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Recent Trends in Credit Control in Selected Countries of Western Europe 26 pages

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Summary and Appraisal

Flexible monetary policies have been relied upon increasingly in European countries in recent postwar years. Several factors have operated to foster this development. First, the greatly improved economic situation itself facilitated the substitution of indirect financial controls for various types of direct controls. Secondly, there seems also to have been a philosophical reaction away from the control mentality engendered by wartime and immediate postwar needs. Finally, especially since 1951, the United States example of successful reconciliation of the use of flexible monetary policies with the large-scale Treasury operations, typical of most modern economies, probably has had considerable influence abroad.

Although Federal Reserve experience is closely watched abroad, European central bankers emphasize important differences in banking structure and practice between Europe and the United States, partly based upon geographical differences. In particular, European banking operations are far more centralized, with the bulk of the banking business generally controlled by a few large institutions, each having numerous branches throughout the country. Because of such centralization, monetary policy can be conducted on a more personal and informal basis in European countries than is possible in the United States.

While the large banks compete vigorously with one another for some types of business, they are highly specialized by type of business and therefore are somewhat less competitive than is the case in the United States. Moreover, they may well all group together in an investment banking syndicate in the sale of large issues in order to spread the risk, a procedure not unlike that utilized by New York investment houses. They may also work very closely together in carrying out the requests or instructions of the Central Bank. Moreover, when a serious conflict of interest is felt to exist, they tend to be drawn closely to one another and to the Central Bank in a common front against the outside world, especially when negotiations involve foreign governments, or *vis-à-vis* the Government itself or the Treasury.

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Consequently, there exists a strong "community of interest" aspect of the relationships among the commercial banks, and between the commercial banks and the Central Bank. This common bond knits the banking community together and makes possible the wide use of informal credit controls. The foreign observer gains the impression that European monetary policy often functions effectively "by ear," or according to tacit agreement or understanding, rather than according to statutory powers of the Central Bank, even when such powers clearly exist.

Broadly speaking, credit controls in Western Europe include the traditional discount-rate mechanism, supplemented by open-market operations, cash or liquidity reserve ratios (or both), "moral suasion," and selective credit techniques. In addition, debt management techniques, foreign and domestic capital-issues control, and Central-Bank intervention in the exchange and gold markets may also operate to reinforce other credit measures.

In the countries under review, little use has been made of open-market operations primarily because it has been difficult to adopt sufficient flexibility in this technique to meet the changing requirements of the money market. However, there is a widespread recognition of the desirability of using this technique whenever necessary, and progress has been made in this direction in the Netherlands and to some extent in Belgium. Open-market policy has been thwarted by a lack of marketable short-term paper in the portfolios of the Central Banks; by fiscal weakness and lack of adequate tax revenues, which necessitate recurrent Treasury calls upon the money and capital markets; and, finally, by Central Bank agreement (open or tacit) to prevent "unsettling" movements in the prices of marketable Treasury bonds.

In the Netherlands and Switzerland, minimum cash reserve ratios have been introduced to "sterilize" liquid assets resulting from rapid growth in gold and foreign exchange holdings; these ratios, however, are thought to be a blunt instrument of monetary control. Required Treasury security reserve ratios (in France and Belgium) generally are considered to be less effective as credit control devices than cash ratios; in fact they are at times thought by some observers to be even detrimental to stability, because of their provision for automatic Treasury access to bank credit.

Since the outbreak of the Korean War, the discount-rate mechanism has been used increasingly. "Moral suasion" has also been quite effective, not only because of the closely-knit banking community and the personal prestige and skill of the central bankers, but also because of the ever-present fear that mandatory banking controls would be put into effect if the voluntary controls failed to work. In addition, selective credit controls, including the regulation of consumer instalment credit and more careful screening of bank loans and discounts, have been important. The monetary authorities in the Benelux countries and in Switzerland have used what might be termed the technique of "uncertainty," injecting a note of caution through warnings of possible further credit dampening, so as to temper undesired stock and bond market price advances.

There is developing also an informal coordination between monetary policy, fiscal and debt management techniques (perhaps especially in the Netherlands), and Central Bank approvals of foreign lending and borrowing. On the other hand, the vagaries of the external trade balance and of short-term capital movements, with their variable and uncertain effects upon internal liquidity and bank reserves, at all times color monetary decisions. Western European monetary authorities at times also buy and sell gold and foreign exchange, in part to influence their price but also in part to help offset the effects on the reserve base of the varying external balance.

Finally, the recent gradual achievement of de facto convertibility in the Benelux and other European countries has focused public attention on the need for greater sensitivity and flexibility in monetary techniques. These techniques can be applied quickly if necessary to make it possible for the now more fully exposed economies to adjust more smoothly to the shock of external disturbing forces.

Introduction

An impressive economic expansion has been achieved in Western Europe in the postwar years. Many factors are involved in this achievement: the normal and inevitable process of recovery from wartime destruction and dislocation; sustained efforts by European industry, labor, and government, with the assistance of foreign aid; extensive investment activity, both governmental and private, much of which provided long-needed modernization of equipment; both voluntary and enforced consumption restraint; and probably, a net easing of political tension and uncertainty. In addition, in recent years the revived use of monetary policy seems to have played an increasingly important role in the achievement of economic stability and in the rebirth of private savings, which has contributed to both general economic recovery and to expansion.

Monetary policy was little relied upon in 1945-48, except in Belgium, but since 1950 has been utilized increasingly in Western Europe as direct controls were eliminated or relaxed. Belgium instituted sweeping monetary reforms immediately after the war in 1945; France began to use more formal monetary techniques in 1948, and strengthened them in 1950 and 1951; and Switzerland and the Netherlands followed in the early 1950's. In part, the greatly improved economic situation itself made possible after 1948 the gradual substitution of indirect financial controls for direct production, consumption, and external exchange and trade controls. In part, the renewed interest in indirect financial controls may have reflected a reaction away from dirigiste techniques, prevalent in the war and immediate postwar years, toward a freer economic system; in part—especially in its development during recent years—it has apparently been influenced by the success of United States use of monetary policy following the Federal Reserve-Treasury "accord" of 1951.

From 1952 until 1955, rapid economic growth was accompanied by quite general internal stability on the Continent. Since 1955 there has been a growing threat to stability in many European countries, including France and the Netherlands, and perhaps Belgium and Switzerland. In a varying degree, efforts to use monetary instruments to restrain inflationary pressures have been intensified in these four countries. A review of the tools and practices of monetary policy in these particular countries, and of their use and interaction, may therefore be of interest at this time. Each major instrument will be dealt with separately in this paper, including the traditional techniques (the discount rate mechanism, open-market operations, and reserve ratios); selective controls and "moral suasion"; and, finally, international loan, exchange, and gold policies of the Central Bank.

The Discount-Rate Technique

The discount rate technique of flexible monetary policy was reestablished at different times during the postwar period in this group of countries. In Belgium, monetary reform involving use of the discount rate was applied immediately after the war; in France the technique was applied about three years later. On the other hand, in the Netherlands, where reconstruction needs were very large, there was reluctance to invoke discount rate changes (and to eliminate the excess liquidity existing at the time), which would involve increases in short-term money rates, because of the probable adverse effects upon Treasury and ultimately upon private financing costs. Moreover, there was probably a tendency to rely mainly on the extensive direct controls which were still in existence.

Later, especially after 1950, it became evident that an adequate volume of internal savings necessary for long-term financing (and an eventual reduction in its cost) would not be forthcoming in the absence of sustained internal stability. It was also felt that flexible money rates and fairly free markets, at least for short-term money, were necessary to the maintenance and achievement of stability. In addition, given the existing dissatisfaction with such direct controls, the Korean boom provided an incentive to restore the use of more traditional methods.

Moreover, discount rate changes have appeared to "spearhead" basic changes in monetary policy in Belgium, the Netherlands, and (at least until recently) in France, and to have had significant effects upon savings and the long-term capital markets as well as upon short-term money markets. Short-term rate flexibility seems to have dampened speculative activity and wide erratic price changes in the long-term bond and stock markets through their immediate effects upon market expectations and, somewhat later, their impact upon the supply of and demand for investment funds. In France, Belgium, and Switzerland business financing costs have been reduced since 1951, in part as a direct result of the growth of personal and institutional saving, and the revival and more normal functioning of the capital market.

At times, the discount rate has been raised mainly for precautionary reasons (as in Belgium in the fall of 1955), when the banks were not heavily indebted to the Central Bank. In such cases, the rate change was considered to be a warning of possible future restrictive action. It appeared to dampen the loan activities of the banks, and to create some hesitation by private investors to enter the bond or stock market, for fear of incurring capital losses; and the impact was therefore transmitted rather quickly, although indirectly and chiefly through the effect on expectations, to the money and capital markets. At other times, as in France in 1950 and 1951, the impact was conveyed to the money market directly, because of the prevailing heavy level of bank borrowing at the

Central Bank; in the French case cited, the impact was sufficiently heavy that it was felt necessary to cushion it by various "safety valve" devices.1/

Paradoxically, thus far in 1956 the Netherlands Bank—the last Central Bank in the group to apply quantitative credit controls—has been the only Bank in this group to apply discount rate increases this year to meet the present inflationary threat.

Impact of discount rate changes

The impact of discount rate changes varies from country to country, due to such factors as the varying levels of typical bank borrowing at the Central Bank. In France, individual discount "ceilings" have been established for the commercial banks, which tend to be continually indebted to the Bank of France, their discount levels being sometimes at or slightly below the established rediscount ceilings (as in late 1955) or at other times (as in 1950-52) above the ceilings, where penalty rates are operative. Therefore, when the Bank's General Council changes its prime discount rate, or related rates (such as the rate on 30-day advances against Treasury paper), it can be fairly certain that the banks (and hence the market) will almost immediately feel the impact.2/

1/ "Safety valves" have been built into the French discount system. Certain paper has been specifically excluded from the discount "ceilings" (i.e. the maximum amount of paper which any bank may have on discount at the Bank of France at any time, set by the Bank of France for each bank individually): e.g. (1) medium-term paper issued by the Crédit National for the financing of re-equipment of industry and by the Crédit Foncier for housing finance; and (2) certain export paper. Other types of paper may be discounted by the banks above the established ceilings at, however, "penalty" rates which have generally been 1½ to 2 per cent above the prime discount rate, and are now 4½ per cent. The banks may also obtain reserves from the Bank of France against Treasury paper of a maturity not exceeding three months, the sale being made to the Bank at the market rate.

2/ Discount policy has been used less frequently in recent years in France. The Bank rate was raised twice during 1947, and once again in September 1948, followed by a return to the more normal level of 3 per cent in late September 1948. The rate was again reduced, to 2½ per cent, in June 1950 under a seeming threat of recession. It was raised again in October and November 1951 to 3 and then to 4 per cent.

Subsequently it was lowered to 3½, 3¼, and 3 per cent in September 1953 and February and December 1954, when the monetary situation seemed sufficiently under control to allow borrowers the advantage of lower rates under the continued policy of reducing investment financing costs. No change has been made in the rate since then, although it is believed that increases have been considered from time to time.

In Belgium and the Netherlands, the level of bank discounting with the Central Bank has generally been much lower than in France, and the effect of discount rate changes more indirect. In Belgium, press reports indicated that the small ($\frac{1}{4}$ of 1 per cent) rise in August 1955 was for "psychological" rather than "technical" purposes. However, the rate change probably contributed to the subsequent rise in short-term money rates and is believed to have helped restrain the year's rise in bond and stock prices, thus injecting a cautious note into the money and capital markets.

In the Netherlands, use of the discount rate mechanism has also signaled current and prospective future shifts in credit control policies to the banks and to the market generally, thereby influencing bond and stock prices as well as short-term rates. In addition, it has been coordinated increasingly with other monetary and fiscal policies. For instance, a required pre-payment to the Treasury of corporate tax liabilities in the last quarter of 1955 tightened the banks' reserve position and reduced the liquidity of business corporations; the measure is believed to have forced business corporations increasingly to go to the long-term capital market for new investment financing. A more active open-market policy was announced at the end of the year, and sales in January and February further tightened the banks' reserve position and helped raise short-term money rates and the level of bank discounting at the Netherlands Bank.

Once assured that a rate change would be more effective under the changed situation in the market, the Netherlands Bank then raised the discount rate by $\frac{1}{2}$ of 1 per cent on February 7, to 3 per cent. The effects of this change were indeed quickly transmitted to the money and capital markets. Within one week there had developed a rise in the 3-month Treasury bill rate, a significant reaction in the stock index, a small rise in yields on redeemable Treasury bonds, and a somewhat larger rise in industrial bond yields.

The latest change in the discount rate of the Netherlands Bank on August 25 from 3 to $3\frac{1}{4}$ per cent appears to reflect the Bank's further attempts to curtail inflationary pressures, which mounted during the summer months; to adjust the official rate for bank borrowing to steady increases in money rates during 1956 to postwar high levels, including a rise in the 3-months' Treasury bill rate to 3 per cent in July; and, possibly, to encourage an inflow of short-term capital and thereby strengthen the external balance and the Bank's gold and dollar holdings.

Interest rate flexibility in a country with a stable discount rate

Flexibility both in money rates and in bond yields has increased since the Korean War, even in a country in which the official discount rate has remained unchanged. While there is no mystery about this fact, it is of interest, in view of the occasional tendency to assume that in the absence of an increase in the discount rate under conditions of inflationary pressure, the monetary authorities are not taking anti-inflationary action.

Although the Swiss discount rate is not regarded as unchangeable, in practice it has been kept absolutely stable at $1\frac{1}{2}$ per cent since 1936; the authorities have relied primarily on other techniques, notably voluntary agreements by the banking community to limit credit extension. The large banks have been warned that failure of the existing voluntary agreements to check credit expansion or to check inflationary pressures would require the National Bank to take stronger action. The restraint of credit under the voluntary agreements, in conjunction with the sharply increasing demands for a fairly constant flow of new Swiss investment funds in 1955, brought about an increase in rates in 1955, and braked the rise in Zurich stock and bond prices. By mid-1956, both short- and long-term rates in the Swiss market had increased to the highest point in $6\frac{1}{2}$ years.

Open-Market Operations

Stimulated by—among other things—Federal Reserve experience in the United States, interest in open-market operations as an important tool of monetary policy has been growing abroad. In the past their use has been inhibited, or thwarted altogether, by such factors as: large Treasury recourse to funds from the capital markets, aided by tacit agreement by the Central Bank to support Treasury bond markets (as in Belgium); a lack of marketable short-term paper; and legal requirements for the Bank's purchase of short-term Treasury paper from the banks on the initiative of the latter (as in France).

In each of these countries an increasing effort has been made to overcome these problems, especially the apparent conflict of interest between the Central Bank and the Treasury. In the Netherlands, in particular, the effort has met with growing success, for open-market policy has in 1956 become more active and more flexible. In Belgium, the conflict has been brought to public attention very clearly in the National Bank's most recent annual report.[1]

An illustration of effective open-market policy: The Netherlands

The Netherlands Bank has utilized open-market policy since mid-1952, and with increasing flexibility since late 1953, to offset major

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1/ The National Bank of Belgium, Report Presented by the Governor on the Activities of the Bank in 1955, Brussels, 1956.

monetary disturbances arising, first, from the "favorable" external balance and, later, from domestic pressures.

Initially, when open-market operations were inaugurated in July 1952, the Bank sold Treasury paper on the initiative of the market, and primarily to satisfy market demand for such paper. At that time, they largely were determined by the prevailing technical conditions in the market for Treasury paper.

Toward the end of 1953 and again in 1954, open-market sales were made to help neutralize the monetary impact of changes in the external balance. Treasury paper (chiefly short-term) was sold in the market, generally at fixed rates established by the Netherlands Bank, to "sterilize" excess bank liquidity resulting from an unusally rapid rise in Dutch gold and foreign exchange reserves. Occasionally (in late 1954 and early 1955), Treasury paper was bought by the Bank to ease a temporary credit stringency.

Until December 1955, the Netherlands Bank confined itself to conducting a "passive" open-market policy, so described by the Bank since it was directed chiefly toward the "fixation of any surplus liquidity which might appear." Open-market policy in 1954 and most of 1955 "did not seek through deliberate contraction of liquidity or raising of interest rates to exert a more active restrictive influence on the banks' lending and investment."1/

However, in the course of 1955 there was a shift of emphasis in the conduct of open-market policy. By December 1955, steps were taken to conduct a more active policy, in the sense that action was no longer confined, as before, to sales of Treasury paper at rates fixed in advance by the Netherlands Bank, but tenders were invited for Treasury bonds running for five years.

The object of the announced change in policy in December 1955, which came into operation in the early months of 1956, was two-fold: (1) to exert a certain "disinflationary" influence by raising the level of interest rates in the money market; and (2) to make possible the adoption of a more effective discount rate policy by absorbing existing liquidity.

Central Bank policy involved open-market sales for the first $3\frac{1}{2}$ months of 1956, followed by purchases at occasional intervals to ease

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1/ See The Netherlands Bank, Report for the Year 1955, (Amsterdam, 1956), pp. 77-87.

the market when necessary. The decline in the Bank's gold and foreign exchange reserves in the second quarter, accentuated in June, and the public's increased currency demands further tightened reserves and the money markets. Redeemable Treasury bond yields rose to 4 per cent by August 6, 1956, from about 3.4 per cent at the end of 1955, and the rate on 3-months' Treasury paper to 3 per cent from about 0.75 per cent on similar Treasury offerings in December 1955. The comparable change in private call money rates has been from 3/4 to 1-1/2 per cent and in industrial bond yields from 3.5 to 4.2 per cent.

Illustrative barriers to open-market policy: France, Switzerland, and Belgium

France — Bank of France open-market operations in short-term Treasury paper and private paper eligible for rediscount, authorized in 1938, have in most cases been used to ease rather than to tighten the banks' cash position, for the following reason. The Bank of France may purchase Treasury paper with up to two years to run if it considers that the market needs supplementary reserve funds, although it is forbidden to buy longer-term securities; however, under the law it must buy (at the market rate) or discount all Treasury paper of a maturity of three months or less, offered to it by the financial institutions. It is obvious that if the latter hold substantial amounts of such paper, any open-market sales by the Bank of France of Treasury paper with maturities of up to two years could readily be offset by the banks, by sale or discount of Treasury paper of three months' maturity or less, which the Bank of France cannot refuse.

In fact, about four-fifths of the Bank's open-market portfolio consists of such short-term paper, and most of the remainder represents nonsaleable private bank acceptances or special bank advances against Treasury bills. Accordingly, that fraction of its portfolio with which the Bank can freely operate in the open-market (i.e. Treasury paper whose maturity date is within a range of three months to two years) is very small; and, as already indicated, the banks can readily offset sales of such paper. In 1951 and 1952, the Bank of France purchased some medium-term Treasury paper to ease reserves in a tight market, but since 1953 (when the market has usually been liquid) open-market operations have been reported to be small.

Switzerland — Since 1953, the Swiss National Bank has been legally empowered to buy and sell Federal securities maturing in not more than two years. However, the Swiss national debt is largely consolidated, and the amount of short-term Treasury paper available in the market is very small; the National Bank has virtually none in its own portfolio.

Belgium — The Belgian National Bank has reported the present obstacles to effective open-market operations to be a major weakness of its credit control system.[1] For one thing, the "Fonds des Rentes," a public financial institution which operates with Belgian francs obtained from the National Bank, has safeguarded long-term Treasury bond prices from sudden or disturbing changes. In such support operations, consideration is not given primarily to the reserve positions of the banks. As in the United States prior to the 1951 "accord," such support operations involve the potential for almost unlimited unloading of Treasury issues by the public at assured prices, above some minimum level, and consequently for debt monetization. Some observers would indeed prefer to have the Treasury go directly to the National Bank for its financing needs. Under such a procedure, they point out, the Bank would at least be able to review each Treasury credit, individually.

An additional barrier to effective open-market policy in Belgium is that no real short-term money market, in which rates can be freely determined by supply and demand, exists. Most of the outstanding short-term Treasury paper is held by the Banks under the high compulsory reserve ratios (see the following section), and is therefore effectively non-marketable. The paper available in the market is chiefly medium- and long-term Treasury securities (of from 5 to 20 years' maturity), and any open-market sales by the National Bank would have to be conducted mainly in these issues. However, if their prices were to drop sharply in the market the Fonds des Rentes presumably would make supporting purchases, negating the original open-market sales made for credit-restraint purposes.

Reserve Ratios

Required-reserve ratios were first introduced by Belgium in 1945-46, and later by the other countries included in this study. Generally speaking, the mechanism as it now stands is considered in these countries to be rather blunt, and to be useful only for basic broad adjustments.

The Belgian and French reserve ratios (established in the latter country in 1948), involving largely short-term Treasury issues, helped consolidate and "freeze" the huge postwar floating public debt. However, these ratios within limits, depending upon the rise in bank deposits, provide Treasury financing facilities on an automatic basis which have tended to be spent, even in an inflationary period, rather than used for debt retirement. They therefore are believed by some observers—especially in Belgium—at present to have created more new problems than

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1/ See the National Bank of Belgium, Report Presented by the Governor on the Activities of the Bank in 1955, Brussels, 1956.

solutions to old ones. Both the Bank of France and the Belgian National Bank are studying the possible use of flexible cash ratios, such as those used by the Federal Reserve System.

Cash-reserve requirements of a rather informal character were introduced in the Netherlands and Switzerland in 1953 and 1955, respectively, largely as "precautionary" measures against the threat of over-liquidity arising from the "favorable" external balance.

Cash-reserve ratios

Belgium — In Belgium, cash ratios were first established in 1946, under powers created by 1934 legislation. At present, the ratio is fixed at 4 per cent of short-term bank assets. The Belgian National Bank is presently studying whether this should be raised and periodically changed, when necessary, to reinforce other credit controls. At present, the power to determine the cash ratio rests with the Banking Control Commission, in agreement with the Minister of Finance and the Minister of Economic Affairs. If the cash ratio were increased, the commercial banks might perhaps be compensated for any resulting income loss by being permitted to hold a larger proportion of higher-yield long-term issues in the Treasury security ratios.

The Netherlands — In the Netherlands, the Central Bank has the power, under what it describes as a "gentlemen's agreement" (which was, however, a written agreement signed by most of the banks), to establish a cash ratio, and to vary it between 5 and 15 per cent, although with an interesting provision that before raising the ratio above 10 per cent the Netherlands Bank would sell Treasury paper to the market out of its holdings of such paper. The ratio, which was established (after an interim period at lower levels) at 10 per cent of short-term bank liabilities, originally sterilized part of the country's rising stock of foreign exchange. It was temporarily reduced (in April 1956) to 8 per cent, to facilitate the placement of a new Treasury bond offering, and was later raised back to only 9 (instead of 10) per cent in May. Thus, while open-market and discount policy restricted bank reserves, the cash reserve ratio was lowered to cushion the impact.

Switzerland — In June 1955, also by "gentlemen's agreement," all major Swiss banks (those having assets of more than 50 million Swiss francs each) agreed, provisionally for one year, to deposit in cash 3½ per cent of their short-term liabilities in blocked accounts at the Swiss National Bank. The mortgage banks and the insurance companies made similar agreements. About SF 250 million were blocked on this basis. This action helped to check the rapid growth of loanable bank reserves arising from the "favorable" external payments position, which were depressing internal money rates and which were felt to be feeding speculation in the real estate and Zurich security markets.

Secondary reserve ratios and their limitations for credit-control purposes

France — In France, the Treasury bill "floor," established in 1948, was raised in July 1956 to require the banks to hold, against all sight deposits, 25 per cent in Treasury bills. Between 1948 and July 1956, the banks were required to hold not less than 95 per cent of their September 1948 portfolio of short-term Treasury paper, plus 20 per cent of any subsequent deposit increases; by July 1956 the composite result of these requirements was a secondary reserve requirement of about 21 per cent of the banks' sight deposits, on the average.

Until July 1956, when the French reserve requirement was changed for the first time, the Bank of France hesitated to recommend or approve any variation in the ratio to implement credit policy. In December 1955, for example, the high level of bank reserves was considered a threat to stability; nevertheless there was some unwillingness to recommend an increase in the Treasury bill "floor," because it was believed that it would be difficult subsequently, in the event of business recession, to obtain agreement of the Treasury (with which the Bank shares credit control powers in the National Credit Council)1/ to any lowering of the "floor."

Whether the recent French action to raise the ratio will have any net anti-inflationary effect, on balance, is not yet clear. On the one hand the flow of new bank financing available to the Treasury may have been increased, in an initial amount estimated in the French press, upon the basis of present deposits, at about 80 billion French francs ($230 million). On the other hand, however, bank reserves available for private lending may have been reduced. If an individual bank already has excess reserves in the form of cash or marketable Treasury issues, it will convert all or part of these liquid assets into Treasury paper, thereby reducing its potential for future credit expansion. If, however, it does not now have adequate excess reserves it will be forced to curtail present loan operations, or to borrow at the Bank of France, possibly at "penalty" discount rates. Borrowing from the Bank of France will of course be inflationary, but penalty rates, if they are operative, should have some restraining influence.

A liquidity ratio ("coefficient de liquidité") of 60 per cent between "available assets" and short-term liabilities is also required

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1/ The National Credit Council, created in 1945 to determine French credit policy, which is implemented by the Bank of France, is formally chaired by a Minister appointed by the Government (generally the Finance Minister), although in the case of working decisions it is in fact normally directed by its *ex officio* Vice-President, the Governor of the Bank of France.

in France, but is not generally considered to be restrictive. The banks customarily exceed it be a broad margin, "available assets" being so broadly defined as to include most short-term loans as well as cash.

Belgium — Required secondary reserve ratios in Belgium range from 50 to 65 per cent of total short-term liabilities.1/ Some observers feel these ratios are cyclically perverse, because they provide the Treasury with more bank financing in a period of boom than in one of deflation, (in which bank deposits tend to rise more slowly, if at all); they thus enlarge the possibilities of debt monetization. The commercial banks argue, for their part, that in view of the very high present ratios they are left with a rather limited margin of "free" loan or investment funds available for private loans and investments. One suggestion is that legislation should be enacted to apply the Treasury security ratios only to existing deposits, new bank deposits being made subject to cash reserve ratios only (as in the United States), or to much lower secondary ratios.

The Netherlands — The Netherlands Bank also has power to impose liquidity ratios (consisting of short-term Treasury paper chiefly, but including also cash and eligible private paper) of from 30 to 45 per cent of banking short-term liabilities. The opinion has been expressed in the Netherlands that these ratios would be difficult to administer, and might have an uneven and inequitable impact upon individual banks. There is some fear that significant conflict between Treasury and monetary objectives might arise in the Netherlands if such ratios were adopted.

1/ Secondary reserve requirements were introduced in February 1946 and modified in October 1949. The banks are divided into four general groups: large banks, average-size banks, specialized banks, and regional and small banks. The present ratios for each class of bank are as follows: (1) government security ratios ("coefficients de couverture"), 65, 60, 50, and 50 per cent, respectively of total short-term liabilities of the bank; (2) capital ratios ("coefficients de solvabilité"), establishing the ratio of total capital accounts to total liabilities, 5, 7, 10, and 10 per cent, respectively. The cash ratio of 4 per cent, referred to above, is now uniform for all banks, although when first established in 1946 it varied according to class of bank.

Selective Techniques

Selective credit controls supplement informal techniques of "moral suasion," and are particularly important in France. The Bank of France establishes discount "ceilings," and also has the power of veto over all individual loans made by the banks which would give their clients outstanding credits of 500 million French francs or over. Moreover, acting for the National Credit Council it establishes the minimum downpayment (raised in July 1956 from 20 to 25 per cent of the purchase price) and the maximum length of credit (currently 18 months) on consumer instalment loans made by French financial institutions.

Selective credit controls by the Belgian National Bank are limited to the Bank's treatment of discount applications.

The Netherlands Bank has the broadest selective powers of the three, and probably makes the least use of them. The Netherlands Bank has the power to establish (after consultation with the banks) credit "ceilings" for the banks individually, as well as limits on particular types of credit; however, it has not thus far taken formal action along either of these lines. The technique of voluntary bank restraint (when needed) on credit, based upon consultation between the Netherlands Bank and the commercial banks, and the use of general quantitative credit controls, appears to be preferred.

French use of selective techniques

Since 1948, all bank loans which would give any client total access to bank credit of 500 million francs or over have been subject to approval of the Bank of France. In deciding whether to grant approval of specific loan or rediscount requests, the Bank of France (or one of its branches, depending on the size of the loan) examines: (a) detailed summaries (in some cases 15 to 20 pages long) on the operations of the borrowing firm, giving such information as its financial statement and profit prospects, the breakdown of its debtors and holdings of securities, and the purpose of the proposed loan or discount; (b) the history of the lending bank, including its financial statement and past lending record, especially the extent to which it has cooperated with the Bank of France; (c) the general needs of credit policy itself, with approvals presumably being made on a more selective basis in a period of inflation than in a period of deflation, although statistical evidence of this is never made available publicly; and (d) on occasion, the growth prospects of the industry itself within the French economy, preference given credits to "productive" sectors of the economy.

The Bank of France establishes discount ceilings both for each bank individually and for the banking system as a whole. As pointed out earlier, certain medium-term bank credits have been specifically excluded from these ceilings, in order to raise the supply of business investment and housing financing. Moreover, discounting of other credits above the established ceilings is also possible, but at a rate entailing a penalty of $1\frac{1}{2}$ to 2 per cent. In 1951 and early 1952, there was considerable discounting at the Bank of France at the penalty rate. From 1953 through 1955, the liquidity of the commercial banks was sufficient, due largely to the heavy influx of gold and dollar reserves, to make such penalty discounting unnecessary. Lately in 1956, some bank rediscounting at penalty rates once more has been reported to have occurred, and the July 1956 increase in the Treasury bill "floor" seems likely further to increase such discounts at the Bank of France as well as discounts of medium-term credits above the ceiling.

The Bank of France can refuse discount credit without giving reasons, even if the commercial paper is entirely "sound," and the bank well within the limits of the rediscount ceiling; and it can also refuse to authorize large bank loans which are submitted to it for prior authorization. It is, therefore, in a position to influence the rate of growth of individual segments of the economy. In consequence, it presumably could help weed out "dead" sectors, and foster the growth of highly productive sectors. The extent to which the Bank actually utilizes its selective powers for this purpose is not known.

The more limited use of selective powers by the Belgian National Bank

Selectivity in the Central Bank's handling of discount applications is somewhat less significant as a tool of monetary policy in Belgium than in France. First, a smaller proportion of total outstanding credit is discounted at the Central Bank in Belgium than is the case in France, because it is the practice of the Belgian banks to remain out of debt to the greatest possible extent. As a result, a smaller share of total outstanding bank credits come individually to the attention of the Central Bank. Moreover, there is no provision (as in France) that large bank loans be submitted to the Central Bank for prior authorization, and no provision is made for discount ceilings. However, the Bank can vary the terms on which it will guarantee its readiness to discount external trade bills under the "visa system," a limited instrument of selective credit control, of which increased use has been made since 1947.[1] In general, these terms have been made more restrictive when the discount rate was increased (as in September 1950 and August 1955), and have been eased when the rate was lowered.

Since 1950, the National Bank has also varied the length of internal drafts eligible for rediscount.[2] Variations have been made for different purposes: e.g. to aid depressed industries (leather and

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1/ The technique of the "visa," whereby the National Bank (or the IRG—Rediscount and Guaranty Institute—which rediscounts paper of more than 3 months' maturity), through its "certification" of a bank acceptance, promises to discount the paper at any time for the lending bank, was inaugurated in April 1945. Partly, the system is a protection to the Belgian trader and lending bank; partly, it supplements the discount rate mechanism, because the terms of the National Bank's "visa" are generally changed at the same time as the discount rate. (The changes in the "visa" terms are not published, however.)

For example, in 1947 the National Bank took measures to counter inflationary pressures and, as foreign exchange was still short, to discourage imports which were not needed for production or for "essential" consumption purposes. Thus, it was made more difficult to obtain a "visa" on credits to finance textile or leather product imports (which could be bought at home), while terms on raw materials import credits continued to be approved.

When the discount rate was raised in 1950, it also became more difficult to obtain a "visa" for imports to build up inventories, or for imports of goods which could be produced at home. The terms were eased selectively in 1954 when the discount rate was lowered; and again tightened in August 1955, when the discount rate was raised.

2/ Before the outbreak of the Korean War, the length of draft on commercial bills was unimportant as long as the bill itself did not come to the National Bank for rediscount before the draft had not more than 120 days to run. Since 1950, a scheme has been in effect stating for each branch of industry the permissible length of the draft—including the period before it was offered to the Bank for rediscount—according to the length of the normal process of production. For some kinds of freight operations, for instance, credit is not extended for more than 30 days; for more complicated transactions, (e.g. manufacture of equipment), credit might be extended for 120 days. On occasion, changes have been made in these periods. Such changes were not always timed to correspond with rate changes; at times they have been decided upon for reasons other than general credit control. For example, on some occasions they have been lengthened when depressed industries needed help (as in the case of textile and leather processing in 1955).

textiles in 1955); and to put a brake on excessive growth of inventories when necessary (processing of coffee and wool imports in 1950-51).

Moral Suasion

"Moral suasion" may be applied in public statements and informal meetings with bankers' committees, in personal letters from the Central Bank to the banks, or by means of "gentlemen's agreements." Informal credit mechanisms may be effective because of the personal prestige of the central bankers, the degree of concentration of banking, and the close associations throughout the banking community. They are reinforced by the possibility of discrimination by the Central Bank, in its treatment of loan or discount applications, against a single bank which fails to cooperate with it; and also by the spectre of unused direct central banking controls.

France — Practically, the Bank of France has considerable influence arising from the strategic position of its Governor, both on the Council and in the banking community, and from the Bank's day-to-day contacts with the money market and with individual bankers. However, it has no power to institute or authorize major policy decisions, such as changes in the discount rate or the Treasury bill "floors," which must be made by the National Credit Council. Such decisions are taken jointly by the Treasury, the Bank of France, and other groups represented on the Council, most of whose representatives are appointed by government Ministers.

Moral suasion has been especially important in France in view of the obstacles to effective use of more formal techniques—namely, the factors which limit the Bank's powers or the effectiveness of their use. Such factors include the limited and one-sided effectiveness of open-market operations, and the various "escape valves" earlier noted, such as the possibility of large discounting of certain types of medium-term paper without reference to the "ceilings" on rediscounts.

Given these facts, the volume of bank credit can rise sharply, even if the Bank of France is attempting, under its authorized powers, to restrain bank borrowing. There have been periods, such as in 1950-51, when the rise in outstanding bank credits appears to have been excessive; and the recent sharp rise in 1956 in bank discounts of medium-term paper may present a threat for the future, should the banks continue to mobilize such paper at the same rate as in recent months.

To deal with this threat, the Governor, as acting chairman of the National Credit Council, may write formal advisory letters to the big banks; however, he sometimes prefers (as in 1955) to hold informal discussions, in his capacity as Governor, with the managers of the ten or so largest banks which set the pattern for the private banking system as a whole.

The Governor's personal requests, such as the one made of the banks in 1955 (and again in 1956) to review carefully consumer credits and certain inventory and import credits, and other "non-productive" loans, in fact have some "teeth" in them; and therefore they operate selectively to restrain certain types of bank credits.[1/] Branches of the Bank of France, with detailed knowledge of the loan operations and the financial position of individual banks, report periodically to the Governor on how closely his requests are being followed. In passing upon large bank credits, the Bank of France strongly considers the bank's financial and lending record and its degree of prior cooperation with the Governor's policy requests.

Switzerland — It is also clearly understood in Switzerland, where the level of discounting is in any case low, that the right of a bank to discount at the Swiss National Bank is not automatic or to be taken for granted. If the Bank at any time believed that its discount funds were being used for long-term credits or speculative activity, or to excess for any purpose, the discount paper might be more closely scrutinized and perhaps refused.

The Netherlands — In 1955, the Netherlands credit control largely took the form—as in France—of informal advice, rather than of formal monetary action, such as was taken later, in early 1956. In the first half of 1955, the Netherlands Bank merely studied credit control problems. In the last half of the year, informal bankers' meetings were held, and the banks were then requested:

(1) To refrain wherever possible from consumer instalment financing, either directly or indirectly through short-term credits to specialized finance companies. The banks were told that these companies should obtain the needed funds through the long-term capital market.

(2) To extend only bona fide short-term business credits, and to examine carefully all business loan requests and the structure of business investment financing. Business firms were to be urged to repay any bank credits that were directly or indirectly financing long-term investment needs, and to finance such investments through the private

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1/ Similar "advice" has been given the banks in earlier post-war years as, for instance, in 1948-49, when the Bank of France noticed speculative activity (in wine, wool and sheepskins, cotton, and leather industries), and requested the banks to exercise "great caution" in granting credits to such industries, hoping to force goods on the market and therefore bring down prices; in that instance the advice was believed to have limited effectiveness. Later in 1951, the banks were in a number of cases advised to reduce or even refuse accommodation, especially where there was evidence that bank credit had been used to hold stocks in anticipation of even higher future prices (e.g. sugar, flour, textiles). Such "moral suasion" was more effective when supplemented by other controls, especially those imposed after the general post-Korean boom (as, for instance, in October 1951).

capital market. These efforts to induce consolidation (via the capital market) of short- into long-term financing coincided with the ban on foreign loan flotations, imposed in the fall of 1955. They doubtless contributed, in the last quarter of 1955, to the large rise in bond issues floated both by industrial enterprises and sales finance companies.

Central Bank Intervention in the Foreign Exchange and Capital Markets

The monetary authorities of European economies must closely watch the external balance of their country, and changes in the level of its gold and foreign exchange reserves. Their attitude toward movements of capital into or out of the country is influenced both by these external factors and by internal monetary considerations. The initiative in private foreign loan operations normally comes from the private bankers themselves, but the Central Bank helps to shape policy on such operations, and to integrate it with prevailing domestic monetary and fiscal policies.

The position of a postwar capital-lending country: Switzerland

Swiss authorities state that the tenet of internal financial stability requires them to help the banks, via external loans, to drain off surplus Swiss savings and net inflows of foreign short-term capital. Otherwise, excess bank reserves would build up, and their use might contribute to speculation in real estate or inventories, or to an excessive rise in Swiss bond or stock prices. However, the authorities do not want the flow of funds abroad to become so large that the domestic money and capital markets would be excessively tight. Thus, for the Swiss, controlled foreign lending is a primary instrument of monetary policy.

Because of these considerations, all foreign loans of 10 million Swiss francs (about $2.5 million) or over must be submitted to the Swiss National Bank for approval. The banks themselves each year jointly establish informal foreign-loan ceilings, both globally and by countries, with a view to preventing disruption of the capital market; and they conduct loan negotiations and arrange loan terms within the limits of these informal arrangements. Because of this self-restraint of the private banks, the Swiss National Bank reports that until now it has been able to approve virtually all foreign loan requests. However, since mid-1955, when the money market tightened somewhat, the Bank apparently has introduced a slight "nuance" or shading of its prior policy; while still approving the loans almost automatically, it has given the private bankers specifically to understand that they will be subject to criticism if foreign lending becomes too heavy. At all times, the loan requests have also had to be submitted to the Federal Government offices in Berne.

The National Bank has attempted to discourage "hot money" inflows of capital, which move chiefly for the purpose of avoiding local taxes and restrictions, and against which a high degree of liquidity must be maintained. In June 1955, the Swiss banks agreed to charge a commission on new foreign deposits, and to make such deposits no longer payable upon demand. The banks also agreed not to place such funds in real estate or the stock market. These measures are believed to have had some salutary effect.

The position of a postwar capital-receiving country: France

The French authorities have been faced with the opposite problem of preventing "hot money" outflows, and their adverse effects upon the reserve position of the banks and the national reserves of gold and foreign exchange. In 1948, the French legalized operations in the gold market. Since that time, traders' profits on such operations have been reduced progressively as the premium prices paid for gold bars and coins fell relative to the official rate for the French franc in terms of gold (except for periods of political or economic uncertainty such as have occurred since the fall of 1955). This freeing of the Paris gold market is believed to have restrained short-term capital outflow from France, because current and prospective profits from such gold transactions were reduced and because the action probably helped increase confidence in the French franc at that time.

Because of the concern over French reserves and the level of external debt, prospective foreign loans and foreign borrowings by French nationals must be approved by the Bank of France. Even in 1954, when the balance of payments strengthened, French private firms (with a few exceptions) were not authorized to seek long-term funds in the Swiss capital market or elsewhere abroad. On the contrary, while reserves were rising the Bank of France encouraged reduction both of public and private indebtedness abroad. French debt repayment in 1954 and 1955 has to some extent been motivated by a desire to limit the expansion of bank liquidity resulting from the large increase in French gold and foreign exchange reserves in those years; it was of course desired also as an end in itself.

Because of its improved reserve position in 1954 and 1955, the Bank of France in those years authorized some increase in French direct private investments abroad. Aware that requests were more likely to be approved, private business firms began to submit a greater number of requests to the Bank for clearance than in earlier periods. However, the requests were "screened" carefully on the basis of detailed submissions with respect to the nature of the business, its financial structure and profits and growth prospects, its probable future competitive status in world markets, and so on. Among other things, consideration was given to whether the projected investment would ultimately improve the French external balance.

Countries with a variable external balance: the Netherlands and Belgium

The Netherlands — The Netherlands Bank, while leaving the entire initiative and final settlement of loan terms to the private banks, has required that it be consulted on all prospective foreign bank loans of one year's duration or over, and on all foreign capital flotations on the Amsterdam market.

Lending abroad by Dutch interests was actively encouraged by the Netherlands Bank in the last half of 1954 and the first half of 1955, both to help the Amsterdam banking community restore its prewar position in the international capital markets and to utilize reserves created by the external trade surplus and the heavy purchase by foreigners (especially by residents of the United States) of Dutch international securities, such as Royal Dutch Shell and Philips.

Thus, foreign lending policy reinforced the limited open-market policy, the one utilizing surplus liquidity and re-channeling it abroad in the interests of overall European development and trade, the other "neutralizing" the remainder. Especially in 1955, when open-market sales by the Netherlands Bank were small, foreign loans by Dutch banks, and foreign offerings on the Amsterdam market, helped to tighten the money market. The redemption of the Netherlands' dollar debts and its debt to the International Bank was also accelerated in this period.

At the same time, it was recognized that external loans would result in structural improvement in the balance of payments, raising income from foreign investments. In addition, almost all loans granted at that time reduced "frozen" EPU claims of the Netherlands. A Netherlands observer has pointed out that to the extent that new loans by the Dutch replaced credits outstanding in EPU, the Dutch had been enabled to "choose their own debtors." Moreover, the rate of interest was higher on such loans than on the EPU balance.1/ Trade considerations affecting Dutch exports also were often involved in the loan negotiations.

The Netherlands Bank may sometimes influence or offer advice on the lending terms or the rate of interest; in several cases the suggestion was made to the investment banks handling loan flotations on the Amsterdam market that perhaps the proposed rates were "too low." These restrictions or suggestions are probably less burdensome to the investment bankers than they might appear to be; the intervention of the Bank in the loan negotiations may strengthen the bargaining position of the Netherlands banker (who probably has to deal not only with a private foreign banker but also with the foreign Central Bank and/or Government involved), and enables him to be both more selective and more firm in his demand, for example, for a higher interest rate on the proposed new flotation.

1/ "Economic Survey," Quarterly Review of the Nederlandsche Handel-Maatschappij, N.V., Number 2, 1955, p. 9.

Netherlands investment bankers emphasize the very limited capacity of the Netherlands market to absorb foreign issues. For one thing, the supply of Dutch domestic savings, although growing, still remains small in terms of European capital needs. For another, many institutional investors are bound by legal provisions not to hold more than a specified proportion of their investment portfolio in foreign issues, and individual investors still have reservations about holding too large a proportion of their savings in this form. Despite these limitations, all foreign bond flotations quoted in Netherlands currency have been highly successful. The present ban on foreign loan flotations (which has been extended into the summer of 1956, thus keeping it in effect for a longer period than was originally expected) is still believed to be temporary, and bankers continue to seek out good prospects for foreign issues to be offered on the Amsterdam market when internal market conditions again permit, and the ban is lifted.

Belgium — In Belgium, the question of how to handle, or time, large foreign bond flotations (other than those of the Congo) seldom, if ever, arises, mainly because of the comparatively high long-term interest rates, and also the fact that available domestic capital finds satisfactory outlets in attractive investment opportunities in the Belgian Congo.

The monetary effects of external surpluses and deficits therefore tend to be neutralized in other ways. Large Belgian EPU surpluses in 1951-52, for example (partially offset by Belgian deficits with the dollar area), tended to create an undesired expansion of bank reserves; these were in part sterilized through National Bank "blocking" (for a specified period of time) of certain proportions of the proceeds of Belgian exports to the EPU area. The latter was also intended to discourage exports. The blockings attained a level of 4.5 billion BF ($90 million) in June 1952. During the same period, the terms under which the National Bank would certify for discount bank acceptances to finance exports to EPU countries were drastically tightened.

The Belgian structural trade surpluses with other EPU nations were subsequently reduced, and Belgium's dollar position gradually improved. By late 1955, the Bank's heavily rising reserves both of gold and of convertible currencies—rather than, as in the past, the surplus with EPU alone—were believed to be threatening monetary stability through their expansive effect on bank reserves. Accordingly, in late 1955 and 1956, the National Bank sold in the "financial" (or "free") market dollars and convertible currencies accrued from commercial sources, thereby reducing "free market" rates applicable to capital transactions, and thus facilitating Belgian capital exports abroad.

Rising Belgian capital exports take the form mainly of purchases of outstanding American and other foreign bonds and shares (often through the medium of special investment funds established by Belgian banks), rather than of new offerings on the Brussels market.

Conclusion

Increasingly, monetary techniques have been used to help dampen economic fluctuations in Western Europe, but are still being sharpened and re-defined both by law and by actual practice. They appear to have contributed to financial stability and to the development of savings and capital markets; in certain cases their application has met with dramatic success. The rapid improvement in the Netherlands' external balance and its gold and foreign exchange position and the great widening of the Amsterdam capital market, following introduction of monetary restraint in 1951-53, is an often-cited example.

The relationship between external and internal stability, which the monetary authorities closely watch in all countries, is unusually changeable and direct in the "open" economies, heavily dependent upon world trade. In such countries, the Central Banks must be on the watch for two difficult and volatile situations which may occur at the same time. First, any serious external disturbances—such as inflationary developments abroad, unsettling capital flows, or sharp changes in the terms of trade—are quickly transmitted to the internal economy and the effects must be mitigated by the monetary authorities. Secondly, the development of any internal imbalance, too, may induce capital, payments, or trade shifts, which may, within a matter of weeks, endanger gold and foreign exchange reserves and ultimately the basic trade position itself.

Therefore, the "safety margin" within which errors of judgment in financial policy, affecting external reserves or internal prices, can be made without serious consequences is small. Moreover, the relatively inflexible and cumbersome tax structures in countries such as France and Belgium make an effective counter-cyclical fiscal policy difficult or impossible, thereby tending to make the Central Bank feel a further burden of responsibility.

On the other hand, it is clear that the European Central Banks, discussed in this paper, derive strength from the comparatively small size and intimacy of the financial community.

It is a striking fact that money and capital markets in the countries reviewed in this paper are usually sensitive to restrictive monetary action, however slight, as for instance last year's $\frac{1}{4}$ per cent "precautionary" rise in the Belgian bank rate, or the mere suggestion in Switzerland that coercive measures might be introduced if entirely voluntary agreements failed to be effective.

The important intra-European implications of stronger and somewhat more unified monetary policies are intangible, and more difficult to define. It may be argued that more widespread and more rapid use of flexible monetary policies throughout Western Europe, along with the gradual removal of direct controls, may be indirectly contributing to greater financial integration. The flow of capital from one country to another in response to basic investment needs, as measured by interest rate differentials based more genuinely upon market forces, has been facilitated. Further stimulated by the progressive relaxation of exchange restrictions, the freer and more responsive intra-European capital flow has in turn itself added to the interaction and coordination of monetary policies throughout the area.