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Chapter 6

An Interpretation

We shall now attempt to interpret the statistical results, to uncover their meaning by supplementing the statistics with an analytical description of foreign lending. The forces at work in the process of credit deterioration are often dealt with under the elusive title of 'optimism'. However, this is no more than a label and tells little about what really goes on. We shall try to dig a bit deeper and to reveal the interplay of factors hidden behind 'optimism'.

Though our analysis is confined to foreign loans and to a short period its relevance need not end there. Its results may well reveal some features of credit expansion in general. If so, it may contribute to the understanding of business cycles.[1]

1 *The Picture of Change*

THE EARLY DAYS

The early part of the period under review begins with the end of World War I. No exact date can be set for the end of this period or the beginning of the 'late period'. It depends upon the particular borrower and lender in question. Roughly 1920-24 may be called the early period, 1925 brought the transition, and 1926-29 may be called the late period.

Even the very first step in the process of foreign lending, trivial as it may seem, is symptomatic, because the procedure was later entirely reversed, as we shall see. ". . . it was customary . . . in the

[1] The following is based in part on hearings held by the Senate Committee on Finance, 72d Cong., 1st Sess., on the 'Sale of Foreign Bonds or Securities in the United States' from December 18, 1931 to February 10, 1932. Officials and partners of leading investment banking houses, government officials and financial experts testified at these hearings and submitted data on foreign loans. Various reforms were later made in part by individual bankers on their own initiative and in part by government regulation. In particular the investment banking business was restricted to firms not affiliated with commercial banks.

early days . . . for the Government to entrust to some individual in the country concerned the task of coming to New York and negotiating the loan for the province, state, or municipality . . . the individual concerned was told by the finance minister . . . to see what he could do toward getting a loan. . . ."[2]

In New York it was not easy for the agents of foreign countries to obtain a loan. Many were unsuccessful. Many bankers "declined to have anything to do with this matter. And it was a very difficult business".[3] If a banker was disposed to grant a loan he would weigh the risk carefully and come to a decision slowly.

Once a banker undertook to float a foreign loan he had to convince the public of its safety. "And it took . . . a process of enlightenment and explanation, for instance, to point out why the obligation of the French Government . . . was absolutely good. . . ."[4] The public did not know much about foreign countries or cities. For example, ". . . at that time the City of Christiania [Oslo] was very little known here, and a great deal of work had to be done in explaining it, in sending out literature, and so forth."[5] "And it was a most difficult business because a good many people in our country did not know where Hungary was. We published books with pictures . . . we had a regular campaign in order to let the public know the circumstances. We got some men to make speeches and to explain to the people what the purpose of the loan was. It was quite a campaign."[6]

The necessity for propaganda made the loans more expensive to float and increased the spread, the difference between the price paid the issuer and the price paid by investors, the issuing banker had to charge. The spread was widened further by the riskiness of the business for the banker, owing to the uncertain saleability of the bonds. Again and again at the hearings held by the Senate Finance Committee in 1932 the bankers were asked why the

[2] From the testimony of Henry C. Breck, partner, J. and W. Seligman & Co., Hearings, p. 1307.

[3] James Speyer of Speyer & Co., ibid., p. 618.

[4] Thomas W. Lamont of J. P. Morgan & Co., ibid., p. 20.

[5] Otto H. Kahn, member of the banking house of Kuhn, Loeb & Co., ibid., p. 126.

[6] Mr. Speyer, ibid., p. 616.

spread had to be so high at first and could be so much reduced later. The answer was always: ". . . we had to have a larger spread in the early postwar years. . . ." because we risked being unable to sell the bonds and because our selling costs were high. Yields too, of course, had to be high in order to win over the reluctant investing public.

Thus in the early days a borrower had to seek out a banker who would be willing to lend. The banker in turn had to convince the investing public of the high quality of the bonds he wanted to sell. And the resistance of both banker and public had to be overcome by high yields and large spreads.

THE LATE PERIOD

In the late period this process was reversed from the very first step. The borrower no longer sends his man to New York; now the New York banker sends his representatives to foreign capitals. The testimony at the Senate hearings in 1931-32 is enlightening. Senator Johnson: ". . . you reversed the processes of the ordinary mode of conducting a banking business; you had in these last few years the lenders going to the borrowers. . . ?" Frederick Strauss, partner, J. & W. Seligman & Co.: "Yes, sir." Senator: "And in that fashion they accelerated, stimulated, increased loans of various political subdivisions, Governments, industrial enterprises, and the like; is not that correct?" Mr. Strauss: "That was the effect of it; yes."[7] James C. Corliss, then specialist, Latin American Finance, Department of Commerce, also describes how a great many representatives of American financial houses tried to get loans in a number of countries. The bankers' agents not only tried to negotiate given loans but used high pressure salesmanship to find borrowers. Mr. Corliss: "There was very keen competition in a great many countries for those loans." Senator: "Will you explain what you mean by keen competition. . . ?" Mr. Corliss: "At one time in Colombia there were something like 29 representatives, I was told."[8] The competition was brought out by other witnesses as well. Senator: "Were there others who were competing with you for the loan there?" F. J. Lisman: "We understood there were

[7] Ibid., p. 1324.

[8] Ibid., p. 845-6.

several banking houses there." Senator: "All of them trying to get the loan from the Peruvian Government?" Mr. Lisman: "As usual." Senator: "That is so all over Latin America?" Mr. Lisman: "It was so during the period from 1925-28, all over, I would say."[9] The scope of this development was indicated in another exchange. Senator: "There were many firms . . . who had their agents and their representatives in different places in Latin America seeking to obtain governmental loans . . . is not that true?" Mr. Strauss: "Yes; but it is also true that those things existed not only in Latin America, but the world over. . . ."[10]

This last remark is confirmed by Mr. Lamont in a speech in 1927: "I have in mind the reports that I have recently heard of American bankers and firms competing on almost a violent scale for the purpose of obtaining loans in various foreign money markets overseas. Naturally it is a tempting thing for certain of the European Governments to find a horde of American bankers sitting on their doorsteps offering them money. . . . That sort of competition tends to insecurity and unsound practice."[11]

Oliver C. Townsend, Commercial Attache at Lima, Peru, from 1926 to 1929 reveals something of the climate of loan negotiations of this period and of the "general promotion atmosphere" in a memorandum dated February 10, 1927 to the United States Ambassador to Peru: "Tuesday night's dinner, given at the Hotel Bolivar by S. A. MacGinnis to fifty-odd guests, was a fair sample of what the local society folk are treated to at rather close intervals, namely, entertainment by promoters. . . . Our host . . . is here with a big entertainment fund in the interest of . . . a New York banking firm, to bid on the securities shortly to be issued. . . ."[12]

The keen competition for loans led to bribery and commissions for all who helped or claimed they helped to obtain them. Yet the bankers' spread dropped considerably because selling costs declined

[9] Frederick J. Lisman, F. J. Lisman & Co., ibid., p. 1775.

[10] Ibid., pp. 1323-4. For a lively description of competition among bankers for foreign loans and other aspects of unwise lending, see Max Winkler, op. cit., Ch. IV and V.

[11] Quoted in the Hearings, p. 25.

[12] Ibid., p. 1611.

sharply and there was little risk of getting stuck with the bonds. Selling bonds was no longer a problem. For instance, the spread declined from 6½ to 5½ points between March and December 1927 for Peruvian bonds; from 13 to 8 points between 1925 and 1927 for two loans to Cauca Valley, Colombia. "At that period, say, from 1924 to and including 1928, the bond market was extremely eager and very receptive, for bonds especially those yielding high rates of interest. . . ."[13]

Every aspect of foreign lending had changed. Senator: "The last few years of your business are not comparable with the kind of business or the mode in which you conducted your business in prior years?" Mr. Strauss: "That is quite true, Senator." ". . . the point you are making is about the business methods, the change that has come about. It would not have been natural 10 or 20 years ago."[14]

Thus, in the late period the lender sought out the borrower, offering every conceivable concession to attract him. The public in turn was no less eager to take the bonds from the bankers than the bankers were to find borrowers.

Comparing the two periods we find the characteristics typical of a change from a buyers' to a sellers' market, where the buyers correspond to the lenders and the sellers to the borrowers: depressed prices, high quality of goods, high selling costs in the former; high prices, low quality of goods, low selling costs in the latter. The deteriorating quality of loans fits perfectly into the general picture.

The situation would have been much worse had not part of the banking community resisted the temptation of easy profits and preferred fewer rather than low quality bonds, as was shown in the analysis of individual banking firms in Chapter 4. In this connection the testimony of Grosvenor M. Jones, then Chief, Finance and Investment Division, Department of Commerce, is of interest. Senator: "During the last few years . . . investment houses and the like have indulged in the keenest competition to obtain from the South American Governments and from Latin America the securities for flotation in this country, have they not?"

[13] Mr. Kahn, ibid., p. 394.

[14] Ibid., pp. 1323 and 1325.

Mr. Jones: "In general, I think there are two notable exceptions." Senator: "Two notable exceptions. I think, in justice to those two, we ought to state them." Mr. Jones: "I will not say that they are the only exceptions; but J. P. Morgan and Co., and Kuhn, Loeb and Co. have followed, more or less, the English tradition of the borrower seeking the lender rather than the lender seeking the borrower."[15] This agrees with the statistical findings. The two banking houses Mr. Jones names are the only ones that reduced their lending in the second half of the period; moreover, their default indexes are the second and the third lowest of the group investigated (Ch. 4).

2 *Analysis of Change*

Though the world situation at the time might lead one to suppose it, pressure on the part of borrowers was not a reason for the deterioration of loans.[16] In the 2,000 odd pages of the Senate Hearings foreign political pressure, propaganda, or bribery to induce American bankers to grant an increasing volume of loans is not mentioned once, but there are numerous accusations against American bankers of having used such means to force loans on foreign countries.

Is the explanation of the deterioration of the quality of credit simply that early borrowers had an opportunity during the favorable twenties to get their finances into shape to withstand serious depression, while late borrowers were caught in the depression before they had a chance to put their house in order? Such an argument implies that a major part of 'bad' loans was used to fortify initially weak economies of debtor countries. But such was not the case. The Latin American economies emerged from World War I greatly strengthened; their loans were not needed for restoration or recovery, nor used to build up resistance against depression. German and eastern European debtors were in a different

[15] Ibid., pp. 742-3.

[16] See our interpretation of foreign loan cycles (Ch. 1) which also suggests that forces arising here rather than abroad were decisive in foreign lending.

The picture confirms also what we would expect in theory. An increasing volume of loans accompanied by rising prices to lenders means that the demand curve, representing in this case the lenders, must have shifted to the right.

situation. But in view of their economic policies in general and the improvident use they frequently made of their loans, it is hard to believe that the lapse of a few more years would have put them in a position where they could have avoided default. Indeed, one might well argue that the longer some debtors were able to borrow the less were they prepared for a reversal of economic conditions.

The invalidity of the argument that late borrowers were at a disadvantage when the depression came and that this was itself the cause of the high rate of defaults is demonstrated by the recent history of foreign bonds. As we noted above, despite war prosperity and greatly increased dollar exports all South American countries in default in 1937 were still in default in 1949. Certainly, their present default cannot be explained by their having borrowed too late in the twenties. Nor can the maintenance of full service by Belgium, France, Norway despite enormous war damage be ascribed to their having borrowed early in the twenties.

The high proportion of defaulted loans among issues of the late twenties is not a necessary consequence of their date of issue. To understand the deterioration we must know why the proportion of loans that went to borrowers prone to default rose.

It would be in line with the theory of an increasing shortage of investment opportunities to suggest that 'there are just so many good loans' and, therefore, a surplus of investible funds can only be employed in making unsound ones. At first blush this reasoning seems quite plausible. It might be elaborated along these lines: After World War I nations that had formerly exported capital needed loans for a short while. These were the sound loans of the first period. Later these nations became able once more to take care of their own needs and even to regain their former position as capital exporters, driving the United States as the youngest among the lending nations into the least desirable markets.

Convincing as this may sound, the evidence is against it. When investors are confronted with a lack of sound investment opportunities for their accumulating funds, the pressure on the market for high-grade bonds drives their prices up. To the individual investor, 'scarcity of sound loans' can mean only that their prices are so high as to make investment in riskier but cheaper bonds seem preferable. If, on the contrary, prices of riskier investments rose more than those of low risk investments, we can hardly say that lack of the latter forced investors into the former.

What are the facts in our case? Basic yields on 30-year bonds, which may be regarded as representative for the high-grade domestic bond market, declined from 4.50 to 4.05 percent between 1925 and 1928. In other words, the 'lack of sound loans' meant that the investor had to accept a 10 percent decline in yield. Let us compare developments in the market for foreign bonds. In 1925 the average risk premium for foreign issues, 30 percent of which subsequently proved unsound, was 2.18 percent. In 1928 a crop of foreign bonds, 65 percent of which were failures, could be sold to yield not more than a 2.00 percent risk premium. Thus investors accepted an 8 percent reduction in risk premium for a much riskier investment at the very time they accepted only a 10 percent reduction of yields on high-grade investments of constant quality. Prices of risky foreign bonds, in other words, rose relatively more than prices of high-grade domestic bonds. Hence it cannot be said that investors were 'forced' to resort to risky investments.

High-grade foreign loans might have been expanded if American investors had accepted a more drastic cut in their yields. For instance, the shrinkage in the volume of Canadian loans when total foreign lending reached its peak can probably be attributed to unfavorable conditions for low risk investment in the United States. The public's demand for high yielding bonds excluded borrowers who offered lower yields. To a certain extent the lower grade bonds drove the high-grade bonds from the market.

Lack of good loans cannot account for the mounting proportion of mistakes. Another element is necessary to understand what happened: the delusions of the investors concerning the safety of their loans. Investors bought low-grade bonds because they were not aware of the risks they were incurring and it was their mistaken judgment that kept the prices of high-grade bonds relatively low. These delusions cannot be attributed to the influence of a few fraudulent investment bankers, as has sometimes been suggested. Their roots were deeper and can be understood only by considering the entire economic climate of the 1920's.

The most important single factor leading investors to be less cautious was the complete absence of defaults on foreign government bonds during this entire period. In the early years few unsound loans had been issued and even these few were not defaulted during the mild contractions of the 1920's. (In this respect the severe depression of 1920-21 was no different from the later mild ones; at this time, of course, American bankers had only just begun to lend abroad.) The partial character of liquidation of unsuccessful investments during several successive mild contractions has often been regarded as one of the causes of the ensuing severe depression. In foreign loans there was not even a partial 'liquidation'. Whatever errors were made did not become apparent and bad risks accumulated through the decade. The confidence of bankers and public grew as time passed and no losses were incurred.

Another factor that bred illusions was the considerable profit made by a great number of investors during a long period. Moreover, these gains furnished funds for more investment of the same kind. The longer this period of continuous gains and no losses lasted, the more were people inclined to believe there was no end in sight. The growing distance from the last severe depression dimmed their memory of past catastrophies. Even those who were cycle-conscious were reassured by the mild contractions of the 1920's, which passed without inflicting losses on foreign bondholders and left the impression that severe depressions were a thing of the past, something that had been overcome. The very absence of a severe depression over such a long period might have caused apprehension. But it had the opposite effect: the longer a telling depression was avoided the greater the confidence in the future became. This is not to say that every banker or investor shared these views but overconfidence set the tone.

These delusions had of course a cumulative effect. The new lending they encouraged was used to pay old debts when other funds were not available, thereby prolonging the life of bad debtors, postponing defaults, and in turn adding to the delusions.

What was the American government's role in all this? Was it more foresighted than bankers and investors? According to James

W. Angell, the government "has influenced the course of international finance in an extraordinarily wide variety of ways."[17] Did this influence contribute to or mitigate the decline in loan quality? Concerning the impact of government policies on Latin American, Canadian and Far Eastern loans, Angell comes to the following conclusion: "Undoubtedly, the great majority of the present American commitments in these regions, made chiefly since the war, *would have been effected even had the government remained entirely passive.* The war left the United States, for a number of years, as the only large source of exportable capital to which the rest of the world could turn. No action by the United States Government was needed to induce American business men to reach for the commercial and financial opportunities created by this situation."[18]

It seems probable that capital exports would on the whole have been smaller without the government's encouragement, though in a few cases the government placed an embargo on capital exports. But whether more sound or unsound loans were promoted we do not know.

3 *Role of the Banking Houses*

As the decision of the issuing banker is directly responsible for each loan we can begin to describe his role by analyzing this decision and its motivation. The business of the banker is to lend. The driving force in his decisions is the prospect of profits. But to protect the goodwill of his firm he must refrain from business that might entail losses for his customers. Every loan decision is the outcome of a process of weighing these conflicting motives against each other. Banks are the apparatus designed to do this weighing. In our case this apparatus worked well for a while; the restraining force of risk was strong enough to prevent mistakes except for a small percentage of loans. This same apparatus functioned much less well in the late twenties as the restraining force of risk declined.

[17] *Financial Foreign Policy of the United States* (A Report to the Second International Studies Conference on the State and Economic Life, London, 1933. Prepared for the American Committee appointed by the Council on Foreign Relations, 1933), p. 123.

[18] Ibid., p. 98, italics mine.

Confining our discussion to two factors in the bankers' decisions, risk and profit, is not to deny the influence of others. Undoubtedly a few loans were floated in deference to the wishes of the American government; others were granted because the bankers hoped to win the favor of the government of a country where they had other large investments; personal relations with foreign bankers may occasionally have had some influence; and so forth. But considerations of this kind operated only in isolated cases and were neither general nor powerful enough to explain the drastic deterioration in loan quality during the 1920's.

a) BANKING ESTIMATES OF RISK[19]

Without attempting a complete enumeration, we wish to give a general idea of the large number of factors bankers considered in estimating the soundness of a loan. The charge that most private bankers lacked information about their debtors and that the quality of credit could have been markedly improved if loans had been investigated more carefully does not seem to be supported by the facts. We do not find evidence that bankers were generally ignorant of the factors considered relevant for the soundness of loans. These are some of the factors the bankers took into consideration: 1) The political situation: prospects of peace or war, stability of the foreign government, relations between the United States and the debtor country, etc. 2) Character of the borrowing nation: its willingness to make sacrifices in order to pay its debts. This is important because some nations take advantage of any pretext to avoid paying which, since it is not feasible to force payment of foreign debts, is as bad as incapacity to pay. Other nations, on the contrary, go to great lengths to pay their debts. 3) The general economic situation of the debtor country: This would involve a careful analysis of: "Its past debt record. . . . Its record of income and expenditures for a period of from 5 to 10 years preceding the time at which the loan is being considered, and its budget for the succeeding year or two years. Its import and export statistics for the past 5 or 10 years and an analysis of its 'invisible' trade, if any. Its national debt both on a total and a per capita basis.

[19] 'Risk' always means risk of default, not the risk the banker runs of not being able to sell the issue.

Its national wealth. Its fiscal position as to its holdings of gold or the gold holdings of its central bank in relation to its outstanding currency. . . . Value of its actual or potential trade with the United States. . . ."[20]

This point, the economic position of the nation, was usually deemed to be the most important factor even when the loan was granted to a private borrower.[21]

4) The particular economic position of the borrowing corporation:[22] "First we make a detailed study . . . of the following: Nature and scope of the company's activity. Territory served. Property and business . . . Competition . . . Public relations. Governmental and State regulation. Possibilities of future growth. Second, a study of ownership and management of the company. Third, a detailed study of an examination and appraisal of properties by independent American engineers. Fourth, a detailed study of examination and audit of earnings and balance sheet position of the company, covering a period of years, by American certified public accountants. Fifth, a detailed study of various legal aspects of the situation investigated by our counsel. . . ."[23]

On the points mentioned under 1-4 bankers collected information in various ways. The Department of Commerce bulletins which were based on reports by foreign service officers of the government were widely used. Many bankers sent experts into the borrowing countries, consulted with bankers of these countries, and checked their conclusions against the opinions of such experts as S. Parker Gilbert, Agent General for Reparation Payments, and Hjalmar Schacht,[24] or against the attitude of England and Holland, as the older lender nations.

5) Terms of the loan: many bankers thought the safety of a loan could be increased by inserting certain provisions in the contract. For example, the League of Nations loans contained far-reaching

[20] Memorandum from Kuhn, Loeb & Co., Hearings, p. 293.

[21] See, for instance, Mr. Lamont, ibid., p. 48.

[22] This factor is not without bearing on our analysis because the bonds investigated include government guaranteed corporate issues.

[23] E. C. Granberry, Vice Chairman, Board of Directors, Chase, Harris, Forbes Corporation; ibid., p. 526.

[24] Ibid., p. 102.

provisions to ensure their safety: guarantees by several other nations; priority over all other obligations; the obligation of the debtor nation to balance its budget and provisions for financial control to enforce this.

Sometimes the borrowing country pledged a certain source of revenue as security for the service of the loan or the loan was paid in instalments each of which was contingent upon the maintenance of a balanced budget,[25] or the country simply promised to balance its budget.

In order to increase the safety of a loan the bankers sometimes stipulated that it should be used for some specific productive purpose yielding a revenue that would ensure its service. Some contracts went so far as to provide for control over the expenditure of the money; e.g., in Cuba the money was not paid to the government at all but directly to the contractors against certificates of work done; i.e., it was not available for other purposes.[26]

This recital may suffice to illustrate the variety of factors the bankers said they examined and on which they based their judgments of the safety of their loans. Their contention is well supported. Most convincing are the statements by witnesses at the Senate Hearings who otherwise sharply criticized the bankers. They do not charge that loans were issued in ignorance of the relevant facts; on the contrary, they charge that the bankers were aware of unfavorable circumstances yet issued loans anyway. The declaration of the Committee on Banking and Currency that the bankers "failed to examine, or examined only perfunctorily, economic conditions in foreign countries" seems hardly justified.[27] Ignorance was not in general the cause of the mistakes in foreign lending.

But if all the circumstances of the loan, the debtor, his country, and the world in general were taken into account, why did the

[25] See, for instance, ibid., pp. 1649 ff.

[26] "We did feel an added security in the fact that the moneys we provided would be paid over to the construction contractors themselves. . . ." A. M. Williams, of Rushmore, Bisbee & Stern, Attorneys for the Chase National Bank, ibid., p. 1964.

[27] Stock Exchange Practices, Report of the Committee on Banking and Currency, 73rd Cong., 1934, Senate Report No. 1455, p. 126.

correctness of the bankers' judgment vary so much over time? Why was it sound on the whole at one time and wide of the mark at another? Evidently differences in interpretation of the facts are responsible. The most detailed study of the position of a debtor informs us only about his past and present. It is when we project into the future that we are likely to make mistakes. And if more mistakes are made at one time than at another, projecting into the future must be easier and thus more reliable at some times than at others.

In the first part of our period when the world was gradually recovering from World War I it was conservative to expect this to continue for some time. But in the later period of rapid expansion it was reckless to project the favorable trends into the future. This, however, was precisely what many bankers did.

An example will illustrate how careful information led to wrong conclusions because the banker expected current trends to continue into the future and disregarded inflationary conditions. To show the soundness of Peru's economy a banker reasoned: "After these bonds were issued . . . the total annual service charges on the external funded debt amounted to approximately 20 percent of the average ordinary revenues for the preceding three years (1925, 1926 and 1927). . . . The Peruvian Government's ordinary revenues for 1928 were 20 percent greater than for 1926, and the excess of its expenditures . . . over such revenues was substantially less than for 1926. Exports were 31 percent greater, the excess of exports over imports 215 percent greater, the production of cotton 2 percent greater, sugar 4 percent less, copper 21 percent greater and petroleum exports 6 percent greater than in 1926. . . . As important as, if not more important than, the then favorable current position of Peru were the trends during a period of years. These trends were favorable, too, as indicated by the fact that between 1913 and 1926 ordinary revenues of the Government had increased 186 percent, exports 162 percent, the excess of exports over imports 45 percent. . . ."[28]

The bankers apparently took little account of the probability that these 'favorable trends' were unlikely to continue when, as

[28] Statement of J. & W. Seligman & Co.; Hearings, pp. 2118-9.

in this case, they were based on an enormous expansion of bank credit. Some bankers even evolved a formula that implied the assumption of continued inflation. "They said that if loan charges were covered three times by revenues then the loan was sound."[29] But revenues of a country that borrows heavily do not indicate its future ability to pay.

There were exceptions, of course. Some bankers judged the situation correctly and refrained from lending to countries where inflationary conditions prevailed.[30] A few even went so far as to warn their colleagues. For instance, in 1927 Mr. Lamont warned against "indiscriminate lending and indiscriminate borrowing".[31]

Experts too raised their voices. In his memorandum of 1927 on reparations, for instance, S. Parker Gilbert brought together "the accumulating evidences of overspending and overborrowing on the part of the German public authorities, and some of the indications of artificial stimulation and overexpansion that are already manifesting themselves". He concluded: "These tendencies, if allowed to continue unchecked, are almost certain . . . to lead to severe economic reaction and depression. . . ."[32]

Occasionally a warning came from the borrowing countries themselves: ". . . the president of the Reserve Bank of Peru . . . came up to New York, and told the bankers that they were lending far too much, and that they should at least cut their loans in half. That was in 1927, before they made their first loan."[33]

Yet most of these warnings were in more or less general terms and were often dismissed as not applying to the particular loans bankers were about to make. Their attitude may seem somewhat surprising since, logically, we would expect their caution to grow, instead of decrease, with the distance from the last severe depression. Their awareness that loans are tested in times of severe depression and that the absence of defaults at other times does not prove

[29] Lawrence Dennis, connected with J. & W. Seligman & Co., 1928-30, ibid., p. 1591.

[30] This is one important source of differences between default indexes of individual banks; see Ch. 4.

[31] Hearings, p. 25.

[32] Ibid., p. 897; cf. also Max Winkler, op. cit.

[33] Lawrence Dennis, Hearings, p. 1601.

that all loans are sound should have functioned as a brake on the over-optimism of the public. This it did, to some degree. But to a large extent the bankers were influenced by current favorable aspects of economic developments. The spell of the long defaultless period made them forget that "During the nineteenth century every major downward swing of the business cycle caused the failure of governments and other foreign borrowers to meet their external obligations".[34] Or, if the disasters of the past were remembered they were discounted in the belief that modern economic policy was able to prevent severe depressions, a belief strengthened by the mildness of recent contractions. A reversal of favorable trends was feared less rather than more as time wore on and current trends were confidently projected into the future. As world conditions improved, expectations grew more and more optimistic, i.e., more and more incorrect. Thus the bankers' estimates of risk were an important factor in the decline of loan quality.

b) THE IMPORTANCE OF RISK

Another possible source of variation in the quality of loans is the different weight bankers place upon risk at different times. To determine the role of risk in the decisions of bankers let us listen first to what they themselves say. They are virtually unanimous that no banker ever issued a loan he did not consider safe: Mr. Strauss: ". . . we have never brought out a bond issue that we did not believe at the time was a safe investment; . . . no loans were undertaken, in spite of the madness that you speak of, that were not believed to be safe." Mr. Lamont: ". . . we never issue a bond unless we believe it to be good." Mr. Kahn: ". . . I can say for my house that for every issue that we made we declined six others, or probably more, because we always want to be sure that what we offer is intrinsically sound. . . ." Mr. Lamont: ". . . it was a very attractive investment. That is, if you had faith in the future of the country. And if you did not, it would not be attractive on any basis."[35]

The bankers stress also their lasting interest in their bonds. Senator: ". . . and have you any further interest in those bonds?" Mr.

[34] Madden et al., op. cit., p. 107.
[35] Hearings, pp. 1322, 1324, 40, 342, 49-50.

Kahn: "We have an interest in those bonds until they are repaid according to their due date. We consider that we are under a permanent moral liability to do what we can for the protection of those bonds."[36] Mr. Granberry: ". . . in case a bond is in default quite naturally the original issuing house, or houses as the case may be, use their best efforts, and both time and money, to try to correct the default and make the bond good." Senator: "You do not mean to say that you put your capital into defaulted interest or principal of bonds." Mr. Granberry: "We put our money more or less into defaulted situations to try to make them good."[37] Mr. Speyer: "And that responsibility continues on for 20 or 30 years. . . . The sums of money that we spend in looking after these things, and trying to straighten them out, nobody knows anything about."[38] And again Mr. Kahn: "The issuing house considers it its responsibility to do everything in its power to reconstitute and reestablish the solvency and the good credit of the property, to protect the bondholders . . . to give its efforts, its experience, its ability fairly and properly to deal with the situation which a default has created."[39]

A banker has good reason to examine carefully what he sells and to try to protect his customers from losses. "The banker's prosperity, indeed his very existence, depends on the confidence of the public. If he has not got that . . . his business will shrink to negligible proportions, if not fail completely. Confidence . . . must be acquired every day by the way you conduct your business. . . ."[40] Of few goods is the buyer less able to gauge the true value than of foreign bonds. He must rely largely upon the banker's reputation, on his 'ethical trade mark' which, therefore, will be more important to the banker's business than, e.g., that of a shoe dealer's to his.

Even more convincing than the banker's testimony or our reasoning about the role of safety are the facts mentioned in the preceding section, i.e., the great trouble and expense to which bankers go to assure themselves that their loans are sound.

Of course, the importance attached to risk varies greatly from

[36] Ibid., p. 135.
[37] Ibid., p. 519.
[38] Ibid., p. 617.
[39] Ibid., p. 128.
[40] Mr. Kahn, ibid., p. 352.

one banking firm to another.[41] The better the name of a firm, the more reason it has to protect it. A new firm may be more likely to try to 'make hay while the sun shines'. And in addition to the banker's self-interest his feeling of social responsibility will, to a larger or smaller degree, impel him to look to the safety of his loans.

Does the power of risk as a brake vary over time? That may depend upon the strength of the factor discussed in the next section: public demand for foreign issues.

4 *The Demand of the Public*

a) WHO IS 'THE PUBLIC'?

We know little about investors in foreign bonds. In the opinion of Dwight W. Morrow "The person who invests in foreign bonds is probably the same person who invests in domestic bonds".[42] But this does not tell us much and may not be altogether correct.[43] The attitudes of individual investors differ widely and vary continuously. Some would not touch foreign bonds under any circumstances ('isolationist investors'), others buy only the issues of countries that have proved to be reliable debtors, a third type demands exceedingly high yields, and so forth. Demand for any given loan at any given time will be the resultant of all these tendencies.

There seem to have been no empirical investigations into the type and number of foreign bond buyers except some on a very small scale undertaken by Senator Morrow in 1927. His analysis of the sales of 24 investment houses covering 5 foreign government loans showed that more than 85 percent of the purchases were in small amounts ranging from $100 to $5,000, and that approximately half of these 5 issues went to these small investors.[44]

Another bit of information can be gleaned from registrations of bondholders with protective committees. The Foreign Bondholders Protective Council reports: "The Committee of Bondholders for the Republic of Chile Bonds has included in the registrations

[41] Differences in the regard for risk seem to be one of the chief reasons for the wide differences between the default indexes of different banking houses (see Ch. 4).

[42] Who Buys Foreign Bonds? *Foreign Affairs,* January 1927.

[43] See Ch. 1, Sec. 5.

[44] Hearings, pp. 152-4.

with that Committee individual bondholders, banks, trust funds, schools, colleges, universities, theological seminaries, churches, church societies, libraries, hospitals, memorial homes, foundations, orphanages, Y.M.C.A.'s, and cemetery associations. Every state in the United States, one territory of the United States, the District of Columbia, and thirty foreign countries are represented in the registrations so far received. While a number of the registrants hold substantial amounts of bonds, the average holding is very small, showing an extremely wide distribution of these bonds . . . the average holding of . . . 96% of registrants is $800 worth of bonds per person."[45]

Foreign security holders were estimated to exceed 1.5 million in 1932.[46] The SEC has estimated that between 600,000 and 700,000 investors held defaulted foreign bonds in 1937. In any case there seems to be general agreement that many small investors held foreign bonds. Unlike the large investor, the small investor cannot insure against losses by diversifying his investments. Moreover, he will often be unable to wait and thus ultimately to recover all or part of his loss. As he has to take his full loss, his mistake or carelessness in purchasing a risky bond is relatively greater than would be that of a big investor.

b) WHY DOES THE PUBLIC BUY FOREIGN BONDS?

Why did large numbers of investors deem foreign bonds safe investments? Why were they so confident that a foreign country or town, whose name they had hardly known a few months earlier, would be willing and able to keep up the service of its loans for 20 or 30 years?

It has been said that "faith in the banker was the only measuring rod for the investor"; that "Those bonds were bought by Tom, Dick and Harry . . . without any reference to the solidity or the solvency of the bonds . . . , but entirely on the faith of the house issuing them in New York."[47]

Doubtless the bankers' confidence reinforced that of the public and their propaganda influenced investors. But this is only part of the story. Let us remember that this "faith in the banker" did

[45] Foreign Bondholders Protective Council, *Annual Report, 1935,* p. 99.

[46] Charles E. Mitchell, Chairman, National City Bank, Hearings, p. 70.

[47] Ibid., pp. 325, 352.

not always exist, that the public did not always buy everything the bankers offered. In our description of the early period we stressed the great efforts bankers made and the expenses they incurred in creating a market for foreign bonds. Evidently at that time they could not rely on the public's faith and expect it to buy whatever they offered. They had to refuse many transactions because they feared they would not be able to convince the public of their safety and as a rule could float only sound issues with relatively high yields.

Reliance on the banker was, then, itself the product of a certain period. Why did the public trust its bankers precisely between 1925 and 1928? Why should thousands of individuals develop such a curious unquestioning faith in bankers? The answer is that the public's attitude was not due to any mysterious faith but was caused by the very factors that determined the bankers' attitude. And these factors swayed the public without being checked by competence and responsibility. Investors in foreign bonds had not suffered any losses for a long time; on the contrary, they had repeatedly made sizable profits. This pleasant state came to be regarded as normal; investors assumed the world had entered a period of permanent defaultless prosperity.

Many events served to substantiate this belief. The League of Nations and the Locarno Pacts seemed to open peaceful prospects. Europe had recovered economically, runaway inflation had been stopped in every country, currencies were stable. Confidence in the world in general was the basis for the confidence of both banker and investor.[48]

c) HOW DID THE CHANGE IN THE PUBLIC'S ATTITUDE AFFECT THE BANKERS?

Bankers base their expectations of demand on their own and their colleagues' day to day experience. To foresee potential demand is difficult when a country is taking its first steps in the international

[48] This is shown also by the public's attitude toward other types of relatively risky investment where reliance on the banker played a less important role, e.g., domestic common stock issues. Plentiful credit and mistaken ideas about the future raised the demand for riskier investments and as a result quality quite probably deteriorated in many fields.

capital market or after a period of inactivity in the market. It is easier and forecasts are more reliable when the bankers know how the market reacted to similar loans a short time before. They observe and base their judgment on significant symptoms, such as the attitude of the bond market in general and in regard to the bonds of the specific country, the possibility of catching a favorable moment, etc.

Prospect of sufficient demand is a prerequisite for floating a loan. Therefore, the changed outlook of the public, itself greatly influenced by the bankers, had grave repercussions on the bankers' position. We have seen above how in the early twenties the uncertainty of demand, investors' reluctance to buy, were constantly on bankers' minds, and how this tended to discourage flotations or caused extra outlay and trouble when an issue was finally decided upon.

In the late period the bankers stress the influence of the public's attitude on them more than anything else in their testimony.[49] The public's eagerness is mentioned again and again as the motive for floating bonds. Senator: "Seeking in every way to obtain such loans as you could for flotation here?" Mr. Lisman: "To satisfy the public demand for securities."[50] Senator: "What was it that led to the extraordinarily keen competition among international bankers for South American loans?" Mr. Breck: "I think it was an appetite on the part of the American public to buy foreign loans."[51]

Country banks, tempted by high yields, acted like the general public and considered the bonds "to be sound and safe investments. . . ." "They were anxious to take them. They asked for them. These little bankers wanted to be in bond syndicates just as the big bankers wanted to be, because 90 percent and more of such syndicates at that time turned out to be profitable." They

[49] The fluctuations in the volume of foreign loan flotations (see Ch. 1) indicate that the public's attitude varied also within each period; that it was always easier to sell foreign bonds in times of domestic recession than in times of expansion when domestic stocks absorbed more of the available funds. However, these shorter demand fluctuations within the early and within the late period appear to have impressed the bankers far less than the big increase in demand between the two periods.

[50] Hearings, p. 1775.

[51] Ibid., p. 1321.