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THE THEORY OF FOREIGN INVESTMENTS

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By the term theory of foreign investments we do not mean a congerie of unverified hypotheses concerning investments in foreign countries, but rather certain basic principles which represent the application of broad economic laws to a special field of economic activity.

Basic Principles of Foreign and Domestic Investments the Same

The basic principles of foreign investments are essentially the same as those of home investments. The chief motive power that drives the machinery of both is financial profit. The principal criteria by which the goodness of a foreign investment is judged are the same as those by which a domestic investment is judged, *viz.*, income-yield, safety of principal, and marketability. In both markets the investor desiring these qualities must pay for them. If he wishes a high rate of income he must pay for it by sacrificing in safety or marketability or both; if he wishes a high degree of safety he must sacrifice in rate of income or marketability or both; and if he wishes a high degree of marketability he must sacrifice in one or both of the other qualities. Whether in the home market or the foreign one, each of these constituting qualities of a good investment has its own conditions of demand and supply. Sometimes one is in particular demand, *e.g.*, safety in times of business uncertainty, and sometimes another. The market price of each in terms of the other two in both markets is the resultant of the interaction of the forces of demand and supply, it is the price at which demand and supply in the particular market are equilibrated.

There is, however, a glamor about the word *foreign* which often blinds the eyes to the fundamental likeness of foreign investments and home investments; and, just as a few billion dollars' worth of foreign trade receives more newspaper headlines, editorials and political oratory than several hundred billion dollars' worth of domestic trade, so when American capitalists turn a few million

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dollars into investments in Europe or Latin America, it is heralded as a great event, although the investment by these same capitalists of many times this amount in Texas, California or Alaska, places perhaps an equal or greater distance from our financial metropolis, is looked upon as commonplace. The word *foreign* is a political term, but the word *investment* is an economic one, and political boundaries do not obstruct the operation of economic law. Obviously there is not much difference in motive or in principle between the investment of a million dollars by a citizen of the United States in a paper factory in Ontario and one in New York. It is the likenesses, therefore, rather than the differences, that should be emphasized in comparing the principles of foreign investments with those of domestic investments. None the less, there are differences, and it is with them that we are chiefly concerned in this paper.

These differences may be subsumed under the heads: (a) "Internationally political"; (b) Monetary; (c) Social.

"Internationally Political" Aspects of Foreign Investments

A factor of great importance in the study of foreign investments is international political rivalry. National territorial aggression has probably been a dominating factor in a far larger proportion of foreign investments than most people think. A little over a generation ago in Egypt, and more recently in Korea, China and Latin America, many millions of dollars were invested under conditions that seem explainable only by the motive of territorial aggrandizement on the part of the nation or nations whose citizens have made the investments. Recent history has shown that the steps are often short ones from private investments, say in railroad building, in weak countries by the nationals of strong countries, to spheres of influence for those strong countries with extra-territorial privileges; from spheres of influence to political control as regards foreign relations; and from political control in foreign affairs to political control in domestic affairs; thus bringing the aggrandizing nation into complete control of the weaker and once independent state. Sometimes private investors are the tools of the aggrandizing government, but more often probably the government uses private investments, which have been made by its nationals from purely economic motives, as an excuse for political usurpation.

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MONETARY DIFFERENCES BETWEEN FOREIGN AND DOMESTIC INVESTMENTS

A second difference between domestic investments and foreign ones relates to the currencies in which these investments are made and the monetary units in which their values are expressed. Domestic investments are usually made in the domestic standard of value and the domestic monetary unit, *e.g.*, the gold standard and the dollar in the United States, the silver standard and the peso in Honduras, and a fiduciary paper standard and the milreis in Brazil. Foreign investments, on the other hand, are often made in different standards of value, and are usually made in different monetary units, than those of the home country. This is not an essential difference between domestic and foreign investments, since in times of peace the great majority of the leading countries of the world are on the gold standard, and there are numerous instances in which several countries have the same monetary unit. The modern trend of foreign investments, however, is strongly in the direction of the less developed countries like those of Latin America and continental Asia, and most of these countries do not possess an established gold standard nor *de facto* monetary units identical with those of any of the more advanced countries.

Even in those cases, where the monetary standard in the country where the investments are being made is the same as that of the country from which the capital is coming, differences in the unit of value are to a small extent obstacles to the ready flow of capital. Foreign units, like the bolivar of Venezuela or the colon of Costa Rica, even when on a gold basis, speak a foreign language. The capitalist can translate it by an effort, but it is not a language in which he thinks. He can mathematically compute the equivalents in terms of his own money, but he does not feel them when prices are quoted.

This difficulty, however, is a small one compared with the one arising from differences in the standard of value itself. The wide fluctuations in the gold value of silver during recent years, *e.g.*, 33 per cent in 1907 and nearly 40 per cent so far in 1916 (*i.e.*, to September 15), are familiar to students of economics, likewise the even greater fluctuations in the paper-money units of fiduciary-standard countries. When the gold value of a silver-standard peso or of a fiduciary-standard milreis depreciates, say, 20 per cent as measured

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by foreign exchange rates, it does not mean that local prices in terms of silver or paper-money units will at the same time rise 20 per cent. Price changes respond very slowly, and sometimes imperceptibly, if at all, to changes in the gold values of the monetary units of countries not on a gold standard. Short-time fluctuations in the gold values of these units have little or no effect on local prices, and the long-time swings make their influence felt on the prices of the majority of goods very slowly. This fact is of great significance to the foreign investor.

From the standpoint of the currency problem, foreign investments divide themselves into two classes; in the first class the investor becomes a proprietor, in the second, a creditor.

The "proprietor investments" are represented by the ownership of stocks in foreign corporations and by individual or partnership ownership of unincorporated enterprises. In these cases profits are realized and paid in the foreign money, and upon the shoulders of the foreign investor are placed the risks incident to a fluctuating exchange. When, for example, the gold value of the foreign unit, say the haikwan tael of China, rises, the American investor receives more United States dollars for each 100 taels of profit; when it falls, he receives less. If it falls heavily and he wants to sell out and withdraw his capital, he is likely to find that the market price of his property in terms of silver has not risen anything like so rapidly as the gold value of the tael has fallen and that, so far as gold values are concerned, he must sell at a sacrifice. On the other hand, if silver rises rapidly he may realize a net gain because the local value of his property is not likely to decline in proportion to the advance in the gold value of the tael. For this reason proprietorship investments in silver-standard and fiduciary-standard countries impose large speculative risks on the foreign investor—risks which must be compensated for by prospects of attractive profits.

In the second class of foreign investments the investor becomes a lender. He advances a sum of money in return for a promise from the borrower to pay back the principal at the end of a specified period—sometimes there is no specific maturity mentioned—and to pay a definite rate of interest at regular intervals. The best examples of this second class of investments are corporation and government bonds. Investments of this class may be made payable.

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(1) in local currency, or (2) in a foreign currency, usually in the gold-standard currency of an important foreign country. In the former case the risks due to fluctuations in the gold value of the local monetary unit fall upon the foreign investor, as in the case of the proprietorship investments. In the second case, however, as for example when the investor buys corporate bonds that are payable principal and interest in pounds sterling or United States dollars, the immediate risks incident to the fluctuations in exchange are shifted to the local borrower, *i.e.*, the corporation or, more narrowly, the owners of the corporation stock. I say the *immediate* risk is shifted to the stockholders, for even here the bondholders do not escape entirely, since a substantial depreciation in the local monetary unit is likely to lessen the gold value of the plant which is security for the bonds, and may also lessen the gold value of the corporation's products, especially if they are sold to a large extent locally, for, as we have seen, local prices do not advance at once proportionately to the depreciation in the gold value of the local monetary unit.[1]

SOCIAL DIFFERENCES BETWEEN DOMESTIC AND FOREIGN INVESTMENTS

The third important class of differences between a domestic investment and a foreign one we have called (for want of a better name) social differences. These are of a miscellaneous character, and it will be sufficient merely to mention them. There is the difference of language, which is often an impediment to the ready flow of capital from the cheaper to the dearer market, through preventing a thorough knowledge of foreign conditions and leading to annoying misunderstandings in the negotiation of capital contracts and the conduct of current business. Then there are unfamiliar systems of government, of jurisprudence, and of taxation; and there are business, political and social customs which are difficult for the

[1]If the products are sold largely in gold-standard countries the depreciation of the local monetary unit may increase the corporation's profits and, through their capitalization, even the gold value of the plant itself, because the corporation will receive more local units, *e.g.*, taels, pesos, or milras, for each foreign unit obtained for its products, while local expenses, especially wages, will be constant or at least rise slowly. Of course the situation would be the opposite in case the local monetary unit appreciated in value.

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foreigner to understand—all of which serve as barriers to keep capital from flowing into foreign fields.

It is only when the attractiveness of large immediate or future returns becomes great enough to surmount these barriers in addition to overcoming the natural conservatism of capitalists who prefer to see where their money is working, that capital moves out of the home-land for permanent investment abroad.

HOW CAPITAL REACHES THE FOREIGN FIELD

Superficially viewed, capital is transferred from one country to another chiefly by the mechanism of bank drafts and commercial bills of exchange. Such credit instruments, however, obviously do little more than transfer ownership of capital goods already located in the country in which the foreign capital is being invested, or of goods about to be shipped to that country. The credit instruments are evidences of an outward movement of more substantial things which constitute the real investment. These substantial things may be divided into three groups: (1) merchandise (using that term in its broad sense); (2) services; (3) international money.

Merchandise. The investment of foreign capital in undeveloped countries usually means the building and equipment of railroads and factories, and the opening up of various kinds of plantations and mines.

Much of the capital equipment for these enterprises must come from abroad. Inasmuch as the investing capitalists are most familiar with the products of their own country, are naturally prejudiced in favor of their own nationals, and are often themselves directly or indirectly interested in the production of the capital goods needed abroad, they will usually buy this capital equipment in their own home markets rather than abroad, if they can do so at anything like as favorable prices—a fact which is largely responsible for the slogan "trade follows the investment." This is true whether the investment is a proprietorship investment (such as the purchase of corporation stock or of an individual or partnership interest in an unincorporated business) or a creditor investment, *i.e.*, a loan (such as the purchase of bonds, debentures and the like). In the former case the investor may exercise direct control over the purchase of equipment through the power to vote the stock or otherwise to manage the business. In the latter case he exercises an indirect

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control, but often a very effective one, through the pressure that investors and particularly investment bankers nowadays exercise over concerns in which they are interested. The principal form then in which foreign capital is transferred to a new field is through the exportation of capital goods to that field, and this may be directly from the investing capitalist's own country or indirectly through the mediation of trade with one or more other countries. There are strong forces, however, which tend to cause the capital goods to be shipped directly from the country of the investing capitalists. New countries in process of development, usually for a long time, therefore, show a heavy excess of merchandise imports over exports, an excess which consists chiefly of foreign capital in process of investment.

Services. The second form in which transfers of capital are made is that of services. Here the goods exported are of an immaterial kind and do not figure in trade statistics. They include such items as the services of engineers, chemists and financial experts, who are sent out to do pioneer work in the planning and development of the new enterprises, and whose services often represent an important part of the new capital investment. Under this head also come the value of the transportation services in shipping the capital goods, marine-insurance services rendered by concerns outside of the importing country, and similarly legal and financial services. These services of course may be furnished by the concerns of other countries than that of the investing capitalists through a triangular (or even quadrangular) trade, country A shipping goods or rendering services to country B in compensation for services country B renders to country C, but, as in the case of the transfer of capital goods, there are forces which strongly encourage the securing of these services from the nationals of the investing capitalists.

International money. The third form in which foreign capital is transferred to a country is international money, *i.e.*, gold bullion and gold coins (usually by weight) and, to a limited extent, silver bullion and certain silver coins with an international circulation like the Mexican and British dollars. Strictly speaking, money is a form of merchandise, and is exported for the same reasons that any other merchandise is exported, *i.e.*, because a certain quantity of it is more valuable abroad than it is at home by enough to pay shipping

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expenses and yield an adequate profit. But international money is the most highly marketable of all kinds of merchandise, and this high degree of marketability makes it the great equilibrator in international trade movements, *i.e.*, an article whose shipment "pays trade balances," and is particularly useful in helping maintain a world equilibrium of prices.

The exportation to a new country of capital goods and capital services for investment, and the contemporaneous development of new enterprises causes an expansion of business in the country receiving the capital and an increased demand for media of exchange. Temporarily this may be met by a straining of credit, and, to some extent, by a more rapid turnover of bank deposits and of money in circulation. The demands, however, for additional media of exchange to carry on the country's growing business soon make themselves felt in inadequate bank reserves, insufficiency of loanable bank funds, higher interest rates on short-time loans, and a downward tendency in the prices of the more sensitive securities and commodities; exchange moves to the gold (or silver) import point, and enough international money is imported to bring the country's credit and currency circulation up to the amount necessary to carry on, without undue financial strain, its expanded business, at a price level which is in equilibrium with those of the other countries of the world.

CAPITAL INVESTMENT AND TRADE

This investment flow of foreign merchandise, services and international money may continue for many years. During all this time the country in which the foreign investments are being made—we need an expression "investee country"—carries on its regular import and export trade. But its visible imports continually exceed its visible exports, and this excess consists largely of the foreign capital being invested in the country. The foreign capitalists take their pay in titles to ownership (*e.g.*, stocks and deeds) of this foreign property, or in liens on the property (*e.g.*, bonds and debentures) from all of which they expect to receive sooner or later a regular income.

When the income is realized it may be brought home or left abroad and reinvested. To the extent that it is brought home it tends to turn the balance of trade against the "investee country," for the interest, dividend and other profit payments on capital

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invested are paid back chiefly in the form of merchandise exports. In so far as these profits are not brought home but are reinvested abroad they serve to build up still further the foreign capital equipment of the "investee country." Sooner or later, however, the foreign investor expects to bring home his profits. The periodic return to the investor of profits realized abroad and the return from time to time of parts of the capital fund in the course of time offset the amounts of new foreign capital being invested and cause the country's visible exports to exceed continually its visible imports, thus compensating for the heavy excess of imports which characterized the period of the original foreign investments.

The investment then of foreign capital, the payment of profits realized upon that capital and the repayment of the principal either gradually or in lump sum, are effected through the mechanism of the export and import trade, the chief item of which is the movement of merchandise. Trade follows the investment, and the flow of investment capital together with the return flow of investment profits are substantial items in the foreign trade of an economically new country.

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