

## Interest Rates in France

As in most modern countries, the structure of interest rates in France is relatively complex. Admittedly, this structure is largely the result of the conditions in which the direct matching up is effected between the supply of and demand for capital by the various economic agents: industrial, commercial or agricultural enterprises, the Treasury, consumers and savers. But the intervention of numerous financial institutions influences the way in which interest rates are determined. In addition, the government and the monetary authorities exert an overall influence or take discriminatory measures which, directly or indirectly, force the rate of interest to follow certain paths.

If the rates of interest are determined in different conditions according to whether we are dealing with the markets for short term or long term funds, the adjustment of the supply of and demand for capital is none the less subject, by and large, to general influences stemming from the basic position of the economy and French finances or from the objectives of the government and the monetary authorities.

### **1. The basic position and the objectives of monetary and economic policy**

#### *A - The basic data in the economic and financial fields.*

The data with a bearing on the formation and structure of the rates of interest are related to the conditions in which the economy tends to achieve equilibrium, to the financial procedures used by the government, and to the method for regulating the distribution of credit and foreign exchange operations.

### 1. *Conditions in which economic equilibrium is attained.*

(a) *Investment needs and a rising standard of living.* Perhaps even more than most industrial countries, for it had fallen behind in the years after the economic crisis of 1930, France has considerable investment needs. This gives rise to financing problems which are all the more acute because the population is bent on obtaining a constant improvement in its standard of living. The inadequacy of voluntary savings is perhaps made even more glaring by the development of systems whereby current insurance payments are used to meet current liabilities. Because of this, the French economy is deprived of the mass of investments which would take place if the insurance system were based more heavily upon meeting liabilities through investment income rather than from current income. It follows that the adjustment of savings to investments comes up against serious difficulties almost all the time.

(b) *Trend of prices.* The French economy has often been subjected to very severe strains which have been reflected particularly in demands for higher wages, constantly rising consumer expenditure, and the maintenance of Government expenditures at a high level. This is why the economy has, generally speaking, been able to expand only by means of more or less rapid rises in prices.

These rises, which are the consequence of the difficulties to be overcome in financing investments, complicate the problem by hampering the regular formation of a sufficient volume of savings. These difficulties diminish or even destroy the attractiveness of investments where the nominal income is fixed. And they have exerted a profound influence on the attitude of savers towards the various forms of investment.

However, stiff conditions for loans have never made up for the consequences of monetary depreciation. As for the borrower, even if he has almost always benefited, after the event, by a reduction in the real cost of debts, he has constantly tended to regard the cost of credit as being too high.

### 2. *Intervention of the state in the financing of the economy.*

The need to encourage the harmonious expansion of the country's economy has led the state to intervene directly in the financing of those investments considered as indispensable when the risks

and the high cost of the operation have been such that individual initiative is not sufficient to ensure that these investments will be made. The desire to feed in a regular flow of funds to the Treasury has also prompted the Ministry of Finance to take measures in favour of the holders of or subscribers to state loans.

(a) *Direct action by the state in financing investments.* The investment needs were first revealed after the war was over, when reconstruction had to be embarked upon, and they remained obvious thereafter because of the modernization and expansion of the economy, which have led the government authorities to take a direct part in financing investments by means of loans or even of subsidies.

The loans are granted by the Treasury through the Economic and Social Development Fund at more favourable interest rates and for a longer period than are usually obtainable on the capital market. They are financed by various Treasury sources — savings funds, sale of short or medium term bonds and in some cases even issues of long term securities.

In this way, public finance exerts an influence on the demand for and supply of capital, and hence also on the formation of the rates of interest. The sums provided by public finance for overall business investment amount to slightly more than four-fifths of those supplied by the financial market. To a great extent, they stimulate the channelling of short term savings into long term investments.

(b) *Fiscal measures.* Because of the Treasury's chronic need to obtain abundant funds, it continues to grant generous fiscal exemptions to bearers of or subscribers to state loans.

These exemptions go very far back, for examples are to be found as early as the beginning of the nineteenth century. They have complex repercussions on the direction taken by the supply of capital and investment, for they affect personal tax payments where the rate of taxation rises progressively. Because of this, the comparison between the rates of yields obtainable on the capital market leads to different results according to the income bracket of the taxpayer. In other words, a debenture investment may be more remunerative than the subscription to a Treasury bond for a particular group of incomes. For those with a higher level of income, on the contrary, it may be definitely less attractive.

### 3. Influence of methods of regulation.

The measures in force both as regards credit and foreign exchange also have repercussions on the equilibrium and formation of the rates of interest.

(a) *Measures for the control of credit.* For some fifteen years, France, as for that matter all modern industrial countries, has mastered the art of controlling credit. As readers will be aware, during the whole period when monetary systems were based on the gold standard, and even up to the time of the Second World War, the methods used boiled down to the regulation of interest rates by varying the discount rate of the Central Bank. This method was by no means so ineffective in combating inflationary pressures as has generally been argued. But its application would have sometimes called for such high rates that the competent authorities shrank from taking the drastic decisions involved. However, the inter-war years are rich in examples of the currency and finances of various countries being put on a sound footing by fixing the discount rate at over 10 per cent, which obviously made short term credit and, at least temporarily, all types of loans, extremely dear.

But such methods are global in their nature and harsh in their application, and, by giving priority solely to monetary considerations, they run the risk of inflicting a setback to the economy which is regarded as not really acceptable nowadays, even if it is only temporary.

For this reason, monetary measures have been supplemented by quantitative and qualitative credit arrangements. These arrangements affect the formation of the rates of interest, directly when they fix certain rates by decree, indirectly when they act on the supply of credit or when they steer the distribution of finance in certain directions rather than in others.

(b) *Exchange control.* Although in France, as in most western European countries, exchange control has been very much watered down, for a long time it imposed certain restrictions on capital movements abroad. The effect of these was, to some extent, to shelter the formation of interest rates from foreign influences. Thus, the differences in the rates between French markets and foreign ones were explicable not only in terms of the different conditions governing the demand for and supply of capital as between the two groups, but also by the obstacles which, by hampering the free

flow of funds, interposed themselves between the natural matching up of supply and demand from different countries. Nowadays, as a result of the gradual liberalization in this field, the French market is in much more extensive contact with the foreign markets, not only as regards long term capital but also for short term operations.

### B - *The economic and monetary aims of the Government.*

In its economic and financial policy, the Government, with the backing of the monetary authorities, determines general aims as regards the currency and the rates of interest, and also lays down specific objectives involving discrimination in credit terms according to the economic and social usefulness of the projects in question.

#### I. *General objectives.*

(a) *Monetary stability and economic expansion.* If the rules guiding the action of the Government are simple in theory, their application is complex. Economic expansion, if it is to be lasting, must be accompanied by monetary stability in the form of stable price levels and equilibrium in the balance of payments. These aims, if they are to be achieved, involve not only an improvement in the population's standards of living but also the financing of those investments most likely to increase the productive capacity of the country and develop productivity. The monetary authorities are thus embarked on a difficult policy which, to some extent, tends to stimulate demand for equipment and housing in advance of the formation of savings.

The procedures employed to finance investments by credit modify the conditions in which the demand for and supply of capital are matched, and keep interest rates below the levels obtained in a market in which the only source or supply would be voluntary savings.

(b) *Search for relatively modest rates of interest.* The French economy has been suffering from a serious shortage of capital for some twenty years. This is not because the French have suddenly lost their passion for saving, but because the social and economic aims which the country has set itself are extremely ambitious. At the same time France has constantly had to meet heavy political

commitments which have absorbed a large slice of the national product. To provide for all these capital needs, savings have proved all the more inadequate because over-employment, and the rises in wages caused by it, have given a fillip to consumption. In addition, inflationary strains have made long term investment unattractive and risky.

The combined effect of all these factors has pushed up the rates of interest very sharply, a tendency regarded as dangerous on more than one count. It ran the risk of hampering indispensable economic investments or the expansion of building, and complicating matters for business firms competing abroad. Hence there has emerged, as a continuous and fairly evident trend, a policy not exactly of cheap money but of not so dear money, since it fixed the rates of interest below the level determined by the free play of supply of and demand for capital. At certain times, the search for a widening of the capital market led to strong pressure on the mechanisms for the creation of money, through different channels, both public and private; it may, if it exceeds certain limits, thus give rise to inflationary tendencies and overshoot the mark by creating new tensions affecting the rates. The action to be taken is therefore a matter of the greatest delicacy, and can only give satisfactory results if effected in the context of a strict overall financial policy.

(c) *Concern for harmonization of short or long term capital markets.* The complexity of the conditions governing the interaction of the different compartments of the capital markets makes it difficult to effect the complete harmonization of the rates on short or long term capital markets.

Nevertheless, efforts have been made by the government authorities to aim at this harmonization, but they come up against a certain number of difficulties flowing from the fact that (1) an empirical approach and the need to solve urgent and unforeseen problems without delay have often been given priority, and that (2), the social and economic aims used to justify specific actions are various and complex.

## 2. *Specific objectives.*

Independently of the general measures taken with a view to influencing, directly or indirectly, the rates of interest, the govern-

ment authorities practice discrimination in the cost of money for social, economic and regional reasons.

(a) *Social aspect.* Building is a major sector which owes its expansion largely to the steps taken to reduce the cost of credit, up to the point at which building construction does not exceed certain norms.

The fact is that France, on emerging from the war, was confronted by a serious housing shortage which goes back to the interwar years and, though now less acute, has not yet disappeared. This is due to various reasons, in particular the increase in the population and the drift to the towns. It was considered that only a policy, which gave generous access to self-ownership of dwelling units and, in particular, individual apartments, would make possible a satisfactory expansion in housing. And, to make this policy acceptable, it was felt that it should be based on the distribution of loans at interest rates systematically kept low by rebates and protected against fluctuations in the money market.

Another sector covered by special arrangements is that of sales on the instalment system. The public authorities in fact held the view that in this field the borrower should be protected, for experience has repeatedly shown that competition between lending firms is not enough to ensure a reasonable rate of interest. For this reason, the National Credit Council (Conseil National du Crédit) keeps a particularly careful watch on such matters, and is at pains to eliminate misunderstandings about the rates proposed and to reject excessively high terms.

(b) *Economic aspect.* The financing of sales abroad raises delicate problems because of the methods generally accepted in international trade relations and of the need of large numbers of foreign purchasers for relatively long term credits. In addition, the government has had to make considerable efforts to stimulate exports, for, contrary to the situation in other industrial countries, French firms were often lacking in the tradition, the will and the arrangements to compete in this field.

For these reasons, exports have been given more beneficial financial terms than most other activities, and the main instrument used to implement this policy is a more favourable rate of discount with the Banque de France.

In the same way, equipment credits for operations in line with the aims of the Plan may be granted on better terms than those obtainable on the financial market. These procedures are implemented by controlling the distribution of medium term mobilizable credit resources or the operations of the Economic and Social Development Fund (Fonds de Développement Economique et Social).

(c) *Regional aspect.* It was essential to improve the geographical distribution of economic activities in France, thereby avoiding a widening of the gap in the standard of living and the level of development between the more advanced regions of the country and those which were sagging behind. The government authorities accordingly took steps to encourage the opening of factories in towns where there was a danger of unemployment. This policy aimed at compensating firms for the extra expenditure involved in such operations, and even at stimulating them to build their factories off the beaten track. The policy consists in reducing the cost of new investments by subsidies, loans from public funds on favourable terms, or even — though this method is tending to disappear — by rebates in the interest paid.

#### C - *The different markets - Special characteristics and possibilities of communication.*

A survey of the different kinds of capital shows that, logically enough, each market has its own characteristics and that the rates of interest are formed in different circumstances varying from one compartment to the other. The present study can obviously not be an exhaustive one. Its object is to define only essentials.

The short term money market makes ample use of the banks' power to create money. This does not mean that each supply of credit from the banks entails an addition to the flow of money, since earlier credits are repaid at the same time. Nevertheless, the money supply is known to have increased rapidly in France, reflecting an extensive expansion of the supply of short term capital.

Between this market and the long term capital market, to which savings are directed and which directly finances investments, lies firstly, the mechanism for medium term credits which by various procedures can also affect the creation of new money, and, secondly, the procedures whereby short term savings are used to finance long term investments.

For several reasons, these markets are linked by lines of communication or reciprocal influences.

First of all, the overall financial operations of business firms contribute, in certain circumstances, to the financing of investments through short term credit. This does not mean that the short term funds put up by the banks are directly channelled into the financing of equipment. But, since businesses are able to reduce the part of their working capital financed out of their own resources, they are in a position to engage in new investments thanks to the increase in their credits as a whole.

Moreover, as a result of the development of the funds they receive, the financial institutions are able to undertake long term operations that make use of the savings, which nevertheless still remain available to the individual depositors. In the same way, the introduction of medium term negotiable credit makes it possible to ensure longer investments, as a counterpart of resources on sight or short term.

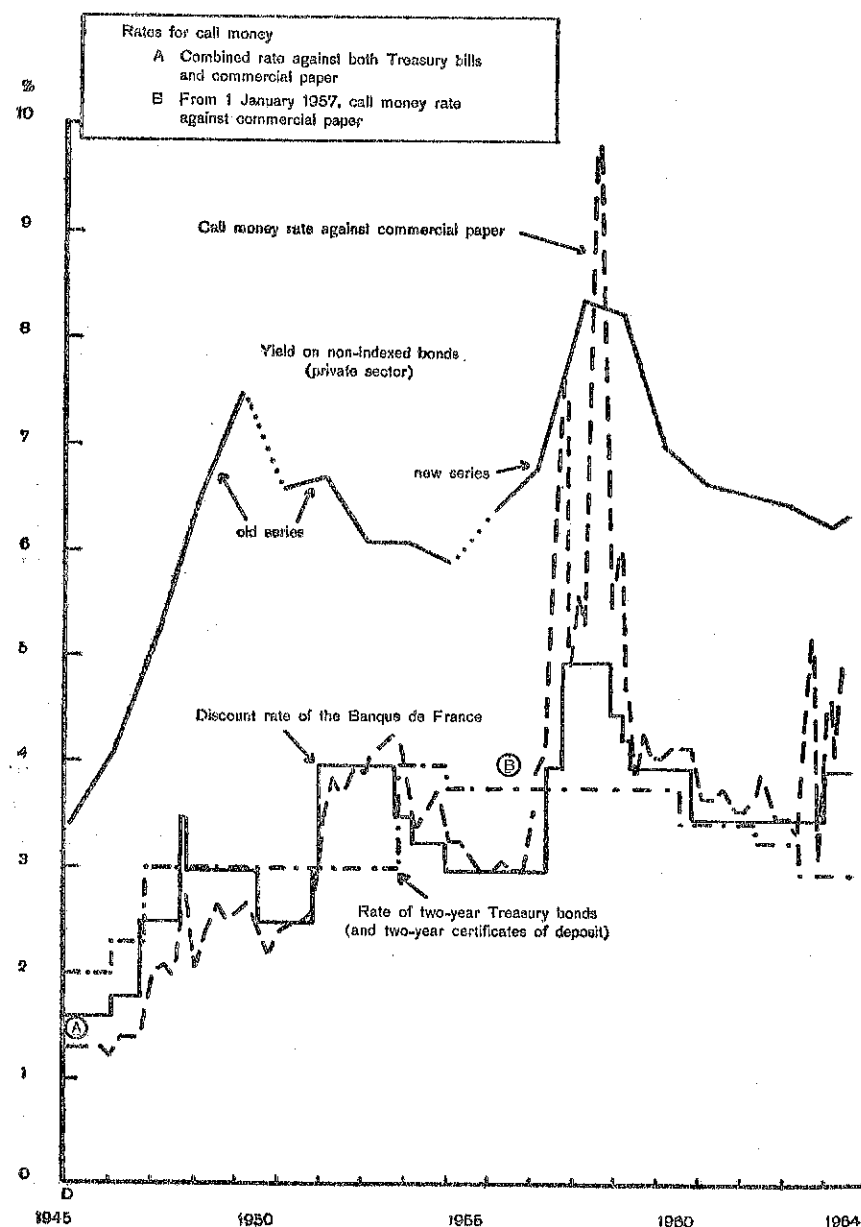
Thus, numerous lines of communication can be established between the different categories of markets, since wide possibilities of choice are offered to borrowers as between different procedures of financing, and to the lenders as between different forms of investment. The long and short of this is that the distortions between the rates prevailing on each particular market cannot exceed certain limits.

The money market in the strict sense of the word operates in quite a separate field. It has its own character and its behaviour may differ from that of the other capital markets, especially the short term credit market.

#### 2. *The interest rates on the short term markets*

As regards the short term markets, it is essential to make a distinction which, despite its importance, is often neglected. There are two completely different markets, the one concerned with the various means of payment (deposits or bank notes), the other, dealing exclusively with liquid assets deposited with the Central Bank. The first (the short term credit market) matches up the supply and demand of private individuals and firms, banks or various financial institutions and the Treasury. The second one (the money market strictly speaking) is open only to organizations

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in direct touch with the Central Bank — banks, financial institutions and the Treasury. The rates of interest on both types of market are subject to very different influences.

### A - The short term credit market.

#### 1. Regulation and practice.

Here, too, a factual consideration is too often disregarded. Neither in France nor in most modern industrial countries is the organization of the market such that businesses and private persons would be in a position to effect short term loans easily and without intermediaries to other businesses or individuals. No doubt suppliers often grant their clients extensions by means of bills of exchange, but these are operations arising out of trade relations, which have only an indirect influence on the supply of and demand for capital.

In the short term money market, the formation of the rates of interest and the rules applied differ according to whether they might affect the possibility of the creation of money.

(a) *The cost of the creation of money for borrowers and the return paid on bank deposits.* In France, the rates of interest charged by the banks are subject to relatively strict rules, both as regards banking loans and the remuneration of deposit balances.

1) Depending on whether *banking credit* is distributed to the Treasury or to individuals and businesses, its *cost* follows very different rules and influences.

The banks provide the *Treasury* with funds by subscribing to short term Treasury bills on current account. Until recently, these subscriptions could be received at any time and were at a fixed rate. The remuneration of the bills thus depended entirely on the borrower and was fixed — for two year certificates, which were the most common — slightly below the Banque de France's discount rate. True the banks were obliged by the regulation stipulating a minimum reserve holding of Treasury bills to keep a specific quantity of bills, whatever their yield. But the remuneration was fixed at sufficiently high levels because of the desire to avoid forcing the banks to engage in an insufficiently profitable investment and also to induce them to raise their subscriptions above the necessary minimum.

With a view to modifying a system which gave rise to numerous criticisms, the Treasury set up, in 1963, a procedure for the issue by auction to the banks and to various other financial organizations. The reform was completed on 24 January 1964 by a change in the arrangements for issue whereby two separate procedures were created.

In one case, the bills intended to form the minimum obligatory holdings — called treasury certificates — are given a fixed rate of interest, at present  $3\frac{1}{8}$  per cent for two year certificates, whereas the official discount rate is 4 per cent.

In the second case, the interest rates on the auctioned bills, which are freely subscribed to, are determined by the bids made by the banks during the periodical tenders, but the Treasury reserves the right to refuse any allocation if the rates proposed appear excessive. The first tenders carried out under this new regime raised the rate of interest for "free" certificates to about  $3\frac{1}{2}$  per cent.

The rates of interest on banking loans supplied to *businesses and individuals* are subject to rules laid down by the National Credit Council which aim at harmonizing the terms for loans by category, while leaving it to the banks to assess the risks involved in each case. For most of the operations, indeed, the regulations indicate minimum rates which are mostly calculated in relation to the official discount rate. The banker retains full latitude, if competition so permits, to apply higher rates. Since the introduction of this procedure in 1947, the National Credit Council has tended to reduce by gradual stages the gap between the minimum terms and the Banque de France's discount terms. At an early stage, the commissions added to this rate were reduced. Then, from 1959 on, the links between the official discount rate and the banks' minimum rate were relaxed. At present, by a decision of November 1963, the base rate coincides with the discount rate when the latter reaches 3.5 per cent. Above or below that figure, the base rate undergoes only half the variations of the discount rate.

Certain categories of credit are subject to special regimes. In the case of the negotiation of credit paper resulting from export sales, for example, the minimum rate varies in terms of the discount rate applied by the Banque de France to these operations. On the other hand, for operations concerning the financing of sales on the instalment system, the rates are subject to the approval of the National Credit Council.

2) *The remuneration of bank deposit balances* is also subject to relatively strict rules, the observance of which sometimes creates difficulties. These rules fix maximum rates of interest which differ according to the demand date (sight, 2 years, 3 years, etc.) and the size of the deposits; thus, the rate is low for sight deposits, and rises proportionately to the duration fixed for the deposit.

It should be emphasized that the payment of interest to the depositors is not aimed so much at attracting into the coffers of the banks funds from various sources as at keeping within the banking system the means of payment created by the banks themselves by the grant of credit or purchases of foreign exchange. It should be lower than the rate fixed for the deposits administered by other institutions. For deposits at sight, the maximum laid down varies from  $\frac{1}{2}$  per cent to  $1\frac{1}{8}$  per cent a year, depending on the particular case.

(b) *The rates of interest on investments and uses of liquid or short term savings.*

1) *Investments.* Sight or short term investments made by individuals or businesses are collected or administered by either the Treasury or various financial institutions, especially savings institutions (*caisses d'épargne*), or by the commercial banks.

The Treasury issues on tap, that is, in unlimited amounts and for an unlimited period, short term bills and bonds reserved for private persons and firms (as opposed to the bonds on current account intended for banks and financial institutions). Depending on the type of bond, the maturity may be as much as five years, and the interest, which is exempt from tax, may range from 1.20 to 4.05 per cent a year. The total amount of bills and bonds thus issued represents about a third of the investments at sight or on short term.

The savings institutions receive deposits which can be withdrawn at sight, except in special circumstances which are laid down by statute and the amount of which may not exceed 15,000 francs for each individual deposit. The whole of these deposits represents a little less than half of the available liquid or semi-liquid savings. The interest, which is fixed by the government and is exempt from tax, goes as high as 3 per cent or 2.80 per cent according to the type of savings institution. However, interest is reduced when the

amount received annually exceeds 300 francs or 280 francs according to the particular case.

The banks play their part in the administration of savings by issuing certificates of deposit and by opening deposit accounts with fixed maturities. The duration of the certificates of deposit must be not less than 6 months and not more than 2 or 5 years according to the type of bank. In the same way, the duration of the fixed term accounts may vary from 2 months to 2 years for commercial banks or 5 years for institutions belonging to the other categories. The rates are controlled by the National Credit Council in relation to the rates charged for other kinds of investments. The maximum rate paid is  $3\frac{7}{8}$  per cent a year for five year deposits. The bank clients can also open "special accounts" which are subject to the ceilings on the maximum size of deposits as are deposits with the savings institutions, but the rate of interest is not so high (2.3 per cent when the funds have remained stable for six months).

2) *Uses.* Savings placed at sight or on short term are first of all employed, by the organizations administering them, in liquid asset operations — subscriptions for short term bonds, deposits with the Treasury, rediscount of bills for medium term credits. But, for the most part, they are assigned to medium or long term loans to businesses and individuals or to public corporations at rates of interest between those on the short term and those on the long term capital market.

The Treasury itself takes part in these allocations to the extent that the loans by the Economic and Social Development Fund find their counterpart in the deposits received from the public and in the receipts from the issues of Treasury bonds. It can be calculated that in 1963 the weighted average rate of interest on the loans granted with public funds (which represented a little less than one-third of the economy's long-term indebtedness registered during the year) was 3.75 per cent.

Among the financial institutions, it is the "Caisse des Dépôts et Consignations" which engages most extensively in the transformation of sight and short term resources into medium and long term investment (about 80 per cent of its funds being transformed into longer term investments). Not only does the Caisse hold a considerable portfolio of securities, especially fixed income issues, but it takes part in the financing of industrial and agricultural

investments and of building, and grants loans to local bodies. It is this policy of long term investment which enables the Caisse des Dépôts to pay savings banks relatively high rates of interest since the interest services the deposits available at sight.

The fixed term deposits administered by the banks may, in the same way, be regarded as a counterpart to fairly long term investments, the actual period depending on the type of establishment, thus justifying the yield of these deposits.

## 2. *Conditions in which the rates of interest are fixed or formed.*

(a) *Basis of the Government's attitude.* The short term money market is profoundly influenced by the long tradition of meeting the Treasury's needs and by the desire of the monetary authorities to regulate the banking profession.

As regards the first point, the system of issuing Treasury bills on tap and the application of especially attractive interest rates which are also tax free are due to two causes. Firstly, there is the more or less permanent concern with feeding the Treasury, whose commitments of all kinds greatly exceed fiscal and state receipts, and secondly, there is the desire to avoid, as far as possible, having recourse to advances from the Central Bank.

The desire to regulate the banking profession has a dual objective. First, the authorities are at pains to see to it that cut throat competition does not lead to dangerous overbidding which would drive up the rate paid on funds deposited with the banking system or reduce terms for credit, and hence compromise sound banking principles and as a result jeopardize the public's funds. For this reason, every effort is made to obviate collapses of the kind that took place during the first half of the 'thirties. Conversely, care must be taken to prevent the banks from coming to understandings which would completely nullify any attempt by the Government to control the formation of the rates of interest on the short term money market.

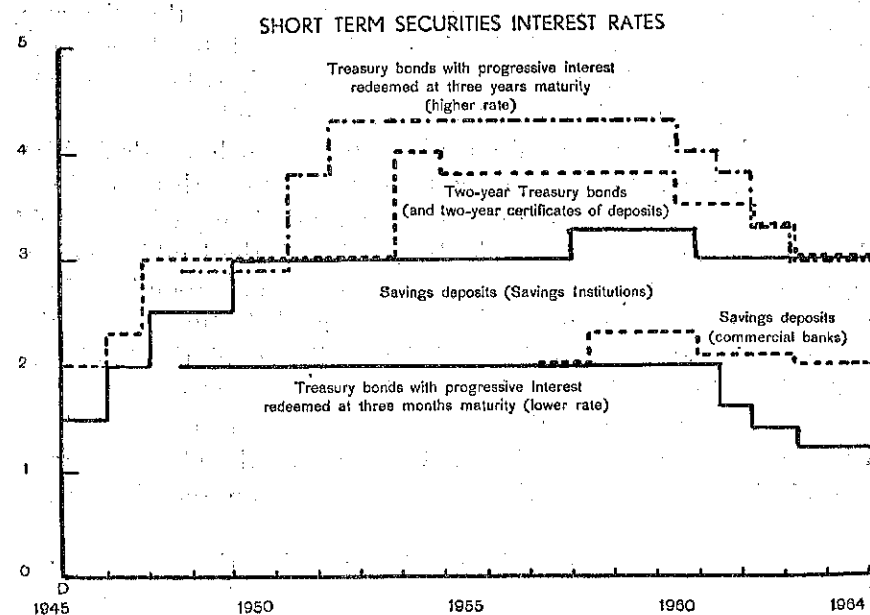
The question has often been asked whether the policy of the National Credit Council has raised or depressed the cost of credit. *A priori*, it might be thought that the upward tendency has been the predominant one since the regulations laying down minima for the terms on which advances and discounts may be granted appears to offer corporative features. But a closer study of the matter



leads to a different conclusion. First of all, the very existence of rates laid down by the National Credit Council — whose action, it should be recalled, has always brought about the reduction of these rates — enables firms to argue about the terms offered them with a better understanding of the factors involved. Secondly, the remuneration of deposit balances is itself limited, and hence the banks are in a position to apply favourable rates to their clients without affecting their profits. Lastly, in the light of these various observations and experiences, both abroad and in the past, it may be asserted that such understandings, if not controlled, would undoubtedly have led to higher terms being charged.

It seems certain, therefore, that, all things considered, the effect of regulation by the National Credit Council has been to lower the cost of credit.

(b) *Main factors in recent years.* Apart from the general factors dealt with above, the short term money market has been subject to special influences linked with the financial and monetary situation.



Since the beginning of 1959, that is, after the adoption of remedial monetary and financial measures by the Government, the most striking development was the reappearance and the subsequent

expansion of the gold and foreign exchange reserves as a factor in the creation of money. These reserves have thus risen from a practically nil net balance at the end of 1958 to the equivalent of about 25 billion francs at the end of 1963. This flow of funds might well have resulted in a sharp decline in the forms of monetary creation, and especially brought about a reduction in the demand for bank loans. Such offsetting effects have often been noted in the past.

But another factor has exerted an extremely important influence, and we should be wrong to underestimate it. This is the public's cash needs. Because of the revival of confidence in the franc, at least as far as the immediate future is concerned, the idle cash balances which had almost completely disappeared during the inflation, were gradually built up from the end of 1958 on, and reached a figure estimated by the National Credit Council at about 40 billion francs at the end of 1963. This phenomenon has to a great extent neutralized the influence of the foreign exchange inflow on the equilibrium of the short term money market. And it explains why, despite the reversal of the situation and the abundance of the supply of money, the demand for funds has remained brisk and has been met only by an active allocation of bank credit. This relative tension in the money market was all the more visible because there was still a very great need for means of payment to satisfy a number of needs for finance resulting from the Treasury's requirements, economic investment, industrial and agricultural expansion, the modernization of the distribution system and the raising of the standard of living. The result was an apparently paradoxical situation: a high degree of liquidity in the economy which tended to rise even further and intense pressure for the creation of money.

(c) *Trends in the interest rates.* Some twenty years ago, the funds in the hands of individuals and firms were substantial, the opportunities to invest scarce, and prices partly kept down by rationing. The rates of interest were therefore relatively low. From 1947 an upward trend became apparent, and this went on till 1959. This trend, incidentally, took the form of a resistance to a fall in the rate at certain times, especially during the period of monetary stability of 1952 and 1953.

During the last five years, on the contrary, interest rates have gradually declined under the influence of Government measures. Thus, the rate for two-year Treasury bills has fallen from 3.75 to

3 per cent at issue. In the same way, the rates of interest paid by the ordinary savings institutions were brought down from 3.25 to 3 per cent in 1961. The rates for fixed term deposits with banks have followed a similar path.

### B - The money market.

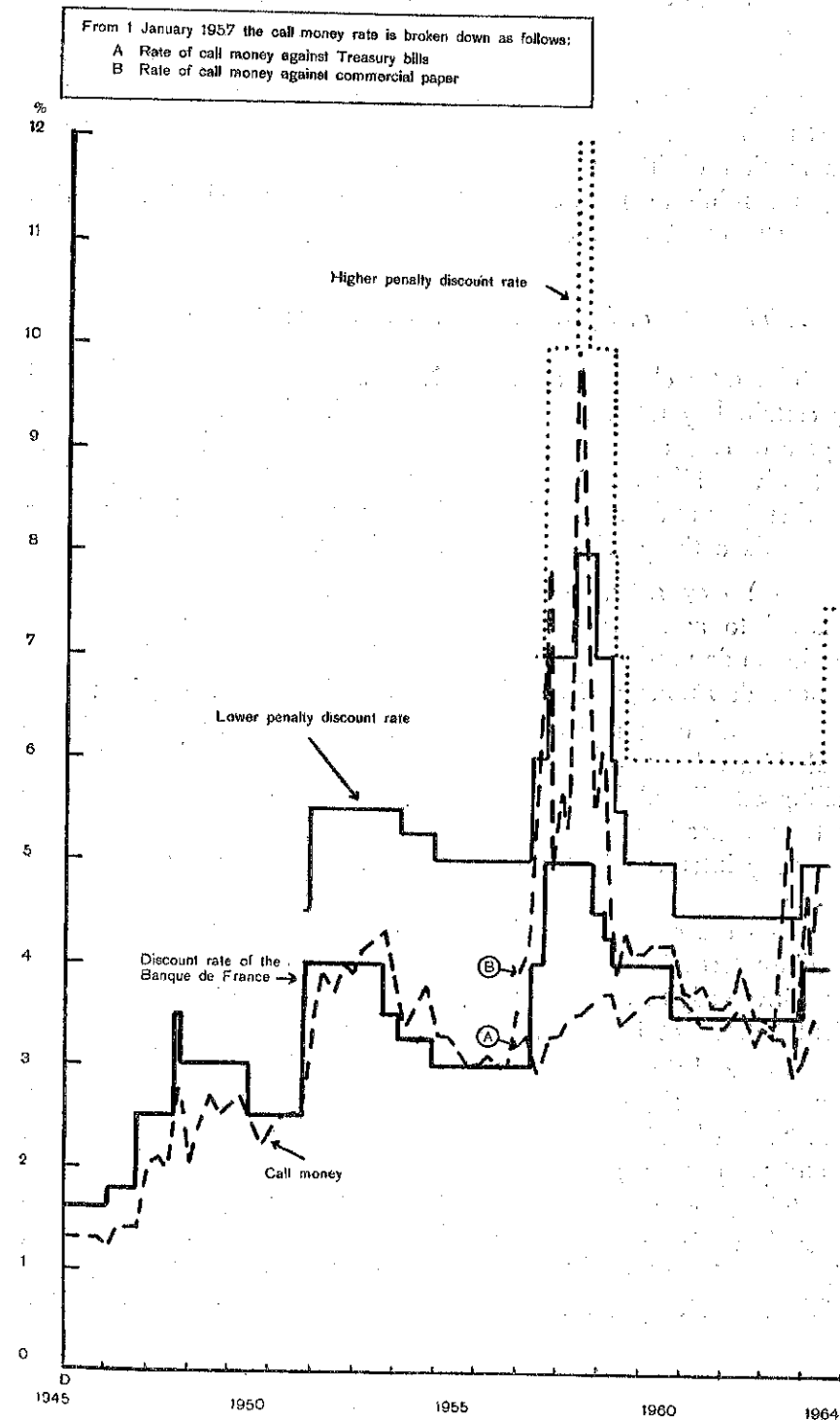
The Paris money market is subject to the influence of the regulations which control the liquidity of the banks — a system of “floors” applied to Treasury paper holdings which was set up in 1948, that is to say, the obligation on the part of the banks to keep a portfolio of bonds equal to a specific proportion of the deposits, and the regime of the so called “treasury coefficient”, established in 1960, which obliges banks to hold in their portfolios assets that presuppose a sacrifice of liquidity on the part of the banks or whose creation is subject to the agreement of the Banque de France. Thus the market has quite distinct compartments, in particular those of public bonds and of other assets included in the numerator of the “treasury coefficient” (basically, bills representing medium term credits) and the compartment of private commercial or financial bills which it is not compulsory to hold. The most typical compartments are those comprising Treasury and private bills.

#### 1. The rates of interest charged in public securities sector.

The system of “floors” has gradually given the compartment of transactions in public securities a special character.

In present circumstances, the banks avoid as far as possible holding Treasury bills in excess of the minimum (since June 1963, 10 per cent of the amount of deposits). However, a number of the banks do in fact keep such extra quantities in order to comply with the regulation governing the “treasury coefficient”. The operations handled are not large and correspond to the exchange of Treasury bills for liquid funds between banks with an excess over the regulation minimum and those which prefer to obtain bills with maturities that suit them, whether by purchase or borrowing rather than by recourse to direct subscription. Various non-banking organizations which hold substantial portfolios of public securities also take part in the market.

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For these various reasons, the rates charged in the compartment of public securities have no great monetary significance. They generally move around 3 to 3½ per cent. However, the recent reforms (creation of Treasury certificates issued at a fixed rate to meet the needs arising from the compulsory minimum holdings and the auction of Treasury bonds for voluntary holdings above the required minimum) are such as to confer a greater elasticity on this compartment of the money market.

## 2. *The rates of interest charged on the private bills market.*

The rates charged on the private bills market are influenced by certain key rates, the operation of which is conditioned by the degree of ease or tightness of the market. It must be pointed out that private bills are so called in contrast to Treasury bills. They are therefore underwritten by public concerns as well as by businesses which lie entirely within the private sector.

(a) *Key rates.* The rates of interest which the banks are induced to accept in order to obtain on the money market the liquid funds needed depend very much on the rates applied by the Banque de France and the first degree rediscount houses, i.e.:

— discount rate of the Banque de France which applies to trade bills submitted to it below the maximum quantitative discount ceiling established for each bank (at present, 4 per cent). Contrary to the practice in certain foreign markets, the Central Bank does not normally intervene in the market at rates lower than the discount rate;

— the rate charged by the financial institutions to negotiate medium term bills (generally 4 to 4.45 per cent according to the type involved) to the extent that the action of the "treasury coefficient" does not hamper such operations;

— and the rate applied by the Banque de France for bills submitted above the maximum quantitative discount ceilings: "hell" and "super-hell", according to the extent of the excess (at present 5 and 7.5 per cent).

The market rates tend to fall into line with one of these key rates depending on the facilities available to the banks at any given time — submitting bills for rediscount within the limits set by the ceiling, obtaining an advance on "medium term" bills (taking

account of the restriction imposed by the "treasury coefficient"), using their discount facilities within the limits set by "hell", or turning to "super-hell".

As the banks are largely in debt to the Central Bank, the market rate falls below the official discount rate for only short periods as a result of the divergences between the inflow of funds to bank reserves and the termination of the commitments with the Central Bank. Conversely, the market rates are not higher than that of "super-hell" except in special circumstances, i.e. in the rare cases when it is in a bank's interest to borrow for a single day on the money market at a rate higher than that of the highest penalty discount rate, the "hell" and "super-hell" borrowing rates being calculated on a two working day minimum basis.

It should be recalled that the securities arising from foreign credit transactions are bought in unlimited quantities by the Bank at a rate which is generally lower than the ordinary discount rate. They do not therefore remain in the banks' portfolios.

(b) *Rates charged on the market.* From 1945 to 1956, the rate for call money has stayed close to the Banque de France's discount rate, which has fluctuated between 1½ and 4 per cent.

In 1957 and 1958, when monetary policy became more restrictive, the rates rose sharply above the ordinary discount rate, and sometimes were even as high as that of "super-hell" (fixed at up to 12 per cent) but they stayed on an average around the rate for "hell" (at most, 7 or 8 per cent).

After 1959 the average rate for the market on transactions regarding private bills first moved nearer the Banque de France's discount rate (4 per cent till October 1960, 3.5 per cent till November 1963, at present 4 per cent), but subsequently became much tighter as the "treasury coefficient" was raised several times, and on numerous occasions, it even reached the "super-hell" levels prevailing up to the beginning of June 1964 (i.e. 6 per cent; since then the rate has been 7.5 per cent).

## C - *Links between the interest rates on the money market and those of the short term credit market.*

### 1. *Relative autonomy of the two markets.*

The very fact that the money market and the short term credit market deal with different types of money instruments means that

the influences on each of them are themselves distinct and largely independent of one another. When industrial managers are astonished that the short term investment instruments at their disposal often bring in interest less than is paid on the money market, they fail to grasp that the money they have to offer (placed in a bank account) is of no use to the money market and cannot affect the supply in any way.

The trend of the short term credit market is determined by the capital needs of individuals and businesses, and also of the state, or by the supply of bank credits in response to these needs; the changes in its trends are generally gradual. The course of the money market, determined by the needs of the banks or financial institutions for liquid assets at the Central Bank, may oscillate much more sharply. The needs for liquidity are themselves conditioned either by the measures taken with a view to controlling banking liquidity or by three series of operations — movements of foreign exchange, withdrawals from or payments by the Treasury, supply and demand for bank notes on the part of firms or private persons.

It will thus be obvious — and everyday experience shows that this is not mere theory — that the two markets do not necessarily move in parallel fashion. There are periods during which one of them is subject to tension or undergoes abrupt changes at the very time when liquid funds are abundant on the other market. Hence the rates of interest often show different variations as between the two markets.

A few simple examples will easily explain this divergence. The additional needs of the economy for bank notes constitute a factor making for tension on the money market. They do not do so however, on the short term credit market, to the extent that the notes are drawn from existing bank deposits. An inflow of foreign exchange tends to feed the money market; it may not entail any expansion of the short term credit market if its only consequence is to allow the banks to reduce their commitments with the Central Bank.

Not only do these various considerations show the reasons why divergences arise between the movements in the rates of interest on the money and the short term credit markets. They also explain why the rates of the short term credit market may be higher than the discount rate and than the rates on the money market. Foreign examples confirm the correctness of this interpretation.

Thus it may be noted that, all through 1963, the "prime rate" in force in the United States was as high as 4.5 per cent (base rate) whereas the Federal Reserve bank's discount rate was 3 per cent, then 3.5 per cent, and that the rates on the money market varied from 2.9 per cent to 3.5 per cent.

## *2. Reasons for interdependence of the two markets.*

It would however be paradoxical to affirm that the two markets are totally independent of each other. And in fact the rates on the money market are one of the factors determining the financial charges of the banks. Moreover, the mechanisms for the creation and administration of money imply the existence of links between the distribution of banking credit and the banks' needs for liquidity with the Central Bank. Lastly, regulations alone contribute to connect the interest rates on the two markets.

(a) The cost of the transactions by which the banks obtain liquidity in their Central Bank accounts constitutes an important item in their financial charges, if not indeed the most important one. The banks must therefore take account of it in fixing the terms for the credits which they grant their customers.

The study of the banks' profit and loss accounts thus shows that, during recent years, the cost of rediscounting represents between 22 and 24 per cent of the gross proceeds of the banks' own lending operations.

(b) If the factors determining the banks' needs for liquidity (movements of foreign exchange, inflow and outflow of notes, changes in the trend of public finances) are largely independent of the control of the banks, some of them are the more or less immediate consequence of the creation of money by the banks themselves.

In fact, the creation of money in the form of bank deposits involves, with a time lag, transfers to postal current accounts or demands for notes, for the proportions between the different kinds of money alter only slowly. The result is to give rise to reciprocal influences between the short term credit market and the money market which are reflected, in varying degrees and more or less rapidly according to the circumstances, in the formation of the different rates of interest. This is why long term tendencies are generally the same for the two markets.

(c) The regulation in a number of countries, or the agreements actually concluded in others, freeze this form of interdependence by strengthening it. By fixing minima for the cost of the banks' credit operations by reference to the Banque de France's discount rate, the National Credit Council confirmed the existence of a link between the rates on the short term credit market and one of the key rates on the money market.

In the same way, the rates for the investments of liquid savings, fixed by the state or by the Credit Council, are often modified with reference to the variations in the official discount rate.

### 3. The long term capital markets

The long term capital markets are divided into two distinct sectors, according to whether institutional investors or financial organizations are intermediaries or whether supply and demand conditions can be satisfied by direct placements.

#### A - *The operations of institutional investors and financial bodies.*

##### 1. *The rate of interest for loans.*

The expansion and modernization of equipment, whether in public or private concerns, are largely financed on relatively favourable terms, thanks to the measures taken, over a period of time, by the Government.

The loans by the Economic and Social Development Fund are granted at rates which range from 3 or 4 per cent in the cases regarded as being the most deserving to 5.5 per cent or 6 per cent, according to the degree of Government support for which the transactions qualify. For the borrower, the actual cost may be a little higher owing to possible commissions which may be levied by intermediaries, or from expenses in connection with the putting up of collateral.

Without trying to review the whole range of the operations engaged in by all financial institutions, we may mention some of the more characteristic of these operations.

For its loans to public concerns or to private firms carrying out investments deemed in the national interest, the "Caisse des Dépôts

et Consignations" applies rates of from 5.25 to 5.5 per cent. The rates charged by the "National Credit" (Crédit National) which makes loans to business and industry reach 6.75 per cent, not including legal expenses and those for collateral. For its normal mortgages, the "French Land Bank" (Crédit Foncier de France) charges a rate of 7.35 per cent.

When a case can be made out on social grounds, the rates are particularly low. Thus the "Mutual Agricultural Credit" (Crédit Agricole Mutuel) grants installation loans to young farmers for amounts of from 12,000 to 18,000 francs, of which the cost is only 2 per cent. For purchases of land for farming, 70 per cent of the purchase price can be borrowed by the farmer at 3 per cent. For the construction of housing not exceeding certain standards, special loans enjoy the following rates: 4.25 per cent in the case of houses or apartments for renting and letting, and 5 per cent in other cases.

As against this, in a quite a different field, that of "Companies for regional development" (sociétés de développement régional), loans are granted at relatively high rates — those prevailing on the financial market plus 1 to 2 per cent. This cost is justified because these companies must themselves turn to the financial market to obtain their funds, and the rate they charge does not hamper operations. It is really a favourable one, since the local firms which in turn borrow from them are too weak to raise funds directly from the public.

##### 2. *The cost of loanable funds.*

The funds employed by the financial institutions are of various origins, hence their cost varies widely.

As has been observed above, the "Caisse des Dépôts et Consignations" has the advantage of administering liquid or semi-liquid savings funds. In applying the arrangements then in force, the "Caisse des Dépôts et Consignations" paid overall interest of 4.3 per cent in 1963 for the funds deposited by the savings banks, thus allowing them to accord their depositors a relatively high remuneration.

In certain circumstances, the "National Credit" and the "Land Bank of France" can obtain from the "Caisse des Dépôts et Consignations" long term loans at a rate fixed in 1963 at 5.25 per cent. They also place debenture loans with insurance companies at rates

lower than those on the financial market. Lastly, even when they approach the public, these bodies obtain favourable rates for their debentures, which by tradition entitle those acquiring them to participate in a lottery held in their benefit. They are therefore easy to place.

As for the "National Agricultural Credit Fund", it issues, among other kinds of loans, long term shares at a nominal rate of 5 per cent which, if account is taken of the repayment premia, represents a real rate of about 5.6 per cent.

#### B - The rates for transactions which involve direct negotiations.

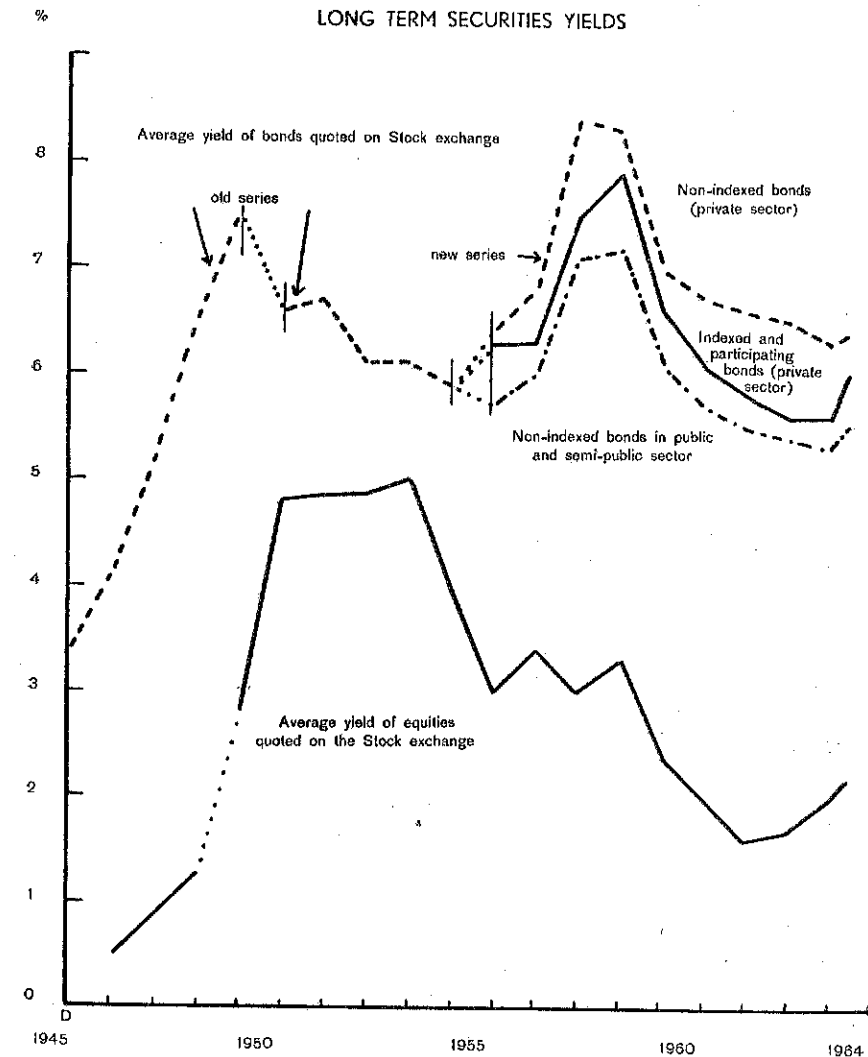
##### 1. The rates of interest charged.

Among the operations involving direct negotiations, we must mention mortgages between private persons. Certain assessments put them at around a billion francs a year, but this is only an approximation, for they are not subject to any census, and mortgages in France are not dealt with in a broad, nation-wide market. The rates charged are 10 per cent, or even 11 and 12 per cent. In addition to the interest the borrower has to pay the stamp duties and the cost involved in cancelling the mortgage which, since they are proportionate to the amount of the mortgage but not to its duration, will be heavier the shorter the length of the operation.

It is particularly in the field of securities that there is a direct encounter between supply and demand for long term capital, whether on the stock exchange or in connection with new issues.

(a) *The rate of yield on stock exchange operations.* When we tackle securities quoted on the stock exchange, for the first time in this study, we come across types of indexed loans which have been issued at different times. Therefore an analysis of interest rates which flow from both (1) the current market quotations and (2) the actual payments made by the borrower should distinguish between two major groups of securities. In addition, although the share market does not quite come within the framework of this study, some reference to it must be made. For, if the payment of dividends cannot be considered as a payment of interest and if share prices are subject to much more substantial fluctuations than bonds, there are frequently reciprocal influences within the securities market taken as a whole.

Immediately after the war, the yield of the classical type of bonds (that is, without indexing) was very poor because of the inadequacy of the opportunities for investment. But the yield



rose rapidly from 1947 to 1949, then remained high during the following years. After easing from 1953 to 1956, the yield increased again in 1957 and 1958 during a strong burst of inflation. From the beginning of 1959, thanks to the measures taken at the time and

to Government action thereafter, the rates declined, first fairly rapidly, and then more slowly. Thus, the average yield for bonds in the private sector as calculated by the "National Institute for Statistics and Economic Studies" (Institut National de la Statistique et des Etudes Economiques) fell from 8.26 per cent in 1958 to 7.03 in 1959 and 6.25 in 1963. The yields for bonds in the public sector are usually fixed about 1 per cent below these figures. During the past year there has been a tendency for the yields to stabilize at their present levels.

Indexing concerns payments of interest as well as the repayment of capital. Different types of clauses were used in the years 1950 to 1958. Indexing is usually based on the price of products supplied by the borrower; occasionally the benefits secured by the borrower entail a bonus of interest (participating bonds). The clauses used are more or less favourable to the lender but cases have been known where indexed bonds have been less profitable to the bearer than classical bonds. In these circumstances, the calculation of a medium rate of yield has no great significance. It merely makes it possible to observe the declines in interest during the previous years — 7.85 per cent in 1958, 6.62 per cent in 1959 and finally 5.55 per cent in 1963.

The yields of shares have always been definitely lower. As a result of a marked rise in quotations, the yields have declined since 1958, falling on an average from 3.31 per cent to 2.37 per cent in 1959 and to 1.61 per cent in 1962. They rose to 1.83 per cent in 1963 owing to the fall in share prices, and they have continued to rise since the beginning of 1964. To these figures we must add any money which the bearers may obtain from bonus issues or from the sale of rights, both of which are a current practice in France.

(b) *Issues and subscriptions on the financial market.* A distinction must be made between two points of view regarding the rates of interest charged, for the cost to the borrower is distinctly higher than the yield to the lender.

1) A correlation can naturally be established between the rates of return on securities when issued and the rate of those already quoted on the stock exchange. The terms proposed (rate of interest, repayment premia) must, if they are to attract sufficient subscribers, be calculated with an eye to existing investment opportunities on the

stock exchange. Nevertheless, the possibility of capital gains generally makes it possible to apply a rate at the time of issue which is slightly lower than those based on existing quotations.

The rates of yield at issue of bonds were very high for a considerable period, and reached their peak in 1957 and 1958. They declined after 1959 and are now below the 1948 level, partly because of the steps taken by the Government which have influenced the market. Thus, the yield at issue of the annual borrowing of the Land Bank of France (Crédit Foncier de France) has gradually fallen from 7.83 per cent in 1958, to 5.61 per cent in 1963; and that of the Groupement des Industries Sidérurgiques (Steel Industries Combine) has fallen from 7 per cent to 5.68 per cent.

To appreciate the attraction of such rates for the savings community, we must bear in mind the repercussions of the income tax on personal incomes. For example, those taxpayers whose top bracket of income is taxed at the highest rate end up with a net remuneration which is 50 per cent less than the gross sum earned. Hence the interest in fact received becomes lower than that which short term but tax-free investments bring in — in particular Treasury bills.

With this problem in mind, the Committee which in 1963 was requested to study the financing of investments proposed tax exemptions, admittedly modest ones, on a part of the income from debentures earned by any one taxpayer.

2) To assess the cost of a debenture loan, we must count not only the sums paid to the lender but also the expenditure incurred at the time of issue (publicity, printing of the bonds, commitments to the banks in connection with the placing of thereof), and also the disbursements in connection with the payment of interest (operating expenses incurred by the borrowers in making payments and deductions for taxes).

The total thus turns out to exceed by about 1.5 per cent a year the rate of yield for the issues of firms. The gap is still greater when the loan is launched by a group — loans to industrial bodies or to companies for regional development — for, in these cases, a part of the product of the loan is reserved in the form of a collateral.

Indexing allowed the borrowers to reduce the nominal amount of interest and of repayment premia, but, as a result of the depreciation of the currency, it has generally given rise to an extra burden of expenses, which, in current francs, is borne by the borrower.

Particularly owing to the fiscal implications, the companies prefer to issue bonds or to have recourse to other forms of loans, rather than increase their capital. The burden of debenture loans is in fact included in overheads, whereas dividends are taken out of net profits after company taxes have been levied. In order to lessen the consequences of the difference in taxation, a decree of 1957 exempts from taxation the dividends distributed during the first seven years when the activity of the firm concerned is regarded as furthering the achievement of the French Economic Plan's aims or regional development programmes. The exemption however is not to exceed an annual return exceeding 5% of newly subscribed capital.

## 2. Government policy and behaviour of the savers.

(a) *Government policy.* In dealing with the problem of rates of interest, the Government policy has two different aspects — one concerning the administration of the State's finances, and the other relating to the conditions on which the economy should be financed.

1) Until recently, the state did not follow any clearly defined line in its issues of long term loans. It did not generally have recourse to such issues except when it experienced serious difficulties in obtaining funds for the Treasury. It then attempted to avoid the full impact of existing market conditions, particularly by granting tax exemption on the interest paid to purchasers of government bond issues; this permitted the Government to float the issue at relatively moderate rates.

On numerous occasions, the Treasury has tried to tap directly private savings by making its loans attractive not only by nominal rates of interest, but also, and above all, by repayment premia which were bound to be regarded as offering definite advantages. In addition, at certain periods, the state put on the market certain securities, the repayment of which is tied to the price of gold, for example, or to the average of stock exchange quotations. To show its determination to keep the currency stable, the Government has, since the end of 1958, given up indexation measures of this kind.

In 1963, two long term loans were issued at rates and on terms which guarantee the bearers a yield of 4.49 per cent for one of the loans and 4.60 per cent for the other. Following a rule adopted in previous cases, the tax advantages attached to the second of these

loans have been reduced, and they now apply only to the first ten years of the total 20 years maturity.

2) For twenty years or so now, the Government has taken steps to exercise directly a control over new security issues. Firms are obliged, even now, to submit their plans for investments above modest levels to the Ministry of Finance in order that the Government may be in a position to spread the issues over a period of time. The "calendar" of new flotations thus makes it easier to adjust demand for capital to the supply and to avoid abrupt changes in interest rates.

In addition, since the beginning of 1958, the authorities have tried to supplement the steps taken to strengthen the currency by creating conditions calculated to encourage the formation of a broad financial market.

Generally speaking, the battle against inflation is expected to make the investment of savings safer, and hence to encourage the increase in issues. In addition, arrangements have been adopted to make certain categories of investment more attractive, in particular by the setting up of open end investment companies. Such arrangements are likely to lower the rates of interest by expanding the supply of capital.

One point of principle is still subject to controversy — that of indexing. Since the beginning of 1959, the law forbids indexing based on general price indices. But the policy of the authorities has gone beyond that decision, for since the end of 1958 the Government has discontinued the issue of all kinds of indexed loans in order to indicate its firm determination to maintain the stability of the currency. This decision has, however, the disadvantage of doing away with a type of issue which gave subscribers certain guarantees and thus contributed to lowering the interest rates.

(b) *Behaviour of savers and borrowers.* Fifty years of, if not inflation, at least of monetary ups and downs, have left their mark on the behaviour of savers. The majority of the working population of France has lived its adult life in an economy where the future of the currency was uncertain. To this more or less permanent concern about the currency, at least in the long run, have been added repeated doubts of an economic and political nature.

The aspirations of savers were profoundly modified as a result and seem dominated by two factors — the search for security



and, failing that, for rapid capital gains. This attitude explains why the French saver has often been content with low rates of yield when these two preoccupations were satisfied.

The share market has for the last twenty years been the object of alternate excessive favour and disfavour. Subjected to a host of influences, arousing exaggerated hopes in which pure speculation occupied a prominent place or indifference which was often unjustified, the quotations resulted in rates of yield which can hardly be considered as representative of the trend in long term rates of interest.

In the case of normal non-indexed bonds, the adjustment of the rates of interest is determined by a number of fairly complex phenomena in which the rate of return on the transactions remains important. The managers of firms generally complain about the high cost of loans. Yet, if we take a close look at the past twenty years, it will be noted that the average annual rate of monetary depreciation has been definitely higher than the interest paid. Thus, generally speaking, the borrowers have benefited from a windfall gain, whereas the lenders have had to bear a heavy financial burden. Nevertheless, this conviction that money is dear is understandable because borrowers base their assessments, in a way, on abstract considerations. They cannot, in fact, reasonably be expected to take account of monetary depreciation in their calculations, even if they are forced to admit the relief afforded them thereby in the past. The rates of interest, when all is said and done, are fixed at a level at which they are still regarded as bearable by the borrower and where they are sufficient to interest the less demanding of the savers, and also the institutional investors whose resources are steadily rising. Thus, every year there is a renewed flow of subscriptions for debenture loans, which is nevertheless insufficient to meet the total needs for financing.

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If interest rates still play a part in adjusting demand to supply on the capital markets, as the above *exposé* shows, this role is no longer a dominant one. Moreover, there are still partitions which protect rates of interest whose artificial character impedes the easy and regular matching up of supply and demand as a whole. However, the loosening of exchange control, the strict administration

of public finances and the prospects of a lasting recovery in the currency hold out hopes that a new trend may be taking shape.

In the conduct of monetary policy, the management of the rates of interest by the monetary authorities has for some twenty years been supplemented by direct action on the liquidity of the economy or on banking liquidity and by selective measures with either restrictive or expansionary effects. This does not mean that the market is denied any real influence in financial and monetary matters or that all possibility of adjustment by the mechanisms of the rate of interest is ruled out. It means that the law of the market and the management of rates are in and of themselves deemed too harsh and indiscriminating in their consequences. The aim of monetary policy is no longer only that of preserving the stability of the currency. It must also contribute to furthering the aims of economic expansion and social progress. This is why monetary policy is buttressed by measures designed to govern the creation of means of payment without throwing too great a strain on the rates of interest and to steer capital in those directions which deserve priority.

Because it lasted so long, monetary uncertainty has, for its part, deeply influenced the attitude of the public. The rate of interest is therefore now only one factor among many to influence the final decision on where to invest. Some types of savings (real estate and gold for example), considered to be a good refuge against uncertainty, still exert a sufficient attraction to compete effectively with other forms of saving. As to business managers, they may rather unfairly assert that the cost of credit and loans is too high, but they probably draw up their investment policy without attaching too much importance to the rate of interest, so imperative has the need to expand become and so vague appears to be the data as regards the outlook for money. Thus, here again we come across the after-effects of inflation; but without any doubt the stability of the currency ought to restore to interest rates, if not their importance in the classical epoch, at least a fruitful regulator's role.

Paris.

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