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INTRODUCTION

1 *Current Opinions on Foreign Lending*

The United States is now entering its second major period of foreign lending. It is, at present, the only country with the capacity for large scale foreign investment with private or public funds, and the greater part of the world needs its economic aid. The resumption of foreign lending creates a host of problems, political and economic, which are being widely discussed. This study does not deal directly with these problems. We treat only past experience but hope that by re-opening the past and by presenting what happened in a new light we may contribute indirectly to the understanding of current problems.

Probably most economists agree that the United States should export capital.¹ However, except for purely political loans, this is considered desirable only on the assumption that foreign lending will be more successful than in the twenties, that the investors' sad

¹ To quote only a few representative opinions:

"A progressive, dynamic world economy on a multilateral basis cannot be reconstructed without the resumption of productive foreign investment." Report of the Committee on Foreign Economic Relations, appointed by the Twentieth Century Fund (Norman S. Buchanan and Friedrich A. Lutz, *Rebuilding the World Economy*, 1947), p. 305.

"On the basis of the replies received it may be said that economists believe that a reasonably large outflow of capital is desirable for broad economic and political reasons. About 90 percent of the replies support this view." Results of a poll conducted by a Committee of the American Economic Association, *Papers and Proceedings*, May 1946, p. 240.

"In the world such as we find it foreign long-term lending is another essential prerequisite for the successful operation of a stable international currency system." Ragnar Nurkse, *International Currency Experience* (League of Nations, 1944), p. 202.

"It is both natural and logical that American capital should resume investment activity abroad." H. B. Lary, *The United States in the World Economy* (Department of Commerce, Economic Series No. 23, 1943), p. 19.

experience with foreign loans will not be repeated.² Will this be possible and how can it be achieved? The answer depends partly upon one's interpretation of the past.

According to widespread popular opinion almost all the American money invested in foreign loans has been lost. Experts know, of course, that this is not true. In their excellent and comprehensive investigation of foreign lending J. T. Madden, Marcus Nadler, and Harry Sauvain find: "The fact is that interest has been paid in full, through the longest and most severe depression of modern times, on almost two-thirds of all the foreign bonds currently [December 1935] outstanding."³ Although losses on foreign bonds were smaller than generally believed they were large enough to constitute a grave problem. Investors cannot be encouraged to buy foreign bonds again unless there is reason to expect that the outcome will be better. What are the chances for such an improvement?

The answers experts offer differ according to the factors they hold mainly responsible for past defaults and their views on the possibility and probability of removing or controlling such factors in the future. Many factors conducive to defaults on foreign loans have been revealed and discussed, factors so numerous and powerful that the reader is sometimes surprised to find that two-thirds of all loans remained safe and sound after all.

First, there are factors inherent in the loans themselves. A large number of foreign loans, undoubtedly, were mistaken *ex ante*, i.e., had they been carefully weighed in the light of then prevailing

² "The world would do well to avoid, even at considerable cost, another debacle of defaults and repudiations, replete with recriminations and strained relationships, such as followed upon the last upswing in American foreign lending in the twenties." Norman Buchanan, *International Investment and Domestic Welfare* (Holt, 1945), p. 120.

"To establish a sounder foundation for foreign lending in future is therefore one of the two or three most important reforms the world needs. . . ." Sir Arthur Salter, *Recovery* (London, 1931), p. 128.

³ *America's Experience as Creditor Nation* (Prentice Hall, 1937), p. 136. See also Cleona Lewis, *America's Stake in International Investments* (Brookings Institution, 1938), p. 398: "Of the existing foreign bonds that were originally issued here during the prosperous twenties, around 35 to 40 per cent are now [1935] in default."

conditions they would never have been granted. Second, other loans were basically sound, and were defaulted only because of the sudden termination of foreign lending and the general depression. These have been termed bad investments *ex post*.⁴ The factors responsible for *ex ante* bad loans have frequently been deemed relatively unimportant. "Under the combined influence of the fall in business activity and in prices, the imposition of the tariff of 1930, and the cessation of new foreign investment, the total amount of dollars paid out by the United States to foreign countries fell from 7,400 million dollars in 1929 to only 2,400 millions in 1932. At the same time foreign countries had contractual debt-service payments of some 900 millions due to the United States each year. Under such circumstances it was inevitable that many of these obligations should be defaulted. By comparison with the magnitude of these strains, all other explanations of the relatively unsatisfactory outcome of the past foreign lending experience of the United States must be of distinctly secondary significance. It is for this reason that I have not attempted to appraise in detail the results of this experience in analyzing future possibilities. . . ."⁵

This emphasis on the transfer problem leads to the view that the success of future loans is predicated on two conditions: American capital must be exported at a stable rate in order to prevent sudden reversals in the balance of payments of debtor countries; and American imports must be expanded in order to assure the service of new foreign loans through an adequate supply of dollars. Opinions differ as to whether these conditions will be met in the future.

2 Nature of the Study

We approach foreign lending from a different angle. Rather than focus attention on the economic conditions prevailing when foreign

⁴ See Ragnar Nurkse, *Internationale Kapitalbewegungen* (Vienna, 1935), p. 210. For an enumeration of factors inherent in the loans themselves see, e.g., Cleona Lewis, *op. cit.*, pp. 403-10.

⁵ H. B. Lary, American Economic Association, Papers and Proceedings, May 1946, p. 683. See also Madden et al., *op. cit.*, p. 166: "The transfer problem . . . must be regarded as the principal cause of the defaults on foreign dollar bonds during the 1930's." The same view is expressed in *International Capital Movements during the Inter-War Period* (United Nations, 1949).

loans were defaulted, or deal with the impact of the great depression on outstanding loans, we investigate the relation between conditions at the time of issue of the loans and their quality, their ability to stand the test of depression. Defaulted foreign loans have hitherto been analyzed with reference to time of default, type of borrower (government or private), and form of lending (portfolio or direct); the time of lending has virtually been ignored. The customary treatment considers foreign loans as if they had been parts of one great investment project instead of a sequence of individual investments. This is grossly inadequate if the quality of the loans changed drastically.

Current judgments on American experience with the foreign loans of the 1920's might be refined and corrected if more attention were paid to the general economic situation at the time of their issue and its influence on their character and soundness. The main period of foreign lending, 1921-29, was marked by an extraordinary expansion of financial activity, mounting in three successively higher waves and culminating in the 'speculative mania' of 1929. Is it not probable that new foreign loans reflected this? Should we not expect the quality of foreign loans to change during such a period, to deteriorate as speculation increased and the boom swelled? And if it did change in any considerable degree would not that affect our judgment and evaluation of the experience with foreign lending?

Though we deal exclusively with American foreign lending, the analysis may have a wider bearing. As far as we know, fluctuations in the quality of new investments of any kind have seldom been investigated empirically. One exception is R. J. Saulnier's study of urban mortgage loans. Another is G. W. Edwards' analysis of domestic bonds. Both studies are described more fully in Chapter 2. Otherwise, although business failures and defaults have been related to various factors, including conditions at the time of failure, little if any attention had been paid to conditions at the time of investment.

Yet fluctuations in investment quality appear to be relevant to the understanding of economic change, particularly the business cycle. Deterioration in investment quality may be one of the factors

implicit in such terms as 'over-optimism', 'reckless speculation', 'boom psychology'. It may prove to be one of the maladjustments that, as in Wesley C. Mitchell's or Gottfried Haberler's theories of the business cycle, develop during expansion and contribute to the downturn.

More specifically, decline in investment quality between 1921 and 1929 would fit well into Arthur F. Burns' and Wesley C. Mitchell's hypothesis regarding major cycles,⁶ this period being the expansion phase of one of these major cycles. Their argument runs as follows: "After a severe depression industrial activity rebounds sharply, but speculation does not. The following contraction in business is mild, which leads people to be less cautious. Consequently, in the next two or three cycles, while the cyclical advances become progressively smaller in industrial activity, they become progressively larger in speculative activity. Finally, the speculative boom collapses and a drastic liquidation follows, which ends this cycle of cycles and brings us back to the starting point." When people become "less cautious" the proportion of unsound investments is likely to increase in various fields.

As an instance of explicit reference to the deterioration of new investments, we may note J. A. Schumpeter's discussion of cyclical expansions, which are characterized in his view by the development of "reckless, fraudulent, or otherwise unsuccessful enterprise, which cannot stand the tests administered by recession."⁷ The importance Schumpeter attributed to this factor is evident in his diagnosis of the great depression: "I submit that, given . . . depressive tendency and supernormal sensitivity, the following facts constitute adequate explanation of the 'disaster' in the United States.

The first fact is the speculative mania of 1927-29. . . . The second fact was the weakness of the United States banking system. . . . Third in importance was the mortgage situation, both urban and rural. Again I maintain that its most serious features were entirely due to reckless borrowing and lending; that is to say, to

⁶ Arthur F. Burns and Wesley C. Mitchell, *Measuring Business Cycles* (NBER, 1946), p. 460.

⁷ *Business Cycles* (McGraw-Hill, 1939), I, 148.

avoidable deviations from normal business practice. The explanatory value for the crisis of this element is ten times as great as that of the most elegant difference equation."⁸

Extensive investigation would, of course, be required to obtain measurements of quality fluctuations in major fields of investment. By endeavoring to obtain some new insights into one historical experience, the foreign lending of the twenties, we hope to make a modest contribution to such a broad collection of evidence.

3 Some Remarks on Our Findings

The statistical analysis in Chapter 2 shows how greatly the quality of new foreign issues, as measured by the proportion that subsequently defaulted, deteriorated during the 11 years 1920-30. For example, only 6 percent of the issues of 1920 went to borrowers who defaulted in the 1930's while 63 percent of those of 1928 suffered this fate; and of all loans issued in the 5 years, 1920-24, only 18 percent went to borrowers who defaulted in the 1930's while for 1925-29 the ratio is as high as 50 percent.

If we consider the impact of unsound loans upon sound ones it is even more striking that issues of the early twenties fared so much better in the crisis than later issues. "Supposing . . . that a modest and useful loan had already been issued to, and on the credit of, a particular country, and utilized for the most productive purposes; the subscriber would still lose if later and wasteful loans disorganized the public finances [of the borrowing country] and compelled default."⁹ Among the defaulted issues of the early twenties some "modest and useful" loans were doubtless defaulted because of later wasteful ones. Consequently, the difference between the outcome of early and that of later loans reflects only a part of the difference in their original qualities. It is the more significant that 82 percent of the loans of the early period remained sound.

The big variations in loan quality and the satisfactory outcome of early loans cannot be explained by transfer difficulties, since

⁸ *The Decade of the Twenties*, American Economic Association, Papers and Proceedings, May 1946, pp. 8-10.

⁹ Salter, *op. cit.*, p. 123.

dollar scarcity in the thirties affected loans of 1920 as much as those of 1928. Nor can they be explained by the other factors held responsible for adverse results of American foreign lending, such as: "our ineptness at this type of business",¹⁰ "the very nature of capital accumulation with the assistance of foreign borrowing", etc.¹¹ Factors that might explain the adverse results of lending in general do not suffice to explain differences in the outcome of loans issued at different times. They must originate in other forces which have so far received less attention.

The evaluation of American experience with foreign lending may be modified by our findings. One group of experts indicts the granting of credits between the two world wars as a complete mistake; another deems it on the whole sound and reasonable and holds the great depression solely responsible for its failure. Both views must be corrected if most foreign loans floated in the early years after World War I were sound and most of the mistakes were made in the later twenties, abnormal years in many respects. In the future it might be possible to improve results of foreign lending by applying the methods of the past successful times while avoiding as far as possible those of the years of unsuccessful lending.

¹⁰ Wesley C. Mitchell, NBER, *24th Annual Report*, 1944, p. 26.

¹¹ Buchanan, *op. cit.*, p. 116.