Credit Controls in Western Europe: An Evaluative Review

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I

This paper examines experience with credit controls in selected countries of western Europe to see what lessons that experience may provide for actual or potential efforts to control credit in the United States. The countries included in the review are Belgium, France, Italy, the Federal Republic of Germany, the Netherlands and the United Kingdom.

"Credit controls" are defined in this paper as measures by which the authorities seek to modify the pattern of incidence of cost and availability of credit that market processes would produce in their absence. Moreover, credit controls are distinguished for present purposes both from measures of budgetary policy and measures of general monetary policy. Thus, credit controls are conceived to exclude both taxes and subsidies involving the budget of the central government and the more traditional instruments of central bank policy. These traditional instruments are taken to be open market operations in short-term government securities, variations in a uniform discount rate charged by the central bank, and a uniform percentage change in the central bank's minimum required cash reserve ratio or in its maximum credit lines to eligible borrowing institutions.

Typically the target of *monetary* policy is an aggregate such as the monetary base, money supply, or the economy's stock of liquid assets. The pattern of interest rates and credit flows is left to be determined by market processes. By contrast, *credit* controls seek to influence credit allocation and interest-rate structure.

In European experience credit controls have been motivated by a variety of purposes. These have been (1) to finance government debt at lower interest rates than market preferences would permit; (2) to

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check the flow of credit to the private sector without raising domestic interest rates and thus attracting foreign funds through the balance of payments; (3) to influence the allocation of real resources to priority uses; (4) to block channels of financial intermediation and thus to assist a restrictive general monetary policy by impeding a rise in velocity; and (5) to strengthen popular acceptance of price-wage controls by holding down interest income to credit granting institutions and private investors. The measures of credit control that the authorities have used to achieve these objectives and the degree of success they have enjoyed are treated in part II of this paper. Part III draws conclusions and applies them to the situation in the United States.

II

There is considerable diversity of attitudes toward and experience with credit controls in the six west European countries reviewed here. At one end of the spectrum is the Federal Republic of Germany (hereafter, Germany) where market-oriented techniques of monetary management are strongly upheld. The principal German experiment with credit controls in recent years was judged a failure and abandoned. As a failure it is instructive.

The Netherlands and, to a lesser extent, the United Kingdom, occupy an intermediate position on the control spectrum, having made fairly extensive use of credit controls in the past 10-15 years but always regarding them as a more or less temporary expedient. Moreover, the Dutch use of credit controls never was strongly allocative in purpose. The British system evolved gradually and pragmatically without legislative enactment beginning in the late 1950s. The rationale advanced for credit controls in the United Kingdom and the methods employed have been much discussed and are of particular interest because of the sophisticated development of British financial institutions and markets. The British system of credit controls was largely (though not completely) dismantled by the official Credit Reform of 1971 when the authorities became convinced that its disadvantages had come to outweigh its advantages.

The principle of controlling credit flows and interest rates to serve national economic interests is fully accepted and has been extensively applied in practice in France, Italy, and Belgium in recent years. Techniques and objectives of credit control have differed among these countries as have other factors that have influenced the effectiveness of the authorities' measures. These differences cast a cross-light upon the respective national systems and thus aid in drawing some lessons from them.

Germany: After their experience with pervasive economic controls during the Second World War most German government officials and businessmen have been enthusiastic supporters of free markets. Credit markets in Germany are among the least regulated in any country. But there is one episode from the years 1965-66 involving ceiling controls for deposit and lending rates paid and charged by credit institutions that fits the pattern of credit controls and deserves mention. During these years governmental authority (dating from the banking crisis of the early 1930s) to set maximum interest rates on deposits and loans of credit institutions was refurbished and applied with renewed vigor. Historically maximum rates for deposits were intended to prevent cutthroat competition for funds by credit institutions and those for loans to protect borrowers from exorbitant interest charges.

During the 1965-66 episode the German central bank was engaged in restricting credit to bring a domestic economic boom under control. Since interest-rate maxima for loans were linked by specified differentials to the central bank's discount rate, officials apparently felt that such a link gave the Deutsche Bundesbank more control over effective lending rates in credit markets than reliance on market forces would have done. However, the ceiling rates become the effective rates only in the presence of excess demand for credit at the ceiling rates.

Ceilings on deposit rates of interest were applied to customer deposits but not to interbank deposits and were varied for size and maturity of deposit. Deposits with maturities of two and one-half years or more were not subject to interest-rate maxima. Ceilings were varied by administrative order of the Federal Banking Supervisory Office in consultation with the Deutsche Bundesbank. In a period of tight credit these ceilings became the effective interest rates paid on deposits except for various forms of evasion. Deposit ceilings were justified as necessary so as to avoid abrupt changes in the relative competitive positions of different types of credit institutions (commercial banks, savings banks, credit cooperatives, mortgage banks) subsequent to decontrol. There was also the hope that ceilings on deposit rates would impede the intermediation function of credit institutions and reduce the incentive for inflows of foreign short-term capital. Both of these results would increase the effectiveness of restrictive monetary policy implemented by more conventional means.

Controls over deposit and lending rates were revoked on April 1, 1967 and have not been restored. To this statement there is an exception for deposits of nonresidents which remain subject to such controls at official discretion. The official explanation for revoking interest-rate controls was given in the 1966 *Annual Report* of the Deutsche Bundesbank:

> One important reason for the complete liberalizing of bank interest rates, after more than 35 years of official regulation, was that even after the various partial liberalizations, the observance of the Interest Rate Order could be verified only with difficulty and could not be enforced at all. At all events numerous "legal" subterfuges enabled the larger and more adroit employers of money to obtain higher rates of interest, although often only at the cost of accepting complicated technical forms like transactions under repurchase agreements and other devices. The official fixing of interest rates also became increasingly questionable the more the course of the "free" rates made it obvious that the hard and fast interest rate structure needed major alterations (for instance through wider spreading of interest rates according to maturities), although without the authorities having any firm guidance as to how great these alterations were to be. Finally, however, it was to be expected that "genuine" interest rates, fully conforming to the market, would guide the markets for credit with more efficiency than governmentally regulated rates, the justification for which lay, at least partly, in the fact that they often diverged from the "equilibrium rate" for the various kinds of deposits.[1]

Thus, the German authorities abandoned interest-rate controls on the familiar grounds of economic inefficiency, evasion, and lack of objective criteria to guide official decisions. It is noteworthy that these controls were not being used to allocate credit among types of borrowers or economic uses, and that they applied to a substantially broader list of credit institutions than commercial banks. Both these factors might have been thought to make their task simpler.

The Netherlands: Quantitative ceilings on bank credit were in active use in the Netherlands from the end of the Second World War until 1952 when they were suspended. Ceilings on bank credit were reintroduced in 1961 and evolved during the decade of the 1960s until they became the primary instrument of central bank policy. During this period the scope of quantitative credit ceilings gradually expanded. At first only short-term lending by commercial banks and

[1] *Report of the Deutsche Bundesbank for the Year 1966,* p. 15.

the central institutions of agricultural banks was subject to quantitative controls. In 1965 controls were extended to cover longer-term loans when banks began to shift to longer loan maturities to evade controls. The growth of commercial banking activities by general savings banks brought about their inclusion under loan ceilings in 1969. They were asked to limit their short-term lending to its traditional modest level and to restrict the expansion of their longer-term lending to the increase in their long-term liabilities. The dividing line between "short term" and "long term" was ruled to be a maturity of either one or two years depending on type of loan or type of deposit. In 1970 an agreement between the Nederlandsche Bank and the Post Office's director general brought lending by the postal check and giro services to the private sector and local authorities within the scope of the central bank's quantitative controls. For the commercial, agricultural, and savings banks, ceilings initially (in 1961) applied only to loans to businesses and individuals. In 1966 loans to local authorities were brought under the ceilings. In a decade or more of use in the Netherlands quantitative loan ceilings have steadily expanded their coverage by type of loan and type of credit-granting institution. In addition they have been accompanied by regulations and requests intended to preserve a degree of specialization in the deposit services and credit activities of different types of credit institutions.

Throughout the period just reviewed, the Nederlandsche Bank had at its disposal three principal instruments of general monetary policy: discount rate, reserve requirements, and open market operations. But these were scarcely used as instruments of active policy during the decade of the 1960s because the banks held ample foreign short-term assets that were easily repatriated to offset a domestic liquidity squeeze by the central bank. In this situation credit ceilings, bolstered by prohibitions on borrowing abroad by Dutch business firms, were regarded as more effective than the traditional instruments. Only with the tightening of foreign exchange controls in 1971 and the floating of the Dutch guilder in that year did the central bank resume more active use of its open market operations and minimum reserve requirements.

Certain features of the Netherland's situation must be kept in mind when evaluating Dutch experience with quantitative credit controls. First, the rationale for these quantitative controls has been to strengthen general stabilization policy rather than to influence the microeconomic allocation of credit. Moreover, the effectiveness of quantitative credit controls has been enhanced by the concentrated nature of commercial banking (dominated by two large branch-banking systems), a tradition (though a declining one) of considerable specialization by different types of credit institutions and a system of foreign-exchange controls that required business firms and individuals to have official permission for short-term borrowing abroad. Further, the Dutch money market, though formally open to many types of participants, remains, in practice, primarily an inter-bank market. The central bank exercises substantial influence over the volume, terms and timing of new issues of bonds in the capital market, and the government regulates municipal borrowing in the capital market by centralizing it through the Bank for Netherlands Municipalities. Thus, both the structure of financial institutions and markets and partial control by the central bank or the government over nonbanking channels of financial intermediation, have favored the effectiveness of quantitative credit controls in the Netherlands. Despite these relatively favorable circumstances, the system of credit controls in the Netherlands has exhibited the familiar pattern of evasion and escalation, and there are the usual complaints about its stultifying influence on competition and efficiency. It is also recognized that large business firms have generally been able to escape the effects of domestic credit restrictions by being preferred customers of banks, by drawing funds from abroad through less obvious channels, and by engaging in interfirm credit transactions that bypass the controlled channels of intermediation.

The United Kingdom: The United Kingdom's experience with credit controls during the decade of the 1960s differs in some important respects from that of the other countries reviewed in this paper. First, the system of financial institutions and markets in the United Kingdom is more refined, less restricted by formal governmental regulation, and provides both borrowers and lenders a wider choice of alternatives than do the financial systems of other west European countries. Second, in using credit controls the authorities have sought both to serve the goal of macroeconomic stabilization and to influence the allocation of credit and real economic resources. Thus, British experience with credit controls is richer than that of Germany or the Netherlands. Finally, British credit controls have been more thoroughly analyzed and debated on both the theoretical and policy-oriented levels so that more is known about their rationale, mode of operation, and effects than is generally the case for other countries in western Europe.

During most of the period from the end of World War II until the Credit Reform of 1971, the British authorities viewed the structure of interest rates, credit flows, and the maturity composition of the national debt as the key financial variables in aggregate demand management. They paid little or no attention to the money supply or to the wealth effects of an overall deficit in the budget of the central government as important influences on aggregate demand. Moreover, their view of the market for long-term government bonds (so-called gilt-edged stocks) stressed the cumulative destabilizing nature of private investors' response to bond price movements and the consequent need for the central bank to maintain price stability in that market to forestall the possibility of a liquidation crisis.[2]

On the policy level these theoretical views were expressed in informal but binding arrangements among the Bank of England, the clearing banks and the discount houses to control a network of short-term interest rates, in official requests and quantitative ceilings to control the volume and, in some measure, the allocation of bank credit, and in open market purchases and sales by the Bank of England to maintain stable yields and prices on government bonds. Understandings among the Bank of England, the clearing banks, and the discount houses tied key short-term interest rates to the Bank of England's Bank rate. The rates so tied included the clearing banks' deposit and lending rates, the rate on call money lent by clearing banks to the discount houses, the rate on commercial bills, the rate at which discount houses bid for Treasury bills at the weekly tender and the so-called "market rate" on Treasury bills offered for resale by the discount houses. Therefore, this network covered the deposit and lending rates of the principal commercial banks and the key interest rates in the traditional money market.[3] When the Bank of England moved Bank rate and thus the rates tied to it, market arbitrage tended to convey similar upward or downward pressures to rates in the interbank and local authorities' markets and to lending and borrowing rates employed by other credit institutions such as savings banks, merchant banks and accepting houses, and finance houses. These latter rates were free to move at any time in response to market pressures, however, while the tied rates moved *only* when Bank rate moved.

The Bank of England supplemented its control over short-term interest rates by a system of quantitative ceilings and requests to control the volume of bank lending to the private sector. These

[2]For a more detailed account and critique of British monetary theory of this period, see my article, "British Techniques of Monetary Policy: A Critical Review," *Journal of Money, Credit and Banking,* Vol. III, No. 4, Nov., 1971, esp. pp. 767-775.

[3]This system of controls over short-term interest rates is analyzed in much greater detail in my *National Monetary Policies and International Monetary Cooperation,* scheduled for publication by Little, Brown and Company, fall 1973, Ch. VII, esp. pp. 175-183.

requests became more formal and more frequent as the decade of the 1960s advanced. They were in effect almost continuously from 1965 until the Credit Reform of 1971. Initially they applied only to the clearing banks. From 1965 they were applied as well to other banks, discount houses and finance houses in an effort to regulate the flow of credit to the private sector through these alternate institutional channels.

A principal aim of this system of interest-rate and quantitative credit controls was to permit the financing of government borrowing (including that of the central and local governments and nationalized industry) at lower interest rates than would have been determined by competitive market forces. This aim was motivated in part by fear that rising yields and falling bond prices might generate a liquidation crisis for the national debt. In part it was motivated by concern for the implications of high interest-rate levels for domestic income distribution and for the burden that interest payments on foreign-held government debt could impose on the balance of payments. A more limited aim of the quantitative ceilings was to guarantee a continued flow of short-term credit at favorable interest rates to high priority activities such as shipbuilding, the finance of exports, and productive investment in manufacturing or agriculture. In addition to requests addressed to the banks specifying categories of loans the authorities wished to see favored, such loans were sometimes encouraged by exempting them from overall credit ceilings. To encourage loans for domestic shipbuilding and medium- and long-term loans to finance exports the Bank of England also offered refinancing on favorable terms. The Bank's credit control requests also indicated categories of credit that were to be discriminated against such as loans for personal consumption, the financing of imports, and inventory accumulation.

There is both quantitative and qualitative evidence on the effects and effectiveness of British credit controls. In an unpublished doctoral dissertation, Alan Pankratz employed econometric techniques to study the effectiveness of quantitative loan ceilings in the United Kingdom and concluded:

> Empirical results indicate that from 49 to 57 per cent of the excess supply of loans [i.e. demand for credit] arising during any given quarter because of a loan ceiling is offset within the same quarter by sales of Treasury bills, national savings, and finance house deposits, and through the issuance of new equities and debentures. This overall strong response appears without considering trade credit, which may be an important channel of offset. . . .

> . . . If ceilings are able to force any cutback in expenditures over the short run, the persons or firms affected are probably those who are quite unsophisticated in financial affairs and those who are relatively small and weak such that they have limited cushions of liquid assets and have no access to the capital issues market.[4]

Pankratz also noted "...a strong response by firms to loan ceilings in the form of increased issues of equities and debentures..." and that "The empirical results of this study suggest...that loan ceilings in the United Kingdom have had the effect of making the rate of growth of the money stock somewhat smaller than it would otherwise have been [i.e. *given* the authorities' interest rate policy]."[5]

In an unpublished paper presented at the Konstanz Monetary Seminar in June 1972, Marcus Miller presented econometric results which led him to a related but not identical conclusion. Miller found that credit controls had a pronounced effect in increasing the cost of capital in the United Kingdom as measured by an earnings/price-ratio variable for equities. The cost of capital, of course, may be regarded as a key variable in determining the volume of private investment and thus the level of aggregate demand. Miller's results also indicate that credit controls can be used to increase the cost of capital *relative* to the yield on long-term government bonds *given* the rate of increase in the money supply.[6] This is similar to Pankratz's observation that credit controls may have reduced the rate of growth in the money supply given the authorities' interest-rate policy. Thus both authors find some support for the authorities' view that quantitative controls on bank lending exerted a contractionary pressure on the economy accompanied by a smaller increase in yields on government long-term debt than would have been possible with full reliance on interest rates to ration credit. To this extent credit controls in Britain performed the task the authorities intended.

In drawing lessons from the British experience, however, other aspects must be considered. Throughout most of the 1960s the British monetary authorities paid little or no attention to growth in the money supply, relying instead on the controls over interest rates

[4]Alan E. Pankratz, "Quantitative Loan Ceilings in the United Kingdom: A Theoretical and Empirical Analysis," Unpublished doctoral thesis, University of Illinois, 1971.

[5]*Ibid*, p. 95.

[6]Marcus H. Miller, "Aspects of Monetary Policy in the U.K., 1954-65," An unpublished paper presented at the Konstanz Seminar on Monetary Theory and Monetary Policy, June 28-30, 1972.

and credit flows that have been described above. The rapid expansion in the money supply that occurred (an average annual compound growth rate of 5.46 percent compared to a 2.72 percent rate of growth in real gross national product) must bear a substantial share of the responsibility for the record of persistent domestic inflation and frequent balance-of-payments crises culminating in the devaluation of the pound in 1967. British experience clearly demonstrates the folly of trying to stem the inflationary effects of too rapid an expansion in the money supply by relying on credit controls selectively applied to financial institutions and markets composing only part of a sophisticated financial system.

The longer credit controls remained in use in the United Kingdom, the more did uncontrolled channels of financial intermediation expand at the expense of controlled channels. Accepting houses, foreign and overseas banks grew in importance relative to clearing banks. Clearing banks organized finance-house subsidiaries to compete at higher interest rates for longer maturity deposits than were sanctioned under their cartel understandings. The markets for interbank deposits, sterling certificates of deposit, and local authorities' deposits expanded to challenge the controlled, traditional money market whose focus was on call money, commercial bills, and Treasury bills dealt in by clearing banks, discount houses, and the Bank of England. The scope of credit controls had to be steadily broadened in the authorities' race to keep up with flows of credit seeking ways around the controls. It is important to recall that a comprehensive and rigorous system of foreign exchange controls was available to protect the authorities' foreign flank in their efforts at credit control throughout this entire period.

In September 1971 following some months of study and discussion the authorities abandoned their efforts at nonprice rationing of credit. The Credit Reform of 1971 abrogated the understandings among clearing banks, discount houses, and the Bank of England by means of which the network of controlled, short-term interest rates had been administered. The reform revoked the quantitative ceilings on bank loans. The Bank of England had already ceased (in the spring of 1971) its relatively inflexible support of gilt-edged prices. No liquidation crisis occurred in the gilt-edge market.[7] In general the

[7] A study by Michael Hamburger entitled "Expectations, long-term interest rates and monetary policy in the United Kingdom" published in the Bank of England's *Quarterly Bulletin* for September 1971 has this closing statement: "Finally, the evidence suggests that in moving to greater flexibility in their policy on interest rates, the authorities have accomplished their objective of allowing market forces to be more fully reflected in the prices of gilt-edged securities. There is no indication, however, that this has impaired the functioning of the market in any way." (p. 365).

reform marked a return by the authorities to more market-oriented techniques and somewhat greater regard for the money supply as an important variable. A succinct statement of the considerations that led the authorities to turn from quantitative rationing to more reliance on market processes in the sphere of monetary policy is contained in these words from a speech by the Governor of the Bank of England:

> ...We must beware of believing that if we do succeed in restraining bank lending we have necessarily and to the same extent been operating a restrictive credit policy. We may by our very actions stimulate the provision of credit through non-bank channels; we may introduce distortions into the financial system; and we may indeed be distorting in harmful ways the deployment of the real resources of our country.[8]

France: Thus far in our consideration of European experience we have been moving along a spectrum from very little reliance on credit controls toward more ambitious use of credit controls. With France we now come to the first of three countries, namely France, Italy, and Belgium, where methods to control and to allocate credit in the service of national economic objectives are fully accepted as desirable and where the authorities have been granted substantial explicit powers to this end.

The French system of credit control received its initial impetus and legislative authorization at the end of the Second World War. In December 1945 major new legislation nationalized the Banque de France and the four principal branch systems of deposit banks and established the National Credit Council to serve as the focal point for formulation of national credit policy. The Minister of Economics and Finance is the president of the Council but normally delegates his powers to the Governor of the Banque de France, the ex-officio vice president. In short-term credit affairs the line of policy implementation runs from the Council through the Banque de France and Banking Control Commission and then via respective professional associations to the banks and other credit institutions. The Council also advises the Ministry of Economics and Finance on subsidies, tax privileges, and other important budgetary measures to influence the distribution of medium- and long-term credit in the economy. Thus, there is formal legislative and institutional provision for official efforts to influence the volume, distribution, and terms of availability of credit in the French economy.

[8] "Key issues in monetary and credit policy: text of an address by the Governor to the International Banking Conference in Munich on 28th May 1971," published in Bank of England, *Quarterly Bulletin*, June 1971.

The broad aims of credit policy in France have been to contribute to the modernization of the French economy and its ability to compete in international markets. Credit policy has sought to stimulate investment in industry, agriculture, and energy industries, transportation, and housing by means of favorable credit terms, subsidies, tax privileges, and greater availability during episodes of quantitative rationing of credit. For many years interest rates throughout the entire maturity structure were kept below market equilibrium levels to encourage investment and to aid the cost competitiveness of French exports. Interest rates were prevented from rising by administrative regulation of lending and deposit rates for banks and other credit institutions, by controlling issue and redemption terms on government securities, by control over new issues of fixed interest securities in the capital market, by stipulating minimum asset reserve requirements for banks in the form of Treasury bills and notes, and, ultimately, by an expansion of central bank credit via privileged rediscounting facilities or to cover Treasury deficits.

To influence the volume and allocation of credit, the Banque de France has used various methods. Banks have been required to observe minimum reserve requirements in the form of specified earning assets. These have included the "Treasury floor" (plancher) in effect from 1948 to 1967, the bank "liquidity coefficient" (coefficient de trésorerie) in use from 1961 to 1967, and the "coefficient of retention" introduced in 1967 and still in effect in 1973. The Treasury floor required banks to maintain minimum holdings of Treasury securities; the liquidity coefficient – of cash and rediscountable medium-term loans; and the coefficient of retention – also of rediscountable medium-term loans. These asset reserve requirements had the dual purpose of adding to bank portfolio demand for the specified assets and of preventing the banks from using these eligible assets for rediscounting at the central bank.

A second technique of credit control, that of quantitative ceilings on bank-credit expansion, has been employed by the Banque de France on three occasions: in 1958-59, in 1963-65 and in 1968-70. During these episodes certain priority categories of loans have sometimes been exempt from inclusion within the general ceilings or permitted more rapid rates of expansion. These have included short-term export credits, medium-term loans for construction and for investment in industrial and agricultural equipment, loans for stockpiling cereals, and loans eligible for the mortgage market. The ceilings were applicable to commercial banks, business banks, banks for long-term investment, people's banks, agricultural credit banks, and mutual credit banks. Penalties in the forms of reductions in rediscount lines at the central bank and of non-interest bearing deposits at the central bank were assessed on banks whose loan expansion was excessive.

One other form of credit control used by the Banque de France has been the scrutiny of individual credits made by banks. The Banque de France reviews directly, before they are granted, individual credits whose eligibility for subsequent rediscount the lending bank wishes to establish. This review provides an opportunity for the central bank to disapprove credits that are not consistent with its current policies. Commercial banks normally do not conclude credits that have been disapproved by the Banque de France. Moreover, until June, 1969, the prior approval of the Banque de France was required on *any* bank credit extended to a firm that brought the total amount of bank credit to that firm above the level of F10 million. This amount has now been increased to F25 million and the requirement altered to ex post reporting. But the lending bank may still be called upon to justify the credit. Banks are also required to report monthly to the central bank's Service Central des Risques credits outstanding to a firm or individual in excess of F100,000. This census is helpful to the National Credit Council in observing the responsiveness of credit flows to national policy objectives. Some 85 percent of bank credit currently is covered by reporting.

In 1971 the Banque de France introduced a new minimum obligatory reserve requirement that is calculated as a percentage of prescribed categories of bank credit. To date there has been no departure from the uniform application of this requirement to the categories covered. Thus its use has been as a general instrument of monetary policy rather than as a selective credit control.

The various measures just described have exerted their primary influence in the sphere of bank credit, predominantly short- and medium-term. Other arrangements, supervised by the Ministry of Economics and Finance and other economic ministries, are intended to direct the flow of savings in the economy and to stimulate priority areas of medium- and long-term investment. These measures have included government control over the flow of savings through non-bank financial intermediaries and investment funds, preferential tax treatment of interest earned on Treasury bills and notes, and priority access to the capital market for new issues of government bonds and those of public and semipublic investment funds and nationalized industries. All savings deposits in public and mutual savings banks must be redeposited in the Caisse des Dépots et Consignations. The investment policies of this fund are determined by the government.

They emphasize loans to municipal authorities, loans for construction of housing, mortgages, and loans to or purchase of bonds issued by other specialized state funds that grant long-term loans for industry, commerce, construction, and the professions. Deposits with the postal checking system are redeposited with the Treasury. The Treasury also makes loans and grants from a Fund for Economic and Social Development whose resources are derived from tax receipts and from bond issues. These various channels, which enjoy administrative sheltering from competitive forces in credit and financial markets, are somtimes referred to collectively as the "Treasury circuit". In addition, the Board of the Fund for Economic and Social Development must approve annually the investment program for nationalized industry, especially important in the fields of energy and transportation.

The Ministry of Economics and Finance has the authority to regulate new issues on the capital market. At present such supervision is relatively relaxed. Until the late 1960s, however, capital market controls were actively used to influence timing and rates on new issues with priority ranking being given to public and semipublic issues.

Official intervention in French domestic credit and financial markets has been accompanied throughout the years since 1945 (with the exception of an interval in 1966-68) by substantial exchange controls on capital movements and since late 1971 by the operation of a dual foreign exchange market. Such controls represent a logical complement to the domestic ones.

Quantitative studies of the effectiveness of French credit controls are not available. This is especially true for efforts to allocate credit into priority uses. Statistics on credit expansion and even on credit granted in specific categories do not answer the question of the extent to which patterns observed ex post can be assigned to the effects of controls.

More impressionistic evidence *is* available in the form of official discussions and reports and the record of recent policy decisions. The current trend in France is toward greater reliance on price rationing and market mechanisms in implementing domestic monetary and credit policies. Quantitative ceilings for bank credit expansion were suspended in 1970.[9] Prior to their suspension in 1970 official

[9]The French authorities restored quantitative ceilings on bank credits in December 1972 as part of a comprehensive set of measures to restrain inflation. These ceilings remain in force in late 1973.

commentary noted the usual deleterious effects of ceilings on competition, innovation, and efficiency in banking and related credit industries as well as successful evasion by larger borrowers. The credit ceilings were thought to have contributed to slowing the rate of growth in the money supply. But the quantitative significance of ceilings in influencing the rate of growth of the money supply compared to loss of foreign exchange reserves, a reduced deficit in the central government's budget, and some shift in household asset preferences toward savings accounts has not been established.

Traditionally in France the principal channel for the extension of central bank credit to the banking system has been rediscounting. For years the Banque de France sought to influence the cost and allocation of bank credit by offering to rediscount certain types of bills and loans at low interest rates and in excess of established ceilings on rediscount credit. Examples of instruments eligible for this special privilege included Treasury bills, export credit, and medium-term equipment loans to industry. There is no quantitative evidence concerning the effect of these measures on the allocation of bank credit. But the privileged rediscount categories undeniably weakened the central bank's control over growth in the money supply and contributed to inflationary pressures in the French economy. This rediscounting practice, as well as the existence of the sheltered "Treasury circuit", was vigorously criticized in a special official study published in 1969, one of whose authors is the present Governor of the Banque de France.[10] Recently the Banque de France has suspended the privileged rediscounting categories and is supplying credit primarily through its purchase of eligible bills in the money market at a uniform but flexible effective rate of interest. The previously sheltered Treasury circuit also has been partially opened to forces of market competition by such measures as permitting deposit banks to compete more vigorously for savings accounts, eliminating the difference between tax treatment of interest income from Treasury bills and notes and savings deposits, and allowing the Caisse des Dépots et Consignations greater discretion to invest in a wider range of assets in response to market opportunities.

French official efforts to control the volume of credit and to allocate it to priority uses have been based on explicit legal power implemented by an extensive administrative apparatus. Yet measures to allocate bank credit have had ambiguous results accompanied by

[10] R. Marjolin, J. Sadrin, and O. Wormser, *Rapport Demande, par Decision en Date du 6 Decembre 1968.*

undesirable side-effects on competition, efficiency, and control of the money supply. Efforts to direct the flow of longer-term investment funds through government controlled financial intermediaries, control over new issues in the capital market, and various public and semipublic investment funds may have been more successful. Recent developments in both areas reveal a trend toward greater reliance on market forces and price rationing to regulate the volume of credit and its allocation.

Italy: In Italy national legislation confers extensive powers of control in monetary and credit matters on the Interministerial Committee for Credit and Savings. This Committee is under the chairmanship of the Minister of the Treasury. Other ministers are members of the Committee. The Banca d'Italia is the Committee's executive agent; the governor of the Banca d'Italia participates in the Committee's meetings. Under authority derived from the Committee the Banca d'Italia can prescribe deposit and lending rates for banks, specify a wide variety of balance-sheet ratios, regulate commissions and service charges set by banks, impose rules regarding the allocation of bank credit to various economic sectors, and fix quantitative limits on bank loans of various types or on total bank loans. The Banca d'Italia also regulates all new issues in the capital market that are listed on any of the Italian stock exchanges or issued through any of the banking and credit institutions subject to the central bank's supervision. These provisions guarantee the central bank virtually complete control of access to the capital market. Under supervision of the Ministry of Foreign Trade the Italian Exchange Office exercises comprehensive powers of foreign-exchange control. The primary limits to these powers of foreign-exchange control have been set by Italian participation in international agreements (such as Bretton Woods, the European Economic Community, and OECD) rather than by domestic legislation. The Banca d'Italia acts for the Italian Exchange Office on the operating level. Thus, on the operational level the Banca d'Italia has comprehensive powers and responsibilities in the realm of credit control and allocation.

Despite these extensive formal powers the Italian authorities have not imposed direct quantitative controls on overall volume or on specific categories of bank credit. But they have been much concerned with the flow of business and household savings through the banking system and the money and capital markets into investment categories assigned a high national priority. Priority categories have included government borrowing, the energy and transportation industries, municipal construction, and productive investment in agriculture and industry, especially in economically underdeveloped regions of southern Italy.

Throughout most of the 1960s the authorities pursued a low interest-rate policy in short-term credit markets by keeping the central bank's rediscount rate at 3.50-3.75 percent, supporting the Treasury bill rate at approximately that same level, sanctioning the banking cartel's Interbank Agreement that set guidelines for interest rates on bank deposits and loans, and imposing a ceiling on the interest rate banks could pay for interbank deposits. In addition to keeping down the general level of interest rates this policy in short-term credit markets was intended to encourage savers to invest in longer-term securities at higher yields than those available on bank deposits and Treasury bills.

Other measures to channel savings into the controlled capital market also were employed. The desire of commercial, savings and cooperative banks to invest in government, mortgage, agricultural, and highway bonds was stimulated by making these eligible to fulfill minimum obligatory reserve requirements for time and savings deposits, requirements that would otherwise have been met by holding deposits at lower interest return at the central bank. During the years 1966-69 the central bank pegged long-term bond prices so as to stabilize yields and thus make these bonds more attractive to the investing public. The pegging policy was suspended when inflationary pressures at home and high interest rates abroad combined to produce a growing deficit in the Italian balance of payments.

In the Italian financial system a major role in directing the flow of credit is played by nonbank financial intermediaries whose investment policies are subject to official control. Over 15,000 branches of the post office offer savings account services to individuals. Savings deposited in these accounts are turned over to an agency of the Treasury known as the Fund for Deposits and Loans and used to make medium- and long-term loans in accordance with public priorities. More important are the "special credit institutions" that specialize in medium- and long-term lending. They are active in industrial, real estate, and agricultural credit, in financing of exports, and as channels through which state funds are funneled to priority borrowers via loans and interest-rate subsidies. The principal source of funds lent out by the special credit institutions is bonds issued in the capital market. A recent article by two Italian economists on direct credit controls as a monetary policy tool emphasizes the degree of official control over the special credit institutions:

> In Italy, three major sources of finance exist as alternatives to bank credit: loans by the so-called "special credit institutions", direct recourse to capital markets, and borrowing abroad. Special credit institutions raise funds essentially through bond issues. Since these issues must be authorized by the authorities, the expansion of the special credit institutions' intermediation can be controlled by limiting the issues. The monetary authorities can also control the two other sources of non-bank financing.
>
> ... We may add that a large proportion of loans granted by the Special Credit Institutions takes the form of subsidized credit. The determination of the supply conditions of this kind of credit is an additional instrument of official economic policy. The Government can, in fact, decide not only the level of subsidized rates, but also the categories of firms, the sectors of economic activity, and the geographical areas eligible for subsidized credit. This discretionary power can be used to implement a selective control of credit.[11]

Favorable treatment of preferred borrowers in the capital market by the methods just described is complemented by tax measures. Since the Treasury, nationalized industries, and special credit institutions borrow in the bond market rather than in the stock market, investors' enthusiasm for the stock market is deliberately dampened by the imposition of a 15 percent withholding tax on stock dividends. In the bond market private borrowers must pay a 38 percent tax on interest paid to bondholders. Public borrowers are exempt from this tax.

Thus, the philosophy of the Italian authorities is to apply direct credit controls primarily to the allocation of medium- and longer-term investment funds rather than to bank credit. Mr. Carli, Governor of the Banca d'Italia has expressed his reservations concerning selective control of *bank credit* as follows:

> Even if it were possible to introduce more selectivity into bank credit, it is hard to see how to avoid arbitrariness, given the complexity and variety of the sector of medium-sized and small enterprise which relies upon bank credit and given, above all, the great number of medium-sized and small banks operating in geographically restricted areas. If these latter were asked to implement directives implying choices of high-priority sectors, they would be all but paralyzed in

[11] F. Cotula and T. Padoa-Schioppa, "Direct Credit Controls as a Monetary Policy Tool," Banca Nazionale del Lavoro, *Quarterly Review*, No. 98, September 1971, pp. 207-208, text and footnote 8.

> practice, or else they would be forced into a concentration of risks incompatible with efficient safeguards for the class of depositors to whom they cater.
>
> For all these reasons I believe that, in the conduct of modern government, qualitative control of bank credit is a tool to be kept in reserve and to be applied with moderation in special conditions rather than as a regular component of credit policy. In certain cyclical phases one kind of credit may indeed have to be curbed in favor of others and, in exercising its overall powers of control and direction, the central bank has from time to time done so and may do so again. But we have only to look at the most recent developments to see that cyclical situations can change very quickly, and for this reason we must be watchful and flexible in anything we do to direct the flows of credit. Moreover, intervention of this kind is apt to have so many general and specific effects of opposite sign and unmeasureable magnitude, that it would seem safer for the monetary authorities not to assume direct responsibility for the innumerable adjustments required by cyclial developments, but to leave these adjustments to the market processes, within the general conditions created by control of the volume of liquidity.[12]

Thus, the Italian authorities have been granted comprehensive legal powers to control the volume and allocation of credit. But they have chosen to concentrate their efforts on the capital market rather than on bank credit. Their attempts to influence flows of medium- and long-term credit take place in the context of extensive powers to regulate both the capital market and capital flows between Italy and foreign countries. The money market is narrowly restricted and heavily controlled. Public and publicly controlled financial intermediaries dominate the institutional channels for medium- and long-term credit. Italian experience and philosophy offer little encouragement for those who seek support for applying credit controls solely to the banking sector.[13]

[12] Banca d'Italia, *Abridged Version of the Report for 1963,* p. 134.

[13] In a departure from former practice on July 26, 1973 the Italian Treasury announced the establishment of ceilings to limit the expansion of ordinary bank credit. A limit of 12 percent has been set for the annual rate of expansion in overall bank credit in the period up to March 31, 1974.

This 12 percent limit applies also to bank credit for certain borrowers: individual firms whose borrowings on March 31, 1973 exceeded 500 million lire as well as to all finance companies, private borrowers and commercial enterprises. Other firms may borrow freely up to the 500 million lire limit.

Belgium: In Belgium the role of governmental policy in directing flows of medium- and longer-term credit into priority investment categories is firmly established. The principal instrumentalities used by the government to channel investment funds are control over the resources of the state savings bank network and the Postal Check Office, capital market controls to govern access of borrowers to the long-term bond market, and the lending activities of official investment funds that are given priority access to the capital market and in turn make loans on attractive terms for investments assigned a high national priority. Market rates of interest are strongly influenced by the policies of two official agencies: the Securities Stablilization Fund, active in stabilizing the yield on government securities throughout the maturity spectrum, and the Rediscount and Guarantee Institute, whose operations are confined to the call money and acceptance portions of the short term money market.

Ceilings have been applied to bank credit in Belgium on three occasions: January 1964 to July 1965, April 1966 to June 1967, and May 1969 to October 1971. Ceilings are assigned to individual banks. The main purpose of these ceilings has been to check the general expansion of bank credit as a counter-inflationary measure. The Banque Nationale de Belgique customarily has accompanied the imposition of credit ceilings with recommendations concerning lending categories to be favored (for example, productive investment in industry and agriculture, export industries, and the financing of foreign trade) and those to be squeezed (typically loans related to consumption). Ceilings on bank credit have been paralleled by lending limits applied to savings banks, official nonbank financial intermediaries (for example, the specialized official investment funds) and insurance companies. These limits have been imposed by appropriate ministries or regulatory authorities in consultation with the Banque Nationale de Belgique.

Deposit and lending rates of banks and other credit institutions are no longer tied to the central bank discount rate as they once were. But they continue to be strongly dependent upon price leadership and official suggestion by the authorities. In 1971 a Consultation Committee for Creditor Interest Rates was established.

> This committee was to devise a consultation procedure for fixing the rates allowed to suppliers of funds by each of the bodies belonging to the three categories of financial intermediaries concerned [i.e. banks, private savings banks, and public credit institutions]. The conclusions of this committee were to be binding. The Bank agreed in principle to use its power as a monetary authority to impose these quasi-statutory measures, which were preferred to the rules of the market economy.[14]

[14]National Bank of Belgium, *Report, 1972* p. XXII.

The Bank's influence over interest rates charged and paid by credit institutions can be used to prevent lending rates from rising when credit ceilings ration loan volume. Thus, the central bank can set maxima to both price and quantity of bank loans. This control helps to separate domestic Belgian credit markets from their foreign counterparts.

The effectiveness of restrictive policies applied to banks and other short-term lenders is increased by the domination of the authorities in the money and capital markets and by exchange controls and the dual foreign exchange market. Nonbank firms and individuals are barred from participation in the money market. The Rediscount and Guarantee Institute and the Securities Stablization Fund are the sole intermediaries in the money market. The Securities Stabilization Fund's operations dominate the market in outstanding government and government-guaranteed securities, including those of the local authorities. The Ministry of Finance and the Banking Control Commission control access of public and private borrowers to the market for medium- and long-term bonds. Public borrowers have priority access at low and stable interest rates in both the money and capital markets. Therefore, borrowers disadvantaged by rationing in bank credit markets cannot successfully by-pass the system of controls by turning to the money or capital markets. Finally, operation of a dual market for foreign exchange with a floating rate for all but a specified list of current account transactions helps to shelter domestic money and capital markets from capital flows through the balance of payments and thus increases the effectiveness of domestic monetary and credit measures.

Belgian authorities have designed a system that appears capable of exerting an important influence on the allocation of investment funds in the economy. The principal ingredients of this system are the high degree of official control over open market channels of financial intermediation, policy control over new issues in the capital market, the role of specialized public financial intermediaries in channeling capital market funds to high priority investment projects, and the shelter provided to domestic credit policy by the dual exchange market. Although quantitative ceilings have been applied to short-term credit supplied by banks and other institutions, the primary intent of these ceilings has been to support general monetary policy rather than to allocate credit.

III

This survey of experience with credit controls in six European countries provides some insights that can aid in evaluating the desirability of greater reliance on credit controls in the United States.

An aspect of primary importance in determining the effects of credit controls is the complexity and flexibility of financial institutions and markets in relation to the breadth of coverage of control measures adopted by the authorities. In general, the structure of commercial banking is far more concentrated in all the European countries studied than in the United States. Moreover, in Europe commercial banks are relatively more important as channels of financial intermediation compared to other institutions and markets. With the exception of the United Kingdom (and to a much lesser extent the Netherlands) money markets are narrow, often limited to interbank transactions, and frequently dominated by the central bank (as in France, Germany, and Italy) or by other official agencies (as in Belgium). In France, Italy and Belgium, public or semipublic financial intermediaries whose investment policies are under public control are the key channels through which medium- and long-term credit flows from savers to investors. Also, in these three countries official control over access to the capital market has been used to channel investment capital to priority uses, either directly or via specialized credit institutions or investment funds. With the exception of Germany the countries studied all operate exchange controls or dual exchange markets to regulate capital flows between domestic markets and their foreign counterparts. To look at credit controls over banks without consideration of the broader context of controls involving these other areas can be very misleading.

Credit controls applied to commercial banks alone have generally not been effective and have had to be extended. In general when the scope of credit controls is limited to one or a few types of institutions in a relatively complex financial system, the controlled institutions have suffered an erosion of competitive position which has increased with the duration of the controls.

The use of quantitative ceilings on bank loans in France, Belgium and the Netherlands appears to have been motivated more by a desire to check domestic economic expansion without raising domestic interest rates and thus attracting short-term capital from abroad than by a desire to alter the incidence of credit restraints. Concern to reduce incentives for an inflow of short-term capital may have contributed also to the German experiment with controls on interest rates in 1965-66. In France, Belgium and the Netherlands the authorities held down interest rates on bank deposits and credits through formal or informal understandings with the banks while simultaneously setting quantitative limits to the expansion of bank credit. Short-term borrowing abroad by banks and business firms also was controlled. Even so, leakages in the system permitted significant amounts of funds to enter from abroad.

The British authorities employed credit ceilings in an effort to reduce aggregate demand in the face of domestic inflation and deficits of crisis proportions in the balance of payments. Their resort to credit ceilings was motivated by two principal considerations. First, they wished to reduce private sector demand by means other than a rise in interest rates which they feared might threaten the stability of the market for long-term government debt. Second, their theoretical views emphasized the importance of bank credit rather than the money supply as a key variable for aggregate demand management. In retrospect both of these views appear to have been mistaken.

Credit controls cannot replace and may undermine controls over the money supply or comparable monetary aggregate. In the United Kingdom concentration on credit controls led to neglect of the money supply for many years, a neglect that contributed to continuing inflation, balance-of-payments deficits, and recurrent crises of confidence in sterling. In France use of privileged rediscounting facilities for certain types of commercial bank bills and loans and for Treasury bills provided an escape from the central bank's other efforts to reduce the rate of growth in the money supply and contributed to continuing inflation. In Italy the pegging of the yield on long-term government bonds in the years 1966-69 to make them more attractive to investors resulted in loss of control over the money supply with growing inflationary results and accompanying capital outflow. These are examples of credit controls taking precedence over measures to control monetary aggregates with unfortunate results.

In those countries where serious and sustained efforts have been made to allocate credit by means of the financial system (as distinct from the budgetary system) the authorities have concentrated on the allocation of medium- and long-term investment capital rather than on bank credit. Moreover, in pursuit of their allocative objectives their principal reliance has been on heavily controlled money markets, a dominant role for public or semipublic financial intermediaries and investment funds, and control over new issues in the capital market. Also, in all the countries surveyed except Germany, central government authorities have a determining voice in the amount of borrowing that local governments are permitted to undertake. Budget grants and interest subsidies often are combined with these other measures to encourage preferred categories of real investment. These structural features of the financial system and these controls applied to money and capital markets have been intended primarily to direct the secular growth of the national capital stock rather than to alter the pattern of credit allocation determined by the market during a cyclical episode of monetary and credit restraint.

A preoccupation among advocates of credit controls in the United States has been the ability of the business sector to obtain credit during a squeeze while the household and government sectors were rationed or priced out of the market. For example, a recent article by one member of the Board of Governors of the Federal Reserve System states: "One of the main objectives of monetary policy in 1969 and early 1970 was the restriction of bank lending to business."[15] European experience offers but faint encouragement to those who seek this goal by means of credit controls on banks and other lending institutions. Consumer credit rather than business credit has been the favorite target of the European authorities during periods of credit restraint. All the countries surveyed regulate consumer instalment loans by specifying minimum down payments and maximum maturities. In addition the authorities often request credit institutions to exercise special restraint in the sphere of personal and other consumption-oriented loans. Official requests also may exempt certain categories of credit from ceilings or express the wish that they be favored within the ceilings. Credits for "productive investment", for exports, and for construction of housing are those favored most frequently. The allocative effects of these hortatory guidelines are uncertain when they conflict with criteria of profitability and customer relationships. Big business is as much a favored customer of banks and credit markets in Europe as it is in the United States.

The recent trend in western Europe is away from credit controls and toward greater emphasis on control of monetary aggregates combined with reliance on market processes to allocate credit. Evidence of this trend is the Credit Reform of 1971 in the United Kingdom, suspension of privileged rediscount categories at the central bank and partial opening to market forces of the closed

[15]Andrew F. Brimmer, "Multi-National Banks and the Management of Monetary Policy in the United States," *The Journal of Finance*, May, 1973, p. 443.

Treasury circuit in France, and the earlier abandonment of controls on interest rates in Germany. In Belgium, Italy, and the Netherlands the authorities traditionally have not sought to influence the allocation of short-term credit in any systematic manner. In Italy and Belgium the authorities continue to exert an important influence on the allocation of medium- and long-term credit. For this purpose they employ the investment policies of public and semipublic financial intermediaries, control over new issues in the capital market, and various tax and subsidy measures of the central government's budget.

European experience suggests that selective controls to influence credit allocation in the United States are unlikely to succeed in view of the low degree of concentration in commercial banking, the variety of alternative institutional lenders, the openess of the money market, the absence of key public and semipublic financial intermediaries, the lack of control over new issues in the capital market, and the limited nature of controls over international capital movements. Moreover, European experience also provides ample evidence of the negative aspects of credit controls in the form of distortion of financial organization produced by efforts at evasion, reduced competition and efficiency in financial institutions and markets, and diversion of the authorities' attention from the macroeconomic task of regulating growth in the money supply. Superficial impressions to the contrary, European experience offers more cautions than encouragement to the application of credit controls in the United States.

Discussion

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Donald Hodgman gives us a very clear description of the different techniques of credit allocation used in six European countries during the last decade. I do not find it useful to add any detail to the Hodgman analysis of the French system, because all the main features of it were very clearly mentioned. But his survey of experience with credit controls in six European countries leads me to some remarks upon three general problems with credit controls: the results expected from the implementation of a selective credit policy, the nature of the instruments for such an implementation, and the role of credit selectivity in the attainment of the objectives corresponding to the so-called public interest.

I would like to develop these three points, using French experience to illustrate them.

I. WHAT IS EXPECTED FROM A SELECTIVE CREDIT POLICY?

A. *Differences of Conceptions Between Post-War and Recent Selective Policies (Last 15 years)*

As it is already well known, French financial structures were deeply marked by the situation of scarcity which characterized the post-war years and justified at that time the setting up of precise priority and discriminatory plans for granting credit. The problem then was to avoid using the bulk of available credit for financing "superfluous economic activities (those which do not satisfy essential consumption or indispensable equipment)" or "business activity which has self-financing possibilities (profit margins large enough to enable self-financing, companies able to collect savings to avoid the grasp of the market of the banking system)".[1]

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The opinions put forward in this note are the author's responsibility only and may not reflect the French authorities' views.

[1]Banque de France Note – Direction Generale du Credit Nov. 30th 1948.

Thus the various sectors of activity were classified into several categories referred to as A, B, C, D, E according to the credit priorities given to each of them.

For example, the A category related to those branches in which industrial and commercial activity had by any means to be expanded or held above a minimum, and which could be granted credit without limitations. In the A category one could find mainly semi-finished products and essential foodstuffs. At the other end of the list, the E category included the trade sectors for the sale to consumers of non-food products such as perfume and furs and any credit to this sector was to be progressively suppressed.

Such ultra-selective policy, adopted in a situation of economic reconstruction when the aims of overall economic policy were clearly and simply defined and in the context of a public opinion prepared to accept the controls necessary to its implementation, undoubtedly contributed to the drastic recovery of the French economy in the early post-war years.

In the experiences of constrictory monetary policy which followed (notably in 1958-1959, 1963-1964 and 1969-1970), the overall economic situation was no longer the same: there no longer existed in France the state of scarcity which, just after the war, has justified priorities and discrimination in granting credit, when the broad objective of monetary policy had been to limit the overall expansion of liquidity in order to prevent demand from becoming excessive and thus to slow inflation. Besides, the selective policy applied in France before 1958 had led the authorities to conclude that a credit policy necessarily had to be global. This is reflected in a note issued by the Banque de France, dated June 4th 1958, which stated that: "The selective derogations granted over the rediscount ceilings in favour of medium-term industrial credits and loans for housing purposes have undoubtedly made it possible to launch programs which would normally have had to be postponed until sufficient savings had been gathered; however they have as well offset the impact on the money supply of rediscount restrictions and, by stimulating demand, hindered the development of new savings which would have provided a sound basis for financing equipment and housing. If this be so, then it must follow that any priority to a branch of activity or a firm must be *ipso facto* accompanied by a refusal given to another branch or firm".

B. *The Aims of Selective Policy Since 1958*

Such remarks did not infer that selectivity in the allocation of bank credit was useless; they simply meant that the results expected from such a policy could only be different in 1958 and in 1969 from those pertaining to an epoch when there was no problem of overall restriction.

In 1958, in a letter sent on February 7th to the banks, the Governor of the Banque de France defined those expected results in broad terms. Indeed, after setting an upper limit to the expansion of all kinds of bank credit which could be broken "provided that such infringement resulted in granting additional or further loans for the financing of foreign trade claims or the prefinancing of exports", the Governor went on: "The banks shall discriminate between the demands of credit so as to be able to go on providing those customers who achieve better results in the export and productivity fields. Such choice shall duly take into account the role played in the economy by commercial and industrial borrowers, whatever scope they have. This choice shall particularly bear upon medium-term credit demand. I request you to urge the banks to inform their customers of the credit facilities available to them for export purposes".

On July 9th 1958, the Economic and Social Council[2], in a little more precise terms, recommended a restrictive policy which "should adopt diversified criteria resting upon a really selective concept, particularly so far as medium-term credit is concerned, according to the following principles:

–Fostering the activities which tend to reduce import bill or increase foreign sales;

–Within the framework of the Commissariat au Plan's directives, favouring the companies whose size or specialization forbid any recourse on their part to borrowing on the capital market or which invest in plant and equipment in order to compete favorably with their Common Market partners;

–Restricting loans when they may have a speculative influence and encourage the process of stock-building (beyond the level required by normal supplies);

[2]Economic and Social Council: Draft note put forward by Mr. Compeyrot in behalf of the Finance, Credit and Tax Committee, July 9, 1958.

—According to the degree of social usefulness, selecting and, if necessary, limiting the volume of funds available for hire-purchase credit."

It also recommended that "in applying those criteria, the banks should bear in mind the economic and social role locally played by a commercial or industrial potential borrower".

II. IMPLEMENTATION OF THE SELECTIVE CREDIT POLICY IN A CONTEXT OF GLOBAL LIMITATION OF BANK LENDING

Thus, in the three most recent experiences, the total amount of credit extended by the banking system was rationed, and the essential task of the selective policy was to organize this rationing by granting a preferential treatment to specific sectors. It is possible, a priori, to consider several directions which could act as guidelines for a selective policy. Some of these refer to the different kinds of credit transactions such as – short-medium- and long-term loans, credit for working capital, equipment, storage, exports, etc. Others refer to the main characteristics of the business firms themselves (productivity, etc.). Others, finally, are related to the drawing up of a general economic plan.

a) Differentiating the general terms applied to the various categories of credit – or at least the introduction of some specific regulation – is the most conventional practice in the matter of selective policy.

There have been many differentiations of this kind in France during the period under review. They are essentially:

—a drastic regulation of hire-purchase business (limitation of outstanding loans according to the amount of ownership, time limit for repayment, minimum cash payment);
—a preferential regulation in favor of medium-term equipment or export credits, which were eligible, in spite of the strictness of the rules, for the Central Bank's rediscount;
—preferential conditions for special housing loans, which are also eligible, under certain conditions, for the Banque de France's rediscount in spite of the rather strict regulation applied to these loans;
—preferential terms, finally, in favor of export credits:

 preferential rate and no rediscount ceiling for paper representative of claims on the foreign sector;

- special ceiling for the rediscount of credits extended for refinancing large export contracts.

b) With regard to business management, one must, of course, refrain from extending excessive support to those firms which are a dead weight for the country's economy. But even though there may be a relationship of one to two or three between the respective productivity of various firms in the same sector (as was the case in the French industry in the mid-fifties), it is difficult to suggest or to indicate to banks precise criteria which would enable them to judge a firm's economic productivity. As criteria must be wide enough to ensure a certain uniformity of action, they would necessarily be inadequate because they would not sufficiently take into account particular circumstances in such and such a sector of activity or even in such and such a firm. Moreover, we must note that it is not bankers' business to interfere in managing their customers' firms and that, as a matter of fact, bankers generally do not have competent staff at their disposal to this purpose. Understandably, the recommendations of the monetary authorities in this field have always been put in quite general terms, just advising banks not to back "lame ducks".

c) In spite of the foregoing reservations, we still have good reasons for thinking that, in some cases, a certain selection of the firms may complement the results which would be effected by a global limitation of credit. On the contrary, using bank credit in order to carry out a nation-wide economic plan is a much trickier matter. This plan does not take into account a particular firm, but embraces each industry as a whole. On the one hand, some firms operate in several sectors or at least influence related markets; on the other hand, even in those cases where firms are distinctly related to specific sectors, it may be that the distinction between industries to be fostered and industries to be discriminated against does not fit in with some public interest aims, for example, because of social or local reasons.

So within the framework of a global limitation of the credits extended by banks, the only scheme which would permit fostering a selective credit policy seems to be the one above described in the first place. It is based on a set of incentives related to differences in the treatment by the Central Bank of the various kinds of credits extended by banks. By these incentives, the Central Bank tries to curb the behaviour of the banks in order to promote a selective policy. It may be asked on that score if a global restrictive credit policy really needs any selective incentive, because normally banks tend to rely on two main criteria for making loans: the profitability of the loan and the customer's solvency. I would like to discuss this point now from the point of view of solvency of firms and public interest.

III. SOLVENCY OF FIRMS RECEIVING BANK CREDITS AND THE PUBLIC INTEREST

In our modern economies credit policy is in fact a global policy. Being individualised, lines of credit are by nature selective. It is therefore a false problem to contrast a "global" credit policy with a "selective" credit policy. This being so, there remains the problem of whether, within a global credit restraint policy, given a certain number of incentives such as those mentioned in the second part of this paper, the structure of bank loans corresponds to the a priori structure consistent with the general interest of economy.

As far as the granting of credits is concerned, decisions are arrived at essentially after taking into consideration the solvency of the firm, and, through it, the presumed credit worthiness of its customers. To take account of a possible lack of customers, the granting of a line of credit can be made dependent on the existence of other guarantees. Credit mergers cannot have any higher criterion on technical grounds than that of solvency. They cannot abandon this criterion and only additionally can they examine whether the operation warranting the opening of credit meets the requirements of the so-called "public interest". Public interest will then be consistent with the interest of banks if, by means of the above-mentioned incentives, some operations considered as particularly advantageous from the point of view of public interest (exports, investments, house-building) are made financially solvent. Other means of improving the solvency of public interest operations can be imagined, for instance, through the granting of budgetary subsidies. Through means of this type, it would be quite possible to enforce a credit policy of global restraint which would simultaneously have selective effects even without adopting any specific selection measures. To this purpose it would be sufficient that the profit and solvency criteria used by banks to allocate credit should simply lead these institutions to make their loans available to some sectors or firms in preference to other sectors or firms, and this result can be achieved indirectly through appropriate fiscal, social and regional policies.

Moreover, it is worth noting that the system of subsidised loans such as practised in France for farm loans extended by the National

Agricultural Bank is a sort of compromise between a selective credit policy in the strict sense and a policy of selective income distribution (since these subsidies are paid out by the Treasury and financed through fiscal and budgetary transfers).

When there are no such fiscal, social or equivalent policies, selective credit policy, such as defined in the first and second parts, may alter the solvency of a credit operation and, somehow, correct the inadequacies in the structure of demand with regard to the so-called public interest. Whether these correctives are efficient is a question we shall try to answer in the light of the precise case of French housing policy from 1958 to 1972.

IV. HOUSING POLICY IN FRANCE: AN EXAMPLE OF SELECTIVE CREDIT POLICY

A. *Structure of Financing for Housing in France in 1958*

A considerable part of house-building financing in France takes the form of loans granted to HLM (low rent housing) and special loans granted by the Mortgage Loan Bank (also used to finance buildings of social character), all these loans being financed on long-term resources.

The part of the banking sector in house-building financing can be defined very roughly as the total housing credits financed or likely to be financed by the Bank of France and banks on which monetary authorities can exert a direct influence. These credits mainly comprise freely rediscountable medium-term loans which were created in 1950, credits qualifying to be refinanced on the mortgage market since 1967, and the non-freely-rediscountable medium and long-term credits which have been growing rapidly, particularly since 1960.

The proportion of these credits to the total of outstanding housing credits[3] from 1958 to 1972 is shown below:

CREDITS FOR HOUSING FINANCED BY THE BANKING SECTOR

(percent of total of outstanding credits for housing)

Year	Percent	Year	Percent	Year	Percent	Year	Percent
1958	5.3	1962	8.2	1966	15.5	1970	25.8
1959	5.2	1963	10.2	1967	18.6	1971	28.0
1960	5.9	1964	11.6	1968	22.7	1972	31.8
1961	7.0	1965	13.6	1969	25.5		

[3]The special credits granted by the Mortgage Loan Bank, of which the medium-term element has a duration of 2½ to 4½ years, are not included. Should special medium-term credits be included, the above mentioned percentages would amount respectively to 9 percent in 1958 and 36 percent in 1972.

These figures indicate that these loans represent a small part in the total housing credit. The bulk of housing finance still consists in lending for low rent housing, special credits by the Mortgage Loan Bank and advances by the Deposit and Consignment Office to its property subsidiary company (outstanding). This part is however rising strongly, having increased from 5.3 percent in 1958 to 31.8 percent in 1972.

B. *Regime Applied to Housing Credit Eligible for Bank Portfolios During the Last Three Experiences of Quantitative Credit Restrictions and Now*

During the first experience (from July 1957 to February 1959), discountable medium-term housing credits represented the majority of loans of this kind eligible for bank portfolios (90 percent). These credits were subject to quantitative restrictions, as were other rediscountable medium-term and short-term loans; but as they could be discounted over and above ceilings at the Banque de France and, given the fact that the so-called financial institutions ("etablissements financiers")[4] which financed one-third of rediscountable medium-term credits at the end of 1958 were not directly affected by the quantitative restrictions, the amount of such lending has risen strongly.

CREDITS FOR HOUSING EQUIPMENT AND EXPORTS ANNUAL INCREASES

	1957	1958	1959	1960
		Percent		
Rediscountable medium-term credits				
– Construction	+10	+14	+17	+24
– Equipment, export	+28	+20	+ 2	+ 9

During the second experience (from February 1963 to February 1967), quantitative restrictions, though not so tough as the first ones, affected all kinds of credit, including rediscountable medium-term construction loans. But the latter amounted only to two-thirds of housing credits eligible for bank portfolios, because non-rediscountable medium-term and non-eligible long-term loans had grown rather rapidly. Also in this case, "financial institutions" were

[4]They can refinance themselves either by increasing their ownership or by turning to non-banking financial intermediaries, or finally by rediscounting bills at the Banque de France. If they resort to banks, the cost of refinancing is higher as the latter are penalized.

not directly affected by the restrictions, and by the end of 1963 they had extended almost half of the amount of rediscountable medium-term construction credits. For the same reasons, the medium-term construction lending increased strongly.

CREDITS FOR HOUSING EQUIPMENT AND EXPORTS
ANNUAL INCREASES

	1962	1963	1964	1965	1966
			Percent		
Rediscountable medium-term credits					
– Construction	+30	+36	+39	+38	+37
– Equipment, exports	+16	+14	+13	+ 9	+ 6

The third experience extended from mid-November 1968 to October 1970. For the first time, rediscountable construction and equipment credit (medium-term export loans and short-term credits by the National Cereals Office were exempted) and the claims eligible for the mortgage market (which was created at the end of 1966) were initially not subject to the ceilings imposed by the monetary authorities. In June 1969 a special regulation was implemented; it was comparatively loose – the maximum permitted increase amounted to 10 percent in 1969 and 12 percent in 1970 for medium-term equipment and construction credit, and, for the mortgage market[5] 100 percent in 1969 and 27 percent in 1970. Therefore, only non-rediscountable medium-term loans and non-eligible long-term loans were subject to the general regime.

CREDITS FOR HOUSING, EQUIPMENT, EXPORTS AND OTHER PURPOSES

ANNUAL INCREASES

	1967	1968	1969	1970
		Percent		
Rediscountable medium-term housing-credits	+18	+ 21	+17	+11
Mortgage market		+246	+91	+29
Rediscountable medium-term equipment, export credits	+17	+16	+24	+10
Total outstanding		18.4	12.8	10.4

[5]The mortgage market was created in December 1966, which explains the erratic figures concerning this item.

C. *Recorded Results*

–The amount of bank home loans has increased much more than total bank credit. From 1960 to 1972 such loans rose by 3600 percent, as against 570 percent for the total outstanding. Similarly, total bank home loans increased considerably more than global lending to individuals and firms (630 percent, as against 380 percent).

–Despite restrictive measures the amount of bank home loans has always increased at a good pace except in 1970 and the same holds true for new loans.

–Similarly, credit restrictions led to a slackening property market in 1970 only, with the 1964-1967 crisis accounted for by other factors. In fact the crisis on the property market from 1963 up to 1967 resulted both from a substantial increase in demand due to the inflow of money from French people repatriated from Algeria and some disinvestment in securities. As a result, there was a very strong rise in prices and a fall in solvent demand for the following years. The 1970 crisis lasted just one year; it appears to have been the consequence of credit restrictions though some relaxing measures were taken. Inventories were easily financed through short-term loans to property development industry which usually was subject to common regulations imposing quantitative credit restrictions.

CONCLUSION

After considering a particular example such as that of the housing sector we are entitled to suggest that the selective policy adopted by the French monetary authorities has enabled this sector which is regarded as deserving a priority to develop well. Nevertheless it must be underlined that these positive results were probably achieved only at the price of a too rapid increase in [or, at least, of some lag in curbing the growth of] overall bank lending, as shown by the period from November 1968 to May 1969, during which a flexible and selective scheme of credit ceilings was applied. (Only short-term credit and nondiscountable medium- or long-term loans were restricted, while nondiscountable medium-term credit – about a third of overall bank lending – remained unrestricted). In fact during the first half of 1969 the course of the economy was characterized by a rapid growth of overall bank lending, an increased pressure of demand, an always larger use of productive capacity and a sharp rise in prices and wages. Moreover, as a result of the subsidized interest-rate policy followed in extending credit for housing, export, equipment and so on, the average credit cost was quite low in France during the whole period reviewed, and this low cost did undoubtedly help the fairly rapid credit expansion, especially at times of restriction, and therefore added to the increase in inflationary pressures. Selective credit policy is, therefore, probably harmful to the expected effectiveness of the global restrictive policy it has been designed to complement. Finally – a point of importance that contemporary economists should remember – monetary policy (in France but also in other European countries) is one of the preferred instruments for the short-term management of an economy. Now, an effective selective policy takes a long time (because of the implied research and controls to be introduced) and, therefore, is very hard to manage in the short term. So there seems to be some contradiction between attempting to make credit policy selective and using it for short-term management of the economy. As this specific use is one of the main characteristics of monetary policy in European countries, the question arises of whether it is not enough to merely run a global credit policy and simultaneously to intervene by such measures as budget appropriations or social benefits and so on in favor of certain industries or classes of people, thereby ameliorating some of the ill effects of the global policy.

Discussion

MARCUS MILLER*

I would like to start with the definition of credit controls. It seems clear from Professor Hodgman's paper that his definition excludes some of the borrower and lender controls discussed earlier at this conference. At the beginning of his paper, credit controls are distinguished both from measures of *budgetary* policy ("taxes and subsidies involving the budget of the central government") and from measures of general *monetary* policy ("open market operations . . . variations in a uniform discount rate charged by the central bank, and a uniform percentage change in the central bank's minimum required cash ratio or in its maximum credit lines"). This would certainly leave under credit controls both "guidelines" on lending for certain institutions and also ceilings on interest rates ("credit controls seek to influence credit allocation and interest rate structure").

Now it can be argued that a rise in the required cash reserve ratios of all those institutions subject to such ratios (with no change for those not so controlled) is analogous to an increased tax on those penalised in this fashion and is therefore a form of lender control. But under Professor Hodgman's definition, as I understand it, a general increase in *existing* ratios would be treated as a part of general monetary policy and not as a form of credit control, despite the tendency for such a measure to drive business away from the intermediaries adversely affected to those left unaffected. Similarly the taxes on particular borrowers discussed by Professor Maisel at this conference would presumably come under budgetary controls as defined above.

Hence I think that Professor Hodgman's paper discusses a *subset* of those credit controls in which the conference is interested, and also that his arguments do not weigh so heavily against credit controls, more widely defined, as they do against those considered in his paper.

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I will consider the U.K. case in some detail because a number of different forms of credit control were given up in 1971, but subsequent developments have hardly shown that the controls were not working or not worthwhile, and it is now an open question as to whether the U.K. authorities may not revert to some of their earlier practices.

If we look first at the monetary system prior to the reforms of 1971, we find that it was characterised by the stabilisation of long term interest rates, by official control of level of short term interest rates (as required for "external" purposes) and by credit rationing to the extent that the authorities channelled banks' funds into the government sector and away from the private sector by lending controls. Using the earnings-price ratio as a measure of the "cost of capital" to firms, there is some evidence that a reduction in the availability of bank credit – measured crudely by the quantity of bank lending as a per cent of private net worth – raised the cost of capital, *ceteris paribus*. Since the loan market was not cleared by price, the quantity of credit available as well as its price could be expected to influence firms' decisions, and both were to some degree controlled by official policy. Although the "cost of capital" variable appeared sensitive to the availability of credit in the period I studied (in the paper cited by Professor Hodgman), it should be noted that lender controls on banks were often complemented by borrower controls on hire purchase customers, for example. Controls on bank lendings were usually activated in a crisis, so the effects on the earnings-price ratio of the lender control alone are difficult to disentangle.

There were also, throughout the period, variations in the amount of "borrower control" in the form of tax credits to companies. A study of the effects of these fiscal changes, which may nevertheless be considered as part of credit control, has recently been published[1] and provides evidence for the U.K. analogous to that presented to the conference for the U.S. by Professor Waud.

Such in outline were some of the salient features of the system before the reforms of 1971. Despite the lack of competition in the banking sector, the system had its attractions for the authorities as it left them in control of short rates, and limited the ability of the

[1]The Estimation of Investment Functions for Manufacturing Industry in the United Kingdom," B.D. Boatwright and J.R. Eaton, *Economia,* Nov. 1972, *39*, 403-18.

banks to compete with the Government in selling debt; and the rationing of credit allowed the authorities to switch the resources of the banks to servicing the government's needs, rather than those of the private sector. It would be possible to think of a set of taxes on the banks and subsidies to chosen borrowers which would lead to the same sort of behaviour as was observed for the major U.K. banks, and surely some such market-oriented controls would have been preferable to the *ad hoc* credit guidelines and interest rate agreements which prevailed. Instead of levying taxes on the major banks and disbursing subsidies to selected borrowers, however, the authorities gave over these duties to the banks, allowing them to collect the tax on the intermediation process in the form of extra profits, and disburse the subsidy in the form of cheap loans to preferred customers (e.g. ship builders). So long as the net profits for the banking system were not too large, the authorities were content to delegate such authority to the clearing banks in exchange for those features described above which attracted them. Such was the *modus vivendi* before the introduction of the new system of "Competition and Credit Control" in 1971.

One reason for the change to the new system was that the authorities found from 1965 to 1971 that they were having to rely *continuously* on intervention in the market for bank credit. They recognised, however, that the biggest contractionary effects of such intervention come quickly, diminishing as circumvention increases with the passage of time. But such circumvention could lead to the growth of new channels of finance, which a policy of sustained intervention would also have to check, and so the financial system would become progressively distorted over time. A change of the system seemed a welcome alternative to the prospect of ever-widening circles of control, particularly to the new Conservative government which took office in 1970 with a commitment to freeing markets and using the price mechanism.

Since the new government had also been committed to cutting back the accelerating pace of price inflation it was no coincidence that unemployment rose to almost 4 percent in 1971. With fairly high unemployment and no balance of payments problems on the horizon, the time seemed propitious to stimulate competition in the financial system and end the sort of direct credit controls discussed above. The name of the new system was perhaps designed to reassure its critics that there did remain control over the extension of credit by the financial system, though clearly of a different kind from that previously exercised.

Just after this change was inaugurated, however, the government decided to "go for growth", hoping that the expansion of money incomes would raise prices less as real income growth was accelerated. Monetary policy was subordinated to stimulating the growth of real income, and was aided mightily by an expansionary budget in early 1972 (which included *inter alia* a measure giving tax relief for all interest charges above a minimum of £35 p.a.) When questions were raised as to what tool would handle an excessive rise of prices, the Bank of England, though not the government, would customarily mention the need for incomes policy. In these circumstances the money supply grew by 25 percent on the broad definition in 1972, and this growth rate has not tailed off since. Despite their market orientated philosophy, moreover, the Conservative government enacted an incomes policy in late 1972 – self-consciously following the path trodden by the Nixon administration a year before.

The new system has certainly encouraged competition, but has hardly controlled credit. Initially there were problems of interpreting the significance of the growth of money supply figures. This was because one would expect there to be some re-intermediation as the banks competed for deposits and moved – dare one say it – towards "the optimum quantity of money". These problems were exacerbated by the fact that the broad money definition adopted included CDs, which tended to *increase* whenever market rates rose sharply above administered "base" lending rates, as they did whenever bank reserve assets were in short supply.

The behaviour of M_3, the broad money aggregate, initially adopted as the quantitative indicator of monetary policy, differed from that of the narrowly defined money supply, M_1, including only cash and demand deposits, giving rise to further problems of interpretation. It may be that part of this difference is to be explained by the fact that the "speculative" demand for capital-certain assets has switched from Treasury bills to CDs as the rates on the latter have risen above Treasury bill rate. The ability of the authorities to control the money supply, however interpreted, was not enhanced by two other features of the new system – the continued existence of the discount houses which could create reserve assets, and the need to sell gilt-edged stocks to squeeze the reserve asset base.

Why did the authorities adopt a system whose behaviour seems so difficult to interpret and control? In the first place, the authorities had surely not anticipated such considerable stochastic elements in the monetary sector. If one was to follow Bill Poole's analysis, the good "fits" found for demand for money equations prior to 1971 would have provided good reason for preferring money supply control to interest rate control for avoiding variations in GNP. Moreover, after the unwelcome task of controlling the quantity of credit in an undeniably *ad hoc* fashion for some time, any change may have seemed for the better to the monetary authorities; and they could surely not have forecast the size of government sector deficit that they would be called upon to finance so soon after the "Competition and Credit Control" was inaugurated.

The operation of the new system which replaced the old credit controls has clearly been unsatisfactory, so what will the authorities do next? All the options discussed above under the broad definition of credit controls remain open. While the likelihood of going back to guidelines on lending is not very great, as it would seem too much of a return to the *status quo ante,* other forms of credit controls seem quite probable. It would be easy to remove the tax concession enjoyed by consumers in respect of loan interest, for example; changes in investment tax allowances for businesses are fiscal options available at any time; and consumer credit controls (in the form of minimum down payments, maximum terms) could well be reintroduced if the present monetary experience continues. These are all forms of borrower control and look more likely than forms of lender control which are more easily circumvented.

I would conclude therefore by returning to the question of the definition of credit controls, and arguing that if these are defined more widely (to include "taxes" and "subsidies" on borrowers and lenders as well as lending limits and interest rate ceilings) then they are quite likely to be effective; and given the mixed experience with the new regime, may well reappear in the U.K. It may well be objected that this is a second-best strategy, that there is a policy of money supply control which has not been tried, perhaps because of the interest rate implications, or for other reasons; but the U.K. authorities may be content to settle for second-best after their recent monetary experience.