France's experience of exchange controls and liberalisation

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This paper reviews the foundations and performance of the French policy of capital account liberalisation. It also attempts to illustrate the lessons China may draw from this experience.

1. A brief history of foreign exchange controls in France

France's economic history since the Second World War and, in particular, its capital account control history, can be roughly divided into two distinct periods.

1.1 The first period: World War II to 1983

The first period lasted until the mid-1980s and featured an economic management style that suited France's relatively closed, protected and regulated economy. Monetary policymaking in this period was based on quantitative credit controls and strict foreign exchange controls.

Current account and capital flows were regulated most of the time, with additional restrictions, mainly concerning current account transactions, being frequently implemented following exogenous shocks, which were sometimes symmetrical and sometimes asymmetrical:

– In December 1958, payments related to current account transactions were liberalised; at that time, foreign exchange controls were exclusively focused on capital flows.

– After a brief period of abolition of control measures in 1966, the political crisis in May 1968 led to a re-establishment of regulations on payments related to current account transactions.

– Exchange rate controls were at their tightest in March 1983 after speculative attacks against the exchange rate and three devaluations of the French franc inside the EMS exchange rate mechanism (ERM) in 18 months; measures intended to prevent evasion via the use of leads and lags in current account transactions and to prohibit all forward exchange transactions by importers and exporters were introduced; drastic curtailments in foreign travel allowances were also implemented.

The explanation for this situation can be found in some of the distinctive features of the French economy in the 1970s and early 1980s:

– The slow adjustment of the French economy to the two oil shocks created a persistent current account deficit and spurred the French authorities to use foreign exchange controls to protect the French franc against speculation.

– Credit ceilings were inevitable so long as French interest rates were held down to artificially low levels.

– This policy of low interest rates was necessary because of the poor financial situation of French firms up until the mid-1980s.

1.2 The second period: 1984 to 1990

The second period started in 1984 when the situation of French firms and of the French balance of payments began gradually to improve. Regulations, notably foreign exchange regulations, were dismantled progressively in the second part of the 1980s at a time when hard policy choices had to be made to improve macroeconomic fundamentals. Foreign exchange controls, which had been in force for almost 50 years, were totally dismantled in six years. The liberalisation process ended with a decree in December 1989 to abolish all remaining foreign exchange controls. The process was carefully sequenced in three steps.

In the first step, trade-related operations were gradually liberalised from 1984 to 1986. Notably, in 1986, currency hedging for foreign currency denominated imports was totally liberalised and the administrative control of trade transactions was definitively removed.

In a second step, from 1986 onwards, most financial transactions were allowed:

(i) In 1986, French residents - households, corporations, banks - were allowed to buy freely shares listed on foreign markets.

(ii) French banks were also authorised in 1986 to lend in francs to non-residents within a ceiling defined by the outstanding balances of non-resident deposits on their balance sheets.

(iii) Corporations and households were allowed in 1987 to borrow in foreign currencies and also in francs abroad within a FRF 50 million ceiling, which was also abolished in 1988.

(iv) Direct investment abroad was also gradually liberalised: the acquisition of foreign real estate by French residents was fully liberalised in 1986; control of foreign investment abroad by French firms was relaxed progressively; in 1986, only investments in holding corporations and foreign direct investment in France were still subject to prior authorisation from the Treasury (the ceilings above which interest-taking by non-EU resident companies was subject to administrative authorisation were removed).

The last step, from 1988 to 1990, was mainly dedicated to the phasing-out of the remaining controls:

(i) Residents were allowed in 1989 to freely open and keep foreign currency denominated accounts in France and foreign currency and franc-denominated accounts abroad.

(ii) In 1989, lending in francs by French banks to non-residents was also totally liberalised.

(iii) All remaining administrative restrictions regarding foreign direct investment in France were also phased out.

2. The importance of a consistent economic and financial framework

To succeed, capital account liberalisation has to be part of a consistent economic and financial framework and to be sequenced carefully. Capital account liberalisation in France was envisaged, from the start, as part of an all-encompassing process.

2.1 Capital account liberalisation as part of a sound economic policy framework

Monetary policy played a leading role by providing economic agents with a solid anti-inflationary anchor. Since 1979, France had been part of the ERM. That implied a commitment on its part to keep the franc’s fluctuations vis-à-vis the other currencies in the system within a range relative to their central rates. This commitment acted as a very powerful constraint on economic and monetary policy. However, the central rate between the franc and the Deutsche mark had to be readjusted on six occasions between 1979 and January 1987, evidencing, inter alia, the growing ineffectiveness of foreign exchange controls.

Foreign exchange controls can only help to delay an unavoidable readjustment of the exchange rate. Moreover, such controls entail heavy administrative costs. Also, exchange role controls do not ensure a level playing field between banks or firms: big banks and/or firms, arguing that they suffered a competitive loss vis-à-vis their foreign competitors, were awarded derogations whereas small banks/firms were subject to the normal regime. Finally, financial innovation undermines foreign exchange controls as it complicates the assessment of its observance and facilitates its avoidance.

A more coherent and stringent policy mix and subsequent successes in the fight against inflation gradually worked to strengthen the external credibility of the franc.

Indeed, monetary policy became part of a consistent economic policy framework in which fiscal policy and wage cost moderation converged towards the goal of curbing inflation. Accordingly, from 1983 till the beginning of the 1990s, France ran a tight fiscal policy in general which helped to forestall any additional shortfall in public saving. Furthermore, the mechanisms of wage formation were modified: wages were no longer linked to past inflation but to an official norm for the expected rate of price increase. This disindexation led to a distribution of value added more favourable to firms, enabling them to cope with the consequences of the anti-inflationary stance of monetary policy, which led to an increase in real interest rates with the abolition of subsidised loans.

Therefore, on the domestic scene, economic agents steadily incorporated the authorities' resolve to maintain the stability of the currency in their expectations. This provided them with a solid anti-inflationary anchor as they could no longer rely on currency depreciation to maintain or to increase their competitiveness.

In turn, this increased credibility of economic policy minimised the risks of foreign exchange liberalisation which could have otherwise contributed to draining official reserves.

2.2 Capital account liberalisation as part of the financial policy framework

Tight economic management is all the more sustainable and credible, moreover, if economic agents are willing and able to adjust to the new environment. So there is also a need for policies to hasten the modernisation of supply in keeping with a sound macroeconomic management. Essentially, these policies seek to inject a healthy competitive climate where most needed and, simultaneously, to promote the development of rational resource allocation. Therefore, a comprehensive package of liberalisation measures was implemented to adapt France's financial markets to the reality of an open world economy and the general move towards financial deregulation and globalisation and to promote financial sector stability.

At the beginning of the 1980s, the French financial system presented three main characteristics:

(i) bank financing predominated, given the low profitability of firms and consequently their poor cash flow, the weak development of financial markets and the important role of subsidised loans;

(ii) the distribution of credit was closely monitored by the monetary authorities;

(iii) these authorities also kept under close control the distribution of credit and financial transactions with the rest of the world.

The cons of this regime of administrative financing became more and more apparent: permissiveness as regards inflation, excessive cost of bank financing, and suboptimality of the allocation of financial resources. Moreover, financial markets were unable to respond to growing borrowing needs by the central government and by corporations. These growing needs required the introduction of new types of securities whose characteristics would attract resident and non-resident investors alike and would limit the management cost of the debts induced by the increase in interest rates.

The mid-1980s saw many momentous changes in the environment and in the organisation of the French capital markets as well as the development of financial innovation. A regulated derivatives market was created in 1985. The French government securities market was overhauled, with issues covering the full range of maturities, new issuing procedures and the selection of primary dealers. The money market was also fully reorganised into two compartments, one for interbank transactions, and the other open to all borrowers and investors on which short-term instruments are traded. Moreover, the development of money market funds (MMFs) gave non-financial agents easy access to money market-related remuneration for their liquid assets.

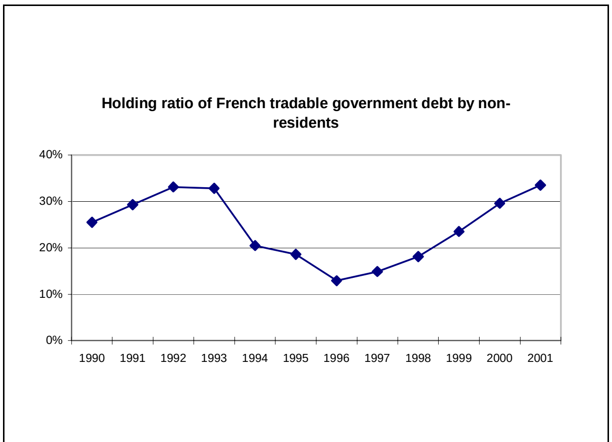
The banking system was liberalised and banking supervision was rendered more effective in keeping with increased competition among banks and with the gradual liberalisation of capital flows. The 1984 banking law promoted the regulatory harmonisation of credit institutions and banking deregulation. State-owned banks were privatised from 1986 onwards. In 1989, the control of the aggregate foreign exchange position of commercial banks was abolished and replaced by prudential regulations. The prudential framework derived from the decisions taken by the Basel Committee was progressively implemented.

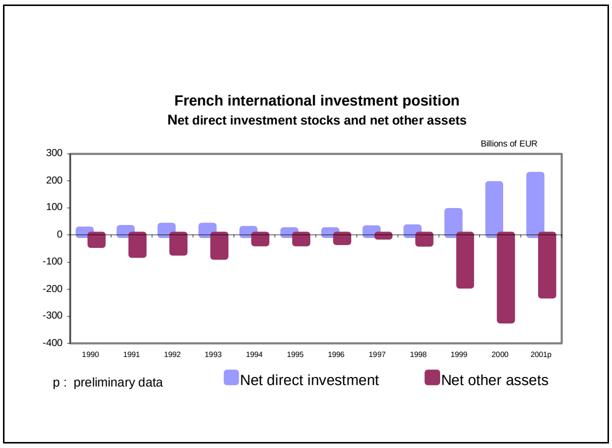
In turn, the enhanced credibility of the policy mix, together with the development of large and efficient financial markets, prevented the risk of a massive portfolio reallocation in favour of foreign financial assets following the liberalisation of capital controls and the subsequent relaxation of regulations restricting currency mismatches on institutional investors' balance sheets concerning inter alia insurance companies.

Capital flows (in billions of euros)					
	1980	**1985**	**1989**	**1991**	**2001**
Financial account	**1.24**	**–0.36**	**10.18**	**1.71**	**–27.50**
of which					
Direct investment	0.12	0.49	–8.35	–7.09	–33.74
French abroad	*–2.00*	*–3.07*	*–17.70*	*–19.31*	*–92.55*
Foreign in France	*2.11*	*3.56*	*9.35*	*12.23*	*58.81*
Portfolio investment	0.19	8.88	23.05	11.47	20.99
By residents in securities issued by non-residents	*–1.33*	*–3.38*	*–6.04*	*–12.37*	*–93.02*
By non-residents in securities issued by residents	*1.53*	*12.26*	*29.08*	*23.84*	*114.01*
(Net errors and omissions)	**(1.46)**	**(0.40)**	**(–5.75)**	**(3.57)**	**(4.08)**

Source: Bank of France

In the aftermath of the removal of capital controls, the increase in net capital outflows by French residents (in particular, direct investments abroad) was more than offset by the surge in foreign capital inflows, essentially the purchase of French securities by non-residents. In particular, the aforementioned reforms in the functioning of the public debt market led to growing investment in French government securities (bonds, bills and notes) by non-residents.[1] The holding ratio of marketable French government debt by non-residents, almost insignificant in the 1970s, peaked at 35% at the end of 1992 (33.5% at end-2001).





As regards the French international investment position, the global balance did not show diverging trends between the net direct investment stocks (IIP signs) and the net position for other assets and liabilities during the major part of the 1990s. It is only at the very end of the 1990s that the figures for the net direct investment stocks became increasingly positive because of the growing number of operations by French companies, and the other assets and liabilities increasingly negative. However, these two phenomena can be partly related: the outflows of direct investment have been financed by growing foreign currency debts, either in the form of securities issued by investors or via the resident banks borrowing from their non-resident correspondents.

[1] The government is a major player on the Paris bond markets, representing 57% of gross bond issues compared to 23.5% for banks and financial institutions and 12% for firms.

2.3 A careful sequencing

The French experience could almost be analysed as a classical textbook case concerning the pace of the liberalisation of foreign exchange controls:

(i) The liberalisation of current account transactions has to go hand in hand with or, preferably, to be preceded by reforms aiming at strengthening the real sector and the competitiveness of the real economy.

(ii) These reforms will also help the economy to withstand the liberalisation of inward foreign investment.

(iii) Liberalisation of portfolio capital flows has to be coordinated with domestic banking sector strengthening and liberalisation, as well as with the development of efficient financial markets so as to broaden the ranges of financing and investment instruments available, and with the improvement of banking supervision and financial discipline.

(iv) These reforms have an impact on monetary policymaking, which has evolved into an interest rate-based monetary policy. Consequently, the effects of monetary policy are no longer transmitted via financial intermediaries alone. They are propagated throughout the financial markets and affect the behaviour of economic agents via their portfolio choices. This makes the task of gauging the impact of interest rate changes on consumption and investment more complex.

3. Conclusions

Admittedly, the precise operational sequencing of capital account liberalisation depends on the nature of the controls that are being liberalised, the objective of the reforms and the starting position of the country.

However, three main conclusions and issues seem to stand out from this overview of the foundations and performance of the French policy of capital account liberalisation:

(i) the need to enhance the capacity - in terms of soundness of balance sheets but also of accounting procedures, prudential regulation and supervision - of the real and of the financial sector to manage the risks associated with capital flows prior to the liberalisation process;

(ii) the need to coordinate all economic policies towards this goal;

(iii) the key role of the choice of an appropriate exchange rate regime and nominal anchor for monetary policy consistent with medium-term economic fundamentals and therefore conducive to a stabilisation of expectations.

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