American Foreign Investments

by

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Foreign investments have played an important role in developing the natural resources of many countries and in raising the standard of living of both capital-exporting and capital-importing nations. To promote world economic health private capital in the United States will have to flow in increasing amounts to the rest of the world when the Marshall program comes to an end. Such a movement would assist the development of economically-retarded areas, facilitate the integration of the Western European economies, and help to modernize plant and equipment and to increase the standard of living of the peoples involved.

Aside from periods of war or emergencies requiring government intervention and aid, foreign investments have been considered primarily the function of private enterprise. They took two forms: direct investments, *i. e.*, investment by corporations or individuals in enterprises in foreign countries, and portfolio investments, *i. e.*, the purchase of foreign securities in the currency of either the creditor or the borrowing country. Frequently, portfolio investments also took the form of participations by a business concern in one country in a foreign company. The international flow of short-term funds, attracted primarily by high rates of interest, also played a very important role in the world money and capital markets. This study, however, is concerned exclusively with the movement of long-term capital, and particularly with the outlook for American foreign investments.

Since the end of World War II the United States has invested abroad huge amounts of long-term capital. While most of this took the form of government loans and grants, direct investments were also substantial, particularly in the oil industry. On the other hand, aside from the acquisition of Canadian and a relatively small amount of some Western European securities by American investors, portfolio investments played an insignificant role. Point Four of President Truman's Inaugural Address of January 1949 has raised the hope that after the necessary legislation has been passed, the flow of private capital from the United States to economically-retarded areas as well as to economically-highly-developed countries will increase materially, thus speeding the rehabilitation of free countries and helping to combat Communism. The revival of foreign investments on a large scale will also help end the acute shortage of dollars abroad and ultimately to bring about the free convertibility of Western European currencies.

The primary purpose of the present study is to analyze the following points: 1) the flow of American capital abroad after the two World Wars; 2) the experience of American investments abroad and the causes of the numerous defaults on American foreign dollar bonds sold during the '20's; 3) the prerequisites for a continued large flow of capital abroad; 4) the extent to which existing institutions or the proposed legislation on Point Four will stimulate the flow of American capital abroad, and 5) finally, the outlook for the export of capital from the United States.

American Investments Abroad, 1919-1930.

Whereas prior to 1914 the United States was a debtor nation to the extent of 2 to 3 billion dollars, in 1919 American investments abroad, exclusive of inter-governmental debts, amounted to \$ 6½ billion, consisting of \$ 3.9 billion in direct investments and \$ 2.6 billion in portfolio investments. During the '20's, when money rates in the United States were lower than in many other countries and the need for American capital to rehabilitate foreign economies, particularly in Europe, was very great, there was a large outflow of American capital. At the end of 1929 American private investments abroad totaled \$ 16,800 million, composed of \$ 7,700 million direct and \$ 9,100 million portfolio investments, showing an increase during the ten years of \$ 10,300 million. The bulk of the American capital invested abroad took the form of foreign dollar bonds sold primarily to individuals and institutions in the United States. Direct investments increased by \$ 3,800 million during the decade, being used to develop the natural resources of economically-retarded countries and to establish branch factories and subsidiaries throughout the world but notably in Latin America and Canada.

As of 1939 about 39 per cent of all foreign dollar bonds originally offered in the United States were in default, causing large losses to American investors. Because of the large proportion of defaults, foreign bonds acquired a poor reputation and, with minor exceptions, the flotation of these securities came to an end. In view of this experience, it is not likely that this type of capital outflow will be revived to any great extent, except for Canadian obligations and those of the International Bank for Reconstruction and Development; the latter, for the time being, rest largely upon the credit of the United States Government.

By the end of 1945 the composition of American foreign investments abroad had undergone a considerable change. Total private long-term investments were then estimated at \$ 13,658 million, of which direct investments amounted to \$ 8,369 million and foreign dollar bonds to only \$ 1,748 million. Securities payable in local currencies and other long-term investments amounted to \$ 3,541 billion. The long-term investments abroad of the United States Government amounted to \$ 1,680 million. These figures indicate that while a drastic reduction occurred in portfolio investments between 1929 and 1945, direct investments in spite of the depression during the '30's and the ravages of the war actually increased by about \$ 670 million.

The postwar period has been marked by a substantial increase in the foreign investments of the United States Government and of private direct investments. Portfolio investments, on the other hand, remained practically unchanged from 1945 to 1948. At the end of 1948, total American long-term private investments abroad aggregated \$ 16,762 million, of which direct investments amounted to \$ 11,318 million or 67.5 per cent, foreign dollar bonds to \$ 1,673 million, and securities payable in foreign currencies and other long-term investments to \$ 3,771 million. On the other hand, long-term United States Government investments amounted to \$ 12,903 million, or 43.5 per cent of the total American long-term investments abroad. Moreover, government investments abroad do not include the huge amounts of grants made by the United States in the postwar period.

The developments during 1945-48 forecast to some extent the character of the flow of capital that may take place in the future. They indicate that any large-scale export of capital from the United States will very likely be financed by government agencies including the International Bank or take the form of direct investments, primarily to develop the natural resources of foreign countries. Considering the difficulties now being encountered by the American oil companies in disposing of the products of their foreign subsidiaries, it may be doubted, however, that the flow of direct investments abroad in the near future will be as large as in the immediate past.

Reasons for Default of Foreign Dollar Bonds.

Although this question is rather ancient history and has been the subject of countless discussions, it is important to analyze it at this time in order to indicate the mistakes to avoid in the future. The principal reasons for the defaults may be summarized briefly as follows:

1) the total volume of foreign loans issued in the United States was too large and the principal and interest payments constituted too heavy a burden on the balance of payments of the rest of the world. Failure to pay interest

and principal when due constitutes a default. This is not the case with direct investments, on which profits and dividends are paid only when they have been earned. Moreover, the inability of a foreign subsidiary to remit earnings in the currency of the capital-exporting country does not constitute a default and does not reflect on the credit standing of the capital-importing country;

2) individual countries borrowed beyond their capacity to pay the debt in the currency of the lender. This also is unlikely to happen in the case of direct investments since the company usually makes a careful analysis of the economic position of the foreign country before establishing a subsidiary or branch or undertaking the development of some natural resources;

3) very often the proceeds of the loans were used for purposes which did not create foreign exchange or reduce the demand for foreign exchange, *i.e.*, they were not used to increase exports or to reduce imports, visible and invisible. Even when the investments helped the general economy of the borrowing country, they led to trouble when they did not improve its balance of payments. Moreover, at times the proceeds of the loans were used for purposes other than those for which they were intended;

4) the foreign exchange transfer problem was aggravated by the sharp decline in world prices of raw materials and farm products and the decline in business activity throughout the world. Furthermore, the unsound hightariff policies adopted by the United States Government during the '20's, as well as the existence of war debts reparations, contributed at least in part to the wholesale defaults on foreign dollar bonds.

With few minor exceptions, notably securities issued by Canada and the International Bank for Reconstruction and Development, the entire period from 1930 to 1950 was devoid of foreign loans.

The lessons that the experience of the United States with foreign dollar bonds teach, briefly, are these: loans to foreign governments or corporations, on which interest or principal has to be paid in the immediate future do not constitute a good medium of investment, particularly if the amounts involved are large and are thus likely to create a transfer problem. They are useful, and could be used again in the future under certain conditions, if the amounts involved are not large, and particularly if the proceeds are used to improve the balance of payments of the borrowing country. Loans in moderate amounts which would lead to an increase in exports and a reduction in imports, visible or invisible, are sound and will be made again in the future. Because of the bad experience with foreign dollar bonds, and because economic and political conditions do not seem to be propitious, it does not appear likely, however, that the near future will witness any substantial outflow of capital from the United States to foreign countries in the form of long-term loans sold to individuals or institutional investors. Such loans as are made will be small and will be confined to a few countries, and principally Canada. An outflow of private capital from the United States will be almost exclusively in the form of direct investments.

This outlook applies also to loans by the International Bank for Reconstruction and Development. The Bank's capital amounts to $ 8.3 billion, of which $ 6.7 billion is still uncalled. It is evident, however, that American investors consider its securities sound only so long as they rest on the credit of the United States. Once the dollar quota of the Bank has been used up it is doubtful whether it will be able to sell a large volume of securities in the American market. This becomes all the more clear when one takes into account the fact that the savings of the United States have become largely institutional in character and are handled primarily by insurance companies, savings banks, savings and loan associations, trust companies and commercial banks. These institutions are as a general rule very conservative in their investing policies and are likely to look upon foreign securities with considerable suspicion.

Experience with Direct Investments.

The experience with American direct investments abroad has, on the whole, been much better than with portfolio investments. The direct investments were based on the judgment of individual companies and were made only after careful study. Often they were made for the purpose of developing the natural resources of the foreign country and thus made possible an increase in exports. Furthermore, the establishment of manufacturing subsidiaries and branches in foreign countries led to a decrease in their imports. Thus the balance of payments of the foreign country was favorably affected in both directions.

The difficulties encountered by direct investments, aside from changes in business activity which affected profits in local currencies, were, briefly, as follows: 1) the inability to transfer profits into the currency of the investor. In these cases, however, the latter could reinvest the earnings and thus expand the earning power of the enterprise; 2) legislation on labor relations, wages and prices. In these respects the foreign subsidiary or branch was generally affected no differently than the local manufacturer; 3) legislation requiring native directors and executive personnel in foreign subsidiaries; 4) nationalization of property without adequate compensation; 5) confiscation and destruction of the properties during the war; 6) devaluation of currencies, which had an adverse effect on the current assets of foreign subsidiaries when converted into the currency of the investing country; 7) legislation discriminating against foreign capital.

These difficulties are inherent in most foreign direct investments and constitute the normal risk the investor takes in making such investments. The principal advantage of these investments is the higher rate of return on the funds invested abroad, which often constitutes adequate compensation for the increased risk. However, if conditions are such that the risks involved are greater than usual and are not compensated by the higher return, corporations will become more hesitant to invest abroad. In the postwar period the return on capital invested in the United States has increased materially and does not lag far behind the yield on foreign capital. This is indicated in the following table:

RATIO OF EARNINGS TO INVESTMENTS
(*In Per Cent*)

	United States Foreign Direct Investments		Investments in United States
	Underdeveloped areas *	Developed areas	
1945	11.5	7.2	7.7
1946	14.3	10.1	6.1
1947	18.1	12.4	12.0
1948	19.8	14.2	13.8

* Represent in part the large income derived from investments in oil properties.

On the other hand, the foreign risks appear to have increased. Thus, unless measures are taken to mitigate these hazards, the flow of foreign capital from the United States in the form of direct investments is likely to be retarded.

The difficulties that will have to be overcome in connection with foreign direct investments are briefly these:

1) the political and economic instability in many parts of the world. Unlike previous periods, when the ending of a war was followed by a prolonged period of international political stability, the present situation is marked by the « cold war », accompanied by increased armaments in all countries and a widespread fear of war. Such a condition is naturally not conducive to the international flow of capital on a large scale;

2) the dollar shortage abroad is very pronounced and it is likely to continue after Marshall aid has ended unless there is a large outflow of private capital from the United States;

3) there is a growing tendency toward nationalism in many countries which had led to restrictions of foreign investments and their exclusion from some fields reserved for the governments. For example, in some of the newly-independent nations in the Far East the construction of basic public works is reserved entirely to the respective governments;

4) there is a tendency to nationalize certain basic industries, or at least to regulate their activities. Foreign capital is naturally hesitant to invest in enterprises which may be either nationalized or hamstrung by all kinds of government regulations;

5) many countries are suffering from political unrest and some of their labor unions are dominated by the Communist Party which, as is only too well known, is hostile to foreign investments in general and to American investments in particular;

6) despite the recent devaluation of currencies, there still exists uncertainty about their ultimate international value. Moreover, devaluation has again set in motion a spiral of prices and wages, the end of which cannot as yet be foreseen. This naturally has complicated the cost factor and tends to handicap direct investments;

7) while the need for foreign capital in economically-retarded areas is very great, conditions are not yet ripe for large-scale investments in these areas. Before such a capital flow can take place great improvements will have to be made in health and transportation facilities and in agriculture, which are primarily functions of government rather than of private enterprise;

8) in the colonies of some European countries American investors encounter restrictions from industries located in the home country.

As long as these conditions exist, direct investments of American capital will be seriously deterred. To eliminate them and to give American investors some insurance against the abnormal hazards will require special measures by foreign countries and by the United States Government as well.

Point Four and Governmental Loans.

Because of the unfavorable economic and political conditions prevailing in many parts of the world, which create an unfavorable climate to foreign investments, and because of the realization that it is to the interest of the United States to strengthen the free countries of the world and thus combat the spread of Communism, the President of the United States, in his Inaugural Address in January, 1949, announced the now world-famous Point Four. In this message the President advocated making available to economically-undeveloped areas American knowledge and technical skill and stimulating direct investments abroad by American private capital. The basis for this plan was the realization that even after the termination of the European Recovery Program in 1952 there will continue to be a dollar shortage abroad. This gap will have to be filled primarily by private capital, aided by the Government and supplemented by credits granted by the Export-Import Bank and the International Bank for Reconstruction and Development. Point Four proposed that the United States Government assist economically underdeveloped countries to improve health, transport and agricultural conditions and thus prepare the way for attracting private capital to those areas to develop their natural resources and to raise their living standards.

This program has raised high hopes in many parts of the world but so far little has been accomplished. Several bills have been introduced in Congress, one of which authorizes the President to extend technical assistance to foreign countries through agencies of the United States Government or, where practical, through agencies of the United Nations and private agencies or individuals, and to empower the Export-Import Bank to guarantee private investments abroad against inconvertibility of profits of foreign investments into dollars, and loss resulting from expropriation, confiscation or seizure by a foreign government. The President has also recommended granting certain tax advantages to American corporations operating abroad. Under the proposed program the United States will conclude investment treaties with foreign countries to create conditions which will encourage the investment of American capital abroad.

An analysis of these points will throw some light on the prospects for the flow of American private capital abroad under Point Four.

For the first year an appropriation of $ 45,000,000 has been recommended by the President for technical assistance to foreign countries. This amount is rather small, considering the enormous economic problems confronting the economically-retarded areas. Moreover, the financing of the sanitation, education, transportation and agricultural developments will have to be carried out by the respective countries themselves, and their ability to cover these outlays is limited. In addition, the lack of skilled workers increases the difficulty of accomplishing the desired results within a short time.

In general, political and social conditions in economically-retarded areas are not now conducive to the attraction of foreign capital. Nevertheless, large investments have been made in the development of natural resources for which there is a strong world demand and in manufacturing enterprises which promise to be more profitable than similar operations in the United States. For example, during the three years 1946-48 American oil companies invested almost $ 1.2 billion abroad, much of it in economically-backward countries, with rather unfavorable living and working conditions. When these investments were made, however, they promised to yield substantial returns, and this proved to be the case. The adjusted ratio of income to total foreign investments in the petroleum industry rose from 14 per cent in 1945 to 28 per cent in 1948. The ratio of earnings to investments in certain areas, particularly the Middle East, was much larger. Some American steel companies are preparing to invest large amounts in the development of iron ore resources in Venezuela, an economically-retarded country, and in Canada, a country which is highly developed. These examples clearly demonstrate that where conditions are favorable, no government guarantee is needed to induce American capital to go abroad.

Despite the limitations mentioned, technical assistance rendered under Point Four will have a beneficial effect in the countries involved. If the improvement in health and educational standards and the expansion of transportation facilities and agricultural output lead to higher purchasing power and increased demands for commodities they will undoubtedly tend to attract foreign capital. For the time being, however, the amount is bound to be small, partly because of the uncertain conditions prevailing in the various areas and partly because their absorptive capacity is still very limited.

Guarantee of Foreign Investments.

While the government guarantees against inconvertibility of currency apply to economically-retarded areas as well as to E.R.P. and other countries, they are primarily intended for the more industrially-developed nations. At first glance it might appear that assurance by the United States Government of currency convertibility would stimulate a large outflow of American capital. This, however, may not necessarily be the case. Guarantees against inconvertibility have been provided for by the E.C.A., and for this purpose $ 300 million was set aside for the first year and about $ 150 million for the second year. Nevertheless, so far applications for guarantees amount to only $ 5 million. This would seem to indicate that the existence of a guarantee against inconvertibility does not in itself constitute a strong attraction to American companies, partly because of red tape involved in the establishment of branch factories or subsidiaries in some of the E.R.P. countries but primarily because the guarantees are intended to meet the requirements of small and medium-sized concerns. These companies as a rule do not have much experience with foreign investments, and their managements, even under the best of circumstances, are rather reluctant to invest capital abroad. Direct investments by American companies will be made primarily by the very large concerns with considerable experience in this field. These corporations, however, are not particularly interested in a guarantee which is bound to involve an element of cost and under certain conditions may prefer to carry out their operations without government assistance. With a more favorable economic and political climate, however, a guarantee against inconvertibility could stimulate the outflow of capital from the United States, although not in as large amounts as was formerly hoped for.

Similarly, although tax concessions by the Government to foreign investors would be welcomed, not too much hope can be placed in this suggestion of the President. It is not yet clear what the tax concessions will be and how much they will save the corporations investing abroad. Nevertheless, such a measure, particularly if it provided liberal concessions and also embraced investments of individuals, could be an important factor contributing to the outflow of capital from the United States.

Bilateral Investment Treaties.

Although the treaty phase of the Point Four program has received relatively little attention, it can, if other conditions are favorable, play a most important role. Already some treaties have been concluded, for example with Italy, and others are under consideration. These treaties remove the danger of discrimination against American capital and create a more favorable investment atmosphere. They give assurance to American corporations that no discriminatory legislation will be passed or that if such action is taken the United States Government will take steps to remedy the situation.

In themselves, however, the treaties cannot create a large outflow of capital. Other conditions over which the signatory countries may have no control could play a much more important part. Among these may be mentioned the following: 1) the ratio of earnings to invested capital, which is smaller in the E.R.P. countries and their dependencies than in some other areas, for example the American republics. It must be reiterated that the investment of foreign private capital is done primarily with the desire to make a profit. If profits are not satisfactory or the outlook is not good, capital will be hesitant to go abroad; 2) labor conditions in some countries, Italy and France for example, are at present not conducive to large-scale investments. Where political strikes are common and where, because of labor difficulties, the investor is not sure whether his branch plant or subsidiary will be able to operate satisfactorily, capital will naturally be very hesitant to go in; 3) the internal taxation system, labor legislation, and other laws applying to investors, domestic as well as foreign, may also retard the flow of American capital to some countries. However, in spite of these drawbacks, the investment treaties constitute a step in the right direction.

Taking the various provisions of Point Four into account and analyzing the various factors involved, one reaches the conclusion that Point Four in itself is not likely to set in motion a large flow of capital from the United States. This does not preclude the investment of considerable sums by American firms in Canada or some of the neighboring countries, nor does it rule out the possibility of substantial investments in the development of natural resources in certain areas and of investments in countries where sentimental reasons may play a more important role than economic factors, as for example in Israel.

The Possible Flow of Capital Abroad.

Various estimates have been made regarding the amount of foreign, primarily American, capital needed to develop economically-retarded areas and to restore healthy conditions in the developed countries. The Food and Agricultural Organization of the United Nations has estimated that an annual foreign investment of about $ 8 billion will be required for a period of four years. This estimate is unrealistic, since such huge sums could not be raised in the few countries capable of exporting capital and it is doubtful whether the capital-importing countries could absorb them without creating inflationary conditions. Desirable as such investments might be, the targets set are altogether too high to be achieved within a reasonable period of time.

The National Association of Manufacturers of the United States based its estimates of the expected export of capital from the United States not so much on the needs of the foreign countries but rather on the ability of the United States to supply them. Based on the ratio of foreign investments to total national income for the period 1922-29, and assuming a national income of $ 225 billion per annum, a figure of American foreign investments of between $ 2 and $ 2½ billion was reached. This amount can be raised in the United States, particularly if the estimate includes both direct investments by American corporations abroad and loans made by agencies of the Government

such as the Export-Import Bank and the International Bank. Moreover, one can go a step farther and state that under certain conditions the total can be reached even if Canada is excluded from the list of borrowing countries.

The Export-Import Bank and the International Bank for Reconstruction and Development combined will be in a position to furnish about $ 700 million annually for a period of four to five years. The amount of capital that can be exported by these institutions is relatively small, partly because of the limited amount of dollars at their disposal and partly because their activities are rigidly circumscribed by law. Under present legislation the Export-Import Bank is in a position to lend between $ 150 and $ 180 million a year over a period of four or five years. At the end of 1949, the World Bank had made loans and commitments of $ 740 million. During the next four or five years the Bank may be able to sell about $ 500 million of its debentures per annum in the United States and place these sums at the disposal of foreign countries. This assumes, however, that suitable projects can be presented by the respective borrowers to the Bank.

If carefully handled, an outflow of capital from the United States of about $ 2 billion per annum, aside from any further assistance that may come from the United States Government in the form of loans and grants, could have an important favorable effect on the economies of the countries affected. While this amount in itself is not very large, particularly in view of the present purchasing power of the dollar, it could lead to a material increase in the standard of living of the recipient countries and contribute materially to bridge the dollar gap, thus making possible the free conversion of the leading European currencies arising out of current transactions.

Conclusions:

1) the fruitful effects of the international flow of capital are well understood. It is generally recognized that such a flow of capital is desirable and has a beneficial effect on both the capital-exporting and the capital-importing countries. For the latter, it leads to the development of natural resources and the better utilization of existing resources, to gradual industrialization and an increase in the general standard of living. For the former, it leads to an increase in exports and thus stimulates production and creates employment;

2) at present there are only a few countries in a position to export capital on a large scale. Of these the United States is by far the most important, followed by Switzerland and Canada, which are able to export capital in moderate amounts. There is also a slow but steady flow of capital from Great Britain to the sterling area countries;

3) there is no lack of capital in the United States which could be invested abroad if conditions were propitious. Money rates in the United States are extremely low and large institutional investors are confronted with a serious problem of finding suitable outlets for the funds at their disposal. Because of previous bad experience with foreign loans, however, a revival of the flotation of foreign loans in creditor countries is not to be expected for years to come. Direct investments abroad are also handicapped at present by the uncertain political and economic conditions prevailing in the world, and in particular in some of the countries most in need of foreign capital. The backwardness of some economically-retarded areas also reduces their ability to absorb large amounts of foreign investments. This, however, does not apply to the investment of capital for the purpose of developing natural resources, such as oil, for which there is a great world demand. But even in the case of oil a temporary over-supply seems to be in the making and a slowing down of American investments to develop foreign oil resources may be expected. The high rate of return which capital can obtain through investments in the United States is also a handicap to investments abroad. So long as American capital can obtain a high return at home, it is not likely to seek risky investments abroad even though they may promise a higher rate;

4) Point Four of President Truman's Inaugural Address has been carefully formulated and in the long run could play an important role in facilitating the export of capital from the United States. The high hopes which have

been raised regarding it are, however, not likely to materialize in the immediate future;

5) what form Point Four will take it is as yet impossible to state. It will depend on the type of legislation that will be passed by the Congress. But even under the most favorable conditions the flow of private capital from the United States to foreign countries will depend not so much on legislation passed by the Congress of the United States as on economic and political conditions prevailing in the capital-importing countries. If the cold war subsides, if the danger of war and nationalization is removed, if the nationalistic trend in many countries subsides, a considerable outflow of capital can be expected from the United States;

6) for a short period of time, even after 1952, the United States Government may continue to place moderate sums at the disposal of foreign governments in the form of loans or grants. It has been fully recognized in this country that the United States cannot be prosperous in a poverty-stricken world and that a strong and healthy Western Europe with a rising standard of living will not only have a favorable effect on international trade in general but will also constitute the strongest bulwark against the spread of Communism;

7) the flow of capital from the United States to foreign countries, eliminating intergovernmental loans and investments that may be made in Canada during the next few years, is not likely to be very large. Under the most favorable conditions one can expect in the immediate future an outflow of capital of about $ 2 billion, consisting of direct private investments, and loans that may be made by the International Bank for Reconstruction and Development and by the Export-Import Bank. Relatively small as this amount is, if properly handled, and particularly if accompanied by technical and managerial assistance provided by the United States Government, it could at least lay the foundation for a much larger international movement of capital once world conditions become more normalized and more stable.