity of Germany.

The degree of difficulty thus occasioned mani-

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visions of the Plan. The passage quoted can only mean, therefore, that the German government and the Reichsbank must avoid all extraordinary measures that might tend to cause any special difficulties in the transfer operations. We may express the same idea in positive terms by stating that the said authorities must conduct their business on normal lines. As for the German treasury in particular, it is incumbent upon it not to cause the monetary policy of the Reichsbank any special difficulties. For the rest, its obligations with regard to facilitating transfers are obviously limited to the avoidance of any extraordinary aggravation of the conditions on the German capital market, for, as we have seen, the adequate provision of the German capital market is the only side of the transfer problem on which Germany can possibly have any influence. It may of course be asserted in a general way that any particularly heavy taxation limits the capacity to accumulate capital, and in this manner causes difficulties to the capital market. This is a point of view which should be taken into account in every country much more than is the case at present. But specific demands on the German treasury cannot possibly be based on a general principle like this. On the other hand, the Reparations Agent may justly insist upon public

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difficulties in a capital market already in a state of acute tension. The foreign credits indeed facilitate the transfers for a certain period of time, but the relief must be paid for by increased difficulties later on. This fact must be carefully borne in mind by both sides: the recipient countries cannot at present, any more than Germany can, enjoy the benefits of the artificial facilitating of the transfers without having to reckon with correspondingly increasing difficulties in the future.

What can Germany do, then, to eliminate as far as possible the evil effects of the transfers on the German capital market? The German government is bound under the Dawes Plan to facilitate the transfers "in every reasonable way within their power." This provision, however, does not impose upon Germany any specific positive obligation, and it is absolutely impossible to interpret it to mean that the Reparations Agent can in virtue thereof demand any extraordinary measures he may choose. If the Dawes Plan had assumed anything of the kind, it would certainly have laid down very definite demands on the point. The Plan has been so thoroughly thrashed out in all its details and its text is so definite that it is quite impossible to assume any new specific demands of importance to be included within the general pro-

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expenditure in Germany being in general kept within reasonable limits, so that no exceptional restriction of the accumulation of German capital shall result from the imposition of exorbitantly high taxation.

It should, however, be noted in this connection that the big loans, which have been taken up by the German states and municipalities and which have evoked so much criticism in the international discussion, although in some respects they may be due to an unnecessarily high standard of luxury, have yet almost without exception served productive purposes. In so far as this is the case, the investments themselves create the fund requisite for interest and amortization. It is not fair to place such loans on the same level as public loans for the purposes of consumption. Important services that are in Germany rendered by means of state or municipal institutions are in the United States discharged by the public utility companies; and the capital requirements of these companies have, as is well known, risen within recent years to colossal proportions and have played a very prominent part in the American capital market. If German municipalities likewise make large demands for similar purposes, these are, in fact, essential in a country like Germany, which is progressing econom-



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ically, especially as the capital needs of German municipalities have had to be postponed for an abnormally long period of time. Interest on post-war debts of this character do not constitute heavy burdens for German states and municipalities, such charges being all the lower, inasmuch as pre-war debts have practically all been wiped out. As for the German capital market, it is manifest that necessary and genuinely productive foreign loans for public purposes can only tend to ease it; and from the standpoint from which we are now judging the possibility of transfers, such loans cannot therefore be condemned.

The practical conclusion of this examination of the reparations question is that there are two essential difficulties standing in the way of reparation payments. One is the stringency of the German capital market that must be caused by the transfer of the payments from Germany to the recipient countries. The financial burden can probably be faced so long as the money paid in to the Reparations Agent is being kept in Germany and thus forms a part of the country's capital equipment. The transfer deprives Germany of this capital and thus represents a new burden. The capacity of Germany to bear this burden without the aid of foreign loans has not yet been proved and

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will certainly not be easy to prove without exposing the country to very serious risks.

The second difficulty is the aversion of the recipient countries to that import of German goods—visible or invisible—which represents only the other side of the reparation payments. This difficulty is the same for all war debts. If the creditor countries do not wish to receive goods from the debtor countries, the payment of debts must naturally meet with insuperable obstacles.

This is a situation in which the United States have a very great interest. We have seen that the fulfilment of the war obligations must ultimately result in an import into the United States for which the United States have nothing to pay and which, therefore, does not create any purchasing power abroad for American goods. Such a trade is generally not looked upon in America with favor. Americans usually insist upon foreigners buying American goods in exchange for goods imported to America. Moreover, it is known that the United States do not like to have cheap goods imported to them. It should therefore cause no surprise if they refuse to open their frontiers to goods that would be delivered for nothing.

Personally I do not wish here to take any standpoint in this very controversial matter. But I want

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to point out with the greatest possible clearness the contradiction there is between the desire to receive and not to receive. The United States must once and for all make a definite choice between their interest in protecting home industries and their interest in alleviating their federal budget. It is of no use on one occasion to speak of the interests of the producer and on the other of those of the taxpayer. It is necessary to advance so far that both interests are considered together in their natural and insoluble connection. As soon as this is done, it will be clear to everybody that a choice has to be made. If the United States wish to remain a protectionist country sheltering its industries by means of high tariff walls against foreign competition, it would be logical to direct all endeavors toward a far-reaching cancellation of war obligations. A partial cancellation or abatement, for instance, only of the debts owed directly to the United States, would hardly be in their interest. Both as Germany's creditor and as partner in the world's trade the United States are equally interested in the reduction of the German indemnity. As long as these indemnity payments go on, they form an artificial stimulus to German competition both within the United States and in other countries where American exporters have to compete.

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A general settlement of all war obligations on reasonable lines is from this point of view a matter of very important interest for America. But even if we take a broader view of the whole situation, and even if we look upon the problems involved with the eye of the free-trader, it must obviously be recognized as a paramount interest for the United States, as well as for civilized humanity at large, that political claims should not be forced beyond what is compatible with economic welfare, and that therefore with regard to war obligations, a solution should be arrived at allowing the whole economic life of the world a fresh start and the best chances for a prosperous development.

**FOREIGN INVESTMENTS AND BRITISH  
PUBLIC OPINION**

*By* **THEODOR E. GREGORY**

I  
GREAT BRITAIN AND FOREIGN  
INVESTMENTS

In this lecture, I propose to discuss three views which are currently entertained as to the value of foreign investment to the economic life of England. They are the views which can be respectively distinguished as (1) the orthodox Free Trade view, (2) the Imperialist-Protectionist view, and, lastly, (3) the Economic-Nationalist view. Broadly, the first view is the view of the City; the second that of the Conservative party and its industrial affiliations; the third view is that of the economic and intellectual group who are engaged in reshaping the ideas of the Liberal party, the most brilliant single representative of this group being J. M. Keynes. It is hardly necessary to say that very many shades of opinion exist and that to group them in this way is to do injustice to the finer shades of meaning, but all I desire to do at the outset is to contrast broad differences of standpoint.

British opinion on foreign investment, as on any and every other economic subject, has been greatly influenced by the postwar depression and

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its accompanying circumstances. I cite four or five points of particular importance in this connection. (1) Unemployment generally, and particularly in the "unsheltered" trades, which are largely coextensive with the industries producing "capital goods," in the ordinary sense of the word, especially iron, steel, engineering, ship-building. The effect has been to make government anxious to do something which will improve prospects for these industries. To stimulate capital exports is *one way*, but it is not by any means the inevitable way of helping the unsheltered trades. What these industries want are new orders, and these could be obtained not only by stimulating capital exports but by stimulating home demand, either by a conscious policy of "public works" or—more simply still from the administrative standpoint—by a policy of protection. The fact that government chose rather to help these industries through the Trade Facilities Acts than through far-going protectionist methods is itself some indication of the strength of free-trade sentiment in Great Britain. (2) The transition to the gold standard. Loans to foreign countries, at a period when the domestic price-level is too high relatively to foreign countries, involve either an export of gold or a restrictive credit policy or both. For at least a year after

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the return to gold in April, 1925, there was the fear that our price-level was too high, and during part of that time the Bank of England maintained an "unofficial" embargo on the raising of foreign loans in the London market. This is an important fact, not only in itself, because it obviously does affect, to the extent that it is successful, the prospects of the export trades, but also because it represents a departure from orthodox practice in that center to which one must look for an appreciation of a free-capital market. If the City tolerates the presence of an embargo in the interests of the gold standard, why should not, if it were proved necessary, the Labour party tolerate an embargo on capital exports in the interests, say, of social reform? (3) Intellectual skepticism as to the virtue of individual self-guidance in economic matters. The reaction against "governmental interference" might be cited as evidence against the thesis that intellectual skepticism as to the virtue of individual self-guidance plays an important part in shaping the economic policy of the country. But, to begin with, the extent of the reaction has been exaggerated—it is confined largely to the business community and takes the form of objections to a social reform policy which "increases the cost of production." It does not in the least imply that business



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men object to protection for their own particular industry; nor does it follow that it has affected at all the mentality of the workers or of the intellectual classes who stand apart from the business world. The constant tendency to impose new duties and spheres of activity on government is a sign that in so far as the reaction against government interference is a general one, it is rather directed against interference with personal liberty than against the assumption of economic functions by the state, and that, apart from this, it is a surface irritation rather than a fundamental change of heart. (4) The fourth fact is the falling off in the volume of national savings—estimated by the Committee on National Debt and Taxation as being some 150–200 million pounds and giving “ground for anxiety but not for pessimism.”<sup>1</sup> The feeling that our savings may not be adequate for our needs gives ground even for orthodox circles to argue that some discrimination should be practiced in our foreign loans—or, as the *Times* put it in the case of the Amsterdam municipal loan in 1924, “We cannot afford the luxury of financing municipal building programmes either in Amsterdam or any other foreign capital.” Gone, in this case, is the view that, if there are limited resources, they

<sup>1</sup> *Colwyn Committee Report*, par. 60. Cf. pars. 69f ff.

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should go to the highest bidder, and that the price paid for capital is the index of need!

The orthodox Free Trade view is implicit in the organization of English financial life and represents, therefore, the *status quo* and is now having to face the criticisms of more heterodox stand-points. The ultimate support of the orthodox view is, of course, the double contention that the free play of market forces will adjust the rate of interest to be paid by the different classes of borrowers in such a way that the price of each loan reflects both the degree of risk involved and the need of the borrower and, that being so, it should be left to the individual to invest or not to invest as he pleases. The immediate supports of the orthodox view must be put in more concrete terms: that the financial organization of London represents an important source of earning capacity (and the more difficult the position of British exports, the more important financial services must become relatively as a means of balancing the visible adverse balance of trade) and that capital exports must result, directly or indirectly, in a stimulus to exports of real things.<sup>2</sup> More concretely still, that a decline

<sup>2</sup> Cf. *ibid.*, p. 204, for opinion of some representative witnesses (par. 564). The Colwyn Committee thinks that the effect of duty on bearer bonds "requires to be carefully watched: it would be un-

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in the volume of capital exports must be accompanied by a depression in those industries manufacturing more specifically for foreign markets.

A great deal of this line of analysis would be accepted, in fact, by the adherents of the Imperialist-Protectionist school of thought. For, in so far as capital exports involve an export of goods, it is obviously in line with protectionist thought, always inclined to exaggerate the value of exports for their own sake. But in the case of the Imperialist-Protectionist school there are three lines of thought which are inconsistent with the purely orthodox point of view. The first is the view that capital exports should be made to stimulate exports of goods by deliberate design. It is this point of view which is responsible for the demand which crops up time and again,<sup>2</sup> that foreign borrowers should be made to place a certain proportion of the nominal value of the loan in the shape of orders to British industry. The alternative correlative view,

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justifiable to continue the duty at its present level, if it appeared to have a material influence in diverting foreign loan business" (par. 565). Cf. par. 700.

<sup>2</sup> See, e.g., the series of questions that were addressed to the Secretary of State for India in 1921 on Indian orders for railway material in relation to the then recent 7 per cent sterling loan (*House of Commons Debates*, Vol. 142, col. 2079; Vol. 143, cols. 256, 925).

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of course, is that capital loans should not be sanctioned which result in capital facilities being placed at the disposal of foreign competitors of this country—a view which was in part responsible for the opposition to raising part of the German Dawes-Plan loan in Great Britain, a view which is not only popular in business circles but has also been voiced by Mr. Lloyd George.<sup>1</sup>

A second element in the Imperialist-Protectionist view is that governmental action can be made to stimulate the export of goods and thus to provide employment at home. It is this idea which underlies the body of legislation known as the Trade Facilities Acts. Under those Acts the Treasury was empowered to guarantee the payment of the principal or interest or both principal and interest on

<sup>1</sup> Mr. Lloyd George, June 19, 1924, on the Board of Trade Vote: "There is going to be a temptation—I have no hesitation in saying that, from certain symptoms I have seen and from enquiries made at the present moment—there is a danger that the capital of this country will flow into channels where it will be used rather to re-equip our competitors than to develop countries which will be purchasers in our markets . . . whether it is desirable that we should have a free money market or whether we should do what every other country in the world does—with the possible exception of America—and I believe to a certain extent America does it—have a certain amount of governmental control or direction which will prevent the surplus money of this country from going into quarters of that kind" (*ibid.*, Vol. 174, col. 2399).

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capital loans raised by governments, municipalities, or corporations, either in the United Kingdom, the empire, or some foreign country, provided that an Advisory Committee was satisfied that the loan was calculated to promote employment in England and that the proceeds of the loan would be applied toward or in connection with the carrying out of any capital undertaking. The original liability which the Treasury was to be allowed to incur was fixed at a maximum of 25 million pounds; the period of application of the Acts was finally extended to March 31, 1927, and the maximum guaranty liability raised to 75 million pounds.

The primary aim of the Acts was, of course, to relieve unemployment and not to assist capital exports. Up to June 30, 1926, the total of guaranties extended to domestic undertakings of all kinds were more than three times as large as those to the rest of the world, empire and non-empire both included. The total empire guaranties were only slightly larger than the total non-empire loans, being 8.3 million pounds and 7.3 million pounds, respectively, out of a total of 64.9 million pounds. The main foreign undertakings to which guaranties were extended are given in Table I.

The third element in the Imperialist-Protectionist scheme is, of course, that capital loans to

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the empire should be particularly favored, partly on the ground that the empire buys more per head of its population from Great Britain than does the rest of the world, partly on sentimental grounds

TABLE I

| FOREIGN UTILITIES                          | Million<br>Pounds | FOREIGN INDUSTRIALS                   | Million<br>Pounds |
|--|-------------------|---------------------------------------|-------------------|
| Electrical supply, tram-<br>ways, etc..... | 3.38              | Tin undertakings.....                 | .40               |
| Railways.....                              | .20               | African Finance Co....                | 1.15              |
| Railway construction...                    | .13               | Anglo-Hungarian Spin-<br>ning Co..... | .06               |
| River navigation.....                      | .01               |                                       |                   |
|  | <u>3.72</u>       |                                       | <u>1.61</u>       |
|  |                   | Million Pounds                        |                   |
|  |                   | 5.33                                  |                   |
| Foreign shipping.....                      |                   | <u>2.10</u>                           |                   |
|  |                   | 7.43*                                 |                   |

\* Up to March 31, 1927, guaranties given in respect of 73.2 million pounds, of which 2.0 million pounds repaid. Guaranties outstanding as at March 31, 1928, 70.2 million pounds.

with which one is not concerned here. This side of imperialist sentiment is manifested, not only in a special section of the Trade Facilities Act of 1924,<sup>1</sup> which, in Part II, allows the Treasury to make a grant of three-fourths of the interest payable in the first five years in respect of portions of loans ex-

<sup>1</sup> This portion of the Act expired on May 15, 1927, and practically no use was made of it.

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pendent in the United Kingdom and raised by governments, local authorities, or public utility undertakings in the empire—a portion of the Act arising out of the proceedings of the Imperial Economic Conference of that year, in which the offer of the British government so to guarantee loans was distinctly coldly received—but also in the policy associated with the conferring of the status of trustee securities on colonial and dominion loans authorized under the Colonial Stock Act, 1900, or any act extending the same. As the wisdom of this policy is now being questioned, it is as well, in the first instance, to see what the situation under these Acts and the Trustee Acts is. Broadly, then, a trustee may invest in any stocks, funds, or securities authorized under the Colonial Stock Act, 1900, or any act extending the same, subject to the restriction that if the stock is redeemable at par or some other fixed rate, a trustee shall not purchase the stock at a price 15 per cent above the redemption price or, if the stock is redeemable within fifteen years of the date of purchase, at a price exceeding its redemption value. To become an authorized trustee security under the Colonial Stock Acts, 1877-92, as amended by the Colonial Stock Act, 1900, the stock must be registered in the United Kingdom, and in respect to such stock

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such conditions must have been observed as the Treasury by order may prescribe. The most important conditions are (1) that the colony shall provide by legislation that any sums which may become payable to stockholders under any judgment, etc., of a British court shall be met out of the revenues of the colony, (2) that the Treasury shall be satisfied that adequate funds (as and when required) will be made available in the United Kingdom to meet such judgments, (3) that the colonial government will formally record its opinion that any legislation of the colony which appears to the imperial government to "alter any provisions affecting stock to the injury of the stockholders or to involve a departure from the original contract in regard to the stock, would properly be disallowed."

Under these acts some 750 million pounds of securities have been allowed to become trustee securities,<sup>2</sup> and public opinion in Great Britain regards these acts as in the light of a *quid pro quo* for the extension of dominion preferences to British goods. And this raises the whole question of the value of the acts to the dominions and other portions of the empire: the service, or disservice, they

<sup>2</sup> The amounts raised between 1921 and 1926 represent some 368 million pounds.



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do to Great Britain is another matter which must be left over for a later stage.

Since the war the volume of trustee securities has increased enormously, in consequence of the great extension of the volume of the British national debt. Apart from this, the economic resources of the dominions themselves have greatly increased in the last quarter-century, enabling them to meet their own demand for capital, at least in part; and there have developed competing capital markets to which they can turn. This is, of course, of particular importance to the Dominion of Canada. It would seem to follow that at the present time the value of the trustee privilege is less than it was at the time the principle was first laid down, and is more important for the smaller areas than for the larger ones. It is impossible to tell what the actual cash value of the privilege is; the usual statement is that it saves the dominions at least 1 per cent on their loans. On the other hand, it must not be forgotten that though the privilege does not carry with it any immunity from public criticism (and such criticism has not been wanting, particularly in the case of New South Wales), the fact that the loans offered are trustee securities does confer a certain status upon them which in itself is valuable, though it cannot be

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evaluated from the pecuniary standpoint. There is no sign that the adherence to this policy is seriously threatened, in spite of the criticism proffered in respect to it.<sup>1</sup> The general opinion appears to be that, *if* the Colonial Stock Acts *do* enable the dominions to borrow more cheaply, that is a good thing.

I turn now to the third point of view—that which I have described as Economic-Nationalist. That view is also inclined to stress three points—the positive dangers of foreign loans in general,<sup>2</sup> the specific evils which result from placing colonial securities on the list of trustee securities, and the dangers which result from neglecting the demands of the home market. Or, as the *Nation* put it in its issue of April 25, 1925, we can no longer afford “the somewhat arrogant luxury of financing foreign countries. What is wanted is systematic discouragement of the issue of large foreign, including colonial, loans and systematic development of useful public works at home.”

Before the war, with a large total credit balance, the annual volume of overseas loans was less than the amount of interest which this country

<sup>1</sup> *Colwyn Committee Report*, par. 700, and *Evidence*, QQ. 4003-6.

<sup>2</sup> Keynes, “Foreign Investment and National Advantage,” *Nation* (London), August 9, 1924, pp. 584 ff.

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was entitled to draw, so that, broadly speaking, this country was re-investing a part of its previous investment and was, therefore, increasing its foreign-capital holdings at compound interest. More importantly, though the new loans may have stimulated particular industries and developed the purchasing power of particular areas by building up their capital resources, the immediate net advantage to this country was reduced, in so far as income which might have been spent was not spent, in the sense that Great Britain did not consume the total real income to which it was entitled. Not all the money which was so re-invested did effectually build up the world's resources, in so far as any part of it was used for purposes of armaments. Armament loans have not the excuse that in the long run they increase the purchasing power of the community to which they are made. But since the war, it can be argued that at times the overseas loans of this country no longer exceed the current volume of credit items due on the Balance of Payments as a whole, though foreign interest still continues to exceed foreign loans, so that our foreign loans are made at the expense of short-term borrowings—at least in part. It may be held that a policy of foreign investment assumes a very different complexion under the second state of affairs than under

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the first. And, in any case, as Mr. Keynes has urged, the foreign creditor of government is, in the modern world, particularly liable to be suspect and to be unfairly treated in consequence.<sup>2</sup> Apart from the general bias against the foreign creditor, there must be considered the case where, in consequence of unsuccessful war, followed by revolution, accompanied by inflation, the investor has lost everything. The leading case is Russia; but the whole of Eastern Europe, including Germany and Austria, is equally relevant. Considering, however, that in France the value of the franc has declined by four-fifths, and that in England and the United States the purchasing power of money has also fallen, it may be argued that inflation is not an argument against foreign investment *in general*, for some loss of real income has also been suffered by the domestic investor. In this case, however, the fact still remains that British and French economy, if not the British investor, has gained from the previous investment of capital at home; whereas if the same amount of real resources has been invested abroad, no one in Great Britain, except perhaps through somewhat remote indirect effects, now gains, while the British investor has undoubtedly lost.

The case against the Colonial Stock Acts was

<sup>2</sup> *Ibid.*

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put by Mr. Keynes before the Committee on National Debt and Taxation in the following form. At the time when the range of trustee securities was increased greatly by the Colonial Stock Act of 1900 the market in which trustees could invest was very limited and the colonies did not borrow very much. The situation today is very different:

The Colonies are prepared to borrow practically as much as we are prepared to lend them. The consequence is that if money is available in the gilt-edged market, and there is no new home investment to take off those surplus funds, they almost automatically find their way to the Colonies. Thus the diversion of money into the gilt-edged market now creates an unduly strong presumption in favour of its leaving the country. The Colonies have socialised a number of services which we have not socialised. Thus the money required for such services in the Colonies is easier to borrow than money required for similar services in this country, and in many ways . . . . the extension of the Trustee Acts so as to cover nearly all Colonial Government securities, when at the same time the volume of home Trustee securities is being reduced, creates a dangerous bias *in favour of excessive foreign investment*. . . .

The question cannot be disposed of without taking policy into account:

There are some people who think it primarily important to develop the Colonies; there are others who think it primarily important to develop good conditions at home. It is a question of balance between those two ideas. I believe that we ought to pay more attention than we have paid lately to

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the conditions at home, *the return on which, in terms of public welfare, would be quite as great as the return we get from loans to the Colonies.*<sup>1</sup>

For the situation so described Keynes has two remedies: (1) either a discretionary power to be vested in the Treasury, so far as the admission of new securities is concerned; or, if this is regarded as inadmissible, (2) the complete abolition of the Trustee Acts, "for which there is a great deal to be said, or if they are retained, I would allow as new trustee securities only home securities of specific types."<sup>2</sup>

The important general issue which is raised in this evidence and which is, further, the keynote of the new Liberal Industrial Report, so far as it is concerned with the issue of foreign investment at all, is the question of "excessive foreign lending." This phrase has acquired a certain technical meaning in the British financial press which is not in point here. When the British financial press discusses "overlending," it is thinking of a volume of loans in excess of our immediate capacity to transfer without pressure on the exchanges. Permanent overlending, in the financial sense of the word, is impossible; permanent overlending, in the light of

<sup>1</sup> *Colwyn Committee, Q.Q. 4000, 4006.*

<sup>2</sup> *Ibid., Q. 4000.*

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a given economic or social ideal, is another matter. When overlending is discussed in terms of public welfare, the question is whether the net effects of investing more at home and less abroad would give a better economic result than rather more lending at home and rather less lending abroad.

The Liberal Report<sup>r</sup> argues that

so far as industrial, mining and agricultural overseas enterprises are concerned, we think that the freedom of foreign investment has in the past greatly increased the national wealth and is increasing it now. We see no reason to do anything but encourage the trading, business and pioneering private enterprise of British citizens abroad.

But, the Report goes on to say,

We are more doubtful whether, at the present time, the existing machinery for investment necessarily preserves the correct balance between expenditure on Public Utilities at home and loans for similar purposes abroad to Governments, Provinces, Municipalities and other public bodies in foreign countries and in the Dominions . . . . the development and extension of transport facilities, public utilities, industries, housing and agricultural equipment *at home* should be a first charge on the national savings, and . . . . *only the surplus, after the satisfaction of all reasonable domestic requirements under these headings, should be made available to public bodies abroad.*

It is this emphasis on attaining a "correct balance" and on the expediency of satisfying home requirements first which justifies the ascription of the

<sup>r</sup> *Britain's Industrial Future*, p. 110.

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phrase "Economic Nationalism" to this particular standpoint.

In order to implement the policy outlined, the Liberal Report desires to see established a Board of National Investment. It would be the function of the Board to give its sanction to any new trustee loans and, in co-operation with the Bank of England, to exercise a power of control over foreign issues generally in cases of emergency or "when the currency position demands some measure of regulation of overseas issues,"<sup>1</sup> the only condition of granting or withholding permission to float the loan being "the availability of surplus national savings,"<sup>1</sup> apart from the specific cases of loans for war or armament purposes, or of loans by borrowers who are in actual default on previous loans.

These suggestions raise two main problems. The first is a matter of economic theory, and is in the main the problem of deciding what assumptions it is legitimate to make in attempting to give concrete substance to the idea of a "correct balance" between expenditure on public utilities at home and abroad. The second is an administrative problem: it is concerned with the translation of the terms of any theoretical solution arrived at into canons of action.

<sup>1</sup> *Ibid.*, p. 113.



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If one starts by rejecting the assumption that pecuniary standards—that is, willingness and ability to pay—are to be the deciding factors in settling where capital is to flow, then the problem of excessive investment abroad is only a special case of the general problem of the redistribution of wealth. The actual distribution of the national flow of savings may be the best possible, given the right of lender and borrower to ask and to pay the market price; but it does not follow that the *de facto* distribution of capital resources is the best under all circumstances. The world as a whole might be better off if more were invested in clearing the slums—even if that did not bring in to the capitalist as much as improving the lighting or harbor facilities of some South American seaport. So much must be admitted, but it is clear that there are no objective standards which can be applied. Administrative action, if it is to follow this road, has nothing but a vague presumption of rightness to guide it.

On the other hand, it may be argued that, even accepting the adequacy of pecuniary guides to action as a general principle, the existing framework of laws, institutions, and knowledge is capable of improvement. The law may deliberately discourage investment at home; political prejudice may disincline the investor to put resources at the

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disposal of the home market or may disincline political bodies from borrowing sums which they would be in a position to pay for; unjustifiable pessimism about the future of the country may prevent capital extensions which, if made, would pay for themselves; the self-interest of financial institutions, such as the great Issue Houses, may lead them to prefer foreign loans because they are more familiar with the routine. From this point of view, the solution lies in improving the mechanism of investment in the expectation that, if it is improved, the flow of capital, as influenced by the rate of interest offered, will in itself result in a better all-round distribution.

Some parts of the formal, especially the legal, environment are obviously amenable to improvement through administrative channels; those parts which are at present defective in consequence of economic and political prejudice are not so directly amenable. More borrowing powers could be conferred upon local authorities, for instance, or trustees could be empowered to invest in a wider range of domestic securities; but it will not follow that any use will, in fact, be made of the powers so bestowed. And, if in its impatience to get something done, the administration passes from regulation to action, there is the danger that its own effort

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may merely be substituted for private action which might otherwise have been undertaken. A widespread housing policy undertaken by government does not necessarily increase the total of all houses by the number which it itself builds, in so far as by building some houses itself it may deter the private builder from building as many as he otherwise would have done.

From the standpoint of Great Britain, the difficulty of interfering with the Trustee Acts is the sentiment that something should be done for imperial economic development. It would appear better, then, to widen the list by including more domestic securities, rather than to sweep the whole machinery away. But a really close control over foreign issues, implying the formal recognition of a prior right of the home market for any capital that is available is obviously only justifiable if the margin between the total savings available and the minimum requirements of the home market is so narrow as to give cause for immediate alarm. The problem has been recently investigated from this angle by the Committee on National Debt and Taxation. Estimating the national savings at between 450 and 500 million pounds, the Committee considers that on the basis of £400 per capita, the minimum requirements for new capital to provide

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equipment for the probable increase in the *occupied population* will fall from 50 million pounds per annum up to 1931 to  $18\frac{1}{2}$  million pounds per annum from 1931 to 1936, to fall to 8 million pounds per annum in the next five years.<sup>1</sup> Though the Colwyn Committee themselves remark "that the figures quoted above represent only a small portion of the savings needed in order to cover losses due to wastage and obsolescence of assets, and to provide for factories, plant and machinery, etc., in line with the latest improvements and inventions," it is also true that the Report points out that "provision of capital according to old standards, and sufficient to maintain the existing rate of production and the status quo of the standard of living, can continue to be found without the least difficulty."<sup>2</sup> Even if, then, it is held that a larger per capita investment at home than was normal in the past is desirable in the future, it is improbable that a slight shift in interest rates would not succeed in diverting funds to home use, even without any administrative interference with the processes of investment other than some extension of the volume of domestic issues having the status of trustee securities.

<sup>1</sup> *Report*, par. 700.

<sup>2</sup> *Ibid.*, par. 699.

## II

### FOREIGN INVESTMENTS AND THE BRITISH BALANCE OF PAYMENTS

In the eight years from 1920 to 1927, the total volume of capital issues floated in the London market, on the basis of the net figures published by the Midland Bank, amounted to 2,050 million pounds, or  $10\frac{1}{4}$  billion dollars. Of this amount, 920 million pounds, or 4,600 million dollars, represented issues of foreign securities. Official estimates for the balance of payments for the year 1921 are lacking; excluding this year, one gets the result that during the years 1920-27 the aggregate excess of credit items over debit items in the balance of payments was 737 million pounds, or 3,685 million dollars, whilst the foreign capital issues amounted to 804 million pounds, or 4,020 million dollars. The year 1920 was, however, exceptional, inasmuch as the volume of foreign-capital issues was small and the excess of credit items over debit items in the Balance of Payments was exceptionally large. If this year is eliminated, the result emerges that against 485 million pounds of excess credits, there were capital issues for foreign countries amounting to 744 million pounds, or 3,720 million dollars. The

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disparity in particular years is very great: in 1926, for instance, there was in all probability a small debit balance on the Balance of Payments against capital issues of 112 million pounds, or 560 million dollars. It is the relationship between these two magnitudes which is the subject matter of this lecture. The Balance of Payments must always balance, but the question is whether the means by which it is balanced reflect a satisfactory or an unsatisfactory state of affairs.

The unsatisfactory character of the semi-official statement of the annual Balance of Payments published in the *Board of Trade Journal* is not confined to the formal characteristic that the figures are net figures, so that it is impossible to judge tendencies except in an indirect way. Much more important is the second characteristic that the total volume of "invisibles" is divided into only four categories and that two of these, namely, "short interest and commissions" and "net receipts from other sources," are omnibus categories, which, to judge of their stability from year to year over a group of years, must contain a good deal of guesswork, even if they are not entirely conjectural. Since, thirdly, the Balance of Payments represents revenue items only, the capital transactions which must particularly concern us are not specifically

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analyzed at all. It is assumed that if the sum total of the credit items exceeds the visible adverse balance of trade, the difference measures the net balance of all the capital items. The first result of this method of treatment obviously is that errors in any of the items actually recorded may give a very misleading idea of the balance of capital transactions. The second is that a misleading simplicity attaches to the annual statement as published, because the capital transactions may be much more diverse than the transactions actually recorded; and of this diversity not a glimpse is to be had from the published return. And as the estimation of net income from overseas investments must be affected by the correctness of the analysis of the capital transactions, an indirect influence is exerted even on the items actually recorded. If the degree to which capital is actually invested overseas annually is overestimated, this will affect the estimate of net income from investment in the future and will result in the Balance of Capital Transactions being larger than it ought to be, unless other (and unknown) countermovements are simultaneously taking place in the unrecorded Capital Account. If income from past investments is underestimated; the real degree of new investment may be greater than we think.

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What are the items on Capital Account which have to be considered? The phrase "foreign investments" does not by any means merely indicate the taking up of shares or stock publicly offered in the London capital market. It also includes the purchasing of foreign stocks and shares in foreign countries and the repurchase of British securities or stocks held by foreigners. In addition must be considered the investment of capital abroad by firms and undertakings, whether issuing capital publicly or not. The totality of the sums so sent abroad constitutes the new volume of foreign investment taking place at a given moment. How it affects the balance of payments depends on the volume of foreign investment taking place in Great Britain, but this is certainly less than the volume of British foreign investments. But the volume of new investments is not the totality of the movements taking place on Capital Account. If loans are being repaid whilst new loans are being made, the effective volume of new capital invested abroad is reduced.

Further, in addition to sinking-fund movements and movements in the supply of long-period capital, movements in the supply of short-period capital have to be considered. The net excess or deficit of invisibles over or under the visible trade balance



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—the residual Capital Account figure—is thus itself the resultant of a complicated interrelation of quantities, even if those movements only are considered which have a relation to the pecuniary self-interest of individuals. But in the modern world—capital movements include payments on Capital Account among governments. In the case of the British Balance of Payment figures, it is stated that the items “Estimated excess of government receipts over payments” or “Payments over receipts” include “payments and receipts on account of the overseas activities of the War Office, Admiralty, and other public departments, payments and receipts of the interest and principal of loans and Indian home charges, except payment on account of debt and interest on railway capital (both of which are included with income from overseas investments).” Thus these two items in the statement contain certain capital elements which logically should go into the Capital Account, though it makes no difference where these items are put, provided they are not reckoned twice over.

The two most important items among the invisible sources of income are the net earnings accruing from shipping services and the net income from overseas investments. In recent years the depression in the shipping industry has led to the

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construction of numerous indices both for freight and time-charter rates; movements of tonnage and of passengers are both known and, consequently, though there are obvious difficulties in the way of arriving at accurate results, the margins of error are not so wide as to make the figure of shipping earnings inherently unreasonable.<sup>1</sup>

What reason have we to suppose that the net figure of 270 million pounds of income from overseas investments is approximately correct?<sup>2</sup> At twenty years' purchase, this would indicate a capital value of 27 billion dollars or 5,400 million pounds; on a  $7\frac{1}{2}$  per cent basis, it would indicate a capital investment of 3,600 million pounds, or 18 billion dollars. There are two possible sources which throw some light on this question: one is the information possessed by the Inland Revenue Department with regard to income from abroad; the other is the information available in the books of banks and other registration and paying author-

<sup>1</sup> See discussion in the *Board of Trade Journal*, February 2, 1928.

<sup>2</sup> This category is officially defined as "the surplus of income accruing to residents in the United Kingdom from investments in other countries (whether these are in Government loans or in public companies or in private undertakings) over the income accruing to persons not resident in the United Kingdom from similar investments in British property or securities or from the employment of their balances in the United Kingdom" (*ibid.*, p. 135, col. 1).

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ities. Some surprising information gathered from these latter sources has recently been made public in a speech by Sir R. Kindersley, a partner in the eminent London issuing house of Lazard Brothers.

The income-tax year does not correspond with the calendar year and, in any case, there are serious gaps in the information afforded by the Inland Revenue figures. The "taxable income from abroad" is divided by the Inland Revenue Department into three groups, viz.:

Group I.—Dominion and Foreign Interest and Dividends paid through paying agents or received by the encashment of coupons through bankers, coupon dealers, etc., in this country.

Group II.—Income arising from businesses controlled in this country but mainly carried on abroad and with assets situate abroad, interest and dividends payable abroad (not included in Group I.) and income from other foreign possessions.

Group III.—Income arising from trading operations *carried on abroad* by British concerns trading mainly at home but partly abroad.

Of these categories it is stated that "Group I. is identifiable, Group II. is in part identifiable and certain data exist on which an estimate of the aggregate amount can be made. Group III. cannot be identified."<sup>2</sup> The figures provided by the Inland Revenue authorities are thus not complete; but so

<sup>2</sup> *Seventieth Report of the Commissioners of Inland Revenue*, Cmd. 2789, p. 89.

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far as they go, they show movements which might have been expected on a priori grounds. They reveal a considerable rise between 1913-14 and 1925-26 in the revenue from government securities: a considerable fall in the revenues from foreign and dominion railways, and a fall also in the miscellaneous revenue from foreign and dominion coupons and dividend warrants. They show also a considerable recovery in the position since 1920-21, when the revenue from these four groups was still somewhat below what it was in 1913-14. This is to be expected, in view of the sale of our American railway holdings during the war and the industrial boom at home after the war, which attracted capital that might otherwise have gone abroad.

The rise in the estimated identifiable income from Group II has been much greater proportionately, being in 1925-26 some 30 per cent above the 1913-14 level. This, again, is what one would expect, in view of the rise of world-prices, which have affected the profitability of the trading enterprises included in Group II proportionately more than the fixed interest-bearing securities included in Group I, though the rise in interest rates is obviously the main explanation of the rapid recovery in the income from this group since the war. But the information given by the income-tax authorities

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is not in itself sufficient to enable one either to reject or to justify the Board of Trade estimate as a whole.

The figures given by Sir Robert Kindersley cover not only the annual income from foreign investments but also give, for the first time, an estimate of sinking-fund repayments and of the proportion of subscriptions on new loans due to foreigners and British people, respectively. These figures were collected from some sixty banks and several hundreds of companies. The results are very striking.

Sir George Paish, in a well-known paper, estimated Great Britain's foreign investments (at the end of 1907) as in the neighborhood of 2,700 million pounds, or  $13\frac{1}{2}$  billion dollars, yielding an average return of 5.2 per cent, that is, 140 million pounds, or 700 million dollars.<sup>1</sup> A later estimate of his brought the total (to 1910) into the neighborhood of 3,200 million pounds, or 16 billion dollars<sup>2</sup> (the income from which would presumably be in the neighborhood of 160-170 million pounds, or 800-900 million dollars); but this figure was not complete, for "if allowance be made, on the one hand, for the foreign capital employed in British

<sup>1</sup> *Journal of the Royal Statistical Society*, September, 1909, p. 475

<sup>2</sup> *Ibid.*, January, 1911, p. 186.

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companies both at home and abroad and in British loans and, on the other, for the vast amount of private capital which the British people have placed abroad, I think the net total of our investments in other lands would not be much short of £3,500 millions [ $17\frac{1}{2}$  billion dollars]."<sup>1</sup> For 1927, the estimate made by Sir Robert Kindersley is 3,990 million pounds, with a gross income of 309 million pounds which, after allowing for American and other debt settlements, produces a net income of 280 million pounds, or 1,400 million dollars.

Total sinking-fund payments remitted to this country are estimated at 41 million pounds, of which amount 34 million pounds was the British share and 7 million pounds the foreign share. This figure of 41 million pounds is very large: it is equal to 14 per cent of the net income from foreign investments; it is, in fact, four times as large as the amount guessed at by Mr. Keynes in his article on the "British Balance of Trade, 1915-27."<sup>2</sup>

How do these figures affect the problem of the British Capital Account in relation to the excess of invisible income items and our visible adverse balance? In 1927 this excess was 96 million pounds. New issues for overseas were 138 million pounds, of

<sup>1</sup> *Ibid.*, p. 187.

<sup>2</sup> *Economic Journal*, December, 1927.

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which the British subscription is estimated by Kindersley to have amounted to 109 million pounds, or five-sevenths of the total. Since sinking-fund repayments amounted to 34 million pounds, the new investment out of income was 75 million pounds, or 375 million dollars. Thus, instead of there being in that year an excess of new issues over invisible income items to be accounted for, there was in that year an excess of invisible income items over new investment out of income on British account in the neighborhood of 20 million pounds, or 100 million dollars. Sinking-fund repayments and foreign subscriptions convert an apparent excess of 43 million pounds, or 215 million dollars, of "new investment over invisible income items" into an excess of half that amount of "invisible income items over new issues."

A single year is, however, a very poor basis for argument. On the somewhat doubtful assumptions that (1) sinking-fund payments averaged 30 million pounds or 150 million dollars a year, and (2) that British subscriptions to new foreign issues averaged five-sevenths of the whole amount offered during that period, the results for the five years 1923-27 would be as given in Table II. What are the conclusions which can be drawn from the figures in this table?

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1. The net amount of subscriptions to new foreign issues being only 285 million pounds, the result emerges that, in terms of pre-war money, during the years 1923-27, taking the average Board of Trade index number to be 155, the subscription

TABLE II

|   | Million<br>Pounds<br>Sterling | Million<br>Dollars |
|---|-------------------------------|--------------------|
| Total foreign issues (Midland Bank).....                        | 609                           | 3,045              |
| British subscription.....                                       | 435                           | 2,175              |
| Foreign subscription.....                                       | 174                           | 870                |
| Sinking-fund repayments.....                                    | 150                           | 750                |
| Subscription out of "new income to new public issues".....      | 285                           | 1,425              |
| Excess of invisible earnings over visible balance of trade..... | 331                           | 1,655              |
| Excess of invisible income items over new subscriptions.....    | 46                            | 230                |

is equal to a lending of 190 million pounds, or 950 million dollars—an amount about equal to the total export of capital in the year 1911. But, since there remained available an excess of invisible income items of 230 million dollars, the total *net* addition during these five years to total foreign investments was 285 million pounds plus 46 million = 331 million pounds, or at pre-war prices 230 million pounds, which is nearly equal to Dr. C. K. Hobson's estimate of the amount of capital exported in the



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year 1912, though the figure which he assigns for that year is admittedly excessive.<sup>1</sup>

2. As regards the effect upon the "heavy" export trades, it must be remembered that we have so far been discussing the net new investment, not the total *gross* investment, in these five years. From the standpoint of these capital goods producing industries, what matters is the total of orders that they are given; and sinking-funds turned back into new investments are just as satisfactory as new savings of an equal order of magnitude, from this point of view. Capital goods ordered in the past have been paid for in the past, and for new capital goods the source out of which payment is made is irrelevant. The falling off in the rate of net new investment, from the standpoint of Great Britain's economy as a whole, must be distinguished from the effect on the iron and steel, engineering, and other export trades. True, they would be still better off if the rate of new net investment were greater, but the rate of new net investment is no direct guide to the total of orders given for new capital goods.

3. The view taken of the rate of new net investment must be affected by the opinion held as to the accuracy of the "invisible income" item as a whole,

<sup>1</sup> *Export of Capital*, p. 204.

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and especially by the figure of the "net income from investment." "Unidentified" income covers only the income not identified as such, though returned to the Inland Revenue authorities, but there is also income which evades assessment altogether. Both may be larger than is suspected, and, if so, there is a margin available for taking up foreign securities in foreign countries and for adding to the scope of private capital in business or undertakings of many different kinds.<sup>2</sup>

<sup>2</sup> Owing to the fact that the Board of Inland Revenue now gives an estimate for the total income derived from Group II investments (see table in Appendix), it is no longer possible to use the old ratio between identified and unidentified income which was drawn into service by Mr. C. K. Hobson (on the basis of certain suggestions of Sir George Paish as to the amount of unidentified income in 1907) in his attempt to arrive at total income from abroad in his *Export of Capital* (pp. 201 ff.), yielding a result to which Sir Josiah Stamp gave qualified approval (*British Incomes and Prosperity*, p. 231). The aggregate of Group I income and Group II income (estimated in regard to the latter) is, for 1913-14, 170 million pounds, against an old figure of "Income from Abroad so far as it is Identified" of 118 million pounds (*Fifty-eighth Report, Inland Revenue*, Table 125, p. 118). For 1911-12 the corresponding figures are 156 million pounds and 104 million pounds. C. K. Hobson's estimate of total income (identified and unidentified) for that year was in the neighborhood of 170 million pounds. If the old figure of total income is approximately correct, and the new figure of identified income is also approximately correct, the amount of unidentified income was about 10 per cent of the whole; but we have no means of knowing whether this is a correct assumption for the post-war period or not.

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The discussion so far has failed to take account of the position in individual years, and of the manner in which the foreign subscriptions to the foreign-capital issues taken up have been financed. As regards the former, the opinion has been steadily gaining ground and has received the sanction, not only of authorities like Mr. J. M. Keynes but also of the *Board of Trade Journal*, that an important source of capital receipts by Great Britain in the recent past has been short-term loans to the London money market, based partly upon differences in the rates of interest in different centers, partly upon anticipated exchange profits in the days before the return to the gold standard, and partly upon the convenience of London as a center in which to hold short balances.

The volume of these balances is quite unknown. Mr. J. M. Keynes, reviewing the position at the end of December, 1927, and on the assumption that "the two sides of the account of the sale and purchase of securities to and from foreign countries, other than new issues, are more likely to be nearly balanced than they are to be widely different,"<sup>2</sup> came to the conclusion that

a *prima facie* case exists for the view that our net foreign investment during the last three years—apart from the balance

<sup>2</sup> *Economic Journal*, December, 1927, p. 555.

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of short-period borrowing and lending—may have exceeded our available income surplus by some figure not less and £150 millions [750 million dollars] and perhaps in the neighbourhood of £200 millions [1 billion dollars]: from which it would follow that we have adjusted the position by diminishing our liquid assets or increasing our short-period obligations by a similar sum.”<sup>2</sup>

Now, the figure for foreign subscriptions for the five-year period was estimated above as 175 million pounds, a figure which lies well within the range of Mr. Keynes' estimate of the growth of short-period indebtedness. From the standpoint of the problem before us, it makes no essential difference whether long-term capital loans to foreigners by one set of people (British investors) are offset by short-term loans by another set of people (foreigners) to Great Britain, or if the short-term loans originally made are not withdrawn in that form, but are passed through the long-period capital market and are then withdrawn on long-term capital account. Mr. Keynes gave a lower figure for sinking-fund repayments—a figure of only 10 million pounds, which, of course, increased the amount which he had to find to balance his account in the shape of short-term loans. There is nothing inherently improbable in the assumption that a large part of the short-term balances ultimately found their way

<sup>2</sup> *Ibid.*

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into the long period capital market; indeed, this would explain why, in spite of the largeness of the figures currently mentioned, the strain on the foreign exchanges has not, on the whole, been greater than it has been in recent years.

The whole of this discussion raises two questions of principle:

1. The first is the question of the rate at which our capital investments are growing. That net growth is distinctly smaller than the figures at first sight would indicate, largely because the importance of the sinking-fund repayments has hitherto been neglected. Against this new factor—diminishing the size of our new net investment—must be set, as already mentioned, the possible underestimation of net income from previous foreign investments of all kinds. If the decline of foreign investments were accompanied by evidence that our total investments were still at as high a level as before the war, the shift in the direction might either be left to look after itself or, on the lines of the argument set up by the Economic Nationalist school, be evidence of a more satisfactory development of the home market for capital. But this is not the case; we know on other grounds that the total savings have fallen off, and the conclusion is irresistible that the decline of foreign investment

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is evidence of a decline in total savings. The general problem of determining the limits of desirable saving cannot be discussed here, but it is at least profitable to suggest that the relative levels of interest rates show that capital is still needed more urgently abroad than at home and that the special case for foreign investment by Great Britain lies in the impossibility of financing our need for food and raw materials without a large invisible income, to which foreign investments contribute so large a share.

2. The second question concerns the expediency of "borrowing short and lending long." This is a policy which can expose the money market to a sharp and sudden strain, for the only way of meeting it is by exports of gold and, ultimately, a rise in the bank rate of interest, for the purpose both of keeping the short balances here in liquid form or of inducing their investment in long-term securities by making these cheaper. It is true that other countries—the United States especially comes into account here) are also in the position of being short-term borrowers and long-term lenders, but it may be legitimately argued that the gold reserves of the Federal Reserve System enable an outflow of short-money from New York on a much larger scale before it becomes necessary to

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force an investment into long-term securities by harsh pressure on the money market. It is certainly the case that the currency legislation of Great Britain is so designed as to make it difficult for the Bank of England to lose gold in any quantity and yet postpone the raising of the bank rate: and, undoubtedly, such a rise may come at a time when industry is not in a position to suffer a rise of money rates with equanimity. From the standpoint of the national welfare, therefore, the profit to be derived by trading on the difference between long- and short-term interest rates is not necessarily, and, at all times, a *net* profit, in so far as it may be offset, in part or in whole, by the economic and social wastage involved in an increase of unemployment.

TABLE III  
THE BALANCE OF TRADE OF GREAT BRITAIN IN RECENT YEARS  
(Figures in Million Pounds)

|   | 1913 | 1920 | 1922 | 1923 | 1924 | 1925 | 1926 | 1927 |
|---|------|------|------|------|------|------|------|------|
| Merchandise balance.....                                  | 158  | 343  | 171  | 203  | 324  | 384  | 475  | 392  |
| Estimated excess of government payments<br>overseas†..... |      |      |      |      | 25   | 11   |      |      |
| Total.....  | 158  | 343  | 171  | 203  | 349  | 395  | 475  | 392  |
| Excess of government receipts*.....                       |      |      |      |      |      |      | 3    |      |
| Net shipping income.....                                  | 94   | 340  | 110  | 115  | 140  | 124  | 120  | 140  |
| Net income from overseas investments.....                 | 210  | 200  | 175  | 150  | 220  | 250  | 270  | 270  |
| Net short interest and commissions.....                   | 25   | 40   | 30   | 30   | 60   | 60   | 60   | 64   |
| Net income from other services.....                       | 10   | 15   | 10   | 10   | 15   | 15   | 15   | 15   |
| Total.....  | 339  | 595  | 325  | 305  | 435  | 449  | 468  | 488  |
| Balance on items above.....                               | +181 | +252 | +154 | +102 | + 86 | + 54 | - 7  | + 96 |
| Midland Bank figures of overseas issues.....              |      | 60   | 135  | 136  | 134  | 88   | 112  | 139  |

\* Includes "payments and receipts on account of the overseas activities of the War Office, Admiralty and other Public Departments: payments and receipts in respect of the interest and principal of loans and Indian home charges, except payment on account of debt and interest on railway capital (both of which are included with 'income from overseas investments')."†



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TABLE IV  
IDENTIFIABLE INCOME FROM ABROAD: ON BASIS OF INLAND  
REVENUE DEPARTMENT FIGURES  
(Figures in Million Pounds)

|  | 1913-14      | 1920-21      | 1925-26      |
|--|--------------|--------------|--------------|
| <i>Group I</i>   |              |              |              |
| Government securities . . . . .  | 38.6         | 38.7         | 57.3         |
| Dividends, interest, etc., on dominion<br>and foreign stocks, shares, etc.,<br>payable in Great Britain . . . . .                              | 18.3         | 17.5         | 22.4         |
| Dividends of dominion and foreign<br>railway companies payable in<br>Great Britain . . . . .   | 12.7         | 6.0          | 7.9          |
| Other foreign and dominion coupons<br>and dividend warrants . . . . .  | 19.2         | 23.2         | 12.9         |
| <b>Total . . . . .</b>   | <b>88.8</b>  | <b>85.4</b>  | <b>100.5</b> |
| Less dividends belonging to persons<br>not resident in Great Britain . . . .   | 2.0†         | 3.7*         | 4.5†         |
| <b>Net total . . . . .</b>   | <b>86.8</b>  | <b>81.7</b>  | <b>96.0</b>  |
| <i>Group II</i>  |              |              |              |
| a) Profits from certain concerns trad-<br>ing abroad and having assets<br>abroad** . . . . .   | 91.4§        | 124.0§       | 120.0§       |
| b) Interest and dividends (not in-<br>cluded in Group I) and other in-<br>come from foreign possessions aris-<br>ing abroad and payable abroad |              |              |              |
| <b>Totals . . . . .</b>  | <b>178.2</b> | <b>205.7</b> | <b>216.0</b> |

\* United Kingdom.

† Great Britain and North Ireland.

\*\* This entry covers: (a) railways, tramways, etc., operating abroad; cables, telegraphs, and telephones situated abroad; (b) mines, oil wells, and nitrate fields situated abroad; (c) tea, coffee, rubber, sugar, etc., plantations abroad; (d) gas, water, harbor, mortgage, financial, manufacturing, and trading undertakings operating abroad.

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‡ Suggested figure.

§ These figures are "an estimate of the income of the group . . . made by reference to the results shown by an annual sample consisting of a large number of individual cases in which the figures of actual profits were obtained, and their relation to respective Income Tax assessments were used as an index of the income of the whole group. Treating this sample as representative and, therefore, indicative of the fluctuation of profits from year to year, estimates have been made for successive years of the actual income of the group—as distinct from the statutory income as assessed. . . . The actual income as stated for any year represents the income, as computed for Income Tax purposes, for annual accounting periods ended within that year, e.g. the income for the year 1923-24 includes the income of concerns whose accounts were made up at 30th June, 1923 or 30th September, 1923 or 31st December, 1923 or 31st March, 1924. These estimates may be subject to an appreciable margin of error, and it should be borne in mind that they cover income arising from abroad which though chargeable to tax here, may not be remitted to this country" (*Sixty-eighth Report of Commissioners of Inland Revenue*, Cmd. 2547, pp. 101-2. Cf. *Seventieth Report*, p. 90). It may be added that the main classes of concerns belonging to Group III, for which no estimate is provided, are "shipping, banking and insurance companies having branches abroad, and manufacturing and trading concerns with works or branches abroad." Part of the income thus unidentified would thus be included under other estimates in the Balance of Payments.

### III

## THE BRITISH CAPITAL MARKET SINCE THE WAR

A discussion of the British capital market since the war must necessarily begin with an investigation of the relationship between the volume of securities offered and the volume of the net national savings. Whatever may be the differences in this respect between Great Britain and the United States, arising from the differences in the structure of industry and the methods of raising capital in the two countries, there is at least this similarity between the capital markets of the two countries, namely, that in recent months security prices have shown a very "bullish" tone.<sup>1</sup> A contrast is drawn very frequently, and, on the whole, perhaps, it is rightly drawn, between economic conditions in the United States and those prevailing in Great Britain. In view of the circumstance that economic conditions in Great Britain are so much less favorable than those in the United States, the coincidence in the movement of security prices in

<sup>1</sup> An index of twenty industrial shares prepared by the London and Cambridge Economic Service shows in May, 1928, a level of 246 as compared with 100 pre-war.

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the two countries point to the existence of underlying forces, such as the trend of long-period interest rates, which are not always taken into account fully in discussions of this subject.

The market for long-period capital offerings is an extremely poor index of what is, economically considered at any rate, the fundamental aspect of the problem. It is a very poor index, in other words, of the extent to which the volume of the national savings is increasing or decreasing over time.

In the first place, figures of capital issues in any market contain, and in these days contain a great deal of, overlapping. If a successful business man sells out his business to the public, and buys with the proceeds a new government security, both the shares offered to the public in the form of ownership rights in the business and the stock offered to the public in the shape of the government securities will appear in the statistics of capital issues. But, from the standpoint of the national savings, it would have made no difference had the business man kept his business and the public put its money into the government security instead of into the shares of an existing industrial enterprise, allowing the former owner of the concern to take up a new form of ownership right.

In the second place, we now know that in re-

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cent periods foreign investors have played an important part in taking up new capital issues in the London market. To the extent that the capital rights so taken up have remained in foreign hands permanently, the figures of capital issues are a misleading guide to the capacity of Great Britain to save in this particular form.

Thirdly, there has been going on in recent years a change in the method of financing British business—a change due to changing circumstances of ownership. The private partnership and private company is giving way to a larger extent than before to the joint-stock company, so that it is natural to expect a larger volume of public issues to be made. There is not necessarily any increase in the volume of the net national savings.

Lastly, a considerable amount of savings can be invested—and, of course, is invested—outside the organized capital market. The paradoxical result can follow that the volume of securities offered on the long-period capital market may be falling off, whilst the volume of the aggregate net national savings may be increasing, and perhaps increasing rapidly. Great Britain offers one very important illustration in point. The end of the war found Great Britain face to face with a grave social problem—a housing shortage of serious

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magnitude. That shortage—involving the construction of well over a million houses—has largely been overcome; but the funds required for the purpose have for the greater part come from sources lying outside the organized long-period capital market. Certain British municipalities have borrowed in the form of housing bonds for the purpose of themselves constructing or subsidizing the construction of new houses, and part of the expenditure of the central government has been devoted to housing purposes; but the greater part of the total expenditure has been financed out of the resources of building societies and insurance companies and out of short-term borrowings by building firms, and has hence played no part in the operations of the long-period capital market at all. In short, it is a great mistake to confuse the problem of whether the net capital resources of the country are growing with the growth in the volume of public securities offered on the British capital market.

The rate of growth of the national savings does, however, throw some light upon the conditions under which new securities can be easily taken up; and there is a general consensus of opinion that since the war the volume of the national savings is less than it was before the war. That is the opin-

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ion not only of private investigators like Professor A. L. Bowley and Sir Josiah Stamp, but it is also the view expressed by the Committee on National Debt and Taxation, usually known as the Colwyn Committee. The view of that Committee is that, taking the net addition to the capital resources of the country as lying between  $1\frac{3}{4}$  and 2 billion dollars for the year 1913 (a very prosperous year and, therefore, not necessarily typical of pre-war years), the nominal value of savings for the year 1924-25 was higher, lying somewhere between  $2\frac{1}{4}$  and  $2\frac{1}{2}$  billion dollars: a scale of savings which, when allowance has been made for the change in the price-level, implies that the volume of the national savings has fallen off in terms of post-war purchasing power by three quarters of a billion to a billion dollars.<sup>1</sup>

For this decline in the rate of the national savings there are three possible lines of explanation:

1. In the first place, there is, of course, the direct loss of previous saving and of capacity to save due to the war. The war directly affected the value of the British holdings in Russian, Central, and Southeast European securities, and involved the sale of American and other dollar-securities.

<sup>1</sup> *Report: National Debt and Taxation* (Cmd. 2800), p. 17, par.

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And, further, four years of war meant a running down of the capital equipment of the country which has, to some extent at least, affected the productive capacity of the country.

2. The war has affected the distribution of the national income of Great Britain, somewhat to the advantage of the "working classes"—part of the general effect of inflation in every part of the world. And, of course, it is hardly open to doubt that any increased saving on the part of the working classes cannot possibly compensate for a decline in the capacity to save of the middle classes of the population and of those recipients of large incomes who have been subjected to the influence of high taxation.

3. In post-war Great Britain it is the effect of high taxation—which in this connection connotes "death-duty legislation," as well as income and "Super" tax—upon the volume of savings which has excited most discussion. The general feeling among the business classes undoubtedly is that high taxation has had an unfortunate effect, not only upon business enterprise—upon the willingness to risk money for an ultimate return—but also upon the capacity to save.

The Colwyn Committee, which necessarily had to investigate this problem at length, arrived at



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conclusions very much less pessimistic in tone than those generally entertained with regard to it.

In the first place, it came to the conclusion that industry has suffered materially, in so far as the supply of capital is concerned, from the effect of high income tax and super tax rates.<sup>1</sup>

In the second place, the Committee came to the somewhat surprising conclusion that, if the psychological as well as the physical effect of death duties as compared with income taxes is taken into account, the volume of savings has been more adversely affected by death-duty taxation than by income-tax legislation.<sup>2</sup> That is to say, it would really be worse from the standpoint of savings to reduce the income tax and raise death duties than it would be to raise income taxes and lower death duties.

Thirdly, the Committee think there has been a very substantial, but not startling, reduction in the volume of savings as compared with pre-war conditions—an opinion which is shared by every authority looking into the matter.<sup>3</sup>

The final conclusions reached are certainly re-

<sup>1</sup> *Ibid.*, p. 169, par. 444.

<sup>2</sup> *Ibid.*, par. 533. But the difference in effect of the two taxes is not great.

<sup>3</sup> *Ibid.*, par. 691.

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assuring. They are to the effect that it is not clear that the lower standard of saving in this country has been inadequate to meet the *actual* new demand for capital, and, lastly, in opposition to what is probably the prevailing opinion among nine-tenths of the British business community, that high taxation is not one of the main causes of the industrial difficulties of the country.<sup>2</sup>

When, therefore, one is comparing the relative importance of high taxation, of the trade depression, of shifts in the distribution of the national income, and of the effect of the war as affecting the stream of the national savings, it is interesting to bear in mind that the highest investigating authority is inclined to minimize the influence of taxation as compared with the difficulties arising out of the destruction of material wealth during the war itself. That is an inference which deserves to be better known than appears to be the case.

When one passes from considering the problem of the national savings to a more detailed discussion of the position of the capital market, the first point which deserves mention is the increasing tendency for industry to finance itself out of prof-

<sup>2</sup> *Ibid.*, par. 702. "In our opinion the present taxation—even in conjunction with the loss of material wealth, which lies behind the National Debt—is not one of the main causes of industrial difficulty."

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its. The Inland Revenue authorities presented to the Colwyn Committee a statement showing the gross and net profits earned by British joint-stock companies in the years 1912 and 1923. The result emerges that gross and net profits have not kept pace with the rise of prices; on the other hand, the ratio of amounts added to surplus, as compared with net profits, has gone up from 33 per cent in 1912 to 46 per cent in 1923. These amounts added to surplus are exclusive of the amounts set aside under the statutory allowances for depreciation and wasting assets permissible under British income-tax legislation.

It can hardly be denied that, on the whole, this development is thoroughly desirable, especially at a time when the ability to save on the part of the private individual, if not the willingness to save, has suffered a check. On the other hand, the policy of adding to reserves has undoubtedly been one of the factors stimulating the rise of security prices, since stock bonuses, or the capitalization of reserves, has this advantage from the standpoint of the investor, as compared with higher dividends, that the latter are subject, whilst the former are not, to payment of super tax. The company has to pay income tax on the reserved amounts but does not pay super tax. Bonus shares are not subject

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to taxation, and thus the capital value of existing shares tends to be influenced more than proportionately by the chances of bonus distributions in the future.

The long-period capital market is necessarily affected, not only by taxation policy but also by the position in the short-period money market. And the British money market since the war has been influenced by two sets of special influences not always working in the same direction. The first of these influences has been the position of British governmental finance. The British government has necessarily favored a "cheap-money" policy, not only because its conversion operations on long period debt are favorably affected thereby but also because it still has a very large floating debt, mainly in the form of Treasury Bills, and a rise in the cost of credit involves it in additional debt charges and also in the difficulty of getting the market to absorb the volume of Treasury Bills that it desires to dispose of. A policy of cheap money, whilst it may assist government financing operations, has also effects on the capital market generally, which are not necessarily consistent with the attainment of parity with the dollar, the declared object of British monetary policy since the end of the war, the attainment and maintenance of

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which (since 1925) being the second special influence to which the working of the money market has been subordinated—an influence which, on the whole, has made for dear money and has consequently had a depressing effect upon the capital market.

Between 1920 and 1927 (both years inclusive)—if the Midland Bank figures of security issues are taken—they are exclusive of the refunding issues of the British government and other complicating factors—something like  $10\frac{1}{4}$  billion dollars were offered to the public, the actual price of issue and not nominal par values being understood. If the figures published by the *Economist* newspaper are taken, the total swells to  $13\frac{1}{4}$  billion dollars, the main difference lying in the inclusion among the latter figures of government refunding issues.<sup>2</sup>

Four different questions can be asked with reference to this very large total of security offerings. The first concerns the geographical distribution of those figures. The second concerns the nature of the borrower; and the third, the manner in which he has borrowed. The fourth question concerns the yield from different types of securities in recent years.

<sup>2</sup> The figures on which the statements in the text in this and following paragraphs are based will be found in the tables at the end of this chapter.

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Before the war, the greater part of the securities offered on the London market related to overseas issues—whether the issues of foreign or colonial governments—or public utility enterprises of different kinds. British domestic issues—though, as in the case of the railways and the municipalities, large absolutely—were of relatively smaller importance than overseas issues. Since the war, partly owing to the competition of New York as a market for long-period capital, partly owing to the change in the organization of British industry, at times to a partial embargo imposed in the interests of the gold standard on overseas issues, the situation has very largely changed. The proportion of issues representing domestic requirements has been as high as 85 per cent in one year (1920) and in the eight years covered by the tables at the end of the chapter has never fallen below one-third of the whole (1923). In more recent years the tendency would seem to be for the proportion to fluctuate between 50 and 60 per cent of the whole. If the *Economist* figures are taken as a basis, the proportions have varied in these years between 89 and 40 per cent, as compared with a range of 14 and 26 per cent in the years 1908-13. Again, if issues for foreign countries are taken, they fluctuate (basis *Economist*) from 2 per cent of the whole in 1920 to

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25 per cent of the whole in 1924, as compared with a range of 44-25 per cent in pre-war years. Whilst capital issues for account of British possessions in pre-war years accounted for some 30-40 per cent of the total offered in the post-war period, the proportion has been as low as 9 per cent in 1920; and in more recent years has been below 30 per cent of the whole. The geographical distribution of British capital issues has thus altered considerably since the war; and though, no doubt, a position of final equilibrium has not yet been reached, the pre-war proportions are not likely to be reverted to again. The shortage of capital, the competition of New York, the growing capital resources of the dominions themselves, combine to make this unlikely.

On the basis of the Midland Bank figures, of the  $10\frac{1}{4}$  billion dollars offered to the public, some  $4\frac{1}{2}$  billions represent the securities of governments, municipalities, and railways in different parts of the world, whilst nearly 6 billions were offered by industrial and other undertakings of all kinds. The year 1920 was altogether exceptional in respect to the total of government and railway issues in proportion to the whole, the percentage in that year being one-fifth of the total. Since 1921 the tendency has been for the proportion of government, municipal, and railway issues to decline—a

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natural state of affairs, in view of the gradual consolidation of governmental finances in the quite recent past, though it must not be overlooked that in the modern world, in which the productive sphere of government is large, the tendency for governments to borrow appreciable amounts is likely to be a permanent one.

If the Midland Bank figures for industrial issues are taken as a basis (exclusive of railway, gas, and water enterprises), then, in the eight years in question, a total of 1,830 million dollars was offered to the public in the shape of indebtedness, and a total of 3,870 million dollars in the shape of capital rights: that is, for every dollar taken up in the shape of debt, two dollars were taken up in the form of capital rights. Here, again, the year 1920 is altogether exceptional. In that year 85 per cent of the industrial issues represented capital rights. A marked change of tendency occurs after the years 1922 and 1923. In those two years nearly equal amounts were offered in the shape of debt and of capital rights, but in the four years 1924-27 the tendency for capital issues to increase and for debt issues to decline becomes more and more marked. The most obvious explanation of these changes is the state of trade: during and immediately after a depression, business finds it difficult to convince



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investors of the existence of a silver lining to the cloud; in an ascending phase of security prices and with better trade, the attractiveness of capital rights against the holding of bonds or debentures increases.

An analysis of money raised by companies of various classes throws light, not only upon the changing phases of the trade cycle but upon the vicissitudes of particular industries and the tastes of investors. The figures are given in detail in the tables at the end of the chapter; here only some salient points need be alluded to. Apart from the large and heterogeneous group "commercial and industrial," which far outweighs the rest, the largest amount was raised in these years by financial, land and investment, and trust companies, though the influence of the depressed years 1921-23 is very marked in the distribution of the amounts over time. The iron and steel group follows, but the significance of the fact that nearly one-half of the total raised was obtained in the single year 1920 must not be overlooked. The time-distribution also throws light upon the alternation of depression and boom in the rubber and plantation group and in the oil group, the miserable showing of the nitrate group upon the depressed state of that industry; whilst the electric light and power group shows a

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remarkably steady expansion over the same period of time.

If the movements in the volume of capital issued throw some light upon the position of different industries, the rate of return upon securities throws some light upon the attractiveness of saving to the investor. The index of yield on four fixed-interest-bearing securities (base 1913=100), published by the London and Cambridge Economic Service, shows that that yield is some 20-30 per cent higher than it was before the war, the exact rise in the yield depending, of course, in part on the situation in the money market from time to time. In his evidence before the Colwyn Committee, Mr. Layton<sup>1</sup> gave a summarized version of the well-known figures published from time to time in the *Economist*, from which it appears that while the return on preferred capital in the period 1919-23 was only 5.2 per cent, as compared with 4.8 per cent in the period 1909-13, in the same period of time the yield on ordinary capital had risen from 8.1 per cent to 10.2 per cent. In more recent years the position in this regard has remained substantially unaltered, as the figures in Table V will show.

The value of these figures is, of course, strictly limited by the fact that only a relatively small

<sup>1</sup> *Evidence*, I, 177.

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number of companies is covered by the *Economist* inquiries. Still, the figures, so far as they go, confirm the view that it is the residual owner of industry who has tended to gain most from the lowered purchasing power of money since the war and, further, that the tendency of profits to decline,

TABLE V

|                              | Yield on<br>Debentures<br>(Per Cent) | Yield on Prefer-<br>ence Capital<br>(Per Cent) | Yield on<br>Ordinary Capital<br>(Per Cent) |
|------------------------------|--------------------------------------|--|--|
| 1924.....                    | 4.9                                  | 5.4  | 9.8  |
| 1925.....                    | 5.1                                  | 5.5  | 10.3                                       |
| 1926.....                    | 5.0                                  | 5.4  | 11.1                                       |
| 1927.....                    | 5.1                                  | 5.3  | 10.8                                       |
| 1928.....<br>(First quarter) | 4.8                                  | 5.3  | 11.3                                       |

which was a marked feature of the slump, has again been checked.

Three questions arise when the future of the British capital market is discussed.

The first is a matter of world rather than of merely local import, namely, the future of the rate of interest. But Great Britain has in the past furnished such a large proportion of the savings available for opening up the overseas areas of the world that the future rate of interest is intimately bound up with the local situation in Great Britain.

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If it were possible to reduce the existing high level of taxation, there is some reason to believe that those classes of the population which save almost "automatically" will increase their savings beyond the amount they at present save. Again, a fall in the price-level will, on the whole, lessen the burden on the salaried middle-class worker and will cause him to save rather more than he is saving now. In any case, apart from increased effort to save, the normal operation of the sinking-fund on the national debt will provide a stream of liquid resources which will flow back into productive channels. There is some reason to suppose, therefore, that the rate of interest is likely to fall; but the rate of fall depends on matters of public policy, especially in the sphere of taxation, about which nothing can be predicted.

The second question concerns the influence which is likely to be exerted on the rate of interest by the movement to integrate British industry into large productive units—the so-called "rationalization" movement. One of the most important questions upon which so far very little light has been shed is the extent to which these large aggregations propose to re-equip the industries which they control, and how the new combines propose to raise the capital which they may need. In the

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long run it makes no difference whether the capital sums required are raised in the capital market or are retained out of the realized profits of the concern; but in so far as the rationalized industries are prepared to sacrifice the immediate interest of their shareholders to their interests in the long run, then industrial amalgamations may exercise a steadying interest on the capital market, since they can afford to time their appeals more carefully than smaller units which have not the same resources to fall back upon could do.

The third question relates to the state of the law upon the organization and responsibilities of joint-stock companies. There seems to be unanimity among the authorities on the point that in recent years the investing—at any rate, the semi-speculative, semi-investing—public has largely increased. Apart altogether from the growth in the number of investors, there is a growing volume of opinion which sees in increased publicity one of the essential pillars of soundness in economic life. Neither in regard to the protection of the shareholder nor in the furnishing of information of general interest is the present position entirely satisfactory.

The question of amending the law has been under consideration for two years. In 1926 there

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appeared the report of the Company Law Amendment Committee;<sup>1</sup> and a bill incorporating the major recommendations of that report has passed all its stages in the House of Commons and will, within a relatively short period of time, become law, though it will not become effective law for some time, since it is intended to consolidate the new legislation with the previous Companies Acts by means of further legislation.

So far as the investing public is concerned, public attention has mainly been called to two points, (1) the ease with which the provision of information in the prospectus can be evaded by means of the device known as the "offer for sale," that is, the sale of securities to an intermediary who can resell to the public without (hitherto) having to comply with the requirements as to prospectuses in the Companies Acts, and (2) to the device known as "share hawking," that is, the sale of securities by means of the personal solicitation of the intending investor. Thus the usual methods of disposing of securities in the United States, through an underwriting syndicate<sup>2</sup> and by means of bond

<sup>1</sup> Cmd. 2657, of 1926.

<sup>2</sup> The British underwriting syndicate differs altogether from the American in that the former takes up shares or stock if not sold to the public, whereas the American buys the shares or stock for the express

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salesmen, have in their British counterparts revealed themselves as liable to grave abuse. Even in the case of prospectuses which fall strictly under the Companies Acts, there has been a tendency to evade the law by the issue of so-called "abridged prospectuses" annexed to invitations to subscribe to stocks or shares. All these abuses it is proposed to stop in the future: personal solicitation is to be forbidden, the "offer for sale" is to be assimilated to the offer to subscribe, and abridged prospectuses are also to be prohibited in the future. The law is also to be strengthened with regard to balance-sheet information and the disclosure of directors' interests in certain types of contract. But it is doubtful whether even the present bill fully meets the requirements of the case: whether, in other words, with a new and larger investing public, the view that the buyer should be left to look out for himself can even remotely be the principle by which the affairs of a great capital market should be regulated.<sup>2</sup>

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purpose of resale. One of the problems dealt with by the Company Law Amendment Committee was the desirability of limiting underwriting commissions—the limit suggested being 10 per cent of the shares underwritten (*ibid.*, p. 19).

<sup>2</sup> Cf. the *London Times*, August 1, 1928: "There is no doubt at all that, especially during the past decade, the investing public have suffered heavy losses through unnecessary secrecy and sometimes

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TABLE VI\*

A. TYPES OF SECURITIES FLOATED FOR INDUSTRIAL AND OTHER  
PURPOSES, EXCLUSIVE OF RAILWAYS, GAS, AND WATER  
UNDERTAKINGS

(In Million Pounds Sterling)

| Year      | Debit | Capital | Total | Debit<br>(Per Cent) | Capital<br>(Per Cent) |
|-----------|-------|---------|-------|---------------------|-----------------------|
| 1920..... | 46.7  | 261.0   | 307.7 | 15                  | 85                    |
| 1921..... | 42.2  | 47.9    | 90.1  | 47                  | 53                    |
| 1922..... | 48.8  | 49.8    | 98.6  | 49½                 | 51½                   |
| 1923..... | 44.7  | 45.8    | 90.5  | 49                  | 51                    |
| 1924..... | 38.1  | 62.0    | 100.1 | 38                  | 62                    |
| 1925..... | 45.2  | 87.2    | 132.4 | 34                  | 66                    |
| 1926..... | 49.9  | 91.0    | 140.9 | 35                  | 65                    |
| 1927..... | 50.0  | 129.0   | 179.0 | 28                  | 72                    |

\* *Midland Bank Review*, December, 1927—January, 1928.

through sheer want of straightforward dealing in the company world. They have been led to part with their savings on the strength of prospectuses full of optimism and omissions; they have been persuaded by all the arts of highly paid publicity to subscribe for the purchase, say, of a derelict war factory at a price ten times that which had been paid for it by the vendor a short time previously; they have been shocked to learn that companies which they had assumed to be prosperous, because their balance-sheets gave them that appearance, were suddenly unable to meet their obligations. This happened as a rule because their appointed watchdogs, the auditors, had failed till too late to inform the shareholders of the true position of affairs. The present Bill will not prevent such things happening again, but it will make them more difficult."



## FOREIGN INVESTMENTS

TABLE VI—*Continued*

**B. DISTRIBUTION OF CAPITAL ISSUES (EXCLUSIVE OF BRITISH  
GOVERNMENT LOANS RAISED DIRECTLY FOR NATIONAL  
PURPOSES)**

(In Million Pounds Sterling)

| Year      | Governments,<br>Municipalities,<br>Railways<br>(1) | Industrial<br>Undertak-<br>ings of All<br>Kinds<br>(2) | Total | Percentage of Total |      |
|-----------|--|--|-------|---------------------|------|
|           |  |  |       | (1)                 | (2)  |
| 1920..... | 75.1   | 309.2  | 384.3 | 19.5                | 80.5 |
| 1921..... | 122.8  | 93.0   | 215.8 | 57                  | 43   |
| 1922..... | 134.4  | 101.3  | 235.7 | 57                  | 43   |
| 1923..... | 110.8  | 92.9   | 203.7 | 54                  | 46   |
| 1924..... | 121.5  | 102.0  | 223.5 | 54                  | 46   |
| 1925..... | 84.5   | 135.4  | 219.9 | 38                  | 62   |
| 1926..... | 108.1  | 145.2  | 253.3 | 43                  | 57   |
| 1927..... | 132.6  | 182.1  | 314.7 | 42                  | 58   |

TABLE VII\*

NEW MONEY RAISED BY COMPANIES OF VARIOUS CLASSES, 1920-27  
(Million Pounds Sterling)

| Year      | Banks,<br>Dis-<br>count,<br>and In-<br>surance | Brew-<br>eries and<br>Distill-<br>eries | Com-<br>mer-<br>cial<br>and In-<br>dus-<br>trial | Electric<br>Light<br>and<br>Power | Finan-<br>cial,<br>Land,<br>Invest-<br>ment,<br>and<br>Trust | Iron,<br>Coal,<br>Steel,<br>Engi-<br>neering,<br>Indus-<br>tries,<br>Motors<br>and Avi-<br>ation | Mines | Oil  | Nitrate | Ship-<br>ping,<br>Canals,<br>Docks | Tea,<br>Coffee,<br>and<br>Rubber | Tele-<br>graphs<br>and<br>Tele-<br>phones | Tram-<br>ways<br>and<br>Omni-<br>buses |
|-----------|--|---|--|-----------------------------------|--|--|-------|------|---------|------------------------------------|----------------------------------|---|--|
| 1920..... | 19.7   | 3.0                                     | 180.3  | 1.9                               | 13.1   | 40.3   | 5.8   | 16.7 | .1      | 15.7                               | 6.6                              | 3.0                                       | 1.5                                    |
| 1921..... | 5.0  | 4.5                                     | 37.6   | 7.0                               | 2.7  | 5.7  | 1.0   | 16.6 | .....   | 6.7                                | 1.3                              | .5  | 1.5                                    |
| 1922..... | 1.9  | 1.7                                     | 25.9   | 3.2                               | 9.6  | 14.4   | 1.8   | 17.0 | 1.7     | 16.9                               | .5                               | 2.3                                       | 1.7                                    |
| 1923..... | 1.4  | 5.2                                     | 37.3   | 9.9                               | 7.2  | 9.8  | 4.4   | 4.4  | .9      | 4.5                                | 3.5                              | .9  | 1.0                                    |
| 1924..... | 5.1  | 2.1                                     | 35.8   | 4.7                               | 17.2   | 18.7   | 3.4   | 2.4  | 1.2     | 3.2                                | 1.8                              | .5  | 3.9                                    |
| 1925..... | 4.3  | 1.4                                     | 59.4   | 7.2                               | 21.6   | 4.5  | 6.5   | 1.3  | 1.1     | 7.3                                | 15.0                             | 2.1                                       | .4                                     |
| 1926..... | 2.7  | .5                                      | 55.3   | 11.5                              | 33.1   | 9.2  | 4.9   | .4   | .....   | 5.6                                | 14.2                             | 1.2                                       | 2.4                                    |
| 1927..... | 15.8   | 8.4                                     | 60.8   | 10.9                              | 46.2   | 5.6  | 6.5   | 2.2  | .....   | 14.8                               | 4.9                              | 1.0                                       | 1.8                                    |
| Total..   | 55.9   | 26.8                                    | 492.4  | 56.3                              | 150.7  | 108.2  | 34.3  | 61.0 | 5.0     | 74.7                               | 47.8                             | 11.5                                      | 14.2                                   |

\* Constructed from the *Midland Bank Review*, July-August, 1925; December, 1927-January, 1928.

TABLE VIII\*

## GEOGRAPHICAL DISTRIBUTION OF NEW CAPITAL ISSUES, 1920-27

(Million Pounds Sterling)

|                            | 1920   | 1921   | 1922   | 1923   | 1924   | 1925   | 1926   | 1927   |
|----------------------------|--------|--------|--------|--------|--------|--------|--------|--------|
| United Kingdom:            |        |        |        |        |        |        |        |        |
| Amounts . . . . .          | £324.5 | £100.1 | £100.5 | £67.6  | £89.3  | £132.1 | £140.9 | £176.0 |
| Percentages . . . .        | 84.5%  | 45.5%  | 43%    | 33%    | 40%    | 60%    | 56%    | 56%    |
| Total overseas:            |        |        |        |        |        |        |        |        |
| Amounts . . . . .          | £59.7  | £115.7 | £135.2 | £136.2 | £134.2 | £87.8  | £112.4 | £138.7 |
| Percentages . . . .        | 15.5%  | 53.5%  | 57%    | 67%    | 60%    | 40%    | 44%    | 44%    |
| India and Ceylon:          |        |        |        |        |        |        |        |        |
| Amounts . . . . .          | £3.5   | £29.6  | £36.1  | £25.4  | £2.6   | £3.4   | £2.1   | £1.3   |
| Percentages . . . .        | 1.0%   | 14%    | 15%    | 12.5%  | 1%     | 2%     | 1%     | .5%    |
| Other British Possessions: |        |        |        |        |        |        |        |        |
| Amounts . . . . .          | £37.1  | £61.3  | £39.4  | £62.2  | £70.9  | £54.0  | £50.0  | £86.4  |
| Percentages . . . .        | 10%    | 28%    | 17%    | 30.5%  | 32%    | 24.5%  | 20%    | 27.5%  |
| Foreign Countries:         |        |        |        |        |        |        |        |        |
| Amounts . . . . .          | £19.1  | £24.9  | £59.7  | £48.6  | £60.7  | £30.4  | £60.4  | £50.9  |
| Percentages . . . .        | 5%     | 11.5%  | 25%    | 24%    | 27%    | 14%    | 24%    | 16%    |

\* From *Midland Bank Review*.

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**AMERICAN LOANS TO GERMANY**

*By* **ROBERT R. KUCZYNSKI**

## AMERICAN LOANS TO GERMANY

### I

Up to a few years ago, the history of Germany's foreign credit relations was much like that of other industrial countries. When, shortly after the Napoleonic wars, she began to establish factories and to build railroads, she had to resort to foreign capital. This period during which she was a typical debtor nation with a surplus of agricultural products lasted for about fifty years. The industrial boom after the Franco-Prussian War and the receipt of the French indemnity enabled Germany to dispense with foreign credits and in course of time she became herself a creditor nation. By 1914, her foreign investments exceeded the investments of foreigners in Germany by about \$5,000,000,000. During the ten years following the outbreak of the World War, she lost the greatest part of her investments abroad, while foreigners acquired an ever increasing amount of German securities and German real estate. At the same time she assumed the burden of huge reparation payments. She thus shifted once more from a creditor nation to a debtor nation. But she so far had not contracted any important foreign loans.

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This self-sufficiency in the German credit market which lasted until the summer of 1924 is usually explained by the lack of confidence on the side of foreign capitalists who did not dare extend long-term credits as long as the German monetary system was disrupted and reparation obligations were not fixed. This certainly was the case, but it does not tell the whole story. Throughout the inflation period the Reichsbank freely granted mark credits both to the German government and to German industries, thus enabling them to function after a fashion. German industries, it is true, could no longer pay for imports with German marks and over and over again emphasized the necessity of foreign loans. When, therefore, after endless discussions, a revolving credit of \$56,000,000 (fl. 140,000,000) was concluded with Holland in 1921, this was generally welcomed as a great relief, but for some years practically no use was made of those credits. Every individual industrial enterprise was afraid of taking a loan to be redeemed in sound currency. I well remember our reaction when in 1922, at a hearing of a committee of which I happened to be a member, a director of one of the largest German industrial concerns told us that they had just refused an offer from British bankers covering a loan of £15,000,000: we were much

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surprised by the sum he named, but we were not surprised that they refused to accept it.

Conditions changed only after the Reichsbank, on April 7, 1924, in order to prevent a breakdown of the new currency, passed its famous credit-restriction resolution which put an end to the extension of artificial credits. Since inflation had destroyed savings and thereby dried up the sources of all domestic credit agencies, the rate of interest went up to 100 per cent, and even at such a rate and with the best securities as a backing, it was well-nigh impossible to borrow a few thousand dollars' worth from a single German bank. Credit seekers, then, had practically no other alternative than to borrow abroad. But the economic and political outlook of Germany still seemed so dark that foreigners were not tempted even by the highest rates of interest. It was not before it became evident that the new Reparation Plan would be ratified by the various governments that confidence in the future of Germany began to be re-established. Between July and October, 1924, a few German industrial unions like the Potash Syndicate and the Rhine-Westphalia Coal Syndicate, and a few concerns like the North German Lloyd and the Dye Works, then, succeeded in securing credits in the United States and Great Britain. These credits

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were mostly short-term loans and served in part in financing exports. This first period of German borrowings was closed by the issue of the Reparation Loan.

The second phase in the recent history of German borrowings abroad covers the winter of 1924-25. Soon after the conclusion of the Reparation Loan, a few German cities appeared on the American credit market. They too secured mostly short-term loans. They were followed by some public and semi-public corporations and by several Catholic institutions, which contracted long-term loans. At the same time a number of private corporations likewise succeeded in obtaining long-term loans. But all these were only single cases. The grant of German loans was still considered almost as an adventure, and in the two months which followed the election of President Hindenburg in April, 1925, none but Catholic institutions succeeded in contracting a loan abroad.

The third phase began in July, 1925. At first the small short-term municipal loans were refunded and converted into large long-term loans. But the unforeseen possibility of hastening, through foreign help, the economic and financial rehabilitation, which for more than a year had been severely hampered by lack of funds, created an almost



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universal desire to borrow abroad. States, cities, church organizations, public, semi-public, and, most of all, private corporations sought the foreign-credit market. Almost every week brought one or more new long-term loans. This period was closed at the end of 1926 by the temporary recovery of the domestic-credit market.

The fourth phase began in June, 1927. While in the preceding six months only now and then a single loan had been contracted abroad, a new rush upon the foreign-credit market then set in; but this was checked as early as October, 1927, by the intervention of the Agent General for Reparation Payments and by the passive resistance of the "Advisory Council" established in the Ministry of Finance. Between November 12 and January 22, no foreign loan was floated outside of Holland, and for some more months none but public utilities, public credit institutions and private industrial concerns secured loans in the United States. All German municipal loans contracted abroad in the winter of 1927-28 were contracted with Dutch bankers without the approval of the Advisory Council and under very unfavorable terms. It was not before May that the German authorities lifted the embargo on public loans. Since then,

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America again has assumed the lead as grantor of loans to Germany.

The United States indeed is by far the most important of the recent creditors of Germany. This preponderance, it is true, does not become evident as long as one merely considers the number of loans. Out of a total of 370 German loans floated abroad since the fall of 1924, 70 only were issued exclusively in the United States, 46 in the United States and Europe, and 254 exclusively in Europe. But the picture is quite different if one examines the amounts issued in the various countries. Out of a total of \$1,546,000,000, \$1,039,000,000, or two-thirds, were issued in the United States, \$190,000,000 in Holland, \$171,000,000 in England, and \$146,000,000 in all other countries combined. At the same time, the part which Germany played among the countries borrowing in the United States was much less conspicuous. Her share in the total amount of foreign bonds publicly offered in the United States did not reach one-fourth.

### II

In analyzing the American loans to Germany there are two alternatives as to the focus: one may either compare the American loans to Germany with the American loans to other countries, or com-

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pare the American loans to Germany with the loans of other countries to Germany. Since I am not sufficiently familiar with the American loans to other countries, I will choose the second alternative.

1. One difference between the American and the other loans to Germany has already been indicated. The number of American loans is comparatively small, but their total amount is very high. This discrepancy is mainly due to the fact that a borrower looking for a small credit will have better chances in a neighboring country, while a very big loan can only be placed on a market like that of New York. Out of a total of 370 foreign loans publicly issued there were not less than 180 granted to Catholic corporations, and of these 180 loans there were 171 of less than \$300,000 each, which all were contracted in Holland.

2. America, on the other hand, has an especially high share of the loans granted, for instance, to German public credit institutions. The share of the United States in the nominal capital borrowed by the various groups was as follows:

|                                  | Per Cent |
|----------------------------------|----------|
| Public credit institutions.....  | 82       |
| Public utility corporations..... | 81       |
| States.....                      | 75       |
| Cities.....                      | 74       |

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|  | Per Cent |
|--|----------|
| Provinces, counties, and associations of municipalities..... | 72       |
| Private commercial companies.....                            | 68       |
| Industrial corporations.....                                 | 56       |
| The Reich (Reparation Loan).....                             | 48       |
| Religious and welfare organizations and institutions.....    | 41       |

3. The American loans to Germany are all dollar loans, while quite a few of the other foreign loans contracted by Germany are mark loans, the total par value of the mark loans floated abroad since 1925 being equal to \$55,000,000.

4. The floating of German loans did not encounter the same opposition of controlling authorities in America as in some other countries. The Department of State, it is true, requests that American bankers contemplating issuing a German or any other foreign loan should inform the Department with reference thereto in order that it might advise the bankers as to whether there was or was not objection to any particular issue. But it apparently discouraged only a single German loan: that of the Potash Syndicate, against which the Department of Commerce protested on the score that potash was within the group of foreign products controlled by monopolies contrary to American interests. It should, moreover, be

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mentioned that since the Department of State does not require information with reference to bank credits extended to foreigners, it had no opportunity of preventing the short-term credits granted by American banks to the German Potash Syndicate for financing export.

The Bank of England, on the other hand, had, in 1924, imposed an embargo on foreign issues which was lifted only in the fall of 1925. As a consequence thereof, aside from the British share of the Reparation Loan, no German loan was publicly offered in England before December, 1925, the first loan thus offered being the very loan of the German Potash Syndicate which had been debarred from the United States.

Difficulties of another kind prevailed in Holland. The Amsterdam Stock Exchange Association had forbidden the listing of any German loan as long as no satisfactory agreement should be reached with the Dutch owners of former German bonds on the revaluation of those bonds. As a consequence thereof not a single German loan, aside from the Dutch share of the Reparation Loan, was listed in Holland before December, 1926, although a large number of German loans had been publicly floated in Holland.

5. A last difference worth while mentioning be-

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tween American and other foreign loans to Germany consists in that American bankers in placing German loans pursued a different policy, especially from that of British bankers. Once they had entered the field of long-term lending to Germany, American bankers immediately offered such loans to the public, and it was only under quite exceptional circumstances that they resorted to private placing. That the British bankers did not publicly issue German loans before December, 1925, was due to the fact that the Bank of England at that time opposed practically all public offerings of foreign loans. But even after this impediment was discarded British bankers, in order to evade the 2 per cent tax imposed on public offerings, placed privately quite a number of British loans to German industrial concerns, and especially participations in German dollar loans publicly offered in the United States.

### III

The American loans granted to Germany have thus far proved beneficial both to Germany and to the United States. The economic and financial rehabilitation of Germany has been considerably promoted by the funds obtained from abroad. The German borrowers were enabled to expand their

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business. With increasing prosperity receipts from customs duties and taxes increased. The internal raising of reparation payments thereby became comparatively easy. Foreign exchange became so abundant as to provide both for the transfer of the reparation payments and for the payment of the ever increasing imports. The American bankers, on the other hand, earned high commissions, the American investors received a high rate of interest, American exports found an outlet in Germany. No doubt, those loans have proved beneficial in the past. But will it be the same in the future?

As matters stand, the outlook would be very bright if America could permanently go on granting large loans to Germany. But let us assume that the United States some day should not be able for a number of years to extend further credits to Germany. Would Germany then be able to raise and to transfer reparation payments? Would she be able to redeem the American credits, and if so, what would be the effect upon the economic life of the United States?

There are many, otherwise well-informed, persons in this country who believe that since the Reparation Plan has operated so successfully in the past four years it is bound to work equally well in

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the future. The *New York Times* in an editorial of June 13, 1928, thus said:

That famous German "capacity" on which so much metaphysics was once expended has been simplified to the extent that we now know Germany can pay in cash and kind the sum of \$625,000,000 annually. The problem of transfer, another of the pre-Dawes "impossibilities," has also been mastered.

1. It might be asked first of all whence "we now know Germany can pay in cash and kind the sum of \$625,000,000 annually." The fact that Germany in the forty-five months that the new Reparation Plan has been in operation has paid all told \$1,200,000,000 is certainly no conclusive proof that she will be able to pay the standard annual payments of \$600,000,000 which come into force in the fifth reparation year, beginning September 1, 1928. It should, moreover, be fully realized how those \$1,200,000,000 have been raised. The Reparation Loan has furnished \$190,000,000, the railways and the transportation tax about \$620,000,000, industry about \$145,000,000, and the budget of the Reich about \$245,000,000. If we now compare the yearly averages of the past with the requirements of the future, we find that the railways (including the transportation tax) have paid about \$165,000,000 and will have to pay \$230,000,000, that indus-



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try has paid about \$40,000,000 and will have to pay \$70,000,000, and that the Reich out of its budget has paid \$65,000,000 and will have to pay \$300,000,000. No one has ever doubted that railways and industry would always be able to fully live up to their obligations, and the fact that they have paid in the past without considerable inconvenience a yearly average of \$205,000,000, may be taken as a proof that they will be able to pay \$300,000,000 in the future. But as to the other \$300,000,000 to be furnished by the Reich, everything remains in the dark. All we know is that the Reich in the past has paid on an average \$65,000,000 and will in all likelihood pay the \$120,000,000 due in the current reparation year. That famous German capacity on which so much metaphysics was once expended has not yet been simplified to the extent that we now know Germany can pay in cash and kind the sum of \$625,000,000 annually.

But the pertinent question is not at all: Can German railways with a traffic swollen through foreign loans, can German industry with orders swollen through foreign loans, can the German treasury with customs duties and tax receipts swollen through an artificial prosperity due to foreign loans, squeeze the German consumer so as to make him pay each year \$600,000,000 which in

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themselves do not benefit railways or industry or the treasury? It rather is: Can railways and industry, even if no new loans arrive and if the old loans have to be redeemed, raise each year \$300,000,000 without increasing rates and prices to a degree that would seriously impair the whole economic life of the country? And can the German treasury with a reversed foreign-credit situation comply with the requirements of the Reparation Plan, that is, pay each year \$300,000,000 without imposing upon the German people a heavier burden of taxation than that borne by the peoples of the Allied countries? The experiences of the past certainly do not furnish any clue. The real test is yet to come.

2. Has the problem of transfer actually been mastered? In order to answer this question, we must first again ascertain what amounts have been transferred so far and what amounts are to be transferred in the future. According to a compilation of the German Statistical Office, Germany, up to December 31, 1927, had paid to the credit of the Agent General the equivalent of \$980,000,000 of which \$465,000,000 have been used for deliveries in kind, \$100,000,000 have been spent in Germany as cost of occupation and of various commissions, \$380,000,000 have been transferred in cash, and \$35,000,000 represent a balance not disposed of by

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the Agent General before 1928. The total cash transfers in forty months, then, amounted to only \$380,000,000, that is to not much more than will have to be transferred in each standard year.

But even in the past the transfer was not carried out without some friction. As a rule, it is true, the Agent General could secure the foreign exchange necessary for cash transfers from the funds that poured into Germany in connection with foreign loans, but in April, 1927, for example, when foreign loans had stopped for a while, the transfer of as small a sum as \$20,000,000 or \$30,000,000 caused the dollar to rise in a menacing degree at the Berlin stock exchange. The experience of the last years has shown indeed that transfer is feasible with an adverse balance of trade—if the transferring country can secure adequate foreign credits. But this is exactly what the Dawes Committee had in mind when, after having stated that the reparation payments could only be transferred with a surplus of exports, they added: "Loan operations may disguise the position—or postpone its practical results—but they can not alter it."

Germany, as a matter of fact, has thus far transferred reparation payments only to an amount which represents a small fraction of the total that she has borrowed abroad. If at any

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time she should not be able to secure more foreign loans she could transfer cash only if she succeeds to export more than she imports. The chances for such a surplus of exports are not very promising. For twenty-five consecutive years before the war, German imports of commodities surpassed exports by more than \$160,000,000, the average excess of imports amounting to \$282,000,000. In 1924-27, the average net adverse balance, according to the foreign trade statistics, was \$610,000,000. It is possible that the value of imports was actually somewhat lower and the value of exports somewhat higher than shown by the official statistics. But even if we accept the most radical corrections that have been suggested and if we include services, but on the other hand also include the specie trade, we obtain a yearly net deficit of \$513,000,000. This surplus of imports, of course, was attainable only by means of foreign credits, and it will vanish as soon as foreign credits cease. But it is hard to see how Germany could master the surplus of exports then necessary for a transfer of cash.

3. In turning now toward the capability of German borrowers to redeem the American credits in case they should not be extended, we have again to distinguish between the raising of the funds and the transfer. The total par value of the German loans

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publicly issued in the United States has amounted to \$1,039,000,000. The net yield to the borrowers was about \$925,000,000. The charges, inclusive of payments on the principal, will amount to approximately \$2,000,000,000 in the course of the next twenty-five years or \$80,000,000 per year. These charges do not appear particularly high. But it should be borne in mind that another \$40,000,000 will have to be paid each year for loans publicly issued in other foreign countries and that in order to ascertain the total payments due from Germany to the United States and to other countries, account would also have to be taken of the loans privately placed, commercial short-term credits to German firms, and foreign purchases of German mark bonds, shares of German stock companies, German real estate, etc.

In any case, the terms on which American loans were granted to Germany were by no means easy. The total cost—expenses of issue, interest (and premium), and incidental expenses of debt service—will annually average about  $9\frac{1}{2}$  per cent of the net proceeds to the borrower. There has recently been some discussion about the fairness of those terms. A German nationalist paper had emphasized that the American bankers who were so eager to help Germany are lending her only at unjusti-

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fiably high rates whereupon a well-known American expert had refuted this contention by pointing to the fact that German domestic loans are issued at prices yielding materially in excess of corresponding issues sold in New York. But the problem of the fairness of lending terms is too intricate to be solved by ironical attack and by ironical defense. It is evident that when an American banker purchases a German loan he wants to sell it as quickly as possible and at a good profit. His earnings do not depend on a high rate of interest nor on a low price of issue. Once he has purchased the loan he is even interested in a high price of issue and in any event he must offer better terms to the borrower than he would get at home.

But when all is said and done, there remains the uncontrovertible fact that grave and minor abuses have been committed in the past in connection with the issue of German loans. A few examples may serve as an illustration. According to the *New York Times* of November 30, 1926, underwriters for the \$25,000,000 issue of notes and debentures by the Stinnes interests of Germany were forbidden by the State Public Utilities Commission to sell the securities in Michigan, because the plan called for a bonus or commission of 500,000 shares for the underwriters, which they

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proposed to sell at \$20 a share. This payment to the agents was considered as excessive, and in the opinion of the Michigan Securities Commission the sale of such securities might work as a fraud upon the public. Another case: The 7 per cent bonds of a Bavarian public utility corporation were issued at  $97\frac{1}{2}$  per cent, while the actual yield to the borrower was only  $82\frac{1}{3}$  per cent; here again the borrower may not be the only victim of the transaction, and the investors who paid  $97\frac{1}{2}$  should at least have been informed at what terms the loan was contracted. It would lead me too far to discuss here all those minor items which enormously increase the burden of the German borrower. A detailed analysis has been given in a volume published last year by the Institute of Economics. That some of those expenses are perfectly superfluous can be easily ascertained by any reader of the financial section of the daily press who will take the trouble of comparing the size of the redemption notices for domestic and for foreign loans.

4. Heavy as the terms of many American loans to Germany may be, if measured by the yield to the borrower, the total amount so far involved is not of a size as to make it doubtful that almost every borrower would be able to raise the funds

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necessary to fulfil his obligations when they become due. But it is, of course, not possible to foresee whether, if no further credits are granted, all borrowers of American loans would find sufficient foreign exchange to transfer the principal. All depends on who in such an emergency will get hold of the scarce available foreign exchange: the Agent General for Reparation Payments, the debtors to the United States, the debtors to other foreign countries, the would-be importers of commodities, or who else? There has been a great deal of discussion on the question of priority as between Germany's reparation obligations and the service of her foreign loans. But in all this discussion the legal side has been overemphasized. The Transfer Committee, doubtless, will maintain its claim of priority for reparation payments against the German state loans, but otherwise it probably will hold true what Roland W. Boyden, the former American Observer with the Reparation Commission, said in a recent article in *Foreign Affairs*:

I repeat that in this matter the legal technicalities are really unimportant. The fundamental safeguard is the fact that it would be financial folly for anyone to place obstacles in the way of providing exchange for the service of any of these foreign loans. Reparation payments are dependent on Germany's credit. Germany's credit is bound up with them, and any failure to meet them would destroy that credit.



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If, then, the American loans to Germany are kept within reasonable limits as to amounts and as to terms, the American investors can feel pretty sure that practically all German borrowers, even in case America some day should stop lending, will be able to raise the funds necessary for the redemption of the principal and they may also expect that the transfer of the sums will not encounter unsurmountable difficulties.

5. What will be the effect of the redemption of the German credits upon the economic life of the United States? Germany, like any other country borrowing abroad, has used the proceeds of her foreign loans largely to pay for imports and must, like any other country redeeming foreign credits, curtail her imports or expand her exports. If, then, the United States should not lend to other countries the principal received from German borrowers, she would have to curtail her exports or expand her imports. A recent report of a New York bank described the situation very clearly by saying:

The transfer of sufficient capital to pay back the principal, without new foreign borrowings by the same or other debtors, would involve so heavy an importation of goods into the United States or into our foreign markets, such as South America and Asia, that this country could only receive it at the cost of domestic depression.

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Some weeks ago, an official of the American Federation of Labor vigorously attacked the transfer of American money to foreign lands where labor is cheap and plentiful and declared that American labor must adhere to the policy of opposing the use of American capital for competing foreign industries. He evidently assumed that foreign loans stimulate exports from the borrower's country. This may be true indeed for certain manufactured goods; but on the whole the foreign loans granted by the United States have stimulated imports into the borrowers' countries and, therefore, were rather beneficial than harmful to American labor. It may, of course, be that in the long run, American loans to a country like Germany will increase the country's competitive strength. But as long as Germany goes on borrowing in America, she will have a surplus of imports, and she can finally redeem her American loans only by a surplus of exports, that is, by successfully competing with American industry.

We thus reach the conclusion: If America continues to export capital to Germany, she will find there an open market for her commodities, the Reparation Plan will operate successfully, and the American savers will enjoy profitable investments. If America should stop lending, she would lose a

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good market, both for commodities and for capital, and reparation payments would become doubtful. But America cannot go on forever lending to Germany. Some day there must be a settlement. Some day America must be prepared to accept redemption with all its consequences.

**BACKWARD COUNTRIES AS A FIELD  
FOR INVESTMENT**

*By* **HENRY KITTREDGE NORTON**

## BACKWARD COUNTRIES AS A FIELD FOR INVESTMENT

The word "investment" readily suggests the placing of funds where they will bring a return—be it in interest, dividends, or profits—to the investor. There would be no interest or dividends or profits, however, if invested funds did not satisfy somebody's need or desire. In a great majority of cases—the exceptions are so few as to be negligible—money must be "put to work" in order to earn a return. Investment thus becomes a part of the universal economic process by which the world progresses, by which the well-being of its peoples is improved, by which civilization advances. It is this aspect of investment which I would ask you to bear in mind during this discussion. Not to the exclusion of the aspect of profits for the investor. That must not be forgotten. In fact it is quite a necessary factor. But after all, the chief function of profits from the broader economic point of view is to keep alive the incentive and furnish the necessary capital for continued investment. The really important thing is the constructive work which that employment of capital accomplishes.

I emphasize this aspect of the matter because

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it is only in the last few years that the United States as a nation has been called upon to give it any consideration. Before the World War the investment of American capital abroad was to only a slight extent a matter of national concern. Comparatively few individuals and banks were operating in the foreign field. These had indeed invested what seemed then the rather large total of \$2,500,000,000. In discussing foreign investment totals the figures run high, and on this account it is sometimes difficult to see them in proportion. The amount of our pre-war foreign investment does not look so large when we realize that over twice that sum, or about \$5,000,000,000, was at the same time invested by foreigners in this country. In other words we were a debtor nation to the extent of \$2,500,000,000.

It was perhaps natural that under such circumstances we should not have given much thought to investment except as a means of securing a profit. But the World War gave us an entirely new position in the financial world. I have no doubt that this matter has been gone into in detail at other sessions of the Institute, so I shall only summarize the change. By the end of the war we had canceled at least \$2,000,000,000 of what we formerly owed abroad and had loaned an additional amount.

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to other countries of upwards of \$9,000,000,000. We emerged from the war a creditor nation instead of a debtor nation. Not only were we a creditor nation, but we had become in less than a decade the second largest creditor nation in the world, Great Britain's foreign investment alone exceeding ours.

Had this condition been a merely temporary one, the effects of which were destined to pass as the war which caused it receded into history, we should not have been faced with some of the problems which face us today. But while the conflict was smashing into bits the economic structure of the old Europe, it greatly enlarged the capacity and increased the effectiveness of our own. The war left us the most powerful economic unit in the world. An enormous productive capacity, operating with a high degree of efficiency, not only satisfies the old wants of our people, but hundreds of new ones. And still we have a tremendous annual surplus which the people of other countries readily purchase from us.

This great economic activity entails a corresponding accumulation of capital. So rapidly is this capital accumulating that the mere matter of keeping it profitably invested becomes a problem in itself. Our gross national income is estimated at from \$75,000,000,000 to \$90,000,000,000 each year.

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About \$9,000,000,000 of this—roughly 10–12 per cent of the national income—finds its way as savings into the channels of investment. Demands for new capital in this country absorb \$7,500,000,000–\$8,000,000,000 of this sum. The remainder, let us say \$1,500,000,000, seeks investment abroad.

It is evident that, looking at the matter in its proper proportions, we are hardly overdoing the matter of foreign investment. As a nation we are saving and investing about 10 per cent of our annual income, and less than 2 per cent of our annual earnings are going abroad. Even if this foreign investment involved greater risks than it does, it would be no vital matter. If we should lose the entire amount we should not starve. The loss of our entire foreign investment at one stroke would undoubtedly send a jar through our economic structure, but we should manage to carry on with comparatively little change in our daily life. With our total national wealth estimated at \$400,000,000,000 we should hardly have to give up the struggle because we had lost \$10,000,000,000, or even \$20,000,000,000, 5 per cent at most.

Nevertheless the investment of \$1,500,000,000 abroad each year entails a somewhat grave national responsibility. In the first place \$1,500,000,000 is a great deal more money in any other country.



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than it is in the United States. For example, while it is only one-third of 1 per cent of our own national wealth, it represents 2 per cent of the national wealth of France, 4 per cent of the national wealth of Italy, 5 per cent of the national wealth of Japan, and probably as much as 1 per cent of the national wealth even of the United Kingdom. The power of this sum in the world's money markets is therefore much greater than we might expect from its comparative insignificance at home.

It is not in the developed countries—those which have reached economic and political maturity, such as England, France, Germany, Italy, and Japan—that the power of American money is most strongly felt. These countries have sufficient economic strength and sufficient financial experience so that they are quite able to take care of themselves. In dealing with them we deal more or less as equals, on somewhat the same basis as the banker ordinarily deals with his customers. With investments in such countries the emphasis is almost wholly on the financial aspects. Political considerations and relative military power play but a small part or none at all. There is of course the political aspect of the war debts, but this is a temporary matter which is gradually working itself out.

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In the main our transactions with such established countries—and this designation would include Canada and some of the more advanced countries of Latin America—are now, and will be more so in the future, on a purely credit basis. We lend the money and rely upon them to put it to work in such a way that it will earn sufficient to pay principal and interest, with such additional advantage to the borrowers as they are able to obtain from the use of it.

Such countries absorb roughly two-thirds of the amount the United States has available for foreign investment each year. The remainder of our foreign loans goes to countries of a different type: countries which are at the beginning of their economic development, countries with far less political stability, countries in a state of national immaturity—in short, “backward” countries. Investment in such countries creates peculiar problems—problems in which political and even military, as well as financial, power are involved. Under such conditions the question of the investment of American funds assumes from the national point of view a quite different aspect from that which it has in developed and stable countries.

In this connection a change has taken place which is not yet fully appreciated. We do not

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have to go back many decades to find a time when the capitalist and the laborer were generally assumed to be engaged in an eternal struggle for the profits of any enterprise in which they were jointly concerned. This assumption created an atmosphere of hostility, a psychology which warranted each side in securing all it could by force or by fraud. Out of it arose the sorry history of the long-drawn conflict between capital and labor.

When the surplus profits of capital caused its owners to seek new fields of activity outside the borders of their own country they carried this psychology with them. They sought opportunities in parts of the world which promised larger returns than could be had at home. And all too often they availed themselves of their combative psychology to justify the use or abuse of power to multiply their profits.

Foreign investment so conceived was of course sheer exploitation. If white men armed with rifles could go up the Congo River and force the natives to collect and deliver to them huge quantities of rubber for which the whites paid little or nothing, it was a profitable investment to equip gangs of white gun-men and send them up the Congo to collect rubber. An expedition of this kind was the first crude capitalistic method of accomplishing the

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same ends which led Hernando Cortez and his joyous brigands to slay the Aztecs and take their gold and lands. It was the early capitalistic interpretation of the same spirit which has inspired other conquerors from the dawn of history.

The process of refinement set in almost at once. Foreign traders secured "treaties" from black, brown, and yellow chieftains. These treaties were elaborate documents of whose contents the chieftain was wholly ignorant and on which he saw no objection to placing his mark in return for a few European baubles. He did not know, until the foreigners moved in and began to order him about, that he had signed a document which under the incomprehensible foreign law had made his country a "protectorate" of this or that European power. He did not know that somebody in England or Holland or France had made an investment in a backward country. But if he attempted to assert his former rights, or avail himself of his former privileges, he promptly discovered that the foreign law provided for the invasion of foreign troops to protect the claims—be they ever so outrageous—of the foreign investor.

It is not necessary to rehearse the whole story of aggressive imperialism. It is sufficiently well known and sufficiently depressing. This type of

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imperialism has succeeded in bringing under the domination of several white powers and Japan vast areas of the earth's surface and hundreds of millions of people. What we must avoid is the easy assumption that because such things have happened they are always going to happen, and that any participation of one country in the life of another is necessarily and always aggressive imperialism. Such an assumption, with all its background of benevolent sympathy for oppressed peoples, may hamper and retard a process highly beneficial to the peoples concerned by utterly misjudging it and misbranding it with the abhorred mark of imperialism.

Aggressive imperialism was a natural expression of the earlier "Capital versus Labor" psychology. We have had plenty of that psychology in this country and we still occasionally find politicians and others who linger in the thought world of the nineties, reviving the old charges and shouting the old battle-cries. But the process of amelioration went on, until today even imperialism has been robbed of most of its terrors. America in particular has achieved a new viewpoint. The new industrial psychology in this country has not only been a cause of gratification to Americans, but a source of wonder to innumerable foreigners who

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have studied our post-war development. The capitalist and the laborer in this country have learned that by working a little closer together and a little more efficiently they can each secure a larger return than either would have had if he had been able to obtain the whole body of profits under the old system in which production was a sort of by-product to a running fight. The psychology of cooperation and collaboration has so largely replaced the old psychology of combat that this new attitude has become a distinguishing feature of our national life. Vestiges of the old psychology still linger. We have our strikes and our lockouts, and shall have them occasionally until the old-style capitalist and the old-style labor leader have gone to join their pugnacious forefathers. But such struggles are destined to become less frequent and less bitter as the new conception penetrates into all corners of the industrial life of the country.

There is nothing sentimental about this new attitude. It is prompted by no spirit of self-sacrifice. It is simply a belated appreciation of the fact that there is more in it for everybody on this basis than any other. It is very fairly described by a term which is often used in referring to it—"enlightened self-interest."

This more mature attitude is quite as discern-

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ible in banking circles as in the industrial field. In fact it may have had an even earlier start in the banking world. Money-lending long ago ceased to be a matter of advancing money on a mortgage with the half-suppressed hope that foreclosure would be necessary. Modern bankers are thoroughly imbued with the idea that greater returns are to be had from building up prosperous businesses than in foreclosing on unprosperous ones. I think the same spirit of collaboration is fairly general among our international bankers. Certainly the outstanding leaders in this work are thoroughly convinced of the value of co-operation in bringing about a general economic development. The old spirit of domination and exploitation has been quite abandoned, not necessarily because it was morally wrong, but because it was economically unprofitable.

In backward countries these new ideas are put to the test. These countries differ considerably among themselves. China and Mexico, for example, are both considered "backward" countries. Mexico is backward, economically speaking, because its vast natural resources have not been developed to the point where they are capable of giving the people of Mexico an adequate living standard. These people themselves are socially

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immature, and their social and political institutions are consequently unstable. China, on the other hand, is "backward," not because of a *lack* of development, but because of a rather high development along lines incompatible with the present industrial life of the world. Inherited economic methods, deeply rooted social institutions, and an inflexible political system are all breaking down because of this lack of adjustment. Reconstruction is necessary, and this reconstruction must, as in the case of Mexico or any other backward country, reach into the economic, social, and political life of the people.

There is probably no people in any backward country of the world which is not ardently desirous of improving its standard of living, of securing a larger measure of the material things of life, better houses, better food, better clothing, a kerosene lamp, a sewing machine, a victrola. It is all very well to look with scorn upon such items as merely material, but nevertheless it is human nature to want them. Individuals may reach a high degree of spirituality by ignoring earthly wants. But among peoples the higher things of life are apt to have a fairly secure economic basis.

These countries, then, desire their own economic development. They want to apply modern sci-



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tific methods of agriculture to their land, to the exploitation of their mineral resources, to their transportation systems, and to such commerce as they may possess. For all of these things capital—ready capital in large quantities—is necessary. Something may be said for the desirability of proceeding slowly and letting a backward country produce its own capital and do its own development work. Mexico on this basis might, for example, reach a desirable state of economic development in the course of the next century. But that process, whatever its value in the cold light of reason, has no vital charm to the people of Mexico today. They themselves want to participate in the increased well-being which is to come from such development. They want their children to have an even more generous share. And be it said that this desire is not wholly material. The desire for better education for their children is perhaps quite as insistent as the desire for victrolas. So it is with all peoples in backward countries. The only way they can do this is by importing capital. The United States has reached its present position with very considerable help from foreign capital. Australia, Argentina, Uruguay, Japan, all have borrowed heavily abroad and achieved a more rapid rate of progress on that account.

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With half a billion dollars accumulating in the United States every year over and above our running expenses, our own capital needs and the credit requirements of the developed countries of the world; with great areas such as China, Mexico, Central and South America earnestly desiring funds for development, the investment of these moneys in such backward countries is hardly to be avoided. It would be very delightful if loans to such countries could be made on the same credit basis as we make loans to England or Germany. But until we remold the world closer to our heart's desire this cannot be the case. The people of these backward countries are, from the point of view of modern industrial civilization, socially immature. They have had no experience in handling large sums of money. They are without established traditions of financial trusteeship. They have developed no national credit to inspire confidence in investors. Their social institutions are so weak as to be subject to disruption by any ephemeral social theories which happen to come their way.

This social immaturity finds its most frequent expression in political instability. The institution of government has not settled down into the habits of the people sufficiently to withstand the onsets of personal ambition. Nor, if this disrupting factor

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were wholly eliminated, has any form of government become so rooted that it is not in constant danger from movements induced by imported doctrinaire political theories which promise much to tempt the inexperienced populace.

Let us take Mexico as a specific example. Much has been said of the exploitation of Mexico by foreign capitalists. And there is no contesting the fact that foreigners have taken enormous profits from Mexican investments. On the other hand it must be conceded that foreign financed industries in Mexico have brought great returns to the people of that country. Wages have been raised. The standard of living has been improved and, by and large, the Mexican people are better off materially than they would have been if no foreign capital had ever come into Mexico. Nor can any impartial observer examine conditions in that country without soon convincing himself that only a beginning has been made. There is a crying need for capital in every direction, not only for roads, railroads, irrigation dams, and other large developments, but to furnish the individual farmer with the necessary machinery and equipment to enable him efficiently to work his land. And above all, there is the need for schools and more schools. Expenditures for all of these purposes would repay the people

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of Mexico many times their cost if the money were available.

Surely Mexico then offers a most desirable field for the investment of a share of our annual half billion dollars which is to be devoted to backward countries. Let us suppose that a half billion dollars were loaned to and invested in Mexico on the same financial basis that a similar sum might be loaned to and invested in Germany. What would be likely to happen?

The present government of Mexico happens to be made up of a fairly intelligent and reasonably patriotic group of men. We may even assume that their character is such as would warrant the placing of a half billion dollars under their unsupervised control. We may assume, further, that they would intend to expend the money advantageously on constructive projects which would sufficiently increase Mexican productive power to enable the country easily to make the required payments on the loan.

The present Mexican government, however, like all of its predecessors since Mexico became a Spanish colony four hundred years ago, rests upon military force. Aside from any other good or bad qualities which it may possess, it is a dictatorship and is subject to all the inherent weak-

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nesses of dictatorships. Some unexpected turn of events may at any time throw the forces opposed to the government into a coalition sufficiently strong to overthrow it. A government resting upon force is a continuing invitation to restive ambition to overthrow it by force. This invitation operates within the controlling group as well as outside it. Disruptions caused by intrigue or rivalries in government circles themselves may bring about its downfall.

If after a successful revolution a new government succeeded to power, which would take over the administration of the half billion dollars and handle it with equal ability and integrity, no great harm would be done. Such revolutions have occurred in established countries without loss to foreign creditors. But Mexico is not an established country. Continuing to assume the honesty and capacity of the present government, we may picture the funds passing intact to its revolutionary successor. This successor being unnamed and unknown, we may ascribe to it ideals and habits which it would be indelicate to ascribe to an existing government. That successor being also a dictatorship would be conscious of its limited lease of life. It would not be unduly invidious to suppose that the men who compose it would do what men

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in a similar position in Mexico and other American republics have repeatedly done before—take advantage of their governmental sojourn to deposit as large a sum as possible in banks in Paris, London, or New York against the day when the next revolution may send them abroad for their health. Under such onslaughts even half a billion dollars would not last long. The precedents suggest that their successors would find the treasury empty. Taxes would have to be levied on the Mexican people for years to come to repay a loan which had not served to increase the productive capacity of the country in any appreciable degree.

I use Mexico merely as an example. This sort of thing has not actually happened in Mexico on any large scale because the Diaz régime was fairly dependable in such matters and the succeeding governments have not been successful in borrowing. It has happened, however, on numerous occasions in other Caribbean countries and it has happened in China. It has given rise to a system of financial control which has been applied to a number of Caribbean countries—a system which has been subjected to considerable criticism. These criticisms are worth examining.

Faced with such a breakdown of ordinary credit, investors would have to choose between refusing

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to make further loans to backward countries and finding some method to insure the proper application of the funds loaned and the honest handling of governmental income from which they were to be repaid. If all investors refused to make further loans it would not only mean the loss of a large investment field with a consequent intensification of competition and a lowering of interest rates elsewhere, but it would mean an even greater loss to the people of the backward countries by depriving them of the capital necessary for advancement.

When applications for loans are received from such countries, then, the financiers reply that they will only make loans on condition that expenditures therefrom shall be made under the supervision of their own agents and that certain sources of national revenues—usually the customs-houses, but sometimes railroads, telephones, telegraphs, sometimes internal taxes and sometimes government banks—shall be placed under the administrative control of such agents.

Millions of dollars have been borrowed by backward countries under these conditions with results highly beneficial to the people of those countries. Huge sums have been properly expended in constructive projects. An honest administration of the national revenues has, without raising taxes,

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often produced a large increase in government income. In the Dominican Republic, for instance, an American receiver took charge of the customs-houses in 1905. The expense of his administration was not to exceed 5 per cent of the revenue collected. Fifty per cent of this revenue was to be applied to the service of outstanding debts. The remaining 45 per cent was to go to the government. No sooner had this arrangement gone into effect than it was found that the national treasury was receiving more from the 45 per cent than it had received from a supposed 100 per cent under Dominican administration. It received so much more, in fact, that the opponents of the government immediately started a revolution so that they might have the opportunity to handle the extra money. But that is another story.

The point is that financial control of this kind, even though it does somewhat limit the activities of the military politicians, does as a general thing redound to the benefit of the people of the country concerned. Yet ardent devotees of the theory of national sovereignty vehemently condemn such control as an infringement of the sovereign rights of a small country. It is domination by a great power. It is financial penetration. Nay, it is that ghastly thing—imperialism!



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Call it what you will, but let us not be frightened by the calling of names. Whatever it is, it is a process which is lifting the peoples of backward countries out of the slough of poverty and degradation and bringing to them such benefits as modern civilization can confer. These may not be great, and unquestionably the process has its attendant evils. But the alternative is to let the backward peoples stew in their own juice, a juice pressed out by revolution, military despotism and unconscionable exploitation by native tyrants. It is all very well to say that these people should be allowed to work out their own destiny just as the more advanced peoples have done. It has taken centuries of suffering and infinite bloodshed for even the more advanced peoples to reach their present status. Why should the backward peoples be condemned to travel the same road when there is now available a shorter and easier path to the goal? We do not leave our children to themselves and adjure them to work out their own destiny. We assist them, we educate them, we restrict them, and we sometimes punish them—all in a process of training which enables us to transfer to them the responsibilities of life as they are able to carry them. I am quite familiar with the resentment which flushes the face of the mature, educated,

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and cultured representative of a backward people when the suggestion is made that his countrymen should be treated as children. But such resentment is quite uncalled for. We were not all born at the same time, nor had we all the same opportunities. While each of the Caribbean countries has a small minority of people quite capable of taking an honored place in the foremost ranks of civilization and culture, the fact remains that the great mass of the people of these countries do not possess such qualities. As a result these nations are politically immature. They require tutelage as a child requires tutelage. And, in the absence of natural parents, such tutelage must come from the more mature of the neighboring nations.

The training of a child involves grave responsibilities. The training of nations, in the complete absence of the natural ties which bind parent and child, involves still greater ones. And it is the discharge of these responsibilities in practice which leads some idealistic persons to advocate the complete abandonment of the task.

It must be admitted that the task has its disagreeable aspects. In the first place we are charged with hypocrisy and self-interest because Americans make money out of the financial transactions involved. Yet this seems not nearly so serious as it

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might be. American investors do receive interest on their money. But they also receive interest on moneys invested at home or in other established countries. The Middle Ages looked upon the taking of interest as a crime. But the world has long since learned to regard it as a highly useful factor in the progress of civilization. If no interest were received on investments in backward countries, there would be no such investments. And we should be back where we started.

Nor should the fable of enormous profits be taken too seriously. It is a familiar charge that international bankers make loans in backward countries at a high rate of interest to compensate for the risks involved, and then, by using the naval and military forces of the United States to insure payment, eliminate the risks. This is, of course, simply not true. It is based upon the myth that "Wall Street" is some mysterious entity which works under a unified command to strip the rest of the world of its goods. A myth is a persistent thing. You can destroy a reality, but there is no way to kill a myth. As a matter of fact, competition is probably as keen in Wall Street as anywhere in the world. It is quite improbable that any bank or group of bankers could make loans at exorbitant interest rates without immediately

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having to face the competition of a dozen other groups. Interest rates would immediately descend to a figure consonant with the real risks and labor involved. That loans to backward countries should bear a somewhat higher rate of interest than domestic loans or loans to established countries is natural. If the rate were the same, there would be no money available for the backward countries. Investors would not go to the trouble of arranging and supervising the necessary controls unless the return was enough higher to cover the cost of such administrative measures. Again, a slight enhancement of the interest rate is necessary to tempt the investor's money to leave its own country. All this, however, is simply a part of a legitimate cost of developing a new country. The United States, Australia, New Zealand, Japan, Argentina, Uruguay, all have paid it. Some of them are still paying it. The fact that Americans "make money" in this way cannot fairly be criticized. It is a part of the general economic development in which all share. And in every case the greatest share from this economic betterment goes to the people of the country concerned in the shape of increased wages and higher living standards.

Other aspects of the system of administrative control in backward countries are still more un-

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pleasant. The typical political adventurer in a backward country has little more regard for a loan contract providing for such control than he has for the repayment of the loan itself. He would have no hesitation in driving out the administrative officers in order to get his hands on the funds in their charge. Only by a fantastic extension of the theory of national sovereignty is any violation of that sovereignty entailed in resisting his efforts. The people of the country—in whom the sovereignty is supposed to reside—have no more sympathy with his depredations than have the investors concerned. They are, in fact, fellow-victims of a practice which might well be classed with piracy, as an international crime. But the people of the country are powerless to resist the military adventurer. The investors, being reasonably law-abiding people, cannot organize military forces of their own to defend their interests against these depredations. The investor's government however—at least in the case of American investors in Mexico and the Caribbean area—has a double interest in the matter. It is interested in general in the preservation of law and order and the protection of its citizens abroad. It is specially interested in the maintenance of stable government and orderly conditions in the neighborhood of the Pan-

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ama Canal. When some politico-militarist breaks loose in this region and threatens to set the wheel of revolution once more awhirl, the United States readily responds to the call of its nationals for protection. It may send a battleship, it may land marines, and it may get itself mixed up in something closely resembling a small war before the matter is straightened out. The cost of the operations will be considerable. It may on occasion exceed the value of the interests immediately involved. But that is no reason for not undertaking the task. I suspect the cost of maintenance of all the police forces in the United States is considerably larger than the total sum lost by robbery and theft each year. Yet no one in his senses recommends discontinuing the police forces and using the money thus saved to reimburse those who suffer such losses. The cost of reimbursement would soon far outrun the cost of maintaining the police, to say nothing of the incidental passing of the secure and orderly life of the community.

The failure to uphold law and orderly procedure in the backward nations of the Caribbean would be just as costly in the long run. And we should again be faced with the alternative that those countries would be left to continue their turbulent existence as a drag upon civilization.

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We have been discussing these matters in connection with loans to backward countries. Very much the same reasoning applies to other types of investment such as those in industries, railways, mines, and oil wells. Investments of this kind may pay handsome profits to investors. But in every case the greater part of the return from the operations is distributed to the people of the country in wages and the purchase of supplies. Such investments must be protected in exactly the same way and by exactly the same means as investment in government loans. Furthermore, where American money goes into a backward country, American managers and superintendents go with it to supervise its application in the same manner in which American administrators are sent to supervise government loans. These American citizens usually take with them their wives and children. While the attitude of these expatriates toward the people of the country in which they live is not always such as to commend itself to a philosopher, they are nevertheless performing an important service in the building in that country of a new economic structure by which the people of the country will greatly benefit. In the event of an upheaval in which American interests are threatened, there is thrust upon these expatriates the

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duty of protecting and preserving the properties committed to their charge. Their lives are at once endangered. And the United States is called upon to protect them. American citizenship would be worth little outside our own borders, Americans could take little part in the reclaiming of backward areas, if the government did not respond by sending them the protection necessary.

Sometimes adequate protection requires a very considerable military force. It is held up to us as absurd to send four or five marines to Nicaragua for every American who resides there. The naïve suggestion is made that it would be cheaper to furnish passage home for all the American residents and withdraw the marines. But the United States is concerned in such cases not solely with the protection of American citizens, nor yet with the control of a dangerous situation in the immediate neighborhood of the Canal. It is concerned also with the preservation of its rights, the rights of its citizens, and the establishment of a reign of law in Nicaragua. This may involve considerable effort and expense. But if civilization has any lesson for humanity it is that the establishment of a reign of law is well worth whatever it costs.

It seems to me quite evident that the investment of capital in backward countries is not only



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a legitimate, but a desirable, proceeding. It seems desirable even in view of the unpleasant duties that sometimes go with it. Nevertheless the exercise of unlimited power by one country over the people of another may readily open the door to abuses of the gravest character. If, for example, the power of the United States Navy should be used to force the government of some Caribbean country to sign a loan agreement giving exorbitant profits to some banking house favored by the government, and if the government continued to use its naval power to enforce the repayment of such a loan according to the letter of the bond, there would be ample cause for complaint on the part of the Caribbean people concerned—and on the part of the American people. The existence of such a situation is frequently assumed by critics of our so-called imperialism. But in order to support the charge they have to select their facts with great discrimination. We enjoy a competition for news as keen as the Wall Street competition for foreign loans. If there were any unholy alliance between the State Department and the international bankers, the evidences of it would be strewn broadcast. It would not only make marvelous “news,” but it would furnish unending grist to the mills of editorial criticism in newspaper offices opposed to the

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administration which happened to be in power. And yet, with the exception of a few ultra-radical periodicals whose editors dream awesome nightmares to solace their restive souls, we find very little to support the charge of an unholy alliance between Washington and Wall Street to rob the people of the Caribbean.

Nevertheless, such an alliance might be made, and we as a nation should be on the alert for any indication of a tendency on the part of the government or investors to abuse the national power in the interest of high profits. It is not unduly sentimental to consider our enormous capital reserves as in a very realistic sense a trust of civilization. That trust requires that we should not misuse the trust fund to our own advantage. The same trust, however, requires that the fund should be used for the advancement of civilization, not as a charity or a gift, but in the ordinary processes of economic development. Nowhere is there greater need for such development than in the backward countries of the world. Despite the awkward responsibilities and the unpleasant duties which may be thrown upon us as a nation in connection with investment in such countries, we shall hardly be playing the part assigned us in the progress of humanity if we lock our coffers against the backward peoples.

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There is no need to forego the advantages the use of these funds might bring to both them and us for fear that they—or we—might abuse our trust. The problem of backward countries as a field for investment is the problem of finding at one and the same time adequate restraint for them and adequate self-restraint for ourselves.

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