

# Finance and Development in Southeast Europe in the Interwar Period

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**Abstract:** How do financial systems affect economic growth? How effective were international financial flows in promoting economic development in Southeast Europe in the Interwar Period? A large literature argues that financial systems evaluate prospective entrepreneurs, mobilize savings to finance the most promising productivity-enhancing activities, diversify the risks associated with these innovative activities and reveal the expected profits from engaging in innovation rather than the production of existing goods using existing methods. Important part of the theoretical literature also argues that foreign capital, in contrast to other available sources of funding – like domestic financial sector and state capital - is more effective in monitoring performance, in promoting better corporate governance, promoting technological improvements and ensuring access to export markets for developed and large scale enterprises - but less effective in alleviating asymmetric information problems and ensuring access to funds to small and medium sized enterprises. This paper provides a review of the theory behind the above claims and argues that asking similar sorts of questions in relation to the economic development of the Balkans can be a very fruitful line of research. It proceeds to present aggregate data on international financial flows and their relative importance for industrial growth for the four Balkan countries of Bulgaria, Greece, Romania and Yugoslavia during the 1920s and 1930s.

**Key Words:** Finance and Growth, Balkans in the Interwar Period, International Capital Flows.

**JEL Code:** N14, N24, O16;

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## 1. Introduction

Questions surrounding the economic links between finance and growth have occupied scholars for a long time. As early as 1912, Joseph Schumpeter made a clear theoretical connection between financial and economic development.<sup>1</sup> Other researchers, like Joan Robinson, have considered finance as a passive factor in the models of economic growth.<sup>2</sup> In more recent research, following the development of information economics and transaction costs economics, the topics of credit provision by banking and finance have occupied a central role in explaining differences in development and firm performance.<sup>3</sup> The main themes of enquiry ask if finance affects economic growth through improving efficiency and information provision; if financial systems differ from each other – if so why and what consequences this has for development. Other important strands of research compare different types of financing and assess their costs, and crucially, attempt to trace microeconomic effects of these on firm performance and make inferences to macro-level technological spread and aggregate growth.

Some of the economic ideology that arose from research on the above themes has found its way to policy makers' tools, especially in development help to third-world countries over the last half-a-century and in promoting regulatory regimes, aimed at attracting foreign direct investment.<sup>4</sup> These policies have met with ambiguous results – an outcome matched by the empirical surveys of economists who tested the finance-growth nexus theories on the aggregate, macroeconomic level.<sup>5</sup> New lines of research, focusing on micro-level effects of financial institutions and flows have proved more fruitful. Not only are the latter more effective at detecting the direct and indirect benefits of efficient financial systems and foreign capital influx, but their results may prove more helpful when and if they make their way to the economic policy toolkit.

Economic history can be very illuminating in the above context. It can provide ideal testing ground for the theories by allowing us to pick both successful and unsuccessful industrialisers, as well as offer a comparative setting over the long term. These in turn can illustrate the interaction that financial systems and international investment have with local institutions, of political, financial or economic nature.

The Southeast European Region during the first half of the 20<sup>th</sup> century offers all of the above together with proximity with the developed European core, common cultural and institutional setting, as well as sophisticated financial systems. All these factors helped ensure access to technological innovations, markets for core exports and a stream of foreign investment. While full industrialisation was achieved in the post-1945 period, by methods of forced saving and far-reaching government intervention, the initial stages of structural transformation and the origins of an industrial sector were arguably noticeable during the Interwar Period.<sup>6</sup>

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<sup>1</sup> Schumpeter, J., (1912).

<sup>2</sup> Robinson, J., (1952).

<sup>3</sup> Lescure, M., in Jones, G., Zeitlin, J., Oxford Handbook in Business History, OUP 2007.

<sup>4</sup> A policy described as the Washington Consensus by Williamson, (1990), see also Stiglitz et al., (2006).

<sup>5</sup> See Easterly, W., (1997, 2002, 2006) for explanations of the failure in growth promotion policies in the developing world, mainly Africa.

<sup>6</sup> Ivanov and Tooze (2007).

Scholarly work on the region has traditionally stuck by the now classic Guerschenkronian tradition of explaining any development through the prism of ‘relative backwardness’. It makes largely unfavourable comparisons with either German or Russian industrialisation from the late 19th century.<sup>7</sup> Work of Marxist historians during the post-1945 era has focused its energies on painting a negative picture of failed capitalist states between the wars. The latter described the Balkan states as mired in domestic political struggles while gradually succumbing to the influence of German economic imperialism on the international scene.<sup>8</sup>

As economic theory has advanced from the neo-classical growth theory, of which most famous is the Solow growth model, based on exogenous technology, catch up growth and convergence to a long-term growth path, so has thinking about development in historical perspective. Recent research has emphasized much more the role of efficiency in the economy, intermediation between savers and investors, production and innovation in a capital deficient environment, and most of all amelioration of transaction and information costs.<sup>9</sup> The themes of institutions and rigidities, which may slow down economic development, have long been discussed in the literature. These are major part of scholars’ focus, but now seen through their interaction with financial markets.<sup>10</sup> Credit institutions have been placed at the centre of economic interactions, because of their ability to gather and efficiently process information about the production process and the economic agents involved in it. They can promote invention and innovation, spread entrepreneurial risk, but also allow long-term investment in projects with a higher pay off.<sup>11</sup>

Older work on the development of the Southeast European region has followed a more narrative tradition. It has attempted to reconstruct aggregate measures and to provide a subjective vision of failure or success in industrialisation. The theme of finance and growth, on the other hand, can provide us with concrete questions as well as testable hypothesis of factors that influence development, thus throwing light on the intricate interactions between the different modes of the economy.

Scholarly work on Southeast European development can benefit immensely from such a line of research. The Balkan countries possessed relatively sophisticated financial systems, which have left behind a wealth of archival information. Following the finance-growth nexus can allow us to track micro effects and interactions that in turn make it possible to trace structural changes and other trends that remain hidden on the aggregate level. Uncovering the relationships of credit institutions and industry and the final effects on productivity can enable researchers to then provide answers to general questions with greater confidence. They can also provide feedback to current development issues in third-world economies.

This paper looks at Bulgaria, Greece, Romania and Yugoslavia as these countries formed the core of the Southeast European region during the Interwar Period. Furthermore, data is most readily available for them – this being the reason to exclude Albania. Sections two and three look at the new developments in economic theory concerning information costs, role of finance and the influence of foreign credit as opposed to domestic sources of finance. Sections four, five and six look at Southeast

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<sup>7</sup> Jelavich and Jelavich, (1983).

<sup>8</sup> Berov, (1989).

<sup>9</sup> Parente and Prescott, (2000).

<sup>10</sup> Rajan and Zingales, (2004).

<sup>11</sup> King and Levine (2002).

Europe in particular, presenting aggregate data of international capital flows and their tentative distribution according to industry. The last section concludes.

## 2. Finance and Economic Development – The Story So Far

The large questions in relation to the economic development of the Balkans are still very much open. When did structural transformation occur? What drove industrial development? Who financed enterprise? What role did corporate structures, state role, relationship with foreign trade partners or investors, play? These are questions that still need clarifying – not only for the benefit of our understanding of the periphery of industrialised Europe, but also for the purpose of refining our theories of economic growth.

The point of departure for any work on the mode of development in relative backwardness is the classic work of Alexander Guerschenkron. He developed his ideas of economic stimuli substitution around the historical experiences of late 19th century and early 20th century Germany, Russia and the Balkans. Latecomers to the industrialisation ‘scene’ usually exhibit capital shortage. To substitute for this Germany developed large, universal banking institutions that combined both an investment and a commercial arm, which established long-term relationships with specific industrial clients and channelled savings to fund their growth. Late 19th century Russia was a step back in its economic, financial and institutional development, and the role of liquidity provider was taken by the state. The young Balkan states combined the example of the above two with a strong state presence in industry and financial sectors as well as universal type banks.

This orthodox view on banking, finance and industrial development has persevered in the economic and economic history literature, but has not gone unchallenged. Recent work has noted the underemphasised role of legal and political factors in the Guerschenkronian hypothesis.<sup>12</sup> For instance, the Bubble Act of 1720 and the monopoly of the Bank of England over limited liability banking until the early 19th century may have kept the majority of the English banks smaller and more conservative than they would have been in a time of rising demand for industrial finance.<sup>13</sup> In contrast the German Reichsbank both squeezed other banks out of much of the short-term commercial business and facilitated those banks’ provision of riskier investment services. Regulatory legislation of securities markets and shareholding companies was also instrumental in the promotion of the universal banking system.<sup>14</sup>

Verdier (1997) has directly opposed Guerschenkron’s thesis, suggesting that political structures, rather than relative backwardness, were more influential in shaping financial systems and subsequently economic performance. Similarly to other generalising theories, there are two pitfalls with such claims. Political centralisation was neither the sole factor, nor the decisive one in determining the financial structure of a state. Moreover, political and legal structures are not independent of economic backwardness – in fact is more likely that they are endogenous to the stages of economic development.

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<sup>12</sup> Verdier, (1997).

<sup>13</sup> Tilly (1994b).

<sup>14</sup> Fohlin, (2007).

Similar problems bedevil the studies by economists and development economists on the relationship between modern day financial systems and growth. This line of research has caused a considerable academic debate and consequently a spiralling literature produced by leading scholars in economics and economic history.<sup>15</sup> Recent literature suggests that well-developed financial systems not only ease the exchange of goods and services, but increase efficiency in information production and sharing and subsequently in the allocation of capital. They also promote more transparent corporate governance structures, and help with mobilising and pooling savings.<sup>16</sup> Empirical work is less conclusive as to the positive effects and the line of causality between financial development and economic growth.

King and Levine have formalised the Schumpeterian view of finance and growth, the idea that finance ‘lubricated’ the real economy, into a model of endogenous growth.<sup>17</sup> They suggest four channels, through which financial development feeds into growth: screening prospective entrepreneurs and selecting most promising projects, mobilising capital to fund investment, diversifying investors’ portfolios to eliminate risk and revealing potential benefits of participating in productivity-enhancing activities.<sup>18</sup> Further to that, Fohlin (1998) has provided a summary of recent models of finance and growth. In a simplified model, per capita growth rate is a function of the savings rate, return on investment and costs of intermediation:  $y = f(S, I, C_{int})$ .<sup>19</sup> The variable cost of intermediation ( $C_{int}$ ) describes the efficiency of the domestic financial system, which in turn is linked to the ability of capital to reach high-return investment opportunities, thus promoting productivity improvements.

Much of these theoretical cost benefits of financial intermediaries stems from problems of information asymmetry between entrepreneurs and potential sources of finance. Incomplete or imperfect information may be a cause of misallocation of resources due to misreporting of returns. A financial intermediary can alleviate such misallocations most efficiently. Even in a world without misreporting, the process of intermediation can help diversify the risk of investment, due to unforeseen exogenous shocks.

When the world is tax-free with free and perfectly competitive markets, and symmetric information, there is no difference between the choice of financial instruments on offer by intermediaries. Under such stringent assumptions, Modigliani and Miller (1958) have proved the proposition that firms cannot alter the value of their securities by changing the mix between debt and equity.

In reality, however, such assumptions do not hold. As a consequence, there are a number of theories, which try to explain firm capital structure, based on problems of asymmetric information, agency problems and the presence of large transaction costs. Firms that face some of the above problems may find it least costly to finance investments in the productive process through own savings and retained profits. External finance is costly and only becomes viable if firms find some mechanism

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<sup>15</sup> The research agenda on finance and growth is not new – scholars as early as Bagehot (1873) and Schumpeter (1912) have suggested a role for finance in economic growth. More recently, Goldsmith (1969) and McKinnon (1973) have been strong proponents of the same idea. On the opposing side has stood Nobel Laureate Lucas (1988), and more recently Gourinchas and Jeanne (2006), who claimed that the role of finance was overstressed.

<sup>16</sup> See summary of theoretical and empirical results in King and Levine (2003).

<sup>17</sup> Ibid.

<sup>18</sup> King and Levine (1993).

<sup>19</sup> Fohlin (1998); p.3.

to transmit credible information about them. Once decided on outside finance, firms have to choose between debt and equity financing. Because debt finance comes in many forms, with different lengths of maturity, level of monitoring and cost of bank negotiations, firms that have established reputation may prefer bond issuance. The latter presupposes well developed capital markets and established firms that can convey credible information and reputation.

This structure of choices of finance is called the pecking order of financial instruments hypothesis. It provides a clear line of progression of firm financing, either as economies become more sophisticated or during a firm lifecycle. It is, however, only one way thinking about the different strands of financing that firms can use from origin to maturity. The following section looks at a number of theories, which try to explain the rich availability of financial institutions, instruments and capital flows that can exist in a number of economic settings.

### **3. What Kind of Finance**

Economic theory suggests that the efficiency of financial institutions may often depend on the scope of their activities. Therefore, the structure of financial systems affects the overall efficiency of corporate finance, not only due to physical costs of providing funds, but also because of costs relating to information transmission.<sup>20</sup> Considerable effort has gone into the problem of distinguishing the costs and benefits of different financial structures.<sup>21</sup> Broad conclusions of this literature suggest that banks perform better at the early stages of development, but capital markets tend to cope better with the information problems of more complex, advanced economies.<sup>22</sup> Universal banking, a structure which combines the investment as well as the commercial arm of banking within one institution has arguably performed best in the case of the late industrialisers, such as Germany, and also the Balkan countries. Calomiris (1995) has emphasised the information reusability and the long-term relationship of these banks with their clients, while Rajan (1995) has also pointed to the benefits of reputation spread from one arm of the bank's business to others. In general, universal or relationship banking can offer a number of cost saving advantages, through their scale, ability to collect, retain and reuse information about clients, as well as boosting long-term returns on investment, because of stable and long-term financing horizon.

There can be adverse effects of arms-length client relationships and the economies of scale and scope that universal banks promote. Having established their network of clients, universal banks have little incentive to seek risky investments for higher return, thus they are naturally more conservative investors than pure investment banks or venture capital funds. In fact, universal banks have an incentive to seek client relationships that result in director interlocking and insider lending to minimise the cost of monitoring and the risk of default in economies plagued by widespread information problems.<sup>23</sup> Although, arguably positive institutional development for the early 19th century east-coast US banks, this has been shown to have seriously undermined the efficiency of banking systems in modern day developing economies.<sup>24</sup> Thus, universal banks can be the cause of some of the

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<sup>20</sup> Fohlin (2007), p.52.

<sup>21</sup> See Diamond (1991), and Chemmanur and Fulghieri (1994).

<sup>22</sup> Rajan (1994), also Calomiris (1995).

<sup>23</sup> Lamoreaux (1994).

<sup>24</sup> La Porta, De Silanes, et al (2002) use a case study of Mexico to provide evidence of this claim.

institutional rigidities, which stifle entrepreneurship and risk-taking – the backbone of Schumpeterian creative destruction growth pattern. Hence, the economic literature has promoted the view that international capital flows can improve on these inefficiencies by breaking such rigid lending practices and seeking out more risky, but higher return investments. The economic policy of international institutions like the IMF and the World Bank has been consistent with promoting foreign direct investment to improve efficiency of domestic finance allocation.<sup>25</sup>

The literature commonly cites four main channels, through which foreign investment can lead to beneficial changes in the recipient economy, particularly in the performance of local firms.<sup>26</sup> In the first place competition from foreign companies can lead to changes in the scale of domestic production, allowing to exploit efficiency gains from increasing returns to scale. Secondly, local firms may acquire foreign technology, either through licensing agreements or technological spillovers. Foreign investment may also provide access to export markets for domestic producers. Finally, the presence of foreign capital may bring about greater transparency and better corporate governance and in this way uproot inefficiencies arising from institutional rigidity and insider lending.

It will be impossible to account for all these mechanisms using aggregate analysis of macroeconomic data, as is often done to determine the link between foreign investment and growth. It is likely that foreign investment will have different effects on aggregate growth, depending on the sector receiving it. There may also be inefficiencies caused by the presence of foreign capital, for instance, problems of information asymmetry may be aggravated and small-scale enterprises may be denied access to foreign funds, because of these problems. To resolve these issues and formally estimate the effects that foreign investment has on host economies, especially their industries and firms, we need to resort to firm level data. Micro-level data can help us disentangle the mechanisms of foreign investment's impact, because it allows us to estimate variables that represent technological spillovers, productivity, as well as efficiency.

The following simple framework, suggested by Navaretti and Venables (2003) can be used to illustrate one way of theoretically formalising our thinking about productivity and spillover effects of foreign investment.<sup>27</sup> It is not a complete model and it raises a number of theoretical uncertainties. As will be shown below, it focuses on measuring positive contributions of foreign investment, like productivity and efficiency gains, but does not include possible negative effects. For instance, foreign investment may lead to a crowding out effect and impose a technological bias with regard to domestic production with some social and economic implications.

Firms have a set of characteristics ( $x$ ) that determine productivity ( $q$ ). Local firms have technology summarized by the function  $q = \beta z(x)$ , where the function  $z(\cdot)$  is increasing in the characteristic and  $\beta$  is an efficiency parameter. Firms here are heterogeneous and the proportion of total employment in firms with characteristics  $x$  is given by the density function  $n(x)$ . The following equation describes the average productivity of local firms:

$$q^* = \int \beta z(x) n(x) dx$$

<sup>25</sup> A policy described as the Washington Consensus by Williamson (1990); see also Stiglitz et al, (2006).

<sup>26</sup> Navaretti and Venables, (2006), pp.151-153.

<sup>27</sup> Ibid., p.154.

Similarly, average productivity of firms with foreign capital is described by:

$$q^M = \int \alpha z(x) m(x) dx$$

Foreign-participated firms have productivity  $q = \alpha z(x)$ , and for a given  $x$  are more efficient if  $\alpha > \beta$ . The distribution of such firms' employment across firms with different characteristics is  $m(x)$ .

For the economy as a whole, a proportion  $\mu$  of the labour force is in firms with foreign capital and  $1 - \mu$  is in domestically-financed firms, so average productivity across the board is:

$$q = \mu q^M + (1 - \mu) q^D$$

We can frame a number of hypotheses linking foreign investment to growth within this framework. For instance, firms with foreign capital have higher productivity when  $q^M > q^D$ . To be able to claim that for technical efficiency ( $\alpha > \beta$ ) requires some statistical analysis to control for observable firm characteristics, like scale, market opportunities, management structure, etc. Similarly, spillover effects occur if  $\beta = \beta(\mu)$ , hence the increasing presence of foreign capital in the economy affects domestic firms' productivity. Indirect effects of foreign investment, like the ones mentioned above, are not incorporated in this framework and render further exploration.

Given the theoretical and empirical uncertainties of the literature on these issues, a study of foreign investment effects in the context of developing countries in historical perspective can be instructive. Notel (1986) has suggested very tentatively a link between international finance and improvements in industrial technology, through management practices, machine techniques as well as market orientation, for the Southeast European region during the early part of the 20th century.<sup>28</sup> This paper sets up the basis of a broad research project aimed at investigating the sources of development in the Balkans, in particular the effects of international capital flows on the host economies of Bulgaria, Greece, Romania and Yugoslavia during the 1920s and 1930s.

#### 4. A Snapshot of the Southeast European Economies in the Interwar Period

The economic history literature offers no consistent narrative of the development of the Southeast Europe pre-1945. Local historians and economists, largely writing before 1989, follow Gerschenkron in presenting a negative picture of failed industrialisation and inefficient agrarian sector in the midst of political turmoil, possibly explained by a class struggle.<sup>29</sup> Recently, efforts have begun to review our understanding of the economic history of the region. Ivanov and Tooze have reconstructed GDP figures for Bulgaria for the late 19th century and link these to the murky picture we have for the 1920s and 1930s.<sup>30</sup> The authors put forward a more optimistic appraisal of the agricultural sector, which saw significant structural changes, enough to act as precondition for modern economic growth. Next to

<sup>28</sup> Notel, R in Kaser and, Radice, (1986).

<sup>29</sup> Gerschenkron, (1962); Berov, (1989); Jelavich and Jelavich, (1983).

<sup>30</sup> Ivanov and Tooze, (2007).

nothing is known about the industrial development of the countries in the region, as well as the financial sectors.<sup>31</sup>

What follows is a brief summary of the little we know about the economic development of the Balkan region during the Interwar Period. Most of the data is collected from the League of Nations “International Statistical Yearbook”, which in turn has reported figures found in the national yearbooks of Bulgaria, Greece, Romania and Yugoslavia.<sup>32</sup>

Chart 2, presents the plight of industry during the 1930s. Particularly buoyant in Yugoslavia, the index of industrial production was falling or stagnant for the other three countries. This contrasts with the double digit growth rate percentages exhibited by the four countries in the 1920s (see table 1). Unfortunately, disaggregated figures are unavailable for all the years and all countries in the League of Nations publications. Even from the simple average growth rates, during 1921-1930, the fast recovery from World War I destruction and the subsequent period of sharp increase in output are visible. The obvious explanations for this disparity between the two decades are the Depression as well as the outflow of foreign capital, which provided liquidity for the credit sector and funds for enterprises in the 1920s. Some of the buoyancy of the 1920s, especially in Bulgaria, can be explained by distinctions in the recuperation of the financial sectors. Chart 3 presents a per-capita index of total banking assets of Bulgaria, Romania and Yugoslavia. New and larger funds available for credit may account for the faster growth of Bulgarian industry before the Depression set in.

The following section provides an overview of capital movements around the world, before concentrating on the Balkans region.

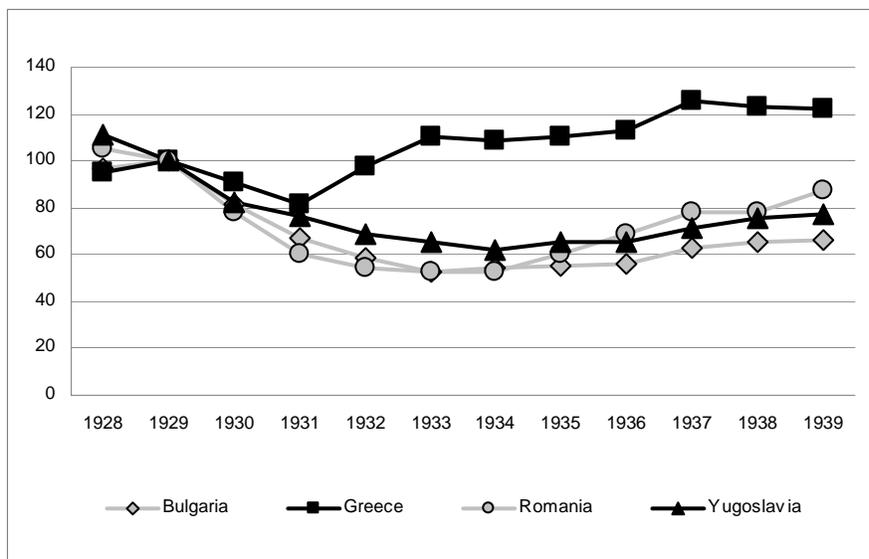
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<sup>31</sup> Koshev, (2008); has presented new data for the development of the Bulgarian banking sector during 1924-1937, which show a dynamic sector with interest in financing industrial enterprises.

<sup>32</sup> League of Nations, Statistical Yearbook, Geneva, various years; There are some missing values, largely because the League of Nations data was not fully compiled from the national statistics, but rather relied on government reports, which were regular only when the respective governments were involved in loan negotiations or debt repayment restructuring.

Chart 1

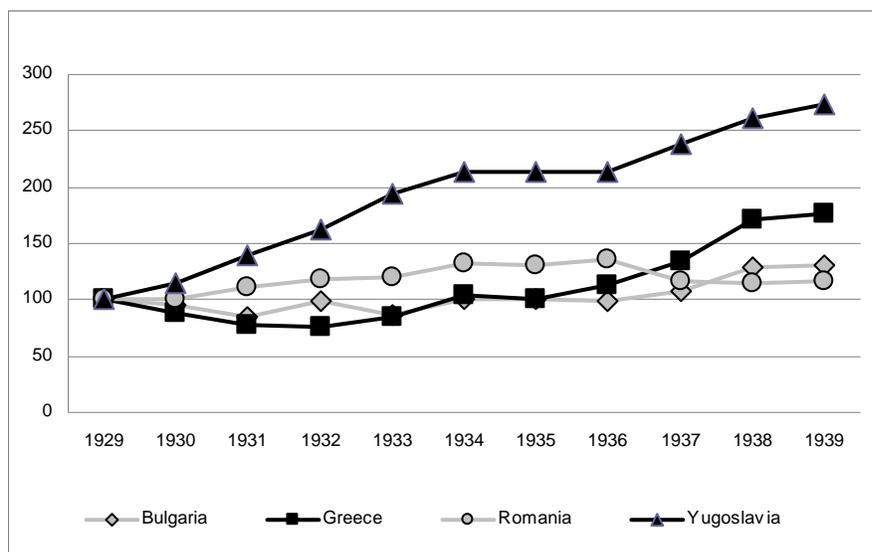
**Domestic Price index of Bulgaria, Romania, Greece and Yugoslavia, 1928-1939; 1929=100**



Source: League of Nations, various years.

Chart 2

**Industrial Production index of Bulgaria, Romania, Greece and Yugoslavia, 1929-1939; 1929=100**



Source: League of Nations, various years.

Table 1

**Average Annual Growth of Output  
(%, 1921-30)**

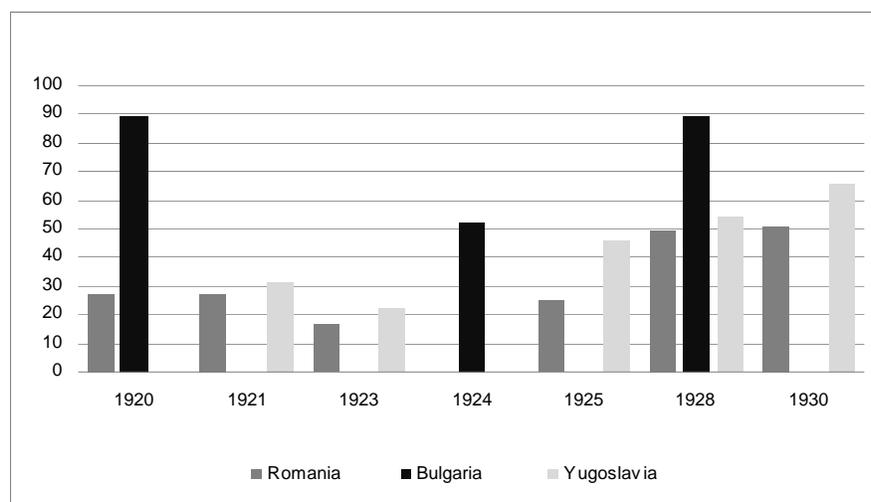
	Bulgaria	Romania	Greece	Yugoslavia
Metals and machinery	29.4	19.8	21.9	18
Chemicals	27.9	20.5	6.6	---
Non-wood building materials	18.2	12.5	11.6	17.4
Wood processing	16.2	2.2	---	---
Paper	12.1	17.6	32.4	---
Textiles	23.5	18.6	12.6	---
Leather	10.8	9.9	1.2	---
Foodstuffs	14	23.8	3.1	14.4

(--- no data is available)

Source: Lampe and Jackson, 1982.

Chart 3

**Index of Total Commercial Banking Assets;  
1920-1930; 1911=100**



Source: Own calculation and Lampe and Jackson (1982);

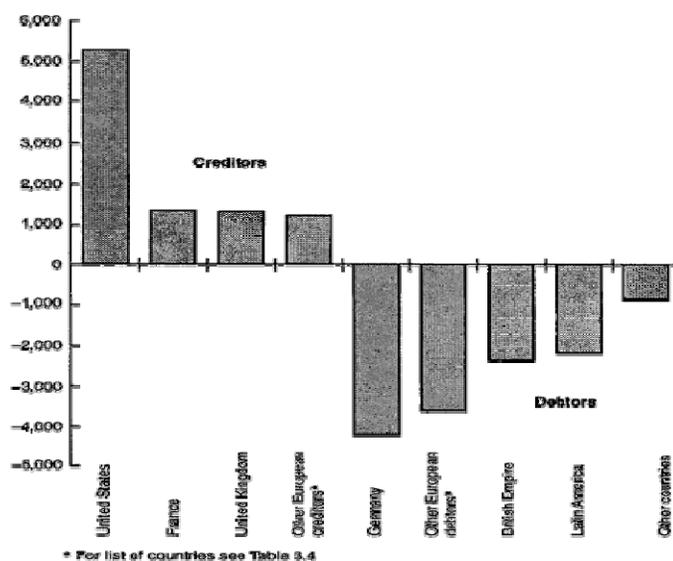
## 5. Global Capital Flows in the Interwar Period:

Both the character and the magnitude of international capital movements in the Interwar Period left a significant mark on the economies of the core and the periphery. In fact, the sums which flooded into Europe immediately after the First World War and then raced back to the creditor countries, are seen as one of the most influential factors for the 1920s and 1930s economies. Keynes expressed his doubts

about the magnitude of European bonds issued in the US as early as 1922: he could not see a fundamental ability to repay the American credits and prophesized the sharp reversal of flows that was to happen in the 1930s.<sup>33</sup> Bloomfield condemned the erratic behaviour of international capital flows: '... far from serving a useful function, they left nothing but disturbance and damage in their wake'.<sup>34</sup> A more recent re-examination of the evidence by Feinstein and Watson has confirmed the 'destructive and destabilising effects' that occurred in the 1930s, but whose potential could already be detected in the 1920s.<sup>35</sup> The following two graphs are extracted from Feinstein and Watson (1995) and trace the movements of capital flows on the aggregate level in the World economy.

Chart 4

**Composition of global capital flows, 1924-1930, \$ml.**  
(SEE countries appear under Other European Debtors)



Source: Feinstein and Watson, 1995.

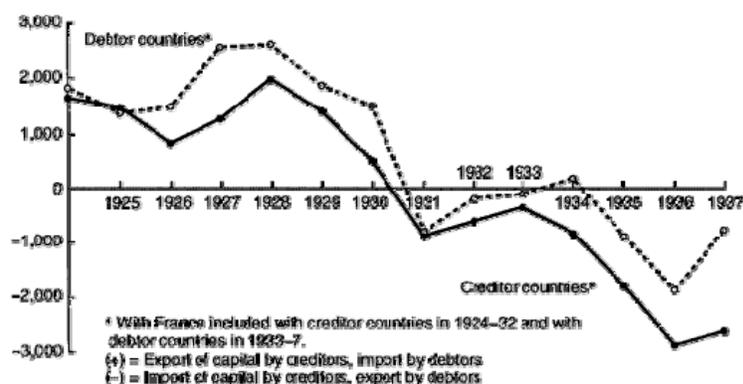
<sup>33</sup> Keynes, (1922), p. 162.

<sup>34</sup> Bloomfield and Irving, (1950), viii.

<sup>35</sup> Feinstein and Watson, in Feinstein, (1995).

Chart 5

## Global capital flows, 1924-1937, \$ml



Source: Feinstein and Watson, 1995.

Chart 4 presents the breakdown of capital flows according to country of origin or receipt. The stylised fact of the literature was borne out – the US is the largest creditor. France and the UK have an equal share of exports of capital, while a string of other European countries were also capital exporters – among them the most significant were the Netherlands, Switzerland, Sweden and Czechoslovakia. The rest of the World was on the receiving end of these capital flows – Germany obtaining the lion's share with \$4.2bn, or about one-third of the total sum for debtors (\$13.2bn).<sup>36</sup> Large sums, a quarter of the total, were also channelled into Eastern Europe and the Scandinavian countries.

Feinstein and Watson make a comparison of the long-term private investment outstanding at the end of the Interwar Period and the pre-World War I period.<sup>37</sup> By 1938 the estimated total was approximately \$53 billion, only about 15% higher in nominal terms than the total in 1914 – some \$46 bn. In real terms, however, taking into account the inflation of World War I and the post-1919 years the value of accumulated foreign assets was well below its pre-war level.<sup>38</sup> The largest change in terms of foreign assets was seen in the French and the German case – neither country rebuilt its pre-1914 portfolios. The other striking case was the US, which increased its long-term external assets threefold, from \$3.5bn to \$11.5bn between 1914 and 1938.<sup>39</sup> Despite this – the UK remained the largest foreign investor even after the Interwar Period with assets double those of the US - \$22.9bn.

These stock comparisons are only illustrative and not a thoroughly reliable indication of the net flows of capital. The differences between 1914 and 1938 may well reflect changes between the market value of the company securities and the book value of direct investments, exchange rate revaluations and the loss of government securities through defaults or wartime disposals. This overall comparison

<sup>36</sup> Feinstein and Watson (1995), p. 110.

<sup>37</sup> Ibid, pp.97-100.

<sup>38</sup> United Nations, (1949).

<sup>39</sup> Ibid, p.10.

also conceals some of the crucial and most volatile aspects of capital flows in the interwar period. Firstly, one cannot get an appreciation of the extent and character of short term flows that grew in size and volatility during the period. Secondly, the character of capital flows, both short and long term, differed very markedly in the two successive decades of the 1920s and 1930s. Chart 5 presents estimates of the actual movements of capital within the period.

Evident is the sharp discontinuity between the two interwar decades. The high point of international investment occurred in 1928, while after 1930 there was no further net investment abroad by the major creditors as a whole. The US maintained a small net outflow for a further three years, while the major European creditors became net importers of capital from 1931 onwards. The investment pattern during the 1920s was similar to the one before 1914. The rich creditor countries were channelling funds to the less developed countries in Europe and around the World. Debtor countries wished to exploit the greater wealth of the western economic core in support of their own economic development, while private investors from the US, Great Britain and France chose to buy foreign bonds and shares in expectation of higher return.<sup>40</sup> From the break-point of 1930 onwards this trend was sharply reversed. Vast sums flowed from the less developed World to the former creditors. Furthermore, these capital flows followed a seemingly irrational path – from countries with balance of payments deficit to ones with surplus, from capital markets with high interest rates to ones with lower.

There are economic and political reasons for this seemingly irrational behaviour of 1930s international capital. The early 1930s banking and financial crises undermined the confidence of investors in the stability of the debtor economies. Given the initial outflow, more and more countries chose to attempt to protect their currencies from depreciation and their dwindling reserves of gold and foreign currency, by erecting protective measure. This spurred further outflow, as the final loopholes were being closed. Furthermore, the recovery of the security prices on Wall Street from the spring of 1935 onwards provided a further incentive for capital flight to the US.<sup>41</sup> Some strong political messages from the mid 1930s supplemented the economic concerns. The increasingly aggressive foreign policy actions of the radical regimes in Europe, like the Italian invasion of Ethiopia, German remilitarisation of the Rhineland in 1936, and the Spanish civil war of the same year, ensured that the US and Great Britain were seen as the only safe heavens for investors' capital.

This is not an exhaustive account of the factors that influenced international capital flows, but rather a few broad lines, which may help us comprehend the aggregate capital flows into the Southeast European region – to which we now turn.

## **6. Capital Flows in the Southeast European Region during the 1920s and the 1930s**

Availability of data from printed sources on interwar capital movement in the Balkan states is limited. The main source for estimates of capital movements are the accounts of the balance of payments – more specifically of the capital account, which distinguished between the short term and long term obligations. These figures include merchandise trade, services, remittances and other transfers, interest and dividends, as well as gold and foreign exchange estimates. They are reasonably

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<sup>40</sup> Feinstein and Watson (1995), p. 111.

<sup>41</sup> *ibid*, p. 102.

reliable and regularly reported in the publications of the League of Nations, 1922-1939.<sup>42</sup> They do not, however, give us any further breakdown of the gross flows. The capital accounts of the League of Nations, Balance of Payments, provide more detailed information on the transactions in international debt. These cover long term portfolio investment, long term direct investment by companies in foreign subsidiaries or associates and the short term holdings of foreign assets.

A small booklet, issued by the United Nations – International Capital Movements during the Inter-War Period – in 1949, is also helpful to cross-check the estimated deficits/surpluses on the balance of payments accounts.<sup>43</sup> This is really an update and aggregation of the earlier League of Nations publications and acts to confirm reliability. A rather more useful source is an unpublished League of Nations paper – Europe’s Capital Movements, 1919-1932: A Statistical Note.<sup>44</sup> This paper provides data on bonds issued by the Balkans states until 1932 together with information on where the loans were floated, the countries which subscribed them and also any repayments made since issue. Unfortunately, the period post-1932 is not covered.

The information on long term direct investment by companies in foreign subsidiaries and the short term holdings of foreign assets is rather more erratic – especially for any region outside of the major countries. Data on Romania and Greece is missing for large parts of the 1930s. Particularly problematic is Romania, which has provided no estimates on its capital account post-1933. These missing estimates will have to be collected from a comparison of outward investment from the creditor countries – where information on long term portfolio investment and direct investment is available in a comprehensive manner for the US, but in a considerably poorer manner by the other major creditors – and inward investment from local company balance sheets and returns for tax purposes in the Balkan states themselves.<sup>45</sup> This is data still to be collected and will allow the much broader questions in the research agenda to be addressed.

\* \* \*

Table 2, constructed with data from Feinstein and Watson, presents the sums provided by creditors and borrowed from debtors within Europe during the two decades of the Interwar Period. All four of the Balkans states were significant debtors during the 1920s. The largest debtor was Romania, with \$440 millions of borrowed sums, while the smallest amount of funds was lent to Bulgaria – some \$50 million. Bulgaria was also the only country of the four that became a creditor during the 1930s.

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<sup>42</sup> League of Nations, Balance of Payments, and LN, Statistical Yearbook, various years, 1922-1938.

<sup>43</sup> United Nations, 1949.

<sup>44</sup> A typed copy of that paper is to be found in the Nuffield College Library, Oxford; it is dated June 1943.

<sup>45</sup> US Department of Commerce, (1975); see also Lewis (1938).

Table 2

**European Creditors and Debtors: 1924-1937**

	1924-1930	1931-1937	1924-1937
<b>Balances on current account, gold and foreign currency: European creditors and debtors, 1924-1930 and 1931-1937 (\$mn., to nearest \$10m)</b>			
<hr/>			
<b>Europe: creditors</b>			
UK	1,300	-4,000	-2,700
France	1,340	-690	650
Netherlands	380	-290	90
Switzerland	370	-340	30
Czechoslovakia	250	90	340
Sweden	180	-20	160
<i>total</i>	3,820	-5,250	-1,430
<b>Europe: debtors</b>			
Germany	-4,190	1,010	-3,180
France	-	2,190	2,190
Austria	-860	-150	-1,010
Italy	-710	-50	-760
<u>Romania</u>	<u>-440</u>	<u>-110</u>	<u>-550</u>
Poland	-400	70	-330
Hungary	-320	20	-300
<u>Greece</u>	<u>-310</u>	<u>-120</u>	<u>-430</u>
Belgium	-240	230	-10
Norway	-140	0	-140
<u>Yugoslavia</u>	<u>-80</u>	<u>-50</u>	<u>-130</u>
<u>Bulgaria</u>	<u>-50</u>	<u>20</u>	<u>-30</u>
Finland	-40	150	110
Denmark	-40	60	20
Baltic States	0	40	40
Ireland	30	-130	-100
<i>Total</i>	-7,790	3,180	-4,610
<i>Total Europe</i>	-3,970	-2,070	-6,040

Source: Feinstein and Watson 1995.

Chart 6 (further below) shows that all of Romania, Yugoslavia and Greece experienced outflows of capital in 1933 but that was only temporary. All three continued to receive foreign funds throughout the 1930s, although on a much smaller scale and rather more intermittently. For Romania in the 1930s, we only have Feinstein and Watson's guesstimate of a total figure, which they constructed from anecdotal evidence on continued investment into the oil industry around Ploesti. Bulgaria was the one country

which followed the general pattern established for debtors during the Interwar period – accumulation of foreign investment during the 1920s and then a slow but sustained outflow during the 1930s. It was also the only defeated nation in World War I from the region. This can explain the small inflows during the 1920s relative to the other three nations – it obtained two loans organised with the help of the League of Nations, the Stabilisation loan of 1926 and the Settlement loan of 1928.

Table 3

### Capital Issues for Southeast European Account

Capital Issues for European Account: Bonds, 1919-1932 (\$s mn.)										
Borrowing Country	Total	Lending Countries						Nature of Borrowers		
		US	UK	France	Netherlands	Switzerland	Sweden	A	B	C
Bulgaria	38	14	15	5	2	2	non	38	non	non
			10							
Greece	141	25	5	non	1	3	7	118	non	23
Romania	153	13	22	71	4	5	38	148	non	5
Yugoslavia	140	50	17	41	non	10	22	121	non	19

T-total, A-Gov, B – Municipalities, C- Corporations, non-not available.

Source: League of Nations, 1943.

Table 4

### Capital Issues for Southeast European Nations: Bonds

Capital Issues for Balkan Countries: Bonds, 1920-1932, \$ mn				
	Bulgaria	Romania	Greece	Yugoslavia
1920	0	3	0	0
1921	0	0	0	12
1922	0	0	0	15
1923	0	39	0	0
1924	0	0	43	3
1925	0	0	1	0
1926	14	0	8	0
1927	0	4	10	37
1928	24	4	54	22
1929	0	75	1	5
1930	0	0	11	0
1931	0	27	13	46
1932	0	0	0	0

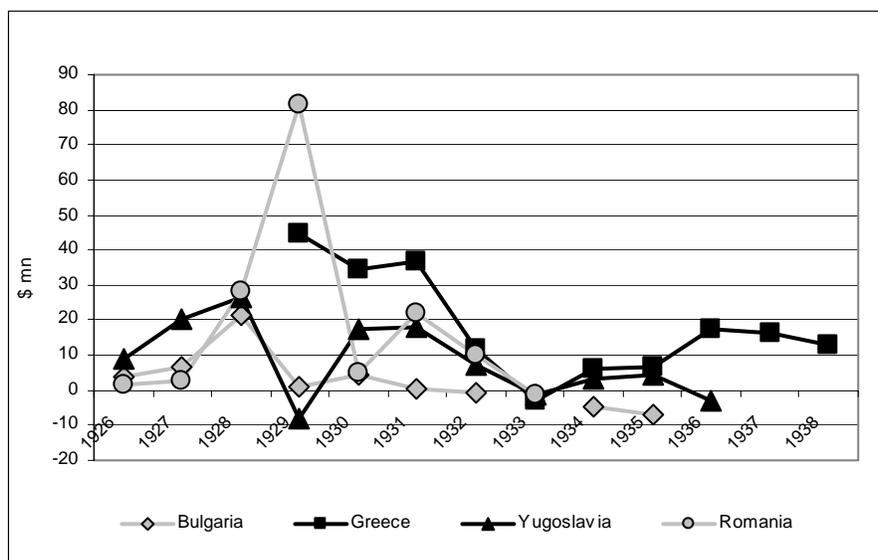
Source-League of Nations, 1943.

Tables 3 and 4 illustrate the bond issues by the Balkan states until 1932. The majority of these loan subscriptions were issued with the assistance of the League of Nations. For defeated Bulgaria, there were two reasons for League supervision – first to oversee the reparation settlements, and second to establish financial stability after the post-war inflations, to enable this country to meet any reparation repayments. The Financial Committee of the League also assisted with reconstruction loans to Greece in 1928, Romania in 1928, 1929 and 1931, and Yugoslavia in 1922, 1927 and 1931.<sup>46</sup> Table 3 is particularly useful because it allows us to follow through the country of origin of the investors which subscribed to these bond issues. Great Britain was the leading investor in the region. US was an important creditor – with an amount that was approaching French funds, while Germany, a very significant investor in the pre-1914 period, was completely absent.

The aggregate patterns in chart 6 are broadly following the stylised knowledge of the capital movements of the Interwar period. The rate of inflows was intensive in the pre-1930 period and then started receding. The international financial and economic crisis had a sharp effect on the Balkan economies. The capital inflows after the Depression were infrequent, some of the corporate stock was written-off and a lot of the capital was repatriated.

Chart 6

#### Capital Account Net Inflows, Southeast European Nations, 1926-1938



Source: League of Nations, various.

The following two tables, 5 and 6, present two snapshots of the distribution of foreign funds in the Balkan economies in 1928 and 1935. Governments received the largest share of foreign funds,

<sup>46</sup> Europe's Capital Movements, (1943); Kaser and Radice, (1982), pp.200-204.

something expected given the mammoth task of reconstruction the Balkans had to undergo after the damage incurred during World War I. Industry, including mining, steel, oil, and tobacco, as well as banking and financial services constituted the other significant sectors that attracted foreign investment.

Table 5

### Indicators of Foreign Capital Investment, 1928

<b>A: Comparative Levels and Distribution around 1928</b>				
	Bulgaria	Greece	Romania	Yugoslavia
<i>Gold Francs (per capita)</i>	122	293	123	105
Distribution (%)				
Public Finance	82.6	70.7	74.6	67.7
Trade	2	7.7	0.8	3.3
Banking	2.8	7.1	1.8	6.4
Industry	12.2	3.5	22.1	20.2
Transport and Communications	-	7.5	0.5	1.9
Insurance	0.1	-	-	0.1
Other	0.3	3.5	0.2	0.4
<b>total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
<b>B:</b>				
Source (%)	Bulgaria	Greece	Romania	Yugoslavia
French	11.2	12	17.4	24.5
English	1.4	57	26.6	22.8
Belgian	28.5	8	16.8	4.4
Italian	9.8	4.5	9.4	4.9
German	6.8	6	6.3	6.6
Czech	6.3	-	6.6	16.3
Swiss	23.4	2	2.6	13.3
American	8.4	10.5	7.8	5.6
Austrian/Hungarian	4.2	-	6.5	1.6
<b>total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Source: Lampe and Jackson, 1982.

Table 6

**Foreign Capital Participation in Domestic Enterprises: 1935-1939**

	<b>Foreign participation in domestic enterprise, 1935: distribution by countries</b>			
	\$ mn. Pre-1934 parity		% distribution	
	Bulgaria	Yugoslavia	Bulgaria	Yugoslavia
France	2	15	11	30
US	2	6	11	11
Germany	1	1	5	1
UK	0	7	1	15
Belgium	4	3	28	6
Austria	0	4	3	8
Switzerland	4	3	23	7
Netherlands	0	1	1	1
Czechoslovakia	1	5	6	10
Italy	2	2	10	4
Sweden	...	1	-	1
Hungary	0	2	1	4
Unspecified	-	1	-	2
<b>total</b>	<b>16</b>	<b>51</b>	<b>100</b>	<b>100</b>

Source: Kaser and Radice, 1986.

There are some disparities between the data from Lampe and Jackson (used for table 5,B) and table 3, because the border date for the data collected for table 3 is before the loans arranged in this year – which would explain the smaller share of US and British investors. Table 6 outlines the foreign participation in domestic enterprises in Bulgaria and Yugoslavia for 1935. There is a question about its reliability since Koser and Radice do not present a clear source for these figures.<sup>47</sup> Still, comparing tables 3 and 6, we can see that Great Britain and Switzerland (both with 24% and 37% from table 5B respectively and only 16% and 30% from table 6 respectively, obtained by adding the percentage participation in Bulgaria and Yugoslavia) were amongst the leading subscribers to the publicly floated loans to Bulgaria and Yugoslavia, hence were less active in direct participation in domestic enterprises. France, the US and Austria (with 36%, 14% and 5.8%, in participation in the foreign debt, respectively), however, more than made up for their share in the national loans by purchasing direct shares of domestic enterprises in these countries (41%, 22% and 16%). This provides a small snapshot of the competition, which went into acquiring shares of the financial borrowings of the periphery – described in Moreau's memoirs of the activities of the Bank of France in the period.<sup>48</sup>

If we look at the distribution of foreign investment by sector, presented in table 5 A, it seems that the theory is matched by foreign capital chasing the sectors with most profit potential, like industry, the

<sup>47</sup> Kaser and Radice, (1982), pp. 270-277.

<sup>48</sup> Moreau, E., *The Golden Franc*, Oxford, 1991.

financial services, trade and insurance. Analysis of disaggregated data at the firm level will allow a test of the effects of these investments. At the micro level foreign investment may have boosted productivity via spillovers of technological innovations, yet on the macro level, foreign capital may have exhibited a bias towards large, and what appeared secure investments, thus stifling alternative profitable projects, with high information cost. Separating these effects will then make possible a comparison of diverging theories of development – fuelled by foreign capital, export opportunities and technological transfer, or a large state sector, which provided liquidity to universal banks that in turn boosted industrial production.

## 7. Conclusions and Suggestions for Further Research

The figures presented in this essay are rather tentative and can only claim limited reliability. They allow us only a cautious peek into the aggregate movements and distribution of capital flows in the Balkans during the Interwar Period. What they underline is, however, the dynamism of foreign funds which entered the region in large volume despite the economic and political turmoil after World War One. Table 5 (A) is a small step in confirming the speculation that the nature of foreign funds going into the region after 1919 changed in comparison to those pre-1914. Before the Great War, the only large-scale borrowers were the governments themselves, plus railroad companies (many of them government owned and guaranteed), since lack of knowledge and trust prevented private capital from reaching local enterprises. This meant that the majority of the funds were used to support the national unification ambitions of the Balkan nations, effectively creating the military forces, which fought each other and some of the Great Powers during the conflicts of the 1910s.<sup>49</sup>

Foreign funds, during the Interwar Period, went to different destinations. Although smaller than the share of public finance, foreign investment that went into private enterprises was often very important in the context of some sectors. Lampe and Jackson suggest figures of significant magnitude – the foreign share of the banking sectors of Romania and Bulgaria was 65% and 40% respectively; while in mining, textiles, tobacco production and metal works amounted to around 70% and 45% respectively.<sup>50</sup>

Further data collection of the disaggregated figures of firm level capital structure, will allow us to pursue the agenda suggested at the beginning of this essay – identifying the competing effects of foreign and domestic capital, the effects that international capital had on the development of the Balkans states and in particular, to test some of the hypotheses suggested about beneficial transfer of technology, managerial expertise and spillovers from the industrialised core. Moreover, broader conclusions can be drawn, based on inter-sector comparisons. Thus, we can begin to understand better the structural changes that Southeast European economies experienced up until 1945, and assess the contributions of the state in contrast to private and international finance. Not only are such conclusions important in the context of Balkan economic development, but, as suggested earlier, they are paramount in the current debates about development aid, trade and capital movements liberalisation, and the role of the state in the early stages of industrialisation.

Final contribution of this line of research is to further the debate around the classic Guerschenkronian substitution hypothesis, where at different levels of backwardness, self-financing,

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<sup>49</sup> Fishlow, (1985).

<sup>50</sup> Lampe and Jackson, (1982), pp.428-429.

large financial institutions (often backed by the state) and the state itself play leading roles. Pagoulatos (2003) has expressed pessimistic views about state finance interference in the Greek post-1945 economy. Indeed recent work on economic growth emphasises not simply availability of capital and mechanisms of mobilising savings, but also the institutional rigidities and imperfections, which often exists in economies and ‘retard’ economic performance. Technological knowledge on its own is not too expensive and can be easily obtainable. It is certain impediments of political, social, institutional nature that prevent such transfers and financial flows are one channel, through which the cost of such impediments to growth can be lessened. This is why the micro story of foreign investment and its relationship with domestic factors is important and matters, if we want to understand the macro growth narratives.

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