Managing Monetary Policy Reforms. Lessons from the French Experience[1]

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I. Introduction

Many countries are now engaged in a transition from direct to indirect instruments of monetary policy as part of financial liberalization programs. If not carefully planned, this transition may result in a loss of monetary control, forcing the authorities to revert to direct controls. One striking example in this respect is the British experience after the introduction of Competition and Credit Control (1971) which, among other things, abolished direct credit controls. Rapid monetary growth in the following period forced the Bank of England to reintroduce in 1973 some forms of direct control (the "Supplementary Special Scheme" or "Corset"), an action that delayed the transition to a full fledged market-oriented system. Several other examples of failed transitions to indirect monetary controls in developing countries can be cited.

Perhaps the French experience is less well-known but quite relevant to the study of transition periods of the type mentioned above, especially because it concerns two attempts by the same

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country. As early as 1967, the French authorities tried to replace the prevailing policy framework by a more market-oriented system. This transition, however, turned out to be premature. The authorities reverted to the use of direct controls, first temporarily in 1970-71 and afterwards on a permanent basis since 1972. Fourteen years elapsed before these direct controls were totally and formally replaced by a fully market-based system. Since 1987, indirect mechanisms have prevailed and functioned satisfactorily.

The objective of the present article is to identify factors which may have contributed to the failure and success of the French efforts to adopt a market-oriented policy approach. This analysis may provide useful insights on the appropriate sequencing of reforms in the policy area and the mechanisms behind transition processes for those countries that are embarking on financial reforms.

The article is organized as follows. Section II gives a brief overview of the insights acquired in the literature on this subject. Section III discusses the 1967 liberalization attempt. The subsequent sections concentrate on the period since 1972. Section IV describes the developments in the policy framework in the 1973-1987 period and section V briefly describes the 1987 reforms. Section VI attempts to shed some new light on the *de facto* functioning of the 1973-87 policy framework, contrasting it with the common institutional presentation and section VII highlights the major lessons to be drawn from the French experiments.

II. A Brief Survey of the Literature

While a considerably vast literature on the sequencing of broad economic reforms – including macroeconomic stabilization, trade, foreign exchange and domestic financial sector liberalization – has emerged throughout the years, much less attention has been given to the detailed sequencing of the reforms of the domestic financial sector. The trend toward financial sector liberalization, intensified by the collapse of the centrally planned system has highlighted questions regarding the appropriate sequencing and management of the transition towards indirect monetary control, against the background of other macroeconomic and structural reforms.

Recent publications on the issue develop some guidance on the transition process, mainly based on recent experiences in several developing countries. On the general context of financial liberalization processes, Villanueva and Mirakhor (1990) highlight the importance of macroeconomic stabilization, improved banking supervision, appropriate banking regulations and adequate interest rate policies for successful financial liberalization.

Leite and Sundararajan (1990) discuss how interest rate liberalization should be concretely pursued. Their policy recommendations start from the recognition that the failure of several countries to accept reasonable interest rate levels is at the origin of many failed attempts to move to efficient and effective indirect controls. They emphasize that any move toward more liberal rates should be accompanied by the development of the appropriate instruments capable of influencing rates indirectly.

Finally Bisat, Johnston and Sundararajan (1990) try to derive lessons in managing financial liberalization from the experiences of five developing countries that recently went through the process.[2] They point, among other things, to the need to start financial market development as early as possible in the process; to develop new monetary policy instruments in the early stages; to pursue competition enhancing policies before embarking on full interest rate liberalization and to the need for broader supporting policies (through the budget) when reforming selective credit policies.

III. The Unsuccessful Attempt: 1967-71

1. *Background*

Throughout most of the 1950s, the public sector played a major part in the financing of the French economy, either directly through the government budget or through specialized credit institutions which received most of their funding via concessional borrowing from the government. The banking sector's business was restricted to short-term lending and financial markets were poorly developed. The early 1960s marked a gradual but steady substitution of the banking

[2] Argentina, Chile, Indonesia, Korea and the Philippines.

sector for the budget as the major source of funding. Gradually, the banks became the dominant financial intermediaries.

The Banque de France's (hereafter BdF) main monetary policy instrument was *medium-term refinancing* at very favorable rates.[3] Even though individual refinance ceilings were established, access to central bank finance was in practice unlimited because some types of credits were exempted from the ceilings, the ceilings were very often raised and additional refinancing could always be obtained at a higher rate. So, the central bank was a major source of credit to the economy. For its part, the steady rise in bank lending led the political authorities – concerned about the proper financing of priority sectors – to introduce a host of selective measures.[4]

2. *The 1967 Reform*[5,6]

Increasingly, the absence of well-developed financial markets was felt as a drawback, because of the growing role of the banks in the intermediation process. Thus, the 1967 reform was intended to lead to the creation of a large money market, allowing the use of monetary policy instruments similar to those used in the United States and the United Kingdom. Two new instruments were introduced in 1967: *minimum reserve requirements* on the banks' liabilities and a *minimum portfolio of medium-term securities*. The latter instrument was introduced to prevent excessive refinancing in times of tight monetary policy. The liquidity coefficient was abolished and the money market was opened to other nonbank financial institutions.

The first experiences with this new policy framework were highly disappointing as it soon proved to be ineffective in times of tight monetary policy. In 1968, the authorities tried to halt speculation against the French franc (FRF), stemming from excessive demand for credit, by raising both interest rates and reserve requirements. This strategy appeared to be ineffective and the BdF eventually had to tighten exchange restrictions and impose quantitative credit controls (November 1968-October 1970).

Learning from this failure, the 1969 Marjolin-Sadrin-Wormser Report recommended a thorough market-oriented reform of the financial sector and a further reform of the policy framework, aiming at the abolition of unlimited refinancing facilities. Of these recommendations, only a few – predominantly technical in nature[7] – could be implemented, because shortly after the elimination of credit controls in October 1970, new problems emerged. This time the authorities greatly relied on raising reserve requirements to contain excessive demand for credit because the position of FRF was limiting the extent to which the interest rate could be raised. Again, this attempt failed and in the second quarter of 1971, additional reserve requirements were imposed on the banks' assets. They were substantially increased in 1972, and at the end of that year the first liberalization attempt came to a formal end.

3. *A Short-lived Liberalization*

With hindsight, there were two major reasons for this failure, both pointing to shortcomings in the sequencing of the reforms. First, the instrument-mix – open end refinancing facilities *cum* reserve requirements – was ill-designed and, second, the adopted sequencing of the reforms – the (premature) introduction of flexible interest rate management in a highly segmented financial market with no competition – was another major cause of the failure. In addition, monetary policy suffered from a lack of well-defined policy targets. Monetary policy was not guided by any intermediate target and the range of final economic targets was wide, with the government's emphasis shifting frequently from one objective to another. The efforts to

[3] Two other instruments played a minor role, the *liquidity coefficient* (introduced in 1960) and the *mandatory investments in government paper* ("bons du Tresor", 1956), both requiring the banks to invest a certain percentage of their liabilities in government paper. Because a large part of France's economic development was still funded through budgetary mechanisms, the banks indirectly helped funding the other credit institutions through this instrument.

[4] Patat (1987b) reports that in 1978 there were 68 different subsidy schemes, amounting to 18% of gross fixed capital formation, and 65 schemes for lending at below market rates, which applied to 46% of total outstanding lending.

[5] This section draws on Besnard and Redon (1985 and 1986).

[6] The appendix provides an overview of the monetary policy instrument-mix throughout the period 1960-89.

[7] In early 1971, in the wake of a worldwide decline in interest rates, the money market rate was lowered, below the level of the rediscount rate, so that the latter was no longer the central bank's leading interest rate. Also in 1971, individual rediscount ceilings were abolished and replaced by *one-* and *three-month repurchase arrangements* to be used at the commercial banks' discretion. This technical change did not enhance the instrument's effectiveness.

move to indirect monetary policies were on the Government's side clearly not accompanied by any intentions to yield the central bank and its monetary policies more independence than before.

An inappropriate instrument-mix. Interest rate management was meant to become the central bank's main policy instrument. To complement domestic monetary policy management at times when interest rate policy had to focus on the external balance, the BdF had high expectations with respect to a flexible and active use of reserve requirements.

The existence of open ended rediscount facilities was a major factor substantially reducing the effectiveness of reserve requirements. Using reserve requirements to influence the banks' lending behavior presupposes limited access to the central banks' rediscount window. Without that, any increase in reserve requirements leads to additional refinancing with the central bank without any significant effect on the supply of credit to the private sector. The only possible effect could be an increase in the cost of credit as higher, non interest-bearing reserve requirements imply higher costs for the banks. This rise in the cost of credit would only significantly affect bank lending when the demand for credit is interest elastic. However, according to Patat (1987a), the demand for credit was predominantly inelastic at that time.

Inconsistencies between the instruments and the functioning of the financial markets. Three characteristics of the functioning of the financial sector at the time of the reform attempt need to be highlighted: the high degree of market segmentation, the permanent indebtedness of the sector toward the central bank and, as a consequence of the first feature, the very uneven distribution of this indebtedness. The heterogeneity of the financial sector further reduced the effectiveness of required reserves. Reserve requirements on liabilities only affected a small fraction of the sector. During the period under review, the French financial sector included on the one hand a large number of institutions which had limited deposit bases but were quite important in terms of total lending. Many of them, the specialized institutions, were mainly funded through the public budget, while the others relied heavily on central bank refinancing and on the interbank market. Since these institutions were only minimally affected by changes in reserve requirements, the monetary

authorities eventually imposed additional requirements on bank assets. On the other hand, those institutions with large deposit bases (large retail banks) were almost constantly in an excess liquidity position and were therefore hardly affected by any increase in reserve requirements.

The ineffectiveness of reserve requirements implied that the burden of domestic monetary adjustment fell entirely on interest rate management. The functioning and structure of the financial sector further narrowed the central bank's room for interest rate management. The sector's indebtedness toward the central bank and the uneven distribution of this indebtedness, prevented the authorities from setting the discount rate at a penalty level. The large banks never used their refinancing ceilings in full and they used to align their lending rates to the rediscount rate. The other banks, with permanent liquidity shortages, were mainly price-takers. They were usually at their refinancing limits with the central bank and were borrowers in the interbank market. Hence, if and when the central bank raised the money market rate too high, their interest rate margin narrowed substantially and many of them became unprofitable. This vulnerability was a major concern for the central bank and an impediment to the effective use of the interest rate policy. Hence, in times of conflict between internal and external goals, the authorities had to resort to direct controls and to tighten exchange controls.

IV. Evolution of the 1973-1987 Policy Framework

1. *Credit Ceilings: The Dominant Instrument*

At the end of 1972, the authorities reintroduced quantitative credit controls to help cope with the growing inflationary pressures (the "Encadrement du Crédit"). The authorities contemplated to use interest rates to offset exchange rate pressure and credit ceilings to insulate the cost of credit from any unwanted, foreign-induced changes in the spread between domestic and foreign interest rates.

Technically, the "encadrement du crédit" was conceived along the following two lines.[8] The BdF annually set a growth target for

[8] See Patat (1987a) and Quintyn (1991) for more detailed descriptions of the system.

commercial bank credit to the private sector. Monitoring took place on a monthly basis, with non observing banks being required to deposit non interest-bearing "supplementary reserves" in a special account with the central bank. Their highly progressive rate discouraged breaching the ceilings.[9] Various types of credits were excluded from the ceilings, including foreign currency credits, medium- and long-term export credits and special credits such as social housing, export promotion, and energy-saving investments.

Throughout the years, several changes were introduced. Basically, they aimed at two goals: to increase the system's flexibility and to make credit policy more selective. As to the first objective, from December 1974 on, banks were allowed to carry forward, up to a maximum of six months, credit previously unutilized.[10] Also, gradually a "marché de désencadrement" developed and became a major source of bank flexibility. Banks with unutilized room under the ceiling started buying credits from other banks that were in danger of exceeding their ceiling.

Another important modification was the authorization, in 1973, for financial institutions to expand their lending activities beyond the ceiling, provided these credits were funded with new capital funds or through the issuance of long-term bonds (hereafter called "stable resources"). This gave banks an incentive to expand their business by relying on long-term funding. The macroeconomic rationale behind this provision was that it could enhance the interaction between the interest rate structure and the demand for money. When, for example, the ceiling was binding because of excess demand for credit, banks could fund additional lending by issuing bonds. This would raise the interest rate on bonds, which would, for its part, help reduce the demand for money and restore the equilibrium.

These features were, however, overshadowed by the effects of various other selective measures which ultimately rendered the system less transparent and manageable and more open to exceptions and

[9] If, for example, a bank exceeded its ceiling by 5 percentage points, the supplementary reserves amounted to 5.25% of its total *outstanding amount of lending to the private sector*. A 10 percentage point excess corresponded to a deposit of 18% of the total amount outstanding.

[10] As Argy (1983) notes, since the base for calculation of the norm was the actual amount of credit extended, there was an implicit penalty for undershooting the banks-specific targets.

avoidance. Selectivity was increased in two ways. First by defining different growth targets based on the institutions' size and activities. Smaller and newly established institutions and some specialized institutions received looser targets, while, in general, the targets were tighter for the larger banks.

Second, the amount of credits exempt from the ceilings also increased substantially throughout the years. Their proportion rose from 1.7% of total bank lending in 1973 to 7% in 1978 and nearly 11% in 1983. These measures increasingly led individual banks to request special waivers at times they experienced difficulties, introducing additional arbitrariness into the system.

In 1982 some attempts were made to simplify the system; however, its growing complexity and the related increasing forecasting problems, forced the authorities in 1984 to cancel, unannounced, the accumulated unutilized credits.[11] Then, one year later, the credit ceilings were abandoned and, for 1985 and 1986, monetary control was based on a system of contemporaneous *reserve requirements on bank assets* calculated on the basis of a highly progressive formula. Most of the other features of the old system remained in place. Thus, credits funded through "stable resources" and credits to priority sectors continued to be excluded from the reserve base (though the number of exceptions was reduced). All in all, commercial banks gained some autonomy, but technically speaking the system remained at least as nontransparent and complex as before.[12]

2. *The Other Monetary Policy Instruments*

The BdF's other instruments were mainly designed to fine-tune money market conditions and banks' day-to-day liquidity management. From 1971 onward, *7-day repurchase arrangements* at the commercial banks' initiative were the main vehicle for liquidity

[11] Their size had become so huge that they would severely threaten any future effort to tighten monetary policy.

[12] Under the new system the banks could decide more autonomously on the desirable growth rate of their credit portfolio, given the progressive reserve requirements. The authorities were facing an even more complex forecasting problem than before as they had to identify the appropriate progressive scale for the reserves, given their (implicit) credit growth target.

management. In 1973, the BdF introduced two new instruments to influence money market conditions. First, the BdF began to set the *call-money rate* in the Paris money market on a daily basis. Second, the authorities introduced quarterly "appels d'offres", *outright purchases of government paper. Minimum reserve requirements* on the banks' liabilities were no more than an (inactive) relic from the first liberalization period. Through 1984, they were only changed once, for a short period of time (in 1979-80).

The major feature of the subsequent years (1974-86) was a reduction of the number of instruments that created liquidity at the commercial banks' own discretion, thereby enhancing the central bank's control over money creation. The one- and three-month repurchase arrangements were abolished in 1980. Also in 1980, the authorities discontinued the automatic rediscounting of medium-term export credit at preferential rates, another relic of the pre-1971 policy framework. From then on, the 7-day repurchase arrangement was the only source of liquidity provision accessible at the banks' discretion. Beginning in 1984, it was gradually deactivated, as the central bank progressively turned to controlling the call-money rate through one-day repurchase arrangements at its own discretion or through outright purchases.

3. *The Intermediate Targets*

The 1973 policy changes also marked a first step toward the introduction of intermediate targets into the French monetary policy. However, the initial attempt was highly confusing. In the 1973-76 period the BdF publicly announced annual targets for bank credit growth but clearly indicated that bank credit was an instrument. Annual growth targets for M2 were also set, but exclusively for internal use, as these were not announced in public.

A major change occurred at the end of 1976, with the public announcement of M2 as the intermediate monetary target for 1977.[13] Another important milestone in France's intermediate target framework was 1979, when exchange rate stability was adopted as an additional target. France became the single industrial country explicitly pursuing an exchange rate and monetary target. Because their simultaneous pursuit is generally not possible without binding capital controls, the authorities adopted a pragmatic approach (Robert and Patat, 1988, p. 60). Important though exchange rate stability was, it was not allowed to be the sole objective of monetary policy. Since the French economy was not as open as some other, smaller EMS economies, complete disregard for domestic objectives was not seen as desirable. In addition, since the authorities believed that exchange rate movements were not always guided by objective observation of the fundamentals, a domestic target had to underpin the exchange rate target.

[13] See Bordes and Strauss-Kahn (1987) for an almost encyclopedic overview of monetary targeting in France.

V. The 1987 Reform[14]

On January 1, 1987 the BdF adopted a genuine indirect monetary policy approach. Central to the reform of the instruments was the elimination of reserve requirements on bank assets and the daily setting of the call-money market rate. Instead, the minimum reserve requirements on liabilities and the 7-day repos were both reactivated and the outright purchases of government paper were replaced by periodic repurchase tender offers.

Under the new policy framework, the BdF monitors *two key official interest rates*, the rate on repurchase tenders (the intervention rate), and the 5- to 10-day repurchase rate. Under normal circumstances, the interbank rate is situated between the two rates, with the intervention rate being the lower boundary and the 5- to 10-day repurchase rate the upper boundary.

The main instrument used to influence commercial bank reserves and the interbank interest rate is the *repurchase tender offer*, held on average each week. The other instrument, standing 5- to 10-day *repurchase agreements*,[15] is more of a marginal source of funds for

[14] For more detailed overviews, see Batten, *et al.* (1990), Icard (1987 and 1988), and Kneeshaw and Van den Bergh (1989). Melitz (1990) offers some views on the liberalization process in general.

[15] Actually, it was the old 7-day facility until August 1988, but then, in a context of uncertainty about developments in money market rates, the authorities decided to offer the banks a choice between 5- and 10-day maturities.

banks. Similar to the pre-1987 practice, this mechanism is available to the commercial banks at their own discretion. Normally, this facility is only used intensively when the interbank rate exceeds the rate on these repos. In this situation, reserves supplied through this mechanism will tend to alleviate the upward pressure on the interbank rate and gradually restore the normal relationship between these interest rates. In addition, very short repurchase agreements (24 to 48 hours) or outright sales or purchases of Treasury bills are used infrequently, primarily aiming at smoothening daily fluctuations.

VI. Explaining the Smooth 1987 Transition: the 1979-86 Developments Reconsidered

Financial liberalization is often followed by periods of rapid monetary growth or increased volatility in both aggregates and interest rates. None of these developments seems to have taken place in France, indicating that the 1987 reform has been smooth and successful. In sharp contrast to the first liberalization period, the battery of new instruments has allowed monetary policy to be at least as effective as under the previous regime.

This section explores the factors that may have contributed to this success. Its contention is that neither 1985 nor 1987 were really breaking points in the policy design, as it is usually presented, but that roughly the 1979-81 period has been the starting point of a gradual but steady transition, leading to the smooth 1987 reform.

The 1979-81 period coincides with the shift to the dual intermediate target structure, giving for the first time explicit attention to exchange rate stability. Since that time, the monetary policy procedures have gradually become more and more market-oriented, and the effectiveness of, and the hierarchy among, the main instruments – credit controls and interest rate policy – have gradually evolved, eventually resulting in the smooth 1987 transition. Without underrating the 1987 reform, it can be stated that it merely concerned technical changes to the system. Several observations underscore this contention.

a) *The System of Credit Controls Lost Effectiveness and Meaning*

There are several indications that throughout the 1980s, credit controls were increasingly losing their effectiveness as a result of interactions between macroeconomic developments and problems inherent in direct control systems.[16]

The Table shows that throughout the period, the authorities were targeting a continuously and significantly shrinking portion of total banking lending and of total credit to the economy, making the setting of credit targets and their interpretation as instrument to guide the money supply less meaningful. Due to the functioning of the control system itself, credits exempt from the ceilings and those funded through "stable resources" steadily increased. Macroeconomic developments, such as the expansion of credit to the government in the second half of the 1970s are a second reason.

Finally, from 1975 on, controlled credits and bank lending, both as a portion of total domestic credit, also declined significantly because of disintermediation. The 1978 Monory Law, injecting new life into the French bond and equity markets through tax action, gave a first impetus.[17] This initiative greatly stimulated the creation and expansion of the SICAV's ("Sociétés d'Investissement à Capital Variable" – short-term, open-ended, mutual funds). A few years later, in the early 1980s the authorities launched a global financial market modernization plan, in an effort to keep up with financial market developments worldwide. Markets for commercial paper and certificates of deposits expanded quickly and further eroded the grip of credit controls. According to Patat (1987b), the degree of intermediation (measured on the basis of credit flows) fell from almost 80% at the end of the 1970s to nearly 60% in the mid-1980s. The growing importance of the SICAV's, which invested heavily in long-term bank securities and were at the same time very liquid for the investor, steadily deprived the "stable resource" provision from its initial goal (non-monetary financing of lending), since a large part of bank bonds were monetized through this process.

[16] There is some unanimity that credit ceilings were more or less effective in the initial years of their existence. See Argy (1983) for some comments on the 1973-80 period.

[17] Because the Monory Law made the issuance of stock and bonds very attractive, it is fair to state that the success of this initiative and the explosion of credits based on "stable resources" in the subsequent years are based on a high degree of cross-fertilization.

TABLE

FRANCE: EVOLUTION OF THE SHARE OF BANK LENDING UNDER THE CEILINGS IN TOTAL CREDIT, 1973-83

(in billions of FRF)

	1973	1975	1980	1983
Bank lending under ceilings (1)	451.4	565.5	948.2	1,193.0
Lending exempt from ceilings (2)	10.5	28.9	98.4	228.4
Lending financed through stable resources (3)	66.1	92.4	187.1	335.1
Bank credit to government (4)	56.1	104.1	130.9	253.6
Total bank lending (including adjustment) (5) = (1) through (4)	*587.5*	*795.9*	*1,388.6*	*2,100.1*
Other debt[1] (6)	387.2	490.3	1,032.7	1,606.4
Total domestic credit (7) = (5) + (6)	*974.7*	*1,286.2*	*2,421.3*	*3,706.5*
Authorized lending (8)	–	18.8	95.1	194.9
Grand total (9) = (7) + (8)	*974.7*	*1,305.0*	*2,516.4*	*3,901.4*
(1) as a percentage of (5)	76.8	71.0	68.2	56.8
(1) as a percentage of (9)	46.3	43.3	37.7	30.6
(5) as a percentage of (9)	60.3	60.9	55.2	53.8

[1] Monetary financing through the budget, by non-bank financial institutions and private non-financial sector bonds.

Source: Bruneel and Patat (1984) and own calculations.

Moreover, by 1983-84, the growing complexity of the system made it increasingly difficult to forecast a credit growth rate consistent with the intermediate monetary target. The growing uncertainty surrounding the various components involved in the forecast made the exercise more and more precarious.[18] So, in 1984, the size of the unutilized credits under the ceiling had become so huge and nontransparent, that any targeting effort was bound to fail. This was the immediate cause for the 1985 reforms. These reforms were just a recognition of a *de facto* existing situation wherein credit ceilings were no longer the appropriate instrument for domestic monetary management.

[18] A striking feature of the French credit control procedures was the highly complex forecasting procedure. The first step was the fixing of a target for M2. The next step was a consistent forecast for the growth of both the domestic and external counterparts of this aggregate. Third, from the forecast on net domestic credit, an estimate on bank lending had to be derived. Fourth, in order to arrive at a target for the controlled credits, the authorities had to predict the growth of lending to preferential sectors, the evolution of the banks' "stable resources", the evolution of credits to the Government and, finally, they had to have a feel for the evolution of the unutilized credits under the ceilings throughout the year. Such a lengthy procedure is likely to result in errors, making the outcome poorly consistent and threatening the central bank's credibility.

b) *Growing Priority for the Exchange Rate Target*

The adoption of the exchange rate target further reduced the usefulness of credit controls. During the first EMS years (1979-82), the French commitment to a stable exchange rate did not prove to be very firm.[19] But, when in 1983 the French economic policy stance shifted dramatically and the anti-inflationary policy was assigned the highest priority, the dual intermediate target regime quickly turned into one where the exchange rate objective nearly always was given priority. As a consequence, money growth became endogenous and in periods of short-term inconsistency between both targets, either the money supply target was adjusted or money supply was allowed to diverge from its target. In other words, the authorities' focus gradually shifted from control of the quantity of money to interest rate control to achieve the exchange rate target.

c) *Consequences for the Instruments*

The shift in hierarchy between the intermediate targets produced a shift in the hierarchy of the instruments. Interest rate management became much more important than credit management, making the latter marginal. Looking back on the 1980s, there appear to be only a few occasions where quantitative credit controls were able to insulate the cost of credit from interest rate pressures associated with external developments.[20]

Furthermore, as can be seen from the chart, the endogenization of the money supply also loosened the link between net domestic credit and money, thus reducing the usefulness of credit targets to

[19] In the period March 1979-March 1983, the FRF was devalued 3 times. Moreover, exchange controls were significantly tightened through 1982-83.

[20] See Bruneel and Patat (1984).

guide money targets. During the first years of the "encadrement", money growth and domestic credit growth moved in a strikingly parallel way. However, growth rates diverged increasingly, implying that the influence of the external counterpart of the monetary aggregate became more significant. During most of the 1980s, domestic credit growth was superior to money growth, and at times (*e.g.*, 1982-83) there was almost no relationship between the evolution of both variables.[21]

Interest rate management, conducted through the daily setting of the BdF's intervention rate and the tender and repurchase arrangements, gradually gained in importance during the early 1980s. It is worth recalling that, from 1984 on, the BdF increasingly controlled the intervention rate through repos or outright purchases. The efficiency of interest rate management increased as the French financial markets became more homogeneous, allowing interest rate changes to be transmitted more easily throughout the market. Admittedly, interest rate policy still had its limitations in the early 1980s. Its main influence was on the short end of the market (Truquet, 1986) as the lack of developed markets greatly reduced the impact of the central bank's intervention rate on the longer end of the yield curve. Nevertheless, the combined impact of the intervention rate and the long-term rate gave the development of the markets a strong impetus.[22]

d) *The 1987 Transition in Perspective*

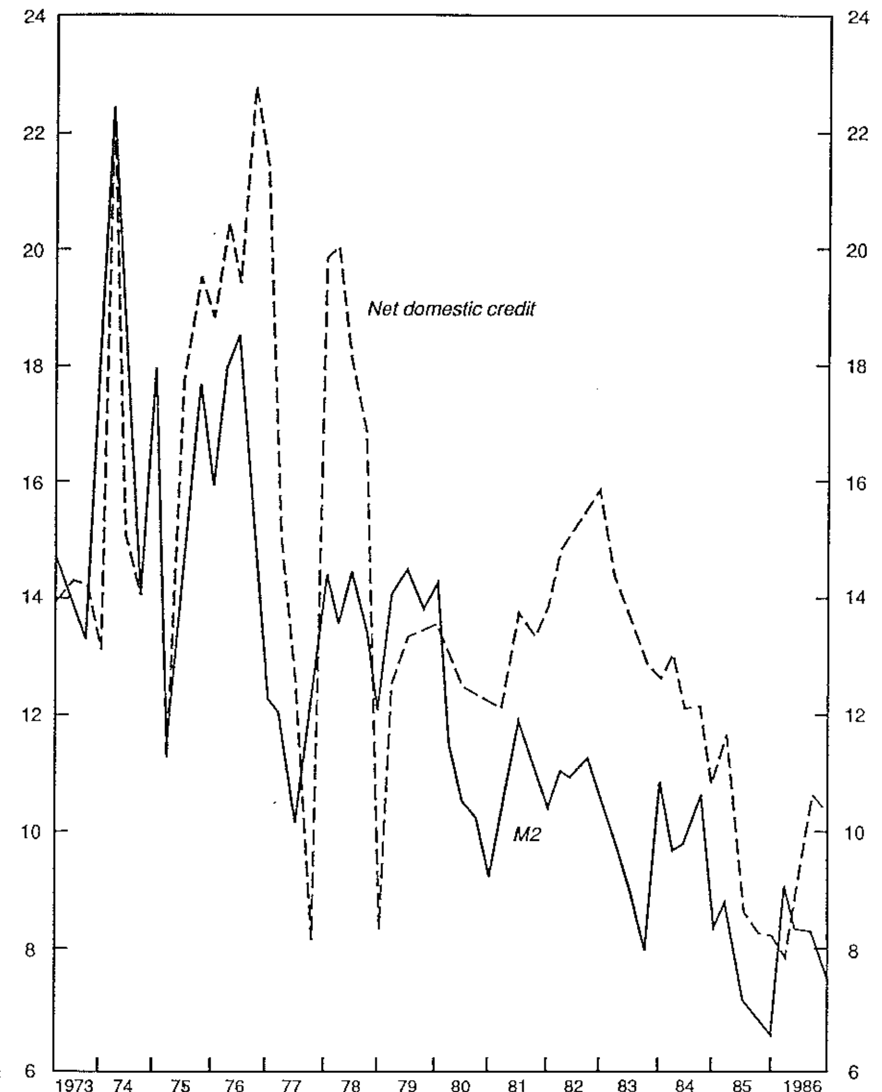
Against this background, we are tempted to describe the 1987 reform as the transition from an *administered interest rate policy* to a genuine open market system. In the run-up to 1987, markets had been gradually developing, new financial instruments were appearing and the financial system was on its way for a change from a debt-based to a fully market-based system. Financial markets still lacked the necessary depth and width to allow the central bank to influence

[21] In the 1973.1-1975.4 period, the correlation coefficient between both variables was 0.89. It dropped in the subsequent eight quarters through 1978.4 to 0.58. In the 1979.1-1982.4 period the coefficient was –0.04 and between 1983.1 and 1986.4 it was 0.66.

[22] The combined effect of the 1978 Monory initiative, the provision on the use of "stable resources" and the development of a government bond market in the early 1980s, gradually enhanced the role of the long-term interest rate and therefore the role of market forces in the French financial system.

FIGURE 1

FRANCE
NET DOMESTIC CREDIT AND MONEY DURING THE "ENCADREMENT"
Q1 1973 - Q4 1986
(Percentage changes over four quarters)



Source: IFS.

interest rate movements indirectly. On the other hand, the central bank already had a sufficient battery of techniques (outright purchases and repurchase arrangements) to conduct an interest rate-based policy, and the financial institutions were already familiar with this type of central bank intervention. So, as soon as the central bank could avail of a standardized and broadly accepted instrument such as Treasury bills, it was in a position to move from a policy of *pegging* the interest rate to one of *guiding* the interest rates. Treasury bills were introduced in 1985 and in 1987 this market was sufficiently developed, so that the final step could be taken. Some of the technical changes made at that time further enhanced the efficiency of the central bank's intervention. The added flexibility in the Banque de France's intervention techniques also facilitate the central bank's task to guide the interest rates in its pursuit of the exchange rate target.

This interpretation helps to explain why the 1987 transition was so smooth. Based on this view, the 1987 reform was a qualitative change rather than a major leap from a highly administered system to a totally open policy structure. It is, with hindsight, also justified to point to the importance of the two 1973 policy innovations, the daily setting of the call-money rate and the introduction of the tender system. At that time the introduction of these instruments was almost completely overshadowed by the introduction of the credit controls, but in fact, they were major building blocks for the indirect policy approach adopted in the late 1980s.

VII. Lessons from France's Experiences

When drawing lessons from a country's experience, one always has to be careful since the historical and institutional setting often plays an important part and makes reforms "unique" and hence difficult to transplant.

However, even with this caveat in mind, several general lessons can be drawn from France's liberalization experiences, for those countries that are attempting to conduct monetary policy via market-based approaches.

The lessons from the *1967-72 liberalization* are quite straightforward. The failure highlights the vital importance of an *appropriate instrument mix* and of the *proper sequencing of policy instrument reform versus market development*. Reserve requirements are ineffective to support domestic monetary management, as long as the refinancing facilities with the central bank are open-ended. The latter, still a common feature in many less-developed countries, need to be abolished in an early stage of the transition toward indirect instruments. Another important stumbling block in the French case was the lack of coherence between financial sector liberalization and monetary policy reform. At the time of the 1967 policy reforms, the French financial sector was still operating in such a way that the transmission of indirect policy actions was bound to fail.

The *1972-87 period*, on the other hand, contains a large variety of suggestions of the "copy" and "don't copy" type.

(i) on the use of *direct credit controls*, France's protracted reliance on this instrument brings another proof of the untenable nature of this type of arrangement. Unlike in many other countries, competitive distortion was not the major issue in France.[23] However, it turned out that the provisions needed to avoid these negative effects were in the end part of the system's self-destructive mechanisms.

In conjunction with credit controls, the French authorities have traditionally demonstrated a preference for reserve requirements based on assets. Whereas their use could be justified in those days when several financial institutions were funded through the public budget, the French experience does not lend support for a generalized use of asset-based reserve requirements. Apparently, inertia and a higher sense of security with this approach prolonged its use. Experience shows that reserve requirements on liabilities are as powerful an instrument as on assets. Moreover, reserve requirements on assets always contain the temptation to use them as a selective credit tool. The post 1972 experience with credit ceilings nevertheless points to one very interesting aspect: the provision to exempt lending based on "stable resources" from the ceilings was not only a bridge

[23] There were some shifts in market shares in favor of those nonbank financial institutions specialized in lending categories exempt form the ceilings (see Bruneel and Patat, 1984).

with market-related mechanisms, it also contained positive effects on the banks' balance sheet and incentives to develop long-term financial instruments. As part of the sequencing of reforms, this clause is worth closer attention as a tool to strengthen the banks' balance sheet and financial sector development in general. However, in the early 1980s, the provision also reached its limits because of the system's growing complexities and the growing sophistication of the markets. The increasingly disproportionate growth of subsidized credits entailed that the growth rate of the credits under the ceiling had to be set extremely low. Those banks that were suffering the most from these tight ceilings were also those that had to rely heavily on the "stable resource" provision, implying that they were increasingly paying the bond rate on marginal funds.

(ii) With respect to the *sequencing of the reforms*, the 1980s offer another useful hint. The transition toward a market-based system was greatly facilitated by the development of a "parallel" policy framework. By pegging the interest rate and through the use of other instruments such as repurchase arrangements and outright purchases, both the central bank and the financial sector gradually got familiarized with market mechanisms. During a transition period, these arrangements may enhance the authorities' confidence in market-oriented mechanisms and the role of credit ceilings can gradually be reduced to a safety net.

The success of the transition was also ensured by other factors: financial markets had the time to develop, real interest rates were positive throughout most of the period and macroeconomic circumstances in 1986-88 were favorable (a contrast with the 1967 attempt). Also, exchange control liberalization only started towards the end of the domestic financial liberalization (1984). Equally important was the fact that the Government wholeheartedly supported the reforms – in fact the Government instigated capital market development from the late 1970s onward (the Monory Law and the Government's desire to develop Government securities markets). This crucial element is often missing in reform attempts in developing countries.

(iii) Finally, some comments relate to *the policy framework* in general. The French post-1972 policy framework was highly complex and non-transparent. The authorities set targets for credit, but these targets – which needed to be compatible with the intermediate

monetary target – were actually at the instrument level. The paper has explained some of the technical and other problems involved in this approach. This type of ambiguities in the policy framework should be avoided. Instead, the question that should have been addressed was whether credit or monetary aggregates should be targeted. The choice depends, *inter alia*, on the prevailing exchange rate regime. This question, however, is beyond the scope of the present paper.

An interesting aspect of the French case was the link between the transition from direct to indirect instruments and the increase in central bank independence. Direct controls and selective credit procedures mostly serve specific goals set by the political authorities. The French experience demonstrates that the introduction of intermediate targets enhances central bank autonomy and credibility in two ways. First, the announcement of the targets in itself increases central bank autonomy. The need for appropriate instruments to attain them should not be underrated as a second channel. In France, the announcement of the exchange rate target and the discipline it required have particularly increased the need for market oriented instruments. By definition, these instruments give the monetary authorities a much higher degree of independence from political influences than direct controls, as they have to adhere to "the rules of the market".

Finally, the 1980s experience is also interesting with respect to the pursuit of a dual target structure. Although the French authorities initially emphasized the equivalence of both targets, practice has shown the dominance of the exchange rate target in an environment where exchange controls were gradually lifted. Even for a relatively large country like France, the consequences of international financial integration do not leave much leeway in terms of the independent pursuit of domestic targets. So, when exchange control relaxation will be addressed in less developed countries – particularly in those with small and open economies – the choice of the best target (exchange rate versus monetary aggregate) to influence inflationary expectations will come to the forefront.

VI. Conclusions

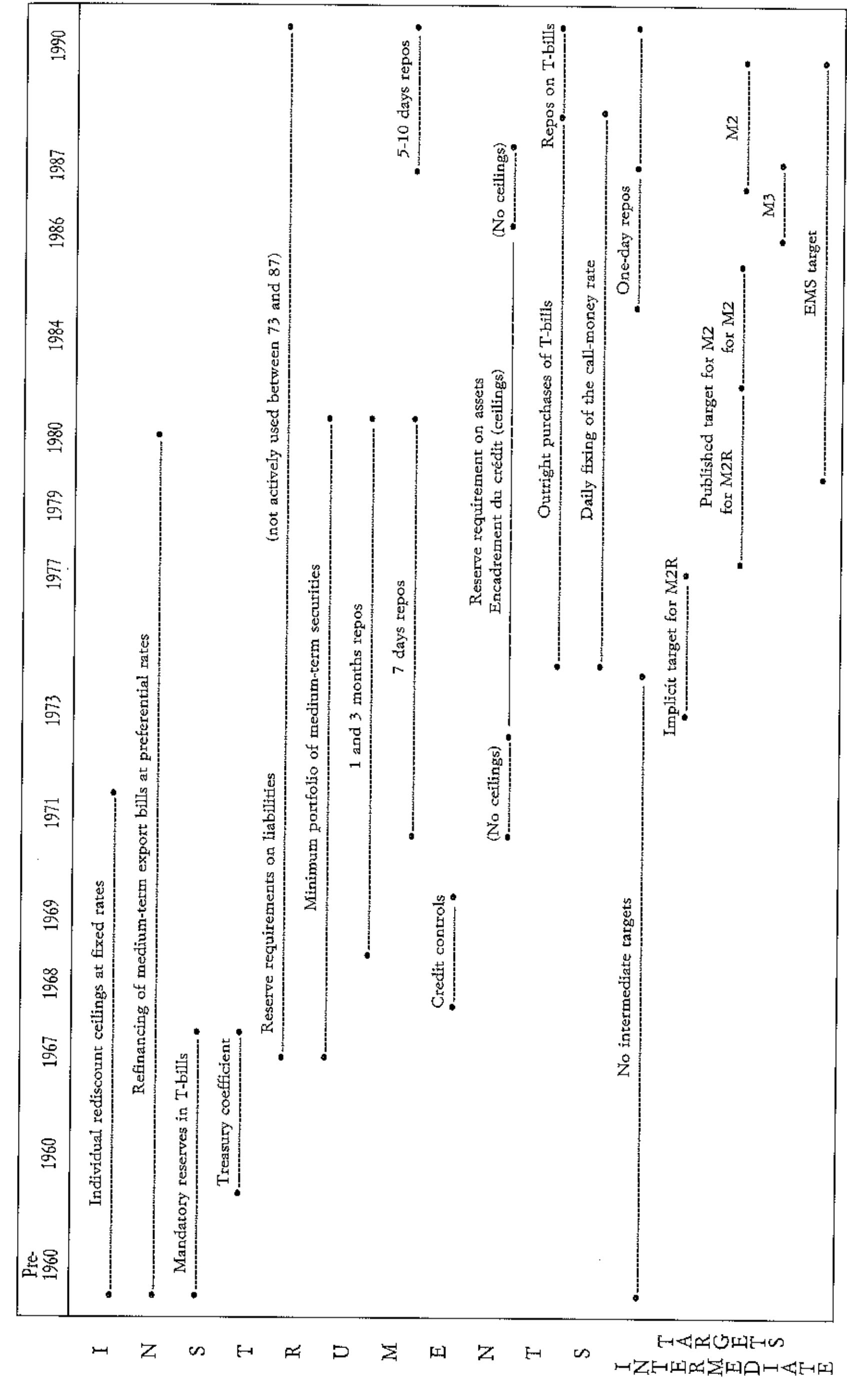
In many respects, the French postwar monetary policy history is very instructive. Between the end of the Second World War and, roughly, the mid-1980s, the French monetary economy moved very gradually from a debt-based system to a market economy. As early as 1967, the authorities attempted to rely on a market-based monetary policy system. This experiment was rapidly aborted due to inconsistencies in the instrument-mix and to an ill-designed sequencing. The authorities resorted to quantitative credit controls at the end of 1972. These controls lasted until the end of 1986 and were then replaced by a market-based control system.

On the 1972-86 period, this paper has argued that, *de facto,* monetary control and the transmission process have gradually changed throughout the years so that 1987 rather marked the end of a process than a thorough reform. More specifically, it has been argued that the 1979-81 period marked the beginning of a transition wherein credit controls were no longer the dominant policy instrument and their effectiveness gradually eroded. The growing emphasis on the exchange rate target made the interest rate the key policy instrument and flexible interest control replaced control over the money stock which became an endogenous variable.

The interaction of these developments helps explain the smoothness of the 1987 reform. This reform was, in this perspective, not a shift from an administered credit control system to a fully market-based system, but from a pegged interest rate regime to one of guiding the interest rate. The 1987 transition was on the whole a rather qualitative leap.

The final section presents some additional insights in the management of financial sector reforms, gained from this reinterpretation of developments in the French policy framework.

APPENDIX



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