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Remarks of J. L. Robertson

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Lest We Forget

The invitation to participate in this conference gladdened my heart for two reasons. First, it provided an opportunity to come back to Nebraska. (It is always nice to come home, but it is particularly good to be asked to come.) Second, it was heartening to see evidence of interest here in the Midwest in international economic problems.

There is still some tendency in the East to look on us Midwesterners as unsophisticated rustics. Not having been one to hide the fact that I was born and raised in Broken Bow - and for once I am sure that I do not have to explain where Broken Bow is - I have had to take a certain amount of guff from Easterners during my temporary residence of thirty-six years in Washington. I have done my best to educate them to the fact that the West is no longer wild and primitive, but this is not easy for one who, himself, does not yield easily to polish, and so there are still a few people who have not been convinced.

One thing they often ask me is how Broken Bow got its name, and I take delight in explaining to them that - contrary to their imaginings - it had nothing to do with the Indian wars. I tell them that it was originally called Edinburgh on the Plains; that Paganini once came to play his violin at our annual music festival, and that as he walked out on the stage of the old opera house he stumbled and fell on his bow and broke it. The world-wide interest in the incident naturally resulted in the change of the name of the metropolis to Broken Bow.

When they express disbelief, I go on to tell them that one of the backers of those early music festivals was a local banker, a very shrewd old man who could have run circles around many a city slicker. Asked how he got started, he said, "Well, I just went out and hung up a big sign reading BANK. First thing you know, some feller came along and deposited $100. A little later another feller came in and deposited $200. By that time I was so confident that I put in $10 of my own money!"

This old gentleman once had a horse that behaved peculiarly. Some days it limped all over, but on other days it seemed perfectly all right. He called in the veterinarian and asked what he should do. The vet gave the animal a thorough examination, scratched his head, and finally said, "Well, I'll

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tell you what I would do. The next time he walks normal, I'd sell him."

Not long after that a traveling preacher came by, and the banker negotiated a deal with him. His wife saw what was going on, and when he came in she said, "Henry, you didn't sell that old lame horse to that preacher, did you?" "I sure did," Henry replied. "He was a stranger, and I tuk him in."

In discussing international capital movements, which is a topic fairly close to the one assigned to me, I shall be expressing only my own ideas. Some of you may think that topic sounds pretty dull, but actually it is loaded with dynamite. I can perhaps show this best by taking you back some thirty years to review a little history.

This past summer marked the thirty-second anniversary of the great international financial crisis of 1931. Anyone who has not passed at least his fiftieth birthday cannot be expected to know from personal experience much about the events leading up to those fateful days and their aftermath. Those who were personally involved have memories which will never be forgotten, but for the younger generation - the generation into whose hands the responsibility for guiding the destinies of our nation has already largely passed - this is now in the realm of history. The collapse of the stock market is, of course, well known, but that part of the drama has undeservedly overshadowed developments of more far-reaching significance. This must be the reason we find ourselves today repeating some of the same mistakes that made the depression of 1929-33 the worst in history.

It is largely forgotten today what an important role international capital flows played in that world-wide depression. For every thousand Americans who know something of the stock market crash, you would probably have trouble finding even one who could explain the Credit-Anstalt crisis and its significance. Yet this was a matter of such importance that some people have contended that the great international financial crisis that began in 1931 would never have occurred had this large Austrian bank not defaulted on its foreign obligations. Others argue with considerable logic that the Credit-Anstalt crisis was only the spark that ignited an abundance of

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dry tinder. Had Austria's weakness not been exposed, the spark would have come from another source - probably Germany - since there was no lack of tinder.

What was this tinder?

It was the structure of international debt - the end result of the international movements of capital of the World War I and postwar periods - and of the reparations settlements. Just as an unprecedented volume of securities trading in Wall Street had been achieved by a tremendous expansion of stock market credit, so in international commerce, trade had been based to an unprecedented degree on international borrowing.

The kind of thing that was going on in a number of countries can be most clearly seen in the case of Germany. Burdened with heavy reparations and interest payments and a substantial deficit on commodity trade, Germany depended on large capital imports in the 1920's to balance her international accounts. As time went on, both the reparations and the interest payments increased, and not enough long-term capital could be obtained from abroad to keep Germany's international payments in balance. Consequently, large amounts of short-term capital were attracted into Germany by the simple device of keeping the rate for short-term money well above that prevailing in other countries. This enabled Germany to avert any large loss of gold. In 1927 she actually added over $100 million to her gold holdings, but in the same year she added over $400 million to her short-term liabilities. By the end of 1930, Germany's short-term foreign liabilities totaled nearly $2.5 billion, which was four times the gold holdings of the Reichsbank.

The dam broke in 1931 - for a number of reasons - and in the first seven months of that year nearly $700 million of short-term capital was withdrawn from Germany. Large scale flight of German capital added to the strain. Germany could no longer service her foreign debts. A debt moratorium was arranged by President Hoover, but this did not avert the disastrous consequences of the German collapse.

The Austrian Credit-Anstalt had been obliged to default on its large short-term debt in May 1931. The German default

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followed two months later. The British were heavy losers in both cases, and confidence was shaken in the pound sterling - which was the key reserve currency of the time in much the same sense that the American dollar is today. The Federal Reserve, the Bank of France, and foreign private banks tried to bolster the pound with loans totaling over $650 million to the Bank of England, but the effort was in vain, and in September 1931 England devalued the pound and abandoned the gold standard.

Those who talk lightly today of the possibilities of devaluation - even of its benefits - should review the consequences of the British action of 1931.[1] The depreciation of sterling delivered a staggering blow to the whole international monetary structure. A world-wide wave of distrust caused every currency and almost every bank to be regarded with doubt and suspicion. Foreign trade throughout the world was disorganized by the currency chaos that followed. Country after country hastened to erect new customs barriers, introduce quotas, and employ various other methods of interfering with foreign trade. These evils lived on long after the event and they accentuated the decline in world trade. These were the sour fruits of the devaluation of sterling. There is a lesson in this for those who assert that devaluation of a reserve currency is mild therapy for balance-of-payments ills.

Why was the pound sterling so vulnerable in the crisis of confidence which developed in the summer of 1931?

Britain's position, like Germany's, had been weakened by the accumulation of short-term liabilities during the 1920's. In March 1931 these liabilities were estimated by the Macmillan Committee at about $2 billion, but J. M. Keynes thought they were perhaps double that amount.[2] Even the $2 billion figure was nearly three times as large as the Bank of England's gold holdings. Britain had not suffered any serious gold drain in the years preceding the crisis, but her large short-term liabilities placed her at the mercy of her creditors, especially France. Once the confidence of those

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[1] See Paul Einzig, World Finance, 1914-1935, Macmillan, New York, 1935, pp. 232-5.

[2] See Milton Gilbert, Currency Depreciation, University of Pennsylvania Press, 1938, pp. 42-3.

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creditors in the pound sterling was undermined, even the huge loans to the Bank of England, which I mentioned, could not stem the outward flow of capital.

The collapse of the international monetary system probably would not have occurred had the structure not been rendered so vulnerable by the proliferation of unsound international debts. The volume of international indebtedness at the end of 1930 was conservatively estimated at $60 billion, and the interest and amortization charges required annual payments of about $3 billion.[3] Once world recession had set in, the payment of interest and amortization charges on this debt acted as a strong special depressant on international trade. The debtor countries, faced with a decline in the inflow of capital and a drop in export prices, were compelled to take drastic measures to increase their surpluses on commodity trade account in order to earn the foreign exchange to service their debts. This meant cutting back imports and trying to expand the physical volume of exports in order to offset the reduction in export prices. The resulting intensification of competition to sell in international markets depressed prices still further and made the task of servicing the debts even more difficult. Producers in the creditor countries reacted by demanding increased protection from imports, making it much harder for the debtors to make the transfers of real goods and services which had to be accomplished if the debts were to be serviced.

The illogic of permitting the development of an international financial structure which involved large annual payments by debtor to creditor countries while at the same time putting obstacles in the way of the movement of goods was recognized at the time.[4] But words of wisdom then expressed were of no avail. The rush to erect new barriers to international trade was intensified. The League of Nations stated that by the middle of 1932 it was obvious that the international trading mechanism was in real danger of being smashed as completely as the international monetary system had been.[5]

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[3]See Brookings Institution, <u>The Recovery Problem in the United States</u>, 1936, p. 37.

[4]See "The Wiggins Report", quoted in James H. Rogers' <u>America Weighs Her Gold</u>, Yale University Press, New Haven, 1931, p. 88.

[5]See League of Nations, <u>World Economic Survey</u>, 1932-33, p. 17.

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There is not the slightest doubt that the unparalleled depth and length of the great depression were in large measure due to the collapse of the international monetary system and its consequences.

What is the relevance of this, if any, to the problems which confront us thirty years later? The question is really: How well have we learned the lessons of this bitter inter-war experience, and how well are we applying them in the current environment?

In one field we have done very well. The policies of the victorious powers at the end of World War II were vastly different from those that had been followed at the conclusion of the first World War. No crushing burden of reparations was imposed on the vanquished. Instead, the United States supplied large scale assistance, both to the defeated Germans and Japanese and to our exhausted allies as well. A very large part of this assistance was provided in the form of grants. This was done to avoid the kinds of problems that grew out of the reparations and debts of World War I. We deserve high marks from history on this score.

In a second area, we have earned lower marks - still creditable, I think, but not such as to put us at the top of the class. I refer to the re-emergence of a large volume of short-term debts among the industrialized countries, and particularly the growing short-term liabilities of the United States. The U. S., of course, has been lending and investing abroad on a <u>long-term</u> basis much more than it has been borrowing from others on <u>short-term</u>. Most bankers do the same. But any good banker also knows that borrowing short and lending long has its prudent limits, and that it creates a certain exposure that must be prepared for and guarded against in order to insure smooth and sound operations.

The hazards of large U. S. short-term liabilities to foreigners have increasingly been recognized, and I am glad to say that some steps have been taken with the view of preventing spasmodic movements of short-term capital from endangering the stability of the dollar and thereby of the existing international payments system. The establishment and

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gradual strengthening of the International Monetary Fund, the expanded cooperative relationships among the central banks of all major countries, and, perhaps even more important, the growing comprehension of the interrelations between international and domestic fiscal and monetary policies of the industrialized countries - all these developments have created strong safeguards against a repetition of the disasters of the 1930's.

Meanwhile, the underlying factors feeding the growth of short-term U. S. liabilities to foreigners - namely, the ingredients of our persistent balance-of-payments deficit - are being countered by a number of U. S. policy actions. These are designed to preserve price stability at home, increase the world-wide competitiveness of American business, reduce the incentives for foreign borrowing in the U. S., and increase the attractiveness of investing in U. S. businesses and securities. Hopefully, such actions will bring our deficit into line, but at best it will take some time for this to happen.

We must assume that the stability of the U. S. dollar will continue to be the subject of concern, at least in some quarters, until such time as we manage to reduce our payments deficit to smaller dimensions. However, if we demonstrate determination and progress in that direction, the international financial safeguards I mentioned should render the dollar and with it the monetary system of the free world as a whole - reasonably safe from the consequences of a sudden withdrawal of foreign short-term funds of the kind that led to the downfall of the Austrian schilling, the German mark, and the pound sterling in 1931.

There is a third area, however, in which I think history may grade us harshly. This involves the burgeoning debt structure of the less developed countries, and the role we have played in its development.

We must recognize at the outset that foreign aid and international lending, both public and private, are here to stay. Their continuance is assured by the hardheaded national-interest considerations of military and diplomatic strategy, by the profit-making potential awaiting businessmen and investors in foreign markets, and by our natural instincts of

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neighborliness and concern for the welfare of the less fortunate.

The problem is how to shape the form and the dimension of our capital exports in order to be of lasting benefit to the recipient countries, to aid - or at least not prejudice - the U. S. balance of payments equilibrium, and to avoid any threat to international financial stability.

A recent study by the World Bank reveals that the external debts of the governments of the less developed countries more than doubled between 1955 and 1961. The foreign exchange expenditures required to service this rapidly growing debt rose even faster than the debt itself. The Bank points out that in almost every such country the debt service burden rose considerably faster than export earnings, gross national product, domestic savings, government revenues, or any other magnitudes relevant to a consideration of the debt service capacity. The cost of servicing the external public debt of the less developed countries as a group was equal to nearly 30 per cent of the capital which these countries obtained from abroad in 1961. The percentage was much higher for some countries, and it would be still higher if the cost of servicing external debts of the private sector were added. Many of these countries, in the view of the World Bank, have more than exceeded their capacity to service additional debt on the Bank's normal terms.

With many of the debtor countries already overextended, the unsoundness of this part of the structure of international debt is obvious. But it is disturbing that the remedy most frequently prescribed involves a further substantial increase in the debt. It is proposed that the creditors lower their interest rates, lengthen their maturities, and increase the volume of their lending.

This clearly indicates that one of the most important lessons of 1931 has indeed been forgotten. That lesson is simply that international credits are not sound when there is little or no possibility of effecting their payment by the transfer of real resources from the debtor to the creditor countries. To be able to pay their debts, the borrowing

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countries must at some point transform their large current-account deficits into surpluses, and the creditor countries must move into a deficit position. The emergence of Western Europe as a surplus area in the past decade suggests that we should not close our eyes to the possibility of similar economic miracles elsewhere in the world. However, we must make our judgments on the basis of probabilities, and there is very little in the recent performance of most of the debtors among the less developed countries which suggests that they are on the way to becoming surplus countries. In most cases export earnings have not even kept up with the growth in external payments for debt service.

A serious obstacle to the reversal of the direction of the capital flow at some future date is resistance within the creditor countries to a rapid expansion of imports of manufactured goods from the less developed areas. In the last few years we have heard a good deal about the need for curbing imports which cause "market disruption", even though the disruption thus far has been almost imperceptible. This suggests that the problem of getting the creditor countries to accept repayment of their loans and investments in the form of imports of real goods and services may present difficulties in the future just as in the past.

Actually, many people recognize that the bulk of the credits being extended to the less developed countries probably will never be repaid, at least on schedule. They will probably be forgiven, repudiated, stretched out, or refunded.

It may be argued that since these debts are known to be unsound, they pose no threat to the stability of the international monetary system. There is a grain of truth in this, for it would come as no great surprise to the world financial community if one or two of the most overextended debtor countries declared a debt moratorium tomorrow. Singly or collectively they would not have the same impact as the Credit-Anstalt default, but it would be foolhardy to assume that this would not have any negative psychological effect. In my view, defaults on the part of some less developed countries might have consequences far beyond the direct effect on their creditors. For example:

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(1) The flow of new private funds not only to the defaulting but also to other less developed countries might be seriously reduced. Private capital already there might seek to get out.

(2) A series of defaults might make it more politically difficult for the governments of industrialized countries to continue lending to any of the overextended debtor countries. The World Bank would almost certainly refuse to lend to the defaulting countries as a matter of principle. It is already chary of extending additional credits on its normal terms to many of the less developed countries for fear of overtaxing their ability to service their debts.

(3) A sudden large reduction in long-term capital flows, both public and private, to the less developed countries might have a serious impact on world trade. Imports of the less developed countries of between $4 billion and $5 billion annually are being financed by capital transfers. If a substantial part of this financing were to dry up, the affected countries might respond in ways reminiscent of the early 30's with comparable effects on world trade and commodity prices. If this were the case, world trade might fall by considerably more than the amount of the reduction in capital flows. Such a curtailment of international commerce and investment would certainly be felt by the industrialized countries, and if it happened to coincide with a period of cyclical downturn - heaven help us!

It is a mistake to believe that these possibilities can be avoided by simply continuing to expand the volume of unsound international debt. This will only postpone the day of reckoning. It will also make it more difficult in the end to work out a genuine solution which will not administer a severe shock to international trade and our monetary system.

Is there a way out?

We have already gone a good deal farther down this road than prudence would dictate, but if we can only recognize

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the danger we may still find ways of averting it. It is most important that we take action before action is forced upon us. Fortunately, in contrast with 1931, the economy of the free world is prosperous. Confidence in the U. S. is still high, and we can count on the cooperation of other free countries in any sensible effort to insure the health of the international financial structure. This is a particularly favorable time to act because the Communist bloc is wracked with inner dissension and beset by economic failures. This gives us more freedom to do what is sound economically in areas that heretofore have been largely dominated by the tactics of international politics.

Under these favorable circumstances, I suggest that we should direct our attention immediately to the problem of reducing the financing of world trade through the expansion of debt that is unsound in the sense that the odds are overly great against its ever being repaid by a net transfer of real resources.

It would be unwise to cut these capital flows abruptly, since this might precipitate the very crisis that we are trying to avoid. However, there is no reason why we could not embark upon a phased reduction and reconstitution of the total flow. One phase might well be the cancellation of much of the outstanding government-to-government debt of the less developed countries on some equitable basis. We may as well recognize officially that the chances of these debts ever being paid are slim. By the magnanimous gesture of cancelling enough to reduce the debt service burden to manageable proportions now, we would avoid the psychological effects of the inevitable defaults. At the same time, the debtors would be freed of a very substantial burden of debt service. This would permit a reduction in the flow of fresh capital to these countries of an amount at least equal to the annual cost of debt service on the cancelled debt. This might be substantial, since it is estimated that in 1961 the less developed countries were spending $2.5 billion a year just to service their foreign public debt.

It might be logical to suggest that we put all of our aid program back on a grant rather than a loan basis, but I would be reluctant to do this. The grant approach has the

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advantage of avoiding the dangerous accumulation of unsound debt, but it has the grave disadvantages of diminishing rather than increasing economic consciousness and of giving the recipients the impression that the capital has no cost. This is likely to encourage the wasteful use of capital, and this is what we must strive to eliminate.

International capital movements can play an important role in assisting economic development. We have seen this demonstrated in a number of countries, including our own. However, it is essential that money borrowed from abroad be employed in an economically productive manner. This is where many of the debtor countries in recent years have tended to err, and the United States has been at least an accomplice in the error.

Foreign financing benefits a country only if it leads to increases in output large enough not only to cover the cost of servicing and repaying the debt incurred, but also to pay for the cost of transferring labor, domestic capital, and the use of natural resources to the new types of production. Moreover, this new output must not be absorbed entirely by increased domestic consumption. Parts of the existing or the new production must be diverted to exports, in order to earn the foreign exchange with which to service the debts. (It is sometimes argued that the less developed countries cannot increase their exports appreciably, but a number of countries have demonstrated that this simply is not true. Outstanding examples are Peru, Taiwan, and Thailand.)

Needless to say, productivity may be increased not only by the establishment of new plants or the introduction of new techniques, but also by advances in public and private management, acquisition of new skills, and improvements in public health and education. However, their effects on productivity are often so uncertain and so long delayed that it would seem to me preferable to finance them by grants rather than loans.

One way to relate international capital flows more closely to growth in the capacity to service debt is to put them on an equity investment basis. This has an advantage

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over loans in that the repayment burden on the recipient is not fixed in amount, but is related to the productivity of the investment. It is more flexible both for this reason and because it is directed by private response to profit motivation. The great obstacle to more reliance on this form of capital flow is the hostility toward foreign private investment in many parts of the world. This hostility is based largely on a mythology which misinterprets economics. But even though it is based on a misunderstanding, it is a fact of life which we cannot will away. We can hope, however, that over time more of the less developed countries will acquire a better comprehension of the advantages of foreign private equity investment and do more to encourage it. In the meantime, we should bestir our imaginations and try to find ways in which we can transfer to equity investment some of the capital flow to the less developed countries that is now in the form of official loans.

In conclusion then, a realistic and foresighted program at this point would call for a phased reduction of the excessive unsound international debt that hangs over the less developed economies. If we are so unwise as to continue to increase such debt, we deserve the fate that lies in store for us.

Once the debt structure has been reformed, we should guard against a repetition of past errors. This is important, because if the slate is wiped clean without a crisis, there will be a strong temptation to take the same lax view toward new accumulation of debt that has led to the present situation.

I submit that this new approach will be of great benefit to both the debtor and the creditor countries. The adoption of sound economic policies will benefit the debtor countries far more than a large scale influx of capital which is not effectively employed. Any action which helps avert serious damage to the international monetary system is clearly advantageous to the creditor countries, and that would be the effect of a real solution to the debt service problem of the less developed countries, as distinguished from a postponement of the day of reckoning.

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If we take this approach, we may not only shield the international financial system against a conflagration sparked in the 1931 manner, but we may even see some economic miracles in the less developed parts of the world. I cannot guarantee the latter, since it is up to the people in those countries to determine their own policies and their own destinies. What they do is a matter of real concern to the United States and Europe, and our interest in their economic progress is deep and sincere. However, we must remember the lessons of history as we endeavor to avoid the pitfalls in our path. Sound international economic principles cannot be breached with impunity today any more so than thirty years ago.

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