Bank Loans or Bonds: Some Lessons of Historical Experience *

Introduction

It is now widely recognised that the world debt problem which is a legacy of the past decade has had three main interconnected causes: (a) The OPEC oil price increases and resultant abundance of investible funds. (b) The readiness of American and other banks to recycle petrodollars to LDC (and Comecon) governments, excessively confident of the latter's capacity to service such debt, free from regulatory control in offshore lending, and protected by deposit insurance or implicit assurance that the US and other OECD governments would not allow large banks to fail. (c) The international recession and high (primarily US) interest rates of the early 1980s which seriously reduced the capacity of debtor countries to meet their debt service obligations.

With the benefit of hindsight, it is apparent that the banks frequently misjudged the risks they were running and were encouraged in this by an unbalanced regulatory framework— constraint at home but freedom abroad. The banks tended to discount the risks because they believed that neither their depositors nor their shareholders would suffer if things went wrong. One inference that is now being drawn from the experience is that there is more to be said for prudential regulation and less for deposit insurance than was commonly thought a decade or so ago. Another is that high-risk long-term lending is a function that should be handled by an international bond (and equity) market, rather than by banks.

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R.I. McKinnon has put this case in several recent papers. Speaking of "the negative aspects of unregulated Euromarkets [which] began to emerge in the 1970s: highly risky long-term loans to LCDs, with few or no loan-loss provisions", he went on to say: "This is not the kind of lending traditionally associated with monetary intermediaries that are supposed to be regulated towards conservatism in order to protect the payments mechanism... The willingness of individual banks to take very great risks in their international portfolios through the Euromarkets reflected the fact that their domestic portfolios were primarily regulated towards safety. This incentive for undue risk-taking was further aggravated by deposit insurance in domestic markets, and by the known commitment of the central banks to come in and bail out domestic depositors if any threatening bank crash occurred... [Thus] the shareholders get the upper tail of the distribution of profits, in which the American government does not share, but the government must cover a disproportionate share of any massive losses. The bottom line here is that commercial banks are the wrong institutions to be engaged in long-term international lending on a large scale... It is the regulatory imbalance — rather than superior efficiency — that has caused insured commercial banks to dominate the international capital market. A long-term international bond market cannot thrive in the face of such heavily subsidised competition" (McKinnon 1984a, pp. 18f.).

In another paper, McKinnon has spelled out the second inference: "Although sounding anachronistic, I think that the international market in private financial capital in the 1980s should be encouraged to evolve back to something closer to its late nineteenth century format. This would happen naturally, of course, if official guarantees of private credit were phased out, deposit insurance was circumscribed, and the regulation of the commercial banks' international and domestic activities were brought into better balance... The World Bank or IMF would still play an important role for those countries who remained poor credit risks... Both would nicely complement the evolution of an active long-term international market in bonds and equities — from which deposit-taking commercial banks were largely absent" (McKinnon 1984b, p. 480).

It is the purpose of this article to follow up the latter suggestion, particularly by drawing on the historical experience during the period 1870-1930. Through most of the nineteenth century and until 1914, long-term development capital was supplied largely through the international market for negotiable securities, chiefly long-term bonds. After a precarious revival in the 1920s, that market virtually collapsed in the 1930s. Two sets of questions suggest themselves. First, could the current LDC debt problem be relieved, and the risk of a recurrence reduced, by a return to such securities as a major way of providing external capital to governments, and perhaps also to the private sector, in developing countries? Secondly, what are the conditions for a resuscitated international market for LDC bonds, and how are they most likely to be met?

Historical Experience

(a) *The Pre-1914 London Capital Market.* In the proverbial "heyday" of international trade and investment before World War I, huge flows of capital were effected internationally by the issue of bonds, and to a lesser extent equities, floated principally in London. Such flows generally eclipsed direct foreign investment. "Portfolio investment was a far more important component of long-term capital movements before 1914 than direct investment; and it consisted much more of transactions in bonds and other debt instruments than in equities" (Bloomfield 1968, pp. 3f.; also Cairncross 1962, p. 45).[1]

Attempts to gauge the total volume of these capital flows have not been easy. There is now convincing evidence that earlier, widely accepted, estimates considerably overstated the volume of British foreign investment before 1914 (Platt 1980, 1985), simultaneous issue of many loans in several countries being one important cause of double-counting. But the directional patterns of lending and the structure of securities do not seem to be in dispute. There is little doubt that virtually all issues were listed in London (which is not to say that they were necessarily taken up wholly by British subscribers, not even when issued solely in London). We may therefore reasonably quote data relating to London as indicative at least of the composition of security issues.

[1] The concepts of portfolio and direct investment — never very precise — have changed their meanings since World War I. Some of what was historically recorded as "portfolio" investment, in that it was effected through purchase of equity shares on the stock exchange, would now be regarded as "direct" if it secured effective control of an overseas enterprise (Svedberg 1978).

Among the best available flow estimates are those by Jenks for the short period 1860-75 (Table 1) and more recent and comprehensive ones for the period 1865-1914 by Simon (Table 2). Jenks also showed that in the period 1860-75, more than forty different overseas borrowers — national governments, principalities or cities — offered bonds in the London market.

The flow data in these tables are reflected in the oft-quoted, though admittedly inflated, estimates of the stock of outstanding long-term foreign investments and debts in 1914 (Table 3). New issues appear to have influenced the country patterns of these stocks more than did international transactions in existing securities (Bloomfield 1968, p. 4). But the latter were not unimportant, and secondary markets were active.

All these data underline the importance of bond and debenture finance. They also show that most of this capital went to finance infrastructure investment, especially railway development. Much of the borrowing for the latter was undertaken by private companies, but usually under some form of guarantee by their governments. Extractive and manufacturing industries absorbed only 16 per cent over the longer period. Table 1 reveals that two-thirds of foreign securities issued during the years 1860-76 consisted of government bonds. For the longer period covered by Table 2, government bonds were not predominant but — notwithstanding a surge of equity investment in overseas plantation and extractive companies after the turn of the century — it seems likely that bonds (or debentures) remained the major form of securities right up to 1914, partly because of the importance of railway development which was financed by fixed-interest securities (Feis 1930, pp. 27-8, 32). In sum, "... what passed into the portfolios of investors usually consisted of bonds issued by governments or public utilities, particularly railways" (Cairncross 1962, p. 45).

Three features characterised this large flow of pre-1914 British bond finance of investment overseas, and they largely account for its successful operation over half a century.

One was the complementarity of trade between lender and borrowers. "International investment was an essential condition of this increasing trade. The development of the new countries required large capital expenditures on the building of railways" and other infrastructure (RIIA 1937, p. 3). At the same time, it met the needs of the United Kingdom for increasing supplies of foodstuffs and raw materials. "The chief lending country, namely Great Britain, herself constituted a market with unlimited possibilities of expansion for the produce of the

TABLE 1

OVERSEAS SECURITIES ISSUED AND SUBSCRIBED IN LONDON, 1860-1876

		£ million	%
Foreign Government Loans		320.7	44.6
Colonial and Indian Loans		161.9	22.7
Company Securities			
of which:		232.0	32.5
European Private Railways	34.4		
Colonial Railways	11.7		
U.S.A. Railways	70.5		
South American Railways	19.1		
Other foreign companies	95.7		
TOTAL		714.6	100.0

Note: Includes only new issues made publicly, as far as possible the table excludes conversions, vendor's shares and discounts.
Source: LELAND H. JENKS, *The Migration of British Capital to 1875*, London, Nelson, 1971, Appendices D and E.

TABLE 2

NEW MONEY CALLED IN THE BRITISH CAPITAL MARKET, 1865-1914

	£ million
Colonial and foreign governments	1477.1
Private firms (including railway ventures)	2209.4
Mixed enterprises	395.6
TOTAL	4082.1

By economic sectors, this sum breaks down in the following proportion:

Social Overhead Capital (including Railways 41%)	69%
Extractive industries	12%
Manufacturing industries	4%
Other	15%

Source: MATTHEW SIMON, "The Pattern of New British Portfolio Foreign Investment, 1865-1914" in A.R. Hall (ed.), *The Export of Capital from Britain 1870-1914*, London, Methuen, 1968, pp.23, 25, 42-43.

TABLE 3

INTERNATIONAL CREDITS AND DEBTS BY MAIN COUNTRIES, 1913

Gross Credits			Gross Debts		
	$ Billion	%		$ Billion	%
United Kingdom	18.0	40.9	Europe	12.0	27.3
France	9.0	20.4	Latin America	8.5	19.3
Germany	5.8	13.2	U.S.A.	6.8	15.5
Belgium, Netherlands and Switzerland	5.5	12.5	Canada	3.7	8.4
U.S.A.	3.5	8.0	Asia	6.0	13.6
Other countries	2.2	5.0	Africa	4.7	10.7
			Oceania	2.3	5.2
TOTAL	44.0	100.0		44.0	100.0

Source: BRINLEY THOMAS, "The Historical Record of International Capital Movements to 1913" in J.H. Adler (ed.), *Capital Movements and Economic Development*, Macmillan, 1967. Reprinted in J.H. Dunning (ed.), *International Investment*, Penguin, 1972.

countries to which she was lending and her lending served to increase the development of precisely the commodities which she was ready to consume" (*ibid.,* p. 13). And British manufacturers were well aware that overseas loans fed their export sales. A Turkish loan in 1858 was ill-received in London but "... was taken up in the provinces where the market for British manufactures seemed more important" (Jenks 1971, p. 306).

A second feature of British pre-1914 bond finance was that British investors enjoyed some degree of protection of their investments against sovereign risk. Most colonial and Dominion issues had the benefit of trustee status under the Colonial Stocks Acts, permitting trustees to invest in any securities the interest on which was for the time being guaranteed by Parliament (RIIA 1937, p. 97). As regards lending to foreign governments, the official British policy during the nineteenth century was one of *laissez faire* as illustrated by Palmerston's precept that "losses of imprudent men who have placed mistaken confidence in the good faith of foreign governments would prove a salutary warning to others" (*ibid.,* p. 98). But governments did not always adhere to this policy. Palmerston himself once informed a defaulting Central American government that "the patience and forbearance of HM's Government have reached their limits, and if the sums due to the British claimants are not paid within the stipulated time and in money, HM's Admiral commanding the West India Station will receive orders to take such measures as may be necessary to obtain justice from the ... nation in this matter" (*ibid.,* p. 99). It was also not unknown for loans to foreign governments to be made conditional on their agreeing that agents of the lending government supervise expenditures and that certain sources of revenue — usually customs-houses, but sometimes railways and other public utilities, even internal taxes or government banks — be placed under the administrative control of such agents (Norton 1928, p. 212).

The third, and in our context perhaps most important, feature of pre-1914 British bond finance was the nature of the London long-term capital market. The unique characteristic of that market was that the British commercial banks were not involved. In accordance with the "real bills" doctrine which had evolved in the early nineteenth century, they confined their lending to the provision of short-term trade credit which was supposedly self-liquidating (Nevin and Davis 1970, pp. 89-91). The banks could adhere to this conservative philosophy because specialised institutions had developed to look after domestic and international long-term finance. The main ones were international financing firms (which would now be called "merchant banks") and other issue houses which negotiated the loans and issued the bonds; brokers and others which acted as underwriters; and the stock exchange which provided a primary and secondary market of unmatched width and depth.

Lavington, in his study of the English capital market published in 1921, gave a detailed account of the role of these institutions. "Foremost in this organization are the Issuing Houses proper, composed of highly respected firms like Rothschild, Schroeder or Seligmann, whose main work lies in marketing such securities as those of foreign governments and railways" (Lavington 1921, p. 183). In general, they confined themselves to securities of high financial standing. Less involved in international public bond issues were trust and finance companies sometimes referred to as issue houses and, beyond them, ephemeral promoting groups formed to sell a particular venture and then dissolved (*ibid.,* pp. 183 f.).

The alternative to engaging the services of an issue house was "for the risks to be borne by the vendors themselves [*i.e.* the borrowing governments] acting through financial agents in London", such as

Agents-General, High Commissions, the Crown Agent of the Secretary of State for India or banks acting as financial representatives, such as the Bank of England for New Zealand, the Bank of Adelaide for South Australia, etc. Each government had its own broker, usually one of the large firms, *e.g.* Nivison & Co. for the Dominions, who would advise their clients on terms and allot the underwriting (*ibid.*, p. 196).

The role of the underwriters was described by Hartley Withers. "The English issuing house sends round a stockbroker [to the agent of the borrowing country] to underwrite the loan. If the issuing house is one that is usually successful in its issues, the privilege of underwriting anything that it brings out is eagerly sought for. Banks, financial firms, insurance companies, trust companies, and stockbrokers with big investment connections will take as much underwriting as they are offered, in many cases without making very searching inquiry into the terms of the security offered" (Withers 1916, p. 49).

It was the issue houses that took responsibility for the quality of the securities they were marketing. Lavington quoted a comment by Foxwell: "They are accustomed to make exhaustive examinations of propositions submitted to them. They employ expert engineers, accountants and lawyers; and every pertinent detail in regard to process of manufacture, plant management, earnings, labour conditions and past history is taken into account. But the issue houses fight shy of ordinary home industrial propositions. They prefer those put forward by foreign Governments, municipalities or the very largest transport companies" (Lavington 1921, p. 212).

The issue houses tended to share out the market. "Between the larger institutions some agreement existed, especially as regards government loans, based on some arrangement for dividing the business". Lavington also explained that "one or two houses, it would seem, have substantially a monopoly in marketing the securities of certain foreign States; but sale is in effect through negotiations which amount to competitive tender. Part of the margin goes, of course, to underwriters, for practically all these issues are underwritten" (*ibid.*, p. 195). Loans were normally issued at a fixed price, the risk of failure being borne by the underwriters. The customary charges were 1 per cent for underwriting, plus $^{1}/_{4}$ per cent each for the issuing bank, the broker and broker's stamp, plus stamp duty ($^{1}/_{8}$ – $^{5}/_{8}$ per cent), *i.e.* $1^{7}/_{8}$ – $2^{3}/_{8}$ per cent in all (*ibid.*, p. 197).

The crucial point, for our purposes, is that, in Great Britain, it was the large investors, individual and institutional — including life offices

but *not* deposit banks — that bought overseas securities. "The small private investors and the commercial banks avoided overseas securities because of their common concern with the safety of their investments" (Atkins 1977, p. 123), although, judging by anecdotal evidence in books about life in Victorian and Edwardian England, it was not uncommon for clergymen and other gentlefolk to put some of their savings in colonial, Dominion and even foreign stock.

Once floated, the international bonds could subsequently be traded on the London stock exchange. They thus enjoyed liquidity subject, of course, to fluctuations in capital values. In the worst event of a collapse in the value of any particular stock (through default or loss of confidence), the loss was borne by the relevant bondholders and not by the commercial banks nor by the community at large. If debtors defaulted, or even repudiated, bonds could be sold on the stock exchange at low prices to buyers who were gambling on recovery (de Cecco 1985, pp. 62-3). Even major defaults which buffeted the system of international borrowing and lending did not demolish it, notwithstanding the fact that overseas lending was unregulated by the U.K. authorities. The London market safely weathered the defaults of Argentina in 1890 — "the Baring crisis" (cf. Hawtrey 1938, pp. 105-110) — and Brazil in 1898-1900. Crises were overcome in a variety of ways. Sometimes payments of interest and amortization were deferred (in modern parlance, rescheduled). Sometimes loans were in effect funded, to permit interest payments, and even to sustain domestic investment and economic growth of exporting countries. Sometimes deflationary measures were imposed by the creditors.

(b) *Pre-1914 French and German Foreign Lending.* The situation was very different in France and Germany. Partly because neither had an international securities market comparable to that of London and partly because foreign lending when it developed was much more politically motivated, French and German banks were much more directly involved.

While there had been some French and a little German foreign investment in the earlier decades of the nineteenth century, it was not until the last two decades before 1914 that French and German foreign lending assumed major proportions, though even then nowhere near as large as British. In France the 1870/1 war indemnity preempted a large part of surplus savings into the 1880s, while in Germany domestic industrial development absorbed virtually all domestic savings into the

1890s (RIIA 1937, pp. 123, 126). When foreign lending got under way, much of it was in support of political objectives and strongly guided by government, in France to support the Russian alliance and colonial development, in Germany to extend German influence in Central Europe and the Balkans, although some private French and German capital also went elsewhere, especially to Latin America, in pursuit of commercial opportunities.

In the absence of a comparably developed international securities market at home, French and German investors to a considerable extent relied on the London market. A significant proportion of foreign securities issued in London was bought, not by British investors but by investors in other countries, not least in the borrowing countries themselves. "Securities returned quite naturally through the international market" (Platt 1983, p. 2). Thus, many railway securities issued in London are said to have "returned to native ownership — all German railways, nearly all Brazilian, a large part of Canadian, all Rumanian, while Keynes said the same for the United States. Even the Chinese, for the first time in 1908, took a considerable share themselves in a national railway issue brought out in Britain and Germany" *(ibid.)*. More generally, while "British investors bought securities on foreign exchanges,... they had much less reason to do so than, say, French investors (who found it convenient to subscribe to Russian issues in London), Dutchmen (who used London as a kind of supermarket for Latin American securities), and Germans (who bought the stock of China and Japan)". It was, as the *Economist* pointed out, the "unique freedom experienced in marketing securities", free from government pressures, that made the London stock exchange the most important in the world (*ibid.*; also Platt 1980, p. 15).

Through most of the nineteenth century, France was the main source of external finance of other governments in continental Europe. Feis has described the process whereby French small and large savers sought liquidity and presumed safety in foreign securities, and these securities were "distributed to millions of Frenchmen through Paris banks" (Feis 1930, p. 39). In the earlier part of the century the business was dominated by private banks such as Rothschild and the Haute Banque (a group of five smaller but highly respected merchant banks). Rothschild's preeminence declined after the payout of the 1871 indemnity. "The defaults of many of the foreign governments whose securities they had introduced, of Spain and Portugal and Greece... had shown their fallibility" *(ibid.)*.

After the 1870s, newer joint-stock industrial banks became dominant; each held shares of banks abroad; each established foreign branches. These industrial banks had large share capitals and a small number of wealthy depositors and clients, chiefly the companies they organised and financed. "They had the capacity and daring to undertake large government loans" — in cooperation with the deposit banks (*ibid.*, p. 41). "Upon the Deposit Banks, these Industrial Banks leaned heavily for aid in the sale of the loans they brought to Paris". Consortia were formed. "It was through the Deposit Banks that the scattered savings of the French were most effectively reached... Now and again the Deposit Banks arranged the issues themselves, dealt directly with the borrower and bought the loan outright, or on option, as did the Crédit Lyonnais with the Russian Government. But far more often the loan was arranged and underwritten by the Industrial Banks, and the Deposit Banks participated in the selling syndicate, or sold merely on commission" (*ibid.*, pp. 41f.).

Occasionally, according to Hartley Withers, the French banks took up loans issued in London. "Negotiations are entered into [by the agent of the borrowing government] with a group of French banks and an English issuing house. The French banks take over their share, and sell it to their customers who are, or were, in the habit of following the lead of their bankers in investment with a blind confidence, that gave the French banks enormous power in the international money market" (Withers 1916, p. 41). Feis confirmed this judgment. "French foreign lending was not dominated by careful, objective measurement of economic opportunity. Guided and often controlled by government and the opinions of the financial institutions, it was swayed by antipathies and sympathies, traditional, emotional, political" (Feis 1930, p. 50).

In Germany, the marketing of German state loans had come to be dominated by syndicates of banking houses, a Prussian syndicate for Prussian loans, another for Imperial loans and so on (Lavington 1921, p. 198). When large-scale foreign lending got under way, the same practice was followed. While there was vigorous competition among the banks for the accounts of depositors, "in their financial negotiations and relationships... with foreign governments, ... the rule was division or combination rather than competition". Thus, the Deutsche Bank looked after Turkey, the Darmstaedter Bank after Austria-Hungary, etc. "Often for large or unusually risky issues joint consortiums were formed among all the syndicates". "The depositors of each of the Great Banks ran into many thousands and these ordinarily purchased the

securities recommended or offered to them... The banks sometimes disposed of foreign securities by direct sale to their depositors or affiliated institutions, without seeking listing. But the more usual method of issue was by general public offering through syndicates and listing on the stock exchange" (Feis 1930, pp. 64-7). In Feis's opinion, "individual investors retained more independence of judgment than in France. The financial journals were better informed and more honest... The German Great Banks could not lead German savings into gambling adventures with foreign governments as easily as could the French" (*ibid.*).

In the end, it was sovereign, not commercial, risk that destroyed most pre-1914 French and German savings lent abroad, the Russian and other revolutions in the case of the French, the consequences of defeat in World War I in the case of German investments.

(c) *American Foreign Lending in the 1920s.* While this article aims primarily at drawing lessons from the pre-1914 experience, a little should be said, if only by way of contrast, about American lending in the 1920s.[2] The bulk of American lending to Europe in the 1920s was very different from the typical international lending, certainly from British lending, of the nineteenth century. As Keynes once put it: "If European bonds are issued in America on the analogy of the American bonds issued in Europe during the nineteenth century, the analogy will be a false one; because, taken in the aggregate, there is no natural increase, no *real* sinking fund, out of which they can be repaid" *(A Revision of the Treaty,* cited RIIA 1937, p. 12). Unlike British pre-1914 foreign lending which helped increase the productive capacity of borrowing countries for export commodities which Britain herself needed in ever increasing volume, much post-1918 lending to Europe was for purposes which did not, at any rate in any direct way, raise the borrowing countries' productive and export capacity. Moreover, these borrowers were industrial countries whose exports were competitive with US industry. Most of the money lent by the United States was for stabilisation and debt service on war debt and other loans which were used to meet debt service on war debt and reparations, to replenish gold and foreign exchange reserves or to improve municipal facilities, such as hospitals, workers' housing, public libraries and swimming baths, which raised

[2] This, with other inter-war experience, has recently been interestingly re-examined by M. DE CECCO (1985).

living standards but did not enhance the debtor's capacity to service foreign debit. Nor was the servicing capacity of the debtors helped by the "wasteful purposes to which much of the money had been offered" (de Cecco 1985, p. 58). At the same time, the United States pursued increasingly protectionist policies which obstructed efforts by Germany and other debtors to meet debt service once the flow of funds from the U.S.A. slowed down with the New York stock exchange boom and slump in 1929. By the early 1930s, under the impact of the Great Depression, most of this debt was in default, and the defaults led to the virtual collapse of the international bond market (Arndt 1944, pp. 12f.).

The mechanism of American foreign lending during the 1920s was closer to Continental than to British practice. De Cecco has described the American practices as technology variation in the "production" of foreign bonds. In the process, in his view, the New York banks moved decisively towards universal banking and "cut through the whole [specialized] structure of British type finance to intermediate, in only one step, between the ultimate lenders and the ultimate borrowers" (de Cecco 1985, pp. 55-6). This interpretation, however, may give too much emphasis to the banks and neglect the complementary role of the non-bank issue houses. "In New York, between 1925 and 1930, this business [flotation of foreign long-term securities] was undertaken by specialised issue houses. These issue houses, or syndicates of issue houses and banks, first made short-term advances to foreign borrowers which, when market conditions were favourable, were usually funded into long-term loans ... An issue might pass through the hands of several firms before being offered to the public". Special effort would be needed to sell issues to the public especially in the early post-war years because American investors were unfamiliar with foreign securities. "Thus the employment of 'bond salesmen', whose services had been very valuable to the issue houses in the flotation of domestic securities before the war, became an essential feature". Metropolitan banks also created special companies, "security affiliates", which sold new issues all over the country (RIIA 1937, pp. 168f.).

Underlying the "astonishing success" in selling foreign bonds in America was the rise of an affluent American middle class with disposable savings and a dearth of other financial assets. The strength of domestic demand for securities gave a powerful incentive to the American financiers to solicit foreign borrowers into obligations. The U.S. Department of State may unwittingly have assisted the financial

success of the loans by vetting for *political* appropriateness all foreign bond issues in the United States (de Cecco 1985, p. 58).

After the collapse, there was much *ex post* criticism of U.S. foreign lending. "The US", it was said "had neither the machinery nor the discriminating experience accumulated by the UK in this field, and there was a good deal of extravagant and imprudent lending" (R. Mikesell, cited Dunning 1972, pp. 60f.). But there have also been defenders of the American issue houses. "Some American issue houses employed experts of the highest standing to investigate financial and economic conditions in order to ensure as far as possible that new loans would be successful" (RIIA 1937, p.172). The practice of employing bond salesmen was open to abuse, but overoptimistic judgments were not encouraged by the issue houses (*ibid.*).

Lessons for the Future

What lessons can we learn for the future from the historical experience that has been recounted in the preceding sections?

The first, undoubtedly, is the soundness of the instinct which lay behind the English conservative banking principles. In R.I. McKinnon's words: "Commercial banks, which are the custodians of the national money supply and the international payments mechanism, should not be in the business of long-term, highly risky, lending" (McKinnon 1984b, p. 480).

McKinnon has indicated some of the reforms needed to correct the "regulatory imbalance" which in the 1970s played a major part in tempting American and other western banks into imprudently far-reaching departure from this principle. In essence, the new regulatory approach he recommends aims at "restoring the essential distinction between monetary institutions — where the safety-first rule is paramount — and the 'risk-taking' capital market" (McKinnon 1984a, p. 20). Some version of the principle embodied in the 1934 Glass-Steagall Act, of requiring separation of merchant banks and securities houses from commercial banks, with only the former providing risk capital, "should apply in a balanced fashion at both the domestic and international levels. This would encourage a more appropriate development of the international capital market, based mainly on bonds and equities" (*ibid.*). McKinnon recognises that "getting the commercial banks out of the long-term capital market cannot be accomplished any time soon. The existing debt-overhang in less developed countries is so large that only the banks have the capability — and strong enough vested interest — refinancing it". But he thinks it important that the commercial banks should not "dominate the international capital market in the 1990s as they did in the 1970s" (McKinnon 1984b, pp. 480f.).

The second lesson of the 1870-1930 experience is one that has probably been learned well enough in the North, although it is still often challenged in the South. This is that politically motivated lending — whether to subsidise allies, to prop up client states, to rehabilitate war-torn economies or to aid countries that are poor credit risks — is not an appropriate task for the private capital market. It is a case for government-to-government grants or at best concessional credit by bilateral or multilateral agencies set up for the purpose.

A third lesson is that, even in an international bond or equity market, there is room, indeed an essential role, for banks — even perhaps for deposit-taking commercial banks. We saw that in all the major pre-1914 capital markets, financial intermediaries played a vital part, in examining the creditworthiness of governments and others seeking to borrow, in negotiating the terms and conditions of a loan with the borrowing government, in organising or undertaking underwriting, in placing issues, and in marketing bonds by stock exchange listing or direct sale to the public. In London the financial intermediaries involved were specialised institutions, merchant banks and others functioning as issue houses, and stockbrokers and others as underwriters. In France, Germany and the USA, industrial and even commercial banks were actively involved in foreign lending, individually or in consortia. But — and this is the decisive difference between most pre-1914 and general post-1970 practice — the banks did not, except temporarily, lend their own funds. They acted strictly as short-term intermediaries, taking up foreign securities but then selling them to the public as rapidly as possible. Thus they did not, to anything like the extent prevalent in the 1970s, themselves assume the risks of long-term lending.

The American experience of the inter-war years yields further lessons, notably in the field of bank regulation. Foreign lending by banks should be subject to appropriate prudential controls, and banks should be restrained from soliciting borrowers abroad and bond buyers at home. The practice of universal banking, or the "financial super-

market", is not self-evidently a good model and should be assessed critically by monetary authorities.

There remains the central question whether resuscitation of an international bond and equity market of the pre-1914 London kind is in fact feasible in the world economy of the 1980s and 1990s. Of course, McKinnon's new regulatory approach would help by containing the competition of subsidised banks. But is it at all likely that the international bond market which received a severe shock at the end of World War I and collapsed so completely in the 1930s can be revived after the further experience of the inevitable reschedulings, if nothing worse, of international bank debt in the 1980s? Will investors have sufficient confidence in bond issues of even the most reputable LDC governments? Is there any reason to believe that imprudent lending and borrowing would be less likely in such a market than by and from banks?

Sceptics will point out that even in its nineteenth century heyday, much investment in the London bond market had, and perhaps needed, the protective cover of British government guarantees under the Colonian Stockt Acts and in the last resort the British navy; that general government guarantees, without close supervision which would nowadays rarely be tolerated, are just as liable to encourage imprudent bond issues as deposit insurance and bailout expectations for banks; that, while something is gained by safeguarding the banking system and depositors in general — and thus money as a public good — from the risks of long-term international lending by deposit banks, individual depositors are little better off if they are pressured by their banks or by bond salesmen into buying dubiously safe foreign securities; that there can hardly be a worse time to attempt to revive an international bond market than when most potential borrowing countries have tens of billions of debt like millstones round their necks; that in a slow-growth and increasingly protectionist world economy LDC borrowing countries are liable to face the same difficulties in earning foreign exchange needed for debt service as did the industrial debtors of the USA in the 1920s (as contrasted with the primary-producer borrowers from pre-1914 Britain); and finally, as McKinnon has pointed out, that "a long-term capital market operates best when international price levels and exchange rates are fairly stable — as they were under the nineteenth century gold standard" (McKinnon 1984a, p. 19).

It is a formidable list of doubts. What can be said on the other side? Eight points might be made.

1. The strength of the case for favouring bonds over banks as the main vehicle for international long-term lending needs to be recognised, though one must also heed McKinnon's warning that any such development will take time.

2. It may not be too cynical to point out that the memory of past losses fades with time. By the 1870s British investors had got over the shock of the defaults of the 1830s (Platt 1980, p. 8).

3. The argument about the importance of trade complementarity between borrowing and lending countries can be overdone. It was the sudden drying up of loan funds and the depression that caused the defaults of the early 1930s. There is no more need for international than for domestic debt to be repaid. What matters is that external debt ratios do not rise continuously and that individual investors' foreign assets should be liquid, as bonds are in a large and well-functioning market.

4. While guarantees by lending governments should be avoided, there is a broad presumption that reckless overoptimism and neglect to evaluate creditworthiness of borrowers — which have clearly been a feature of a good deal of international bank lending in the past decade — would be less likely in a capital market in which bond issues are subject to widespread public scrutiny. Risks would be further reduced if the issue of bonds by merchant banks and other financial intermediaries were subject to regulatory supervision to ensure care in risk evaluation.

5. Experience is being gained at present through the efforts by Citibank and others to fund some of their outstanding loans by conversion into floating bonds and other securities to be sold to investors (Amex 1984, Meyer 1984). These experiments represent a useful testing of the water for a revival of an international bond market.

6. Encouragement of domestic bond and equity markets in LDCs could accustom investors in these countries to holding wealth in this form (cf. Drake 1985). Conversely, just as many foreign loans issued in the pre-war London market were, as we saw, taken up by nationals of the borrowing countries, so there may be a case for LDC governments initially taking advantage of the greater confidence which issue in a major international financial centre, rather than in the domestic market, may inspire among their own nationals.

7. No one financial centre can nowadays fill the role of an international securities "supermarket" that London performed in the

period 1870-1914. But most of the economies of scale can probably be reaped through the telecommunications links that now turn national and offshore financial centres into virtually a single world market.

8. Finally, one can but admit that any loss of price and exchange rate stability compared with pre-1914 gold standard days would mean a less favourable environment for a world-wide bond market. But in practice for most of the period 1850-1914 the rules of the gold standard were neither as relevant nor as widely observed as the textbooks suggest. Fluctuating exchanges were the general rule in Asia and Latin America until about the turn of the century. And as various countries then moved to gold-backed currencies they had to cope with fluctuations in the silver:gold price ratio. The international bond market continued to function despite variations in relative currency values. How far indexation of bonds and longer-term hedging facilities can overcome present day exchange rate variability requires further consideration.

Private Sector Borrowing

The preceding discussion has focused primarily on international borrowing by governments. In fact, however, as McKinnon has pointed out (McKinnon 1984a, pp. 10f.), a good deal of the present volume of external debt contracted by LDCs is on private rather than on government account. It may be worth adding a few words on private sector international borrowing which raises some special issues.

In most developing countries, little risk capital is raised by the issue of equity shares, for three main reasons. First, much productive enterprise is state-owned. Secondly, local businesses in the private sector generally find the company form of organisation unattractive. Family or kin-group proprietorship is preferred. Public disclosure of information about the firm, to competitors or government, such as is required for incorporation and share flotation, is disliked and avoided if possible. Frequently, the local professional accounting infrastructure is inadequate to ensure the reliable external audit of company accounts which is essential for public share issues. Often the size of the business is too small to warrant public company form. Thirdly, well-established private firms have little difficulty in obtaining domestic bank credit

which, although nominally short-term, may in fact be rolled-over indefinitely. Often the availability of local bank credit is facilitated by personal connections. In these circumstances, there has been little incentive for LDC businesses to attempt to raise long-term capital either by the issue of equity shares or by the sale of debentures. The additional supply, in recent years, of international bank credit to LDC businesses has fitted in with the ingrained borrowing habits of those firms.

What may be relatively low-risk credit to a local bank knowledgeable about the country and its business sector and personalities is liable to be much higher-risk credit for absentee international banks. A major flaw of much of the international bank lending to private borrowers in LDCs in the past decade, which even branch offices and merchant bank affiliates have not always remedied, has been that lenders have lacked accurate knowledge drawn from first-hand observation of the abilities and personal qualities of the borrowers. Not for nothing do domestic banks extend their branches into quite small towns and villages.

The alternative, obvious at first glance, of replacing international bank lending to private business in LDCs by equity issues in internatio-nal financial centres runs into a different problem. Foreign equity finance encounters economic-nationalist concerns about foreign ownership and control. Few LDCs businesses, moreover, are large enough and sufficiently well known to have much hope of successful share issues overseas.

The task therefore is to develop and broaden existing domestic securities markets, to create such markets where none yet exists, and to attract foreign capital into such markets. The former set of problems has been much discussed in recent years (cf. Drake 1985). The notion that markets for private securities in LDCs could provide a vehicle for capital import on a large scale needs to be considered in conjunction with the alternative of foreign direct investment by multinational companies and varieties of joint venture. Another option is the issue of private sector bonds or debentures. This form of capital raising would not involve dilution of ownership or control and would require less disclosure than would the issue of equity shares. The bond thus represents a way round the dependence on bank credit which is at present so prevalent among LDCs businesses, and it provides for long-term risks to be borne in a manner which is safer for society.

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