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ECONOMIC POLICIES AND PRACTICES

[redacted]

Joint Economic Committee

Paper No. 3

A DESCRIPTION AND ANALYSIS OF CERTAIN EUROPEAN CAPITAL MARKETS

MATERIALS PREPARED FOR THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

Prepared for the use of the Joint Economic Committee

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LETTERS OF TRANSMITTAL

JANUARY 20, 1964.

To Members of the Joint Economic Committee:

Transmitted herewith is a detailed description and analysis of a number of European capital markets. This is one of a series of studies being issued as aids to an increased understanding of economic policies and institutions in the various industrial countries, and of their international implications. No precise pattern will be followed in the series. I believe however that, by making data more readily available for a comparison of national policies and practices in various areas, members of the Committee, other Members of Congress, and the general U.S. reader will be aided in understanding economic problems within the framework of the enterprise and free market "rules of the game" as practiced by the leading industrial nations.

The study was prepared at the Joint Economic Committee's request by the staff of the Treasury Department, particularly the Offices of International Affairs, Financial Analysis, and Debt Analysis. The Committee very much appreciates the cooperation of Secretary Dillon, Under Secretary Roosa, and the staff of the Treasury Department.

Faithfully,

PAUL H. DOUGLAS, *Chairman.*

THE SECRETARY OF THE TREASURY,
Washington, D.C., December 31, 1963.

Hon. PAUL H. DOUGLAS,
Chairman, Joint Economic Committee,
Congress of the United States, Washington, D.C.

DEAR MR. CHAIRMAN: Pursuant to the request made by the Joint Economic Committee during its hearings held on July 8 and 9, 1963, I am pleased to transmit herewith a description and analysis of certain European capital markets.

Sincerely yours,

(Signed) DOUGLAS DILLON.

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FOREWORD

The immediate occasion for this study was a request of the Joint Economic Committee for a description and analysis of European capital markets. While the status and evolution of the major capital markets of Europe have been matters of close and continuing interest to the Treasury Department for some time, no summary analysis of these markets had been available either for our own use or for that of a wider audience. Consequently, the request of the Committee was most welcome, for the preparation of this report has not only added to our own understanding of the functioning of these markets and the prospects for their future development, but may also provide a useful starting point for further studies by the Congress and other interested observers in the United States.

Most of the data and descriptive analyses in the study have been drawn from official documents of European governments or other published accounts, and have previously been available to students of these markets. The major contribution of this study therefore lies not in developing new information, but in distilling the great variety of material already available on European capital markets into a more relevant form for an American understanding of their functioning and development.

An attempt has been made to point up similarities and contrasts among the capital markets of the major European countries and to suggest the implications of their performance for international as well as domestic flows of medium- and long-term funds. Overall patterns of savings and investment, the forces affecting the supply of and the demand for capital, and institutional structure of the European capital markets are each dealt with in turn.

While broadly conceived, this study cannot be considered comprehensive or definitive for the specialist on particular aspects of European markets. Limitations of time and availability of staff have, for instance, made it impossible to study all of the more important capital markets of Europe; the omission from the study of the rather well developed market in the Netherlands and the restriction of the chapter on Switzerland to a few notes on foreign lending are particularly regrettable. Moreover, the study deals with markets which are beginning to change in important respects under the pressure of needs and events. Even during the months it has taken to prepare this study, there have been a number of changes which could not be fully taken into consideration or properly evaluated. But within these limits, I am confident that the study will make a useful contribution to American knowledge of the long-term capital markets of Europe, and will fill a definite gap in the literature now available on this subject.

While the focus of the study is descriptive and analytical, the performance and prospects of the European capital markets clearly have important policy implications for the United States as well as Europe. The process by which a nation's capital market gathers the funds of savers and distributes these funds among competing investment outlets has a vital bearing upon internal growth and development. And in a world of convertible currencies closely linked by ties of trade and investment, the growth of one nation and the performance of its capital market will inevitably have repercussions upon its trading partners.

The capital markets of Europe, as befits an area which led the world into the industrial revolution and for many years was the principal capital exporter to the rest of the world, are on the whole characterized by a long-established and well developed institutional structure, capable of mobilizing substantial amounts of funds. Moreover, recent years have seen an encouraging growth in the size of these markets in most countries. But, this study also confirms that these markets, taken as a whole, are not as efficient and as effective as they might be, and as they will need to be, to play the role in the financing of European economic growth of which they are potentially capable.

The absence of a fully efficient, diversified, and integrated capital market to serve the needs of Western Europe can clearly be traced to a number of factors—including the limited size of some of the countries within Europe and restrictions on the free flow of investment funds between them, the disturbances of first the 1930's and then World War II, and the abnormal needs and circumstances of postwar reconstruction. Equally clearly, the deficiencies in terms of today's needs and circumstances have been increasingly recognized within Europe, and there are encouraging signs that adjustments are beginning.

During the early postwar years, investment priorities in Europe were clear cut and the urgency and potential profitability of investment in productive facilities was great. Under these conditions, it was possible to draw needed capital into appropriate channels—frequently with the direct intervention of Government—despite inefficiencies and structural impediments in the various capital markets. Moreover, supplementary amounts of capital could be obtained from the United States, first in the form of aid and then increasingly in the form of market borrowings, without straining our balance of payments.

Today the situation is quite different. The enormous growth of Europe has greatly enlarged its savings potential but these potential savings are widely dispersed in the economy of each country. At the same time profit margins have narrowed; businesses that can no longer readily finance their expansion with internally generated funds are now turning more and more to outside sources for the needed financing; and investment priorities are less obvious. Moreover, a tendency to look toward the relatively cheap and large American market for a substantial share of the growing need for investment funds, at a time when Europe was already in balance-of-payments surplus, has concontributed to strains on the entire international payments system. Under these circumstances, the need for an efficient, flexible, and diversified capital market mechanism to assure that the available savings within Europe are effectively utilized for its own development is greatly increased.

This study suggests that a variety of factors have combined to limit the efficiency and growth of European capital markets. The relative importance of these factors clearly varies substantially from country to country, and from this distance it is not always easy to appraise the full significance of one impediment against another. Moreover, it must be recognized that some factors that impede the development of a flexible and diversified capital market may serve other national economic policies, and that measures to improve the market mechanism must, for the country concerned, be evaluated in the light of these other policy objectives. But, amid these complexities, some useful generalizations are possible.

In a number of European countries, for instance, elements in the tax structure have clearly inhibited market financing, raised its cost appreciably, and virtually eliminated some kinds of borrowing. This is perhaps most obvious in the case of an exceptionally high—and for some types of issues almost prohibitory—tax on new securities. In other instances, the methods used to tax interest and dividends are a significant restraining influence on market financing.

Reflecting both the limited amount of market financing in the past as well as the historical pattern of development of particular markets, an effective competitive mechanism for underwriting and economically distributing new issues to a wide range of individuals and savings institutions is lacking in some countries. Further inhibitions on the flow of funds arise from unduly narrow customary or legal restrictions on the kinds of investments that may be made by institutions accounting for an important part of the flow of savings. These restrictions, in turn, are partly a reflection of another characteristic of many European markets—the paucity of reliable and current information on the financial position of borrowers, as well as on the prices and availability of a broad range of outstanding securities.

Finally, governmental policies to direct or influence the flow of credit in the interest of stimulating or restraining activity in particular sectors, or to insulate a domestic market from external influence, have frequently inhibited the development of strong and adaptable markets. Several European countries still strictly control domestic as well as foreign new security issues so that neither borrowers nor lenders are able to negotiate freely on the basis of normal market considerations. A less direct, but perhaps even more pervasive, influence arises from the policies of some governments to direct a large proportion of the available financial resources to selected areas of the economy, sometimes bypassing the normal market mechanism entirely in the process, but in any event sharply reducing the volume of funds free for investment in other areas of the market.

There is much evidence that these problems are now receiving the attention of financial leaders in Europe, and that progress toward improving the efficiency of these markets has begun. The Organization for Economic Cooperation and Development has provided leadership to this effort through its own study and encouragement of ways to liberalize international capital transactions and policies required to strengthen domestic markets. Several possible means of promoting international security issues, thereby broadening the potential market and bringing together larger aggregations of underwriting support and distribution facilities, are being actively explored. In other cases, new initiatives are being taken to eliminate barriers to foreign security offerings and to facilitate the use of the most developed markets within Europe as a kind of financial entrepôt for the use of borrowers and lenders of other nations. Finally, special commissions and other groups in several continental European countries have recently studied these problems and come forward with useful recommendations for strengthening and improving their internal markets.

If this study is successful in contributing to American understanding of the problems and the potential for future development in this complex area, and encourages policies that will facilitate and assist in progress toward realization of this potential, our effort in its preparation will have been amply repaid.

The conclusions and judgments expressed in the study are, of course, solely those of the U.S. Treasury. Most of the actual drafting and statistical analyses were prepared within the Offices of International Affairs, Financial Analysis, and Debt Analysis of this Department, and I would like to acknowledge publicly my appreciation for the energy and enthusiasm with which staff members carried this task to its conclusion on top of their already full schedule of other duties. In addition, this work could not have proceeded without the contribution of officials of U.S. Embassies in the principal European centers, and the cooperation of the Department of State and our Ambassadors is gratefully acknowledged. Officers and staff members of both the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York offered constructive criticism throughout the drafting process, and officials of European central banks were kind enough to review the respective country chapters in an early draft stage. The suggestions and comments received have enabled us to avoid a number of errors and misconceptions.

DOUGLAS DILLON.

DECEMBER 31, 1963.

A DESCRIPTION AND ANALYSIS OF CERTAIN EUROPEAN CAPITAL MARKETS

CHAPTER I

INTRODUCTION

There has been a growing realization that more efficient means of mobilizing and allocating the capital resources of Western Europe must be developed if Europe is to fulfill all of its hopes for continued rapid economic growth in the years ahead. Some countries have recognized the urgency of the problem by undertaking special studies of their own capital market facilities. Throughout the entire European economic and financial community there is awareness of the enlarged role that capital markets will be called upon to play in the future, and a lively interest in plans to insure that European capital markets make a maximum contribution to the achievement of sustained economic growth.

The common interest of the industralized nations of both Europe and North America in encouraging rapid economic growth was formalized at a Ministerial Council meeting of the Organization for Economic Cooperation and Development in December 1961. At that time, the Ministers established a target for growth during the 1960's of 50 percent in the real gross national product of the 20-member countries combined. With the liberalization of trade and invisible transactions in recent years, particularly since the return to external convertibility in Western Europe at the beginning of 1959, growth in individual countries has become much more closely linked with developments in international markets.

The formation of capital—through domestic savings allocated to domestic investment—remains, however, the basic foundation for the economic growth toward which each country is directing its efforts. Coordinated expansion with other countries and markets is greatly to be desired, but the deepening and widening of the capital base at home is an absolute essential. Continued rapid growth in Europe will require enormous amounts of capital, as did the immediate post-World War II reconstruction period and the years of economic progress that have followed; but it cannot, on balance, be imported capital over the years ahead. Indeed, in view of the present and prospective scale of the world's demand for capital, it becomes ever more important that Europe make the most efficient possible use at home and abroad of its capital resources. Both theory and experience suggest that the needed efficiency in the allocation of these resources can best be achieved through the mediation of flexible and fluid internal capital markets.

It was relatively simple for Europe to establish investment priorities during the reconstruction period. The pressing need to rebuild basic industries, to restore transportation facilities, and to provide adequate housing was obvious. Balanced growth in a dynamic economy with high living standards will require more diversified investment and a sensitive responsiveness to changing patterns of private and public demand. Capital must be available on reasonable terms for well-conceived enterprises of promising viability, small and large alike, if growth is to be sustained and initiative encouraged. Balanced growth will require a continuing adaptability in capital market mechanisms and institutions.

That this adaptability is not now present in European capital markets to the degree required for the needs of coming years is largely the result of the powerful external forces that have prevented an orderly evolution during most of the past three decades. Depression, war, and reconstruction operated to separate national capital markets from each other, to dislocate their internal mechanism, and to encourage reliance upon official directives rather than market processes. This has meant that only for a relatively brief recent period has there been the favorable sort of economic environment within which the functions of a free capital market could fully develop. Moreover, it could not be expected that all the changes that are required would occur rapidly and spontaneously in view of the long periods of time for which some capital markets have been subject to rigid direction or characterized by a general lack of scope for free market decisionmaking. Many European observers feel that what is needed is a continuing effort designed to bring the efficiency of individual capital markets more rapidly into correspondence with the requirements of the present situation, and to encourage the closer integration of the operations of the several markets in the future.

A byproduct of adaptable and accessible markets would be improved ability to play a needed role vis-a-vis the developing countries. Government lending and cooperative international efforts can and do provide a basic and indispensable flow of development capital; but there will also be demands which can most reasonably be accommodated in a free capital market. It would be incongruous if the Europe which supplied private risk capital for the development of North America out of the low income levels of the 18th and 19th centuries should fail to make its proportionate contribution to wider reaches of the developing world in the latter third of the 20th century.

Efficient long-term capital markets can assist materially in Europe's achievement of vigorous domestic growth and an optimum scale of external lending. In addition, recent experience suggests that structural deficiencies in world capital markets may be an important contributor to strains that may be placed upon the international payments mechanism. Where access to capital markets is restricted either by governmental regulations or by other institutional factors, net international flows of capital tend to proceed in one direction only—from countries with free and highly developed capital markets to those with narrow, controlled markets—regardless of the balance-of-payments position of the countries concerned. This is not to say that there may not be other important influences operating to affect international capital flows; clearly the coming into being of the

Common Market and the divergence in growth rates and capacity utilization of resources between Europe and North America in recent years, with their concomitant effects on prospects for profit, have been in themselves important determinants of capital flows. Nevertheless, where the legal and institutional restrictions limit the amount of capital funds in a particular market below that which would be available if the market operated with full freedom and efficiency, or where markets are compartmentalized in such a way that interest rates rise to inordinately high levels in a particular sector, the normal marketplace allocation of international capital will be disrupted and the actual directions of flows can be disequilibrating.

During 1962 and the first half of 1963, progress in removing the deficit in the U.S. balance of payments threatened to be delayed beyond prudent limits by rapidly increasing amounts of long-term foreign borrowing on the New York market. The proposed interest equalization tax is designed to moderate those demands during a transitional period while balance is being restored in U.S. external payments. That same transitional period is one in which other industrial countries with balance-of-payments surpluses have an attractive opportunity to expand the scale of their own participation in long-term international lending, since profitable opportunities will emerge as some creditworthy borrowers choose not to use New York facilities. The relaxation of existing European legal and institutional restrictions on lending abroad would be an important factor enabling Europe to resume its historic international lending function. However, any significant expansion in European long-term foreign lending will also require a concerted and imaginative response on the part of the European banking and financial community. Fortunately, there are already early signs of just such a response.

The extent to which flows of long-term capital may eventually come to perform an important equilibrating function in international payments—as short-term capital movements do under normal circumstances—is not a settled issue. However, it is amply clear from recent experience that long-term capital flows must not be permitted to become disruptive in the sense of seriously aggravating an existing payments imbalance and causing a movement away from rather than toward balance-of-payments equilibrium. The best present insurance against the repeated emergence of such a problem is a cooperative effort designed to insure that advanced industrial countries as a group carry on a volume of foreign lending consistent with their income, wealth, and external payments position, and that their relative contributions as international lenders are adjusted flexibly to take account of changing payments positions among them. The chief obstacle appears to be the comparative absence in some surplus countries of adequate market facilities for long-term international lending.

PLAN OF STUDY

This is the general background within which the present study was conceived and executed. Its fundamental concern is with the functioning of long-term capital markets and with the questions that arise from the description and analysis of market performance. The examination of public policy issues is not the primary purpose of this study, although various possible alternatives are noted and discussed whenever relevant. This study—primarily designed for an American audience not closely informed on European capital markets—is an attempt to bring together available descriptive material as an aid to the understanding of public policy as it evolves.

Four chapters following the present one are devoted to a cross-section analysis of European capital markets which considers their size and structure, their relationship to financial flows, the degree of their accessibility to foreign borrowers and lenders, and other selected market characteristics. Frequent comparisons are drawn between European and U.S. situations. This is inevitable if the nature of European markets is to be readily understood by American readers. It must be recognized that the contrasts that are drawn are between national markets which have separate, if related, historical origins and which have been called upon to perform somewhat different functions. It would be unreasonable to suppose that any specific form of market arrangement could equally serve the diverse objectives of all of the countries.

The bulk of the study consists of country chapters covering Belgium, France, Germany, Italy, Sweden, and the United Kingdom. A few brief notes are included on the Swiss capital market. with particular reference to the movement of capital into and out of Switzerland. While somewhat broader scope and more intensive coverage would have been desirable, limitations of time and manpower made it necessary to accept some restrictions. At least one important European capital market, the Netherlands, is not the subject of an individual country chapter.

In general, the market for new issues is more extensively treated than are other aspects of securities markets. Data are often not complete, in some cases because none have been gathered by the local authorities. Observations in the first five chapters are based principally on the experience of the larger European countries. The markets are dynamic. Changes in patterns of activity and in governmental policies have occurred during the preparation of the study to which it has not always been possible to give adequate attention.

Frequently reference will be made in the four chapters following the present one to "European capital markets" as if they formed a homogeneous pattern. It is realized that the great diversity of European capital markets is one of their leading characteristics; it is hoped that the usefulness of generalization outweighs the drawbacks of omitting, in the earlier analysis, some of the detail that is later presented in the country chapters.

The country chapters also include, in most cases, data on the margin between cost to borrower and return to lender on new security issues. Also included is some information on the level and structure of national interest rates. Fuller examination of the range of factors bearing upon the determination of long-term interest rates in the countries studied would have been desirable; but it would have broadened the scope of this study beyond manageable proportions.

CHAPTER II

THE SIZE AND STRUCTURE OF THE UNITED STATES AND EUROPEAN CAPITAL MARKETS

A country's capital market provides the financial mechanism through which pools of funds accumulated by individuals, businesses, or governments in excess of their current spending requirements may be channeled to investment in the facilities which will serve future consumption needs. Despite the identification of a capital market as a financial mechanism, much more is involved in its efficient operation than a routine transformation of funds from one use to another. In a market-oriented economy, the capital market becomes the focal point at which the full range of those private and public plans for economic growth that require external financing is brought into correspondence with, and accommodated to, the amount and pattern of long-term funds provided by individuals and institutions. The existence of a high degree of competition in markets for long-term capital insures that the level and structure of long-term yields on financial instruments will adjust sensitively to changing conditions of supply and demand, thereby directing funds toward their most profitable use and exercising an equilibrating influence upon the total flows of saving and investment.

AN INITIAL CONTRAST OF U.S. AND EUROPEAN SITUATIONS

Broad similarities between U.S. and individual European capital markets are naturally to be expected since so much of the U.S. financial structure and practice was originally modeled upon European experience. Indeed, the comparative maturity and efficiency of European capital markets during the 18th and 19th centuries were largely responsible for directing a flow of foreign investment funds to the United States and offering useful assistance in the financing of U.S. economic growth. Beyond the direct effects of European capital invested in American industry, agriculture, and transportation, the lessons of European experience shaped the institutional development of the U.S. capital market and provided a model for the early financial structure of the United States. A very general and pervasive influence was the encouragement of reliance upon the operation of a competitive, price-directed capital market. This essential similarity between European and American capital markets has continued down to the present, although the direction of evolutionary development, particularly with respect to the degree of public control over capital markets, has recently come to differ somewhat, both among individual countries in Europe, and to an even greater extent between Europe and the United States.

Many of the financial institutions of Europe have their counterparts in the United States, including commercial banks, savings

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banks, building and loan societies, postal savings systems, credit unions, insurance companies, pension funds, government-sponsored credit institutions, and other specialized forms. However, while the major functions of these institutions are usually much the same as those performed in the United States, the relative importance of a given financial institution to the long-term capital market often differs substantially between Europe and this country. For example, insurance companies are of much less importance in continental European capital markets than they are in the United States where insurance companies supply a major portion of long-term funds. On the other hand, an institution which some European countries have developed extensively is the mortgage bank or house which issues long-term bonds and reloans the proceeds either directly into mortgages or to local mortgage societies and other outlets for mortgage credit. This entry of mortgage financing directly into the bond market is not found, as such, in the United States, although local housing authority bond issues serve much the same purpose. Mortgage bankers in the United States have not directly entered the long-term market for funds and remain in the roles of brokers and dealers, and as servicing agents for other financial intermediaries. Other detailed differences of this sort between European and United States financial practice will be discussed in the chapter to follow the present one and, in much greater detail, in the individual country chapters.

It is desirable at this point to emphasize a broad difference of degree that has come to exist between the United States and European situations, although fuller development of its significance must also await later stages of the discussion. Governmental influence upon the supply and demand side of European capital markets is, in general, far more extensive than it is in this country. The demands of relief and rehabilitation following the devastation of World War II were so great that some European governments came to perform a central decisionmaking function in allocating the scarce supply of domestic savings and U.S. aid funds—a function which some governments have chosen to continue to exercise. Also, in most European countries, railroads, telecommunications, public utilities, and even some manufacturing establishments are nationalized. Many of these undertakings require external financing, and government ownership frequently implies preemptive rights to a portion of capital market funds.

In terms of the provision of loanable funds to the market, public and quasi-public financial intermediaries play a large role in most European countries by transforming the very liquid assets for which the public displays a strong preference into the long-term financing of investment needs. This function of financial intermediaries is an important one in both Europe and the United States; the major difference would seem to be the extent to which the publicly owned, or controlled, intermediary predominates in Europe.

STATISTICAL COMPARISONS

The remainder of this chapter is devoted to a comparison of U.S. and European capital markets on the basis of three statistical measures: (*a*) the market value of outstanding securities at the end of 1962, (*b*) the market value of gross issues of securities during 1962, and (*c*) the market value of net issues of securities (gross issues less redemptions) during 1962. The nature and broad significance of the pattern revealed by each of these measures will be discussed in turn.

Individual country tables giving data on the value of outstanding securities and on gross and net security issues for the 3-year period, 1960–62 and, as a memorandum item, the country's gross national product for the same years appear as an appendix to this chapter. These country tables provide more extensive notes indicating details of definition and nature of source than it seemed essential to include in the summary chapter tables.

The detailed notes to the appendix tables provide some indication of the difficulties encountered in the statistical compilations and should prove useful to those who wish to extend the coverage of these comparisons in time, or to refine their present degree of accuracy. Even the detailed listing of sources and their coverage has its value in an area such as this where the available information is scattered.

Although the data have been examined and assembled with care, it is undoubtedly the case that they can only be regarded as estimates subject to a considerable range of possible error. Care is taken in the text discussion to draw no conclusions which would depend upon an improbably high degree of accuracy in the basic statistics. This also accounts for the relative absence of statistical manipulation of the data so as to yield derivative measures; it is felt the data will support broad comparisons and little else at their present level of refinement.

A few general observations as to definition and coverage will be helpful in the interpretation of the tables to be presented in the chapter. Long-term securities are defined here as debt or equity instruments with a stated or implied maturity in excess of 1 year This may depart somewhat from the frequent convention of a separation between short, intermediate, and long-term securities. However, it seemed better to err upon the side of inclusiveness rather than to seek to restrict coverage to securities with a life in excess of, say, 5 years. Had the study been directed to the U.S. market, the decision as to maturity would probably have been different.

Mortgages are included along with security issues. This appeared to be desirable because mortgages do account, in many countries, for a significant share of the demands for long-term funds and because this study is concerned with long-term capital markets rather than security markets narrowly construed. From the point of view of statistical convenience, the inclusion of mortgages was troublesome since it broadened the definition of capital markets commonly employed by European countries.

OUTSTANDING ISSUES

Table I shows that from the standpoint of the value of outstanding long-term obligations the U.S. capital market is extremely large both relative to individual European countries and to European countries combined. For example, if mortgages are included but foreign securities and central government securities are excluded so as to measure the extent of the domestic private market, the estimate for the United States is $920.4 billion. This would appear to be more than 10 times the total for the next largest country, the United Kingdom.

The total value of outstanding obligations on this basis for the seven European countries, including generous allowances for Italy, the Netherlands, and Belgium whose data are incomplete, cannot be more than $300 billion. Hence, the U.S. total may safely be taken as more than three times the total for the seven European countries combined.

TABLE I.—*Estimate of the amounts of outstanding long-term obligations in various countries as of Dec. 31, 1962*

[Billions of dollars]

	Businesses		State and local governments	Total business, State and local governments	Mortgages	Foreign	Central government
	Bonds	Stocks					
United States	104.5	484.1	81.3	669.9	250.5	6.8	110.5
United Kingdom	4.1	62.4	7.4	73.9	15.0	2.3	46.4
France	7.0	23.1	.6	30.7	8.7	(1)	3.2
Germany	10.1	9.3	4.2	23.6	20.3	.2	1.2
Italy	8.4	23.2	(1)	[2] 31.6	(1)	(1)	4.1
Netherlands	.8	8.0	3.9	12.7	3.3	(1)	4.2
Belgium [3]	4.0	4.0	1.0	9.0	(1)	1.½	6.0
Sweden	3.0	(1)	1.5	(1)	8.9	(1)	3.0

[1] Not available in sources used.
[2] Total is believed to include the bulk of State and local government-type issues which are included in the business total and cannot be shown separately.
[3] Estimated.

Source: Appendix tables I-VIII.

This general relationship is not greatly affected where the basis of comparison is narrowed to exclude mortgages. The exclusion of mortgages actually increases the ratio of the value of U.S. to European outstandings slightly, but the data are inexact and it probably is safer to regard the relationship as about the same whether or not mortgages are included. If the basis of comparison is broadened to include not only mortgages but also foreign issues and central government issues, the ratio of the U.S. total to the European total is lowered somewhat, mainly because of the relatively large amount of outstanding central government obligations in the United Kingdom. However, the U.S. total still remains some three times the total for the seven European countries combined.[1]

It must be pointed out that the outstandings data refer to the market value of obligations rather than their value at the time at which they were issued. As a consequence, the value aggregate is not a measure of the amounts of capital actually raised through the sale of these securities. Discrepancies are likely to be greatest in the case of the market value of stocks, where even the meaningfulness of international comparisons is open to question in the event of sharply divergent movements in stock prices among countries. The data on gross and net issues, to be presented later in the chapter, are directly affected to a lesser degree by these valuation changes although even a temporary decline in stock prices can cause the volume of new issues to be sharply restricted.

[1] For some purposes, it is desirable to correct for the influence of the economic size of the country. There is a degree of arbitrariness in any correction of this sort, but the ratio of outstanding securities to a country's gross national product may be of some interest. The ratios of the value of outstanding securities (excluding mortgages, foreign issues, and central government issues so as to be able to compute ratios for all of the countries at the end of 1962 to the value of GNP in 1962) are as follows: United States, 1.21; Belgium, 0.70; France, 0.42; Germany, 0.28; Italy, 0.79; Netherlands, 0.98; Sweden, 0.54; and United Kingdom, 0.96.

The European statistics have been assembled, to the extent possible, so as to include in the business sector the nationalized industries which would be privately owned in the United States. Missing elements in both the U.S. and European presentations are term loans by banks and loans by banks and governments which, though nominally short-term, are turned over year after year. The statistical difficulties in the identification of such items were substantial and they could not be surmounted in the time available. It is not believed that their omission affects the overall conclusion as to the significantly greater extent of the U.S. capital market in terms of the volume of outstanding issues.

The statistics on outstanding issues measure the size of the national capital markets in stock terms, i.e., they provide a measure of the value of security and mortgage holdings at a given point in time. From some points of view a measure of flows over time would be more significant as a guide to the scale of the market and to its potential for the achievement of efficiency in operation. Unfortunately, reliable data on turnover of ownership in outstanding securities are simply not available. However, scattered turnover data in conjunction with available descriptive material on U.S. and European markets leave very little doubt that the volume of trading in U.S. security markets is also high by European standards. Consequently, it seems permissible to use the data on outstandings—in conjunction with data shortly to be presented on gross security issues—not only as a stock statistic, but also as a proxy for the flow statistic which is not available directly. It is true that a country's volume of outstanding securities could be large, yet the actual amount of trading activity could be so small as to reduce the marketability of those securities very appreciably. This seems to be the case in Italy, for example. However, to the extent that this is a characteristic of European capital markets, the use of data on outstanding securities in lieu of data on the turnover in securities will operate to understate, rather than overstate, the extent to which trading activity in U.S. securities markets exceeds that in European securities markets.

The inclusion of mortgages in the U.S. statistics may seem, on the other hand, to bias the U.S. outstandings' figure because the market for mortgages in the United States is primarily a local one and does not involve active trading. While a secondary market does exist for mortgages—particularly for those with government insurance or guarantee—the market remains a thin one. However, it should be noted that a similar state of affairs exists in many European countries; furthermore the approximate relationship between the value of United States and European outstanding securities is about the same whether mortgages are included or excluded.

Security markets with a large volume of transactions should achieve substantial economies of scale, in a very generalized sense. If the buyers of long-term securities are assured of the continuing existence of an active market in which securities can be sold, many buyers will accept a lower yield than they would on a security which was equivalent in all respects save for its lack of marketability. The existence of an active market gives an additional and valued attribute to all marketable long-term securities in the minds of many buyers. The sellers of long-term securities not only borrow at lower interest cost as a result of this greater liquidity, but they also enjoy the advantage of facing a broader array of buyers, which usually means readier access to the market, more flexible terms, and lower issue and underwriting costs.

From a theoretical point of view, a large security market with active trading could involve a number of alternative structures—ranging from those with few participants to those with many. In practice, trading activity seems typically to be most extensive and competition most vigorous where there are large numbers of actual and potential participants on both sides of the market. The U.S. market for capital funds is serviced on the supply side by thousands of banks and financial intermediaries as well as individuals, and by a vast number of businesses and individuals on the demand side. Although the market is by no means a textbook model of perfect competition it does have many of the prerequisite elements to a high degree, i.e., (1) freedom of access by both borrowers and lenders despite official or other limitations on some particular types of institutions, (2) a relatively homogeneous product (in this case capital funds), (3) large numbers of buyers and sellers unable individually to affect the price of nationally or regionally traded instruments, (4) the economic motivation of self-interest on the part of the borrowers to obtain funds at the lowest possible cost and on the part of the lenders to supply funds at the highest price possible, and (5) highly developed sources of information on prevailing prices, volume of activity, sources of supply and demand, and other relevant factors.

The U.S. capital market has developed to the point where investment funds flow with comparative freedom from capital surplus regions to capital scarce regions, from overcapitalized economic sectors to undercapitalized economic sectors, from one kind of debt security to another, or from equity to debt and vice versa. The major financial markets such as New York, Chicago, and San Francisco stand at the center of a complex national network serving to assemble and distribute long-term funds.

European countries on the other hand have not had a similar need in the past for quite such a complex and elaborate mechanism. There have been smaller numbers of lenders of long-term funds, and borrowers have been influenced by habit, tradition, and the restrictions upon access established by the fiscal and monetary authorities. There has been insufficient information available to potential investors to encourage maximum public participation in the purchase of securities. A large issue in an individual European country typically meets a thin market and little syndicate competition if underwritten. An obvious, and very promising, course of action now that Europe needs much more efficient capital markets would be greater freedom for long-term capital to move freely over European boundaries. In such a way a market might be established not greatly inferior to that of the United States in size and embodying an institutional structure and practice uniquely appropriate for the European situation.

GROSS ISSUES

Table II presents data on the value of gross issues of securities in billions of dollars during the year 1962. These data provide some further indication of the transactions size of securities markets, thereby supplementing in a useful way the previous comparison of the value of outstanding securities. The comparison based upon gross issues is also helpful in providing some indication of the "depth" of securities markets, in the sense of their capacity to absorb new issues. This latter aspect of market behavior is also revealed, although somewhat less fully, in statistics on the size of net security issues which will be presented in the next section.

TABLE II.—*Estimates of the amounts of gross issues of long-term obligations in various countries during 1962*

[Billions of dollars]

	Businesses		State and local governments	Total, business, State and local governments	Mortgages	Foreign	Central government
	Bonds	Stocks					
United States	9.8	2.1	8.6	20.5	(1)	1.3	58.0
United Kingdom	1.2		(1)	(1)	(1)	.1	5.6
France	1.2	.8	(2)	2.0	(1)	0	0
Germany	2.0	.6	.6	3.2	(1)	(2)	(1)
Italy	(1)	(1)	(1)	(1)	(1)	(2)	(1)
Netherlands	.1	.1	.1	.3	(1)	.1	.1
Belgium	.4	.4	.2	1.0	(1)	(1)	.6
Sweden	.7	.2	(1)	(1)	(1)	.1	.2

1 Not available in sources used.
2 Less than $50,000,000.

Source: Appendix tables I–VIII.

The value of gross security issues is contrasted by excluding the value of mortgages issued, since reliable gross issues data for mortgages are almost consistently not available. Data are available to include central government security issues but their inclusion weights the comparison heavily in favor of the United States because of the relatively large volume of central government refundings in this country. With central government and foreign borrowing included, the volume of U.S. gross issues is from four to five times that of the seven European countries. If gross issues by central governments and foreign borrowers are excluded, the data of table II suggest that U.S. gross security issues are only somewhat more than two times as large as those of the European countries considered here. Considerable interest also attaches to a comparison of the business sectors alone, excluding State and local government issues. On this basis, U.S. gross issues are approximately 1½ times those of the European countries.

The disparity between the United States and European countries on the gross issues basis is therefore substantially less than in the case of the value of outstanding issues (if central government gross issues are excluded.) It will be recalled that table I suggested that the value of U.S. outstanding securities is in excess of three times the value of European securities although this may reflect, to some extent, higher relative equity valuations in this country. As has also been mentioned previously, the outstandings comparisons are broadly unaffected by the inclusion or exclusion of moitgages.

Gross issues of securities by the business sector, as it is defined here, for the seven European countries appear from the data of table II to be roughly two-thirds those in the United States; total gross domestic fixed capital formation for these European countries is also about two-thirds that in the United States.[2] This suggests the possibility that the relative dependence upon internal and external sources of financing may not have been greatly different during 1962, for European and American businesses. This receives some confirmation from the incomplete data on internal financing presented in table III. The entries for the United Kingdom are based upon the experience of a sample consisting of large companies whose shares are quoted on the stock exchange and this probably biasses the United Kingdom percentages downward relative to the other three countries.

TABLE III.—*Internal financing as a percentage of total sources of funds for the business sector*

	1959	1960	1961	1962
France [1]	58.4	57.5	53.6	55.0
Germany [2]	70.8	67.0	60.3	62.3
United Kingdom [3]	55.0	49.5	50.1	54.5
United States [4]	54.5	63.0	59.6	60.4

[1] Including all nonfinancial enterprises.
[2] Business enterprise sector.
[3] Sample of companies whose shares are quoted on a United Kingdom stock exchange.
[4] Corporate sector only.

Source: Ch. VII, table IV; ch. VIII, table IV; United Kingdom, "Board of Trade Journal," various issues, United States, "Survey of Current Business," July 1963, p. 29.

During the early postwar period, European business firms relied to a much greater extent upon reinvested earnings and only in recent years has the volume of security issues become large. There is some indication that the ability of firms in many European countries to finance desired expansion out of internal cash flows has been reduced substantially in recent years. Continuation of such a pattern would probably operate to increase the extent to which the European business sector would resort to new security issues as a source of funds.

NET ISSUES

The final statistical comparison to be drawn in this chapter is the value of net security issues in the United States and Europe during the year 1962. These data are shown in table IV. Since central government net borrowing may fluctuate widely from year to year because of fiscal policy considerations, its exclusion seems desirable in comparing the volume of net issues. If the comparison is drawn between the totals for business and State and local government net issues in the United States and Europe, the U.S. total is approximately equal to that for the seven European countries whereas in the case of gross issues the U.S. total was about twice the European. If the comparison is further confined to net security issues by the business sector alone, the total for the European countries clearly exceeded

[2] On the basis of annual averages for the period 1959–61 of data taken from "General Statistics," OECD, November 1962.

that for the United States during 1962. It should be pointed out that 1962 featured a sharp break in U.S. stock prices that dampened the amount of new stock sold. New stock issues were $2.6 billion in 1961; they fell off to only $0.5 billion in 1962—an abnormally low level.

TABLE IV.—*Estimates of the amounts of net issues of long-term obligations in various countries during 1962*

[Billions of dollars]

	Businesses		State and local governments	Total, business, State and local governments	Mortgages	Foreign	Central government
	Bonds	Stocks					
United States	5.0	0.5	5.1	10.6	24.7	1.0	4.1
United Kingdom	1.0	.7	1.4	3.1	1.2	(1)	2.6
France	.9	.8	(1)	1.7	1.2	0.	−.2
Germany	1.7	.5	.5	2.7	2.9	(1)	.3
Italy	1.5	1.0	(2)	[3] 2.5	(2)	(2)	−.2
Netherlands	.1	.1	.1	.3	.5	(1)	.1
Belgium	.2	.2	.1	.5	(2)	(2)	.4
Sweden	.6	.1	.2	.9	.7	(1)	(1)

[1] Less than $50,000,000.
[2] Not available in sources used.
[3] Total is believed to include the bulk of State and local government type issues which are included in the business total and cannot be shown separately.

Source: Appendix tables I-VIII.

The net issues comparison is much more favorable to Europe because it registers more fully the current impact upon the capital markets of the continuing rapid pace of economic growth in Europe. On the other hand, comparisons based upon the value of outstanding securities and, to a somewhat lesser extent, those based upon gross security issues tend more to reflect the accumulated effects of the past. European capital markets have only recently begun to feel the full effects of postwar economic growth.

The scale of European net issue activity is an extremely encouraging sign, but its significance is limited in two very fundamental respects. First, the volume of net issue activity in Europe is chiefly impressive only as an aggregate for the main European countries. While connections do exist between the securities markets of the individual European countries, as a unit they are far from constituting a single market area for securities in the same sense that the United States does. Consequently, there is a presumption that, as a consequence of their limited size, the segmented national capital markets of Europe forego efficiencies in operation that a wider, integrated European capital market could achieve. Second, the amount of foreign security issues—either other European issues or non-European issues—accommodated in European capital markets has been extremely small. This disturbing phenomenon is to be examined more closely in chapter IV.

APPENDIX TABLE I.—*United States*

[In billions of dollars]

	Business		State and local	Total	Mortgages		Foreign	Central Government
	Bonds	Stocks			1 to 4 family	Other		
Outstandings:								
End of—								
1960	[1] 92.7	[2] 434.0	[3] 69.1	595.8	[4] 141.3	[4] 65.8	[5] 5.4	[6] 102.4
1961	[1] 98.1	[2] 551.4	[3] 74.2	723.7	[4] 153.0	[4] 72.8	[5] 5.9	[6] 104.3
1962	[1] 104.5	[2] 484.1	[3] 81.3	669.9	[4] 168.4	[4] 82.1	[5] 6.8	[6] 110.5
Gross issues:								
During—								
1960	[7] 9.7	[8] 2.7	[9] 7.2	19.6	[10] 29.3	([11])	[12] .7	[13] 40.4
1961	[7] 10.7	[8] 4.3	[9] 8.3	23.3	[10] 31.2	([11])	[12] .6	[13] 57.3
1962	[7] 9.8	[8] 2.1	[9] 8.6	20.5	[10] 34.2	([11])	[12] 1.3	[13] 58.0
Net issues:								
During—								
1960	[14] 5.0	[15] 1.6	[16] 3.7	10.3	[17] 10.4	[17] 5.8	[18] .6	[19] 5.3
1961	[14] 5.1	[15] 2.6	[16] 5.0	12.7	[17] 11.7	[17] 7.0	[18] .8	[19] −3.6
1962	[14] 5.0	[15] .5	[16] 5.1	10.6	[17] 15.4	[17] 9.3	[18] 1.0	[19] 4.1

Gross national product:

1960	502.6
1961	518.2
1962	554.9

[1] Estimated market value of corporate bonds outstanding ("Federal Reserve FOF/August 1963 Bulletin," p. 1155, table 7) plus par value of nonguaranteed Federal agency debt ("Treasury Bulletin").
[2] Estimated market value of all shares outstanding ("Federal Reserve FOF/August 1963 Bulletin," p. 1155, table 7).
[3] State and local government long-term debt at market value (*ibid.*, p. 1155, table 7 as revised by unpublished corrections).
[4] Estimated value of all mortgages outstanding (*ibid.*, p. 1156, table 7).
[5] Foreign bonds outstanding at market value (*ibid.*, p. 1155, table 7).
[6] Federal Government marketable securities neither due nor callable within 1 year at market value (estimate).
[7] Estimate of gross proceeds for new capital and refunding less underwriting costs (Securities and Exchange Commission).
[8] New issues of common and preferred stocks by corporations other than investment companies ("Federal Reserve Bulletin," August 1963, p. 1120).
[9] Gross proceeds of U.S., State and local securities issues (*ibid.*, p .1119).
[10] Nonfarm mortgage recordings of $20,000 or less as estimated by Federal Home Loan Bank Board (Commerce Department, "Survey of Current Business").
[11] Not available.
[12] Foreign government and corporation gross issues for new capital (Securities and Exchange Commission).
[13] Gross new issues of marketable debt securities, excluding bills, but including exchanges ("Daily Statement of the United States Treasury," various dates).
[14] Net increase in corporate bonded indebtedness ("Federal Reserve FOF/August 1963 Bulletin," corporate nonfinancial and nonbank financial sectors).
[15] Net change in outstanding corporate stocks other than investment companies (*ibid.*).
[16] Net change in outstanding (Federal Reserve FOF/adjusted for statistical discrepancy).
[17] Net change in outstanding.
[18] Net increase in liabilities represented by securities for "rest of world sector" ("Federal Reserve FOF/August 1963 Bulletin").
[19] Net change in maturity value.

APPENDIX TABLE II.—*United Kingdom*

[In billions of dollars]

	Business		State and local		Total	Mortgages	Foreign	Central government
	Bonds	Stocks	Bonds	Mortgages				
Outstandings:								
End of—								
1960	[1] 2.8	[2] 55.7	[3] 5.2		63.7	[4] 12.5	[5] 2.4	[6] 41.1
1961	[1] 3.1	[2] 60.4	[3] 5.8		69.3	[4] 13.8	[5] 2.3	[6] 39.4
1962	[1] 4.1	[2] 62.4	[3] 2.4	[3] 5.0	73.9	[4] 15.0	[5] 2.3	[6] 46.4
Gross issues:								
During—								
1960	[7] 1.3		[8] .2	([9])	([9])	([9])	[10] .1	[11] 3.9
1961	[7] 1.7		[8] .1	([9])	([9])	([9])	[10] .1	[11] 2.2
1962	[7] 1.2		[8] .4	([9])	([9])	([9])	[10] .1	[11] 5.6
New issues:								
During—								
1960	([12]) ([13])	[14] .9	[15] .1	[16] .3	1.3	[13] 1.1	[17] —.2	[18] 2.1
1961	[13] .3	[14] 1.2	[15] .1	[16] .5	2.1	[13] 1.2	[17] —.1	([18]) ([12])
1962	[13] 1.0	[14] .7	[15] .4	[16] 1.0	3.1	[13] 1.2	([17]) ([12])	[18] 2.6

Gross national product: [19]

1960	70.9
1961	74.9
1962	78.2

[1] Outstanding "loan capital" of "companies" at market value ("Interest and Dividends upon Securities Quoted on the Stock Exchange, London," Council of the Stock Exchange, London, March 1963, p. 14).

[2] Outstanding preference and ordinary share capital at market value for all companies registered and managed in the United Kingdom other than investment trust companies and foreign denominated securities and annuities (*ibid.*).

[3] Estimates of outstanding over 1-year debt other than temporary borrowing and Public Works Loan Board Mortgages (Central Statistical Office, "Financial Statistics," No. 17, September 1963, p. 21 and "Economic Trends," No. 112, Feb. 1963).

[4] Mortgage loans outstanding held by building societies, insurance companies, local authorities' superannuation funds, other superannuation funds and local authorities. Does not include mortgage debt outstanding issued by local authorities (' Financial Statistics" No. 17, September 1963, Central Statistical Office, various pages).

[5] Loan capital outstanding only, at market value. Data on direct investment and share capital not available (as in 1. Bank of England estimates of $7.0 billion (market value) for United Kingdom holdings of overseas securities at end of 1962 based on a 1958 benchmark estimate which would not appear valid after 4 years).

[6] Outstanding marketable debt other than Treasury bills at market value (as in 1).

[7] New gross capital issues of "companies" (unpublished data).

[8] New gross capital issues of local authorities' "quoted securities" (unpublished data).

[9] Not available in sources used.

[10] New gross capital issues of "overseas" category (unpublished data).

[11] Gross issues for cash and exchange of marketable securities other than Treasury bills (Central Statistical Office, p. 4, "Financial Statistics," No. 17, September 1963).

[12] Less than $50 million.

[13] Change in outstanding.

[14] Bank of England, "Quarterly Bulletin" and Central Statistical Office, "Financial Statistics."

[15] Issues less redemptions (as in 11 p. 67).

[16] Estimates of net issues based upon data from source as in 11, p. 20 excluding under 1 year issues.

[17] Change in outstanding market value of loan capital only.

[18] Gross issues less redemptions (as in 11).

[19] IMF, International Financial Statistics," October 1963.

APPENDIX TABLE III.—*France*

[In billions of dollars]

	Business [1]		State and local	Total	Mortgages	Foreign	Central Government
	Bonds	Stocks					
Outstandings: [2]							
End of—							
1960	5.5	13.0	0.4	18.9	6.5	(3)	3.1
1961	6.3	18.6	.5	25.3	7.6	(3)	3.2
1962	7.0	23.1	.6	30.7	8.7	(3)	3.2
Gross issues:							
During—							
1960	.9	[4] .5	(5)	1.4	(3)	(3)	0
1961	1.3	[4] .7	(5)	2.0	(3)	(3)	0
1962	1.2	[4] .8	(5)	2.0	(3)	0	0
Net issues:							
During—							
1960	.7	[4] .5	(5)	1.2	1.1	(3)	−.2
1961	.8	[4] .7	(5)	1.5	1.1	(3)	−.2
1962	.9	[4] .8	(5)	1.7	1.2	0	−.2

Gross national product: [6]	
1960	58.4
1961	63.1
1962	[7] 73.7

[1] The business sector includes public as well as private financial and nonfinancial enterprises.
[2] At market value.
[3] Not available in sources used.
[4] "*Rapport présenté au Ministre des Finances et des Affaires Economiques parle Comité chargé d'étudier le financement des investissements,*" 1963, p. 22.
[5] Less than $50 million.
[6] IMF, "International Financial Statistics," October 1963.
[7] Preliminary estimate.

NOTE:—Unless otherwise noted, the source for these figures is the *Conseil National du Credit* "Annual Reports."

APPENDIX TABLE IV.—*Germany*

[In billions of dollars]

	Business		State and local	Total	Mortgages		Foreign	Central Government
	Bonds	Stocks			Residential	Other		
Outstandings:								
End of:								
1960	[1] 7.3	[2] 7.9	[3] 3.2	18.4	[4] 10.4	[4] 4.5	[5] 0.1	[6] 0.6
1961	[1] 8.5	[2] 8.8	[3] 3.7	21.0	[4] 12.1	[4] 5.3	[5] .1	[6] .8
1962	[1] 10.1	[2] 9.3	[3] 4.2	23.6	[4] 14.0	[4] 6.3	[5] .2	[6] 1.2
Gross issues:								
During:								
1960	[7] .9	[8] .8	[9] .3	2.0	(10)	(10)	(11) (12)	(10)
1961	[7] 1.5	[8] .7	[9] .6	2.8	(10)	(10)	(11) (12)	(10)
1962	[7] 2.0	[8] .6	[9] .6	3.2	(10)	(10)	(11) (12)	(10)
Net issues:								
During:								
1960	[13] .7	[14] .7	[15] .3	1.7	[15] 1.6	[15] .6	(11) (15)	[15] .3
1961	[13] 1.2	[14] .8	[15] .5	2.5	[15] 1.7	[15] .8	(11) (15)	[15] .2
1962	[13] 1.7	[14] .5	[15] .5	2.7	[15] 2.0	[15] .9	(11) (15)	[15] .3

Gross national product: [16]	
1960	70.6
1961	77.6
1962	84.2

[1] Nominal values of mortgage bonds, "other bonds" of credit institutions, industrial bonds, "Public loans" and medium-term notes of the Equalization of Burdens Fund, the Federal Railways, the Federal Postal Administration and an "other" category which comprises mainly loan issues of special credit institutions. Also includes "loans against borrowers' notes" held by the insurance sector. (Statistical yearbook 1963, pp. 391 and 405; and September 1963 monthly report of the *Deutsche Bundesbank*, p. 86).
[2] Total shares in circulation at nominal value. (Statistical yearbook 1963, p. 391).
[3] "Kommunal obligation" and "Loans of lander and local authorities." (Statistical yearbook, p. 391, and September 1963 monthly report of the *Deutsche Bundesbank*, p. 86).
[4] Statistical yearbook 1963, p. 386.
[5] Statistical yearbook 1963, p. 391.
[6] Excludes special credits for payments to international institutions and indebtedness to other public authorities as well as Treasury bills. (September 1963 monthly report of the *Deutsche Bundesbank*, p. 89).
[7] Comprises gross placings at nominal value of mortgage bonds, bonds of specialized credit institutions, industrial bonds and other bonds n.e.c. plus net increases in outstanding of bonds and notes of the Equalization of Burdens Fund, Federal Railways, and Federal Postal Administration; data on gross placings of "loans against borrowers' notes" is not available. (*Ibid.*, pp. 75 and 86).
[8] Increases in share circulation at nominal value excluding issue of bonus shares. (*Ibid.*, p. 78).
[9] Comprises gross placings of communal bonds and net change in outstanding of "Public loans of landers and local authorities" (*ibid.*, p. 78).
[10] Not available in sources used.
[11] Less than $50,000,000.
[12] *Ibid.*
[13] Gross placings less redemptions (*ibid.*, pp. 76 and 86).
[14] Issue value of shares placed (*ibid.*, p. 78) not strictly comparable with gross issues data due to valuation differences. The net placings at nominal value were 1960, $0.5 billion; 1961, $0.5 billion; and 1962, $0.4 billion.
[15] Net change in outstanding.
[16] IMF, "International Financial Statistics," October 1963.

APPENDIX TABLE V.—*Italy*

[In billions of dollars]

	Business		State and local [1]	Total	Mortgages	Foreign	Central Government
	Bonds	Stocks					
Outstandings:							
End of:							
1960	[2] 5.4	[3] 23.0	(4)	28.4	(5)	(5)	[6] 3.8
1961	[2] 6.7	[3] 26.4	(4)	33.1	(5)	(5)	[6] 4.0
1962	[2] 8.4	[3] 23.2	(4)	31.6	(5)	(5)	[6] 4.1
Gross issues:							
During:							
1960	(5)	(5)	(5)	(5)	(5)	(5)	(5)
1961	(5)	(5)	(5)	(5)	(5)	(5)	(5)
1962	(5)	(5)	(5)	(5)	(5)	(8)	(5)
Net issues:							
During:							
1960	[7] 1.1	[7] .8	(4)	1.9	(5)	(5)	(5)
1961	[7] 1.4	[7] .7	(4)	2.1	(5)	(5)	(7) (8)
1962	[7] 1.5	[7] 1.0	(4)	2.5	(5)	(5)	[7] —.2

Gross national product: [9]	
1960	32.1
1961	35.3
1962	[10] 40.1

[1] State and local data seems to be included with the IRI statistics which appear in the business section and are not available separately in the sources used.

[2] Includes Government guaranteed bonds, bonds of the special credit institutions, ENI, IRI, and private industrial enterprises at estimated market value. (Bank of Italy "Annual Report" 1962, pp. 431 and 462.)

[3] Valued at market price, net of duplication through exchange of shares in interlocking companies (estimated at 20 percent) (as in footnote 2, p. 462.)

[4] Not available separately.

[5] Not available in sources used.

[6] Estimated market value of State securities other than short-term and guaranteed obligations (as in footnote 2, p. 462).

[7] Net proceeds of new issues within the definitions used for outstandings.

[8] Less than $50,000,000.

[9] IMF, "International Financial Statistics," October 1963.

[10] Preliminary estimate.

APPENDIX TABLE VI.—*Netherlands*

[In billions of dollars]

	Business [1]		State and local	Total	Mortgages	Foreign	Central government
	Bonds	Stocks					
Outstandings:							
End of:							
1960	[2] 0.7	[3] 7.6	[4] 3.5	11.8	[5] 2.4	([6])	[7] 3.8
1961	[2] .7	[3] 8.4	[4] 3.8	12.9	[5] 2.8	([6])	[7] 4.1
1962	[2] .8	[3] 8.0	[4] 3.9	12.7	[5] 3.3	([6])	[7] 4.2
Gross issues:							
During:							
1960	[8] .1	([9] [8])	[10] .2	.3	([6])	([9] [11])	[12] .3
1961	[8] .1	([9] [8])	[10] .1	.2	([6])	[11] 0.1	[12] .2
1962	[8] .1	[8] .1	[10] .1	.3	([6])	[11] .1	[12] .1
Net issues: [13]							
During:							
1960	[8] .1	([9] [8])	.2	.3	[14] .2	([9])	[15] .2
1961	([9] [8])	([9] [8])	([9])	.1	[14] .5	.1	[15] .1
1962	[8] .1	[8] .1	.1	.3	[14] .5	([9])	[15] .1

Gross national product: [16]	
1960	11.8
1961	12.3
1962	[17] 13.0

[1] Includes the "money creating" institutions, "non-money-creating" credit institutions, industry, electricity, gas and water supply companies, transport companies, trading companies, ecclestastical and charitable institutions and mortgage banks. ("1962 Report of *De Nederlandsche Bank N.V.*", p. 198).
[2] Nominal value of outstanding "private sector" bonds (market value not available). ("*Maandstatistiek van het Financiewezen*", December 1961 and December 1962; includes only bonds listed on Amsterdam Stock Exchange; 1962 estimated.)
[3] Market value of "private sector" shares listed on Amsterdam Stock Exchange (*Maandstatistiek van het Financiewezen*", March 1961 and February 1963).
[4] Net consolidated debt of provinces and municipalities at nominal values (market value not available. "1962 report of *De Nederlandsche Bank N.V.*", p. 209).
[5] Estimates based on recorded uncancelled mortgage data and sampling study published in "*Maandstatistiek*", June 1962.
[6] Not available from sources used.
[7] Includes internal and external consolidated debt and pre-subscription accounts of the Treasury. ("1962 Report of *De Nederlandsche Bank N.V.*", p. 205).
[8] Actual amounts obtained including bonds and shares placed privately in advance on subscription terms, but excluding conversions. In the case of bonds includes the following gross proceeds of issues of mortgage banks: 1960, $35 million; 1961, $26 million; 1962, $44 million; and net proceeds of such issues: 1960, $32 million; 1961, $19 million; and 1962, $37 million. (*Ibid.*, p. 198.)
[9] Less than $50 million.
[10] Gross issues of Provinces, Municipalities and the Bank for Netherlands Municipalities. (*Ibid.*, p. 176.)
[11] Gross issues of bonds and shares from foreign countries. (*Ibid.*, p. 176.)
[12] Gross issues of Government "bonds". (*Ibid.*, p. 176.)
[13] Gross issues less redemptions unless otherwise noted. (*Ibid.*, p. 176.)
[14] Change in outstanding.
[15] Includes the following amounts of net payments into pre-subscription accounts of the Treasury: 1960, $29 million; 1961, $72 million; and 1962, $106 million. (*Ibid.*, p. 176.)
[16] IMF, "International Financial Statistics", October 1963.
[17] Preliminary estimate.

APPENDIX TABLE VII.—*Belgium*

[In billions of dollars]

	Business [1]		State and local [2]	Total	Mortgates	Foreign [3]	Central Government [4]
	Bonds	Stocks					
Outstandings:							
End of:							
1960	[5] 3.7	[5] 3.7	[5] 0.7	8.1	([6])	[5] 1.4	[5] 5.4
1961	([6])	([6])	([6])	([6])	[7] 1.1	([6])	([6])
1962	[8] 4	[8] 4	[8] 1	[8] 9	([6])	[8] 1½	[8] 6
Gross issues:							
During:							
1960	[9] .4	[10] .4	[9] .1	0.9	([6])	([6])	[11] .6
1961	[9] .5	[10] .4	[9] .1	1.0	([6])	([6])	[11] .3
1962	[9] .4	[10] .4	[9] .2	1.0	([6])	([6])	[11] .6
Net issues:							
During:							
1960	[12] .2	[13] .2	[12] .1	.5	([6])	([6])	[12] .3
1961	[12] .3	[13] .1	[12] .1	.5	([6])	([6])	[12] .1
1962	[12] .2	[13] .2	[12] .1	.5	([6])	([6])	[12] .4

Gross national product: [13]	
1960	12.2
1961	[8] 12.8
1962	[8] 13.6

[1] Includes private businesses, nationalized industries, banks, *Fonds des Rentes*, savings banks, mortgage societies, insurance and pension operations (public and private) and public credit institutions.
[2] Includes local authorities and *Credit Communal.*
[3] Includes foreign bonds and stocks exclusive of capital subscriptions to international financial organizations.
[4] Includes bonds and excludes short-term certificates.
[5] Estimated market value (maturity value when market value not available). (*Banque Nationale de Belgique, "Bulletin d'Information et de Documentation."* September 1963, p. 224–225.)
[6] Not available in sources used.
[7] Mortgage loans held by the intermediate credit institutions including commercial banks, savings banks, mortgage societies, *Caisse Générale d'Epargne et de Retraite*, insurance companies, public and private pension funds, and public credit institutions. *Banque Nationale de Belgique, "Bulletin d'Information de Documentation,"* September 1963, various pages.)
[8] Preliminary estimate.
[9] Gross issues of long- and medium-term securities (i.e., more than 1 year) with the exception of "tap" issues which are included on a net basis. (As in 5 pp. 258 and 267.)
[10] Gross issues of shares and participations at nominal value and seemingly inclusive of stock dividends.
[11] Gross issues of the State (*directe uniquement*) with a more than 1-year maturity (*ibid*).
[12] Gross issues les retirements (*ibid*).
[13] Net proceeds of stock issues (*ibid.*).
[14] Source: IMF "International Financial Statistics" October 1963.

APPENDIX TABLE VIII.—*Sweden*

[In billions of dollars]

	Business		State and local	Total	Mortgages	Foreign	Central Government
	Bonds	Stocks					
Outstandings:							
End of:							
1960	[1] 2.1	[2] 3.4	[3] 1.2	6.7	[4] 7.5	([5])	[6] 3.0
1961	[1] 2.4	[2] 3.6	[3] 1.2	7.2	[4] 8.2	([5])	[6] 2.9
1962	[1] 3.0	([5])	[3] 1.5	([5])	[4] 8.9	([5])	[6] 3.0
Gross issues:							
During:							
1960	[7] .2	[8] .1	[9] .2	.5	([5])	([10] [11])	[12] .2
1961	[7] .3	[8] .2	[9] .1	.6	([5])	([10] [11])	[12] .1
1962	[7] .7	[8] .2	([5])	([5])	([5])	[11] 0.1	[12] .2
Net issues:							
During:							
1960	[13] .2	[14] .1	([10] [13])	.3	[13] .6	([10] [15])	[13] .1
1961	[13] .3	[14] .1	[13] .1	.5	[13] .7	([10] [15])	[13] —.1
1962	[13] .6	[14] .1	[13] .2	.9	[13] .7	([10] [15])	([10] [13])

Gross national product: [16]	
1960	12.2
1961	13.4
1962	15.7

[1] Outstanding bonds of mortgage institutions and companies at par value. (*Sveriges Riksbank* 1962 "Yearbook," p. 88*.)
[2] Market value of outstanding stock. (See p. 213 for 1960 and p. 198 for 1961.)
[3] Outstanding bonds and long-term promissory note loans at book value. ("Monthly Digest of Swedish Statistics." Swedish Central Bureau of Statistics, Stockholm, N. 7, July 1963, p. 518.)
[4] Mortgage holdings of Central Government, *Riksbank*, savings banks, post office savings, postal giro service, mortgage institutions, National Insurance Pension Fund, insurance companies, and building credits of commercial banks. (As in 1, various pages.)
[5] Not available from sources used.
[6] Outstanding interest-bearing bond loans and premium bonds, at par value. (*Ibid.*, p. 73.*)
[7] Gross issues of bonds of mortgage institutions and "companies." (*Ibid.*, p. 88.*)
[8] Gross issues of stock excluding "bonus issues" and stock dividend issues by insurance companies and commercial banks. (*Ibid.*, p. 508.)
[9] Long-term borrowing of local authorities including bonds and long-term promissory notes. (*Ibid.*, p. 91.*)
[10] Less than $50,000,000.
[11] "Imoirts" of foreign securities at transaction prices. (*Ibid.*, p. 65.*)
[12] Gross issues at par value. (*Ibid.*, p. 88.*)
[13] Changes in outstanding.
[14] Net amounts raised by stock issues; issues by Government-owned companies included. (See p. 206; primary source: *Riksbankers Forvaltninigsberaitelse fön år* 1961, p.-10.)
[15] "Imports" less "exports" of foreign securities, i.e., net financing of foreign securities in Sweden. (As in 1 p. 65.*)
[16] IMF, "International Financial Statistics," October 1963.

CHAPTER III

A COMPARISON OF FINANCIAL FLOWS

Having contrasted the size and structure of United States and European capital markets, it is desirable now to turn to a consideration of comparative financial flows so as to reach a fuller understanding of some of the reasons for differences in capital market development. Ideally, this discussion of financial flows would proceed entirely within the framework of a statistically consistent set of flow-of-funds accounts for the United States and European countries. However, flow-of-funds statements are only available upon a reasonably comparable basis for the United States, France, Germany, and the United Kingdom.[1] Even here there are sufficient differences in definition and coverage so as to prevent the type of systematic analytical comparison that would prove most rewarding. Consequently, it is inescapable that the discussion must proceed at many points in a descriptive, qualitative fashion. The individual country chapters provide the detailed justification for most of the conclusions drawn in this chapter; the emphasis here will be upon broad similarities and differences between financial flows in the United States and the Western European countries. Upon occasion, more or less subjective evaluation is offered as to the characteristics of European financial flows. This is described as such where it appears, so that the reader can readily recognize the points upon which difference of opinion is almost certain to exist.

The principal characteristics of continental European financial flows as compared to those of the United States that will be discussed in this chapter can be summarized briefly as follows:

(1) In Europe, government and other public or quasi-public institutions play a larger role in gathering savings and allocating them to alternative uses.

(2) A smaller proportion of European savings is channeled through private nonbank financial intermediaries. In particular, private insurance companies and pension funds play a much smaller role in continental European capital markets than they do in this country.

(3) A smaller proportion of total savings arises in the household sector in Europe.

(4) Europeans tend to display a greater preference for the acquisition of very liquid assets.

(5) European financing includes a larger proportion of direct credits, particularly bank credit, and a smaller proportion of new securities issues.

[1] Data were available for Belgium, as well, but only through 1960.

ROLE OF THE PUBLIC SECTOR

Any attempt at direct statistical comparision of the roles of the public sectors in separate economies encounters serious difficulties of consistency as to what is to be included in the public sector for valid international comparisons. An initial approximation of some value is provided by the United Nations "Yearbook of National Accounts Statistics" because of the fact that a serious, and at least partially successful, effort has been made to insure the maximum degree of consistency in the reporting of country data. In general, table I, based upon the U.N. source, testifies to the extensive role of the public sector in Europe both as a source of savings and as an investor in fixed assets.[2] The general government and public corporation share in net savings is, on the average, substantially larger than in the United States. Similarly, in Europe, the public sector (public corporations, government enterprises, and general government) share in domestic fixed capital formation consistently exceeds the similar share in this country. Belgium provides an exception both in savings (for which a detailed breakdown was not available in the source) and in fixed capital formation; in each case its sectoral distributions are quite similar to those of the United States.

TABLE I.—*Percentage distribution by sector of gross domestic savings and gross domestic fixed capital formation, 1961*

	United States	Belgium [1]	France	Germany	Italy	Netherlands	Sweden [2]	United Kingdom
Gross domestic savings: [3]								
1. Capital consumption allowances	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
(a) Private sector	89.0	89.0	[4]	[4]	[4]	78.3	[4]	60.7
(b) Public sector	11.0	11.0	[4]	[4]	[4]	21.7	[4]	39.3
2. Net saving	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
(a) General government	12.8 (a and b)	−9.8	40.2	44.5	17.8	32.3	31.9	3.9
(b) Public corporations		[4]	13.9 (b and c)		82.2 (b, c, and d)	2.7	45.4 (b and c)	−4.8
(c) Private corporations	21.3	[4]		8.7		19.8		41.3
(d) Households and private nonprofit institutions	65.9	[4]	45.8	46.8		45.2	22.7	59.5
Gross domestic fixed capital formation:								
1. Fixed capital formation	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
(a) Private enterprises	81.5	80.6	61.5	86.8 (a, b, and c)	87.4	68.2	61.8	60.3
(b) Public corporations	2.6 (b and c)	.	25.8 (b and c)			4.6	8.3	19.9
(c) Government enterprises		9.4				8.9	13.2	8.9
(d) General government	15.9	10.0	12.7	13.2	12.6	18.2	16.8	10.9

[1] 1960.
[2] Percentage distribution of gross domestic saving since capital consumption allowances are not shown separately.
[3] Excluding deficit on current account of the balance of payments and statistical discrepancy.
[4] Not shown separately.

Source: "Yearbook of National Accounts Statistics, 1962," United Nations, 1963.

[2] So as to show more clearly the proportion of net saving attributable to households, to which later reference is made, separate sectoral percentage distributions are provided in table I for capital consumption allowances and net saving. This does involve the loss of some detail since the proportions of capital consumption allowances to gross domestic savings are not shown separately. The proportions were: United States, 56.7 percent; Belgium, 45.2 percent; France, 45.2 percent; Germany, 31.8 percent; Italy, 36.3 percent; Netherlands, 33.2 percent; and United Kingdom, 44.6 percent.

While the data of table I are suggestive, they reveal only a part of the government role in financial flows since they are based upon the standardized national income definitions. These definitions prevent direct statistical recognition of the fact that the government sector in most European countries also borrows funds from other sectors of the economy, and its total available resources in terms of savings plus borrowing usually far exceed the government's own requirements for investments in physical assets. Thus, the government sector acts as an intermediary on a large scale as it lends funds to other sectors, including in many cases the private enterprise sector.

When the government's role both as saver and investor and as borrower and lender is taken into account, the true dimensions of government participation in the financial flows of the economy are revealed. Unfortunately, it was not possible to assemble comparable statistics for the individual European countries so as to show the exact dimensions of this larger role of government. The separate country chapters will provide a guide in each case. To cite but a single example, in Germany about one-fourth of the total resources available for investment in recent years (savings plus intersectoral borrowing) arose in the government sector. A comparable figure for the United States would be about 10 percent.

In addition to the government role in gathering and allocating financial resources, many leading financial institutions in Europe are public or quasi-public entities. They not only act as vehicles for the administration of government loans to the economy, but they also accept deposits from the public or issue bonds themselves in order to raise loan funds. In France, the Treasury is at the center of a network of specialized official and semiofficial institutions which collects liquid savings from the public and transforms these into longer term funds. In this way, as well as by direct controls, the amount and pattern of national investment are under close public direction. In Italy, a large part of the banking system, the postal savings system, and some medium- and long-term lending institutions are publicly owned. Also, a large part of Italian industry is publicly owned, or controlled through the industrial holding company (IRI), or similar agencies. As in the case of France, the public influence upon the pattern of financial flows and savings-investment decisions is substantial. The origins of some of these institutional developments are to be found in the financial stresses of the interwar period. Emphasis upon the public character of financial and investment decisions was also increased by the demands of reconstruction after World War II.

The extent to which public or quasi-public long-term credit institutions are subject to central direction and control varies a great deal from country to country but is perhaps greatest in France where the central government has utilized these institutions as an instrument of national planning. In Germany, on the other hand, control of public credit institutions is highly decentralized. Most of the public credit institutions in Germany, which consist primarily of numerous municipal savings banks, public mortgage banks, and a few specialized long-term credit institutions, operate as independent units.

The situation in the United Kingdom differs substantially from that on the Continent in that the financial system remains predominantly under private ownership and control even though a high proportion of investment is public in character. Although the proportion of fixed investment by public enterprises in the United Kingdom is among the highest in Europe, the public sector as a whole does not provide net savings and, therefore, draws funds from the private sector in order to finance itself. Within the public sector, however, the central government normally has a surplus of savings from current fiscal operations and in addition borrows substantial amounts from the private sector in order to finance public enterprises and, to some extent, local authorities (through the Public Works Loan Board). Thus, a sizable proportion of the nation's financial resources is directed through the central government accounts, even though most of the financial system remains in private hands.

Evaluation of the net effect of the extensive role of the public sector in European financial flows upon the functioning of capital markets is hazardous, not only because of great variation in the situation from country to country, but also because there has, in most cases, been only limited experience with present arrangements. It must also be remembered that present arrangements frequently embody conscious social and political decisions as to how the financial system should operate, and that questions of pure efficiency of market operation may not have been paramount in reaching those decisions. As a consequence, the following summary evaluation is offered with hesitancy and with recognition of its inevitable subjectivity.

While the extensive participation of the public sector in European financial flows does undoubtedly facilitate detailed public control of the savings-investment process, it may tend also to introduce a degree of rigidity into financial markets thereby reducing their capacity to respond adequately to changing conditions. From a more static point of view, the preferential treatment given to borrowers whose projects meet with official approval may tend to increase the cost of capital in unsubsidized uses. Each of these possibilities will be discussed briefly.

It is possible that some European countries will find that the close public direction of capital markets which evolved in times of stress is not ideally suited to the needs of the future. Now that personal savings have reached a high level, and confidence in monetary stability has grown, the need for government action to mobilize private savings and to direct their flow may have diminished. If this should be the case, there would be an opportunity to allow somewhat wider scope for the private financial sector to develop new instruments and techniques whereby a wider appeal might be made to private savers than can readily be achieved where public and semipublic financial institutions are dominant influences.

It is hardly possible to conclude with total certainty that a close governmental control of the savings process will inevitably lead to a lower rate of national savings and to an inferior allocation of those savings to competing uses. However, it does seem likely that over long periods of time the optimum division between public and private functions, undoubtedly differing between countries, would be such as to allow considerable scope for the spontaneous development of private financial practices and institutions. On the face of it, it would appear that some European countries may, in the future, wish to allow additional scope for the free interplay of market forces in the savings-investment process.

Not only would an enlargement of scope for the private sector assist in the evolutionary development of some European capital markets, it might also encourage a potentially useful dependence upon the allocative function of the long-term interest rate. At present, there is a widespread practice followed by many European public authorities of relending funds at subsidized interest rates or to certain borrowers for whom standard public lending rates represent a saving. This has the effect, in general, of increasing the cost of capital for unsubsidized borrowers and may involve an unplanned restriction of activity in some competitive sectors. Without complete specification of the surrounding circumstances, it is not possible to estimate the net effect in terms of the height or rigidity of long-term interest rates. However, some observers feel that in Germany, for example, government stimulation of housing construction by various means has been a major factor behind the high level of interest rates in recent years, particularly on the bond market where about one-half of all mortgage loans are refinanced.

FINANCIAL FLOWS OF HOUSEHOLDS

European households not only account for a smaller proportion of net national savings than their American counterparts (as may be seen from table I above), but there are also important differences in the composition of financial assets which households in the different countries choose to hold. Table II presents a comparison of the net acquisition of financial assets by households in the United States, France, and Germany during 1959–61 and in the United Kingdom during 1960–62. In addition, information presented in the country chapters permits some additional generalization with respect to the financial behavior of households in other European countries.

TABLE II.—*Net acquisition of selected financial assets by households, average 1959–61*

[Billions of dollars]

	United States [1]		France		Germany		United Kingdom [2]	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Currency and demand deposits	0.7	2	1.8	50	0.5	13	1.6	36
Time and savings deposits	14.0	46	.8	23	2.2	54		
Savings bonds [3]	−.6	−2					.5	11
Other securities	2.9	9	.7	19	.7	18	−.7	−16
Mortgages [4]	2.0	7					.6	14
Life insurance and pension funds	11.7	38	.3	8	.6	16	2.4	55
Total	30.7	100	3.5	100	4.0	100	4.4	100

[1] Consumer and nonprofit organizations excluding investment in noncorporate business.
[2] Average 1960–62 for the personal sector which includes unincorporated businesses and private nonprofit organizations as well as individuals.
[3] Includes U.S. savings bonds and postal savings system deposits and United Kingdom national savings except for deposits with trustee savings banks which are included in currency and deposits total shown above.
[4] For United Kingdom, increases in local authority debt held by the personal sector.

Sources: Federal Reserve Board, "Bulletin," August 1963; "*Rapport sur les Comptes de la Nation de l'Annee 1962*," "*Imprimerie Nationale*, Paris *Deutsche Bundesbank*, "Monthly Report," May 1963; Bank of England, "Quarterly Bulletin," September 1963.

The data of table II and related information in the country chapters suggest that one characteristic of European households is their marked preference for liquid assets, particularly in France and Italy and, to a somewhat lesser extent in Germany. During the 1959–61 period covered in table II, French households chose to hold no less than 50 percent of the increase in their financial assets in the form of currency and demand deposits, and almost another 25 percent in time and savings deposits. German households took a little more than 10 percent of the increase in their financial assets in the form of currency and demand deposits (as against 30 percent in the early fifties) and in the United States the proportion, during this period, was only 2 percent. Data available for the United Kingdom did not permit the separation of demand deposits from other types of deposits. (The comparisons of table II refer to incremental changes over a 3-year period and are not necessarily representative of the average relationships existing over longer periods of time.)

Many observers feel that the greater continental preference for liquid assets is closely connected with the European history of inflation. If they are correct, a basic precondition for any voluntary increase in the flow of European personal savings into fixed-return, long-term investments is the maintenance of a considerable degree of monetary stability over an extended period of time. Otherwise even high money rates of return on debt obligations will be discounted heavily by potential purchasers and will not offer much inducement to give up the liquid position which allows a ready shift into goods, gold, foreign exchange, or other traditional hedges against inflation. Without a sustained period of reasonably stable prices it is argued, Europeans cannot be expected to change saving habits which have been influenced by several decades of intermittent inflation. The German pattern of saving and asset formation suggests to some that even a decade or more of monetary stability cannot completely erase the effects of the past.

It could hardly be contended that the expectation of inflation offers a complete explanation of European preference for very liquid assets. There are other special influences in individual countries that are detailed in the country chapters. One of these centers around the important role of social insurance upon the Continent and it will be discussed here, although briefly.

Table II suggests that a striking difference in household financial behavior is to be found in the relatively larger significance to U.S. households of life insurance and pension funds, which accounted for over 35 percent of the increase in households' financial assets in the United States during 1959–61, as against 16 percent in Germany and only 8 percent in France. In the United Kingdom, where the preference for very liquid assets does not show as sharply, the available statistics suggest that over 50 percent of the identifiable increase in household assets during the 1960–62 period occurred in life insurance and pension fund savings. The United Kingdom data also show persistent net sales of company securities by the personal sector. Most of these securities are believed to be purchased by insurance and other companies.

Private insurance companies do not play a very important role in the capital markets of France, Germany, Italy, and Belgium. They do play a more important role in the United Kingdom, the Netherlands, Switzerland, and Sweden—countries which have enjoyed a substantial degree of price stability. At the end of 1961, the assets of British insurance companies were almost four times as high as those of German companies and almost six times as high as those of French companies. This reflects a rather basic institutional difference in that private insurance in continental Europe has been supplanted to a very considerable extent by social insurance. Social insurance plans are often financed out of current receipts; thus they do not always result in large capital accumulations which might be invested in securities.

The extent of the activity of private insurance companies and pension funds has an extremely important bearing on securities markets. In highly developed markets, these institutions normally purchase a very large proportion of new security issues. At the end of 1962, insurance companies held almost one-third of all fixed-interest securities outstanding in the United States and about 75 percent of all corporate fixed-interest securities. In Germany, by contrast, insurance companies hold only slightly more than 10 percent of all fixed-interest securities outstanding. This is an example of an institutional difference between European and United States capital markets which seems likely to persist and to continue to influence the direction of their respective development.

FINANCING BUSINESS INVESTMENT

Since the scale of activity on European security markets has only recently increased, business enterprises in Europe have in the past relied upon nonmarketable forms of credit for a large proportion of their outside financing needs. Table III, which compares the sources of external business finance in the United States, France, and Germany during the period 1959–61 and in the United Kingdom during 1960–62, shows the preponderance of nonmarketable credits in the two continental European countries. The U.S. proportion of nonmarketable credit is obviously less than that in France and Germany even after allowance for the fact that mortgage financing by American enterprises as well as some bonds which are privately placed are often similar to nonmarketable credits. The data for the United Kingdom suggest that a high proportion of recent external financing in the United Kingdom has been through capital issues.

TABLE III.—*Sources of external business financing, average, 1959–61*

	United States [1]		France		Germany		United Kingdom [2]	
	Billions of dollars	Percent	Billions of dollars	Percent	Billions of dollars	Percent	Billions of dollars	Percent
Bonds	3.7	22	0.50	11	0.2	4	1.0	45
Shares	2.3	14	.64	14	.8	16		
Mortgages	5.0	30	---	---	---	---	.1	5
Short-term credit	6.0	[3] 35	1.56	34	1.2	24	1.1	50
Long-term credit			1.94	42	2.2	44		
Other	---	---	---	---	.5	11	---	---
Total	17.0	100	4.63	100	4.9	100	2.2	100

[1] Corporate and noncorporate, nonfinancial business.
[2] 1960–62 data for nonfinancial companies.
[3] Includes bank loans, other loans (mainly commercial paper and loans from finance companies), and trade credit.

Sources: Federal Reserve Board, "Bulletin," August 1963; "*Rapport sur les Comptes de la Nation de l'Annee 1962,*" *Imprimerie Nationale*, Paris *Deutsche Bundesbank*, "Monthly Report," May 1963; Bank of England "Quarterly Bulletin," September 1963.

Heavy reliance on direct credits from banks and governmental institutions to finance long-term investment arises almost inevitably from the absence of well-developed capital market mechanisms. It is difficult to generalize with complete assurance as to the net effect upon allocative efficiency where direct extension of credit predominates. However, there is some presumption that allocative efficiency may be impaired and growth inhibited unless those seeking long-term financing have a reasonably wide range of choice between alternatives. For some borrowers, the existence of an active securities market may frequently represent an attractive alternative to obtaining investment funds from a limited number of direct lending agencies or institutions.

TRANSACTIONS OF FINANCIAL INSTITUTIONS

Most of the characteristics of European financial flows which have been discussed in this chapter are reflected and summarized in the balance sheets of European financial institutions. Reference to table IV, which gives changes in the assets and liabilities of financial institutions in the United States, France, Germany, and the United Kingdom provides a convenient summary. The major points of interest are the comparative importance of short-term credit in the French and German structures; the greater use of marketable credit instruments in the United States and the United Kingdom; the lack of substantial life insurance and pension funds in France and Germany and their greater relative importance in the United Kingdom; the large volume of government credits channeled through French and German financial institutions (not directly shown in table IV); and the importance of the German institution of mortgage banks, which accounts for the relatively high proportion of securities issued by German financial institutions and has a counterpart in the extension of mortgage credit which appears in table IV as long-term credits.

TABLE IV.—*Transactions of financial institutions, average, 1959–61*

	United States		France		Germany		United Kingdom [4]	
	Billions of dollars	Percent	Billions of dollars	Percent	Billions of dollars	Percent	Billions of dollars	Percent
Net acquisition of financial assets:								
Currency and deposits	0.7	2	0.3	6	(1)	----------	(1)	----------
Securities	10.9	29	.5	10	1.1	14	1.6	31
Mortgages	14.6	39	----------	----------	----------	----------	1.0	19
Short-term credits } Long-term credits	11.4	30	1.4	29	1.6	20	2.6	50
Long-term credits			2.1	42	5.0	61		
Other, including net foreign position	−.1	----------	.6	13	.4	5	----------	----------
Total	37.5	100	4.9	100	8.1	100	5.2	100
Net increase in liabilities:								
Currency and demand deposits	2.5	8	2.1	45	1.3	16	2.4	46
Time and savings deposits	15.2	44	1.4	29	[2] 3.9	48		
Life insurance and pension funds	8.5	25	.3	5	.8	10	2.3	44
Securities	3.1	9	.3	6	1.3	16	.4	8
Credits	1.1	3	.9	19	----------	----------	----------	----------
Other	3.6	11	−.3	−4	[3].8	10	.1	2
Total	34.2	100	4.7	100	8.1	100	5.2	100
Discrepancy	2.3	----------	.2	----------	----------	----------	----------	----------

[1] Less than $50,000,000.
[2] Including other funds placed with banks, except those placed with banks by Government, and funds placed with building and loan associations.
[3] Includes $600,000,000 of funds placed with banks by Government.
[4] Average 1960–62.

Sources: Federal Reserve Board, "Bulletin," August 1963; "*Rapport sur les Comptes de la Nation de l'Annee 1962*," *Imprimerie Nationale*, Paris; *Deutsche Bundesbank*, "Monthly Report," May 1963; Bank of England, "Quarterly Bulletin," September 1963.

CHAPTER IV

FOREIGN LENDING AND EUROPEAN CAPITAL MARKETS

The two previous chapters have concentrated upon internal aspects of European capital markets and financial flows. This chapter examines the extent to which European capital markets have been open to new security issues by foreign borrowers, describes the effect of existing restrictions on international transactions, and notes some recent signs of greater international long-term lending activity in European markets.

INTERNATIONAL TRANSACTIONS IN NEW SECURITY ISSUES

In recent years, the securities markets of two European countries, Switzerland and the United Kingdom, have regularly accommodated a significant volume of new security issues by foreign borrowers as shown in table I. However, both of these countries carefully control the access of foreigners to their long-term capital markets, and almost all of the borrowing in the United Kingdom market has been limited to the rest of the sterling area. Germany, which does not impose restrictions on capital movements, has provided only relatively small amounts for new foreign security issues because of high issue costs and the high level of interest rates prevailing there. The Netherlands permitted a substantial volume of foreign issues in 1961, but no foreign issues in 1959 or 1960, and only a very small amount in 1962 and 1963. France permitted no foreign security issues until late in 1963, apart from franc area issues, while Belgium and Italy have opened their markets to limited borrowings by international institutions but to few others.

TABLE I.—*New foreign bond issues in Europe and the United States,[1] 1959–63*

[In millions of dollars]

	Germany	Netherlands	Sweden	Switzerland	United Kingdom	United States Gross amount offered: Canadian issues	Other	Total
1959	34	--------	--------	107	98	496	284	780
1960	14	--------	12	132	82	278	287	565
1961	3	146	7	218	112	324	301	625
1962	25	28	2	140	62	544	596	1,140
First half of 1963	25	--------	19	91	38	695	466	1,161
Total	101	174	40	688	392	2,337	1,934	4,271

[1] Refunding issues are included but IRBD issues are excluded. European data are nominal amounts; U.S. data are net of discounts and commissions. European data cover only publicly offered issues; U.S. data cover both public offerings and private placements, including issues purchased in connection with U.S. direct investments abroad. European and U.S. data include purchases by both residents and nonresidents. The U.S. data shown thus differ from U.S. balance-of-payments figures on new issues of foreign securities, which cover only portfolio purchases by U.S. residents and include equities as well as bonds.

Sources: U.S. Department of Commerce and the International Bank for Reconstruction and Development.

In the same period, the U.S. market, long an important source of long-term capital for the IBRD and for Canadian local governments and companies, also became a major source of external capital for a widening group of foreign public authorities and private companies, most of which formerly obtained capital from European sources. As shown in table I, during 1962 and the first half of 1963, new foreign bond issues (including private placements) in the U.S. market rose steeply from the average level of about $650 million, which had been characteristic of the 1959–61 period, and reached an annual rate in excess of $2,000 million in the first half of 1963. The massive scale of foreign bond issues far exceeded the total of foreign bonds publicly issued on all European capital markets during the same period—comprehensive data on private placements in European markets are not available. (Private placements do not, however, play the important role in European markets for new issues that they do for foreign borrowings in the United States.) Even if Canadian borrowings are excluded from the U.S. total, in view of the long established financial relationship between the United States and Canada, the disparity between recent European and United States accommodation of new foreign security issues is wide indeed. It should also be noted that when the proposed U.S. interest equalization tax was announced in July 1963, there were indications that European flotations in the United States were about to increase sharply.

The failure of most European markets to absorb new foreign security issues in significant amounts stands in marked contrast to the extensive participation by Europeans in foreign lending through the New York market. Information on such participation is incomplete, but in some past years as much as one-half, or even more, of European bonds publicly issued in the United States (as distinct from private placements) were purchased by Europeans themselves. In 1962 and early 1963 when the strains upon the U.S. balance of payments caused by foreign borrowing in this country became so severe, foreign participation continued but on a considerably reduced scale.

Informed sources attribute some foreign purchases of European securities sold in New York to the influence of special factors, such as exemption from U.S. withholding tax on interest paid to nonresident alien holders of foreign dollar bonds, and possibly even the desire to evade taxation in the home country. Also many investors may prefer to hold some part of their assets in dollars rather than in their own currency, not necessarily because of any apprehension as to the value of currencies other than the dollar, but simply from a desire to have part of their resources denominated in an international reserve currency—one that is widely used both as an international medium of exchange and as a store of value. Long-term interest rates in some foreign countries have been below those in the United States—Switzerland and the Netherlands are examples—and dollar bonds probably have often been purchased on the straightforward basis of more attractive yields in New York than were available in domestic markets.

While each of these factors undoubtedly has been influential in certain cases, it also seems likely that a broad encouragement for

TABLE II.—*Summary of controls over capital movements*

Country	Convertibility of currency on capital account	Direct investments abroad	Portfolio investment abroad	Commercial credits 5 years and under	Financial loans	Deposits in foreign banks	Flotation of securities issued by nonresidents	Repatriation of direct investments by nonresidents	Repatriation of portfolio investments by nonresidents	Areas where special regulations apply[1]
	Type of capital movement									
Belgium-Luxembourg	External	Control via free market.	Control via free market.	Control via free market.	Control via free market.	Control via free market.	Banking laws and free market exchange rate.	Control via free market	Control via free market.	None.
France	do	Liberalized	Free	Liberalized	Individual licensing and banking laws.	Generally not permitted.	Controlled under both banking and exchange control laws.	Liberalized	Free	French franc area.
Germany	Full	Free	do	Free	Free	Free	Free	Free	do	None.
Italy	External	Largely liberalized.	Permitted through Bank of Italy or its agents.	Credits under 1 year liberalized.	Individual licensing.	Generally not permitted.	Controlled under both banking and exchange control laws.	Liberalized	Liberalized	Organization for Economic Cooperation and Development and European Economic Community.
Netherlands	do	Liberalized	Control via free market.	Liberalized	do	do	do	do	Control via free market.	Guilder area.
Switzerland	Full	Free	Free	Large credits controlled under banking laws.	Large loans controlled under banking laws.	Free	Controlled under banking laws.	Free	Free	None.
United Kingdom	External	Individual licensing and control via free market.	Control via free market.	Controlled over 6 months.	Controlled under both banking and exchange control laws.	Generally not permitted.	Controlled under both banking and exchange control laws.	Free on approved investments.	Control via free market.	Sterling area, Uniscan and European Free Trade Association.

[1] Payments to bilateral account countries not listed here are also under special controls.

NOTE.—The notation "liberalized" indicates that prior authorization is required, but is freely given. The notation "control via free market" indicates that transactions are permitted, but the call on foreign exchange to finance them is restricted by channeling them through a free market, to which the supply of foreign exchange is limited. Tendencies for outflow to increase result in changes in the free market exchange rate rather than in an increased outflow of foreign exchange.

foreign purchase of dollar bonds in New York is simply to be found in the much greater marketability of foreign security issues when they are made in the large New York market characterized by wide ownership and active trading rather than in the narrower domestic markets of the borrowing countries. The purchaser of foreign dollar bonds may feel more confident that reasonably firm price quotations will be available on the issue throughout its period to maturity. There is an obvious importance to many investors in being able to liquidate securities, if required, on a broad and responsive market.

For their part, foreign borrowers in the U.S. market have been able to tap sources of funds not available to them in their domestic markets, and in a few cases borrowing by central governments has enabled them to bolster their foreign exchange reserves. While these borrowers may at times obtain funds from their own nationals through a loan offered in the U.S. market, often the foreign subscriptions are by investors from countries other than the borrower.

A general factor conditioning the recent relationship between United States and European capital markets is the fact that European regulations on borrowing abroad have been liberalized much more rapidly than have the corresponding restraints, legal and institutional, on the flotation of new security issues in European markets. The strength of this influence will diminish as existing restrictions on the entry of foreign borrowers to European capital markets are relaxed and the capacity of those markets to absorb new issues is increased.

RESTRICTIONS ON NEW SECURITY ISSUES

The country-by-country summaries which make up the body of this study provide a detailed account of the national restrictions in force on new security issues by foreigners and on international capital transactions in general. The review which follows is based upon the country chapters. It seeks briefly to call attention to what seem to be some of the more important restrictions and to comment upon their probable effect. This review is supplemented by table II which consolidates much of the detail more fully discussed in the country chapters.

Often an arm of domestic financial policy, controls over new security issues involve licenses or other forms of official approval for the flotation of new issues and may extend beyond security issues to the raising of new money by nonresidents through the national banking system. Such controls limit or suppress the foreign demand for capital in order to permit effective regulation of domestic credit conditions and to keep capital funds at home. Switzerland and the Netherlands, with small but relatively well developed capital market facilities, carefully restrict foreign access in an attempt to prevent the demands of foreign borrowers from driving up domestic interest rates. In some countries, especially France, direct controls over both foreign and domestic security issues serve as an instrument to channel financial resources into industries and firms designated as of high priority in the national economic plan.

There has been a welcome tendency in recent years, stronger in some European countries than in others, to reduce legal restrictions on new foreign security issues or to relax their application. But the outflow of capital from European countries with respect to volume and countries of destination is still closely regulated in most countries and outright prohibition is not unknown.

Most European countries have restrictions on domestic as well as foreign capital issues. However, foreign borrowers usually face greater formalities and frequently are permitted entry, if at all, only after the needs of domestic borrowers are satisfied. Such seems to have been the case in the Italian, British, and French capital markets. The Swiss and Dutch apply restrictions with a lower degree of legal rigor, and their controls are subject to removal by administrative decision for determined periods of time, although both have established maximums for the size of individual issues.

Germany is the only major European country without legal restrictions on capital exports, although high interest rates and the very limited character of capital market facilities have operated in the past to make foreign issues a rare occurrence. This same net result has occurred in Italy and France where the restrictions preventing ready foreign access are, however, numerous and effective. Since 1932, the new issues market of London has been subject to government control, and has ceased to be an important source of long-term capital for borrowers outside the Commonwealth and sterling area. In the postwar period, annual loan repayments by non-Commonwealth countries have usually exceeded the amount of new money raised.

The purchase abroad of outstanding foreign securities is generally possible but administrative techniques are sometimes employed to prevent a net outflow of capital because of domestic purchases of foreign securities. The Netherlands and the United Kingdom, for example, permit transactions in foreign securities by residents and in domestic securities by nonresidents, but the call on foreign exchange to finance outflows is restricted by channeling transactions through a special market, to which the supply of foreign exchange is strictly limited. An increased demand for foreign securities results in a change in the special rate of exchange applicable to the purchase of foreign securities, rather than in a net capital outflow. Belgium maintains a somewhat similar market but permits all capital transactions to be carried out in it and exchange rates in this market have rarely exceeded margins prescribed by the IMF for current transactions.

On the other hand, there are still limitations in most European countries on the borrowing of foreign currencies from banking and other institutions as well as borrowing from nonresidents. These restrictions were even tightened by France in August 1963, in order to discourage a capital inflow that might have upset official policies of monetary restraint.

In general, the trend toward liberalization of capital movements has made substantial progress during recent years, often upon the free initiative of national governments, and frequently upon the recommendation of international bodies in which such governments were members. As this progress continues, it would be very helpful if it came increasingly to include the relaxation of regulations affecting new security issues, which to date have been less affected by liberalization than most other capital transactions. Some European countries do apparently regard direct controls over new security issues—domestic and foreign—as an important instrument of national policy. For several countries, in fact, exchange control measures have been entirely removed while direct controls on new issues remain basically intact.

In December of 1961, the Organization for Economic Cooperation and Development adopted a code of liberalization of capital movements that has had considerable influence toward lessening restrictions on international capital movements. The code is now being revised, and its adaptation should strengthen tendencies toward liberalization. With a membership of 20 countries—18 European countries, Canada and the United States—the OECD has been a forum for close consultation on problems of international payments and capital markets. Working Party 3 of the Economic Policy Committee of the OECD, which brings together government officials responsible for the formulation of financial policy, has been particularly effective in such consultations.

Article 67 of the treaty establishing the European Economic Community has also strengthened the movement toward the freedom of capital transfers. The Common Market's first directive in this field in 1960 was limited specifically to exchange control regulation, but in December 1962 a second directive was issued extending the liberalization measures to other types of restrictions. Freedom to transfer capital among the member countries of the European Economic Community has already been achieved for direct investments, personal transfers, short-term and medium-term commercial loans, and operations in listed securities. For other types of capital transactions, the Community has adopted a system of conditional liberalization. Much less progress has been made, however, in the very important area of new security issues. The EEC Commission proposed early in 1963 that members' capital markets be completely opened to each other's security issues by the end of 1967.

It is clear that progress toward further liberalization of capital movements in Europe will have to be a coordinated effort involving all of the major countries. Unless progress is achieved on a cooperative basis, only those nations with the highest interest rates and most inadequate institutional facilities will readily open their financial markets to foreigners. Indeed, in such cases the net result may not be much more foreign lending by the countries in question, but an increase in borrowing as an inflow of capital from abroad is attracted by high interest rates. If interest rates remain high and the capital inflow is unchecked, the effect upon international equilibrium could be disruptive.

SOME RECENT DEVELOPMENTS

The increasing concentration of long-term foreign borrowing upon the New York market during 1962 and the first half of 1963 provided a graphic demonstration of the dangers inherent in a state of affairs where foreign access to European capital markets is strictly limited.

While the inherent desirability of more closely integrated and readily accessible European capital markets has long been appreciated, the urgency of rapid progress toward that goal was underlined sharply by the events which led to the proposed U.S. interest equalization tax. Not only is the need for expansion in European lending now more clearly exposed, but also the prospect of a temporary diversion of some demands for long-term funds away from the New York market has created an unusual and profitable opportunity for the European banking and financial community to enlarge its role in long-term international lending.

The first months after the proposal of the interest equalization tax have been too brief a period in which to allow full European response to the altered circumstances, and the eventual effects of the stimulus to European lending are necessarily still somewhat conjectural. However, there have already been a number of interesting developments and there is the prospect of further experimentation with new techniques designed to enlarge the scope of long-term lending across European national boundaries.

There has been, for example, recent evidence of renewed European interest in so-called unit-of-account loans. These seek to attract potential investors by denominating a given loan not in a single national currency but in a composite currency unit. While European investors have displayed a willingness to buy dollar securities in large amounts, the development of European markets has not been carried to such a point that any currency other than the dollar is quite so widely acceptable as a standard of value. The technical details surrounding individual unit-of-account issues are necessarily complex because gold clauses are illegal in a number of European countries, yet borrowers and lenders frequently want something other than a simple multiple currency clause. A rather complicated formula has emerged by which the determination of the European unit of account is accomplished and the terms of payment are stipulated. On the face of it, the degree of definitional complexity attached to these loans would seem to reduce their potential for wide development. An additional factor working against them is that the monetary authorities of some countries do not care to see the use of this technique extended or oppose the inclusion of their currencies in the formula. However, some successful use has been made of unit-of-account loans in the past and they do not lack persuasive advocates who foresee much wider recourse to them in the future.

Another plan, this one suggested by Dr. Herman J. Abs, of the Deutsche Bank, would also seek to encourage European-wide participation in new security issues and has the substantial advantage of greater simplicity. There would be no dependence upon a complicated unit-of-account formula. Instead, the broad outlines of the Abs proposal call for any given, large, international loan to be divided into a number of parts. Each part would then be sold in an individual national capital market and denominated in that nation's currency. The fact that long-term rates of interest differ to some extent between separate European capital markets would be surmounted by maintaining a single overall nominal interest rate on the entire issue, but varying other terms of the separate national portions of the issue so as to make them of comparable attractiveness to national investors. The proposal would seem to have considerable merit, particularly as a transitional device by which large issues could more readily be accommodated in Europe. However, unless it stimulated, or was accompanied by, a relaxation in existing national impediments to new security issues, it might tend only to perpetuate the existence of limited and segmented national capital markets.

Another noteworthy recent development has been the renewed international lending activity of the London market. Limitations upon direct British participation in foreign security issues remain a fundamental barrier to any drastic enlargement of London's long-term lending role. However, this has not prevented the City from expanding the scale of its brokerage and underwriting activities, frequently in close cooperation with European banking houses.

Within the last year London has seen a £5 million Japanese refunding issue, and its first nonsterling currency loan since World War II, a $20 million Belgian Government issue financed on the basis of Euro-dollars. This was followed by another Euro-dollar loan of $15 million to *Autostrade*, a private Italian subsidiary of IRI, the Italian industrial holding company, and a second loan to the Belgian Government for $20 million. Aside from these Euro-dollar operations, London has recently arranged a loan to the city of Copenhagen, amounting to 60 million Swiss francs. It remains to be seen to what extent London can continue to expand the scale of these activities. To this point the City has functioned primarily only in an entrepôt role in its long-term international lending. An encouraging recent development has been the opening of the London capital market to EFTA member governments; access previously was granted to the Scandinavian countries under the terms of the UNISCAN Agreement.

A potentially significant development occurred in France in November when the European Investment Bank sold a 60 million franc bond issue in Paris. This latter loan, while modest in amount, was a noteworthy event since it was the first foreign bond issue floated on the Paris market since World War II and suggests the possibility of further loans to foreign borrowers.

All of these recent developments testify, in one way or another, to renewed European interest in long-term lending. They demonstrate, as well, the presence of a necessary technical competence joined with the willingness for financial experimentation. These are hopeful signs, but further relaxation of existing legal and institutional restrictions on new foreign security issues, particularly appropriate for countries with very strong external payments positions, will have to be coupled with a concerted effort to strengthen and integrate individual capital markets if Europe is to play its full role in long-term international lending.

CHAPTER V

SELECTED MARKET CHARACTERISTICS

Three previous chapters have been concerned with the measurement of the size and structure of U.S. and European capital markets, the description of the relationship of U.S. and European capital markets to broad patterns of financial flows, and the examination of the nature and extent of recent foreign lending activity in European capital markets. The present chapter concludes this general introductory section by summarizing what seem to be the more significant characteristics of the European capital markets. Details and more extended analysis are provided in the country studies which follow.

In the comparison of financial flows in Europe with those of the United States it was noted that as a general rule government and other public or quasi-public institutions play a major role in Europe in gathering and allocating savings; there is a heavy reliance on direct credit rather than new securities issues, and a strong preference on the part of savers for very liquid assets. Household savings provide a lesser fraction of total savings and, in most European countries, private insurance companies and other nonbank financial intermediaries play a relatively minor role. The existence of these characteristics is readily understandable in the light of recent European financial developments but some of the institutional arrangements and legal framework may, in present circumstances, serve as obstacles to further capital market expansion.

These legal and institutional influences are so numerous and complex that this selective review can touch only on the more important influences. It must also be emphasized that what is described here as an obstacle to expanded capital market activity may be adjudged quite desirable from the broader standpoint of national economic policy in an individual European country. However, it does not seem appropriate in a study of this sort to go much beyond the technical issues that arise from the analysis of market operations; consequently, judgments expressed here as to the effect of a given legal or institutional arrangement do not attempt to take fully into account policy objectives unrelated to the functioning of long-term capital markets.

CONTROL OVER NEW SECURITY ISSUES

In several European countries governmental controls over new security issues are major factors affecting the entire market. Switzerland and the Netherlands exercise such controls as an important instrument of economic policy. By regulating the volume of new issues, governmental and central bank authorities are able to influence the total volume of investment and so to reduce inflationary -ressures when they appear. These controls extend to both domestic and foreign new security issues, with the control over foreign issues also providing a means of influencing the volume of capital exports. If other elements in the balance of payments are tending to cause a surplus and if reserves are already ample, foreign security issues can be licensed in amounts sufficient to offset the surplus. At other times, the licensing control can be used to prevent a flood of new foreign issues, attracted by low interest rates, which might otherwise cause a large reduction in reserves and tend to push up long-term rates. The controls over foreign issues substantially insulate the domestic capital market from foreign markets and permit the maintenance of interest rate structures sharply contrasting with those of neighboring countries.

In France, the Government exercises its control over the issuance of bonds, as well as the availabilities of the bulk of other finance, with reference to both the pressures on the economy and to the specific contribution which the particular investment may make to the French economic plan. The system provides a means by which investment can be guided in the directions desired by the French authorities, but the resulting allocation of savings to investment may not be in accordance with the priorities which would be established by a marketplace allocation.

Italian authorities also give priority to those investments considered by the authorities to have the highest social, political, and economic value in determining which issues can be floated and which must be postponed when the pressure on the economy or the situation in the market does not permit all requests to be met on the terms the Bank of Italy wants to maintain.

In Belgium the authorities exercise control to insure that each security offering meets prescribed standards and does not harm the "equilibrium" of the capital market. The Banking Commission may reduce the size of an issue or require that it be issued in installments.

In the United Kingdom only non-United Kingdom residents and local authorities within the United Kingdom must obtain permission for new issues. Timing of new issues of more than £1 million and the terms of certain securities, largely those of public authorities, are also subject to control. The governmental concern is to protect the balance of payments in the case of nonresident borrowers, and simply to facilitate debt management by the central government in the case of the local authorities.

Sweden has no controls on issues of stocks by domestic issuers but conditions and timing of issuance of domestic bonds are controlled. Only in Germany are there no direct official controls over the total volume of domestic or foreign flotations.

GOVERNMENTAL INFLUENCES ON DIRECTION OF INVESTMENT

In a number of European countries, governments exert a powerful influence over the direction of investment in a way which has important resulting implications for the capital markets. It has already been noted that French and Italian authorities give preference to certain desired types of investments when licensing new issues and allocating public savings. New issue proposals which do not fit in with the government's economic plans may never reach the "head of the queue." The existence of the system undoubtedly discourages many potential borrowers from even applying.

In Germany the nature of the capital market is conditioned by the allocation of Government savings to enterprises, the artificial stimulation of construction and a system of premium and tax-privileged savings. Since savings by the Government sector are about double its physical investment, the Government sector is a large net supplier of investment funds to other sectors of the economy. Most of these funds are channeled to business through the banking system or in the form of direct credits, thus bypassing the organized capital market. With half of all residential construction being given government assistance and building demand otherwise actively stimulated by all levels of government, the demand for long-term finance is so great that savings become available to other borrowers only at relatively high prices. In general, the housing subsidies are perhaps the principal cause of the high level of long-term interest rates prevailing in Germany. The system of premiums for savings deposits and for funds placed with building and loan associations for fixed periods have contributed to a localization of financial circuits, and probably also to the high level of interest rates.

Similarly, in Sweden the Government has encouraged investment in housing by various techniques, channeling funds directly and also through mortgage institutions and banks. In recent years about one-fifth of housing construction has been financed out of the budget. Subsidization of residential construction in one form or another is also important in France and Belgium.

Public development programs have a major impact on the allocation of resources in some countries, most notably in Italy. Large-scale governmental investments in particular sectors of the economy siphon off a substantial share of available savings as do housing subsidies in Germany. Other potential borrowers can compete only for those savings which are left over—and must inevitably pay a higher price for them than if all borrowers were competing on equal terms. In Italy the capital market is faced with very heavy governmental borrowing requirements to meet compensation payments to former owners of the nationalized power industry, a heavy investment program in nationalized power, commitments for agricultural development, railway modernization, school construction, and housing. It seems likely that the Inter-Ministerial Credit Committee will give preference to these governmental demands over the claims of private industry.

EFFECTS OF TAX SYSTEMS

Inevitably, perhaps, tax systems exert an important influence on the functioning of European capital markets, but in some cases they operate as a serious drag to investment in long-term instruments. One of the most obvious illustrations is the 2½ percent tax on new security issues levied for the benefit of the state governments in Germany. This tax greatly increases the cost of issuing private industrial and foreign bonds (German public issues being exempt). For such issues with maturities of less than 10 years it is virtually prohibitive. It is this tax which is probably primarily responsible for the development of a business in "loans against borrowers' notes"—essentially long-term loans exempt from the tax. The effect of the tax upon the development of a market in industrial and foreign bonds is obvious.

Several other countries also levy stamp taxes although the rates are much lower. Belgium has a tax on new issues of industrial bonds with a maturity of 5 years or more of 0.7 percent of nominal value and 0.7 percent on new domestic stock issues. For foreign securities held in Belgium the levy is 1.6 percent of market value. In Sweden the stamp duty on bonds is 0.6 percent. In Italy the stamp tax varies with the nominal value of each security but is relatively small. In the United Kingdom the duty on registered bonds is only 0.125 percent, although, since subsequent transactions are not taxed, there is a much heavier initial charge for bearer issues—3 percent for United Kingdom companies and 2 percent for others. France does not levy any issues tax on either bonds or shares, and one of the reasons that banks in Luxembourg have had success with international issues is the absence of stamp duties.

The nature of the French capital market is affected by other tax arrangements. Issuance of shares is discouraged by taxes assessed on capital increases and by the fact that a withholding tax of 24 percent is applied to dividends while the rate on interest from private bonds is only 12 percent. (Public issues, on the other hand, are generally exempt from the withholding tax altogether.) The withholding tax on bonds is in theory borne by the lender who is to include it in his income and obtain a partial tax credit, but in practice the borrower usually contracts to pay the tax so that his cost is substantially increased. As a result of the differences in taxation of various types of investments there is in some cases practically no spread between the net return after taxes from short-term investments and from non-tax-privileged long-term bonds. In fact, for individual taxpayers in higher brackets the short-term investments offer the higher yield.

The Italian Government affects the pattern of capital market investment by offering special tax exemptions for bonds issued by special credit institutes. The market has recently had difficulty in adjusting to the levying of a 15-percent withholding tax on dividends. There is generally no withholding tax on interest.

COMPETITION AND EFFICIENCY IN MARKETING

The institutional arrangements which have been developed for the issuance of new securities may also have an important effect on the efficiency of the capital market and the way in which it operates. In Germany new issues other than the "on tap" sales by mortgage banks and banks making local authority loans are underwritten by banking syndicates which change very little in composition or in subscription quotas from issue to issue. A private voluntary agency, the Central Capital Market Committee, brings together the dominant borrowers (the mortgage banks) and the dominant lenders (commercial and savings banks) to determine the timing—and in practical effect the amount and terms—of capital issues by all other borrowers. These arrangements suggest that there may be something less than optimum competition in the issuing of bonds.

There are no banks in Germany which specialize in security investments or underwriting. Commercial banks are of the mixed type, engaging in underwriting and securities investments but only as a sideline. Heavy reliance on banks as suppliers of capital and the subsidiary importance of securities investments for most banks makes the German capital market highly susceptible to fluctuations in the money market and in the past has been an element of instability. In Belgium also the investment banking institution is missing. The commercial banks are limited in their ability to underwrite offerings and the holding companies do not have investment banking authority.

In France, it is the custom for the banks to send sales agents to their customers' places of business to conduct a personal solicitation of the customers. While thorough, the technique is so elaborate and time consuming that it significantly increases the cost for issuing companies. Whether the additional savings brought to the market by this technique compensate for the added cost is questionable.

In contrast, London capital market facilities are among the most highly developed in the world and the chief future questions relate more to the adequacy of total resources that can be made available to the London market rather than to any question as to the market's ability to allocate funds at low cost. Security dealings in London are facilitated by the activities of specialist securities jobbers, dealing on their own account, who create a market and smooth the effect on market prices of transitory buying and selling. A major role in the new issues market is played by the issuing houses, many of whom are specialized. Others carry on other banking and financial activities. Large issues are usually underwritten, with investment trusts and insurance companies participating along with the issuing houses.

ROLE OF INSTITUTIONAL INVESTORS

Governmental regulations and customs covering institutional investors and financial intermediaries may also act as a barrier to the development of an efficient capital market. In France the specialized lending institutions endorse 90-day commercial bills and by automatically renewing these endorsements enable the banking system and the Bank of France to accept these bills as short-term assets while giving the borrower what is in effect a medium-term loan without the necessity for a capital market issue. Only in recent months have open-end investment trusts been allowed in France. This step may be helpful in mobilizing savings from smaller investors and may also lead to purchases of foreign securities.

The failure of financial institutions in Germany to make net investments in securities may be one of the fundamental weaknesses of the German market. These institutions, over all, sell bonds to raise money with which to extend direct credits, largely going into housing. Private insurance companies have placed only a small portion of their long-term assets in negotiable securities and hold only a minor portion of the bonds in circulation. This results in heavy reliance on direct credit which tends to make German enterprises vulnerable to any sudden curtailment of credit.

The Italians have an extensive system of direct and indirect monetary and fiscal controls with which to influence savings and investment decisions. The existence of comprehensive powers enables the Bank of Italy to exert considerable influence through "moral suasion." The bank has direct control over the composition of bank investment portfolios, amounts accepted and interest paid by savings banks, and short-term interest rates on various bank transactions. Even with these powers the bank has had difficulty in maintaining a sufficient differential between short-term and long-term interest rates to stimulate long-term investment.

In Belgium, incorporated banks may hold bonds and shares in nonbanking organizations only for sale to the public and only for 6 months for this purpose. Insurance companies, mortgage institutions, and private savings banks are sharply limited in the types of assets which they may purchase. Life insurance companies and savings banks for instance, may invest in securities of Belgian firms only if they have met their commitments from their ordinary resources for 5 consecutive years. Investment of savings bank assets is limited to securities to Belgian borrowers unless other investments are specifically authorized.

In Germany also the regulations governing insurance company investments are conservative. Greater participation by these institutions in the capital market could be expected to contribute a good deal of strength and stability.

On the other hand, in Sweden the National Pension Insurance Fund has authority to invest in gilt-edge bonds and other debt securities and has become a major purchaser of bonds. Still neither the commercial banks nor the National Pension Insurance Fund can acquire stock issues for their own account. Enlargement of the scope for purchases of stock by insurance companies could be beneficial. Additionally, Swedish bond market instruments are characteristically secured by mortgages on real property to a high proportion of their face value which tends to reduce the ability of growing firms to raise adequate external capital through the bond market.

Lack of reliable information on credit ratings and financial status of borrowers appears to be an important obstacle to the willingness of investors to put their funds in industrial issues in many countries. It is particularly acute in France and Italy and it operates not only as a handicap to domestic markets but also as an obstacle to investment by foreigners in issues of French and Italian borrowers.

Another factor characteristic of several European markets, particularly those in Germany and France, is the lack of the wide variety of debt instruments and flexibility in terms which would have maximum appeal to individual and institutional savers.

INTEREST RATES AND BORROWING COSTS

This section contrasts the level of long-term interest rates in the individual European countries and the margin between the cost to borrower and yield to investor on new security issues.[1] The absolute level of long-term interest rates is influenced by supply and demand factors of both monetary and nonmonetary origin and by noneconomic factors as well. As a consequence it is difficult to ascribe the level of long-term interest rates at a particular time, or their pattern of fluctuation over time, to a single cause. However, in some cases inferences can be drawn as to the relative strength of separate influences upon the level of rates in the individual countries.

Comparison of the margin between what the borrower pays for long-term funds and what the lender receives for providing them is

[1] Informative discussions of these factors will be found in Bank of England, "Quarterly Bulletin," June 1963, pp. 106–117 and Peter B. Kenen, "Toward an Atlantic Capital Market." Lloyd's Bank Review, July 1963, pp. 15–30.

more informative as to the relative efficiency of different markets than a comparison of the absolute level of long-term interest rates in different countries. Other things being equal, the larger and more efficient the market for long-term funds, the smaller should be the market's markup in the form of the margin between borrower's cost and lender's return. The competitive efficiency of the process by which security issues are floated is possibly best indicated by the underwriting spread itself. In many countries there are also additional taxes and charges that raise the cost to the borrower or reduce the yield to the lender, and serve to discourage somewhat the resort to new security issues as a means of raising funds. This wider margin including all the applicable charges in addition to the underwriting spread will be the main object of attention in this section.

Detailed calculations of this margin are provided in most of the country chapters. In other cases available published and unpublished information has been examined in order to estimate the average margin for a particular country. No precision can be claimed for the estimates which should, in principle, refer to security issues with exactly comparable terms but which, in practice do not always do so. The estimates do consistently refer to a long-term domestic bond issued by a private company of good credit standing. The spread between cost to borrower and return to lender would sometimes be greater on a foreign bond of comparable quality. It appears that this is ordinarily the case for borrowing in Switzerland and, of course, the proposed U.S. interest equalization tax is expressly designed to raise the effective foreign borrowing cost where securities are sold to U.S. residents.

In France, the yield on new corporate bond issues declined from about 6.5 to 5.7 percent between 1959 and mid-1963. There is a substantial difference in France between the cost to borrower and yield to lender which was estimated by the Lorain Committee at 1.80 to 1.85 percent on issues of private companies.[2] Thus the private bond issue which yielded 5.70 or 5.75 percent might involve a cost to the borrower of 7.50 to 7.60 percent.[3]

Yields on fixed interest securities in Germany fluctuated widely from 1958 to 1961, first falling from 8 percent to less than 6 percent, then rising to about 6½ percent by mid-1960 before falling somewhat again in 1961. During 1962 and 1963, on the other hand, yields have been very stable at about 6 percent. It appears that the margin between borrower's cost and lender's return may be 1 percent per annum or more, for private industrial issues including the 2½ percent securities tax. This would suggest a private borrowing cost through the issuance of bonds well in excess of 7 percent, assuming a prevailing bond rate of 6.1 percent. The cost of borrowing on a loan against the borrower's notes, which is exempt from the securities tax, would probably be slightly below this figure.

These borrowing cost figures for Germany are, it will be noted, not greatly different from those for France—actually somewhat less despite the lower market yield on fixed-interest securities in France.

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[2] See ch. VII.

[3] The Lorain Committee estimates would appear to include the 12 percent withholding tax on interest and redemption premiums which it is customary for the borrower to assume. The tax amounts to about 0.70 percent per annum at present interest rate levels and may be claimed by individual borrowers as a tax credit up to three-fourths of the amount withheld, and up to the full amount by corporate borrowers. This operates to raise the after-tax yield to many investors rather appreciably.

Italian private bond yields averaged around 7 percent consistently from 1953 to 1957, then declined by almost 2 percentage points from 1958 to 1960. Bond yields again rose from 1960 onward and by mid-1963 stood slightly in excess of 6 percent. Estimates from different sources of the spread between lender's return and borrower's cost vary somewhat but usually suggest a figure in the neighborhood of 2 percent per annum including the income tax on bond interest as a recurrent cost to the borrower. This would imply a cost to borrower in excess of 8 percent. However, it may be equally reasonable to assume that some part of the tax incidence rests upon the lender which would serve to reduce somewhat the effective cost to the borrower. Even with this allowance, costs to Italian private borrowers are obviously quite high, even higher than similar costs in France. Italian costs of security issue, alone, appear to be low by European standards.

Swedish yields on industrial loans have not varied widely in recent years. Average yields were slightly above 5 percent in 1958 and 1959, rose to 6 percent in late 1961, and have since declined to the range of 5¼ to 5½ percent. The margin between the return to lender and the cost to borrower is quite narrow. Calculations on a recent representative issue suggest that a return to the lender of 5½ percent would involve a cost to the borrower of only 5.857 percent, a spread of some 0.35 percent per annum.[4] In the case of local authority borrowing or mortgage bank issues the spread would probably be reduced even further.

In the United Kingdom, long-term bond yields on private obligations were forced sharply higher by the July 1961 increase in Bank rate. Since that time they have fallen gradually and by mid-1963 yields on industrial debentures were about 6.4 percent, and they have fallen still further since then. The margin between return to lender and cost to borrower at about 0.25 percent per annum is narrow and reflects the efficiency and extensive development of London's market facilities. The margin in the New York market is, however, still narrower, perhaps typically in the range of 0.06 to 0.09 percent per annum. Even with some upward allowance for a certain degree of underpricing that is common practice on new issues, it seems quite clear that New York margins are appreciably less than those in London, and very much below those ruling in Continental markets.

On the basis of the size of the spread between return to lender and cost to borrower, it may be inferred that of the European countries considered in this chapter, the security marketing facilities in Sweden and the United Kingdom are particularly efficient. Long-term bond yields themselves in Sweden have typically been somewhat below those in the United Kingdom. An obvious influence has been the extent to which the entire interest rate structure in the United Kingdom has been conditioned by the need for external balance and the protection of the position of sterling as a reserve currency. Sweden, on the other hand, has been better able to insulate its domestic interest rate structure from international effects. Long-term interest rates in France, Germany, and Italy are relatively high. To some degree, this undoubtedly is due to the rapid pace of their recent overall economic growth and simply reflects the relatively high average returns on private investment projects. However, there is also reason to

[4] See ch. X.

believe that in these countries institutional factors have in some cases held long-term rates higher than necessary.

RECENT EXPANSION OF EUROPEAN CAPITAL MARKET ACTIVITY

A striking characteristic of European capital markets has been the sizable expansion in their internal lending activity during recent years. While much of this expanded lending activity has taken the form of direct credit, there has also been a marked expansion in the issuance of marketable securities. As has been noted in chapter IV, this recent expansion has unfortunately not extended to foreign security issues to any significant extent. However, throughout Europe there has been a resurgence of domestic activity in security markets and it will be useful to establish the extent of this increased activity in the individual countries even though the overall outlines have previously been revealed by the aggregate comparisons of chapter II.

Although stock and bond issues in France still account for only a relatively small proportion of total financing needs, the rapid pace of recent French economic growth has induced a considerable absolute increase in net sales of securities. For example, net sales of stocks and bonds by nonfinancial enterprises amounted to 5.72 billion francs in 1959, which was only 12.6 percent of their total financing, and 30.2 percent of their external financing.[5] By 1962, net sales of stocks and bonds had risen to 7.94 billion francs, an increase of almost 40 percent over 1959, but net sales of securities by nonfinancial enterprises still only accounted for 12.6 percent of their total financing, and 27.7 percent of their external financing.

In Germany, the volume of capital issues has grown very sharply even though the scope of private activity has been limited because of the predominance of public authority borrowing and mortgage refinancing on the bond market. For example, net placements of fixed interest bearing securities averaged 2.3 billion deutsche marks annually during 1953–1957 and more than tripled to an average of 7.6 billion deutsche marks annually during 1958–62. Net placement of industrial bonds declined, however, from an annual average of 0.6 billion deutsche marks in 1953–57 to an annual average of 0.5 billion deutsche marks in 1958–62.[6]

New security issues in Italy have displayed remarkable growth although the market remains a thin one potentially susceptible to wide price fluctuations. During the period 1953–57, new security issues averaged about 525 billion lire, and more than doubled to an average of some 1,170 billion lire during the period 1958–62—rising from 645 billion lire in 1958 to 1,642 billion lire in 1962. Long-term bond issues by the Italian special credit institutes have accounted for most of the recent growth in new bond issues with their issues amounting to more than four times the volume of new bonds issued by Italian private enterprises during 1962.

Rapid recent expansion in capital market activity has also been characteristic of Sweden. Long-term financing through the Swedish capital market—including the use of long-term bonds, stocks, and long-term loans against borrowers' notes—amounted to about 3

[5] These comparisons are based upon ch. VII, table IV.
[6] Based upon data from "Monthly Report" of the *Deutsche Bundesbank*, October 1963, p. 102.

billion kronor in 1958 and doubled to some 6 billion kronor in 1962. This served to increase capital market borrowing from about 5 percent of gross domestic fixed capital formation in 1958 to about 35 percent in 1962. Since 1960, the issuance of stocks and bonds has increased greatly as a means of raising funds and accounted for more than one-half of new long-term credit extended during 1962.

United Kingdom capital markets with their highly developed facilities have also experienced increases in the volume of security flotations during recent years. It is necessary to exclude central government security issues in estimating the recent trend of activity because these fluctuate widely from year to year and tend to obscure recognition of the regular growth in other components of total security issues. For example, gross central government security issues were £1,385 million in 1960, fell by almost one-half to £781 million in 1961, and then more than doubled to £1,993 million in 1962. With central government issues excluded, an upward, if somewhat irregular, trend in United Kingdom capital issues is revealed. Gross issues, chiefly by private companies, rose from £387 million in 1958 to £693 million in 1961 and then declined somewhat to £630 million in 1962. A substantially similar pattern occurred in net security issues in 1958–62 since the volume of redemptions was relatively constant—actually declining somewhat—in a range of £65 to £95 million annually.

From 1958 to 1961 the growth in United Kingdom new issues was concentrated in the issue of shares but during 1962 new bond issues increased markedly.

Recent years have seen a significant expansion of capital market activity throughout Europe, reflecting sustained economic growth and involving, in most European countries, a steadily increasing volume of new domestic security issues. This growth in the volume of marketable security issues in Europe is so general that it seems almost certain to continue in the years to come, and may accelerate. More rapid expansion would be greatly facilitated by the easing of the legal and institutional impediments outlined earlier in this chapter.

It seems possible to conclude that these institutional and legal barriers to further expansion of capital market activity in general, and to the issue of marketable securities in particular, are most serious in France, Germany, and Italy, somewhat less so in Belgium and Sweden. The United Kingdom, Switzerland, and the Netherlands, with their efficient low cost capital markets and their very high degree of external orientation, have a problem in seeking to harmonize internal and external objectives. It is striking that France and Germany with their relatively large margins of output available for capital formation have, in some respects, inadequately developed capital market facilities. There is little doubt that the next decade will see a concerted effort on the part of these countries to enlarge and diversify their long-term financial facilities.

CHAPTER VI

THE CAPITAL MARKET IN BELGIUM

SECTION I—SUMMARY

If the Belgian economy is to grow over the next few years at the rate used in its economic programing, higher rates of private investment in productive facilities seem necessary. The Belgian economy is extremely sensitive to external facors because of a heavy dependence upon foreign trade. If Belgium is to remain competitive, a major effort of reorganization, modernization, and diversification would appear to be required. An increase in the savings-consumption ratio appears necessary to finance the investments called for, as do measures to insure that available funds are offered where they are most needed. That changes in the financial system are an essential part of any program to achieve these objectives has been officially recognized in Belgium.

The present situation is characterized by the importance of the demand of the public sector for loanable funds. The central government takes an important percentage of the total of funds available each year on the domestic securities markets, and also borrows abroad from time to time to meet budgetary needs. Domestically, it borrows a high proportion of its funds at long term; its foreign borrowings are primarily at short and medium term. It is seeking to reduce its dominant role in the financial market by eliminating its deficit on current operations. The rest of the public sector, including the public credit institutions, ranks with the government as a solicitor of funds available through the securities markets.

Business turns frequently to loans rather than to issues of marketable securities when its self-financing capacity does not suffice. In part because of the fact that the banking system has not gone in heavily for medium- and long-term credit, business undertakes an important portion of its borrowing from the public sector financial intermediaries. Its security offerings to the public—small alongside those of the public sector—are primarily of stocks, with few bond sales.

Among the financial intermediaries, the public sector institutions are dominant, but private savings banks, mortgage institutions, insurance companies, pension funds, and investment funds all play a significant role in the system. On the other hand, public attention to limitations on the ability of the commercial banking system to participate in the distribution of new security issues has also brought out the lack of investment banking institutions in the structure. The commercial banks are limited in their ability to underwrite offerings and holding companies do not have investment banking authority. The appeal of the stock market to potential investors is reduced by, among other things, the low degree of liquidity of securities traded in a relatively thin market. If security markets were broad enough to afford greater liquidity the strong preference of individual savers for liquid holdings could be expected to bring even more funds into the market, giving further depth and strength.

The effectiveness of what nevertheless emerges as a generally well-developed financial market in Belgium is reduced by the existence of a number of rigidities. In particular, specialization in the supply of funds has not been accompanied by a parallel development of transfers of funds between lenders. All proposed offerings of securities are subject to control and new issues must "avoid harm to the equilibrium of the markets." The authorities may compel a borrower to reduce the size of an offering or put it out in installments. Furthermore, special tax benefits and interest rate subsidies, especially in connection with government borrowing and lending by the financial intermediaries, have strengthened the tendency toward compartmentalization. Stimulated by various governmental subsidies, over 30 percent of domestic fixed investment goes into housing, reducing the supply and increasing the cost of funds for other sectors of the economy. Financial intermediaries are sharply limited in the nature of the long-term assets they are permitted to hold. Industrial bonds, for instance, may generally be purchased only if the companies issuing the bonds are Belgian and only if they have for 5 years met their commitments from their ordinary resources.

Issues of new industrial shares are subject to a stamp tax amounting to 0.7 percent of the nominal value for domestic issues and 1.6 percent of market value for foreign securities to be held in Belgium. For industrial bonds the rate is 0.7 percent of nominal value for issues with a maturity of over 5 years. Transactions taxes amount to 0.6 percent on cash transactions in stocks, 0.3 percent on forward transactions and 0.24 percent on negotiable bonds.

In order to search for ways of dealing with the problems of financing investment, a governmental commission was formed in 1961. Among other things, it recommended reduction of government deficits, greater flexibility for financial institutions in their investments, measures to improve the ability of the commercial banks to distribute security issues and efforts to lower long-term interest rates.

Belgium generally welcomes inflows of foreign investment. Belgian residents are virtually free from exchange controls on their exports of capital, but the potential outflow is controlled by the channeling of their investments abroad through a free exchange market where premiums can develop to inhibit outflows.

SECTION II—THE PATTERN OF SAVINGS AND INVESTMENT [1]

An important but declining call by government upon the savings of other sectors was a leading characteristic of the savings/investment pattern in Belgium in the period 1959–62. A high proportion of self-financing by business was also apparent. A large portion of consumer savings took the form of investment in housing. These are the principal conclusions to be drawn from table I.

[1] Figures in this chapter are in Belgian francs. U.S. $1 equals 50 Belgian francs.

TABLE I.—*Sources and uses of gross savings, 1959–62*

[Billions of francs]

	1959	1960	1961	1962
Sources:				
Consumer savings	39.0	54.2	49.6	54.0
Business savings (net)	10.6	11.4	13.9	13.9
Government savings (net)	−2.7	−2.3	3.8	5.3
Depreciation	46.2	48.0	50.0	53.2
Gross savings	93.1	111.3	117.3	126.4
Uses:				
Housing	29.7	33.1	35.9	36.5
Business fixed investment	54.2	63.0	66.6	70.6
Government fixed investment	10.4	10.2	10.5	12.9
Inventory changes	−1.2	3.7	4.2	3.3
Net foreign investment	0.0	1.3	0.1	3.1
Gross investment	93.1	111.3	117.3	126.4

Source: General statistics of the Belgian National Statistics Institute and the Organization for Economic Cooperation and Development (OECD).

GOVERNMENT SECTOR

From the recession year 1958 through 1960, the government sector not only drew on the savings of other sectors to finance its investment but also experienced deficits on its current operations. These deficits gave way to surpluses in 1961 and 1962. In 1961 this resulted in a substantial reduction in the government's financing requirements, but in 1962 the increase in savings was more than offset by a sharp rise in investment.

Within the government sector, both the central government and local authorities, as can be seen in table II, made progress in reducing their recourse to the savings of other sectors. Except in 1960, savings through social security have not regained the levels of the period 1955–58 (not shown), when they ranged from 2.5 to 4.5 billion francs per annum.

TABLE II.—*Government savings and investment, 1959–62*

[Billions of francs]

	1959	1960	1961	1962
Savings:				
Central Government	−4.4	−6.6	0.2	0.9
Local authorities	0.8	1.9	3.5	3.8
Social security	1.7	3.2	1.0	1.6
Total	−1.9	−1.5	4.7	6.3
Investment:				
Central Government	4.1	4.6	4.8	6.2
Local authorities	6.3	5.6	5.7	6.7
Total	10.4	10.2	10.5	12.9
Financing capacity (+) requirement (−):				
Central Government	−8.5	−11.2	−4.6	−5.3
Local authorities	−5.5	−3.7	−2.2	−2.9
Social security	+1.7	+3.2	+1.0	+1.6
Total	−12.3	−11.7	−5.8	−6.6

Source: OECD statistics.

BUSINESS SECTOR

Business is regularly in a position to finance a high proportion of its investment from its own savings. For example, in the period 1959–62, business' gross savings (including depreciation) ranged between 88 and 106 percent of its total investment. Despite a leveling off in 1962, retained earnings grew over the period at about the same rate as fixed investment. Depreciation allowances, on the other hand, increased at only half the rate of growth of fixed investment. Note the influence on the figures given in table III of the swing from net disinvestment in inventories in 1959 to substantial accumulations in the following 3 years.

TABLE III.—*Business savings and investment,*[1] *1959–62*

[Billions of francs]

	1959	1960	1961	1962
Savings:				
Corporate retained earnings	10.6	11.4	13.9	13.9
Depreciation [2]	45.4	47.2	49.1	52.2
Total	56.0	58.6	63.0	66.1
Investment:				
Fixed investment	54.2	63.0	66.6	70.6
Inventories	−1.2	3.7	4.2	3.3
Total	53.0	66.7	70.8	73.9
Financing capacity (+) or requirement (−)	+3.0	−8.1	−7.8	−7.8

[1] Including government corporations.
[2] Differs from table I due to exclusion of government depreciation.

Source: Belgian National Statistics Institute and OECD.

CONSUMER SECTOR

A high proportion of savings by consumers [2] continues to find its counterpart in investment in housing. The capacity of the consumer sector to supply financing to other sectors nevertheless increased in the period 1959–62, as personel savings grew by 38 percent while investment in housing rose by only 23 percent (see table I). It would appear from available information that transfer of the savings of this sector to the government sector represents not only an important claim on consumer savings but also a major characteristic of the Belgian financial system.

FOREIGN INVESTMENT

From 1955 through 1958, Belgium was, by virtue of substantial current account surpluses in its balance of payments, an important net foreign investor. Since 1959, however, Belgium's external position has not resulted in the transfer of resources abroad of the magnitude of the earlier period, although there was an increase of some significance in 1962.

[2] Consumer saving includes saving by nonprofit organizations.

FINANCIAL INTERMEDIARIES

The foregoing discussion of the pattern of real savings and investment might suggest some conclusions as to the role of the financial intermediaries. Nevertheless, conclusions will be deferred until later sections of this chapter, where available data on financial assets and liabilities are considered.

Table IV does, however, utilize such data to provide a first indication of the relative importance of the various types of financial institutions. It should be noted that the importance of the monetary institutions is exaggerated for some purposes by the inclusion of claims on the foreign sector, including especially the gold and foreign exchange holdings of the Belgian National Bank. Adjusting for this factor, the picture presented is a balanced one. Note, however, the substantial proportion of total claims held by the nonmonetary public credit institutions.

TABLE IV.—*Financial claims of the financial intermediaries, Dec. 31, 1960*

	Billions of francs	Percentage of total
Monetary institutions	320	44
Savings and mortgage banks	136	19
Insurance companies and pension funds	135	19
Nonmonetary public credit institutions	133	18
Total	724	100

Source: *Banque Nationale de Belgique, "Bulletin d'Information et de Documentation,"* September 1963, pp. 224–225.

SECTION III—THE DEMAND FOR CAPITAL

In the period 1959–62, gross investment in Belgium ran at a substantial 19 percent of gross national product. Under the influence of investment credit type tax provisions, a high for the 4 years of 19.8 percent was reached in 1962; the low of 17.4 percent was in 1959. Since 1959 gross investment has grown at an average of 9 percent per annum, but this figure conceals an almost 20-percent increase from 1959 to 1960, followed by smaller increases in the 2 succeeding years. This is partly explained by the fact that fixed investment in the key iron and steel and nonferrous metals industries increased sharply in 1960, but leveled off in 1961 and 1962. Investment in another important industry—metalworking—followed a similar pattern, jumping almost 50 percent in 1960 but only 22 percent and 13 percent in 1961 and 1962. Inventory buildup was comparatively regular from 1960 through 1962, after a decline in 1959. Government fixed investment, which was virtually unchanged from 1959 to 1961, increased 23 percent in 1962. Net foreign investment also moved upward substantially in 1962, following less important contributions to total investment in the preceding years.

In spite of the relatively high ratio of fixed investment to gross national product, observers of the economic scene in Belgium have maintained that the proportion devoted to productive investment—or the productivity of investment—is well behind that of neighboring countries. Several factors are given as explanations of this situation.

One is the tendency toward self-financing by business, which is found particularly among the family-owned or controlled enterprises which comprise a large share of the Belgian economy. For example, about half the output of the metalworking industry is produced by small enterprises which rely almost exclusively on self-financing. Such self-financing usually aims at meeting the financial needs of an existing organization rather than creating capital for new and possibly more productive enterprises.

Another factor holding down the rate of productive investment is the marked preference of Belgians for liquidity in their holdings. This may mean that businesses experience difficulties in raising funds because their securities lack a sufficient degree of marketability. In another sense, the sterilization, by hoarding of banknotes, of a part of savings may reduce financial market availabilities (even though in theory compensation could come through the expansion of bank credit).

It has also been held that the government sector, because of its deficits, absorbs substantial amounts of national savings which might otherwise be available for private investment. On the other hand, it has also been pointed out that it is possible that the government sector provides outlets for capital that might otherwise be less profitably employed.

A final factor reducing the level of funds available for private investment in productive facilities is the high proportion of consumer savings which goes into housing. As can be seen from table V, over 30 percent of domestic fixed investment takes this form.

TABLE V.—*Trends in investment, 1959–62*

[Billions of francs]

	1959	1960	1961	1962
(1) Gross national product	535.9	572.2	601.2	637.2
(2) Gross investment	93.1	111.3	117.3	126.4
[As a percentage of (1)]	(17.4)	(19.5)	(19.5)	(19.8)
(3) Gross domestic fixed investment	94.3	106.3	113.0	120.0
[As a percentage of (2)]	(101.0)	(95.5)	(96.3)	(94.9)
(4) Inventory changes	−1.2	+3.7	+4.2	+3.3
(5) Net foreign investment		+1.3	+.1	+3.1
(6) Investment in housing	29.7	33.1	35.9	36.5
[As a percentage of (1)]	(5.5)	(5.8)	(6.0)	(5.7)
[As a percentage of (3)]	(31.5)	(31.1)	(31.8)	(30.4)

Source: Belgian National Statistics Institute and the OECD.

GOVERNMENT

The figures given in table II (sec. II) for the financing requirements of the government sector do not constitute a complete measure of the sector's demand for funds. Omitted most importantly from the national accounts concept employed there are funds required in order to amortize the public debt and for relending. A better view of the central government's demand for loanable funds (and of the instruments through which this demand is expressed) is obtained from an analysis of the Treasury position. (See table VI.)

TABLE VI.—*Treasury financing, 1959–62*

[Billions of francs]

	1959	1960	1961	1962
Budget deficit [1]	26.1	26.5	19.8	16.2
Change in cash and miscellaneous	−1.4	+1.6	−.3	+.1
Financing required	24.7	28.1	19.5	16.3
Borrowing:				
In Belgian francs	(20.1)	(19.9)	(18.0)	(27.4)
Long-term (gross)	20.3	27.2	13.0	20.1
Medium-term (net)	−2.4	−6.1		−1.1
Short-term (net)	(2.2)	(−1.2)	(5.0)	(8.4)
Postal checking system	2.2	2.7	.4	3.5
Commercial banks	−.4	.2	.4	3.0
Semipublic institutions	5.8	−3.1	3.2	3.8
Other	−5.4	−1.0	+1.0	−1.9
In foreign currencies	(5.2)	(10.6)	(3.4)	(−9.2)
Long-term (gross)	1.2	.1	2.2	1.4
Short- and medium-term (net)	4.0	10.5	1.2	−10.6
Change in indebtedness to National Bank	.4	−2.2	.5	−1.4
Net receipts from *Fonds des Tiers* [2]	−1.0	−.2	−2.4	−.5
Financing obtained	24.7	28.1	19.5	16.3

[1] Underlying budget expenditures include amortization of the consolidated debt.
[2] Special funds which keep their cash balances with the Treasury.

Source: Ministry of Finance, "*Bulletin d'Information.*"

Three points of general interest emerge from table VI. First, the importance of domestic long-term borrowing is apparent. Secondly, the wide variation in the ratio of domestic long-term borrowing to total financing required suggests a certain inelasticity in the supply of long-term funds. Finally, the swings in foreign currency borrowings indicate—as is said to be the case—that they are a residual source of funds.

Other elements of the government sector are also important borrowers. Table VII shows not only the medium- and long-term security issues of the rest of the government sector as defined in section II of this chapter (local authorities and social security) but also of the public and quasi-public credit institutions and business enterprises. The quasi-public *Crédit Communal* is grouped with local authorities because its principal function is to provide them with financing.

TABLE VII.—*Net bond issues in Belgian francs by the rest of the public sector (excluding central government), 1959–62*

[Billions of francs]

	1959	1960	1961	1962
Autonomous funds and social insurance institutions	4.7	1.9	3.2	4.0
Local authorities and *Crédit Communal*	4.2	4.2	3.9	6.4
Public credit institutions	7.1	7.6	8.8	6.0
Public enterprises	4.2	−.3	1.7	1.1
Total	20.2	13.4	17.6	17.5

Source: *Banque Nationale de Belgique, "Bulletin d'Information et de Documentation,"* September 1963, p. 258.

Taken together, the rest of the public sector constitutes another major element in the market for funds in Belgium. It should be noted, however, that the demand of the public credit institutions does not represent final demand, since the major portion of their resources is re-lent to the private sector.

BUSINESS

Table VIII compares public sector demand for funds through the securities markets to that of business. In the period 1959–62, public sector issues were consistently four to five times as large as security issues by private corporations. In the bond market alone, corporate issues amounted to roughly a tenth of public sector issues.

TABLE VIII.—*New security issues, 1959–62*

[Billions of francs]

	1959	1960	1961	1962
Corporate/private [1]	8.6	10.3	8.6	12.6
Stocks	(4.4)	(7.9)	(6.1)	(7.7)
Bonds	(4.2)	(2.4)	(2.5)	(5.9)
Public sector	39.5	44.7	36.6	49.3
Total	48.1	55.0	45.2	61.9

[1] Private stock issues are shown net but bond issues (other than "tap" issues) are gross. Figures include foreign based companies, notably in 1959 and 1960 companies incorporated in the former Belgian Congo.

Source: *Banque Nationale de Belgique, "Bulletin d'Information et de Documentation,"* September 1963, pp. 258 and 267.

The limited role of corporate bond issues is in keeping with the propensity of business to self-finance. Furthermore, it should be noted that the figures given for private corporate bond issues seriously overstate business' demand for new funds, since amortization ran between 1.6 and 1.9 billion francs in the 4 years considered.

On the other hand, new stock issues are of some importance. Stock issues in the years 1960–62 were not only substantially higher than in 1959 but also exceeded the level of the years preceding. Despite the substantial volume of stock issues, however, business turns to a greater degree to the financial intermediaries to meet its requirements.

CONSUMERS

Housing construction has not kept pace with the overall increase in investment, although the lag has not been large. In 1959, building permits issued numbered approximately 39,000, which represented a substantial increase from the low levels of the 3 preceding years. In 1960 and 1961, the figures rose to 41,100 and 44,600, respectively; but in 1962 there was a decline back to the 1959 level. The slower growth of investment in housing in 1962 may have been in part due to labor shortages in the building trades. The estimated value of mortgages registered, on the other hand, rose regularly in the period 1959–62, from about 25 billion francs in 1959 to 36 billion francs in 1962. Major changes in the level of residential construction are not foreseen.

As elsewhere, residential construction benefits from extensive government intervention.

FINANCIAL INTERMEDIARIES

Some indications of the demand for funds of the financial intermediaries have been given previously. Table IV at the end of section II suggested the relative importance of the several broad categories of intermediaries at the end of 1960 (the most recent date for which comprehensive statistics on financial claims and liabilities have been published). Earlier in this section, the importance of the public sector credit institutions in the securities market was seen.

The resources of the monetary institutions are, of course, primarily monetary. Approximately one-sixth of their funds, however, comes from time and savings deposits and issues of bonds and certificates (*bons de caisse*). The savings and mortgage banks, including most importantly the public *Caisse Générale d'Epargne et de Retraite* (General Savings and Pension Fund), obtain about three-quarters of their funds in the form of savings deposits. The other quarter of the funds of the *Caisse Générale* is derived from its pension fund and insurance activities; the balance of the funds of the private savings and mortgage banks comes essentially from issues of bonds and certificates. Social insurance reserves are quantitatively much less important than the regular insurance reserves for the category "insurance companies and pensions funds." Finally, the nonmonetary public credit institutions obtain a very high proportion of their resources through the issue of bonds and certificates.

SECTION IV.—THE SUPPLY OF CAPITAL

Comprehensive Belgian statistics on changes in financial claims and debts group business and individuals together, thereby considerably reducing the possibilities for investigation of intersectoral financial relationships in Belgium. It is thus necessary to work in part in real terms and in part from other sources.

INTERNAL VERSUS EXTERNAL SOURCES OF FINANCING

Business, as has been previously stated, generates savings capable of satisfying much of its own requirements for investment capital. The major variable in terms of potential year-to-year changes in its self-financing capacity is retained earnings. This component increased substantially from 1959 to 1961, but leveled off in 1962. In the latter year, the increase in business profits was small, and higher dividend payments left corporate retained earnings almost unchanged from the preceding year. International competition appears to have weighed on profits, particularly in the important metal industries:

Among the sources of external finance, the nonmonetary public credit institutions rank first among the suppliers of funds to business. Government interest rate subsidies and guarantees tend to encourage this situation. Monetary institutions and the purchasers of stock issues—presumably involving a substantial proportion of individual purchases—are next in importance. Bond purchasers do not represent a major source of funds.

Investment by individuals directly in residential construction—consumer self-financing—amounts to roughly one-quarter of consumer savings. The statistical problem noted above renders generalizations regarding other sources of funds for the consumer sector difficult. In its more important role as a supplier, it is apparent that, in addition to direct placements in industrial stocks and bonds and government securities, the consumer sector through the financial intermediaries finances other in the same sector and makes net amounts of funds available to other sectors.

It is recalled that the government sector, although now in a position to finance a portion of its investment from its own savings, makes important calls upon the funds of other sectors of the economy. Others in the public sector, notably the nonmonetary public credit institutions, are also heavy borrowers. Table IX provides a breakdown of the holders of the marketable public debt. It can be seen that individuals and businesses hold over one-half. Among the financial intermediaries, insurance companies and pension funds are the biggest holders, followed by mortgage and savings institutions and monetary institutions. Monetary institutions, however, also hold important amounts of nonmarketable debt (most of the balance is held abroad). Nonmarketable debt has increased less rapidly than marketable debt in recent years, but still amounts to about one-quarter of marketable public debt outstanding.

TABLE IX.—*Holders of marketable public sector debt, 1958–61*

[Billions of francs]

	End of period			
	1958	1959	1960	1961
Nonfinancial domestic holders:				
Private businesses and individuals	163.5	180.3	194.8	207.1
Public enterprises	1.7	2.2	2.5	2.8
Other public sector	1.4	1.6	1.8	1.6
Social security funds	1.1	1.0	1.0	1.2
Congo and Ruanda-Urundi	4.1	4.0	3.4	2.6
Financial intermediaries:				
Monetary institutions	31.5	35.4	35.7	41.1
Fond des rentes	3.3	4.5	6.6	6.9
Mortgage and savings institutions	34.6	38.8	40.7	41.9
Insurance companies and pension funds	51.4	53.6	58.4	60.8
Nonmonetary public credit institutions	5.5	6.5	7.1	8.3
Total	298.1	327.9	352.0	374.3

Source: *Banque Nationale de Belgique, "Bulletin d'Information et de Documentation,"* September 196? p. 261.

Table X provides analysis of the means by which savings are accumulated in Belgium. It may be seen that a substantial amount of savings is in the form of liquid savings deposits, but that saving through insurance and pension funds is not insignificant. Direct purchases by the public of security issues are also substantial.

TABLE X.—*Means of saving, 1959–61*

[Billions of Francs]

	1959	1960	1961
1. Savings deposits:			
Savings banks	9.9	6.6	9.3
Commercial banks	5.1	4.0	10.4
Public credit organizations	.3	1.2	1.7
Total	15.3	11.8	21.4
2. Savings reserves:			
Pension funds	3.2	2.5	3.0
Life insurance companies	5.4	6.8	4.9
Other	1.3	1.2	1.7
Total	9.9	10.5	9.6
3. Savings through real estate:			
Mortgage loans by individuals	1.8	1.1	2.4
Mortgage payments by individuals	8.5	9.2	9.9
Investment by individuals in residential construction	10.3	11.4	12.5
Total	20.6	21.7	24.8
4. New security issues purchased by public	13.4	17.0	13.8
Subtotal	59.2	61.0	69.6
Adjustment for double counting	+.6	+.1	+.1
Subtotal	59.8	61.1	69.7
5. Internal business savings:			
Depreciation	30.7	35.0	35.9
Net savings	5.2	7.7	8.4
Total	35.9	42.7	44.3
Total domestic disposable savings	95.7	103.8	114.0

Source: *Banque Nationale de Belgique, "Bulletin d'Information et de Documentation,"* September 1963, p. 257.

FINANCIAL INTERMEDIARIES

Although table X provides some indication of the importance of the financial intermediaries as sources of funds in Belgium, the full scope of their operations is by no means covered. The following description of their activities by major type of institution will provide a more complete picture.

Commercial banks

The commercial banks supply important amounts of funds to business and individuals by means of normal short-term credit extension and to the government through security purchases. Although the banks are not barred from extending medium- and long-term credit to business, they do not specialize in such lending. They are not a significant factor in the market for corporate bonds and stocks—in general, they may not hold stocks and bonds of commercial concerns other than banks. When, however, banks have collaborated in an issue of stocks or bonds, they may hold such securities for a period not exceeding 6 months.

Other credit institutions

This category is dominated by public and quasi-public institutions. The *Caisse Générale d'Epargne et de Retraite* (General Savings and Pension Fund) is the leading collector of liquid savings (as well as the leading financial institution in Belgium). It can be seen from table XI that a large proportion of its investments are in government and government-guaranteed securities. Among its other lending operations, credit for construction is by far the most important. Note that its rather small holdings of corporate bonds declined in the period 1959–61.

TABLE XI.—*Principal investments of the Caisse Générale d'Epargne et de Retraite, 1958–61*

[Billions of francs]

	1958	1959	1960	1961
Government and government-guaranteed securities	53.3	58.4	61.7	61.9
Construction advances and loans	22.8	24.6	26.0	27.0
Loans to local authorities	1.8	1.8	1.7	1.7
Agricultural credit	3.4	3.5	3.6	3.6
Corporate bonds	3.1	3.0	2.7	2.6
Total (of investments covered)	84.4	91.3	95.7	96.8

Source: *Banque Nationale de Belgique, "Bulletin d'Information et de Documentation,"* September 1963, pp. 252–253.

The private savings banks make over half their investments in mortgage loans, with the balance fairly evenly divided between investments in obligations of the central government and lending to the other public sector organizations. (See table XII.)

TABLE XII.—*Investments of private savings banks, 1959–62*

[Billions of francs]

	End of period			
	1959	1960	1961	1962
Mortgages	15.9	18.0	20.3	23.9
Claims on central government	5.0	6.2	6.9	8.7
Claims on quasi-public organizations	5.9	5.9	6.8	7.9
Other	3.0	3.1	3.4	3.9
Total claims on private and public sectors	29.8	33.2	37.4	44.4

Source: *Banque Nationale de Belgique, "Bulletin d'Information et de Documentation,"* September 1963, p. 254.

Among the nonmonetary public credit institutions, the National Industrial Credit Corp. and the *Crédit Communal* are the most important. The National Industrial Credit Corp. provides medium- and long-term credit to business, as well as participating in the financing of foreign trade. A substantial portion of the credit it extends is guaranteed by the government or by other financial institutions. It makes loans at subsidized rates. The *Crédit Communal* is the financier for the local authorities. It lends to them at all maturities (as well as providing a variety of other services), but its principal function is long-term lending.

The other nonmonetary public credit institutions include an organization to aid small- and medium-sized business; no less than four in the field of housing and real estate; an agricultural credit organization; and the recently organized National Investment Co. This last institution, which is authorized to hold shares in businesses, was established to help provide capital for companies which are not in a position to market their stocks otherwise.

Insurance companies

Table XIII shows the investments of life insurance companies (Belgian companies only). Life insurance companies place about one-fourth of their assets in mortgage loans. The second most important type of investment for them is corporate bonds, but it will be noted that their holdings grew relatively slowly during the period covered. A substantial portion of their resources is also devoted to purchases of securities of the government and the public credit institutions. Their investment in corporate stocks is not large, nor are investments in foreign securities.

TABLE XIII.—*Principal assets of Belgian life insurance companies, 1959–62*

[Billions of francs]

	1959	1960	1961	1962
Mortgage loans	7.8	9.0	10.5	11.4
Government securities	3.5	4.8	5.3	5.7
Securities of public credit organizations	3.1	4.2	4.2	4.6
Corporate bonds	7.2	7.2	7.4	8.1
Corporate stocks	1.7	2.1	2.2	2.3
Foreign securities	.8	1.3	1.9	1.5
Other	6.0	6.3	7.0	7.9
Total	30.1	34.9	38.5	41.5

Source: *Banque Nationale de Belgique, "Bulletin d'Information et de Documentation,"* September 1963, p. 256.

Investment funds

The leading Belgian banks are all actively engaged in the investment funds field, both as sales agents and as fund managers. Mutual funds have not, however, enjoyed the rapid growth in Belgium that they have in the United States, for example. One reason may be that the Banking Commission restricts sales commissions, or loading charges, to 4 percent.

Funds may be listed on the Brussels Stock Exchange. Both the Banking Commission and the Ministry of Finance must approve the listing of funds (as well as individual securities) on the exchange. Only listed funds may be advertised.

Foreign funds are marketed and/or managed in Belgium. Of the 17 investment companies whose shares were sold in Belgium as of January 1, 1963, 8 were incorporated outside Belgium, including the United States. At the same date, assets of the Belgian investment companies exceeded 5 billion francs, of which over three-fifths was invested in foreign securities.

SECTION V—INSTITUTIONAL STRUCTURE

It has been seen in preceding sections that the Belgian capital market is generally well-developed, if narrow in some respects, with the usual variety of institutions found in developed capital markets for the purpose of amassing and channeling savings and other funds. The major conventional institutions which play roles in the mobilization of medium- and long-term funds turned out to be the commercial banks, the savings institutions, the insurance and mortgage companies, the pension funds, and the stock exchange. The nonmonetary public credit institutions—particularly the National Industrial Credit Corp. and *Crédit Communal*—proved to be important.

One institution, however, is missing from the scene in Belgium. Since the major financial reform of 1935—which among other things separated the holding companies and the commercial banks—the investment banker's functions have not been fulfilled. The commercial banks are limited in their ability to underwrite offerings; the holding companies do not have investment banking authority.

SECURITY MARKET CONTROLS

Security issues in Belgium are subject to varying degrees of control by three institutions—the Banking Commission, the Ministry of Finance, and stock exchange listing committees.

The Banking Commission, set up by the banking reform of 1935, examines all proposed offerings of securities to the public. Its members are appointed by royal decree countersigned by government officials. Prospective issuers must submit a prospectus to the Commission, giving extensive information as to the nature of the security, the issue price, the purposes of the issue, the interest of the issuing institution in the corporation whose security is being issued, etc. The Commission may delay the issue for 3 months if certain conditions are not fulfilled. The Commission considers the accuracy of the information supplied, conformity with legal provisions, and the effect of the offering on the capital market. In the words of the Commission: "It must ascertain that the operations are not made under conditions susceptible of inducing errors by the subscribers of the securities. It must also avoid harm to the equilibrium of the capital markets arising from the operations." In connection with the latter, the Commission may request that the size of the offering be reduced or that it be made available to the public in installments.

After its examination, the Banking Commission makes a recommendation to the Minister of Finance as to the suitability of the offering. The Minister of Finance may bar admission to official stock exchange quotations.

A listing committee reviews all proposed listings on stock exchanges in Belgium. Half the members of the listing committee are chosen by the Minister of Finance from among brokers nominated by the commission of the exchange. In addition to the type of examination given by the Banking Commission, the listing committee requests more detailed information on the economic and financial situation of the firm. The listing committee thereafter takes responsibility for the listing of a security on its exchange.

ORGANIZED SECURITY MARKETS

The main stock exchange in Belgium is the *Bourse de Bruxelles*. There are three smaller stock exchanges in Antwerp, Ghent, and

Liege. Trading on the Brussels Stock Exchange is heavily concentrated in a limited number of stocks. Of about 700 issues quoted on the exchange, 25 issues have at times in the past accounted for about 60 percent of trading volume.

Despite organized efforts to broaden share ownership in Belgium, interest in the stock exchange is limited and the market is a relatively thin one. However, perhaps some half-million individuals now own shares in Belgian corporations.

Financial information on corporations is made available by the Brussels Stock Exchange, which issues summary financial statements for listed companies, as well as operating an information service.

REGULATION OF FINANCIAL INTERMEDIARIES

Key aspects of the regulation of commercial banks were discussed in the preceding section. It should be added that in general the banks are supervised by the Banking Commission (not the central bank) in Belgium.

The investments of the savings banks, both the official *Caisse Générale d'Epargne et de Retraite* and the private savings banks, are closely controlled. They may generally invest their assets only in (1) Belgian government offerings or securities of public and semipublic organizations guaranteed by the government; (2) mortgage loans; (3) bonds of Belgian provinces, communes, and cities; (4) bonds of Belgian companies which have for at least 5 years met their commitments from their ordinary resources; (5) loans to farmers or farm cooperatives; (6) credits with state guarantees to industries determined to be of particular importance to the economy; (7) other investments authorized by the Central Office for Small Savers. Minimum requirements and ceilings for various categories of loans by the private savings banks are fixed by regulation. It will be noted that the investment of savings banks assets are to be in Belgian securities or enterprises.

Private insurance companies, except for those issuing life insurance, automobile liability insurance, and workmen's accident compensation insurance, are not subject to legal regulation.

Investment of the actuarial reserves of life insurance companies is subject to the following regulations:

1. At least 15 percent of reserves must be invested in Belgian public funds and securities guaranteed by the state, or in bonds of the *Crédit Communal*, of the National Industrial Credit Corp., or of Belgian provinces and communes.
2. Not more than 10 percent may be invested in obligations issued by international organizations of which Belgium is a member.
3. Fifty percent and 15 percent, respectively, of reserves may be placed in bonds or stocks of Belgian firms which for at least 5 consecutive years have met their commitments from their ordinary resources.
4. Purchase of foreign securities may not exceed 20 percent of reserves and must be proposed by the firm and approved by ministerial authorization.
5. Any purchase of securities other than those thus designated is subject to ministerial authorization.

Provision is made with regard to insurance contracts made in foreign currencies that a corresponding portion of the reserves must be invested in that currency. The details of the investment must be advised by the company for appropriate authorization. Comparable regulations are established for companies engaged in automobile liability insurance and workmen's accident compensation insurance.

Workmen's accident compensation insurance companies may acquire foreign government securities and securities guaranteed by foreign governments. However, the authorization of the Minister of Labor and Social Security must first be obtained, and investments of this type may not be more than 10 percent of reserves. Bonds of Belgian companies may be purchased up to 20 percent of total reserves, and Belgian government securities or those securities guaranteed by the Belgian government must account for at least 20 percent of reserves.

Belgian investment funds must be managed by a company agreed to by the Banking Commission, following guidelines established by royal decree. The commission is also empowered, in conjunction with the Ministry of Finance, to establish obligations and restrictions governing the formation and management of investment funds, as well as the issue of their shares. It also must authorize public statements issued by the funds. As for foreign mutual funds, only the public offering of their shares requires the authorization of the Banking Commission.

TAXATION

In November 1962, major tax reform legislation was enacted in Belgium. The new system became effective January 1, 1963, for corporate income and January 1, 1964, for individual and partnership income. An enumeration of present tax provisions significantly affecting security market decisions follows:

Corporations.—Interest expense is deductible from gross income in the calculation of corporate net income. Corporate earnings composed of dividends or other income from invested capital may be excluded from income to the extent of 85 percent of the net amounts received. In some cases, the deduction is 95 percent. Withholding on dividends and income from real estate may be taken as a credit against the recipient's tax due.

The standard rate of the corporate income tax is 30 percent. In the case of retained earnings in excess of 5 million francs, the tax rate is 35 percent on the excess. The 5-percent tax paid above the standard rate is, however, refunded when and if these retained earnings are distributed. Undistributed earnings below 1 million francs are subject to a 25-percent tax.

Because earnings are subject to the corporate income tax (normally 30 percent), shareholders are permitted a credit against their tax liability on dividends paid from such earnings. The credit (called the *crédit d'impot* usually amounts to one-half the normal corporate tax rate, or 15 percent. At the same time, the paying corporation withholds 15 percent of distributions (called the *précompte mobilier*), also creditable against the recipient's tax liability. Both the *crédit d'impot* and *précompte mobilier* must, however, be taken into taxable income by the shareholder. An additional (creditable) 15 percent—the *complément de précompte*—is withheld by paying agents. However, if a shareholder authorizes the agent to inform the tax authorities regarding the payments in question, this last withholding may be waived.

As noted above, when the shareholder is a corporation, 85 or 95 percent of net dividends received, as the case may be, can be excluded from taxable income. Furthermore, if the dividends are redistributed, the *précompte mobilier* is withheld only on that amount in excess of the 85 or 95 percent withheld, plus the amount of the *crédit d'impot.*

In general, capital gains are subject to the corporate income tax, at a rate of 15 percent. However, there are important exceptions. The first relates to capital gains on land, buildings, equipment, or stock owned for more than 5 years. The second involves capital gains reinvested in fixed assets, equipment or stock for the purpose of creating a new company or as a capital increase, in which case four-fifths of the gains are exempted (all are exempted if the investment is in a development area).

Individuals.—Individual taxable income from real property includes imputed income. On the other hand, mortgage payments may be deducted from gross income in certain circumstances, as may premium payments on life insurance. Certain capital gains, including gains realized from the sale of securities, are also exempted from taxation.

Dividend income is subject to the same rate of taxation as other income. Stock dividends are not taxed.

Taxes on operations in securities.—Issues of new industrial shares are subject to a stamp tax amounting to 0.7 percent of the nominal value for domestic issues and 1.6 percent of market value for foreign securities to be held in Belgium. The stamp tax is 0.7 percent of nominal value for industrial bonds issued with a maturity of 5 years or more, and 0.35 percent for industrial bonds issued with a less than 5-year maturity. There are no coupon taxes.

There is a stock exchange tax on security transactions amounting to 0.6 percent on cash transactions in stocks and 0.3 percent on forward transactions. The tax on negotiable bonds is 0.24 percent.

The issuer of securities pays an annual duty of 0.03 percent on both stocks and bonds.

CAPITAL MARKET REFORMS

In June 1961 a special governmental commission was appointed to study the problems of financing economic expansion in Belgium. In March 1962 the commission (which took its name from its chairman, Mr. F. de Voghel, vice governor of the National Bank of Belgium and former Minister of Finance) published its report.

The commission linked the high levels of borrowing by the government with upward movements of interest rates and diversion of investor attention from the financing of business investment. It thus recommended a reduction in the deficit of the public sector. In this it was preceded by budgetary reforms in early 1961 which aided the government sector in making considerable progress in the direction indicated in 1961 and 1962. With respect to interest rate policies, the commission favored efforts to reduce long-term interest rates the maximum possible consistent with limiting the risk of capital outflow.

In the course of its deliberations, the commission noted the existence of rigidities in the collection and distribution of funds. The nature of the rigidities is suggested by several possible solutions considered by the commission: reduction in the specialization of financial institutions; increased mobility of funds between financial intermediaries; and financial programing, whereby the public authorities would endeavor to supervise the distribution of funds.

A particularly interesting series of recommendations of the commission would provide greater flexibility for the financial institutions in their investments. Incorporated banks, which, it will be recalled, may hold shares and bonds in nonbanking organizations for 6 months when they have collaborated in an issue, would be permitted to hold such securities for 3 years or longer. In addition, it was proposed that banks might be permitted to invest (not merely in connection with a distribution of securities) to some degree in corporate stocks. Another line of approach is change in the investment coefficients of insurance companies, mortgage institutions, and private savings banks. Greater freedom to purchase industrial stocks and bonds was recommended. It also recommended that requirements for bank holdings of government securities be reduced.

The de Voghel Commission recognized dangers in excessive reliance on self-financing. The November 1962 tax reform involved actions to reduce tax discrimination against income from stocks. The favored position of undistributed over distributed profits was also reduced, as was that of interest income (in particular from government securities) over dividend income.

SECTION VI—INTERNATIONAL CAPITAL MOVEMENTS

Belgium's foreign trade is exceptionally large in relation to the size of the economy—over 40 percent of industrial production is exported. This fact importantly influences its attitudes toward international trade and payments arrangements.

All capital flows are free within the Belgium-Luxembourg Economic Union (BLEU). Almost no capital outflows from the BLEU area either by residents or nonresidents are permitted at official exchange rates, but nearly all such transactions are permitted at the free market rate for Belgian or Luxembourg francs. It is necessary to say "nearly all" rather than "all" since there is one important area where specific controls operate—the flotation of foreign issues in Belgium.

Belgium and Luxembourg now constitute the monetary area. The Belgian Congo and Ruanda-Urundi were at one time part of the monetary area and were treated as residents rather than nonresidents for exchange control purposes. Following Congo independence, a series of changes was made in this system during 1960, and on August 26, 1960, the Congo and Ruanda-Urundi were made bilateral account countries. For purposes of capital flows, they are now treated as any outside country: capital may be transferred to them at free market rates.

Under the Benelux Treaty of Economic Union which went into effect on November 1, 1960, capital flows are to be completely free among Belgium, the Netherlands, and Luxembourg. This raises the question as to whether eventually capital flows within the area may take place freely at official exchange rates. However, these clauses of the treaty will be put into effect only gradually, and for the time being there is no change in Belgian practices on capital flows to the Netherlands, which continue to take place on the same basis as flows to all other countries.

EXCHANGE CONTROLS

In April 1955, the BLEU created a free market on which practically all international capital transactions (and a limited number of current operations) are settled. The BLEU authorities viewed this as a necessary measure accompanying greater freedom of capital movements, in view of the inadequacy of their reserves and to meet possible huge outflows of capital. They regard this market essentially as a device to allow freer capital movements without endangering their exchange reserves in times of stress. They claim that in view of the practical difficulty of distinguishing the type of capital movement involved in any particular transaction, it is preferable to maintain a free market rather than to subject outpayments to the controls which would be necessary for ascertaining their actual nature if they were to be screened, with some authorized at official rates and some not permitted.

The free market for foreign exchange, along with the official market, is conducted by authorized banks in Belgium-Luxembourg. Demand for foreign exchange on the free market originates with all residents wishing to export capital from Belgium-Luxembourg or who have raised money on the BLEU financial markets for export, or with residents wishing to make freely certain current payments which are subject to limitation when made through the official market (forward cover for merchandise, gifts, and family maintenance payments, and certain travel expenses).

The supply of foreign exchange to the free market derives from receipts of foreign exchange by residents as the result of a capital inflow or of certain current account transactions—interest, profits, dividends, rents, royalties, participation by company branches and agencies in the administrative expenses of parent companies in Belgium-Luxembourg, company sales expenses, certain tourist receipts, or incoming gifts and family maintenance payments and forward cover for merchandise. Nonresidents may also sell foreign exchange on the free market to obtain francs with which to make any of the above sorts of payments in Belgium-Luxembourg, including all types of investment and financial transactions. (The francs obtained by a nonresident selling foreign exchange on the free market are set up in special accounts called financial accounts, good only for settlement of the above types of transactions in Belgium-Luxembourg or for reconversion into foreign currency at the free market rate.) Payments for Belgian-Luxembourg exports and all invisible transactions not listed above must be made at the official exchange rate, and receipts by residents of foreign exchange from these transactions must be sold at the official exchange rate. Such receipts of foreign exchange cannot be sold on the free market.

Since residents and nonresidents wishing to export capital (or to make those current outpayments not permitted in the official market) are not permitted to do so in the official market, they are generally willing to pay more francs for foreign exchange on the free market than the official rate.

The free market rate for foreign exchange may therefore show a premium over the official rate. At the same time, the authorities stand ready to pay the official rate for all offerings by residents or nonresidents of convertible foreign currencies, or externally convertible European currencies. This puts a floor under the free market rate at the level of the official rate, since, at that point, the supply of foreign exchange would leave the free market for the official market.

Occasionally the authorities have sold foreign currencies out of their reserves on the free market to limit the premium at which foreign exchange was selling (i.e., the discount on the franc) but they do not recognize any obligation or guarantee in this respect. That is, there is no obligation to use reserves to support a capital outflow. The BLEU thus uses the premium on foreign exchange in the free market, rather than exchange licensing, to limit capital outflows should they tend to assume large proportions.

CAPITAL MARKET CONTROLS

The approval of the Minister of Finance is required for the floating of foreign issues of stocks or bonds on the Belgian market (as well as for the trading of already issued foreign securities). This is a long-standing requirement of the basic Belgian commercial law—not a post-World War II aspect of exchange control. Authorization may be refused for political reasons, because of the tightness of the capital market, or for any other reason.

Stock exchange listing committees also scrutinize all securities, domestic or foreign, for admission on Belgian stock exchanges. Only securities listed in their country of origin may be listed in Belgium. The Banking Commission must also be notified before the public offering of any stocks or bonds. Processing of foreign securities by the listing committees and by the Banking Commission is reported to be on the same basis as for domestic securities.

RECORDED MOVEMENTS

Table XIV presents the available balance of payments data on long-term capital flows, on a net basis, for the years 1959–62. The substantial net outflows on recorded transactions in securities during the period for which a breakdown is available (1960–62) is noteworthy. There was also a marked shift in "other transactions," from a deficit (small in 1959 but much larger in the years preceding) to a substantial surplus. In part this was due to the separation of data on recorded security transactions, which appeared in this item until 1960; but a contributing factor may have been increased foreign investment in Belgium following the establishment of the Common Market.

TABLE XIV.—*Net long-term capital movements,*[1] *1959–62*

[Billions of francs]

	1959	1960	1961	1962
Central government	−3.0	+3.2	−5.8	−2.8
Other public authorities and organizations	−1.4	+1.7	+2.2	−.4
Recorded security transactions	(2)	−4.0	−3.2	−2.2
Other transactions	−.3	+1.3	+5.5	+3.4
Total	−4.7	+2.2	−1.3	−2.0

1 Total capital movements excluding recorded short-term movements.
2 Not available.

Source: *Banque Nationale de Belgique, "Bulletin d'Information et de Documentation,"* September 1963, pp. 216–218.

Wide swings in the balance resulting from governmental operations abroad can also be observed. The Treasury has turned to external sources for its borrowings on occasions when domestic financial markets seemed unduly tight, or when it had neared its drawing ceiling of 10 billion francs with the National Bank. The government's short- and medium-term debt in foreign currencies increased sharply in 1960 and the first part of 1961. Subsequently, it was systematically reduced, until at the end of 1962 it had returned to approximately the level of the end of 1959.

CHAPTER VII

THE CAPITAL MARKET IN FRANCE

SECTION I—SUMMARY

In the broadest terms, the prospects appear good for the revival of an active and effective capital market in France. In part, this evaluation is based on the traditional thrift of Frenchmen and on the probability that the level of incomes—and hence savings potential—will continue to rise in the years ahead. In part, it is an expression of confidence that the studies in France of the problems involved in mobilizing savings will be brought to fruition without undue delay.

The present pattern of savings and investment in France and the relative importance of securities markets in marshaling savings and directing them into investment reflect difficulties in providing adequate incentives to save which may be a natural consequence of French history. Individual savers manifest a distinct preference for liquid assets in contrast to bonds, stocks, or other evidence of long-term indebtedness. In the face of this preference, the French have come to rely on the financial system in general and the Treasury in particular as the chief mechanisms for transforming liquid into long-term funds.

While the Treasury is thus important as a financial intermediary, the government sector of the economy (including not only the central government, but also local governments, the social security system and private nonprofit institutions) is not presently an important net contributor of savings to the rest of the economy. Flotations of stocks and bonds are not important among the means of raising capital utilitized by business, government, or the financial intermediaries. Nor do purchases of new issues of stocks and bonds represent an important investment outlet for either individual or institutional investors. Life insurance is not an important vehicle for individual savings in France. The tendency seems to be for the proportion of business investment financed by internal resources to fall somewhat. This suggests that it may be important to provide business with additional access to alternative sources of financing if France is to maintain a satisfactory level of investment and economic growth.

Maintenance of adequate incentives to save is viewed as an important requirement of the present situation. The purchase of financial claims must be made to appear an attractive alternative to increased consumption, hoarding, or even investment in the so-called less productive investments. Thus continuing price stability becomes an essential for insuring that a larger part of the total saved goes into productive investment.

The demand for and the supply of capital in France has been characterized by:

(1) A rapid growth in domestic liquidity and the money supply.

(2) A continuing dependence of both public and private investment upon funds which are supplied from liquid or semiliquid sources.

(3) A decrease in the percentage of total financing accounted for by the flow of savings to the securities market (marche financier).

(4) A growth of medium-term loans and credit to enterprises to permit them to finance new capital expenditures. This type of financing has more than doubled since 1960. The growth of long- and medium-term loans and credits have together increased at a much faster rate than the issue of securities, and supply more capital to enterprises than does the securities market.

(5) Increased needs of the national and local governments for financial resources.

The French Government has shown clear awareness that measures need to be taken to strengthen and improve the existing structure of the capital market and has begun to implement many of the recommendations growing out of detailed studies, especially those of a special commission appointed to study the problem.[1]

A further obstacle to efficient capital market mechanisms in France may be an inadequate supply of equities. The issue of shares offers business a method of raising capital without increasing fixed charges, a consideration which takes on attraction in view of the relatively high continuing costs the borrower must meet in connection with the flotation of bonds. It is stated that one of the factors that has inhibited equity financing is the fear of majority stockholders of losing control of the business. The issuance of preferred shares, shares with plural voting rights, convertible debentures, etc., might be of at least some help in overcoming this obstacle, although their effectiveness should not be overestimated. Considerations of control might be less important if the issue of shares were made more attractive through such devices as the reduction or elimination of taxes now assessed on capital increases (*droits d'apport*) or if there were a reduction in the substantial discounts at which shares are now issued.[2] Some revision in the tax treatment of dividend income may also be warranted. At the present time a withholding tax of 24 percent is applied to gross dividends, whereas the rate on interest from bonds is only 12 percent. It has been proposed that the withholding tax on interest be abolished, but no comparable proposal has been made in the case of dividends. It is not clear why dividend income should be treated less favorably, especially as long as the full amount withheld cannot be claimed by the stockholder as a credit against personal income taxes due.

For the potential purchaser of equities, lack of information on corporate activities has certainly been an inhibiting factor. Stricter

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[1] This group, usually referred to as the Lorain Committee, was one of the three French groups which inthe past couple of years have surveyed the problem of improving the present system of mobilizing savings for productive investment in France. The Lorain Committee was formed in the spring of 1962 at the request of the Minister of Finance and Economic Affairs and takes its name from its chairman, M. Maurice Lorain, Chairman of the Board of Directors of the *Société Générale*, one of the large French commercial banks. The Committee finished its report in May 1963 (*Rapport présenté au Ministre des Finances et des Affaires Economiques par le Comité Chargé d'étudier le financement des investissements*, Paris, 1963). The other two groups which have studied and issued reports on savings—investments flows are the *Commission de l'Economie Générale et du Financement* and the Economic and Social Council. The former is one of the national planning committees, and the latter is a body which renders advisory opinions on certain of the Government's economic policies and proposals.

[2] The Lorain Committee recommended a prudent increase in issue premiums (*primes d'émission*) as one means of broadening and deepening the stock market.

rules and more rigorous practices should be developed with respect to information to be made available to the public by listed companies. Better information seems a necessity if the French stock market is to be substantially broadened.

Open-end investment companies, until recently not authorized in France, would appear to have considerable potential as an instrument for improving the effectiveness of the French capital market. The availability of savings for some purposes may be decreased to a small degree but over time at least the existence of this new instrument should also tend to encourage the generation of additional savings. Since these investment companies may invest part of their assets in foreign as well as French securities, provided they are listed on a stock exchange, the possibility of diversifying French portfolio holdings is enhanced.

The demand for capital through bond flotations exceeds the supply of funds which investors are willing to put into new issues on prevailing terms, with the result that the Treasury finds it necessary to control access to the market. Like the public and semipublic mechanisms for the transformation of liquid savings into long-term capital, this control offers the government an important technique for influencing business decisions in directions judged consistent with national economic objectives. Thus some control over access to the bond market seems likely to be a lasting feature of French economic policy, despite the fact that it may prevent the French capital market from reaching the level of efficiency judged from the market operations point of view, which might otherwise be possible.

The principal factors restricting the supply of funds on the bond market are the same as those which tend to swell the proportion of liquid savings in total savings; fear of currency depreciation and lack of significant yield differentials, especially after taxes, between short- and long-term investments. Investment in long-term bonds is hardly likely to prove attractive as long as there is practically no spread between the net return after taxes from short-term investments and from long-term bonds. For some individuals it appears that bonds even yield less after taxes than do some short-term investments. Although there is a considerable body of opinion in France that favors a return to the technique of indexed bonds (forbidden since 1959) as protection against inflation, the government has rejected this device as undesirable. Reductions in the fairly wide spread between the yields to purchasers (after taxes) and costs to borrowers, and increases in the flotation of convertible and participating bonds, have been recommended by various groups in France.

Instead of being a net exporter of capital, as would appear appropriate in the case of a country with such a strong current account position, France has been a large net capital importer, with only the reduction of official external liabilities to act as a partial offset to the combined effect of the current account surplus and the inflow of private capital. The remainder of the surplus has been devoted to the building up of official reserves of gold and convertible currencies. While the pull of internal demand for capital is great, there would normally be some attraction to investment outside the country, if for no other reason than greater diversification of portfolio holdings than can be achieved from the range of domestic issues. In this connection, despite the liberalization that has taken place in exchange controls, the remaining formalities undoubtedly act as a deterrent to the free movement of money out of France, even though the main obstacle undoubtedly lies in the terms which foreign borrowers would have to meet in order to compete effectively with internal borrowers for French savings. The recent issue by the European Investment Bank on the French market is, however, encouraging. Furthermore, this first step may be consolidated—the French Treasury has indicated its willingness to authorize additional issues in France of foreign governments and international institutions.

The requirements of the French external economic position parallel those of the domestic economy. The strengthening and broadening of the French capital market would seem to be a necessity not only in terms of France's future economic growth but also as the means of enabling France to assume the role in the international financial system which is the logical consequence of a strong external economic position.

SECTION II.—THE PATTERN OF SAVINGS AND INVESTMENT[3]

The overall pattern of savings and investment in France from 1959 through 1962, in national accounts terms, is shown in table I. During the period, the largest single component of gross savings was depreciation charges which consistently amounted to more than 40 percent of gross domestic investment. Consumer savings (including farmers and other individual entrepreneurs) tended to fluctuate more widely, from about 25 to 30 percent of gross domestic investment. These fluctuations were in large measure the result of movements over the period in inventories of agricultural products. Thus in 1960 and 1962, when crops were good, there was a high rate of inventory accumulation and a relatively higher rate of consumer saving than in 1959 and 1961. After allowance for this factor, it would appear that there was a tendency during the period for consumer savings to increase slightly in importance as a source of investment financing. On the other hand, the role of undistributed corporate profits—net business savings—declined somewhat, from a peak of about 19 percent of gross domestic investment in 1960 to less than 17 percent in 1962. This trend is also discernible if one considers only the undistributed profits of nonfinancial enterprises;[4] these fell from about 14 percent of gross domestic investment in 1960 to 12.5 percent in 1962. Finally, the relative contribution of government savings to the financing of investment in France declined during the 4 years in question. This was due to the erosion of the surplus of the central government in its current operations, while gross domestic investment rose sharply. A partial offset was provided by the increase in savings generated through the operation of the social security system and by local governments.[5] The net result was that government savings financed

[3] The data for this section are from the *Rappori eur les Comp.es de la Nation de l'Année 1962*, prepared by the *Ministere des Finances et des Affaires Eccnomiques* and the *Institut National de la Statistique et des Etudes Economiques* and published by the *Imprimerie Nationale*, Paris.

[4] That is, excludes financial institutions, which are included in the amounts shown for "Undistributed corporate profits" in table I. See table IV for the figures on undistributed profits of nonfinancial enterprises only.

[5] See tables II and III for the breakdown of government savings into savings by the central government, the social security system, and local governments and private nonprofit institutions, which in the French system of national accounts are lumped with the government sector. Fortunately, the operations of these private nonprofit institutions are relatively unimportant and therefore do not distort the overall picture.

only 10 percent of gross domestic investment in 1962, compared to nearly 13.5 percent in 1959.

TABLE I.—*Sources and uses of gross saving, 1959–62*

[Billions of francs [1]]

	1959	1960	1961	1962 [2]
Sources:				
Personal saving	12.65	18.49	17.46	22.48
Undistributed corporate profits	9.20	11.83	11.80	12.66
Depreciation charges	23.51	25.23	27.76	30.59
Government surplus on current operations	7.08	7.29	8.21	7.47
Gross saving	52.44	62.84	65.23	73.20
Uses:				
Plant and equipment	31.58	34.98	39.97	44.51
Government investment [3]	5.98	6.28	7.29	8.32
Residential construction	13.27	13.98	15.13	16.53
Gross fixed capital formation	50.83	55.24	62.39	69.36
Inventory accumulation	1.81	7.07	2.93	5.47
Gross domestic investment	52.64	62.31	65.32	74.83
Net external investment:				
Foreign currency areas	2.72	3.52	4.24	3.38
Overseas franc area	−2.92	−2.99	−4.33	−5.01
Subtotal	−.20	.53	−.09	−1.63
Gross investment	52.44	62.84	65.23	73.20

[1] Francs 4.93706 equals $1.
[2] Preliminary data.
[3] Excluding the nationalized enterprises.

Source: See footnote 3 to text.

Insofar as the uses of gross savings are concerned, the rate of gross fixed capital formation (that is, gross investment net of inventory changes) did not vary widely in the period, ranging from a low of 18.6 percent of gross national product in 1960 to a high of 19.6 percent in 1962. However, there were some shifts in the relative importance of the various components within the total. Thus investment in plant and equipment rose slightly from 62.1 percent of total gross fixed capital formation in 1959 to 64.2 percent in 1962, whereas residential construction showed a steady decline, from 26.1 percent in 1959 to 23.8 percent in 1962. Investment in governmental facilities—including schools, roads, ports, and hospitals—remained quite steady at between 11.5 and 12 percent of total gross fixed capital formation. As indicated above, the rate of inventory accumulation fluctuated rather widely over the 4 years, mainly as a function of the variations in agricultural production from year to year. France's net external investment was negative in 3 of the 4 years covered in table I, although it was largely so only in 1962.

GOVERNMENT SECTOR

The investment and financial operations of the government sector are presented in table II (account of the central government) and table III (account of local governments, the social security system, and private nonprofit institutions).

TABLE II.—*Investment and financial operations of the central government, 1959–62*

[Billions of francs]

	1959	1960	1961	1962 [1]
Investment:				
Gross fixed capital formation	1.85	1.85	2.21	2.49
Other operations in physical assets	.05	−.03	.11	.15
Financial assets:				
Short-term	1.35	.67	.15	.34
Long-term	8.42	6.68	5.79	5.53
Gold and foreign exchange	−.04	−.01	.01	[2] −1.23
Subtotal	9.73	7.34	5.95	4.64
Statistical discrepancy	.46	.08	.13	.50
Subtotal	10.19	7.42	6.08	5.14
Total	12.09	9.24	8.40	7.78
Financing:				
Gross saving	3.56	3.71	3.26	1.88
Borrowings (net):				
Short-term	8.87	7.96	8.46	10.03
Long-term	−.34	−2.43	−3.32	−4.13
Subtotal	8.53	5.53	5.14	5.90
Total	12.09	9.24	8.40	7.78

[1] Preliminary data.
[2] The unusually large reduction in foreign exchange assets in 1962 reflects an arrangement between the Treasury and the Bank of France whereby the Bank purchased from the Treasury the asset representing France's right to draw on the International Monetary Fund as a result of the net drawings which the Fund has made on French francs.

Source: See footnote 3 to text.

TABLE III.—*Investment and financial operations of local governments, social security system, and private nonprofit institutions, 1959–62*

[Billions of francs]

	1959	1960	1961	1962 [1]
Investment:				
Gross fixed capital formation	4.13	4.43	5.08	5.83
Other operations in physical assets	.14	.18	.34	.36
Financial assets:				
Short-term	.61	1.73	2.22	2.22
Long-term	.35	.49	.50	1.00
Subtotal	.96	2.22	2.72	3.22
Total	5.23	6.83	8.14	9.41
Financing:				
Gross saving:				
Local governments	1.86	2.10	2.86	3.10
Social security	1.38	1.22	1.78	2.17
Private institutions	.28	.26	.31	.32
Subtotal	3.52	3.58	4.95	5.59
Borrowings (net):				
Short-term	−.09	.36	.18	.54
Long-term	1.57	2.33	2.16	2.35
Total	1.48	2.69	2.34	2.89
Statistical discrepancy	.23	.56	.85	.93
Total	1.71	3.25	3.19	3.82
Total	5.23	6.83	8.14	9.41

[1] Preliminary data.

Source: See footnote 3 to text.

In 1959, 1960, and 1961, gross savings of the central government exceeded its share of gross fixed capital formation, and it was a net contributor to the requirements of other sectors of the economy for investment financing.[6] However, in 1962 this surplus tnrned into a deficit, and the central government had to increase its borrowing from other sectors. This change appears to be due principally to the tendency of current expenditures to rise more rapidly than taxes and miscellaneous current receipts. The increase in fixed investment expenditures has been relatively small and more than offset by the decline in the amount of additional investment in financial assets.

Of course, the net contribution by the central government to the financing of investment in other sectors of the economy (in the years when there was such a contribution) is not a complete measure of the government's role in the financing of investment. As can be seen from table II, the Treasury also plays an important role as a financial intermediary, borrowing large amounts of liquid funds and then relending them at long term. However, throughout the period in question, its importance as a long-term lender to other sectors of the economy declined. In part, this evolution was undoubtedly a function of the decline and finally the disappearance of the surplus on current operations of the central government, as noted above. In addition, the retirement of large amounts of long-term debt in the period, particularly external debt, combined with no new long-term government flotations on the internal market,[7] represented a heavy charge on the financial resources available to the Treasury, as may be seen from the line for net long-term borrowings in table II.

Table III shows that investments in physical assets by other levels of government and private nonprofit institutions consistently exceeded their combined gross savings in the years 1959–62. Although there has been a rapid growth of gross savings by local governments, their financing requirements have been increasing even more rapidly. The social security system, on the other hand, whose investments in physical assets are very small, has contributed a growing surplus to the financing of investments by others. Although no breakdown is available of the gross fixed capital formation of these various groups, it is certain that the investment activities of local governments account for most of the total.

BUSINESS SECTOR

Table IV presents the investment and financial operations of nonfinancial business enterprises from 1959 through 1962. It will be seen that business investment in this period (gross fixed capital formation plus inventory accumulation) grew much more rapidly than business saving (self-financing), and consequently calls on the saving of other sectors increased. Thus whereas self-financing covered 72 percent of business investment in 1959, the proportion fell to 69 percent in 1960 and again to 64 percent in 1961 and 1962.

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[6] The concept of savings by the central government differs from the balance of definitive budget opera tions (which excludes the borrowing and lending activities of the Treasury) for a number of reasons, of which the most important is that gross fixed capital formation, shown in table II, is considered as a definitive expenditure in the budget presentation.

[7] From 1959 through 1962, the Treasury followed a deliberate policy of staying out of the long-term capital market in order to leave other borrowers such resources as became available. This policy was modified in the spring of 1963.

TABLE IV.—*Investment and financial operations of nonfinancial enterprises, 1959–62*

[Billions of francs]

	1959	1960	1961	1962 [1]
Investment:				
Gross fixed capital formation:				
Plant and equipment	31.37	34.74	39.70	44.22
Residential construction	3.63	3.94	4.38	5.03
Subtotal	35.00	38.68	44.08	49.25
Inventory accumulation	1.81	7.07	2.93	5.47
Financial assets	9.08	9.37	10.19	9.75
Statistical discrepancy	−.33	−.18	−1.24	−.82
Total	45.56	54.94	55.96	63.65
Financing:				
Self-financing:				
Depreciation charges	19.14	20.51	22.63	24.93
Undistributed corporate profits	6.74	8.85	8.48	9.35
Net saving of individual entrepreneurs	.74	2.25	−1.11	.74
Subtotal	26.62	31.61	30.00	35.02
Security sales (net):				
Stocks	3.49	2.75	3.59	4.95
Bonds	2.23	2.42	2.69	2.99
Subtotal	5.72	5.17	6.28	7.94
Long-term borrowings (net)	7.59	9.06	9.35	9.64
Medium-term credit	.41	1.17	1.64	2.10
Short-term credit	5.22	7.93	8.69	8.95
Total	45.56	54.94	55.96	63.65

[1] Preliminary data.

Source: See footnote 3 to text.

As for recourse by business to outside financing, the following indexes show the rate of increase in medium- and long-term borrowing during the period in question was practically the same as that for gross fixed capital formation:

	1959	1960	1961	1962
Gross fixed capital formation	100	111	126	141
Medium- and long-term borrowing [1]	100	112	126	143

[1] The total of the lines "Security sales," "Long-term borrowing (net)" and "Medium-term credit" in table IV.

Within the aggregate of medium- and long-term borrowing, the proportion of the total accounted for by medium-term credit (2- to 5-year maturities) tended to increase. In 1959, increases in this category of credit were severely limited by the tight-credit policy then in effect, but this policy was gradually relaxed over the intervening years. (Most of the impact was felt in 1960.) Security sales amounted to approximately 40 to 45 percent of total long-term outside financing obtained. Security sales and net long-term borrowing taken together, consistently failed to keep pace with the evolution of gross fixed capital formation. Thus, a significant part of the increased financial requirements of business had to be met through recourse to short-term credit. It should, of course, be borne in mind that these global figures conceal important differences in trends as regards the various categories of enterprises and that in particular the experience of corporate enterprises was undoubtedly somewhat different from that of individual entrepreneurs as a group.

CONSUMER SECTOR

Table V presents consumer investment and financial operations from 1959 through 1962. Gross savings[8] increased substantially in 1960, rising from 11 percent of disposable income in 1959, to 13 percent in 1960. This reversed a downward trend in the savings ratio during 1957–59. In 1961, increases in consumption and disposable income were about equal, and gross savings remained stable at the high level of the preceding year. In 1962, the rate of gross saving of consumers again increased, this time to 13.6 percent of disposable income. These fluctuations are in part related to production results in the agricultural sector of the economy, with increases in savings in 1960 and 1962 related to increases in the inventories of agricultural products.

Consumer investment in residential housing[9] has increased much less rapidly than capital formation for the economy as a whole, as is shown by the following indices:

	1959	1960	1961	1962
Gross fixed capital formation:				
All sectors	100	109	123	136
Consumer	100	104	112	119

The slower rate of growth of this form of investment is noteworthy in a country short of housing.

With its own investment[10] growing at a relatively slow rate, and with its gross saving tending to rise quite rapidly, the consumer sector has become increasingly important as a net contributor to the requirements of other sectors of the economy for investment financing. By 1962, its net contribution was about two and a half times the level of 1959. As can be seen from table V, however, there was a decided preference on the part of consumers to hold their assets in liquid form rather than to invest them in long-term securities. Indeed, the increases in long-term financial assets of consumers during the period in question were probably not much, if any, greater than their long-term borrowings over the same period.[11] The very minor role of life insurance as a form of financial investment for households is also significant. One factor which tends to increase the proportion of assets held in liquid form is the exemption from personal income tax of interest on deposits in savings institutions and on Treasury bills issued to the general public.

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[8] "Gross consumer saving" in table V differs from "Personal savings" in table I due to the inclusion of saving of households utilized to finance depreciation charges of individual entrepreneurs and (other) households. In table I these items are, of course, included in the line "Depreciation charges." "Personal savings" in the sense of table I averaged around 8 percent of disposable income during the 4 years in question.

[9] Gross fixed capital formation of consumers less investment by individual entrepreneurs in their business capacity.

[10] The term "Consumer investment" as used here includes, in addition to gross fixed capital formation, the financing of investments of individual entrepreneurs and life insurance. It will be noted that the financing of investments of individual entrepreneurs is carried among the uses of financing in the consumer accounts (table V) and among the sources of financing in the account of nonfinancial enterprises (table IV). The negative figure for "new operations" by individual entrepreneurs in 1961 (table V) reflects the liquidation of inventories of farm products accumulated in the previous year.

[11] Unfortunately the French national accounts are presented in such a way as to preclude a hard and fast determination on this point. The line "Securities (net)" in table V includes short- as well as long-term assets, and no further breakdown is available. It may be noted, however, that net investments by consumers in all types of securities were no greater than long-term borrowings in 1959; even though they exceeded long-term borrowings in 1960–62, it appears reasonable to assume that investments in short-term securities were at least equal to the surplus. In addition to the foregoing problem the statistical discrepancy in this account is disturbingly large.

TABLE V.—*Consumer investment and financial operations, 1959–62*

[Billions of francs]

	1959	1960	1961	1962[1]
Investment:				
Housing	9.64	10.04	10.75	11.50
Sole proprietorship:				
Depreciation	4.13	4.45	4.86	5.34
New operations	.74	2.25	−1.11	.74
Total	4.87	6.70	3.75	6.08
Other operations in physical assets	−.19	−.15	−.45	−.51
Life insurance	.68	.73	.82	.90
Financial assets:				
Cash and depositis	10.45	13.65	17.66	22.67
Securities (net)	2.35	2.48	3.87	5.79
Short-term loans (net)	−.06	.12	.45	.60
Gold and foreign exchange	−.32	.52	.64	----------
Total	12.42	16.77	22.62	29.06
Statistical discrepancy	−3.64	−3.49	−7.10	−10.17
Net total	8.78	13.28	15.52	18.89
Total	23.78	30.60	30.39	36.86
Financing:				
Disposable income	188.67	210.45	226.29	245.73
Minus: Consumption	167.63	182.92	198.99	221.41
Equals: Gross saving	21.04	27.53	27.30	33.32
Borrowings (net):				
Short-term	.36	.79	.59	.52
Long-term	2.38	2.28	2.50	3.02
Total	2.74	3.07	3.09	3.54
Total	23.78	30.60	30.39	36.86

[1] Preliminary data.

Source: See footnote 3 to text.

FOREIGN INVESTMENT

As shown in table I, France was a net importer of resources from the rest of the world in 3 of the 4 years considered. This was so despite France's substantial favorable current account balances with foreign currency areas because of operations within the franc area. The heavy public expenditures by France during the period in the rest of the franc area, including sizable military expenditures in Algeria, as well as current operating expenditures and development and technical assistance expenditures more than offset the surplus France normally realizes with the area on merchandise trade, current invisibles and personal remittances. The result was a payments deficit financed by capital inflows from the rest of the franc area (particularly Algeria in 1961 and 1962) and/or by increases in the franc assets (reserves) of the central monetary institutions of the other franc area countries. In national accounts terms this has largely offset the charge that the simultaneous payments surplus with foreign currency areas would have represented on gross savings in France. In 1962 the fall in French exports to Algeria resulted in the virtual disappearance of the French trade surplus with the rest of the franc area, thus further increasing France's deficit with that area to the point where it exceeded the French payments surplus with foreign currency areas by 1.6 billion francs and thereby provided about 2 percent of the total financing for gross domestic investment in that year.

FINANCIAL INTERMEDIARIES

Tables VI and VII present the movements in the financial assets and liabilities of the banking system and of other financial institutions for the period 1959–62.

TABLE VI.—*Financial operations of the banking system, 1959–62*

[Billions of francs]

	1959	1960	1961	1962 [1]
Changes in assets:				
Cash, deposits, and miscellaneous short-term assets	0.86	0.03	−0.45	0.34
Bonds	.07	.08	−.04	.10
Stocks	.22	.34	.43	
Short-term loans	3.52	7.30	8.47	9.42
Medium-term loans	−.25	.03	2.24	4.08
Long-term loans			.11	
Gold and foreign exchange	2.30	2.60	5.13	4.50
Subtotal	6.72	10.38	15.89	18.44
Statistical discrepancy	.17	.88	.81	
Total	6.89	11.26	16.70	18.44
Changes in liabilities:				
Demand deposits	6.80	8.66	12.31	15.48
Other deposits	2.13	2.66	2.70	2.28
Bonds	.01	.11	.13	
Stocks	.21	.08	.11	.17
Gold and foreign exchange	−2.77	−.75	.92	−.19
Subtotal	6.38	10.76	16.17	17.74
Statistical discrepancy				.13
Total	6.38	10.76	16.17	17.87
Financing capacity [2]	.51	.50	.53	.57
Total	6.89	11.26	16.70	18.44

[1] Preliminary data.
[2] Gross saving of the banking system minus its gross fixed capital formation.

Source: See footnote 3 to text.

TABLE VII.—*Financial operations of financial institutions other than the banking system, 1959–62*

[Billions of francs]

	1959	1960	1961	1962 [1]
Changes in assets:				
Cash, deposits, and miscellaneous short-term assets	1.70	−0.08	2.06	3.74
Bonds	1.58	.99	1.49	1.78
Stocks	.48	1.15	.52	.42
Short-term credits	.95	.63	.52	1.01
Medium-term credits	.90	1.45	−.23	−.83
Long-term loans	7.80	8.97	9.63	10.89
Subtotal	13.41	13.11	13.99	17.01
Statistical discrepancy			1.03	.63
Total	13.41	13.11	15.02	17.64
Changes in liabilities:				
Demand deposits	.65	.97	1.20	1.57
Other deposits	4.51	3.93	4.49	6.63
Short-term obligations	.39	.66	.81	1.07
Bonds	1.11	.87	1.45	1.62
Stocks	.07	.10	.09	.05
Medium-term borrowings	.24	.31	.37	1.15
Long-term borrowings	3.89	3.15	3.12	2.04
Subtotal	10.86	9.99	11.53	14.13
Statistical discrepancy	.02	.02		
Total	10.88	10.01	11.53	14.13
Financing capacity [2]	2.53	3.10	3.49	3.51
Total	13.41	13.11	15.02	17.64

[1] Preliminary data.
[2] Gross saving of other financial institutions, plus receipts from life insurance, minus gross fixed capital formation by such institutions.

Source: See footnote 3 to text.

In the case of the banking system, the rapid expansion of short-term credit is evident. Perhaps of greater interest is the increase in medium-term credit. Whereas in the 2-year period 1959–60, the banking system reduced its holdings of medium-term assets somewhat, in 1961 and 1962 it added substantial amounts to its medium-term portfolio. This was largely a result of official action. On the one hand, new credit regulations were instituted requiring the banks to invest a certain minimum percentage of their deposit liabilities in specified types of assets, including medium-term paper rediscountable at the Bank of France. On the other hand, the minimum amount of Treasury bills which the banks were required to hold was gradually reduced from 25 percent to 15 percent of their deposit liabilities. They were thus encouraged to channel funds into the higher yielding medium-term paper.

The primary role of the other financial institutions, a grouping which includes the savings banks, is the collection and transformation into long-term loans of the liquid funds of the public. While the single most important increase in their liabilities is the growth of their time and savings deposits, by far the largest part of their new investment takes the form of long-term loans. The reduction in 1961 and 1962 of their portfolio of medium-term paper is in part related to the converse movements of the holdings of the banking system described above. Note the relatively minor importance of transactions in securities on the assets side.

The relative importance and the nature of the role of the financial intermediaries in the allocation of financing in France may be seen from tables VIII and IX. The first table provides a detailed picture of financial flows in 1962, and the second a less detailed one for the period 1958–62. Intermediary stages within the financial circuit have been eliminated in this presentation, which (unlike tables I through VII from the national accounts) is drawn from the report of the *Conseil National du Crédit.*

TABLE VIII.—*Means, sources, and allocation of financing in 1962*

[Yearly changes in billions of francs]

	The banking system [1]	Savings institutions	Other financial establishments	Insurance companies	The Treasury [2]	Enterprises and local government [3]	Total
I. Means of financing:							
A. Money	17.12				2.95		20.07
Banknotes	5.73						5.73
Coins					.20		.20
Sight deposits	11.39				2.75		14.14
B. Liquid savings	2.18	6.28			3.54		12.00
Time deposits and special accounts	2.18						2.18
Deposits in savings banks		5.21					5.21
Short-term bills (purchased by private individuals and enterprises)		1.07			3.54		4.61
C. Savings received on the securities market (marché financier) [4]	.17	1.38	0.07	0.01	−.88	6.14	6.89
D. Miscellaneous resources of financial institutions	.48	3.56	.02	.94	−3.04		1.96
Loans from abroad		−.12					−.12
Deposits		1.80					1.80
Their own funds	.45	.40	.02				.87
Miscellaneous	[5].03	1.48		[6].94	−3.04		−.59
Subtotal	19.95	11.22	.09	.95	2.57	6.14	40.92
E. Movement of credits and debits between:							
The financial intermediaries	.02	−3.54	.03	−.06			−3.55
and the Treasury					3.55		+3.55
Total	19.97	7.68	.12	.89	6.12	6.14	40.92
II. Allocation and sources of financing:							
A. Gold and foreign exchange	4.79						4.79
B. The central government					.85		.85
C. Local governments		2.81			−.02	.03	2.82
D. Enterprises [7]	10.87	4.36	.01		2.52	6.13	23.89
Employed short term	8.87	−.04					8.83
Employed medium term	1.71	.05	.01				1.77
Employed long term (loans)	.29	3.71			2.52		6.52
Employed long term (stocks and bonds)		.64				6.13	6.77

See footnotes at end of table, p. 84.

TABLE VIII.—*Means, sources, and allocation of financing in 1962*—Continued

[Yearly changes in billions of francs]

	The banking system [1]	Savings institutions	Other financial establishments	Insurance companies	The Treasury [2]	Enterprises and local government [3]	Total
II. Allocation and sources of financing—Continued							
E. Construction	2.55	0.42	0.12	----------	2.55	----------	5.64
Short term	.20	----------	----------	----------	----------	----------	.20
Medium term	2.35	−1.06	.12	----------	.05	----------	1.46
Long term	----------	1.48	----------	----------	2.50	----------	3.98
F. Installment sales	.94	----------	.12	----------	----------	----------	1.06
G. Miscellaneous uses	.82	.09	−.13	0.89	.22	−0.02	1.87
Total	19.97	7.68	.12	.89	6.12	6.14	40.92

[1] The Bank of France and the banks.
[2] Including the deposits of businesses and individual checking accounts.
[3] Including borrowing and amortization by the Postal and Telecommunications Administration on the securities markets.
[4] Including the reserves of insurance companies placed in negotiable securities.
[5] Resources of the Bank of France.
[6] Reserves of insurance companies not placed in the negotiable securities.
[7] Including publicly and privately owned industrial, commercial and agricultural enterprises.

Source: "17th Annual Report of the National Credit Council (preliminary edition)," Paris, 1963; p. V–22.

TABLE IX.—*Means and allocation of financial resources, 1958-62*

[Yearly changes in billions of francs]

	1958	1959	1960	1961	1962
I. Means of financing:					
A. Money	4.36	8.96	11.87	14.84	20.07
Banknotes	2.01	.56	4.37	5.03	5.73
Coins	.03	−.02	.37	.15	.20
Sight deposits	2.32	8.42	7.13	9.66	14.14
B. Liquid saving	4.81	9.82	10.33	11.26	12.00
Time deposits and special accounts	.53	1.96	2.73	2.69	2.18
Deposits in savings banks	2.89	3.81	3.43	3.90	5.21
Short-term bills (individuals and businesses)	1.39	4.05	4.17	4.67	4.61
C. Saving received on the securities market [1]	6.94	5.44	4.71	6.70	6.89
D. Miscellaneous resources of the financial institutions	2.67	4.58	3.47	1.81	1.96
Loans from abroad	.77	.37	−.33	−.44	−.12
Deposits	.96	.73	1.64	.12	1.80
Their own funds	.49	.82	.92	1.09	.87
Miscellaneous [2]	.45	2.66	1.24	1.04	−.59
Subtotal	18.78	28.80	30.38	34.61	40.92
E. Movement of credits and debits between—					
The financial intermediaries	−1.75	−.80	.58	−.32	−3.55
The Treasury	1.75	.80	−.58	.32	3.55
Total	18.78	28.80	30.38	34.61	40.92
II. Allocation of financing:					
A. Gold and foreign exchange	.24	7.23	3.32	4.79	4.79
B. The central government	1.14	−.41	−2.53	−1.64	.85
C. Local governments	1.73	1.82	2.17	2.07	2.82
D. Enterprises [3]	9.60	15.05	17.45	20.79	23.89
Short-term	1.15	5.38	6.99	8.00	8.83
Medium-term rediscountable	1.42	.24	.80	1.12	1.77
Long-term (loans)	2.84	3.61	4.70	5.72	6.52
Long-term (stocks and bonds)	4.19	5.82	4.96	5.95	6.77
E. Construction	4.42	5.18	5.41	5.50	5.64
Short-term	.04	.06	.09	.14	.20
Medium-term rediscountable	1.26	.29	.40	.74	1.46
Long-term loans	3.12	4.83	4.92	4.62	3.98
F. Installment sales	.08	.58	1.01	1.02	1.06
G. Miscellaneous uses	1.57	−.65	3.55	2.08	1.87
Total	18.78	28.80	30.38	34.61	40.92

[1] Including reserves of insurance companies placed in negotiable securities.
[2] Including reserves of insurance companies not placed in negotiable securities.
[3] Including borrowing and amortization of the Postal and Telecommunications Administration on the securities market.

Source: "17th Annual Report of the National Credit Council (preliminary edition)" Paris, 1963, p. V-24.

SECTION III—THE DEMAND FOR CAPITAL

France considers herself a capital-scarce country. This is epitomized in an oft-quoted remark made by the Committee of Experts in its report issued in December 1958 recommending a program for the stabilization of the French franc: "For many years, all French problems will be problems of investment." [12] On the other hand, France, which has run a considerable balance-of-payments surplus ever the past few years and made substantial prepayments on her external debt, envisages a role for herself both as a supplier of capital

[12] "*Rapport sur la Situation Financiere Présenté à Monsieur le Ministre des Finances et des Affaires Economiques en Execution de sa décision du 30 Septembre 1958,*" Paris, *Imprimerie Nationale*, 1958, p. 6.

to the less developed countries and as the financial center of Europe within the context of the Common Market.[13]

The chronic shortage of capital in post-World War II France has been attributable in part to the damages arising from the war, which required the utilization of resources not for expansion, but for replacement. The rapid increase in the rate of growth of the French economy since the end of the war and the investment priorities established by the French economic plans have further intensified the demand for capital in France.

Considerable attention was given in section II to the pattern of internal financing by the various sectors, and this section is therefore primarily devoted to their financing from external sources. Leaving aside for the moment the demand for medium- and long-term credit, it may be useful to look first at table X, which provides a record of negotiable security issues in France during the period 1958–62. It may be seen that total issues of negotiable securities increased markedly during 1961 and 1962, following a decline in 1959 and 1960. On a net basis, however, more funds were raised in 1958 than in any of the following years. Note, however, the substantial volume of long-term borrowing by the Treasury in 1958.

TABLE X.—*Negotiable security issues, 1958–62*

[Billions of francs]

	1958	1959	1960	1961	1962
The Treasury	2.94				
Public authorities	.17	0.02	0.02	0.24	0.18
Public credit institutions	.81	1.15	1.06	1.60	1.94
Of which:					
Bonds	(.81)	(1.15)	(1.06)	(1.60)	(1.90)
Stocks					(.04)
National enterprises and the post and telegraphic system	1.91	1.48	1.50	1.63	2.01
The competitive sector	2.88	4.97	4.25	5.33	5.77
Of which:					
Stocks	(1.77)	(2.98)	(2.15)	(3.00)	(3.66)
Participation	(.19)	(.18)	(.22)	(.24)	(.29)
Bonds	(.92)	(1.81)	(1.88)	(2.09)	(1.82)
Public issues of stock in the national company for the financing of oil exploration		.07			
Electricity and Gas of Algeria			.13		
Total	8.71	7.69	6.96	8.80	9.90
Less	1.77	2.25	2.25	2.10	3.05
Of which:					
Redemptions	(1.57)	(1.87)	(2.28)	(2.00)	(2.52)
Operations in securities issued in the capital market by the *Caisse des Dépôts et Consignations*	(.20)	(.38)	(–.03)	(.10)	(.53)
Net total	6.94	5.44	4.71	6.70	6.85

Source: "17th Annual Report of the National Credit Council (preliminary edition)" Paris, 1963, p. iv-42.

GOVERNMENT

The demand for capital by the central government has been met through normal fiscal methods, through the sale of Treasury bills and other short-term obligations, through the financial intermediaries (such as the postal checking system, the savings banks and the public financial institutions), and, except during the period 1959–62, through long-term borrowings on the capital market.

[13] "*Rapport General de la Commission de l'Economie Générale et du Financement,*" Paris, 1961, pp. 16–17 and 47.

Undoubtedly one of the most important recent developments on the French financial scene was the reentry of the Treasury into the long-term bond market in the spring of 1963 after an absence of nearly 5 years. With the increases in liquid savings following the stabilization of the franc in 1959, the Treasury was able to meet its needs for borrowed resources largely from the funds which various institutions channel to it more or less automatically, and from the subscriptions by individuals and business enterprises to short-term Treasury bills. It therefore refrained from any long-term borrowing in order to leave the market entirely to nationalized and private enterprises. This policy was, however, the subject of some criticism, of course. As early as 1960 the OEEC in its annual review of the French economy had this to say:

> It is not enough that net public indebtedness has ceased to expand. The method of financing the deficit is by no means indifferent; although the French authorities do not seem for the moment to favor the issue of a long-term loan, it seems difficult to imagine that financing can be insured indefinitely simply by increasing the floating debt.[14]

Despite repeated suggestions from various quarters that the Treasury should float a long-term loan from time to time to reduce excess liquidity in the economy, the government continued to refrain from long-term public borrowing for almost 3 additional years.

The amount of the issue in May 1963—1 billion francs—was rather modest compared with previous Treasury flotations.[15] However, in September 1963 the government launched a second loan of 2 billion francs in the context of its stabilization program. This marked a step, as Finance Minister Giscard d'Estaing told the national assembly, "toward the return to a state of affairs where the Treasury's needs are met from long-term resources and to a fiscal situation more nearly comparable to borrowing operations of other countries." [16] It is noteworthy that the government considered it necessary to attach (at least partial) exemptions from the personal income tax to these two issues in order to insure their success.

The May and September issues marked a departure from past practice in one other respect. The banks were required to bid competitively on the underwriting commission for a part of the loans. This experiment was obviously directed at reducing the high commissions generally charged on bond flotations and was not well received by the banks. According to press reports, the banks would have preferred that their commissions simply be reduced somewhat. But it was clearly effective; the cost of placing the May loan was only 0.89 percent, as against 1 percent in 1958, 1.25 percent for the 1956 and 1957 borrowings, and 1.5 percent for loans issued between 1952 and 1954.

BUSINESS

Equity capital

With only a few exceptions,[17] new stock issues can be made without prior authorization by the French authorities. On the other hand, the

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[14] Organization for European Economic Cooperation "Economic Conditions in Member and Associated Countries of the OEEC" France, Paris, July 1960, p. 33.

[15] The 5-percent Ramadier loan, issued in the fall of 1956, brought in 3.2 billion francs, while the 3.5 percent Pinay gold-guaranteed *rente*, floated in the summer of 1958, totaled 2.94 billion francs.

[16] *Le Monde*, Paris, July 21–22, 1963, p. 9.

[17] Issues by companies engaged in petroleum exploration must have the formal authorization of the Finance Ministry when they total more than 250,000 francs, as, since August 1963, must issues by companies engaged in the construction, rental, and sale of buildings for dwelling purposes when they total 10 million francs or more.

conditions of any issue in excess of 1 million francs have to be reported to the Finance Ministry at least 3 weeks in advance, and the Finance Ministry can veto the issue. The problem has not been too many stock issues, but rather an insufficiency of new stock issues to meet the demand for equity securities by investors.

During the past 10 years, the average yield on shares listed on the Paris stock exchange has fallen from about 5.5 percent in 1953 to about 1.6 percent in 1962. (On the other hand, stock dividends are important.) The low yield is partly a reflection of the rapid increase in stock price; from a base of 100 in 1949, the Paris stock exchange index rose to a peak of 793 in April 1962, and despite the decline which began in May 1962, is at present (October 1963) at 641. The rapid increase in the stock prices reflected the narrowness of the market due to the insufficient supply of new issues.

The lack of new issues does not imply large internal cash flows but simply reflects the fact that equity financing is unpopular. This is the result of the high costs of flotation, tax arrangements favoring bond issues, and the fear of loss of control.

The funds raised annually on the stock market since 1957 have varied widely (see table XI). The Lorain Committee views the increase in new issues in 1962 as encouraging. Furthermore, new issues during the first months of 1963 were running above the similar period in 1962 (1.87 billion francs from January through May 1963, as compared with 1.61 billion francs during the same period of 1962).

TABLE XI.—*Stock issues, 1957–62*

[Billions of francs]

	1957	1958	1959	1960	1961	1962
Shares in limited liability companies	0.23	0.19	0.18	0.22	0.24	0.29
Stocks	2.55	1.77	3.05	2.15	3.00	3.70
Total	2.78	1.96	3.23	2.37	3.24	3.99
Index based on 1957 equals 100	100	71	116	85	117	143

Source: "Lorain Committee Report," Paris, 1963, p. 22.

The Lorain Committee recommended that the stock market could be widened and deepened by (*a*) the establishment of open-end investment companies (regulations permitting the establishment of open-end investment trusts were announced in September 1963); (*b*) the prudent increase of issue premiums (*primes d'émission*), which the purchaser of new shares pays the issuer in addition to the nominal value of the shares, thus increasing the amount realized by the issuing company on the operation; (*c*) the issue of preferred stock (this type of equity instrument does not now exist in France); (*d*) the creation of stock with plural voting rights, i.e., the number of votes increasing with the number of years the stock is held; (*e*) the issue of convertible bonds; (*f*) more favorable tax treatment; and (*g*) greater availability of information to stockholders.

Bonded debt

In contrast to the situation with respect to stocks, the demand for funds through bond issues is sufficiently heavy that access to the market is controlled. A queue system exists, and the waiting period is about 6 months. Some requests for permission to issue bonds are refused on financial or administrative grounds.

The volume of capital raised on the bond market in recent years (including nonbusiness issues in order to facilitate comparisons) is shown in table XII.

TABLE XII.—*Bond flotations, 1957–62*

[Billions of francs]

	1957	1958	1959	1960	1961	1962
1. The Treasury:						
Gross flotations	0.84	2.94	0	0	0	0
Amortization	-.63	-.74	-.94	-1.12	-.75	-.86
Net	.21	2.20	-.94	-1.12	-.75	-.86
2. Public authorities, nationalized enterprises, and public credit institutions:						
Gross flotations	2.66	2.89	2.65	2.72	3.47	4.09
Amortization	-.43	-.68	-.75	-.98	-.84	-1.21
Net	2.23	2.21	1.90	1.74	2.63	2.88
3. The competitive sector:						
Gross flotations	.64	.92	1.81	1.88	2.09	1.82
Amortization	-.11	-.15	-.18	-.26	-.34	-.45
Net	.53	.77	1.63	1.62	1.75	1.37
Total gross flotations	4.14	6.75	4.46	4.59	5.56	5.91
Amortization	-1.17	-1.57	-1.87	-2.36	-1.93	-2.52
Net	2.97	5.18	2.59	2.23	3.63	3.39
Index: 1957 equals 100	100	174	87	75	122	114

Source: "Lorain Committee Report," Paris, 1963, p. 34.

The major borrowers during the period were the public authorities and nationalized enterprises; the official bodies which channel savings into favored sectors (the *Crédit Foncier*, the *Crédit Agricole*, and the *Crédit National*); and a number of large business enterprises.

The steel industry as well as a number of small- and medium-sized firms have made use of so-called group issues—several firms in a similar industry joining together to raise funds. (See table XIII.) Group issues will probably grow in importance. Nevertheless, most of the smaller firms may be expected to continue to rely predominantly on credits from banks and other financial institutions rather than market flotations.

TABLE XIII.—*Group bond issues,[1] 1953–62*

[Millions of francs]

	Industrial group issues by the—		Regional development companies	Total
	Steel industry	Other groups		
1953	80			80
1954	200	80		280
1955	215	46		261
1956	225	40		265
1957	220	90	21	331
1958	290	220	33	543
1959	330	223	95	648
1960	340	299	141	780
1961	450	341	199	990
1962	465	99	173	737

[1] Nominal amounts.

Source: "Lorain Committee Report," Paris, 1963, pp. 82 and 86.

The Lorain Committee also recommended several steps to strengthen the bond market. The measures included (a) the issue (particularly by new firms) of bonds which might share in profits; (b) the issue of convertible bonds; (c) a reduction in flotation costs; (d) changes in taxation to make the purchase of bonds even more attractive; and (e) changes in redemption practices, which often result in a loss to the lender.

The Lorain Committee also hoped to bring about a better market equilibrium by continuing to limit access to the market while at the same time increasing the supply of funds. One method suggested was to have the banking system purchase more bonds for its own account.

Other medium- and long-term debt

When the demand for investment funds is not satisfied from the sources discussed above, the borrower usually turns to one of the financial institutions which engage in medium- or long-term lending. These are usually official or semiofficial bodies which collect or channel funds to selected types of borrowers. They usually lend at rates of interest below the market rate which the borrower would pay were he forced to seek alternative sources of financing—if indeed alternative sources existed for him. The tables described below in detail point out the very large role which the Government plays in shaping—and in approving—individual investment decisions in France.

Long-term loans to commercial and industrial enterprises have increased in each of the past 6 years, 1957–62 (table XIV). Their rapidly increasing importance vis-a-vis stock and bond flotations can be judged by reference to tables X–XII. Particularly noteworthy is the steady growth of loans by the semiofficial *Crédit National*, which makes funds available to small- and medium-sized industrial borrowers. Table XV provides an analysis of its loans on the basis of number and value.

TABLE XIV.—*Net annual increase in long-term loans to commercial and industrial enterprises, 1957–62*

[Billions of francs]

Lending institutions	1957	1958	1959	1960	1961	1962	Total outstanding at end of 1962
From Treasury:							
Loans distributed directly by the Treasury	+1.36	+1.74	+2.36	+2.38	+2.13	+2.22	19.53
Loans distributed by the *Crédit National* and the cooperative credit establishments	--------	+.15	+.12	+.14	+.15	+.11	1.94
Caisse des Dépôts	−.08	+.05	+.11	+.39	+.62	+1.35	2.68
Credit National	+.27	+.12	+.21	+.39	+.56	+.82	3.28
Miscellaneous	+.03	+.01	+.04	+.05	+.08	+.04	.79
Total	+1.58	+2.07	+2.84	+3.35	+3.54	+4.54	28.22

Source: "Lorain Committee Report," Paris, 1963, p. 85.

TABLE XV.—*Distribution of loans made by Credit National, 1958–62*

Sum in French francs	Number of loans per each category				
	1958	1959	1960	1961	1962
Loans of:					
Less than 1,000,000	124	162	178	270	325
From 1,000,000 to 2,500,000	19	42	50	75	79
From 2,500,000 to 5,000,000	17	20	41	32	31
From 5,000,000 to 10,000,000	9	9	22	27	25
More than 10,000,000	7	6	11	20	15
Total	176	239	302	424	475

Source: "Lorain Committee Report," Paris, 1963, p. 86.

A relatively recent innovation on the French capital market is the grouping of similar types of borrowers, with guarantees provided by mutual guarantee societies (*sociétés de caution mutuelle*), thus enabling the borrower, particularly small- and medium-sized firms, to meet the requirements of specialized lending institutions such as the *Crédit National.*

Medium-term credit (from 2 to 5 years) rediscountable at the Bank of France plays an important role in meeting the demand for funds. It represents roughly 10 percent of gross investment by industrial and commercial enterprises. Loans for dwelling construction are normally made by two semiofficial lending institutions, the *Crédit Foncier* and the *Sous-Comptoir des Entrepreneurs.* Funds made available to finance exports generally come from the banks, and the bills issued by the borrowers can be discounted at favorable rates with the Bank of France.

Loans for the financing of equipment (which includes funds for working capital, goods to be used in the production process, new equipment, etc.), fall into two categories. If the loan is to a state-controlled enterprise, it takes place generally through a banking consortium; the bills or notes issued can then be discounted at the *Crédit National.* If the loan is to a private concern, the note is not automatically discountable; it is first examined by the *Crédit National* (and where appropriate by the *Crédit Foncier* or the *Crédit Agricole*) and the Bank of France to insure its financial soundness and its value to the government's economic program. It is questionable whether a bank would be willing to make a loan which it felt would not meet the criteria for rediscount privileges. Table XVI shows the growth of medium-term loans by category.

TABLE XVI.—*Medium-term credit outstanding, 1957–62*

[Billions of francs]

	Year end					
	1957	1958	1959	1960	1961	1962
Medium-term construction loans:						
Special loans	7.21	8.34	8.45	8.55	8.88	9.75
Other credits	.95	1.08	1.26	1.56	1.97	2.56
Subtotal	8.16	9.42	9.71	10.11	10.85	12.31
Medium-term exports loans	.65	.73	.78	1.16	1.59	2.22
Medium-term "equipment" loans:						
Industrial or commercial sector	6.02	7.13	7.14	7.44	7.98	8.89
Agricultural sector	.62	.79	.97	1.09	1.24	1.47
Subtotal	6.64	7.92	8.11	8.53	9.22	10.36
Total	15.45	18.07	18.60	19.80	21.66	24.89

Source: "Lorain Committee Report," Paris, 1963, p. 88.

In recent years, banks have financed an increasing proportion of the medium-term equipment loans they distribute from their own resources. A change in credit regulations in the latter part of 1960 placed a requirement on the banks to hold specified categories of assets against a certain percentage of their deposit liabilities (first fixed at 30 percent and since raised in several steps to 36 percent). Among the categories of assets specified was rediscountable medium-term paper, so the banks were led to finance more and more medium-term loans for equipment themselves. (See table XVII.) Over the same period, reductions were made in the minimum required holdings of Treasury bills (from 25 percent of deposit liabilities at the beginning of 1956 to the present level of 15 percent).

TABLE XVII.—*Medium-term "equipment" loans financed from banks' own resources, 1957–62*

[Billions of francs]

	1957	1958	1959	1960	1961	1962
1. Credits distributed by the banks	6.02	7.13	7.14	7.44	7.98	8.89
2. Credits financed by the banks	.57	.45	3.41	2.05	4.43	6.09
Line 2 as a percentage line 1	9	6	48	28	54	68

Source: "Lorain Comm ttee Report," Paris, 1963, pp. 90–91.

The Lorain Committee recommended that the term of medium-term credits be lengthened to correspond with the amortization schedule of the material financed. This amounts to a suggestion that the monetary authorities consider whether medium-term bank credits must continue to be strictly limited to 5-year maturities.

CONSUMERS

Residential construction

France faces an acute shortage of housing, resulting from the low rate of building between the two world wars, the destruction during the wars, the rise in the birth rate since World War II, internal migration, and immigration, including most recently the influx from Algeria of some 800,000 persons of French extraction. In this situation, residential construction has been and continues to be an important source of demand for capital. Table XVIII, which shows the financial resources devoted to new housing in recent years, provides an indication of the magnitude of these requirements. Even at the present level of 310,000 or 320,000 completions per year, scarcely any headway has been made in reducing the backlog of demands. Indeed, taking into account the steadily deteriorating state of many of the older existing dwellings, it seems likely that the backlog is growing.

TABLE XVIII.—*Financing of residential construction, 1958–62*

[Billions of francs]

	1958	1959	1960	1961	1962
I. New credits:					
Loans to public housing authorities [1]	2.14	2.65	2.74	2.91	3.09
Special housing loans:					
Financed by the banking system	.33	−.43	−.89	.64	2.01
Other financing [2]	1.75	2.65	3.14	1.87	.47
Total	2.08	2.22	2.25	2.51	2.48
Other credits:					
Long term	.27	.66	.70	.29	.24
Medium term	.35	.45	.60	.82	1.17
Short term	.04	.07	.11	.21	.30
Total new credit	4.88	6.05	6.40	6.74	7.28
II. Repayment on previous loans	−.55	−.77	−.99	−1.24	−1.64
III. Net new credit	4.33	5.28	5.41	5.50	5.64
IV. Other resources [3]	4.91	4.85	4.80	(4)	(4)
V. Total resources (I plus IV) [5]	9.79	10.90	11.20	(4)	(4)

[1] Financed by repayments on previous loans and resources of the *Caisse des Dépôts* (savings banks), local governments and the French Treasury.

[2] Repayments on previous loans, amounts held in the portfolios of specialized credit institutions (principally the *Caisse des Dépôts*) and sums advanced by the French Treasury for consolidation into long-term loans of special construction loans coming to the end of their 5-year term.

[3] Estimated. Financial resources of individuals, housing subsidies and loans granted by the government and certain public financial institutions, directly to individuals and the mandatory 1 percent employers' contribution to the contribution to the construction of housing.

[4] Not available.

[5] Estimated.

Source: National Credit Council Reports.

A further point illustrated by table XVIII is the very small volume of mortgage lending in France for home financing. (See the lines, "Other credits, long-term," and "Other credits, medium-term.") French insurance companies are reportedly reluctant to make mortgage loans because of the extremely tedius legal process which controls foreclosures. Moreover, there is no equivalent to the U.S. savings and loan associations which specialize in mortgage lending.

Private savings banks may make certain real estate loans out of their own resources, but not out of deposits received from their customers. A part of the capital collected through savings bank deposits is, however, utilized for construction loans through the intermediary of the *Caisse des Dépôts et Consignations;* these funds are mainly utilized in financing low-rental housing. Finally, the *Caisse Nationale d'Epargne* and the private savings banks hold "savings-credit accounts" for prospective home buyers who may, after having made deposits for a certain period, obtain loans from the *Sous-Comptoir des Entrepreneurs.* However, these operations have not become very widespread up to the present time.

Private mortgage banks charge very high interest rates and attempt to secure their home mortgages with additional assets. Group life insurance normally has to be taken out at the same time as a mortgage loan, which sharply increases the overall cost to the borrower. The total charges arising from the mortgage procedure are high and the maturities available usually do not extend beyond 10 years.

These institutional impediments have led the French Government to search for other ways to finance housing construction. Such construction normally takes the form of the building of occupant-owned apartments rather than individual homes. All employers are obliged to invest annually an amount equal to 1 percent of their wage and salary costs in dwelling construction. The government itself each year appropriates considerable sums (almost 4 percent of the total 1963 budget as passed by Parliament) for housing, and recent legislation provides for joint stock companies (*sociétés immobilières d'investissement*) whose aim would be to manage buildings primarily constructed for residential purposes. These companies are eligible for tax advantages and it is hoped that their creation will encourage housing construction. Decrees issued in July 1963 make possible the establishment by private investors of real estate investment companies which are not only exempt from income tax but also receive government subsidies.

Of a total of 307,000 dwelling units completed in 1962, 88,000 units were constructed by public authorities; 176,000 private dwellings also benefited from some form of subsidy. Only 35,000 private dwelling units were built without public assistance. The remaining 8,000 units represent reconstruction rather than new starts. Thus over 88 percent of new dwelling units completed in 1962 either were built by public authorities or benefited from official or semiofficial subsidies in one form or another.

Of particular interest is the rapid growth since 1951 of special loans to construction. The framework for these loans was established by legislation passed in 1950. At present, special loans for low-income and family housing which fulfill certain requirements are made at interest rates of 2.75 percent. The maximum rate of interest charged for loans for the construction of ordinary dwelling units (for example, those having larger rooms than are permitted for loans to low-income and family housing) was increased in June 1962 to 5 percent (from 3.75 percent).

The special loans are administered by a committee of the *Crédit Foncier* and are generally made by the *Sous-Comptoir des Entrepreneurs*, the *Caisse des Dépôts*, and, in some bases, by the *Crédit Foncier* itself. The annual growth of these loans is shown in table XIX. The special loans benefit from special discount facilities granted by the *Crédit Foncier* and the Bank of France.

TABLE XIX.—*Growth of special loans to construction, 1951–62*

[Billions of francs]

	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
Outstanding at the beginning of the year	------	.07	0.47	1.15	2.29	4.11	5.77	7.21	8.34	8.45	8.55	8.88
New credits	+0.07	+.40	+.71	+1.18	+1.90	+1.95	+2.15	+2.08	+2.22	+2.25	+2.51	+2.48
Reimbursements and consolidations	------	------	-.03	-.04	-.08	-.29	-.71	-.95	-2.11	-2.15	-2.18	-1.61
Outstanding at the end of the year	.07	.47	1.15	2.29	4.11	5.77	7.21	8.34	8.45	8.55	8.88	9.75

Source: National Credit Council Reports.

Since 1962, the banking system has been able to hold (*prendre en pension*) bills of exchange representing special credits to construction. As table XVIII shows, the bulk of the financing of these loans shifted to the banks in 1962.

Installment credit

The French have discovered installment buying. Installment purchases increased 34 percent in 1959; 44 percent in 1960; 31 percent in 1961; and 25 percent in 1962. Outstanding installment loans at the end of 1962 were 5.38 billion francs, or roughly 1.5 percent of gross national product. About 77 percent of outstanding credit has been distributed by specialized financial establishments (etablissements financiers), and 23 percent by the banks. The specialized financial establishments borrow extensively from the banking system, however, and thus the banking system ultimately carries 89 percent of the total financing.

Roughly 40 percent of the outstanding installment credit has gone to industrial users, and 60 percent to the consumer sector. About 60 percent of the total credit extended has been used to finance purchases from the automotive industry (automobiles, tractors, trucks, etc.).

SECTION IV—THE SUPPLY OF CAPITAL

About 50 percent of all national savings is accounted for by the various enterprises, which in French national accounts include both publicly and privately owned industrial, agricultural, and commercial concerns. The savings of households have averaged 35 percent of total national savings in recent years. (These figures include depreciation.) The remainder represents the surplus of current government revenues over current expenditures. Table XX shows the sources of French national savings since 1959.

TABLE XX.—*Sources of domestic savings, 1959–62*

[Franc figures in billions]

	1959		1960		1961		1962	
	Percent	Total	Percent	Total	Percent	Total	Percent	Total
Savings of enterprises [1]	54.3	28.45	51.7	32.47	53.0	34.58	51.6	37.75
Savings of consumers [2]	32.2	16.91	36.7	23.08	34.4	22.14	38.2	27.98
Surplus of current revenue of the government over current expenditures	13.5	7.08	11.6	7.29	12.6	8.21	10.2	7.47
Total	100.0	52.44	100.0	62.84	100.0	65.23	100.0	73.20

[1] Including depreciation.
[2] Including depreciation charges of households and net saving of individual entrepreneurs.

Source: French national accounts "(*Rapport sur les Comptes de la Nation de l'Année 1962*)," French Ministry of Finance, Paris, 1963.

Looking ahead, the Lorain Committee has attempted to predict the sources and uses of national savings in 1965. Estimates based on these forecasts are contained in table XXI. Using 1961 as a base, the investment of enterprises is expected to increase by 33 percent, and government investment by 50 percent. The committee points out that the equilibrium between savings and investment in 1965 depends upon an increase in transfers of consumer savings to enterprises and the maintenance of a sufficient volume of self-financing by business. In this connection, the Lorain Committee Report refers to the decreasing ability of industrial and commercial enterprises to provide self-financing at desired levels. One of the reasons is increasing competition, which makes it more difficult to pass on the rapid increases in the costs of production—particularly wages. In some cases, this endangers the financial position of the firms in question and lessens the desire to undertake further investment.

TABLE XXI.—*Estimates of savings and investment in 1965 as compared with 1961*

[Billions of current francs]

	1961	1965	Index, 1961=100
Sources of funds:			
Savings of enterprises	34.58	46.40	134
Savings of households	22.44	31.70	141
Excess of current revenue of the Government over Government expenditure	8.21	7.90	96
Total	65.23	86.00	132
Uses of funds:			
Investment of enterprises	47.28	62.90	133
Investment of households	10.30	10.80	105
Investment of Government	7.74	11.60	150
Balance of operations with the rest of the world	−.09	+.70	
Total	65.23	86.00	132

Source: Adapted from French national accounts and "Lorain Committee Report."

The committee especially admonished certain government-owned firms, which, it said, finance too large a part of their capital investment by recourse to loans. If this policy is continued, it could eventually result in the firms' being able to raise only enough funds to service outstanding debt.

In the last 5 years, the increase in liquid savings has been at over twice the rate of increase of total national savings. The most rapid growth was in 1959, following the stabilization of the franc. Table XXII provides indexes for the various forms of French savings during the past 5 years, and the percentage these categories constituted of total savings. Table XXIII traces the evolution of the various forms of savings from year to year in absolute amounts and shows their relationship to national income. Table XXIV shows in more detail forms and employment of French savings in 1962.

TABLE XXII.—*Changes in selected forms of savings, 1958–62*

	1957	1958	1959	1960	1961	1962 [1]
A. Index based on 1957=100:						
Savings of national origin	100	119	130	150	154	169
Purchases of negotiable securities	100	120	94	80	117	126
Liquid savings	100	106	212	220	237	252
Savings with insurance companies	100	120	128	147	166	193
B. As a percent of national savings:						
Issue of negotiable securities	15.3	15.4	11.1	8.2	11.6	11.4
Liquid savings	12.4	11.0	20.3	18.2	19.0	18.4
Savings with insurance companies	4.03	4.06	3.99	3.94	4.32	4.58

[1] Provisional figures: This table is not exactly comparable to tables XXIII and XXIV, but is included because it offers additional measures of the growth and importance of the categories considered.

Source: "Lorain Committee Report", Paris, 1963, p. 9.

TABLE XXIII.—*Growth of selected forms of savings, 1958–62*

[Billions of francs]

	1958	1959	1960	1961	1962
A. Liquid savings	4.82	9.86	10.38	11.29	12.06
Net savings of insurance companies	.63	.65	.68	.75	.94
Net issue of transferable securities	6.94	5.44	4.71	6.80	7.38
Total	12.39	15.95	15.77	18.84	20.38
B. Total of A as a percentage of national income:					
Old base	6.8	8.2	7.3	8.0	--------
New base	--------	7.9	7.0	7.7	7.5

Source: "17th Annual Report of the National Credit Council," Paris, 1963, p. iv-2.

TABLE XXIV.—*The use of savings in 1962*

[Billions of francs]

The forms of savings in 1962	Total sum	Savings supplied to intermediaries						Savings supplied directly—		
		The Treasury	Savings institutions	Banks	Other financial institutions	Insurance companies	Total	To local governments	To the economy	Total
I. Liquid savings	12.06	3.60	6.28	2.18			12.06			
(*a*) Savings bank deposits	5.21		5.21				5.21			
(*b*) Treasury bills	3.60	3.60					3.60			
(*c*) Bonds of the *Crédit Agricole*	1.07		1.07				1.07			
(*d*) Time deposits and deposits receipts	1.30			1.30			1.30			
(*e*) Special accounts	.88			.88			.88			
II. Net savings received by the insurance companies	.94					0.94	.94			
III. Savings received on the financial market	6.85	−.88	1.38	.17	0.07	.01	.75	0.03	6.07	6.10
(*a*) State loans	−.86	−.86					−.86			
(*b*) Post and telegraph	−.07								−.07	−.07
(*c*) Savings institutions	1.65		1.65				1.65			
(1) Bonds	(1.61)		(1.61)				(1.61)			
(2) Stocks	(.04)		(.04)				(.04)			
(*d*) Local government	.03							.03		.03
(*e*) Enterprises	6.65			.17	.07	.01	.25		6.40	6.40
(1) National enterprises	(1.33)	(5.32)		.17	.07	.01	.25		1.33	1.33
(2) Enterprises of the competitive sector									5.07	5.07
(*i*) Bonds	(1.37)								(1.37)	(1.37)
(*ii*) Stocks and participations	(3.95)			(.17)	(.07)	(.01)	(.25)		(3.70)	(3.70)
(*f*) *Electricité et Gaz d'Algérie*	−.02								−.02	−.02
(*g*) Operations of the *Caisse des Dépôts* in securities issued on the financial market	−.53	−.02	−.27				−.29		−.24	−.24
Total	19.85	2.72	7.66	2.35	.07	.95	13.75	.03	6.07	6.10

Source "17th Annual Report of the National Credit Council" Paris, 1963, p. iv-3.

Table XXIV shows that over two-thirds of the savings under consideration are supplied to financial intermediaries. These intermediaries play a major role in channeling savings into investment and, in conjunction with funds made available from insurance companies and the financial market, have supplanted to a large degree the immediate postwar position of public funds in the financing of French investment.

Table XXV shows the changes which have taken place since 1949 in the relative importance of the various sources of capital for the financing of investment (as distinct from the sources of savings). The decrease in the relative importance of capital supplied directly from public funds does not, of course, signify a reduction in the government's important role as director or manager of the funds available to the various users of capital.

TABLE XXV.—*Sources of investment capital as percentages of gross fixed capital formation, 1949, 1961–62*

[In percent]

	1949	1961	1962
Public funds	46.8	24.1	23.6
Specialized organizations, insurance, and the financial market	8.0	23.7	25.5
Medium-term credit	5.5	13.2	12.2
Other capital resources	39.7	39.0	38.7
Total	100.0	100.0	100.0

Source: "Lorain Committee Report," Paris, 1963, p. 16.

LONG- AND MEDIUM-TERM SAVINGS

The problem of developing long-term savings in France was given a high priority by the Lorain Committee, and measures which the committee advocated to improve and augment the flow of long-term savings into the capital market are outlined elsewhere in this chapter.

In recent years (1960–61 average), long-term saving in France has provided only 36 percent of the financing required for long-term investment. Table XXVI sets forth the sources and growth in long-term financing since 1956. To be noted are: (1) the absence since 1959 of the Treasury from the long-term capital market (as already mentioned, this changed in 1963); (2) the decrease in purely monetary financing; and (3) the very large role of the *Caisse des Dépôts* and the Treasury in transforming liquid savings into medium- and long-term capital flows; and (4) the role of net long-term investment from abroad (between roughly 5 and 10 percent of total requirements).

TABLE XXVI.—*Sources of long-term financing, 1956–61*

[Billions of francs]

	1956	1957	1958	1959	1960	1961 [1]
I. Long-term savings:						
Financial institutions	0.54	0.91	0.72	1.09	0.93	1.53
The Treasury	3.32	.73	2.55	-.42		
Direct subscription	1.88	2.25	3.01	3.22	3.38	4.09
Long-term loans	.12	.09	.09	.18	.82	1.10
Long-term investment by insurance companies	1.12	.90	.93	1.27	1.80	1.85
Total I	6.98	4.88	7.30	5.34	6.93	8.87
II. Long-term investment from abroad [2]	.25	.95	1.42	2.03	1.24	1.23
III. Monetary financing	2.06	1.62	.46	-.54	-.09	.64
IV. Transformation of liquid savings into long-term investment by:						
Caisse des Dépôts et Consignations.						
Medium-term construction	-.36		.02	.57	1.30	.08
Long-term investment	3.35	2.82	3.25	4.02	4.17	4.24
The Treasury: Long-term loans [3]	-.96	3.07	2.18	6.95	6.05	7.60
Total IV	2.03	5.89	5.45	11.54	11.52	11.92
Overall total [4]	11.32	13.34	14.63	18.37	19.60	22.36

[1] Provisional figures.
[2] Net.
[3] Residual figures.
[4] (I+II+III+IV equal total of long-term borrowing.)

Source: "Lorain Committee Report," Paris, 1963, p. 13.

The role of insurance companies in France deserves special mention. The insurance industry in France is not highly developed; nonetheless it plays a role as a collector of savings and investor of funds, and its importance in the flow of savings and investment has increased markedly since 1958. The figures in table XXVII understate available reserves because they do not include sums at the disposal of the National Insurance Society (*Caisse Nationale de Prévoyance*).

TABLE XXVII.—*Growth of reserves of private insurance companies, 1957–62*

[Billions of francs]

	1958	1959	1960	1961	1962 [1]
Total	9.86	11.63	13.70	16.01	18.72
Annual increase	+1.69	+1.77	+2.07	+2.31	+2.71

[1] Estimated.

Source: "Lorain Committee Report," Paris, 1963, p. 61.

French insurance companies are required to make at least half of their investments in government or government-guaranteed securities. One possibility raised by the Lorain Committee was that insurance companies might be permitted to reduce their required holdings of such securities from 50 to 35 percent. A percentage distribution of the outstanding investments of insurance companies as of December 31, 1960, is given in table XXVIII. These investments totaled about 15 billion francs at that date.

TABLE XXVIII.—*Distribution of insurance company investments, Dec. 31, 1960*

	Percent
Government stocks and Treasury bonds	9.3
Bonds of the public or semipublic sector	40.7
Other bonds	3.6
Stocks and participations in French companies	13.2
Foreign securities and miscellaneous	11.3
Real estate	11.0
Mortgage loans	2.8
Other	8.1
Total	100.0

Source: "Lorain Committee Report," Paris, 1963, p. 62.

The data in table XXVIII point up certain interesting characteristics with respect to insurance company investments. First, almost 80 percent of total investments were in securities. Second, holdings of government or government-guaranteed securities were no more than required by law, i.e., 50 percent. Third, of the balance of "free funds," over 22 percent may have been put into foreign securities. This may indicate a genuine interest on the part of French insurance companies for a diversified portfolio, which would include significant amounts of foreign securities.

The increase in the financing of medium-term credits by the banks were mentioned in section III as a significant development in the French capital market. Table XXIX traces this development since 1957.

TABLE XXIX.—*Financing of medium-term credits distributed by the banks, 1957–62*

	1957	1958	1959	1960	1961	1962
Outstanding at end of year:						
Credits distributed by banks: medium-term with rediscount privileges ... billion francs	7.01	8.23	8.28	9.09	10.29	12.14
Credits financed by banks ... do	0.83	0.77	3.91	2.44	5.15	7.21
Percentage of credit financed to credits distributed	11.8	9.4	47.0	27.0	50.0	59.4
Annual change:						
Credits distributed by banks ... billion francs	+1.44	+1.22	+0.05	+0.81	+1.20	+1.85
Credits financed by banks ... do	+0.08	−0.06	+3.14	−1.47	+2.71	+2.06

Source: "Lorain Committee Report," Paris, 1963, p. 17.

THE ROLE OF THE PUBLIC SECTOR AS A MANAGER AND INTERMEDIARY IN THE FLOW OF SAVINGS

The French economy may be best described as a partially planned economy. Although much of it remains under private ownership, an effort is made to secure the compliance of private as well as public enterprises with the established national economic objectives. The allocation of savings into particular investment projects offers important possibilities in this regard, and the French Government therefore uses its considerable financial powers to determine the direction which the flow of savings will take. The Lorain Report states that this management is necessary, and that access to the financial market, as well as control over interest rates, must therefore be left in the hands of the government.

The "*Rapport Général de la Commission de l'Economie Générale et du Financement*" of the fourth economic and social development plan (1962–65) also leaves no doubt as to the views of its members: "The mechanisms to assure, on a priority basis, the necessary capital investment in relation to the objectives of the plan—that is, the control of credit and new issues—exist and we can take satisfaction that they do exist. In the likely assumption of a relative scarcity of capital, these mechanisms must still be used to promote the execution of the fourth plan."

The official and semiofficial intermediary institutions [18] (not belonging to what is normally considered to be the banking system) have large resources at their command. At the end of 1962, the sum of their resources totaled 114.54 billion francs. Their resources grew by 16.4 billion francs in 1962, as compared to an increase of 12.9 billion francs in 1961. Apart from government grants and advances, these institutions mainly depend upon savings deposits and bond issues for new finance. Savings and funds derived through borrowings increased sharply during 1962, totaling 10 billion francs as compared to 6.3 billion francs in 1961. Tables XXX and XXXI depict not only the total resources made available through these institutions but also their relative importance.

TABLE XXX.—*The total, origin, and uses of resources made available by official and semiofficial suppliers of capital as of December 31, 1962*

	Billions of francs
A. Total resources made available by institution:	
1. The Treasury	34. 24
2. *Crédit National*	5. 34
3. *Caisse des Dépôts et Consignations*	49. 61
4. *Crédit Foncier de France et Sous Comptoir des Entrepreneurs*	13. 62
5. *Caisses de Crédit Agricole*	13. 68
6. *Caisses de Crédit Cooperatif*	1. 50
7. *Caisses d'Epargne d'Alsace Lorraine*	. 66
8. *Credit Municipal de Paris*	. 16
9. Financial establishments	. 84
10. *Caisse de Consolidation et de Mobilization des Crédit a Moyen Terme*	. 29
Subtotal	119. 94
Less:	
Advances by the *Caisse des Dépôts et Consignations* for low-cost housing (HLM)	3. 82
Loans of the specialized organization purchased by the *Caisse des Dépôts*	1. 58
Total	114. 54

[18] The most important of these specialized institutions, leaving aside the Treasury, is the *Caisse des Dépôts et Consignations*, whose principal function is the investment of the assets of the savings banks, although it is entrusted with the management of many other funds as well. Other institutions of importance are the *Crédit National*, which provides medium- and long-term credit to industry, the *Crédit Foncier* and the *Sous-Comptoir des Entrepreneurs*, which provide credit for building, and the *Caisses de Crédit Agricole*, for agricultural credit.

TABLE XXX.—*The total, origin, and uses of resources made available by official and semiofficial suppliers of capital as of December 31, 1962*—Continued

		Billions of francs
B. Origins of resources:		
1. Their own capital		3. 91
2. Government grants and advances		45. 48
3. From foreign borrowing		
4. Savings banks deposits [1]		37. 85
5. Depots and managed funds [2]	12. 24	
Less advances to the *Caisse des Dépôts et Consignations* for low-cost housing (HLM)	−3. 82	
		8. 42
6. Short-term bills or bonds [2]		3. 81
7. Medium- and long-term bonds or investments [3]		11. 27
8. Miscellaneous	5. 38	
Less loans of specialized organization—Underwritten by the *Caisse des Dépôts*	−1. 58	
		3. 80
Total		114. 54
C. Uses of resources:		
1. Funds made available to the economy		97. 34
(a) Securities which can be discounted:		
Short term		. 68
Medium-term construction		2. 84
Medium-term equipment		. 81
(b) Loans which cannot be discounted:		
Construction		29. 74
Equipment		36. 71
Local governments		20. 87
(c) Portfolio investment		5. 69
2. Funds made available to the Treasury		21. 79
(a) Long-term advances		5. 49
(b) Deposits at the Treasury		6. 37
(c) Short-term government bills		8. 31
(d) Securities		1. 62
3. Miscellaneous		. 81
Less deduction of funds specified in secs. A and B of this table		−5. 40
Subtotal		−4. 59
Total		114. 54

[1] This heading includes only the deposits of the public (i.e., private and individual savers) in the savings banks.

[2] Including the capital of the savings banks held by the *Caisse des Dépôts*.

[3] Does not include bills and/or bonds worth 3,640,000,000 francs and 130,000,000 million francs of obligations issued by the *Caisse National de Crédit Agricole* and subscribed to by the regional banks. These sums have also been subtracted from the figures relating to the agricultural credit banks.

Source: Adapted from the "17th Annual Report of the National Credit Council," Paris, 1963, pp. v-5, v-11.

TABLE XXXI.—*Lending activities and sources of funds of official and semiofficial financial institutions,*[1] *1959–62*

[Billions of francs]

	1959	1960	1961	1962
Changes in assets:				
Short-term credits	0.09		0.07	0.08
Rediscountable medium-term paper:				
Construction [2]	.74	1.30	−.09	−.89
Equipment [2]	.16	−.02	.06	.06
Other medium- and long-term lending:				
Construction	4.63	4.39	4.62	3.98
Equipment	4.02	5.02	4.95	6.23
Local governments [2]	1.63	2.27	1.95	2.79
Purchases of securities	.62	.55	.35	.51
Lending to central government	1.57	−.46	1.17	3.64
Cash, buildings, correspondents, etc.[3] [4]	.13	.24	−.21	−.04
Total [3] [4]	13.59	13.29	12.87	16.36
Changes in liabilities:				
Own capital	.36	.49	.51	.53
Government grants and advances	6.38	5.94	5.49	5.05
Countervalue of external debts	.12	−.33	−.44	−.12
Deposits and other short-term liabilities [4]	4.92	5.73	4.83	8.08
Bond issues	1.16	.95	1.50	1.96
Other [3]	.65	.51	.98	.86
Total	13.59	13.29	12.87	16.36

[1] Treasury, *Crédit National, Caisse des Dépôts et Consignations, Crédit Foncier, Sous-Comptoir des Entrepreneurs, Caisses de Crédit Agricole, Caisses de Crédit Cooperatif,* Savings Banks of Alsace-Lorraine, *Crédit Municipal de Paris, Caisse de Consolidation* and other financial establishments.
[2] "Construction" refers mainly to residential construction, "Equipment" to machinery, etc., for industrial and commercial enterprises, "Local governments" to public works.
[3] After deduction of amounts representing purchases of bonds of specialized institutions by the *Caisse des Dépôts.*
[4] After deduction of amounts representing advances to public housing authorities by the *Caisse des Dépôts.*

Source: "14th, 15th, 16th, 17th Annual Reports of the National Credit Council (1959, 1960, 1961, 1962, respectively)."

The credits distributed to the economy by these intermediaries during 1962 totaled 12.5 billion francs (the figure was 11.1 billion francs in 1961.) The funds made available to the French Treasury by these institutions also increased markedly, from 1.2 billion francs in 1961 to 3.6 billion in 1962. The largest part of the funds lent by the specialized institutions to the Treasury came from the *Caisse des Dépôts* (that is, from resources generated by the growth of savings deposits).

Government grants and advances channeled through these institutions in 1962 went in the main into long-term loans for construction and industrial development. These specialized institutions also received 17.6 billion francs from the Bank of France (as a result of discount or rediscount operations); the comparable figure in 1961 was 14.8 billion francs. This financing permitted them to increase their own direct lending to enterprises and private individuals (from 9.55 billion francs in 1961 to 12.56 billion francs in 1962). During 1961 and 1962, there was a net decrease in the funds made available from these sources to the banking system. Finally, it should be noted that only a small proportion of the total resources available to the specialized institutions is invested in securities, and only a small part of their total resources is raised through bond issues.

SECTION V—COSTS AND YIELDS

Two subjects of particular interest with respect to interest rates in France will be considered here: First, certain aspects of the relationships between short- and long-term interest rates will be examined. Following this, some of the reasons for the differences between costs to borrowers and yields to lenders will be treated.

RELATIONSHIP BETWEEN SHORT- AND LONG-TERM INTEREST RATES

Despite the high yields available on long-term bond issues (see table XXXII), the potential investor in France often finds that the tax exemptions available on interest from investment in such relatively liquid assets as savings bank deposits and short-term Treasury bills make such investments more attractive, even leaving aside the question of possible depreciation of the currency. Indeed, the only long-term bond issues which seem to have a really greater drawing power than the available short-term investments are those which carry an exemption from the personal income tax. Thus the 1 billion francs, 4.25 percent government bond issue in May 1963 was fully spoken for even before subscriptions were opened.

TABLE XXXII.—*Security yields, 1959 to June 1963*

[In percent]

	1959	1960	1961	1962	1963					
					January	February	March	April	May	June
Stocks	2.37	1.96	1.63	1.61	1.70	1.76	1.73	1.80	1.83	1.73
Outstanding bond issues:										
3.5 percent loan, 1952–58	3.48	3.03	2.58	2.26	2.17	2.23	2.12	2.07	2.09	2.12
Government and government-guaranteed bonds, nonindexed	6.14	5.66	5.52	5.43	5.34	5.36	5.36	5.29	5.36	5.28
Nonindexed corporate bonds	7.03	6.69	6.57	6.45	6.23	6.23	6.23	6.22	6.22	6.25
Indexed or participating corporate bonds	6.62	6.09	5.82	5.64	5.48	5.65	5.59	5.59	5.56	5.40
New bond issues:										
Government and government-guaranteed	6.54	5.80	5.64	5.68	5.61	5.57	5.63	5.58	4.52	5.60
Corporate	6.45	5.83	5.72	5.73	5.72	------	5.70	5.71	5.70	5.70

NOTE.—Figures for 1959–62 are yearly averages; those for 1963 are monthly averages.

Source: French National Statistics Institute (INSEE).

Of course, the financial authorities have been alert to the problem of yield structure as a factor in the choice between short- and long-term placements. Since the beginning of 1961 (see table XXXIII), they have moved several times to bring down the rate of return on short-term assets. During the same period, yields on long-term bonds, both outstanding and new issues,[19] which had previously been falling quite sharply, stabilized at present levels (around 5.71 percent for new corporate bonds issues). However, in the case of persons in the higher income tax brackets, the possibility of tax savings still

[19] No issues of indexed securities have been made subsequent to 1958 because of the law and Treasury policy against them.

makes certain types of short-term investments more attractive than long-term placements, and undoubtedly this attraction becomes even greater when the potential investor introduces factors such as monetary risk into his calculations.

TABLE XXXIII.—*Rates of interest earned on liquid savings, 1960 to August 1963*

[In percent]

	End 1960	End 1961	End 1962	August 1963	Date of last change
Time deposits with banks:					
1 year	3.125 to 3.25	2.875 to 3	2.625 to 2.75	2.375 to 2.5	Apr. 10, 1963
2 year	3.5 to 3.75	3.25 to 3.5	3 to 3.25	2.75 to 3	Do.
Bonds of *Crédit Agricole:*					
3-year progressive rate	2.34 to 4	2.34 to 4	1.5 to 3.25	1.4 to 3	Apr. 11, 1963
5 year	4.75	4.75	4.50	4.25	Do.
Savings bank deposits:					
Caisse Nationale	3	2.8	2.8	2.8	Jan. 1, 1961
Ordinary	3.25	3	3	3	Do.
Treasury bills: [1]					
1 year	3	3	2.75	2.5	Apr. 10, 1963
2 year	3.5	3.5	3.25	3	Do.
3 or 5 year		4⅛ or 4.5	4 or 4.3	3.75 or 4.05	Do.
3 months to 3 years, progressive rate.	2 to 4	1.6 to 3.75	1.4 to 3.25	1.2 to 3	Do.

[1] Issues available for purchase by individuals and business enterprises other than financial institutions.

Source: National Credit Council.

There is a possibility that the financial authorities will move to reduce the effective spread between short- and long-term yields through some changes in the rules for the taxation of the income from long-term bonds. The Lorain Committee has put forward a number of recommendations in this respect, and the Government itself at one time submitted, and then withdrew an amendment to a budget bill which would have repealed the 12 percent withholding tax on income from bonds. At that time, it was indicated that the Government would come forward with a new set of proposals for reforming the taxation of income from long-term bonds after there had been an opportunity to study the matter more thoroughly.

COST TO BORROWER VERSUS YIELD TO INVESTOR

There is a substantial difference in France between the cost to the borrower of placing a new bond issue and the yield which the investor realizes on his investment in the issue. According to the estimates of the Lorain Committee, in 1961–62 a bond floated by a governmental entity or nationalized enterprise which offered the subscriber a return of between 5.60 and 5.65 percent cost the borrower between 7 and 7.10 percent. Bonds of private companies, floated in the same period, carried a yield of 5.70 or 5.75 percent, compared to a cost of 7.50 or 7.60 percent.

These differences are comprised of the following elements:

(1) Most loans carry a provision whereby the borrower has the option of meeting the scheduled repayments either by retiring periodically at face value a given number of bonds chosen by lot or by repurchase of at least some proportion of the bonds in the open market. (Since 1959, this proportion has generally been fixed at 50 percent.) Now, in calculating the cost of the issue to the borrower, the actuaries

take the least favorable assumption from his viewpoint—that is, that the redemption of the bonds will take place entirely through the lottery method, whereas in fixing the rate of return for the lender, they assume the maximum permissible amount will be redeemed through repurchase on the market. This "actuarial difference," which the Lorain Committee describes as "an artificial element" and as being "without any relation to reality," represents about one-quarter percentage point. The committee expresses the hope that the actuaries of the Treasury, the insurance companies, and the banks will be able to agree upon its elimination.

(2) The costs of flotation (publicity, printing of the bond certificates, etc.) and the commission due the banks, both for the placement of the loan and for financial servicing, amount to 0.50 or 0.55 percent per annum, calculated over the life of the loan, for issues by governmental or nationalized entities and to 0.80 or 0.90 percent per annum for private flotations. The Lorain Committee reports that in France the banks charge an offering commission of between 3.10 and 5 percent of the nominal value of the bonds issued which is considered high. The committee discussed the problem of commissions with representatives of the leading banks, who pointed out that in a market consisting to a large extent of small investors, as opposed to a market in which institutional investors play a significant role, the efforts—and hence the costs—required to place a given amount of securities will inevitably be proportionately greater. They did agree that if the volume of new issues in France could be increased significantly, through measures designed to make such investments more attractive, it should be possible for the banks to reduce their commissions.

(3) It is customary for the borrower to assume the 12 percent withholding tax that is due on the interest and redemption premiums, over and above the net amounts paid to the investor. This tax, from which interest on governmental loans and bond issues by public and semipublic entities is exempted, represents a charge of about 0.70 percent per annum at current interest rate levels. It should, of course, be noted that certain investors can claim the tax as a credit against taxes due by them. Thus at the present time individuals are entitled to a credit against their liability under the personal income tax for three-fourths of the amount "withheld," while ordinary corporations may claim a credit for the full amount under the corporate income tax. On the other hand, insurance companies, being subject to special tax rules as regards income from securities, are entitled to no credit whatsoever.

SECTION VI—INSTITUTIONAL STRUCTURE

An outstanding feature of the capital market and related mechanisms for the mobilization of savings in France is the central and dominant role of the French Treasury. The market is a controlled market, to which no important borrower can have access without the assent of the Treasury. Moreover, the financial circuits of the country are such as to insure that in case of need the Treasury has a priority claim on available resources.

This situation is the heritage of nearly 50 years of troubled financial history. In its efforts to cope with the problems encountered, the Treasury progressively extended its sphere of influence until it became the virtual arbiter of the whole French financial system. Basically this state of affairs still obtains, notwithstanding a few minor steps in the recent past to relax the Treasury's control. For even though the needs of the Treasury itself are now less pressing than formerly, the Government still finds these powers over the capital market and long-term lending a convenient and effective tool in orienting investment toward the objectives set in its long-term economic plan.

CAPITAL MARKET CONTROLS

Any company wishing to float a bond issue of over 1 million francs is required to obtain the authorization of the Ministry of Finance. This stipulation gives to the Treasury the possibility of scheduling approved borrowings in such a way that the most favorable periods in the year—normally the winter and spring—are reserved for the Treasury itself (when it wishes to enter the long-term bond market) or for those borrowers, such as the nationalized enterprises, whose issues it is particularly interested in seeing succeed. The requirement also gives the Treasury an important voice regarding the terms of issues offered to the public.

With a few exceptions (notably the oil industry), companies may float new issues of stock without prior authorization. They must, however, in the case of issues for amounts in excess of 1 million francs, give at least 3 weeks' advance notice of the proposed date and conditions of the issue to the Finance Ministry, which possesses a right of veto.

Approval for the listing of securities on French securities markets must be obtained from the *Comité des Bourses de Valeurs* (Committee on Securities Exchanges). This is a quasi-public body, consisting of the governor or a deputy governor of the Bank of France as chairman, the syndic (or chief executive officer) of the Stockbrokers' Association of the Paris Bourse as vice chairman, and six other members designated by the Minister of France to represent various economic, financial, and professional interests. The Director of the Treasury (a senior official of the Finance Ministry) sits with the committee as representative of the government. He may, if he so desires, request the committee to consider a second time any application for listing upon which it has taken a decision, or he may veto any decision of the committee, provided he acts within 4 days after the decision has been taken. The questions to which the committee reportedly addresses itself in passing on an application for listing are whether the applicant company has supplied the necessary data on its financial position, whether it has furnished the required undertakings with regard to the financial servicing of the security in question (transfer of ownership, payment of coupons, etc.), and whether the proposed listing would be likely to constitute an element of activity for the market.

UNDERWRITING AND DISTRIBUTION

In France the banking system plays the principal role in the marketing of new issues of securities. While only investment banks (*banques d'affaires*) may actually acquire participations in business enterprises or take an active part in their management, the large deposit banks with their networks of branches throughout the country, are in an excellent position to serve as the link between the issuer of a new security and its potential purchasers.[20] The usual procedure is for a group of banks to form a syndicate or consortium to underwrite the new issue. One of the members of the consortium, generally the bank with the closest relationship to the issuing enterprise, takes the the lead in working out the arrangements for the flotation. (This bank is known as the *chef de file.*) The participating banks then proceed to mount a sales campaign directed to customers who they think would be interested in the new issues. These activities are not limited to accepting subscriptions at their banking premises or even to soliciting subscriptions through the mail by newspaper advertisement or by telephone.

It is customary for the banks to send representatives on a personal canvass of their customers at their residence or place of business.[21] While the law forbids actual sales by such agents (that is, immediate delivery of the certificates against cash payment), it does allow solicitation, provided the agents are in possession of professional identity cards authorizing them to carry on such activities. These very intensive methods undoubtedly make it possible to reach potential investors, particularly in remote rural areas, who otherwise would not be tapped. At the same time, their elaborate and time-consuming nature swells the flotation costs for the issuing company.

The banks also play an important role in the flotation of long-term government bond issues, as well as bond issues carrying a government guarantee such as those of the large nationalized enterprises (the railways, the gas and electric authorities, and the coal mines). Naturally, subscriptions to Government loans are also accepted at all offices of the Treasury and at the post offices.

ISSUE TERMS

The Lorain Committee devotes considerable space in its study of the French bond market to the question of terms on security issues that will attract prospective investors. It greatly criticizes the lack of variety in issue conditions, with about the only factor subject to variation being the yield, depending upon whether the bond is floated for the account of a public or a private borrower. It also finds redemption clauses biased in favor of the borrower. If rates fall, the investor will be paid off at face value, with no possibility of drawing an advantage from this trend. On the other hand, if rates rise, the borrower can redeem the bonds through repurchases on the market. Moreover, clauses providing for advance redemption tend, in the committee's view, to distort the contract, for they give the borrower the option of extinguishing his debt whenever he feels it in his interest to do so, whereas the lender takes a firm commitment for the stated life of the loan, with only the alternative of selling his bonds on the open market at the possible risk of a capital loss.

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[20] Commercial banking is highly centralized in France. The four largest commercial banks, the *Crédit Lyonnais*, the *Société Générale*, the *Comptoir National d'Escompte de Paris* and the *Banque Nationale pour le Commerce et l'Industrie*—all of which have, incidentally, been nationalized since the end of the Second World War—account for roughly one-half of the total banking business in the country. They all have their principal offices in Paris with branches in all of the principal cities, and each of them has numerous branches in other localities as well.

[21] Such representatives are known as *démarcheurs*. Kettridge's "French-English and English-French Dictionary of Commercial and Financial Terms, Phrases and Practice" (George Routledge & Sons, Ltd., London) makes the following comment: "The *démarcheur*, in France and Belgium, is a canvasser or traveler employed by the banks (even the big first-class banks), outside brokers, and other financial houses to go round soliciting custom or pushing shares. He is in finance what the commercial traveler is in trade."

Among its suggestions for making bonds more attractive to the French investor, the committee sets forth several relating to terms:

(1) *"Variability clauses."*—In the years prior to 1959 the practice had become quite common of offering the investor some protection against future depreciation of the currency by inserting in the loan contract a clause guaranteeing the value of the capital and/or the income in terms of some variable, such as a price or production index. The most celebrated issue of this kind was the 3.5 percent rente issued by the Treasury in 1952 and again in 1958, the capital value of which was tied to the price of the 20-franc gold piece (*"Napoleon"* or *"Louis d'Or"*) on the Paris gold market.[22] However, as part of the program for stabilization of the franc indexation of new issues was declared illegal at the end of 1958. In fact, the policy applied by the Treasury in granting authorizations for new bond flotations subsequent to this measure even went beyond the requirements of the law. While the legal prohibition was on indexation to prices of goods and services having no direct relation with the business of either the borrower or the lender, the Treasury has refused to approve any indexation provisions whatsoever, or even any provisions giving the bondholder an interest in the profits of the issuing enterprise. While recognizing that a return to indexation pure and simple would be widely interpreted as a failure of the Government's efforts to assure a stable currency, the committee argues for a type of instrument that would in effect be intermediate between the classic fixed-income and variable-income securities. The formula proposed is the one used for certain loans between 1952 and 1958, whereby the income and/or the redemption value of the security are made in some degree a function of the profits realized over the life of the loan by the borrowing enterprise. In the committee's view, the variable element in such issues should be sufficiently large to make it possible to fix the minimum rate of interest at a markedly lower level than for ordinary bonds. The investor would be offered a wider variety of securities, since the ordinary types would continue to be available. The activities of some borrowers, notably the Treasury and other governmental entities, are not oriented toward profits, and therefore they could not in any case make use of this new type of security in their borrowings.

(2) *Convertible bonds.*—French law already authorizes the issue of bonds giving the holder the option during a certain period of converting them into shares of the issuing enterprise. However, it appears that the authorizing legislation as now written can, under certain circumstances, lead to administrative complications for the issuer. Moreover, the practice has been for companies to reserve such issues for their stockholders. This is in effect a way for them to carry out a deferred capital increase and, until the option for conversion is exercised, to exclude from taxable profits the income thus distributed to the stockholders in the form of interest. The Lorain committee urges both the necessary legal reform and efforts to secure a wider use by business enterprises of convertible bond as a means of raising funds, particularly by offering such bonds to subscribers other than

[22] In addition, the income from these *rentes* was exempt from all income taxes, and the capital was exempt from estate taxes. Moreover, amnesty was offered to persons holding gold or foreign exchange outside the country in contravention of exchange controls who repatriated it for investment in the *rentes*. Undoubtedly these advantages had a great deal to do with the spectacular success of the 1958 loan.

stockholders (at least after having given the stockholders a prior opportunity to purchase the bonds). This technique would also have the effect of increasing the variety of securities offered to the potential French investor.

(3) *Redemption provisions.*—The Lorain Committee points out that nothing is more harmful to the morale of the investor than seeing a depreciation in the nominal value of his bonds and argues that the terms of each issue should be fixed in such a way as to avoid this if at all possible. Among the techniques, the committee advocates are the following:

(*a*) Shortening of maturities: The committee points out that the tendency is toward the flotation of bonds of shorter maturity and approves the efforts of the Finance Ministry to encourage this trend. It also endorses the technique utilized in the flotation of the 1963 *Electricité de France* loan, whereby (in cases where the nature of the investment to be financed makes a longer maturity desirable) the bondholder is given the option of cashing his bonds at periodic intervals during the life of the loan, with the interest and redemption premium being calculated in such a way as to encourage the holding of the bonds to maturity.[23]

(*b*) Participation of bondholders in gains from repurchase: While recognizing that the retirement of bonds through repurchase on the open market provides a necessary support to the market, the committee finds it unreasonable that the issuing enterprise should be allowed to profit from such repurchases while the bondholder who wishes to cash bonds has only the possibility of selling them at a capital loss. The committee therefore proposes that gains from such operations should be remitted to the bondholders in the form of an increase in the redemption price for bonds retired by lot.

(*c*) Conversion clauses: In many cases, loan contracts give the borrower the option, after a period of a few years, of offering bondholders the redemption of the bonds or their conversion into an issue bearing a lower rate of interest. The committee felt that this arrangement puts all of the disadvantages on the side of the lender: If long-term interest rates rise, the market value of the investment depreciates. On the other hand, if rates fall, the borrower can impose upon him either the liquidation of his investment or a reduction of his income. The committee therefore concluded that the conversion clause ought to be eliminated from future loan contracts, or at least that the borrower should be allowed to exercise his option only after a fairly long period of time.

REGULATION OF FINANCIAL INTERMEDIARIES

The regulation of several of the most important financial intermediaries has been touched upon elsewhere in this chapter. One important aspect of the framework within which the banking system operates and a relatively new development, the authorization of open-end investment companies, remain to be covered.

By custom, French deposit banks do not use demand or short-term deposits to finance other than short-term loans. Furthermore, the

[23] In other words, along the lines of the incentives contained in the schedule for payment of interest on U.S. savings bonds.

Bank of France confines its operations to the rediscount or *prise en pension* of bills with a maturity not exceeding 90 days. But the specialized lending institutions, by endorsing—and automatically renewing their endorsement of—3-month commercial bills, enable the banking system and the Bank of France to accept such paper as short-term assets while providing the borrower with what is in effect a 5-year loan.

Regulations permitting the establishment of open-end investment companies (*sociétés d'investissement à capital variable*) were recently issued.[24] Establishment of such funds had long been rumored and was recommended by the Lorain committee. Highlights of the decree include:

(*a*) Open-end investment companies must have capital of at least 20 million francs.

(*b*) Transformation of existing (closed-end) investment companies into open-end companies and establishment of new companies requires prior authorization of the Finance Ministry, to be given after consultation with the Committee on Securities Exchanges.

(*c*) After the establishment of a company, the issue and repurchase of its stocks are to be carried out at a price to be obtained by dividing the value of its net assets by the number of outstanding shares.

(*d*) The Committee on Securities Exchanges is to decide on permissible minimum and maximum cost and commission charges.

(*e*) At least 90 percent of the capital must be invested in the form of public (i.e., French governmental) issues, transferable securities quoted on a stock exchange, Treasury bills, or in funds deposited in banks.

(*f*) At least 30 percent of the assets must consist of French bonds denominated in francs which have been publicly issued or which are quoted on a stock exchange, French Treasury bills or funds denominated in francs on deposit with banks.

Open end investment funds could prove effective and popular in the mobilization of savings from smaller investors. Ostensibly, at least, they might also lead to purchases of foreign securities should the investment fund managers wish to do so.

TAXATION

France imposes no taxes whatsoever on the issue of stocks or bonds.[25] Nor does the issuing company have to pay any special taxes or duties in connection with the listing of its securities on a stock exchange.

Certain taxes are due, however, when a company is formed and when any changes are made in its capital or corporate structure. A tax of 1.60 percent is levied on the value of all capital assets turned over to a company at the time of its formation (cash subscriptions,

[24] Until recently only closed-end investment companies were allowed in France, and they do not play a significant role in the French capital market. Although the stocks of about 30 such companies are quoted on the Paris stock exchange, their combined capital totals only about 3 billion francs, which represents about 1.8 percent of the total of listed securities on the Paris stock exchange.

[25] Commissions charged by banks or other underwriters in connection with securities flotations are subject to the tax on services at an effective rate of 9.29 percent of the net amount of the commissions. This tax is of course passed on to the issuing company. However, companies which are liable for the value-added tax on their own volume of business may claim the services tax charged on underwriting commissions as a credit against the amount they must pay to the Treasury for the value-added tax. Most, if not all, companies likely to borrow any important sum through the flotation of securities would be liable for the value-added tax.

good will, equipment, inventories, accounts receivable, and real estate). In the case of real estate an additional tax of 0.60 percent is also due. Amounts raised through increases of capital are subject to the same taxes. However, increases of capital accomplished through the incorporation of reserves are subject to a tax of 12 percent.[26] When the corporate form of a company is altered for example, from a *société à responsabilité limitée*, (limited liability company or partnership) into a *société anonyme* (corporation), the only tax due is a fixed charge of 10 francs. However, the transformation must be a real one, involving the creation of an entirely new entity radically different from the old one. In the case of mergers, a tax of 0.80 percent is due on that portion of the net assets not exceeding the capital. The rate becomes 1.20 percent (and is scheduled to rise to 2.40 percent as of January 1, 1964) on the balance of the net assets. It has been suggested from time to time [27] that these taxes (known collectively as *droits d'apport*) should be abolished in order to encourage the issue of shares.

Transfers in the ownership of outstanding securities are subject to a tax varying as follows: 1.2 percent in the case of spot transactions in stocks and shares; 0.6 percent in the case of forward transactions in the same categories; 0.6 percent in the case of spot transactions in bonds; and 0.3 percent for forward bond transactions.

Income from negotiable bonds, including any premiums paid at the time of redemption, as measured by the difference between the redemption price and the issue price, is subject to a withholding tax of 12 percent of the gross. In theory (according to the French tax code and where no special agreement exists between the parties), the tax is borne by the lender. In practice, however, the issuer always contracts to pay the tax so as to offer subscribers to private issues advantages similar to those available on public loans, which are usually exempted from the withholding tax.

Under present French tax legislation the net amount of income received, plus the amount withheld, must be included as a part of taxable income for the purposes of the personal income tax. The individual taxpayer is then allowed a tax credit equal to three-quarters of the amount withheld.[28] It should be noted that since the taxpayer is allowed to exclude redemption premiums from taxable income, the amount withheld on them cannot be claimed as a credit against taxes due but becomes in the nature of a definitive tax on such premiums. Moreover, in the case of income from Government bonds or from any other issues exempted from the withholding provisions, no tax credit is available. In many such cases, however, the income may also be excluded from taxable income.[29]

The Lorain Committee advocated the abolition of the withholding and the tax credit with respect to income from bonds. Under its

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26 This rate replaced the previous rate of 7.20 percent in July 1963. The increase was enacted as one of the measures designed to maintain the equilibrium of the 1963 budget.

27 Most notably by the French Economic and Social Council, a body created by the constitution and composed of representatives of the various economic and social groups in French society, which renders advisory opinions on economic and financial matters.

28 The intention is eventually to allow a tax credit for the full amount. However, the exigencies of the budget have led to the indefinite postponement of this step.

29 This is the case notable for the Pinay 3.5 percent gold-guaranteed *rentes* of 1952 and 1958, the 10-year investment certificates floated by the Treasury in 1953 and 1954 and the 4.25 percent government loan floated in the spring of 1963. The first five annual installments of interest on the Ramadier loan of 1956 were also exempted from the personal income tax, as well as any capital gains resulting from the indexation clause included in that loan.

proposal the bondholder would collect the gross amount of his coupon, and where appropriate—that is, in the absence of an exemption—include the proceeds in his taxable income and pay the tax due thereon. In the case of outstanding issues, the borrower would increase the interest paid to the bondholder by the amount previously withheld for the Treasury. In the case of future issues, the committee throught this reform would make possible an increase in nominal yields without any corresponding increase in the cost to the borrower. It would thus tend to stimulate investment in bonds and, to a certain extent, prepare the way for a subsequent lowering of rates.

In this connection, during the closing phase of the Parliamentary debate on the 1963 budget, the French Government submitted and then withdrew an amendment to the budget bill which would have repealed the 12 percent withholding tax on income from bonds and would also have exempted such income from the *taxe complémentaire* (a temporary tax of 6 percent on certain types of income, notably excluding wages and salaries, which was originally enacted as a transitional measure in 1959 in connection with the reform of the personal income tax but which has now been extended for an indefinite period). In presenting its proposal, the Government underlined the advantages accruing to small savers, who would no longer be forced to request a refund of amounts withheld but not finally due as taxes. It also pointed out that in the case of redemption premiums, the measure would have provided real tax relief, for the reasons explained above. The proposed exemption from the *taxe complémentaire* was described as a step to correct the existing disequilibrium on the French financial market, where there is, on the one hand, "an abundance of liquid assets which do not move into long-term investment," and where, on the other hand, "business and public or semipublic organizations looking for long-term capital in order to finance fourth plan investments encounter difficulties in meeting their requirements." [30]

The Lorain Committee noted that at the present time differences in the taxation have the result that there is practically no spread between the after-tax return from short-term investments and that from investments in long-term bonds. Indeed, for individual taxpayers in the highest brackets, there appears to be an incentive in favor of short-term investments.

In the light of these considerations, as well as the fact that investors at present appear to attach more importance to the potential capital gains from investments in shares or real estate than they do to the higher yields available on bonds, the committee advocated other tax reforms as a means of stimulating greater interest in fixed-income securities. They propose to exempt from the personal income tax income from bonds for an annual amount of 1,000 francs per taxpayer plus 200 francs for each dependent. They also propose an exemption from the estate tax for funds permanently invested in fixed-income securities. They suggest that this amount might be calculated by capitalizing, on the basis of an assumed interest rate of 5 percent, the average amount of income which the deceased realized from

[30] The quoted matter is a translation of passages from the text of the *exposé des motifs*, or explanatory note accompanying the amendment, as published in the financial daily, "*Agence Economique et Financière*", on Feb. 15, 1963. The mention of the "fourth plan" is, of course, a reference to the Government's 4-year plan for economic and social development, 1962–65.

such securities in the last 3 years preceding his death. The benefits of this provision would be limited to inheritance in direct line or between husband and wife.

The Lorain Committee commented favorably on a 1957 decree which provides special treatment for certain corporate dividends. Pursuant to this decree, a 7-year exemption from corporate income tax is granted for dividends paid on shares issued in connection with capital increases approved by the Planning Commission (*Commissariat Général du Plan*), to the extent that the dividends distributed do not exceed 5 percent of subscriptions.

Dividend income is subject to a withholding tax of 24 percent of the gross. As in the case of income from negotiable bonds (discussed above) gross dividends paid to an individual must be included in his taxable income, and only three-fourths of the 24 percent withholding may be taken as a credit against the personal income tax.

Income from both shares and negotiable bonds held in the portfolio of a corporation is subject to the corporate income tax at the rate of 50 percent, with a credit being allowed for the amounts withheld at the time the interest was paid on the bonds or the dividends were distributed. However, if a company distributing dividends—as distinct from interest on negotiable bonds—is a subsidiary of the company receiving them, the parent company may benefit from a considerably more favorable tax status. In the first place, the amount withheld from dividends paid to the parent may be taken as a credit against the amount it is required to withhold on its own dividend distributions. Secondly, the parent company may exclude from its taxable profits, for purposes of the corporate income tax, the net dividends it receives from the subsidiary (that is, after the withholding) less an amount which is intended to cover the costs and charges incurred by the parent company and which has been fixed as follows since July 1962: (*a*) 20 percent of the total net dividend in cases where the parent company holds less than 35 percent of the capital of the subsidiary, (*b*) 10 percent in cases where the participation is at least 35 percent but less than 50 percent, and (*c*) 5 percent in cases where the participation is 50 percent or more. In order to qualify as a parent company, a corporation must in general have held at least 20 percent of the capital of the subsidiary in nominative form either since the establishment of the subsidiary or for at least 2 years.

Arguing that the figure of 20 percent for the minimum participation is too high and that numerous and complex exceptions have already been granted by the tax authorities, the Lorain Committee proposed that it be lowered to 10 percent. The committee also maintained, that the rule concerning costs and charges, by scaling the tax advantages to the relative size of the investment of the parent company in the subsidiary, runs counter to the objective of broadening the ownership of stocks in France. The reasoning is that the rule acts as an incentive for a parent company to increase its participation in its affiliates by buying up shares in the market and as a disincentive against selling shares of its affiliates with the result of reducing its participation. The committee, therefore, advocates that parent companies be uniformly authorized to exclude from their taxable profits 95 percent of the net dividends received from subsidiaries, regardless of the size of their participation in such subsidiaries (provided, of course, they meet the minimum standards prescribed by the tax laws for a parent-subsidiary relationship).

Insurance companies and investment companies are subject to special rules regarding the taxation of their income from securities. Insurance companies are liable for the corporate income tax in accordance with special rules designed to take account of the character of their activity. They do not have the right, however, to offset against the taxes due by them the amounts withheld from the income paid to them on their portfolio of securities. The earnings of investment companies are exempted from the corporate income tax and, when distributed to shareholders, from the withholding tax normally applied to dividends and interest, to the extent that such earnings represent income or capital gains from portfolio investments. Moreover, an investment company is entitled to pass on to its shareholders the tax credits which were created when the withholding tax on dividends and interest was applied to its income on portfolio investments. Individual taxpayers benefiting from this arrangement must, of course, treat the amounts withheld as a part of their taxable income in the same way as they would if they had made the investment directly. In order to qualify for this special tax treatment, investment companies must meet certain standards as to size and types of investment; in addition, their shares must be listed on a securities exchange within 3 years after they have been established.

Capital gains realized by individual or corporate investors are not considered taxable income if they are derived from ordinary share or bond holdings. The same applies to the distribution of bonus shares through incorporation of reserves, which are considered as capital gains. If, however, such shares accrue to an investment company which subsequently distributes these gains to its shareholders, such distributions must be declared by the beneficiaries as income subject to the personal income tax.

SECTION VII—INTERNATIONAL CAPITAL MOVEMENTS

GOVERNMENT RESTRICTIONS

Exports and imports of long-term capital are subject to regulation by the French Government acting through an elaborate system of exchange controls or through various measures designed to give the government greater authority in other fields such as monetary policy. French exchange controls have been explicitly modified as a result of French adherence to three international agreements, the articles of agreement of the International Monetary Fund (IMF), the Rome Treaty establishing the European Economic Community (EEC), and the Convention of the Organization for Economic Cooperation and Development (OECD). In addition, France's strong balance of payments position has made possible a liberalization of some exchange control provisions, and the administration of others in *pro forma* fashion, although it has not led to a dismantling of the structure itself.

French exchange control regulations differentiate between three different groups of countries as far as long-term capital movements between metropolitan France and the rest of the world are concerned. First, the franc area is considered, with a few exceptions, to be within the same exchange control system as metropolitan France. Second, a small group of countries in Eastern Europe—Czechoslovakia, Eastern

Germany, and Rumania—are in a bilateral zone. Transactions with these countries account for an insignificant portion of the overall total in the French balance of payments and will not be dealt with in greater detail here. The third and most important grouping is the convertibility area, which in effect is the rest of the world, except for some purposes Laos and Vietnam.

In order to understand the context of the French Government's regulation of long-term capital movements, it seems useful to examine briefly, first, the structure of the franc area and, second, the two major international agreements which have affected the application of exchange controls on capital movements, the OECD's code of liberalization of capital movements and the EEC's two directives in this field.

The franc area is very nearly congruent with the boundaries of the former French Empire.[31] The franc area defies description in one simple definition, although the French official who said it was comprised of "those countries to and from which France imposes no barriers to the free flow of capital that do not apply in France itself," came as close as possible to a one-sentence summary. The emphasis on France is important, for when they became politically independent many of the members of the area began to impose various obstacles of their own to the import and export of French capital. In the context of this study, the main characteristics of the franc area are the following: (1) Subject to any necessary local permission, the member currencies of the franc area are for practical purposes freely convertible into and out of French francs at a fixed rate of exchange; (2) a single common pool of foreign exchange is maintained in Paris to which most members of the franc area have access in varying degrees and into which most members of the franc area pay their individual earnings of foreign exchange. The net benefit to the French balance of payments of this system in 1962 amounted to the equivalent of 715 million francs; (3) various preferential trading arrangements are maintained between Metropolitan France and the other nations of the franc area; (4) very largely as a result of the first three characteristics, there is a flow of both public and private funds from metropolitan France to the nations of the franc area that is considerable, but difficult to measure precisely. French authorities estimate French investment in the franc area in 1961 at 938.6 million francs, but this estimate makes no allowance for disinvestment. French policy encourages investment in the franc area, and some investment may thus be "diverted" from foreign currency areas.

The OECD's code of liberalization of capital movements has been accepted without reservation by France. The code provides in general that members will progressively abolish restrictions on the movements of capital between each other "to the extent necessary for effective economic cooperation," and that members should "endeavor" to extend the measures of liberalization to all members of the IMF.

[31] The French franc area is comprised of (1) the territory of the French Republic, i.e., continental France, Corsica, the oversea departments (Guadeloupe, Martinique, Guiana, and Reunion), the oversea territories except French Somaliland (Comoro Islands, St. Pierre and Miquelon, New Caledonia, Wallis and Futuna Islands, and French Polynesia); (2) the condominium of the New Hebrides; and (3) the Republic of Algeria, the Republic of Cameroon, the Central African Republic, the Republic of Chad, the Republic of the Congo (Brazzaville), the Republic of Dahomey, the Gabon Republic, the Republic of Guinea, the Republic of the Ivory Coast, the Malagasy Republic, the Republic of Mali, the Islamic Republic of Mauritania, Monaco, Morocco, the Republic of Niger, the Republic of Senegal, the Republic of Togo, Tunisia, and the Republic of Upper Volta.

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Capital movements between members of the European Economic Community have been liberalized by two directives, approved by the Council of Ministers of the Six in May 1960 and December 1962. Both directives apply only to exchange control restrictions on movements of capital between the member states of the EEC, but in practice there is no appreciable difference between the treatment accorded by the French authorities to requests for authorization of transactions with the remainder of the Six and those for authorization of transactions with the rest of the convertible area.

Of the two directives, the first is the more important. It frees from exchange control direct investment and the repatriation of its proceeds, the commonest types of personal capital transfers such as gifts and inheritances, and short (less than 1 year) and medium-term (1 to 5 year) export credits. These capital movements are to take place at exchange rates obtaining for current account transactions, or at rates not differing appreciably from these rates. Other movements are freed subject to certain qualifications: exchange rates may vary more widely from the official rates than is prescribed for those transactions just listed, and members may maintain or reintroduce restrictions in effect when the directive became effective. In this category fall portfolio investment in securities listed on stock exchanges in the member countries of the Six, with the exception of shares in investment trusts (*fonds communs de placement*) and bond issues.

Items which are listed in the directive for liberalization at the discretion of national authorities are the flotation of new security issues on the markets of member states by firms in other nations of the Six, the purchase of unlisted securities, and of listed shares of investment trusts, several categories of export credits, and medium- and long-term financial credits not related to commercial transactions.

The second directive amended and broadened the liberalization measures of the first directive. The most significant change affects transactions in listed securities. Under the first directive the right of residents to acquire foreign securities could be temporarily limited to financial institutions and to firms acquiring an interest in foreign companies with a similar business. The second directive extends to all residents the right to deal in listed foreign securities. The directive also liberalized certain transactions required to finance services and covered certain capital movements of a personal nature.

Responsibility for the administration of the French exchange control system was vested by the initial decree of September 9, 1939, in the Minister of Finance. Since then, and particularly during the period immediately after the war, the system has been greatly elaborated and modified. At present, responsibility for overseeing, and, when necessary controlling, the import and export of long-term capital is vested in the Ministry of Finance and Economic Affairs, which has broad powers over transfers related to commercial transactions and investments, and the Bank of France, which is primarily concerned with transactions of a financial nature, controls over assets held abroad, the repatriation of income, transactions in foreign securities, and other operations of a similar nature. In practice much of the detailed work is done by authorized banks designated by the Minister of Finance and Economic Affairs on the proposal of the Governor of the Bank of France. These banks carry out many transactions on their own responsibility, operating either under a general authorization or an authorization which establishes limits within which certain transactions may be effected without reference to the Government authorities. All capital transactions involving nonresident interests must be effected through authorized banks.

Capital imports

Most imports of capital are freely allowed. Loans and credits not exceeding 1 million francs for a term not exceeding 2 years and with an interest rate of 4 percent or less, and commercial credits of less than 5 years with interest not exceeding 5 percent are exempt from authorization, and need not even be declared. Purchases of French or foreign securities listed on French stock exchanges and purchases of real estate in France must be declared but do not require formal authorization. Formal authorization is required for nonresident purchases of unlisted securities or for direct investment.

Direct investment.—Nonresidents must obtain an authorization to make direct investments. If the investment is less than 500,000 francs, the decision is made by the Foreign Assets Service of the Finance Ministry; if more than 500,000 francs, by the Committee on Foreign Investments. These direct investments include the purchase of real estate, interests in fixed property and goodwill in France, the purchase of French securities and subscription to the direct capital of a French company. However, the stringency of the controls has been somewhat ameliorated by the issuance of two types of general licenses by the Finance Ministry. Under the first, nonresidents may purchase real estate, or shares in real estate companies, without prior authorization provided such transactions are effected through a lawyer or notary (that is, an agent authorized under French law to handle, among other things, real estate transactions). Under the second, nonresidents may freely purchase and sell listed French securities under conditions described in the following paragraph.

Portfolio investment.—Nonresidents may buy and sell securities in France without the specific authorization of the Finance Ministry provided the securities are traded on a recognized stock exchange, the transaction is effected through an authorized French bank, and the investment is financed by the sale of foreign exchange on the market or by drawing down a foreign account in convertible francs. There is no restriction on the transfer of the proceeds of liquidation. Nonresident purchasers of French securities may keep their securities in an account with an authorized French bank or send them abroad as they see fit, but both export and import of securities must take place through an authorized bank.

The purchase of unlisted securities and dealings outside a recognized stock exchange require special authorizations. This type of investment is usually undertaken as a direct investment and is considered as such.

Long-term loans.—The regulation regarding long-term loans by nonresidents to residents was tightened up August 7, 1963. As of that date, only loans which meet the following criteria are exempt from prior authorization: loans must not exceed 1 million francs, must carry a rate of interest of no more than 4 percent, and must be repaid within 2 years. The outstanding foreign indebtedness of any one enterprise may not exceed 1 million francs at any given time.

A possible exception to the above rule concerns commercial credits.

French importers may arrange delays in payment with their foreign supplier without prior authorization provided the interest rate does not exceed 5 percent and the term of the credit does not exceed 5 years. Terms in excess of 5 years may be arranged, and will be authorized, if they do not conflict with normal commercial practices.

Capital exports

Two types of capital exports are fully liberalized and require neither authorization nor declaration. They are credits granted by French banks drawing on their available foreign exchange and export credits of up to 6 months. Two types of transfer are in effect subject to declaration alone: the transfer of the proceeds of liquidation of direct foreign investment in France, and the purchase of foreign or French securities listed on foreign securities exchanges. Formal authorization is required for direct investments abroad, purchases of foreign real estate, purchases of unlisted securities, export credits for periods exceeding 6 months, and financial loans, including credit by overdrafts on foreign accounts in convertible francs. Reportedly, all exports of capital, except the flotation of foreign securities in France, are authorized without difficulty.

Much emphasis has been placed on the progress in recent years in liberalizing some categories of capital exports and in establishing liberal licensing policies for others. The fact remains, however, that the exchange control apparatus still exists and imposes on French residents who wish to undertake the export of capital a prescribed way of carrying out each type of transaction and, in most cases, an elaborate licensing and/or reporting procedure. Thus, for example, French residents who wish to purchase foreign securities are not free to deal directly and exclusively with a foreign broker or underwriter. While they may seek his advice, they must consummate the purchase through an authorized French bank and they may hold their securities only with this bank. It is, of course, difficult to evaluate the inhibitive effect of formalities of this type, but it seems certain that there must be some effect, particularly as regards small and less experienced investors. Nearly 25 years of exchange controls, during most of which time restrictions on transactions with the outside world were quite severe, have undoubtedly given the average French resident a defeatist attitude about what he can do with his money outside of France. Only some dramatic move, like the complete dismantling of the controls, could entirely dissipate this uncertainty and skepticism. Despite the strong balance of payments and reserve position which France enjoys today, the financial authorities have not been willing to take such a decisive step.

Direct investment.—For residents, the French franc is still not freely convertible on capital account. New direct investment abroad must be approved by the Ministry of Finance. The Finance Ministry consults the technical ministry concerned (the Ministry of Industry, for example), the Ministry of Foreign Affairs and the Bank of France before making a decision. One of the factors which is closely examined is the present foreign position of the firm desiring to make the investment. If the firm has maintained large accounts abroad to finance its current operations, the Ministry may suggest that it use these funds to the extent possible to finance the investment. In general, however, it is said that the exchange control authorities apply this rule stringently only in the case of firms that are large and consistent exporters and hence likely to be able to replenish their foreign accounts.

French policy with regard to direct investment abroad is said to be very liberal. In the case of investment in other countries of the EEC, the authorization is granted automatically, pursuant to the terms of the first directive of May 1960. In practice, applications to invest in third countries are investigated and treated in much the same way with authorizations requiring about a month to secure. The exchange control authorities will approve applications for investment in cash or in kind.

The reinvestment of profits made by the branches of French enterprises abroad is also subject to authorization, but the authorities are fairly liberal in authorizing the retention abroad of profits needed for the efficient operation of a business. Apart from these authorized retentions, all of the profits of a branch must be returned to France. In contrast subsidiaries are regarded as foreign corporations, free to manage their affairs as they see fit, and thus the repatriation of only their distributed profits (dividends) is required.

The proceeds of liquidation may be retained abroad, except in the case of recent investments. Appreciation in the value of investments that are liquidated may be subject to repatriation, if it is construed as income which in turn should have been repatriated. The employment of the proceeds of liquidation is subject to prior authorization, but like other capital assets, they may be invested without restriction in foreign or French securities listed on a foreign stock exchange.

Portfolio investment.—Since April 2, 1962, French residents have been free to buy and sell foreign and French securities listed on recognized foreign stock exchanges, but the transaction must be effected through, and the securities purchased deposited with, an authorized French bank. The requirement that the transactions must take place through an authorized bank, does not preclude utilization of the services of foreign banks and brokers, and a number of American brokers maintain representatives in Paris.

The necessary foreign exchange is available at official rates. The proceeds from the sale of foreign securities must be reinvested, or repatriated within 3 months.

Unlisted securities, and transactions outside recognized exchanges may be treated in one of two ways, depending on the circumstances. Either they may be considered a portfolio investment, in which case authorization is required and is generally granted after the price of the transaction has been verified, or they may be treated as a direct investment. In the latter case, authorization is also required, but the criteria are, as explained above, somewhat different.

Income from foreign securities must be repatriated within 3 months, unless authorization is received to employ it elsewhere. Depositing securities with authorized banks has the advantage that the banks effect this repatriation automatically.

Bonds.—The flotation of foreign bonds in the French market is subject to two types of control—regulations governing the issue of all securities in France and exchange control regulations. All issues by foreign companies are subject to specific authorization by the Finance Ministry. The internal regulation of the market is explained elsewhere in this chapter. An outstanding difference in the treatment accorded foreign issues compared with domestic issues is the prohibition on canvassing to sell foreign securities, whether stocks or bonds. that are not guaranteed by the government concerned.

Long-term loans.—Long-term loans are, following the definition employed in the French balance of payments, loans of more than 1 year. Bond issues are treated as securities under "Portfolio Investment." Export credits are entered under merchandise trade in the balance-of-payments accounts and, although they are mentioned here, do not affect the figures which are discussed below under the heading "Recorded movements."

The two types of loans that residents may freely make to nonresidents are loans by French banks utilizing foreign exchange balances held with their foreign correspondents, and export credits of up to 6 months.

Export credits of more than 6 months are subject to specific authorization. In practice, authorizations are granted automatically when the credits are Government-guaranteed and when the terms of the credit are in accord with normal commercial practice.

All other loans, including overdrafts on foreign accounts in francs, require authorization. In general, these authorizations are granted liberally, particularly in the case of overdrafts on franc accounts of foreign banks with French banks to facilitate commercial transactions.

In addition to the restrictions on lending abroad imposed by exchange control regulations, the Bank of France is empowered to exercise controls over domestic and foreign bank lending which are analogous to the controls over the securities market exercised by the Treasury and the Finance Ministry. Pursuant to a 1948 decision of the National Credit Council, the authorization of the Bank of France must be requested whenever the effect of a loan would be to raise the total credit extended by all banks to any single enterprise above a certain figure, currently fixed at 10 million francs. As a check, the Bank audits lesser credits. Although these controls were established as instruments of monetary policy, their existence means that even the abolition of exchange controls would not mean the end of Government control on exports of capital by French banks.

RECORDED MOVEMENTS

Table XXXIV, which shows private long-term capital movements between France and foreign currency areas in 1960–62, is based on official French tabulations of the balance of payments of Metropolitan France with foreign currency areas. The figures for 1962 are provisional and may be altered when the definitive figures are published, probably in mid-1964. The balance of payments is the only published official source which describes the import and export of long-term capital.

TABLE XXXIV.—*Private long-term capital movements between France and foreign currency areas, 1960–62*

CREDIT

[Millions of francs]

	1960	1961	1962
Residents, operations outside franc area:			
(1) Loans of over 1 year	22	27	22
United States and Canada	1	1	5
Other EEC	4	7	5
Rest of OECD	4	2	8
Rest of world	13	17	4
(2) Direct investment	46	141	237
United States and Canada	5	4	6
Other EEC	21	36	164
Rest of OECD	13	32	28
Rest of world	7	69	39
Total of (1) and (2)	68	168	259
(3) Portfolio investment	384	449	1,655
United States and Canada	81	166	653
Other EEC	79	72	411
Rest of OECD	116	118	481
Rest of world	108	93	110
Total of (1) and (2) and (3)	452	617	1,914
Nonresidents; operations in Metropolitan France:			
(1) Loans of over 1 year	916	861	958
United States and Canada	414	232	318
Other EEC	62	88	124
Rest of OECD	147	390	347
Rest of world	293	151	169
(2) Direct investment	739	1,080	1,518
United States and Canada	236	354	386
Other EEC	177	345	367
Rest of OECD	312	350	729
Rest of world	14	31	36
Total of (1) and (2)	1,655	1,941	2,476
(3) Portfolio investment	985	1,560	1,778
United States and Canada	88	212	296
Other EEC	297	385	475
Rest of OECD	577	929	976
Rest of world	23	34	31
Total of (1) and (2) and (3)	2,640	3,501	4,254
Memorandum item: Investment income, private	945	1,001	1,102

TABLE XXXIV.—*Private long-term capital movements between France and foreign currency areas, 1960–62*—Continued

DEBIT

	1960	1961	1962
Residents, operations outside Franc area:			
(1) Loans of over 1 year	123	136	300
United States and Canada	1	14	23
Other EEC	19	35	60
Rest of OECD	59	69	189
Rest of world	44	18	28
(2) Direct investment	316	632	495
United States and Canada	32	61	80
Other EEC	93	262	166
Rest of OECD	115	217	169
Rest of world	76	92	80
Total of (1) and (2)	439	768	795
(3) Portfolio investment	82	130	1,463
United States and Canada	18	16	526
Other EEC	11	39	626
Rest of OECD	52	63	298
Rest of World	1	12	13
Total of (1) and (2) and (3)	521	898	2,258
Nonreisdent; operations in Metropolitan France:			
(1) Loans of over 1 year	151	215	462
United States and Canada	14	42	54
Other EEC	15	31	31
Rest of OECD	104	109	342
Rest of world	18	33	35
(2) Direct investment	160	211	280
United States and Canada	21	25	31
Other EEC	28	36	45
Rest of OECD	100	134	194
Rest of world	11	16	10
Total of (1) and (2)	311	426	742
(3) Portfolio investment	757	967	1,181
United States and Canada	80	72	175
Other EEC	241	277	343
Rest of OECD	422	545	635
Rest of world	14	73	28
Total of (1) and (2) and (3)	1,068	1,393	1,923
Memorandum item: Investment income, private	531	658	802

TABLE XXXIV.—*Private long-term capital movements between France and foreign currency areas, 1960–62*—Continued

BALANCE (SURPLUS OR DEFICIT (—))

	1960	1961	1962
Residents, operations outside franc area:			
(1) Loans of over 1 year	—101	—110	—277
United States and Canada	0	—13	—18
Other EEC	—15	—28	—55
Rest of OECD	—55	—68	—180
Rest of world	—31	—1	—24
(2) Direct investment	—269	—492	—258
United States and Canada	—26	—57	—75
Other EEC	—72	—226	—2
Rest of OECD	—102	—186	—141
Rest of world	—69	—23	—40
Total of (1) and (2)	—370	—602	—535
(3) Portfolio investment	302	319	190
United States and Canada	63	150	126
Other EEC	68	33	—215
Rest of OECD	64	55	183
Rest of world	107	81	96
Total of (1) and (2) and (3)	—68	—281	—345
Nonresidents; operations in Metropolitan France:			
(1) Loans of over 1 year	765	645	495
United States and Canada	400	189	263
Other EEC	47	57	93
Rest of OECD	43	281	5
Rest of world	275	118	134
(2) Direct investment	578	871	1,237
United States and Canada	215	330	355
Other EEC	149	310	321
Rest of OECD	211	216	535
Rest of world	3	15	26
Total of (1) and (2)	1,343	1,516	1,732
(3) Portfolio investment	228	593	598
United States and Canada	8	140	121
Other EEC	56	108	133
Rest of OECD	155	384	341
Rest of world	9	—39	3
Total of (1) and (2) and (3)	1,571	2,109	2,330
Memorandum item: Investment income, private	414	343	295

Residents.—Long-term foreign loans by French residents, after remaining fairly stable in the preceding 2 years, rose sharply in 1962, more than doubling the net deficit on this account. (Repayment of long-term loans remained steady throughout the 3-year period.) The increase was largely accounted for by sharp rises in loans to enterprises in Europe; the balance of loans to the other members of the EEC almost doubled, and loans to the other European member countries of the OECD nearly trebled.

Conversely, gross new direct investment abroad by residents, which doubled from 1960 to 1961, decreased somewhat in 1962, largely as a result of declines in direct French investment in the rest of the EEC and in the economies of other European members of the OECD.

Total long-term loans and direct investment rose steadily from 1960 through 1962, with the largest increase occurring in 1961. The total of French direct investment and loans in the rest of the EEC and the other European nations of the OECD rose from 285 million francs (gross) in 1960 to 580 million francs in 1961, but only maintained this level in 1962.

The most striking feature of the pattern of portfolio investment abroad by residents in the past 3 years was the substantial increase in both investment and disinvestment in 1962. Investment increased elevenfold from 1961 to 1962, with the largest increases in purchases in the United States and Canada (up some 33 times) and in other EEC countries (up 14 times). Disinvestment, however, was also heavy, and substantially exceeded new investment for the third consecutive year.

The main reason for this sudden spurt of activity was probably the liberalization that took place in April 1962 of transactions carried out on foreign securities markets for the account of French residents. Previously, French residents could make purchases of securities on foreign markets only by using the proceeds from sales on foreign markets of securities already owned by residents. This meant that there was a special market for the foreign exchange in question, with transactions taking place at rates freely negotiated between buyers and sellers (although at times the Bank of France in fact intervened).

It should be noted that none of the investments cataloged under this heading represents the purchase by French residents of new bond issues floated on the French market. Indeed, until the issue of the European Investment Bank announced in November 1963, no such issues had taken place since the end of World War II.

Nonresidents.—Long-term loans by nonresidents to borrowers in Metropolitan France have remained steady since 1960. Loan repayments to nonresidents, on the other hand, have risen sharply throughout the 3 years. Long-term loans from the United States and Canada have shown a significant decline since 1960. The only area from which loans have increased is the other member countries of the EEC, but in this case the amounts involved are small.

There has been a steady increase in direct investment in Metropolitan France over the past 3 years, and an equally steady, although much smaller, increase in disinvestment. The greatest increase in direct investment came from the European countries of the OECD, in particular from those that are not also members of the EEC. Direct investment from these nations more than doubled in 1962.

It is very probable that some of the increase in direct investment by other European members of the OECD reflects the investment of American capital through Switzerland. It is also possible that some of the increase may be the result of investment by British enterprises in France in anticipation of a successful outcome of the United Kingdom's negotiations to join the Common Market.

As a result of the increase in direct investment, the total of direct investment and long-term loans showed a steady rise over the 3-year period, reaching a total of about 2.5 billion francs (gross) in 1962.

Both portfolio investment from and disinvestment by all major foreign currency areas rose steadily over the 3-year period.

In 1962, French enterprises floated two bond issues on foreign capital markets. The South European Pipeline Co. issued $40 million worth of 20-year bonds on the New York market, and the *Compagnie des Machines Bull* floated a 40-million Swiss franc issue in Switzerland, repayable in eight equal annual installments beginning in 1970.

CHAPTER VIII

THE CAPITAL MARKET IN GERMANY

SECTION I—SUMMARY

The German capital market has grown impressively in recent years after a slow start in recovering from the devastation of World War II. The stream of long-term investment funds flowing through the capital market, fed by a rising volume of redemption and income payments, has recently reached a level comparable to that of the period 1924–28. But despite its growth in size, the German market still supplies only a small proportion of the economy's total long-term finance (a smaller proportion than before the war) and its scope is limited mainly to financing housing construction, public utilities, and the nationalized railroad and telecommunications networks. Much of the postwar industrial expansion has been financed out of retained earnings and revolving bank credit.

Some of the reasons for the limited scope of the German capital market can be found in the pattern of savings and investment that has emerged since the war. The government sector (including social insurance) generates a large proportion of total national savings through current account budget surpluses, while the bulk of physical investment takes place in the business sector. Since savings by the government sector are about double its physical investment, the government sector is a large net supplier of investment funds to other sectors of the economy. Most of these funds are channeled to business through the banking system or in the form of direct credits, thus bypassing the organized capital market.

Another factor limiting the scope of the capital market is the extraordinarily large proportion of long-term finance which is preempted by building, particularly housing construction. Building demand has been actively stimulated by all levels of government. Half of all residential construction is government-assisted. The resulting heavy demand for mortgage loans from financial institutions falls with great severity upon the bond market because of the practice of refinancing a large proportion of mortgage loans (about one-half) through the issue of bank bonds, particularly mortgage bank bonds.

The government-stimulated demand for construction is perhaps the principal reason for the high level of long-term interest rates prevailing in Germany. In recent months, however, government actions aimed at curbing the construction boom seem to have taken effect and an initial tapering off of construction demand has been observed.

In the past, the scope of the capital market was also reduced by heavy reliance on self-financing by business enterprises, which was made possible by a high level of profits and special tax incentives, particularly accelerated depreciation allowances. The situation has changed somewhat during the past 2 to 3 years, however, and the proportion of self-financing has declined sharply. In the future, reduced self-financing and the need to consolidate short-term indebtedness may lead to a substantial increase in the demand for long-term capital by industry.

Although a tendency toward increased flotation of securities by industry is discernible, the bulk of external financing by enterprises must be obtained through direct credits from financial institutions. A part of this financing finds its counterpart in bonds issued by credit institutions, but most of it is based upon the liquid savings of consumers. Personal savings have increased rapidly in recent years and much of it has been placed in savings accounts, particularly with the extensive network of municipally owned savings banks. Although a part of the savings collected locally are redistributed by the central institutions of the savings bank system, the *Girozentralen*, most of the funds are lent locally, much of it inevitably finding its way into mortgage loans.

The localization of financial circuits through the savings bank system has resulted in part from custom and tradition, including, for example, the practice of accepting savings deposits from legal entities and the absence of any limit on the amount that can be held in savings accounts. But it has also been stimulated to some extent by the Government system of premium and tax privileged savings. With certain limitations on maximum amounts, savers may receive premium payments amounting to 20 to 30 percent of amounts held in savings accounts and 25 to 35 percent of amounts held with building and loan associations provided balances are immoblized for 4½ to 6 years. Individuals in higher income brackets may receive greater benefits by deducting such deposits and premiums from taxable income. While interest rates for savings deposits amount to only 3¼ to 4 percent, depending upon the period of notice, the effective yield for premium savings amounts to 8 to 12 percent, and even more under certain circumstances. These premiums have done much to increase savings deposits and building and loan accounts at the expense of other forms of savings,[1] and have undoubtedly contributed to the high level of long-term interest rates.

One of the leading characteristics of the German capital market is that it is subject to very few direct government controls of any significance. There is no official control over capital issues, for example, and no restrictions on international transactions. Nevertheless, the public authorities exercise considerable indirect influence on the capital market through the regulation of banking and insurance and, as discussed above, through the allocation of government savings to business enterprises, the stimulation of construction, and the system of premium and tax privileged savings.

Another important Government influence is the 2½ percent tax on new security issues levied by the state (*Land*) governments. The securities tax greatly increases the cost of issuing private industrial and foreign bonds (most other bond issues are exempt from the tax) and is virtually prohibitive for such issues with a maturity of less than 10 years. The existence of the tax has given rise to a thriving business in "loans against borrowers' notes," which are essentially long-term bank loans exempt from the tax. These loans are usually arranged by banks and placed with insurance companies in negotiable tranches.

[1] Savings premiums are also available for purchases of securities, provided that the securities are part of a new issue, and the tax privileges are also available for life insurance, but these possible alternatives are not as widely publicized as premium deposits and building and loan accounts.

Among the other institutional characteristics of the German capital market, the two methods of issuing bonds deserves mention in this summary: the first being continuous sales "on tap" by mortgage banks and certain banks making local authority or "communal" loans, and the second being the so-called one-time issues of all other borrowers. The latter type is underwritten by banking syndicates whose members undertake to subscribe to fixed amounts at fixed prices. The composition of the underwriting syndicates as well as the subscription quotas change very little from issue to issue. It would appear, therefore, that there is little competition in the issuing of bonds.

Finally, it should be noted that the timing (and in practical effect the amount and terms as well) of the so-called one-time issues is controlled by the Central Capital Market Committee, a private voluntary agency composed of representatives of the commercial banks (three members, with one serving as chairman), the savings banks and their central institutions (four members) and the mortgage banks (four members), with the central bank sending an observer. Thus the dominant borrowers, the mortgage banks, sit with the dominant creditors, the commercial and savings banks, to determine jointly the amount and terms of capital to be made available to all other borrowers.

These arrangements for issuing bonds may contribute materially to the high cost of raising capital in Germany. Private industrial bond issues with an average maturity of 10 years cost the borrower 7.2 to 7.4 percent per annum, while the interest yield to the investor is about 6.1 percent. The margin of over 1 percent per annum between cost and yield is considerably higher than margins in most other markets. Deductions at the time of issue total about 5½ percent of the amount raised including bank fees of 2½ percent, the 2½ percent securities tax, and printing and advertising fees of about one-half of 1 percent; other continuing charges amount annually to about 0.1 percent of the amount raised.

SECTION II—THE PATTERN OF SAVINGS AND INVESTMENT [2]

Before considering the factors affecting the supply and demand for funds on the German capital market, it may be useful to view the market from a macroeconomic perspective.

As may be seen from tables I and II below, the German economy is characterized by a high proportion of government savings while the bulk of physical investment is accounted for by business enterprises. Savings by enterprises through retained earnings (and if gross investment is considered, through depreciation) also account for a high proportion of total savings, but only 29 percent of total net savings are supplied by the consumer sector. This percentage has increased from less than 20 percent during 1950–55, however, and a further increase in the future seems likely. In recent years, the proportion of total net savings by business enterprises has begun to fall rapidly (from 41 percent in 1959 to 25 percent in 1962) while the government share has recovered from the low point reached in the economic pause of 1958.

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[2] Most of the data utilized in this section are taken from the articles on monetary wealth formation which appear periodically in the Monthly Report of the Deutsche Bundesbank. The most recent article appeared in the May 1963 report. For notes on definitions and methods see the Monthly Report (English translation), December 1961, p. 13 ff., July 1962, pp. 67–68, and May 1963, pp. 16–17.

TABLE I.—*Sources and uses of net savings and investment, annual average, 1959–62*

[Billions of deutsche marks] [1]

	Consumers	Enterprises		Government [3]	Foreign [4]	Total
		Housing [2]	Other			
Sources:						
Savings [5]	15.2	3.4	16.9	18.5	−1.7	52.3
Borrowings	.9	11.0	20.7	3.0	5.6	41.2
Total	16.1	14.4	37.6	21.5	3.9	93.5
Uses:						
Physical investment		14.0	28.9	9.4		52.3
Financial assets	16.1	.4	8.7	12.1	3.9	41.2
Total	16.1	14.4	37.6	21.5	3.9	93.5

[1] On Mar. 6, 1961, the par value of the deutsche mark was changed from DM4.20 per dollar to DM4 per dollar.
[2] Excludes Government-owned residential buildings which are shown under the Government sector. For a detailed statement on the definition of "housing" and the methods used in ascertaining the financial transactions of the housing sector see the *Deutsche Bundesbank* "Monthly Report," May 1963, pp. 16 and 17 of the English translation.
[3] Includes social insurance.
[4] Includes West Berlin.
[5] Includes capital transfers.

Source: *Deutsche Bundesbank*, "Monthly Report," May 1963.

TABLE II.—*Net savings* [1]

[In percent of total]

	1950	1955	1956	1957	1958	1959	1960	1961	1962
Consumers	16.6	20.7	19.0	29.4	34.0	31.7	27.7	29.0	28.8
Enterprises:									
Housing	44.0	45.4	49.1	49.6	54.3	5.9	6.5	6.7	6.8
Other						41.0	37.0	29.3	25.2
Government	32.0	30.8	33.7	29.7	22.1	27.1	29.4	26.7	30.6
Social insurance	9.8	10.0	11.2	7.8	6.1	5.0	6.3	9.6	5.9
Foreign [2]	−2.4	−6.9	−12.0	−16.6	−16.5	−10.7	−6.9	−1.2	2.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[1] Includes net capital transfers.
[2] Includes Berlin.

Source: *Deutsche Bundesbank*, "Monthly Report", July and September 1962, May 1963.

The preponderance of government savings and business self-financing greatly curtails the scope of the capital market. This will become clear as the major financial flows are outlined below.

THE GOVERNMENT SECTOR

The chief source of government savings, as table III shows, is budget surpluses on current account, which have normally been very large. In earlier years these surpluses were concentrated at the Federal level, but after 1958 they shifted rapidly to the state governments. Additional large amounts, ranging between 5 and 10 percent of total net savings, have been accumulated by the social insurance system. These savings are supplemented by a moderate amount of government borrowing, both through security issues and through direct credits from financial institutions. Altogether, the government sector has contributed about 20 percent of the total resources available for investment in recent years.

TABLE III.—*Government sector*[1]—*Sources and uses of net savings and investment*

[Billions of deutsche marks]

	1957	1958	1959	1960	1961	1962
Sources:						
Savings[2]	12.6	9.7	13.0	18.4	20.5	22.1
Borrowing	1.2	2.3	3.1	2.2	3.2	3.5
Total	13.8	12.0	16.1	20.6	23.7	25.6
Uses:						
Physical investment	5.0	5.7	7.2	8.5	10.0	12.2
Funds placed with the banking system[3]	1.2	1.9	.1	5.4	7.9	4.2
Direct loans to enterprises	4.5	2.8	2.3	.9	2.1	4.3
Direct loans for housing			2.6	2.3	2.4	2.5
Acquisition of securities	.8	.6	1.3	2.2	.7	1.8
Fixed interest	(4)	(4)	(1.1)	(1.3)	(1.3)	(1.6)
Shares	(4)	(4)	(.1)	(.9)	[5] (−.6)	(.2)
Other	2.3	1.0	2.6	1.4	.6	.6
Total	13.8	12.0	16.1	20.6	23.7	25.6

[1] Includes social insurance funds.
[2] Includes capital transfers.
[3] Includes cash and money market paper.
[4] Not available.
[5] Includes proceeds of DM900,000,000 from the sale of Volkswagen shares to the public.

Source: *Deutsche Bundesbank*, "Monthly Report" July and September 1962, May 1963.

How are these funds utilized? Between one-third and one-half is used directly for physical investment, for roads, schools, cultural facilities, public transportation, and particularly for housing. Much of the remainder is loaned to business enterprises, partly through special credit institutions such as the Reconstruction Loan Corporation (KFW), the Equalization of Burdens Bank, and certain agricultural banks, and lesser amounts are placed on deposit with banks or used to purchase securities. The social insurance funds account for a large part of government security purchases, but these also often result in support for building, particularly through purchase of bonds issued by mortgage credit institutions. Funds placed on deposit with the banking system originate primarily with local governments and the social insurance funds, although since 1958 they also include a considerable balance held with the central bank by the state governments.

A large proportion of government savings finds its way, directly or indirectly, into housing construction. Through various tax incentives (some of them recently suspended), interest subsidies and direct participation in building (particularly at the state and local level), government has helped stimulate excess demand going far beyond the production capacity of the construction industry. In effect, a part of government savings in recent years has not resulted in real investment, but rather in a substantial inflation of building costs.

The expanded role of government in gathering and allocating resources was a natural consequence of the war and the need to mobilize resources for reconstruction. The most pressing needs of reconstruction have long been met, but patterns of governmental expenditure and finance, once established, are not easily changed. Another major problem in this regard has been the distribution of revenues between different levels of government particularly between the Federal and state governments. Although the Federal Government has been burdened by rapidly rising national security requirements, such as defense and foreign aid, the expenditure needs of the state governments have on the whole increased less persistently. Yet the states receive 65 percent of the income tax receipts jointly shared by the Federal and state governments and enjoy a much stronger financial position in an expanding economy because of the progressive nature of the income tax.

BUSINESS FINANCE

Business enterprises continue to rely heavily on self-financing, although recently the proportion of total resources derived from this source has been declining, primarily because of a reduction in profit margins. This is clearly seen by the decline of retained earnings in table IV. A large proportion of external financing is obtained through direct borrowing from financial institutions, including a large volume of short-term credits, and only a small part through security issues. During the last 3 years security issues financed only 7 to 9 percent of gross business investment.

TABLE IV.—*Business enterprise sector—Sources and uses of gross savings and investment*

[Billions of deutsche marks]

	1959	1960	1961	1962
Sources:				
Internal sources, total	33.9	38.9	38.7	40.1
Depreciation	17.4	19.8	22.1	24.8
Retained earnings [1]	16.5	19.1	16.6	15.3
External sources, total	14.0	19.2	25.5	24.3
Borrowing from financial institutions	8.4	10.9	15.9	13.1
Borrowing from Government	2.3	.9	2.1	4.3
Sale of securities	2.6	4.5	4.7	4.1
(Fixed-interest)	(1.1)	(.2)	(1.0)	(2.2)
(Shares)	(1.5)	(4.3)	(3.7)	(1.9)
Other	.8	2.9	2.7	2.8
Total	47.9	58.1	64.2	64.4
Uses:				
Gross physical investment	39.2	49.9	53.9	56.8
Funds placed with the banking system [2]	5.5	4.6	6.2	4.7
Funds placed with building and loan associations [3]	.9	1.0	1.1	.9
Acquisition of securities	.9	1.5	1.7	1.0
Other	1.4	1.2	1.4	1.0
Total	47.9	58.1	64.2	64.4

[1] Includes capital transfers.
[2] Includes cash and money market paper.
[3] Includes own resources of financial institutions.

Source: *Deutsche Bundesbank*, "Monthly Report," May 1963.

The large proportion of self-financing has been made possible by a high level of profits and by special tax privileges, particularly accelerated depreciation. High profit margins were dependent, at least in part, on the steady influx of cheap labor from the East, union moderation, a willingness to work hard, and a strong international competitive position. These conditions have changed somewhat during the past 2 to 3 years, and retained earnings as a percentage of gross investment declined from 42 percent in 1959 to 27 percent in 1962. Special depreciation allowances, another important source of self-financing, have been greatly curtailed since the early postwar years, but despite the lower rates currently in force, the total amount of depreciation continues to rise rapidly, partly because of continued fast writeoffs under old depreciation schedules and partly because of the rapid growth of new investments. Though down somewhat from the exceptionally high level of the early fifties, depreciation has remained slightly over 40 percent of gross investment since 1959.

During the early postwar period, a high degree of self-financing was necessary to mobilize resources for reconstruction, and to rebuild an equity base for future borrowing. But excessive reliance on self-financing over a long period of time tends to stifle comptetition and may result in less than an optimum allocation of resources. This was perhaps a small price to pay for rapid reconstruction, but with more normal rates of growth in the future, competition and more efficient allocation of resources will assume greater importance. Although an improved profit position in the future may reverse the declining reliance on self-financing, it is unlikely to assume its former role in capital formation.

In tapping external sources of finance, German enterprises have had to rely to an unusually large extent on direct bank credits, including short- and medium-term credits. Bank credits have normally accounted for somewhat more than one-half of total external financing, and this was true in 1963 although they fell back from the high level of the preceding year. The reduction of DM2.8 billion in 1963 was largely offset by the strong increase in government loans. Short-term financing has fluctuated considerably but has been especially important during periods of rapid growth. These credits are often revolved, but consolidation is difficult because German banks are reluctant to extend long-term credits and securities issues are impractical for all but a few firms. As a consequence, German firms tend to be undercapitalized—which is one of the most pressing reasons for the development of a broader capital market in Germany.

THE HOUSING SECTOR

Germany devotes a considerably larger proportion of its savings to financing housing construction than any other major country, including the United States. Since 1958 about 30 percent of German net investment in fixed assets has consisted of housing.

The burden of meeting this heavy demand for capital falls heavily upon the bond market because of the practice of refinancing a large proportion of all mortgage loans (about one-half) through new bond issues—especially through the institution of mortgage banks (see sec. III). Bond issues of mortgage financing institutions account for about 50 percent of total new issues on the German bond market.

As mentioned above, all levels of government are very active in financing and subsidizing housing. Half of all residential construction is governmentally assisted. Assistance takes the form of loans (often at less than market rates of interest), interest subsidies, and accelerated depreciation allowances. Table V shows that in 1962 public authorities provided DM2.5 billion out of the housing sector's total external financial requirements of DM12.9 billion; an even greater proportion was supplied in earlier years. The special tax writeoffs, another important form of assistance, were temporarily suspended until May 1964.

Government subsidized housing credits tend to insulate builders from the full impact of high rates in the private market thus contributing to a higher level of demand than otherwise would exist. To a lesser extent other measures, such as the savings premiums under the housing premium law and the related tax reductions, probably also contribute somewhat to the demand for housing. All of these measures taken together have a significant impact on long-term interest rates because of the close relationship between demand for housing and the demand, through mortgage financing institutions, for funds on the capital market.

TABLE V.—*Housing sector—Sources and uses of gross savings and investment*

[Billions of deutsche marks]

	1959	1960	1961	1962
Sources:				
Internal sources, total	5.2	6.5	7.4	8.2
Depreciation	2.8	3.2	3.6	4.1
Retained earnings [1]	2.4	3.3	3.8	4.1
External sources, total	9.5	10.2	11.5	12.9
Borrowings from financial institutions [2]	6.5	7.7	8.8	10.2
Borrowing from Government	2.6	2.3	2.4	2.5
Other	.3	.2	.2	.2
Total	14.7	16.7	18.9	21.1
Uses:				
Gross physical investment	14.4	16.3	18.5	20.5
Funds placed with the banking system [3]	.3	.4	.4	.5
Total	14.7	16.7	18.9	21.1

[1] Includes capital transfers.
[2] A large proportion of this borrowing is refinanced by bond issues.
[3] Includes cash and money market paper.

Source: *Deutsche Bundesbank*, "Monthly Report," May 1963.

PERSONAL SAVINGS

With basic consumption needs having been met and with confidence in the German currency at least partially restored, personal savings rose swiftly after 1956. The savings ratio (savings as a percentage of disposable income) jumped sharply to over 8 percent in 1957, after having hovered near 6 percent for several years, and it has remained between 8 and 9 percent ever since. In absolute terms the amount of personal savings nearly tripled between 1956 and 1962 as shown in table VI. Personal savings as a percentage of total net savings rose sharply from about 20 percent in 1955 and 1956 to 29 percent in 1957. After 1957 the share of personal savings increased further, but it declined again to about 29 percent in 1961 and 1962.

TABLE VI.—*Consumer sector—Sources and uses of net savings*

[Billions of deutsche marks]

	1957	1958	1959	1960	1961	1962
Sources:						
Savings[1]	9.9	11.7	12.8	14.3	16.4	17.4
Borrowing	.2	.5	1.3	1.0	1.0	.5
Total	10.1	12.2	14.1	15.3	17.4	17.9
Uses:						
Savings deposits	4.7	6.0	6.9	6.9	6.4	8.1
Other funds placed with the banking system[2]	1.6	1.6	1.3	1.4	2.5	1.2
Funds placed with insurance companies and building and loan associations	2.6	2.8	3.7	4.4	4.8	5.1
Acquisition of securities	1.2	1.8	2.3	2.5	3.7	3.5
(Fixed-interest)	(4)	(4)	(1.4)	(1.1)	(1.3)	(2.7)
(Shares)	(4)	(4)	(.9)	(1.4)	(2.4)	([3].8)
Total	10.1	12.1	14.1	15.3	17.4	17.9

[1] Includes capital transfers.
[2] Includes cash.
[3] Includes purchase of Volkswagen shares (about DM 0.9 billion) after denationalization of the firm.
[4] Not available.

Source: *Deutsche Bundesbank*, "Monthly Report," July and September 1962, May 1963.

Personal savings are subject to powerful government incentives in the form of tax privileges and bonus payments. Within certain limitations on maximum amounts, savers may receive premium payments amounting to 20 to 30 percent for savings accounts and 25 to 35 percent for amounts held with building and loan associations provided balances are immobilized for 4½ to 6 years. Furthermore, individuals in certain income brackets may receive greater benefits by deducting such deposits and premiums from taxable income. While interest rates for savings deposits amount to only 3¼ to 4 percent, depending upon the period of notice, the effective yield for premium savings amounts to 8 to 12 percent, and even more under certain circumstances.

The most important effect of these incentives is probably to channel personal savings into savings deposits (particularly at savings banks), building and loan shares, and insurance as opposed to other forms of savings. This is particularly true of higher income groups which might otherwise have purchased more securities. Seventy-five to eighty percent of personal savings flow through these three channels. A considerable portion of these funds flows into security markets indirectly but, as will be seen below, the financial institutions which absorb the bulk of private savings are strongly disposed by the nature of their business, and by public regulation, to favor direct credits (particularly mortgage loans) or bonds of mortgage financing institutions.

FINANCIAL INSTITUTIONS

Only a part of the net savings of consumers, business, and government flow directly into physical investment. About two-thirds normally is placed with financial institutions which perform a distributive function. A considerable portion of the resources of financial institutions (between one-fifth and one-sixth) is obtained through security issues, consisting primarily of mortgage bonds. As a rule, financial institutions sell more securities than they buy.

The failure of financial institutions to make net investments in securities is a fundamental weakness of the German capital market.

The role of the individual investor has declined in most capital markets of the world, but in Germany financial institutions have not risen to take their place. In Germany, private insurance companies have invested less than 25 percent (55 percent if "loans against borrowers' notes" [3] are included) of their long-term assets in securities, and insurance companies hold less than 10 percent of all fixed-interest securities in circulation.

The result of this situation is that in Germany about one-half of net investment is normally financed through direct credits, much of it short-term, while the corresponding average for the United States is between 20 and 25 percent. Dependence on short-term credit to finance many long-term investment projects has made German enterprises vulnerable to a sudden curtailment of credit.

RECAPITULATION

At this point, it may be useful to recapitulate the major elements of the German financial structure which tend to limit the scope of the capital market:

(1) High proportion of total savings arising in the government sector and channeled into government approved projects;

(2) Heavy reliance on business self-financing;

(3) Preference of personal savers for nonsecurity investments, which is reinforced by government savings incentives;

(4) Heavy demand for building, stimulated by government, and the strong position of mortgage lending institutions in competing for capital;

(5) Predominance of direct credit by financial institutions and their reluctance to invest in securities.

SECTION III—THE DEMAND FOR CAPITAL

The German economy is characterized by an extraordinarily high rate of capital investment. Except for a pause between 1955 and 1958, domestic investment as a percentage of GNP increased steadily from about 23 percent in 1950 to 27 percent in 1962. Such high rates of investment impose heavy demands on the nation's ability to generate savings, and must be considered a fundamental factor behind the high level of interest rates prevailing in Germany. The rate of investment may recede gradually in future years as a result of wage increases in excess of productivity gains and the rising share of government consumption, but it seems likely that the demand for capital will continue to exert pressure on savings for some time to come.

Pressure on savings derives not only from the overall level of investment, but also from the composition of investment demand. Construction accounts for over 50 percent of total fixed investment in Germany, including almost 25 percent for housing. The proportions of construction and housing are considerably higher than in the United States. Furthermore, construction activity is growing much more rapidly than total investment and demand far exceeds the production capacity of the construction industry. Thus, building costs are increasing sharply, and by the end of 1962, the carryover

[3] See sec. V for a description of "loans against borrowers' notes" or *Schuldscheindarlehen*.

of unfinished dwellings had risen to almost 800,000 units (production capacity is about 550,000 units per annum).

ROLE OF GOVERNMENT STIMULATED HOUSING CONSTRUCTION

The demand for construction, and particularly for housing, is powerfully stimulated at all levels of government. Perhaps one-third of all construction is performed directly for government and, in addition, government provides financial support for over one-half of all housing construction. Government promotion of housing takes many forms, from direct participation to low-interest loans and indirect interest subsidies.

The demand for housing is of great importance for the capital market because perhaps one-half of the capital raised on the bond market is used to finance housing and fully two-thirds of banks' direct long-term lending (excluding interbank loans) is used for mortgages of all types. While the capital market supplies only a small fraction of the total capital requirements of the economy, about one-third of the cost of housing construction is financed through bond issues; if self-financing is excluded, the ratio rises to more than 50 percent.

The intense demand for housing, powerfully assisted by government, has permitted mortgage financing institutions to attain a dominant position on the demand for funds side of the German bond market. Since about two-thirds of all bonds in circulation consist of bank bonds and since the proceeds of such issues provide about one-half of total mortgage financing, there is obviously a close correlation between the demand for mortgage financing and the demand for funds on the capital market. This close relationship between mortgage demand and demand for funds on the capital market, perhaps more than anything else, explains the stubborn tendency toward high-interest rates in recent years despite an increased flow of savings.

If housing demand can be brought to a more normal level (the Federal Government has taken certain steps in this direction), a decline in the long-term interest rate would seem possible. Some of the slack may be absorbed by increased public and industrial issues, but institutional rigidities would problably prevent demand from those sources from completely offsetting the effects of diminished mortgage demand.

CREDIT INSTITUTIONS

There are four main categories of credit institutions which raise capital by issuing their own bonds:

Bank bonds in circulation, Aug. 31, 1963

	Billions of deutsche marks
(1) Mortgage banks	25.1
Private	(17.4)
Public	(7.7)
(2) Central giro institutions (public)	11.7
(3) State, regional, and local commercial banks (public and private)	4.9
(4) Specialized credit institutions (public)	6.0
Total	47.7

Mortgage banks are essentially financial intermediaries, raising money by issuing securities and using the proceeds for mortgage loans. They account for about 40 percent of total bond issues and supply about one-third of total mortgage lending (tables VII and VIII).

TABLE VII.—*Mortgage financing, position at the end of March 1962*

[Billions of deutsche marks]

	Assets		Bonded debt in circulation
	Mortgage loans	Bank bonds	
Mortgage banks	24.3	0.2	20.1
Savings banks	20.0	7.2	
Central giro institutions	6.1	1.9	8.8
State, regional, and local commercial banks	3.6	.9	3.9
Other commercial banks	.3	1.2	
Other banks	6.4	3.4	[1] 3.9
Total banks	60.7	14.8	[1] 36.7
Building and loan associations	8.2	[2] .4	
Private insurance companies	5.0	[2] 4.0	
Social insurance funds	[2] 1.5	[2] 4.0	
Total	75.4	23.2	[1] 36.7

[1] Excludes *Kreditanstalt fuer Wiederaufbau* and *Berliner Industriebank A. G.*
[2] Estimated.

NOTE.—Total bonds in circulation, 54.4.

Source: *Deutsche Bundesbank* "Monthly Report," May 1962.

TABLE VIII.—*Placement of securities*

[Billions of deutsche marks]

	Bonds [1]							Shares [2]	Total bonds and shares
	Domestic					Foreign	Total		
	Mortgage bonds	Communal bonds	Industrial bonds	Public bonds	Other[3] bonds				
Gross placement:									
1958	1.6	2.3	1.7	2.0	0.4	0.1	8.1	1.2	9.3
1959	3.1	2.4	.9	2.5	.8	.3	10.0	1.9	11.9
1960	2.4	1.1	0	1.3	.5	.0	5.4	2.8	8.2
1961	3.6	2.5	.3	2.1	1.0	.0	9.6	3.3	12.9
1962	4.1	2.4	1.1	3.0	1.3	.1	11.9	2.2	14.1
1963, 1st half	1.8	1.9	.7	2.8	1.3	.1	8.6	.7	9.3
Net placement: [4]									
1958	1.6	2.2	1.5	1.7	.3	.1	7.5		
1959	2.8	2.1	.6	1.9	.7	.3	8.6		
1960	2.2	.9	-.4	1.2	.4	.0	4.4		
1961	3.3	1.9	.1	2.0	.7	.0	8.0		
1962	3.6	1.8	.6	2.5	1.1	.1	9.6		
1963, 1st half	1.7	1.5	.2	2.2	1.0	.1	6.7		

[1] Nominal value.
[2] Net issue value.
[3] Mainly issues of specialized credit institutions.
[4] Gross placement less redemptions.

Source: *Deutsche Bundesbank* "Monthly Report," August 1963.

Other credit institutions issuing their own bonds act in much the same way as mortgage banks—i.e., they issue bonds primarily to finance mortgage loans (mortgage bonds) or loans to local authorities (communal bonds). Taken together, the demand for funds by these banks is almost as great as the demand of mortgage banks.

The most important group, the central giro institutions, are regional clearing banks and reserve depositories for the savings banks. Like member savings banks, giro institutions are instrumentalties of regional and local governments. Their bonds do not differ greatly from those of other banks, i.e., bonds of the so-called specialized credit institutions and mortgage bank bonds. The terms of issue are similar and a considerable portion of the funds raised are for the purpose of mortgage financing. The major difference between the latter groups and mortgage banks is that, being public instrumentalities, a considerable portion of their investment goes into regional and local government projects—public utilities, public buildings, social housing, and other government favored projects.

PUBLIC AUTHORITIES

Since the combined Federal, state and local governments ran large current account budget surpluses throughout most of the postwar period, public security issues were only nominal until recently. Including all government issues—Federal, state and municipal—public authorities accounted for only 22 percent of total outstanding bonds at the end of 1962. Over half of the government issues were floated by the Federal Post and the Federal Railways.

From 1954 through 1960, the state governments accounted for most government bond issues, but since then the situation has been reversed and outstanding Federal issues are now somewhat larger than state issues. The sudden reversal reflects rising surpluses in the budgets of the state governments, which receive 65 percent of the faster rising revenues from the income tax, while the Federal Government, faced with more rapidly rising expenditures but slower growing tax revenues, has been forced to turn to capital market. Apart from one sizable issue in 1960 the Federal Government did not begin to borrow large amounts until the summer of 1962. But between June 1962 and October 1963, DM2.2 billion of Federal bonds were put in circulation. A substantial amount is again in prospect for 1964, and regular sizable Federal issues will probably remain on the capital market scene for some time to come. Although the outlook for large Federal issues has had a certain dampening effect on the psychology of the market, they provide a valuable opportunity to test marketing techniques and to obtain broader public participation, which in the long run could make an important contribution toward a stronger and more efficient market.

BUSINESS ENTERPRISES

Few business enterprises can compete for capital on the bond market with mortgage financing institutions and public authorities, and those which can often find it cheaper and more convenient to raise capital by other means. For example, "loans against borrowers' notes" because of cheaper issue costs and more flexible and convenient terms, have grown in importance during recent years and now surpass bond issues as a source of capital for business enterprises. Net bond and share issues, therefore, represent only a small fraction of total business finance.

Industrial bond issues have been very small in recent years, averaging less than 10 percent of total issues, but between 1956 and 1958 they attained substantial proportions (up to 25 percent) in relation to total issues (though still not very large in absolute amounts). The explanation for the decline in the proportion of industrial issues in recent years can perhaps be found in several areas—in the behavior of interest rates and profits, in housing demand and in the capacity of the stock market to absorb equity issues. The period 1956–58 was characterized by an increased flow of savings and rapidly declining interest rates; the housing boom had not yet gotten underway and business profits were leveling off. Thus, at the very time that enterprises were being forced to turn toward external sources of finance, they found relatively attractive conditions on the bond market. In the years after 1958, on the other hand, industrial profits rose rapidly and, except for brief intervals, the long-term interest rate remained high. Housing demand rose sharply and mortgage financing institutions absorbed a greater share of the capital available in the bond market. Throughout both periods the capacity of the stock market to absorb new equity issues developed in an inverse relationship to the capacity of the bond market, so that total issues of both bonds and shares by industry moved in a much narrower range.

In coming years, however, business enterprises may have to rely more on external sources of finance because of lower profit margins, and the bond market may provide better financing opportunities than the stock market. A move in that direction was already noticeable in 1962.

SECTION IV—THE SUPPLY OF CAPITAL

A large proportion of the funds reaching the German securities market is supplied by financial institutions, and particularly by banks. Much of it represents interbank transactions to refinance mortgage loans—i.e., commercial and savings banks buying securities issued by mortgage financing institutions. Such interbank transactions account for over one-fourth of total fixed-interest securities in circulation. Total bank holdings, however, amount to well over one-third of total bonds in circulation.

Insurance companies, which are so important in American securities markets, play a small role in Germany where they supply only about 10 percent of bond market resources. With a preference for "loans against borrowers' notes" and direct mortgage lending, German issurance companies invest only about one-fourth of their assets in bonds and shares. (Equity investments by insurance companies are very small, being severely limited by the regulatory authorities.)

The social insurance funds have been important suppliers of capital at times, but in recent years they have held a larger proportion of their assets in liquid balances and other types of investment. Their surpluses will probably decline over the next few years making them a negligible factor in the market.

Although the net acquisition of securities by individuals has almost trebled since 1957 (table IX), it still accounts for only about one-quarter of total bond and equity purchases in recent years. Thus, despite the rapid growth of securities purchases by individuals, the proportion of new funds supplied to the securities market by individuals remains disappointingly low. Purchases of securities by nonfinancial business enterprises have been even lower than those of consumers.

TABLE IX.—*Net acquisition and ownership of fixed-interest securities*

[In percent of total]

	Net acquisition, 1959–61	Ownership as of Dec. 31, 1960 [1]
Bundesbank	5.1	0.5
Credit institutions	32.7	37.1
Commercial banks	(2)	7.3
Savings banks and giro institutions	(2)	19.5
Other banks	(2)	10.2
Building and loan associations	1.5	1.1
Insurance companies	10.3	10.2
Social insurance and pension funds	11.7	15.7
Business enterprises	8.8	17.4
Consumers	16.9	
Foreign	[3] 7.7	[4] 5.2
Government [5]	5.1	
Unidentified		12.8
Total	100	100

[1] Data derived from special article in the monthly report of the *Bundesbank*, September 1962.
[2] Not available.
[3] Includes Berlin.
[4] Excludes Berlin.
[5] Includes ERP Fund and Equalization of Burdens Fund.

Source: *Deutsche Bundesbank*, "Monthly Report," September 1962. *Statistisches Bnndesamt*, "*Wirtschaft und Statistik*," July 1961.

SECURITIES INVESTMENTS BY BANKS

Although banks are by far the largest supplier of investment funds for the securities markets, there are no banks in Germany specializing in securities investments or underwriting. German commercial banks have traditionally been of the "mixed type," engaging in long-term investment financing as well as in short-term commercial lending, but the latter has remained the principal and preferred object of business. Savings banks are in a somewhat better position to invest in securities, but they are also "mixed banks" to a considerable degree, with a substantial proportion of short-term deposits and commercial banking type activity. Despite the leading role of banks as suppliers of capital for the securities markets, therefore, securities investments are no more than a sideline for most German banking groups as table X shows.

TABLE X.—*Securities investments of banks*

	Percent of total bank holdings, March 31, 1962			Total securities in percent of earning assets, December 31, 1962
	Bonds	Shares	Total	
Commercial banks	16.9	91.8	27.0	10.3
Big Three	(7.4)	(49.0)	(13.5)	(11.8)
State, regional, and local banks	(7.2)	(25.5)	(9.5)	(8.2)
Private bankers	(1.9)	(15.9)	(3.5)	(14.2)
Specialized banks	(.4)	(1.4)	(.5)	(6.6)
Savings banks system	55.4	6.2	48.6	11.8
Savings banks	(40.7)	(.4)	(35.3)	(13.6)
Central giro institutions	(14.7)	(5.8)	(13.3)	(8.7)
Credit cooperatives	7.4	1.3	6.7	7.9
Mortgage banks	5.0		4.4	2.7
Special purpose banks	3.7	3.7	3.3	2.3
Postal check and savings	11.5		10.0	31.9
Installment credit institutions	.1			.5
Total banks	100.0	100.0	100.0	9.0

Source: *Deutsche Bundesbank*, "Monthly Report," May 1962.

Before going into the details of banks' investments in securities, it may be useful to review the structure of the German banking system. The two largest groups are the commercial banks and the savings banks, each accounting for about one-fourth of total bank resources. If the central institutions of the savings banks, i.e., the *Girozentralen*, are included, the share of the savings bank system rises to over one-third. Among the remaining groups, the most important are the mortgage banks, with about 13 percent of total bank resources; special purpose banks (such as the Reconstruction Loan Corporation which was established to administer Marshall plan aid funds), with another 13 percent; and the credit cooperatives and their central institutions, with about 8 percent. (See table XI.)

TABLE. XI.—*Number of banks by size of total assets,*[1] *as of Dec. 31, 1962*

	Under DM 50,000,000	DM50,000,000 to DM 500,000,000	DM500,000,000 to DM 1,000,000,000	DM1,000,000,000 or over	Total number	Total assets (percent)
Commercial banks	237	85	7	11	340	25.2
Big Three				(3)	(3)	(11.2)
State, regional, and local banks	(50)	(34)	(4)	(8)	(96)	(10.8)
Private bankers	(163)	(39)	(2)		(204)	(2.4)
Specialized banks	(24)	(12)	(1)		(37)	(.8)
Central giro institutions			1	11	12	12.8
Savings banks	515	328	17	7	867	24.0
Central institution of credit cooperatives		14	3	1	18	2.2
Industrial credit cooperatives	727	31			758	3.7
Agricultural credit cooperatives	1,445	4			1,449	2.5
Mortgage banks	11	12	9	16	48	13.2
Private	(6)	(7)	(8)	(9)	(30)	(6.5)
Public	(5)	(5)	(1)	(7)	(18)	(6.7)
Special purpose banks	7	6	3	8	24	12.4
Installment financing institutions	222	19	1		242	1.3
Postal check and savings banks offices	([2])	([2])	([2])	([2])	15	2.7
Total	3,164	499	41	54	3,773	100.0

[1] Excludes several thousand marginal agricultural credit cooperatives and a few other institutions which are not required to report to the Bundesbank.
[2] Not available.

Source: *Deutsche Bundesbank*, "Monthly Report," June 1963.

Commercial banks

The commercial bank group includes the so-called "big three,"[4] which have a nationwide network of branch banks. They have about one-fourth of the short-term deposits and short-term credits of the entire banking system, and they conduct the bulk of Germany's international banking business. The 96 state, regional, and local commercial banks are the second largest component; as a group, they are almost as important as the "big three." The so-called private bankers and specialized commercial banks have much smaller resources and normally maintain close working relationships with larger institutions. The entire group of commercial banks accounts for over 50 percent of total short-term deposits and short-term credits, but less than 10 percent of total long-term lending.

[4] *Commerzbank A. G., Deutsche Bank A. G., Dresdner Bank A. G.* and their Berlin subsidiaries.

Commercial banks, and particularly the "big three," do the bulk of the underwriting business for non-mortgage borrowers. (Most mortgage financing institutions place their issues directly with savings banks, insurance companies, social insurance funds, etc.) Underwriting is the main capital market function of the commercial banks and a large part of their holdings of bonds is transitory and related to the underwriting business. Nevertheless they hold substantial amounts of fixed-interest securities for their own account. At the end of 1962 total commercial bank holdings of fixed-interest securities amounted to about DM3.6 billion or roughly 6 percent of the total in circulation.

Commercial bank holdings of shares and syndicate participations were listed at about DM2.6 billion at the end of 1962 or about two-thirds as high as their holdings of fixed interest-securities. Since shares must be recorded in bank balance sheets according to the lowest value principle (purchase price or market value, whichever is lower), the market value of share holdings is probably substantially higher. Over 90 percent of the equity participations of banks are held by commercial banks; the "big three" alone hold about 50 percent. Practically all of the foreign securities held by German banks are in the hands of commercial banks, largely the "big three."

The holding of securities by commercial banks is limited by their great concern for liquidity. German banks are reluctant to make any long-term commitments which are not backed by long-term deposits. The doctrine of self-liquidating credits is still widely adhered to by German bankers, many of whom remember the banking crisis of 1931 when a sudden withdrawal of foreign short-term deposits brought down the superstructure of long-term credits with a resounding crash.

Yet, while German banks have been reluctant to borrow short and lend long, they have been willing to finance long-term investment projects with short-term loans. Indeed, there was no other way to meet the tremendous postwar financial requirements of German industry. In prewar times, such loans would have been consolidated in the securities markets, but that has hardly been possible since the war.

Savings banks and central giro institutions

The savings bank system consists of 867 municipally owned banks and 12 central giro institutions which act as reserve depositories and clearinghouses. Some of the savings banks rank among the largest credit institutions in Germany, but most of them are rather small, having assets of less than DM50 million. Being municipally owned, they are strongly oriented toward local needs—for example, housing, small business, municipal projects, etc.

The savings banks and the central giro institutions provide the largest and fastest growing source of capital for the bond market. At the end of March 1962, these institutions held 22 percent of all fixed-interest securities in circulation. They accounted for over one-half of total bank investments in bonds—41 percent for savings banks and 15 percent for the central giro institutions.

Savings banks have been especially well placed to benefit from the sharp rise of personal savings in recent years. About one-third of personal savings is deposited with savings banks. A savings account with the local savings bank has long been the traditional form of savings for lower and middle class Germans, and the savings banks have strengthened their hold on small savers through vigorous publicity campaigns. The savings premium laws have probably served to channel an even greater flow of savings into the savings banks.

The regionality of the savings banks shows up in their security investments. Savings banks show a marked preference for investment in bank bonds (84 percent of savings banks' security investments) which comprises in particular mortgage bonds and communal bonds issued by their central giro institutions. Most of the remaining security investments of savings banks consist of public bonds (13 percent of total investments). Savings banks have shown virtually no interest in industrial obligations.

The central giro institutions hold a relatively large proportion of their security investments (23 percent) in medium-term notes (*Kassenobligationen*). Almost 30 percent of all medium-term notes in circulation are held by the giro institutions. The preference of the giro institutions for shorter maturities results from the fact that they function as reserve depositories for the savings banks.

Other banking groups

Other banking groups include the agricultural and industrial credit cooperatives. The function of these institutions is to provide credit for farmers and small business, and this is done primarily through direct credits. They account for only about 7 percent of total bank investments in securities, but for 22 percent of bank holdings of industrial bonds. The central institutions of credit cooperatives, like the central giro institutions, are a significant factor in the market for medium-term notes.

Of the banks which act as pure intermediaries, without power to create money, the mortgage banks are the most important group. Their substantial resources are derived primarily from bond issues, which, as we have seen, dominate the demand side of the capital market. Mortgage banks appear as suppliers of capital only to a very limited extent and primarily because of the legal requirement for "substitute cover" (*Ersatzdeckung*) for the proceeds of bond issues which are not yet invested in mortgage loans.

The Postal Check and Postal Savings Bank offices hold about 5 percent of total fixed-interest securities in circulation and account for over 10 percent of total bank investments in bonds. The investments of these agencies are closely regulated, which is the main reason they hold about one-third of their earning assets in fixed-interest securities, largely bank bonds.

Money market dependence

Heavy reliance upon banks as suppliers of capital, together with the subsidiary nature of security investments for most banks, makes the German capital market highly susceptible to changes in money-market conditions. When bank liquidity is strained and the demand for credit exceeds the lending capacity of the banks, security purchases are sharply curtailed. Sometimes securities holdings are even reduced in order to meet pressing short-term credit requirements. Since banks normally supply one-third to one-half of investment funds for the bond market, their withdrawal as suppliers makes a significant rise in interest rates at such times unavoidable. When liquidity is ample, on the other hand, banks seek longer-term investment opportunities.

There is no easy answer to this relative instability of the German capital market. It is a weakness which will probably plague the market for some time to come. In the final analysis, a stable market will rest upon greater participation by private investors and by intermediaries such as insurance companies. Private participation has already increased a great deal and can be expected to increase further. The future role of insurance companies may be a promising route for Germany.

PRIVATE INSURANCE COMPANIES

In recent years, private insurance companies have accounted for only about 10 percent of net security acquisitions. The role of insurance companies in the capital market, therefore, is rather small. Only about one-fourth of the investments of insurance companies consists of securities (of which about 70 percent are bonds). But insurance companies also provide most of the financing for "loans against borrowers' notes" (*Schuldscheindarlehen*), which are very similar to bonds, and if these are included the proportion rises to over one-half. The remaining part of insurance companies' investments consists primarily of mortgage loans and real estate.

Greater participation by insurance companies would contribute much strength and stability to the capital market. Private insurance companies steadily absorb about 17 percent of personal savings, and they account for about 9 percent of total monetary asset formation in the economy.

The investments of insurance companies are under strict supervision by the Federal Supervisory Office (*Bundesaufsichtsamt*). Regulation is based on the insurance law of 1901, amended. Under the insurance law, companies are required to invest their actuarial reserves in either (1) assets declared eligible for trust investments (*muendelsicher*);[5] (2) advances against the companies' own policies; (3) bonds of public authorities having regular amortization schedules or being redeemable at the option of the investor; (4) assets denominated in foreign currencies, but only to the extent required to cover foreign-currency commitments. Other investments require special permission from the Supervisory Office.

While the above regulations are limited to actuarial reserves, in practice the Supervisory Office has also insisted that life insurance companies comply with the same regulations in investing 85 percent of their remaining assets. Other branches of insurance are given somewhat greater leeway, particularly as regards short-term investments.

As a general rule, equity investments are limited to only 10 percent of total assets and must be confined to public utilities and certain blue-chip shares. (American insurance companies hold about 20 percent of their assets in corporate stock.) Equity investments by German insurance companies were not permitted at all before 1952, except temporarily between 1923 and 1931.

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[5] The requirements for "trust" or "*muendelsicher*" investments are set forth in par. 1807:–10 of the Civil Code. They consist primarily of (1) all claims secured by a domestic mortgage, (2) Federal or state obligations, (3) obligations for which interest payments are guaranteed by Federal or state governments, (4) advances against eligible securities, (5) communal obligations declared eligible by the upper house of Parliament (*Bundesrat*).

Although insurance regulations still appear unnecessarily conservative and outmoded, they have been liberalized rather frequently. During the twenties, insurance companies invested about 50 percent of their assets in mortgages (70 percent for life insurance companies) and about 25 percent in securities (including loans against borrowers' notes). Today, mortgage loans account for less than one-fourth of life insurance companies' assets and only 5 percent of indemnity companies' assets. Securities investments (including loans against borrowers' notes) have increased to 50 percent and 65 percent respectively. The decline of mortgage loans has been primarily to the benefit of loans against borrowers' notes, however, because investments in other securities are only slightly above the prewar rate. (See table XII.)

TABLE XII.—*Long-term assets of private insurance companies by categories of assets as of Dec. 31, 1962*

	Billions of deutsche marks	Percent
Mortgage loans	5.57	17.3
Loans against borrowers' notes [1]	9.93	30.9
Securities	7.93	24.8
Participations	.60	1.9
Loans and prepayments on policies	.45	1.4
Real estate	3.54	11.0
Equalization claims	4.09	12.7
Total	32.11	100.0

[1] *Schuldscheindarlehen;* also includes small amount of other loans.

Source: *Deutsche Bundesbank,* "Monthly Report," July 1963.

The growth of loans against borrowers' notes (*Schuldscheindarlehen*) has been especially rapid since 1957. The main advantage of loans against borrowers' notes is that they avoid the securities tax, thereby reducing costs for the borrower and raising somewhat yields for the insurance companies. For shorter maturities the absence of the securities tax can be quite significant. An additional attraction from the point of view of the insurance companies is the absence of price fluctuations. For both the insurance companies and the borrowers, who are mostly industrial enterprises, the market for loans against borrowers' notes simply provides a more convenient and cheaper means of effecting a securities issue than the inefficient and inflexible bond market.

SOCIAL INSURANCE FUNDS

The main elements of the German social insurance system are old-age pensions, unemployment insurance, health and accident benefits. Savings formation is confined primarily to the first two; the health and accident insurance funds maintain a near balance between income and expenditures, and their reserves are minimal. The total assets of the old-age pension funds stood at about DM20 billion at the end of 1962, while those of the Central Unemployment Insurance Fund approached DM6 billion. (See table XIII.)

TABLE XIII.—*Assets of the social insurance system*

	End of 1961		End of 1962	
	Billions of deutsche marks	Percent	Billions of deutsche marks	Percent
Liquid assets, total	6.72	28.0	7.08	27.1
Bank deposits	4.70	19.6	5.10	19.5
Free loans to banks	1.39	5.8	1.96	7.5
Money market paper	.63	2.6	.02	.1
Long-term assets, total	17.30	72.0	19.02	72.9
Securities	5.85	24.3	6.85	26.2
Claims against the Federal Debt Register	3.22	13.4	3.17	12.1
Loans	6.05	25.2	6.57	25.2
Mortgage loans	1.19	5.0	1.32	5.1
Real estate and inventory	.99	4.1	1.11	4.3
Total assets	24.02	100.0	26.10	100.0

Source: Federal Labor Ministry, "*Arbeits- und sozialstatistische Mitteilungen*," May 1963.

With the sharp increase of incomes and manpower shortage in the boom years of 1960 and 1961, the savings formation of social insurance funds rose from a low of less than 5 percent of net national savings in 1959 to a new peak of 10 percent or DM5.4 billion in 1961, declining to 6 percent in 1962. In coming years the financial position of the old-age pension funds is expected by various expert study groups to deteriorate sharply and savings formation may cease altogether.

The assets of the social insurance funds arise from the excess of current receipts over benefit payments. Receipts are derived from compulsory levies on employees, employers and, in the case of the pension funds, also from contributions by the Federal Government. Coverage by the social insurance system is so broad, however, and contributions are so large (12 percent of national income in 1961), that the savings generated must, to a considerable degree, merely displace voluntary savings by reducing both the capacity and the need for personal savings.

Another basic difference between private and social insurance is the coverage of commitments. Private insurance companies are required to maintain assets sufficient to cover all of their commitments, while social insurance funds normally limit their assets to some fraction of the average rate of benefit payments.

Investments of the social insurance funds are severely restricted by government regulations. Under the Reich Insurance Code, still in force, social insurance funds are limited to investments which serve to finance capital projects in the public interest, such as social housing, public utilities and communication facilities, etc. Regulations governing the unemployment insurance fund even require active coordination with the financial programs of federal and state governments and other public authorities.

One of the most striking features of the investments of social insurance funds is the high proportion of liquid assets. In recent years about one-fourth of their assets have been maintained in liquid form (about 40 percent for the unemployment insurance fund), which is comprised mostly of bank deposits and so-called free loans, i.e., essentially time deposits called loans so as to circumvent regulations limiting interest rates payable on deposits.

Over one-third of the longer term investments of the social insurance funds consists of securities, but here again a large proportion went to banks. Out of total securities investments of almost DM7 billion at the end of 1962, over 80 percent consisted of mortgage bonds and communal bonds. (See table XIV.)

TABLE XIV.—*Security holdings of the social insurance system by types of securities*

	End of 1961		End of 1962	
	Billions of deutsche marks	Percent	Billions of deutsche marks	Percent
Public bonds	0.64	10.9	0.81	11.8
Mortgage bonds	3.27	55.9	3.77	55.0
Communal bonds	1.69	28.9	1.96	28.7
Industrial bonds	.03	.5	.03	.4
Other securities	.22	3.8	.28	4.1
Total	5.85	100.0	6.85	100.0

Source: Federal Labor Ministry, "*Arbeits- und sozialstatistische Mitteilungen*," May 1963.

Earmarked loans to banks, and loans to state and local governments and public enterprises were important forms of investments before 1957, and still bulk large in the assets of the social insurance funds (over 20 percent of total assets at the end of 1961). A large proportion of these loans was utilized for social housing.

It would appear that the social insurance funds are one of the weaker links in the German financial system. While they account for a substantial portion of national savings, they also reduce the capacity and willingness of individuals to save voluntarily. A large proportion of their assets is held in liquid form, and directly or indirectly, much of their savings is channeled into the overstressed building sector. While social insurance funds hold about 15 percent of total fixed-interest securities in circulation, most of this was accumulated in earlier years; since 1958, the social insurance funds have been a minor factor in the capital issues market.

Although the period of large current surpluses seems to be passing, the social insurance funds could still make an important contribution toward strengthening the capital market. An obvious means would be through shifting their investments into Federal bonds. The Federal Government contributes over DM7 billion per annum to the revenues of the social insurance funds, and although the Federal Government will in the future have a greater need for funds than other levels of government, the social insurance funds continue to make most of their funds available for regional and local projects—much of it in the field of social housing.

INVESTMENT PARTICIPATION BY INDIVIDUALS

Despite a highly satisfactory rate of personal savings since 1957, and a steady increase in the proportion of savings devoted to securities investments, participation by individuals in the securities markets remains disappointingly low. At present, the securities markets probably cannot attract more than about 20 percent of personal savings, divided equally between the bond market and the stock market. Even this meager sum, however, is sufficient to supply the bond market with roughly one-fourth of its net capital supply. A relatively small increase in the proportion of private savings invested in securities, therefore, could add a great deal of stability and flexibility to the capital market.

Private savers have become cautious regarding investments in securities as a consequence of the war and the currency reform. Moreover, it would be unrealistic to expect private savers to develop into the mainstay of the capital market, as was the case during the Twenties, and even more so before the First World War. The heavy, progressive tax burdens and highly developed social insurance systems of modern times simply makes this no longer possible. Nevertheless, continuing effort to draw individuals into the securities markets would seem to be an important aspect of any program to strengthen the capital market.

The German Government has made several attempts to promote securities investments by individuals. In 1950, there was an unsuccessful attempt to sell "baby bonds" in DM10 denominations. Later, a system of tax privileges was introduced for certain types of securities, but these were so complex that most individuals were unable to take full advantage of them.

Investment in shares by small savers faces many of the same obstacles confronted by investment in fixed-interest securities. The size of denominations is even more restrictive, with most shares selling for several hundred DM while some bonds are available in DM100 denominations.

SECTION V—INSTITUTIONAL STRUCTURE

Having considered the major economic forces affecting the capital market, we turn now to certain aspects of its institutional structure. We shall principally consider licensing and control of new issues, issue methods, terms of issue and, finally, "loans against borrowers' notes" (*Schuldscheindarlehen*).

PRESENT INSTITUTIONAL STRUCTURE

The German capital market has become progressively freer since 1954, and today there are very few controls of any significance remaining. But while the German market is basically free in structure, this does not mean that it is completely free of institutional rigidities and impediments, some of them traceable at least in part to governmental regulation in related fields, e.g., regulation of banking and insurance. And, as discussed in the preceding sections, the public authorities exercise considerable indirect influence on the capital market through the allocation of government savings to enterprises, the stimulation of construction and the system of premium and tax privileged savings. It is a free market only in the sense that there is no direct official control over capital issues or other internal transactions, and no controls over international capital transactions. New issues (except Federal, state, and foreign issues) are subject to licensing by the Ministry of Economics, and there are also routine requirements for information, but no effective control is exercised.

LICENSING OF SECURITIES

Under the law on state approval of issues of bearer and registered bonds, 1954, bearer bonds placed in Germany are subject to licensing by the Federal Ministry for Economics in agreement with the relevant state authorities, but registered bonds are only subject to licensing if the loan is part of an overall issue involving more than one creditor. Licensing requirements are not particularly burdensome, however, the main consideration being protection of creditors. Foreign, Federal, and state issues are free from licensing requirements.

LISTING ON THE STOCK EXCHANGES

Authorization for listing on German stock exchanges is granted freely by listing committees of the exchanges.[6] The listing committees are under the surveillance of the state government concerned, but governmental intervention is rare. Publicity and disclosure requirements are relatively lenient, and while listing fees appear high, they can as a general rule be reduced upon application.

Foreign listings are welcomed by the exchanges and by the large commercial banks, which usually act as agents for applicants, but under present conditions very few foreign issues find enough local investor interest to build an effective market. Foreign firms often list for its advertising value and for reasons of prestige, but most German investors find it more convenient to trade in large foreign markets when acquiring foreign securities.

ISSUE METHODS

There are two principal methods of issuing securities on the German bond market—the first being continuous sales "on tap" by mortgage banks and certain banks making local authority or "communal" loans, and the second being the so-called one-time issues of all other borrowers. The latter type are underwritten by banking syndicates, whose members undertake to subscribe to fixed amounts at fixed prices. For all practical purposes, there is but one underwriting syndicate which is composed of representatives from each of the three big banks, other commercial banks, private bankers, and the central giro institutions representing the savings bankers. The composition of the underwriting syndicates as well as the subscription quotas change very little from issue to issue. The chairmanship of the syndicate usually rotates among the three big banks, although it frequently goes to that bank with whom the borrower conducts most of his banking business. In a strictly formal sense no single syndicate exists, but a series of underwriting groups because the group disbands and meets anew for each issue.

In 1957 the Central Capital Market Committee was established to regulate the increasing volume of "one-time issues." The committee is a voluntary agency without statutory power, but it does in fact exercise effective control over the timing, amount, and terms of one-time issues. The membership of the committee is composed of three representatives of the commercial banks with one serving as chairman,

[6] There are eight exchanges in Germany. The two major exchanges are located in Frankfurt and Duesseldorf. The Berlin, Hamburg, and Munich exchanges also have national standing while those of Bremen, Hannover, and Stuttgart have a more regional character.

four from the savings and communal banks, and four from the mortgage banks with the central bank (*Bundesbank*) serving as an observer. The most striking characteristic of the group is the heavy representation given to mortgage banks which appear in the market primarily as borrowers, not lenders.

A situation in which the dominant borrowers sit with the dominant creditors to determine jointly the amount, and terms, of capital to be made available to all other borrowers would seem to be a major obstacle to the free and efficient functioning of the German capital market. As seen above, this high degree of intimacy applies to underwriting syndicates as well as to the Central Capital Market Committee. In fact, the entire process of issuing securities is concentrated in the hands of a few institutions and there is apparently very little competition between them. This arrangement may very well contribute to the high cost of raising capital on the German bond market.

In addition to the Capital Market Committee there is a special Federal Loan Consortium to handle all issues of the Federal Government. Meeting under the chairmanship of the central bank, which incidentally is not permitted to subscribe to Federal issues, the Federal loan consortium includes representatives of all banking groups, except mortgage banks.

There are three basic steps in floating a Federal issue. In the first instance, the Finance Ministry prior to its determination of a specific amount informally confers with the central bank and key consortium members on the condition and outlook of the capital market for the next fiscal year.

The second step is the determination of the appropriate amount by the Finance Ministry and its submission by the Government to Parliament. This is done in connection with the budget presentation and this phase is completed when Parliament authorizes a specific figure for the fiscal year.

In the third phase a small group within the Federal Loan Consortium discusses the amount and term of individual *tranches*. This smaller group exercises decisive control, particularly with reference to terms. Approval by the full consortium is merely a formality. The timing of issues is normally decided by the Central Capital Market Committee, but since the composition of the committee and consortium is virtually the same, this makes little difference in reality.

With regard to "continuous" issuers, it should be emphasized that they are free from any restriction or advice of the Central Capital Market Committee.

Principally because of the preponderant position of the mortgage banks as borrowers in the market, these institutions have developed an extensive and efficient sales apparatus for placing their bonds. Their customers consist mostly of other banks, insurance companies, social insurance funds, and individuals.

COSTS OF ISSUE

The costs of issuing private industrial securities in Germany are very high, which is perhaps not surprising in view of the small volume and irregular nature of such issues and the institutional arrangements described above. Private industrial bond issues with an average maturity of 10 years cost the borrower 7.2 to 7.4 percent per annum, while the interest yield to the investor is about 6.1 percent. The margin of over 1 percent per annum between cost and yield is considerably higher than margins in most other markets. Deductions at the time of issue total about 5½ percent of the amount raised including bank fees of 2½ percent, the 2½-percent securities tax and printing and advertising fees of about one-half percent; other continuing charges amount annually to about 0.1 percent of the amount raised (see table XV).

TABLE XV.—*Bond flotation costs as of the summer of 1963*

[In percent of nominal value]

	Private industrial issues	Public issues
A. Non-recurrent costs:		
1. Bank fees:		
(a) Commission for underwriting	2.0	[1] 1½-1⅞
(b) Commission for listing on the exchanges	.5	.25-.5
2. Taxes:		
(a) Securities tax [2]	2.5	None
3. Other fees:		
(a) Admission to trading on the exchanges [3]	[4] .015	[4] .0075
4. Direct costs:		
(a) Printing costs	.05	.05
(b) Prospectus and sales advertising costs	.13	.05
Total non-recurrent costs (approximate)	5.5	2.0-2.5
B. Recurrent costs:		
1. Bank fees:		
(a) Commission for disbursement of interest	.02	.02
(b) Cost of redemption (bank and legal fees, ads)	.03	.03
(c) Trustee fees for collateral land charge	.05	None
Total recurrent costs	.1	.05

[1] The discount as compared to the rates charged to private issuers is largely a quantity rebate and is not indicative of any privileged treatment of public issuers in this respect.
[2] It is possible to negotiate lower lump-sum payments for the introduction of foreign bonds into the German capital market.
[3] There are 8 exchanges in Germany.
[4] Per exchange.

Source: Economics Ministry.

Issues of the public authorities and mortgage financing institutions, however, are much less expensive since they benefit by exemption from the 2½-percent securities tax and lower bank charges usually granted as a quantity rebate.

Equity issues by the larger domestic firms normally cost about 7 percent of nominal value. The 2½-percent securities tax is again a major cost element; bank underwriting fees are 2½ percent or more, depending upon the anticipated circulation, and the bank fee for listing amounts to an additional 1 percent; stock exchange fees, printing, and publicity costs usually amount to about 1 percent also. Foreign issuers of equities can often save 1 to 2 percent by negotation of a lower lump-sum payment of the securities tax and lower bank fees for listing.

THE SECURITIES TAX

As mentioned above, the 2½-percent securities tax is an important element of issue costs for equities and for industrial and foreign bonds. The tax is discriminatory in that government, public service enterprises, and domestic credit institutions under public law (including mortgage financing institutions) are exempt—that is, most issues other than industrial and foreign issues are exempt.

The securities tax is payable upon the initial acquisition of an interest-bearing claim, provided that the rights of the flotation are subdivided. If the rights are not subdivided, but taken over as a whole unit, the borrower is not liable to the tax. It is this latter loophole which gives rise to the market in loans against borrowers' notes (*Schuldscheindarlehen*). The initial purchaser of newly issued equities is also liable for payment of the tax. In the case of claims against foreign debtors or the acquisition of newly issued foreign equities, the tax is payable on the first domestic sale. The securities tax is also payable on the transfer of investment and operating funds by a foreign firm to its German subsidiary.

The securities tax is under the jurisdiction of the state governments. Repeal of the securities tax is widely advocated in Germany, but the state governments have opposed any change because they do not want to lose the revenue from this tax (DM158 million in 1962).

TERMS FOR FIXED-INTEREST SECURITIES

Another element of institutional rigidity in the German capital market is the inflexibility and unimaginativeness of terms. Interest rates have fluctuated substantially, of course, but other terms have changed very little during the postwar period. Little consideration is given to the special requirements of different groups of investors, and particularly of small investors. It is an anomaly of the German situation that loan terms invariably favor the debtor despite a relative shortage of capital supply.

Because of the predominance of mortgage bonds, the average maturity of German securities is very long. Mortgage and communal bonds average 30 to 60 years, and most do not provide for regular amortization. The maturity of public and industrial issues is usually 15 to 20 years, occasionally as much as 25 years. Medium-term obligations (largely *Kassenobligationen*) with a maturity of mostly 3 to 4 years account for only a small fraction of total issues; in fact, the medium-term market was not tapped at all until 1958.

Further development of the medium and intermediate maturity ranges and a shortening of the extremely long issues would probably be desirable. Mortgage banks require long maturities because of the nature of their loans, but maturities over 40 years could probably be avoided. A loan at an interest rate of 5 percent and amortization rate of 1 percent per annum, with amortization payments rising as interest payments decline, would expire within 37 years. With higher interest rates or higher amortization rates, the maturity would decline further.

To some extent, the long maturity of mortgage bonds is related to the abnormally long depreciation period for buildings in Germany. Buildings are normally depreciated over 100 years; proposals to reduce this to 50 or 60 years have been under consideration in the Parliament recently.

RECALL RIGHTS

Almost all German bonds provide the debtor with recall rights, usually after only 5 years and often even earlier. This practice acts as a brake on the rate of decline of the interest rate level. In a market with a long-term downward trend of interest rates, as in post-war Germany, recall rights of the debtor greatly reduce the incentive to invest in fixed-interest securities. For the creditor it means that there is really no such thing as a long-term fixed-interest investment. The creditor has no assurance of earning a high interest return over the full life of the loan, and the potential for capital appreciation is greatly reduced.[7] From the point of view of the debtor of course, it promises a substantial long-term reduction in capital costs. Provisions for early recall might have been advisable in the early postwar period when capital costs were abnormally high and there was a need to stimulate investment, but under present circumstances it would seem advantageous to provide the creditor with greater incentive.

There are no legal obstacles to a liberalization of recall rights except in the case of private mortgage banks, which are prohibited by the mortgage bank law of 1899 from relinquishing recall rights for more than 10 years from the date of issue. Public mortgage banks and other issuers are under no legal limitations.

The Federal Government took steps in the direction of liberalization in the autumn of 1962, when it issued a 10-year loan without recall rights. The move was prompted by the weak condition of the market at that time, but the 10-year nonrecallable feature was retained in a 15-year loan issued in January 1963 under more favorable market conditions. In both cases investors responded to the innovation enthusiastically.

THE MARKET FOR LOANS AGAINST BORROWERS' NOTES (*SCHULDSCHEINDARLEHEN*)

The German central bank translates the term *Schuldschein-darlehen* as "loans against borrower's notes." There is no precise English equivalent. *Schuldscheindarlehen* differ from ordinary documented long-term bank credits in two major respects:

(1) They involve large amounts, several millions of deutsche marks, beyond the capacity of any single creditor;

(2) The claim indicated in the note is assignable in segments, though often only with the agreement of the debtor, or the claim can be split into negotiable segments.

The loan is usually granted to a large- or medium-sized business enterprise by a commercial bank, often one of the "big three" banks, but sometimes also by public authorities or even other business enterprises. Certain private banks have specialized in the business of arranging such loans. Banks normally assign portions of the loan to other lenders as soon as possible, insurance companies being by far the most important group in this secondary distribution. Insurance companies account for about 75 percent of all permanent investments in loans against borrowers' notes.

The terms of loans against borrowers' notes are very similar to those of industrial bonds. Maturity is usually 7 to 15 years with 3 to 5 years free of redemption. The interest rate is normally somewhat above the prevailing bond rate, at the present time about 6.3 to 6.5 percent.

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[7] In 1959, when long-term interest yields approached 5 percent, 8 percent bonds were quoted at only about 108. In the absence of recall rights such an issue with a remaining life of 10 years would normally be quoted at about 120.

The attractive yield together with the fact that the loans are not subject to price fluctuations seems to provide the main attraction for investors. Insurance companies also appear to be attracted by the convenient maturity spans of such loans and the fact that they are often collateralized by mortgages which makes them eligible for investment under the regulations of the Federal Insurance Supervisory Authority.

Although the investor can earn a higher return on loans against borrowers' notes, the total cost to the borrower is actually less than for bonds, because he saves on a number of expenses, particularly the 2½-percent securities tax. Furthermore, capital is more readily available than on the bond market, terms are more flexible, there is no need for price support, no Government license is required, no publicity, etc.

The strong and persistent demand for this type of financing has called forth a large and rapidly rising flow of capital in recent years. The volume of such loans was estimated at DM4.2 billion at the end of March 1962. Loans granted during 1961 alone amounted to DM1.5 billion. During the same period, the gross placement of industrial bonds was only DM320 million.

SECTION VI—INTERNATIONAL CAPITAL MOVEMENTS

GOVERNMENT REGULATIONS

At present there are no significant foreign exchange regulations restricting the free movement of capital. The government has the power to issue foreign exchange regulations under the foreign trade and payments law but, except for rules governing transactions with the Soviet bloc and affecting some short-term transactions, no such regulations exist.

During the past 3 years, the authorities have attempted to stem the inflow of short-term foreign money through banking regulations. At the present time these regulations require the payment of a less favorable interest rate to foreign depositors and prohibit so-called *en pension* transactions. The latter constitute a disguised form of deposit involving the lending of funds to a bank which pledges securities as collateral. Also, foreigners are not permitted to buy German money market paper. These regulations, generally speaking, have not been very effective in curtailing the inflow of short-term funds.

TRENDS

The long-term capital position of Germany, both public and private, has shown a growing tendency to draw capital from abroad over the past 3 years. Long-term capital transactions moved from a net deficit of $46 million in 1960 to a surplus of $41 million in 1962. This movement consisted of increasingly large surpluses on private account and declining official capital exports. (See table XVI.)

TABLE XVI.—*Long-term capital account*

[In millions of dollars]

	1960	1961	1962	First half	
				1962	1963
Official long term (net)	−280	−276	−245	−105	−97
Private long term (net)	+234	+214	+286	+95	+424
Balance	−46	−62	+41	−10	+327

NOTE.—Plus sign denotes inflow.

Source: *Deutsche Bundesbank*, "Monthly Report," July 1963.

Despite an expanding development aid program, official capital exports (net) declined from about $280 million in 1960 and 1961 to $245 million in 1962. The big decline in 1962 probably resulted from the shift to project lending which had the effect of slowing down disbursements.

PRIVATE CAPITAL

Since the introduction of convertibility in December 1958, securities transactions for portfolio and direct investment purposes have consistently shown a net inflow whereas other capital movements, mainly other direct investments, credits, loans, and real estate transactions were in net deficit until 1962, when they also moved into the surplus column. According to estimates of the German central bank, about 40 percent of the net foreign purchases of equities constituted direct investment.

Foreign transactions in German securities

Since the introduction of convertibility about $1.4 billion of foreign capital has been invested in German securities. While this capital inflow has been motivated to a large extent by relatively high interest rates and capital appreciation potential for bonds, and by relatively good growth prospects for stocks, currency speculation was also occasionally a factor. During the first half of 1963 the movement into German securities was again impressive with net purchases amounting to $357 million (net) or almost as much as the $380 million (net) invested in the preceding year. (See table XVII.)

TABLE XVII.—*Transactions in securities*

[In millions of dollars]

	First half		Full year 1962
	1962	1963	
1. Transactions in foreign securities by Germans (net)	−93	−52	−181
Equities (net)	(−65)	(−18)	(−152)
Fixed-interest securities (net)	(−28)	(−34)	(−29)
2. Transactions in German securities by foreigners (net)	+147	+357	+380
Equities (net)	(+79)	(+136)	(+200)
Fixed-interest securities (net)	(+68)	(+221)	(+180)
3. Balance (net)	+54	+305	+199

NOTE.—Plus sign denotes inflow.

Source: *Deutsche Bundesbank*, "Monthly Report," July 1963.

Foreign net investments in German equities reached a record of about $350 million in 1961. In 1962, despite a small turnover and the 25-percent drop in stock prices, foreign investment in German equities reached $200 million.

Foreign interest in German bonds has been limited principally to issues of public authorities. During a recent period foreign participation in new issues of public authorities was estimated at just under 30 percent in contrast to a meager 5 percent for issues of private bonds. In 1962 the net inflow of foreign capital for the purchase of German bonds amounted to $180 million.

German transactions in foreign securities

In purchasing foreign securities, German investors have concentrated primarily on equities. In 1962 equity purchases amounted to $152 million (net), representing 84 percent of net securities investments. The bulk of this amount, according to an estimate of the German central bank, was direct investment. This recent concentration on direct investments contrasts with the emphasis placed on portfolio investments in the 2 years 1958 and 1959. After heavy net purchases of foreign bonds by Germans in these 2 years there was virtually no net movement until 1962. In 1962 German purchases of foreign bonds amounted to only $29 million (net) or only 16 percent of net foreign security transactions.

It is interesting to note that there were a number of foreign bond flotations on the German market in 1958 and 1959. However, after December 1959, there were no foreign issues for a period of 18 months. This is attributed primarily to the tight monetary policy undertaken in 1960 which increased the already high interest rate structure. The rate for new issues increased more than 1.5 percent in 12 months. Coupon rates for foreign loans since mid-1961 have been in the range of 6½ percent. Usually, the coupon rate of interest on foreign flotations is one-half of 1 percent more than domestic issues. Yields, however, run as much as a full percentage point above those for comparable domestic issues.

Balance of securities transactions

The net balance for all securities transactions in 1962 was an inflow of nearly $200 million. Transactions in foreign securities by Germans produced an outflow of $181 million while foreign investments in German securities resulted in an inflow of $380 million.

In the first half of 1963, securities transactions produced a net inflow of about $300 million, some six times the amount for the corresponding period of 1962. This heavy inflow during the first 6 months, particularly the second quarter, reflected not only the strong upward movement of the German stock market in May and rising business confidence, but also the relative political stability of Germany compared to some other European countries. (Markets in 1962 were, of course, unsettled.)

In addition, a significant portion of the large inflow in early 1963, perhaps about $75 million, may have been caused by new Belgian tax measures which stimulated capital movements to Germany.

To what degree the long-term capital inflow has been influenced by currency confidence factors is difficult to determine but they have tended to make Germany—in its position of relative economic and political stability—a magnet for foreign funds.

It is interesting to note that private long-term investments by Germans in the United States have recently shown a tendency to decline. Although German investments in the United States were increasing at the rate of about $40 million per year during the 1959–61 period, they increased only $24 million in 1962. In contrast, U.S. investments in the Federal Republic have gained momentum since 1960. (See table XVIII.)

TABLE XVIII.—*Private United States/German long-term capital movements*

[Millions of dollars]

	1959	1960	1961	1962
German transactions in United States (net)	−49	−32	−47	−24
Securities (net)	(−41)	(−20)	(−19)	(−20)
U.S. transactions in Germany (net)	+115	+99	+169	+184
Securities (net)	(+43)	(+102)	(+168)	(+77)
Balance	+66	+67	+122	+160

NOTE.—Plus sign denotes inflow.

Source: *Deutsche Bundesbank*, "Monthly Report," June 1963.

Other private long-term capital movements

As suggested earlier, a substantial portion of private long-term capital movements consists of transactions outside of the securities field.

In 1962 other private long-term capital showed a net inflow of $87 million, consisting of $150 million of German capital moving abroad and an inflow of about $240 million of foreign capital. This latter figure consists primarily of direct loans to German firms, including loans to German subsidiaries and branches of foreign corporations. Roughly half of these loans came from the United States.

Official long-term capital movements

As noted earlier, development aid constitutes the bulk of official long-term capital exports. In 1961, when the net outflow on official long-term capital account amounted to $276 million, bilateral aid disbursements amounted to $272 million. In 1962, the net outflow was $245 million and aid disbursements were $190 million. Other public long-term capital transactions include redemption payments under the London Debt Agreement and participation in international institutions such as the World Bank, International Monetary Fund, and European Investment Bank.

The outflow of official long-term capital was lower in the first 6 months of 1963 than in the previous corresponding period, and this relationship probably was repeated in the second half.

CHAPTER IX

THE CAPITAL MARKET IN ITALY

SECTION I—SUMMARY

The Italian capital market has developed rapidly over the past decade. Net new securities issued in 1962 totaled 1,642 billion lire and were fivefold the amount issued in 1950.[1] In addition to this big increase in the volume of flotations, there has also been an appreciable change in the type of security offered. Public issues have played only a small part in recent years, whereas at the beginning of the last decade they accounted for nearly half of total new issues.

Despite this notable growth, the market is still a very thin one and its scope is limited. Since the beginning of 1962, moreover, growth of the capital market has been curtailed by an increasing tendency for Italian savers to keep their savings in highly liquid forms or to place them abroad. This is partly the result of lack of confidence in the capital market's future ability to finance both the indemnification payments to former owners of the nationalized electrical power industry and the relatively large-scale expenditures required for private industrial expansion and public development programs. (Although public investment, exclusive of Government-owned industries, has been declining as a proportion of total investment, it is rising rapidly and at present is being financed increasingly by banks rather than from public savings.)

Confidence among savers was adversely affected by the 1962 stock market drop in New York and in other major markets, and by certain policy decisions of the Italian Government, particularly the nationalization of the electric utilities industry and the imposition of a 15 percent withholding tax on dividends. Prices of shares and bonds have been declining since 1961 and transactions in the securities markets are at a low ebb.

Another factor which affects the flow of funds to the capital market is the very small difference between return to the investor on short-term and long-term investments. The Bank of Italy appears to recognize this problem and to be moving to widen the differential so as to create a greater incentive to invest in long-term securities but the problem has not yet been solved.

Apart from these problems, the prospects for a steady increase in the supply of funds to the capital market obtained directly from small investors are dimmed by tradition, the absence of reliable information concerning creditworthiness and earnings prospects of firms, and the small investor's lack of knowledge of the functioning of the securities market. An effort to promote sales of small lots of corporate shares has recently been launched, with small investors being encouraged to pool their orders and effect purchases through a bank charging a smaller fee than would be possible for individual purchases made directly through an odd-lot broker.

[1] The par value of the Italian lira is 625 to $1.

..e absence of legal provisions for mutual fund operations may be ·nother factor which results in a smaller supply of capital for the securities market than would otherwise be possible.

Stamp taxes on securities transactions are relatively small and probably do not constitute a significant obstacle to trading. In 1962, however, a 15 percent withholding tax was levied on dividend income from both Italian and foreign stock holdings. The legislation requires that corporations file an annual report of stock ownership with the tax authorities. This legislation has apparently stimulated a substantial movement to disguise ownership of Italian securities, and during 1963 there has been an exceedingly heavy outflow of Italian capital effected largely through the export of bank notes. Much, although not all, of this capital appears to have been reinvested in Italian securities through the medium of Swiss banks.

A substantial part of savings, instead of being channeled directly to the market, is now being held in the form of bank deposits and savings accounts. The banks are heavily committed in support of the securities market and a large expansion of bank loans in 1962 and 1963 will restrict further financing from this source. During 1962 the banks and institutional investors absorbed 48 percent of the 1,642 billion lire new issues compared to only 27 percent of the 1,301 billion lire issued in 1961, while private investors and companies took only 52 percent last year compared to 73 percent the year before. These operations were based in large part upon an expansion of bank credit. If rising inflationary pressures and the deficit in the balance of payments continue unabated, Italy's monetary authorities will be hard pressed to restrict the expansion of bank credit required to help finance investment needs. In 1963 Italian issuers showed renewed interest in foreign capital markets (city of Milan, *Fiat*, *Autostrade*) and resorted to incentives such as convertible bonds (*Finsider*) to attract Italian investors.

Total demand for long-term funds on the capital market is expected to increase considerably in the future. Private enterprises will need to step up their calls on the capital market since declining profit margins are tending to reduce the scope for financing investment from internal sources. These needs will pose an increasing problem for Italian monetary authorities who must pass upon requests for new issues. Italian monetary authorities control the issuance of new securities and the terms of such issues. They also can influence the subsequent demand for and supply of securities. Until recently they were concerned primarily with the amount and the terms of particular offers in relation to the current absorptive capacity of the market and the current schedule of interest rates. Now, with the growing demand for funds and the economy facing heavy inflationary pressures, Bank of Italy officials have indicated that the relative priority of specific projects would be examined and low priority projects postponed. The special credit institutes—the main source of medium- and long-term funds for medium-size enterprises—are rapidly expanding their operations which are financed largely through long-term bond issues. The public sector also will need large amounts of long-term funds to finance the public investment plans already adopted plus those which will grow out of further evolution of the economy.

In recent years the Italian authorities appear to have taken a liberal attitude toward the flotation of foreign issues in Italy, but the high rates of interest and apparent lack of interest on the part of investors have, nevertheless, discouraged foreign borrowers from floating issues in Italy.

Since the spring of 1963, individual Italian residents have been able to purchase and sell foreign securities issued or payable abroad and listed on foreign stock exchanges, although transactions must be made through the Bank of Italy or agent banks, and securities deposited with an agent bank. The deposit requirement appears primarily designed to prevent avoidance of the withholding tax on dividend income, but it may serve as a deterrent to foreign investment by Italians. Nonresidents are permitted to engage in transactions in Italian securities as long as they are conducted through an authorized bank.

Italy's position as a capital importing nation has also been changing in the last decade. In particular, the early inflows of foreign public capital (including until the mid-1950's economic aid) have tapered off while Italy's increasing acceptance of responsibilities for aid to less-developed countries has initiated a public capital outflow. The inflow of private direct and portfolio investment remains high but at the same time large Italian firms are expanding their own financial interests in Europe, Latin America, and Africa. The Italian authorities must approve applications of Italian firms to float issues in foreign markets, but the authorities appear to be prepared to grant approval in most cases, especially with domestic long-term capital in short supply and the balance of payments in deficit.

Progress toward solution of the present capital market problem seems to require action which will restore the confidence of savers and investors and expand and improve the efficiency of the market. The Government has been concentrating on the first problem as an essential part of its economic policies, as evidenced by repeated references to the need for monetary stability. It seeks to encourage savers to place more of their funds in long-term securities, rather than in bank deposits, and to get businessmen to proceed with investment plans which may have been delayed pending clarification of the political situation. In addition, the monetary authorities in 1962 took steps to expand and restructure the capital market by inducing greater interest rate differentials, among the short-, medium-, and long-term markets, by removing impediments to the free flow of funds among the markets, and by more closely linking the domestic market with foreign securities markets. The tools for overall monetary management were expanded and improved and specific measures to improve the capital market were taken, including liberalization of foreign portfolio investment by Italian residents, authorization of direct controls by the bank of Italy on the investment "mix" of the banks, institution of an auction system for ordinary Treasury bills, and limitations on the interest rates and maturities of savings deposits and security issues.

Italy's rapid economic development in the future would seem to depend in great part upon improving its ability to channel excess liquid assets and new savings into long-term investments. This would appear to require the avoidance of inflation, the restoration of public confidence in long-term investments and the development of an attractive variety of securities geared to the pattern of incomes.

SECTION II—THE PATTERN OF SAVINGS AND INVESTMENT

Italy's rapid economic growth since 1950 has been due in large measure to the high level of gross fixed investment throughout the period. In 1951, the proportion of GNP devoted to this purpose amounted to about 19 percent and during the succeeding 12 years the trend has been persistently upward. As shown in table I, yet another record was achieved in 1962, when gross fixed investment amounted to nearly one-fourth of GNP.

Table I also shows the relationship during this period between net new security issues and these two aggregates. The notable tendency for new issues to gain in importance as a source of investment finance during recent years has been ascribed in part to the reduced ability of private companies to satisfy their financial requirements from their own resources. In addition, new issues by the special credit institutes have shown a marked rise in line with the Treasury's increased reliance upon them.

TABLE I.—*Gross fixed investment and new security issues*

[Billions of lire]

	GNP current prices (1)	Gross fixed investment (2)	Percent of GNP (2÷1) (3)	Net new security issues (4)	Percent of investment (4÷2) (5)	Percent of GNP (4÷1) (6)
1951	9,853	1,860	18.9	247	13.3	2.5
1955	13,163	2,750	20.9	591	21.5	4.5
1959	17,477	3,786	21.7	944	24.9	5.4
1960	19,078	4,441	23.3	1,322	29.8	6.9
1961	21,083	5,099	24.4	1,301	25.5	6.2
1962	23,655	5,846	24.7	1,642	28.1	6.9

Sources: *Relazione Generale* 1962, vol. II, p. 361; Bank of Italy Annual Reports for 1961 and 1962.

New security issues (net) in the period 1959–62 have provided on the average 25 to 30 percent of the funds for gross fixed investment and fixed interest securities have represented about two-thirds of new securities issued in this period (tables II and III). The relative importance of the private and public sectors as issuers has, however, been changing as government issues have declined compared with issues by the special credit institutes and by business. This is largely the result of the Government's policy of relying increasingly on the special credit institutes for financing various expanding development programs, including railroad modernization, rural and urban low-cost housing, and agricultural purposes.

TABLE II.—*Main components of gross fixed investment*

[Billions of lire]

	1958	1959	1960	1961	1962
Agriculture	414	450	538	528	597
Industry	1,027	1,086	1,309	1,607	1,817
Transport and communications	477	561	747	884	1,005
Housing construction	998	1,069	1,101	1,236	1,528
Public works	337	380	449	486	478
Other	228	240	297	358	421
Total gross fixed investment	3,481	3,786	4,441	5,099	5,846

Sources: "*Relazione Generale sulla Situazione Economica del Paese*"; Bank of Italy, Annual Reports; *Istituto Centrale di Statistica*, "*Annuario Statistico Italiano.*"

TABLE III.—*New security issues net of redemptions*

[Billions of lire]

	1958	1959	1960	1961	1962
Shares	222	225	496	417	608
Bonds	423	719	826	884	1,034
Issued by:					
Government [1]	−16	343	162	147	62
Special credit institutions	215	263	412	514	718
Private enterprises	71	30	192	93	164
Government-owned enterprises (IRI & ENI)	153	83	60	115	60
Foreign	-------	-------	-------	15	30
Total	645	944	1,322	1,301	1,642
Subscribed by:					
Credit institutions	113	276	228	356	785
Private investors and companies	532	668	1,094	945	857

[1] Includes Railway, Green plan, and rural housing bonds.

Source: "Annual Reports," Bank of Italy.

Data furnished in the 1962 "Annual Report of the Bank of Italy", suggest that almost 85 percent of all outstanding securities (bonds and shares) are held by large private investors and companies. The remaining portion is held by the banks (including the Bank of Italy, commercial and savings banks, special credit institutes and the Central Post Office Savings Fund) and to a lesser extent by institutional investors (insurance companies and social insurance funds). Banks alone hold 38 percent of outstanding fixed interest securities and these investments represented about 15 percent of deposits at the end of 1962. Table IV shows the importance of the banks to the market for new bank issues.

TABLE IV.—*Net new security issues and subscribers for selected years*

[Annual issues in billions of lire]

	1950	1953	1955	1958	1959	1960	1961	1962
Subscribed by individuals and companies: [1]								
Public bonds [2]	78.7	124.7	172.3	−16.7	210.9	170.9	46.4	−34.0
Special credit institute bonds				152.5	172.9	225.1	347.1	273.5
IRI, ENI and other industrial bonds [3]	65.1	113.3	134.6	173.3	59.7	201.7	210.1	125.3
Stocks	53.0	136.6	144.2	222.3	225.0	495.7	416.8	608.2
Total	196.8	374.6	451.1	531.4	668.5	1,093.4	1,020.4	973.0
Subscribed by banks: [4]								
Public bonds [2]	116.5	96.0	115.1	.4	127.8	−8.6	88.9	96.0
Special credit institute bonds				62.5	89.9	187.0	166.9	444.7
IRI, ENI, and other industrial bonds [3]	22.8	45.0	24.9	50.4	58.0	49.2	25.2	128.4
Total	139.3	141.0	140.0	113.3	275.7	228.2	281.0	669.1
Total subscriptions:								
Public bonds [2]	195.2	220.7	287.4	−16.3	338.7	162.3	135.3	62.0
Special credit institute bonds	50.9	101.0	142.3	215.0	262.8	412.1	514.0	718.2
IRI, ENI, and other industrial bonds [3]	37.0	57.3	17.2	223.7	117.7	251.5	235.3	253.7
Stocks	53.0	136.6	144.2	222.3	225.0	495.7	416.8	608.2
Total	336.1	515.6	591.1	644.7	944.2	1,321.6	1,301.4	1,642.1
Percent subscribed by banks:								
Bonds	49.2	37.2	31.3	26.8	38.3	27.6	31.8	64.7
All securities	41.4	27.3	23.7	17.6	29.2	17.3	21.6	40.7

[1] Includes social security institutes, insurance companies.
[2] Includes railroad and agricultural bonds.
[3] Includes IBRD bonds, and provincial and communal bond issues.
[4] Bank of Italy, commercial and savings banks, central post office savings fund, and special credit institutes.

Source: "Annual Reports of the Bank of Italy" for 1963 and 1962, pp. 301 and 428, respectively.

BUSINESS SECTOR

The Italian business community normally obtains a high proportion of its investment funds through self-financing and borrowing direct from financial institutions (or persons) with relatively little dependence on the flotation of long-term securities (table V). Savings by enterprises through retained earnings and depreciation charged against existing plant and equipment are almost twice as large as the resources supplied through the issuance of bonds and shares plus loans from the special credit institutes and insurance companies. In the last 4 years, however, bond and share issues have been about 17 percent of total private investment. In recent years business savings plus some short-term bank credit have accounted for approximately two-thirds of private (including the publicly controlled industrial holding company, *Istituto Per La Ricostruzione Industriale* (IRI) and the national petroleum agency, *Ente Nazionale Idrocarburi* (ENI)) investment financing and about 50 percent of total investment, while Government budget transfers and total borrowings have provided about a quarter of investment resources.

TABLE V.—*Sources of investment finance*

[Billions of lire]

	1958	1959	1960	1961	1962
Private investment:					
Depreciation reserves	1, 128	1, 207	1, 340	1, 475	1, 637
Share and bond issues	446	338	748	637	832
Loans of special credit institutions [1]	266	291	476	600	833
Loans of insurance companies	114	106	93	53	78
Balancing item: Self-financing, direct investment by savers, and bank credit	671	857	797	1, 291	1, 298
Total private	2, 625	2, 799	3, 454	4, 056	4, 678
Public investment:					
Transfers of ordinary budget revenue	434	462	637	780	870
Loans	376	531	469	435	526
Central Government borrowing [2]	(161)	(268)	(171)	(5)	(63)
Postal savings	(141)	(199)	(211)	(272)	(371)
Borrowing of local authorities and autonomous agencies	(74)	(64)	(87)	(158)	(92)
Income of *Cassa per il Mezzogiorno* and *INA-Casa* [3]	141	143	186	123	42
Total public	951	1, 136	1, 292	1, 338	1, 438
Total public and private investment	3, 576	3, 935	4, 746	5, 394	6, 116

[1] Excluding short-term bank loans and funds supplied by the Treasury to banks and credit institutions.
[2] Including foreign borrowing of autonomous agencies and loans received from the special credit institutions.
[3] Excluding funds supplied by the Treasury to these institutions.

Source: Compiled from Bank of Italy annual reports.

The Italian businessman's past ability to find sufficient resources within his own firm to finance a large proportion of the new investment needed by the economy was dependent in substantial measure upon the existence of good profit margins and an ability to write off old investments at a relatively rapid rate. Wide profit margins have been associated with large-scale unemployment, union moderation in wage negotiations, and a strong international competitive position: Conditions have been changing in the past 2 years. Unemployment is now about 3 percent of the labor force. In 1962 and 1963, the unions negotiated wage and salary increases in excess of expected

TABLE VI.—*New security issues* [1]

[In billions of lire]

Types of security	1961							1962						
	Bank of Italy and Italian Exchange Office	Banks [2]	Special credit institutes	Central post office savings fund	Insurance companies and social insurance funds	Private investors and companies	Total	Bank of Italy and Italian Exchange Office	Banks [2]	Special credit institutes	Central post office savings fund	Insurance companies and social insurance funds	Private investors and companies	Total
Government securities:														
Government stock	2.5	7.6	0.5	−1.0	3.6	−21.1	−7.9	−47.4	28.7	−5.3	−43.2	−1.0	−40.3	−108.5
Bonds issued for Treasury account [3]	16.6	55.9	3.7	3.1	10.7	53.2	143.2	77.0	−9.1	−3.8	99.1	.2	7.1	170.5
Total	19.1	63.5	4.2	2.1	14.3	32.1	135.3	29.6	19.6	−9.1	55.9	−.8	−33.2	62.0
Bonds:														
Industrial credit institutes	3.0	78.4	−.6	15.4	16.1	171.6	283.9	2.3	248.7	1.2	31.2	81.0	73.0	437.4
Other special credit institutes	.3	63.2	7.2		34.6	124.8	230.1	−.1	118.8	19.3	23.3	30.0	89.5	280.8
IRI	−.1	10.0	.8	−.7	4.3	55.2	69.5		20.3	−2.9	−1.1	−3.1	−18.0	−4.8
ENI		11.2			4.3	30.4	45.9		54.7	1.0		−3.0	12.1	64.8
Business companies		−7.9	.1		1.7	99.5	93.4	.2	36.8	2.2		11.4	113.6	164.2
Local authorities						11.5	11.5						−.5	−.5
International credit institutions	2.1	9.5	.2			3.2	15.0	5.1	7.1	5.0			12.8	30.0
Total bonds	5.3	164.4	7.7	14.7	61.0	496.2	749.3	7.5	486.4	25.8	53.4	116.3	282.5	971.9
Shares							530.7							716.5
Less duplicated items							113.9							108.3
Total shares (net)						416.8	416.8						608.2	608.2
Total bonds and shares						913.0	1,166.1						890.7	1,508.1
Grand total	24.4	227.9	11.9	16.8	75.3	945.1	1,301.4	37.1	506.0	16.7	109.3	115.5	857.5	1,642.1

[1] Actual proceeds, net of redemption.
[2] Including banking associations.
[3] Railway, Green plan, and rural housing bonds.

Source: Bank of Italy "Annual Report" for 1962.

annual gains in industrial productivity and other costs have also risen rapidly in the past 20 months. While these additional costs may be recovered to the extent that selling prices can also be increased, this trend would have serious implications for the Italian external position. In these circumstances, Italian firms have drawn increasingly upon the supply of external resources.

FINANCIAL INTERMEDIARIES

The Bank of Italy's "Annual Report for 1962" observes that the stock exchange had a "trying year." Values were depressed by the slump in stock prices abroad, the uncertainties associated with the Government's economic policy, and the fact that the market had enjoyed an almost uninterrupted climb between July 1958 and the middle of 1961. When the electricity nationalization bill was finally enacted, its impact on the market had been discounted, but the withholding tax "continued to cast its shadow over stock prices well after it became law." In the light of these developments it is not surprising to note that total sales of new securities to private investors and companies fell by almost 10 percent in 1962. Sales of shares rose almost 50 percent i.e., from 417 billion lire in 1961 to 608 billion lire but sales of bonds and government securities fell from 528 billion lire to 249 billion lire. Although government issues were less attractive to private investors, sales of bonds issued by business companies increased from 100 billion lire to 114 billion lire. Total sales were up even more due to sharply increased purchases by the banks and the insurance companies (see table VI on p. 166).

Italian firms rely upon the special credit institutes for medium-term credit and the banks for short-term credit. A recent survey by the Bank of Italy covering 500 of the largest Italian companies showed that in 1962, the capital market provided 44 percent of external funds and the special credit institutes and banks contributed 23 percent and 33 percent respectively. Bank credits have been especially important in periods of rapid growth in the past and they may be of even greater importance in conditions of capital market strain when they can be used for longer-term purposes. These credits can usually be revolved until it becomes more convenient to arrange long-term bond issues.

GOVERNMENT SECTOR

Although the development of the capital market in the last 10 years has been notable, its importance in terms of the total volume of investment resources has been limited because of business' ability to finance from internal sources. Since the beginning of 1962 growth of the capital market has also been restrained by a tendency for Italian savings to be kept either in highly liquid forms or to be exported. This has been associated with the earlier noted uncertainty as to the capital market's future ability to finance both the indemnification payments to former owners of the nationalized electrical power industry and the relatively large-scale expenditures planned for private industrial expansion and public development programs.

In recent years the easy position of the Treasury has enabled it to limit its calls on the capital market and public issues have been small.

This situation was very different from the experience of the early fifties when these securities represented nearly half of the new issues on the capital market. Public investment (see table VII), exclusive of government-owned enterprises, has been declining as a percentage of total investment (from a peak of 29 percent in 1959 to 23 percent in 1962.) In absolute terms, however, it is rising rapidly and at present is being financed increasingly by banks rather than from public savings. The launching of more ambitious investment plans will no doubt again compel the public sector to make larger direct or indirect calls on the capital market.

TABLE VII.—*Gross private and public investment*

	1958	1959	1960	1961	1962
	Billion lire	*Billion lire*	*Billion lire*	*Billion lire*	*Billion lire*
Private investment:					
Private sector	2,293	2,474	3,057	3,545	3,992
Government-owned enterprises [1]	332	325	397	511	686
Total private	2,625	2,799	3,454	4,056	4,678
Public investment:					
Central government	422	455	513	574	654
Local authorities and autonomous agencies	267	302	366	403	421
Cassa per il Mezzogiorno	127	178	231	229	218
Other public investment [2]	135	201	182	132	145
Total public	951	1,136	1,292	1,338	1,438
Total investment	3,576	3,935	4,746	5,394	6,116
	Percent	*Percent*	*Percent*	*Percent*	*Percent*
Private	73	71	73	75	77
Public	27	29	27	25	23
Total	100	100	100	100	100

[1] Mainly the *Istituto per la Ricostruzione Industriale* (IRI) and the *Ente Nazionale Idrocarburi* (ENI). Includes self-financed investment as well as investment financed by resources from the capital market. Increase in Government participation in IRI is included in central government.

[2] Mainly homebuilding by the public housing agency and with loans from the *Cassa Depositi e Prestiti*.

Sources: Bank of Italy, annual report: "La Relazione Programmatica del Ministero per le Partecipazioni Statali," and *Istituto Centrale di Statistica*, "Annuario Statistico Italiano."

SECTION III—THE DEMAND FOR CAPITAL

BUSINESS

The proportion of Italian GNP devoted to gross fixed investment has exceeded 20 percent since 1954, and in the past 3 years, the average has increased to approximately 25 percent. Although there is no current indication that this rate is likely to change, there are signs of a change in the direction of investment. As unemployment has been reduced and income to wage earners has risen, investment in industries which supply the Italian consumer with food, automobiles, gasoline, apartments, and household appliances has increased considerably. Industry's recourse to the securities market and special credit institutions for investment funds during 1960–62 has been heavier in the fields of building construction (up 128 percent), food products (up 368 percent), oil and gas (up 130 percent), and metallurgy (up 92 percent), than the average for all industries (up 47 percent).

GOVERNMENT

The main factor affecting the prospective level of demand upon the bond market is the need to compensate shareholders of the nationalized electrical power industry. It has been estimated that this obligation may add between 300 and 350 billion lire annually to the government's financing requirement over the next 10 years. The demand for cash resources will be lessened, however, to the extent that equity holders are willing to accept bonds issued by the nationalized utility company in exchange for their shares. Most of this compensation will be available for reinvestment in other sectors by the former owners, but the magnitude of these and other funds required by the government is relatively large considering the size and present adsorptive capacity of the Italian bond market. In 1962, total (government and private) bond issues floated on this market amounted to 1,034 billion lire which compares with 884 billion lire raised in 1961.

Public investment demands were also heavy during the 4 years ending in 1962, with total investment expenditures by the government increasing from 1,136 to 1,438 billion lire (see table VII). This increase was possible primarily as a result of a gradually increasing surplus (462 billion to 870 billion lire) of current revenue over current expenditure during the period, but the various forms of public borrowing were an important element in satisfying total requirements (ranging between 435 and 531 billion lire).

The expected big demand by government for investment funds introduces uncertainty as to the future ability of the market to absorb both public and private capital issues. The recent high liquidity preference of savers and a record-high ratio of short-term credit to deposits (81 percent in the three "banks of national interest" at the end of 1962, and 80 percent in all banks on October 30, 1963), limits the present ability of the banks to provide financing by the purchase of new security issues. Capital demands associated with the power industry (compensation payments and future investments), the government's commitments to agricultural development and to the south, railway modernization, school construction, housing and other long-term plans, are likely to receive priority over private issues since authorization by the government's Inter-Ministerial Credit Committee is required. The capital market's current thinness and the importance of obtaining committee authorization are implicit in the two recent arrangements to obtain foreign financing for public projects, i.e., a \$20 million municipal 15-year bond offering in the United States by the city of Milan and another \$15 million in Eurodollars arranged in London to finance superhighways for a subsidiary of IRI, the government's industrial holding company. While IRI was able to raise about 70 billion lire through bond sales in 1961, its redemptions exceeded new sales by 5 billion lire last year. In marked contrast the special credit institutes were able to obtain 718 billion lire in new funds in 1962, or almost 40 percent more money than they raised in 1961.

SECTION IV—THE SUPPLY OF CAPITAL

BUSINESS

From the end of the war until 1961, Italian industry probably financed more than two-thirds of its fixed investment from internal sources, but there appears to have been a marked change beginning in 1962. Since that time industry has relied more heavily on outside funds and at the same time investor preference for liquidity has grown. A survey made by the Bank of Italy on sources of industrial financing which embraced 500 firms, private firms with sales estimated to be in excess of 1½ billion lire annually and all publicly controlled companies, showed that financial resources obtained from banks, special credit institutes and the capital market increased from 779 billion lire in 1961 to 1,329 billion lire in 1962. Bank indebtedness increased by 151 billion in 1961 and 440 billion lire in 1962 (about two-thirds of the rise was attributable to the electrical and chemical sectors); indebtedness to special credit institutes increased in the 2 years by 152 to 308 billion lire respectively; the balance of 581 billion was obtained from the securities market and compared with 476 billion lire obtained in 1961.

Data for total private investment show that financing by bond and share issues rose from 338 billion lire in 1959 to 832 billion lire in 1962 (table V); while funds provided by the special credit institutes increased from 291 billion to 833 billion lire. These increases were relatively much faster than the rate of increase in "self-financing" funds. While this category increased from 857 billion to 1,298 billion lire over the 4-year period there was no growth in the last 2 years.

CREDIT INTERMEDIARIES

All sources of new investment capital (medium and long term) furnished a total of 2,356 billion lire in 1962, more than quadrupling the amount of new funds furnished in 1953. (See table VIII.) By far the greatest increase (relatively and absolutely) occurred in new funds supplied by the special credit institutes. The supply of funds derived from new share and bond issues also showed good growth while the increase in resources supplied by the Central Post Office Savings Fund, Treasury, Bank of Italy, and insurance companies was relatively modest. The amount of new short-term bank credit extended increased from 462 billion lire in 1953 to 2,031 billion in 1962. Evidence of the shift in 1962 in the relative importance of short term compared to medium- and long-term sources of supply of capital is furnished by the sharp rise in the amount of new short-term credits extended by the banks. While short-term bank credits increased by 1,468 billion lire in 1961 they rose by 2,031 billion in 1962.

TABLE VIII.—*Total new investments through the credit system and capital market* [1]

[Billions of lire]

Year	Medium- and long-term—				Short-term
	Special credit institutes	Postal savings fund and other institutions	Stocks and bonds [2]	Total	Banks
1953	167.8	148.9	193.9	510.6	461.5
1956	230.8	187.2	244.2	662.2	620.6
1959	372.8	292.2	342.7	1,007.7	760.0
1960	578.9	359.3	747.2	1,685.4	1,335.1
1961	729.3	420.1	637.1	1,786.5	1,467.5
1962	1,040.2	483.6	831.9	2,355.7	2,031.2

[1] Excluding crop-financing bills which increased by 135,000,000,000 lire in 1962.
[2] Issued by business companies, including IRI and ENI.

Source: Bank of Italy "Annual Report" for 1962.

Additional estimates are supplied in table IX which tend to confirm these relationships. In 1962, new medium- and long-term funds in an amount of 2,271 billion lire were supplied to the private sector (E plus F, table IX), and only 32 billion to the public sector. Special credit institutes and banks were the major source of new capital and they provided respectively, 830 billion lire for loans and 527 billion lire for securities. (Note, however, that the special credit institutes took 765 billion out of the market with their own issues.) Although private individuals and companies' investments in securities provided more new funds (1,033 billion lire) than any other source in 1962, the increase amounted to less than 51 billion over 1961.

TABLE IX.—*Formation and use of monetary and financial resources*

[In billions of lire]

	End of 1962 position	Annual changes			
		1959	1960	1961	1962
Borrowing by public sector from or through—					
Short-term credit:					
Bank of Italy and Italian Exchange Office	299.6	−412.0	39.9	223.3	34.9
Banks	2,690.3	437.3	−31.3	179.9	190.3
Private investors and companies	1,029.6	28.7	54.4	24.8	−84.6
Total A	4,019.5	54.0	63.0	−18.6	140.6
Government securities:					
Banks	750.1	108.4	−15.3	63.3	19.6
Postal Savings Fund	152.5	4.6	1.1	2.5	55.9
Private investors and companies	1,620.0	215.7	170.4	50.4	−43.1
Total B	2,522.6	328.7	156.2	116.2	32.4
Total, public sector C	6,542.1	382.7	219.2	97.6	173.0

TABLE IX.—*Formation and use of monetary and financial resources.*—Continued

[In billions of lire]

	End of 1962 position	Annual changes			
		1959	1960	1961	1962
Borrowing by private sector from or through—					
Short-term credit:					
Bank of Italy and Italian Exchange Office	473.5	17.8	22.9	240.4	150.7
Banks	9,244.6	660.8	1,168.5	1,150.9	1,684.0
Total D	9,718.1	678.6	1,191.4	1,391.3	1,834.7
Loans and mortgages:					
Banks	1,009.4	86.8	98.5	128.4	165.1
Postal Savings Fund	1,833.0	160.1	212.7	252.7	286.7
Special credit institutes	3,723.5	340.1	474.6	614.2	829.8
Insurance companies and social security funds	1,173.2	103.4	111.9	112.0	141.3
Total E	7,739.1	690.4	897.7	1,107.3	1,422.9
Securities:					
Banks	1,681.9	187.1	253.0	209.5	526.9
Postal Savings Fund	137.2	11.9	17.0	14.7	53.4
Private investors and companies	17,798.0	452.8	922.7	982.0	1,032.8
Less issues by special credit institutes	3,336.7	279.1	430.5	537.4	765.1
Total F	16,280.4	372.7	762.2	668.8	848.0
Total domestic market G	33,737.6	1,741.7	2,851.3	3,167.4	4,105.6
Net foreign position:					
Bank of Italy and Italian Exchange Office	2,893.1	563.2	101.0	387.4	308.0
Other banks	377.9	−29.6	167.7	−24.8	−269.0
Total foreign sector II	2,515.2	533.6	268.6	362.6	39.0
Total credit, loans, mortgages, and securities	42,794.9	2,658.0	3,339.1	3,627.6	4,317.6
Asset forms by degree of liquidity:					
Primary liquidity:					
Notes and coins	3,134.5	183.9	196.8	360.0	389.9
Current accounts	6,969.4	610.6	685.7	795.4	1,179.1
Total I	10,103.9	794.5	882.5	1,155.4	1,569.0
Secondary liquidity:					
Postal savings books and savings deposits	7,993.0	(1)	732.8	995.3	1,231.3
Other	226.3	(1)	23.3	31.3	−88.7
Total II	8,219.3	729.4	756.1	1,026.6	1,142.6
Other assets:					
Bank of Italy and Exchange Office	574.3	382.3	−20.9	49.8	116.6
Banks	710.6		271.2	−16.5	71.8
Postal Savings Fund	2,208.8	176.6	201.1	191.1	221.9
Special credit institutes	386.8	61.0	44.1	76.8	64.7
Insurance companies and social insurance funds	1,173.2	103.4	111.9	112.0	141.3
Less excess availabilities over credits	(1)	257.7	(1)	(1)	(1)
Total III	5,053.7	465.6	607.4	413.2	616.3
Securities:					
Government securities	1,620.0	215.7	170.4	50.4	−43.1
Bond issues by special credit institutes	2,119.0	172.9	225.0	353.8	294.0
Bond issues by industrial firms, IRI, ENI	1,279.0	54.9	202.0	211.4	130.6
Shares	14,400.0	225.0	495.7	416.8	608.2
Total IV	19,418.0	668.5	1,093.1	1,032.4	989.7
Total monetary and financial availabilities V	42,794.9	2,658.0	3,339.1	3,627.6	4,317.6

[1] Not available.

Source: Bank of Italy "Annual Report" for 1961 and 1962.

The necessity for the banking system to take up about 40 percent of all security issues in 1962 versus one-fifth in 1960 and 1961 reflects the pressure on the capital market during the year. The banks were able to meet the added demand upon them only at the price of record-breaking loan deposit ratios. This occurred despite the fact that savings and current deposits were growing at a faster rate than in 1961 (19 percent versus 17 percent).

As shown in table VI, in 1962 total security issues (net) of 1,642 billion lire were subscribed in almost equal parts by private investors (including companies) and by banks and other institutional investors. In contrast, in previous years, almost three-fourths of all issues were subscribed by private investors. Capital market difficulties in 1962 can be ascribed to a deterioration in investor expectations induced by political developments at a time when the demand for investment finance was rising rapidly. In sum, the general condition of the capital market at the end of 1962 and reduced private investor interest in securities were causing borrowers to place increasing reliance on the money market. This situation was substantially unchanged in 1963.

INDIVIDUALS

The reluctance of savers to invest their funds directly in the capital market is apparent in data for savings and current account deposits. Between December 1961 and December 1962, there was an 18-percent increase in savings deposits and a 20-percent increase in current account deposits. Although the average annual increases in savings and current account deposits in the 10 years ending in 1962 were 18 percent and 13½ percent, the much sharper increase in current accounts in 1962 suggests there was an even greater preference for holding funds in liquid forms. (Part of the recent higher rate of increase in current accounts appears also to reflect the growth in bank credit.) Aside from the question of liquidity preference, however, the prospect for a steady increase in the supply of funds to the capital market obtained direct from the small investor is dimmed by tradition, the absence of reliable company data, and his lack of knowledge about how the securities market functions; for example, the cost of investing in even a few shares of blue-chip stock. Recently an effort to promote sales of small lots of corporate shares to individual investors was launched. Although it is still too early to predict success, sales have reached almost 2.5 billion lire in less than 8 months.

This innovation is sponsored jointly by a consumer magazine and a Milan bank. Small investors have been encouraged to pool their orders and effect purchases through the bank which charges a smaller fee than would be possible if the purchase was made directly through an odd lot broker.

The magazine is now promoting an investment trust law which it has drafted in an effort to provide a basis for mutual fund operations in Italy.

SECTION V—INSTITUTIONAL STRUCTURE

THE BANKING SYSTEM

The present institutional structure of Italy's banking system is based on the Banking Law of 1936. The major features of the system are: (1) acceptance of the principle that the collection of savings in any form from the public, and all credit activities are functions in the public interest; (2) an Inter-Ministerial Credit and Savings Committee which is vested with policymaking and executive authority (technical and supervisory powers are exercised largely by the Bank of Italy); and (3) the separation of ordinary or short-term commercial bank credit from medium- and long-term credit which is the responsibility of the special credit institutes.

The wide powers possessed by the Inter-Ministerial Credit Committee are exercised either directly or through the Bank of Italy or the Treasury Ministry. They include control over the establishment, liquidation, and merger of financial institutions and their territorial and functional limits, opening of new branches and the closing of banks, approval of most new security issues and their terms, approval of increases in capitalization of banks and businesses, changes in bank reserve ratios, regulation of circulating cashiers' checks, and annual review of the terms of the interbank agreement.

The ordinary, or commercial banks, and with some exceptions the savings banks, are limited to collecting current savings and extending normal commercial credit, e.g., discounting commercial paper, advances, and overdrafts. At the end of 1962 this group included a total of 1,258 banks (with 9,838 branches) including 6 public-law banks, 3 banks of national interest, 156 banks organized as joint stock companies or limited partnerships, 213 popular cooperative banks, 79 savings banks, and 801 smaller institutions which operate only on the local level. The six public-law banks and the three banks of national interest are the largest credit institutions in Italy, with nationwide organizations. Total deposits of the six largest banks (the three banks of national interest plus the three largest public-law banks) represented 35 percent of total commercial deposits at the end of 1962.

In addition to official monetary controls, the activities of the commercial banks are also regulated by an interbank agreement which, among other things, fixes within certain limits the spread of interest rates for both deposits and loans.

The special credit institutes which extend medium- and long-term credit are, for the most part, public law entities, special sections of the six public-law banks, or savings banks authorized to engage in special types of credit activity. The individual institutes serve particular sectors of the economy, e.g., credit for industry, public works and public utilities, real estate and housing, agriculture, hotels, tourism, motion pictures, etc. Some of these institutions operate on a national scale, while others are limited to individual regions; some extend both medium- and long-term credit while others specialize in medium-term transactions.

THE SECURITIES MARKET

There are 10 stock exchanges in Italy, all of which have been established by government decree and are subject to legal provisions which fix their duties and regulate their functions. By far the most important exchange is located in Milan, with smaller exchanges operating in Bologna, Florence, Genoa, Naples, Palermo, Rome, Turin, Trieste, and Venice. Public and private securities as well as foreign currencies are traded at the stock exchanges. Only two foreign securities are presently listed on the exchanges and these are bond issues by international institutions. Official negotiations are carried out by public bidding from special posts reserved to stockbrokers and banks authorized to attend as observers. Outside these posts nonofficial negotiations take place, carried out by dealers who are not admitted to bidding (including the banks).

All Italian stocks, with certain exceptions for some stocks issued in Sicily, Sardinia, and Trentino Alto-Adige, are registered. (For fiscal purposes, registered shares are considered to belong to the person whose name appears on the security.) Bond issues take either bearer or registered form. Securities of the national debt, securities guaranteed by the state, real estate securities and securities issued by provinces and municipalities are admitted by law to quotation on the stock exchanges.

The chambers of commerce of the cities where stock exchanges are located may also admit for quotation securities of legally constituted joint stock companies, at the request of the issuing company.

Stamp taxes on security transactions vary depending upon whether payment and transfer of title is immediate or delayed and whether the transaction takes place directly between the parties or through banks or stockbrokers. The taxes range from 10 to 300 lire per 100,000 lire (see table X) and would not appear to constitute a significant obstacle to trading.

Fixed-interest securities are negotiated in amounts of nominal capital and their quotations are expressed as a percentage. Quotations of consolidated redeemable government bonds include the interest accrued from the date of payment of the last semiannual coupon, while quotation of multiyear Treasury bonds and other bonds do not include accrued interest. The quoted price of shares on which dividends are regularly paid includes the prorated accrued dividend. Shares are quoted ex-dividend from the day when the issuing company begins payment of the dividend, and ex-rights (options, bonus allotments, etc.) from the day fixed and published by the managing committee of stockbrokers.

There is no withholding of taxes on income from fixed-interest securities except in rare cases where the tax on interest income must, by contract, be charged to the beneficiary. However, since the passage of law 1745 of December 29, 1962, a 15-percent withholding tax at the source is applicable to dividend income from both Italian and foreign stockholdings.[2] The tax is applicable to cash dividends,

[2] Some exceptions are made for dividends paid by cooperative companies and popular cooperative banks. Also, the applicable rate is reduced to 8 percent and no annual report of stock ownership is required for some shares issued under laws applying to the regions (at present, Sicily, Sardinia, Valle d'Aosta, and Trentino Alto-Adige).

stock dividends, and to increases in the nominal value of the stock (where no payment has been made) except where these are effected with funds originating from monetary revaluation or from previous premium payments (*sovraprezzi*) on increases in capitalization. The tax on Italian stocks is withheld by the paying company. The tax on foreign dividend income is withheld by the Italian banks with whom the securities must be deposited. The withholding tax on dividend payments to foreign stockholders, or Italian nationals living abroad is considered to be: (1) an advance payment on the supplementary income tax (for individuals) or the corporation tax (for firms) if the stockholders are subject to either of these taxes; or (2) a tax, without right to reimbursement if the stockholder is not otherwise subject to tax. The latter provision, however, is subordinate to any international agreements (such as the United States-Italy double taxation agreement of March 30, 1955). The withholding tax also requires that corporations file an annual report of stock ownership with the tax authorities.

TABLE X.—*Stock exchange tax on sales and transfer of securities, law decree No. 589, June 30, 1960*

[In lire]

Type of transaction	Type of contract (for every 100,000 lire or fraction thereof)						
	Cash contract	Time payment contracts amortization, up to—			Delayed transfer contracts amortization, up to—		
		45 days	90 days	135 days	45 days	90 days	135 days
(a) Between contractors directly	80	100	200	300	75	150	225
(b) Between bankers and private persons	60	90	180	270	60	120	180
(c) Between stockbrokers	10	10	20	30	10	20	30
(d) Through stockbrokers or of banks authorized as per Royal Law Decree No. 1607, Dec. 20, 1932	50	75	150	225	40	80	120

NOTE.—Tax is reduced by the half in the case of cash contracts between contractors under (a), (b), and (d) for the sale and transfer of Government and Government-guaranteed securities.

Source: Decree Law No. 589, June 30, 1960.

MONETARY TOOLS FOR INFLUENCING SAVINGS AND INVESTMENT

Italian monetary authorities are able to influence savings and investment decisions through a system of extensive direct and indirect monetary and fiscal controls.

Direct controls

In the first category are the powers of the Inter-Ministerial Credit Committee exercised through the Bank of Italy in such important fields as (1) the determination of interest rates on interbank deposits; (2) limitations on the acceptance of medium-term savings and the rate of interest payable on them by savings institutions; (3) supervision of the interbank agreement which sets limits on short-term interest rates; and (4) direct control over the composition of the banks' investment portfolio. (The fact that the Bank of Italy is so well provided with powers to intervene directly in these matters has made its more frequent use of moral suasion more effective.)

A large part of Italian industry is publicly owned or controlled through the industrial holding company, *Istituto per la Ricostruzione Industriale* (IRI), the national petroleum agency, *Ente Nazionale di Idrocarburi* (ENI), and the new electric utility monopoly, *Ente Nazionale di Energia Elettrica* (ENEL). In the financial field, a large part of the banking system, including some commercial banks, savings banks, the postal savings system and some medium- and long-term lending institutes are publicly owned institutions. These industrial corporations and the medium- and long-term special credit institutes represent a very important source of demand for funds from the capital market, while the commercial banks, savings banks and postal savings system are an important source of supply of funds to the market. While most of these organizations have a considerable degree of operational autonomy, the Government and the monetary authorities may, to some extent, influence their savings and investment decisions.

Indirect controls

The three types of monetary controls commonly used in the United States are of relatively less significance in Italy. Rediscounting by the Bank of Italy has not been extensively used, in part because of taxes imposed on such transactions although advances by the Bank of Italy are of considerable importance. Variations in the banks' required reserve ratio have been infrequent, although changes have been made in computation of the base upon which reserve requirements are determined and in the cash/security "mix" of reserve deposits as well as in the overall reserve percentage. Until recently, open market operations were virtually nonexistent due to the "tap" method of issue of ordinary Treasury bills (BOT's). However, the authorities hope to be able to employ open market operations in the future as a result of the introduction in November 1962 of an auction system of issuing BOT's. Two additional important means of control over bank liquidity have been the variations in the banks' authority to engage in net foreign borrowing, and the use of lire/foreign exchange swaps between the banks and the Bank of Italy's Exchange Office (supplemented on occasion by direct temporary deposits of foreign exchange with the banks by the Exchange Office).

Apart from large scale investment of public funds and the presence of a comprehensive system of incentives (including tax incentives), designed to stimulate both domestic and foreign direct investment in Italy's less-developed areas, fiscal policy tools have not been widely employed as a means of indirectly influencing savings and investment decisions. However, some public bonds issued to finance high-priority development programs and some foreign bond issues have received limited tax exemptions and public debt management has been relied on recently to facilitate the placement of bonds for financing the agricultural development program.

Recent efforts to channel savings into medium- and long-term investment

The combination of short-term difficulties in the capital market and long-term structural inadequacies which emerged in 1962 stimulated the adoption of a number of measures designed to establish a system of interest rate incentives for channeling savings into medium- and long-term investments and to provide adequate bank liquidity.

However, inflationary pressures and appearance of a large balance-of-payments deficit in 1963 caused the adoption of a more restrictive monetary policy, especially in the latter half of the year. Immediate factors underlying recent difficulties in the security markets were a weakening in investor confidence due to political and economic developments in Italy, particularly the nationalization of the electric utility industry, the passage of a 15-percent dividend withholding tax, and repercussions from the sharp drop in the New York and other security exchanges. The chief longer term factors are the reduced ability of industry to finance new investment from retained earnings due to increasing labor costs at the same time that expanding investment programs in the public sector are also increasing the demand for investment capital. The situation has been further complicated by inadequate interest rate differentials among the short-, medium-, and long-term markets, caused, in part, by the bidding up of short-term rates on interbank deposits by the competing banks in violation of the interbank agreement. By placing limits on short- and medium-term rates the authorities hope to entice surplus funds from savings deposits back into the long-term stock and bond markets.

Specific steps taken in 1962 and in 1963 to reduce the short-term rates included the following: (1) The tying of the maximum rate payable on interbank deposits to the current rate on ordinary Treasury bills (BOT's) and the authority given to the Bank of Italy to require that part or all of these deposits be held with the bank; (2) the limitation on the issuance of BOT's and open market operations under the new system in accordance with market developments; and (3) the requirement that 10 percent of the 22.5 percent required reserve deposits be held in the form of cash (rather than in cash or BOT's at the option of the banks) and the granting of authority to the Bank of Italy to vary this ratio.

Measures affecting medium-term savings include (1) the prohibition on commercial banks' accepting medium-term (18 to 60 months) deposits, (2) the tying of the amount of medium-term savings accepted by savings institutions to their level of medium- and long-term investments, and (3) the requirement that the savings institutions and the special credit institutes must obtain prior approval by the Bank of Italy before making new medium-term security issues and the establishment of a range of maximum interest rates payable on medium-term savings of different maturities with a ceiling of 5 percent for the longest maturity.

Measures taken to raise long-term interest rates and stimulate demand for such securities are (1) the adoption by the Inter-Ministerial Committee of a series of policy guidelines for consideration of applications for new long-term issues which included the establishment of a maximum maturity of 18 years, a maximum grace period of 3 years, and a maximum coupon interest rate of 5.50 percent; and (2) the approval of the use of certain long-term securities (multiyear Treasury bonds, certain other securities issued or guaranteed by the state and bonds of institutes authorized to grant mortgage credit) as reserves against circulating cashier's checks (in lieu of the short-term BOT's previously used for this purpose).

In addition to the steps aimed specifically at affecting interest rates, the monetary authorities have also taken some temporary measures to expand bank liquidity and overcome recent difficulties in the capital market by making it possible for the banks to provide medium- and long-term loans and to purchase new security issues. These steps are designed to ease the strain in the capital market until adverse short-term influences have been overcome and longer term structural reforms have taken effect. They include (1) a reduction in January 1962 in the bank reserve ratio from 25 percent to 22.5 percent, (2) the redemption of $307 million in 9-year Treasury bonds which matured in January 1963, (3) the suspension in November 1962 of a previous requirement that banks maintain a net zero position in foreign exchange lending and borrowing operations, and (4) the inclusion of foreign accounts, but the exclusion of interbank deposits in the computation of required reserves (resulting in a net reduction in required reserves).

LICENSING AND CONTROL

Approval and listing of new issues

Italian monetary authorities are well equipped with authority, not only to control the emission of new securities and their terms, but also to influence the subsequent demand for and supply of securities.

Prior authorization is required for all issues of shares and for bond issues whose total amount exceeds 500 million lire. This applies both to issues by residents and by nonresidents. Apart from the government, only joint stock companies are permitted to make public issues of bonds. Authorization is normally granted by the Ministry of Treasury in consultation with the Inter-Ministerial Committee of Credit and Savings, except where the issuer is subject to banking legislation, in which case the approval of both is required. Authorization by the Inter-Ministerial Credit Committee is required if shares or bonds are to be placed through a banking intermediary or are to be quoted on a security exchange. In such cases the amount of the bond issue or the nominal increase in capital stock must be at least 1 billion lire.

Controls on terms of issues

Control by the monetary authorities over the terms of issue of new medium- and long-term securities is part of a general system of control over interest rates and maturities. For short-term deposits the limits on interest rates paid and charged by the banks are embodied in an interbank agreement which is revised annually and reviewed by the Bank of Italy. Under Italy's banking regulations commercial banks may not operate in the medium- and long-term fields. Interest rates paid on medium-term savings deposits and certificates by the special credit (medium and long term) institutes are set by the Bank of Italy under authority granted to it by the Inter-Ministerial Credit Committee. For long-term stock and bond issues which require authorization by the Treasury or the Inter-Ministerial Credit Committee, the specific interest rates and maturities must also be approved, as must any other conditions or special features of the proposed issue. (See table XI.)

TABLE XI.—*Interest rate schedule in Italy*

	Percent
I. Short-term rates:	
Between Bank of Italy and the banks:	
Paid by Bank of Italy for:	
Required reserve deposits	3.75
Deposits in excess of required reserves:	
8 day	1.50
15 day	2.00
90 day	2.50
180 day	2.75
Current accounts	.50
Charged by Bank of Italy for:	
Rediscount operations	3.50
Advances (on the security of public debt certificates, Treasury bonds and Government-guaranteed securities)	3.50
Among banks: Interbank deposits (no higher than current rate on ordinary Treasury bills) (approximate)	[1] 3.50
Between savings institutions, banks, postal saving system and the public: [2]	
Paid by banks for:	
Sight deposits:	
Average annual balance not over 5,000,000 lire	.50
Over 5,000,000 lire (also applicable to 1st 5,000,000)	2.00
Time deposits (for balances exceeding 100,000,000 lire add 0.50 percent to applicable rate):	
3 to 6 months	2.25
6 to 12 months	3.00
12 to 18 months	3.75
Savings accounts and certificates:	
Free deposits [3] (sight deposits in unlimited amounts)	.50
Savings books [4]	1.25
Small savings books [5] (maximum 1,000,000 lire)	1.50
Tied savings books and certificates:	
3 to 6 months	2.25
6 to 12 months	3.00
12 to 18 months	3.75
Charged by banks for:	
Overdrafts: [6]	
Unsecured	7–7.50
Secured and miscellaneous	5.50–6.75
Discounts:	
Commercial bills (up to 4 months)	5.00
Finance bills	5.50–5.75
Advances:	
Secured by Government securities	4.25
Secured by non-Government securities	5.50–6.50
II. Medium-term rates: Between financial institutions (banks and special credit institutes) and the public:	
Paid by banks for: savings time deposits, certificates, etc.:	
18 to 24 months	4.00
24 to 36 months	4.25
36 to 42 months	4.50
42 to 48 months	4.75
48 to 60 months	5.00
Charged by banks for: loans (believed to average about 1¼ percent above costs of funds obtained from deposits and bond issues)	([7])

See footnotes at end of table.

TABLE XI.—*Interest rate schedule in Italy*.—Continued

	Percent
III. Long-term rates: Between financial institutions (banks and special credit institutes) and the public:	
Paid by banks on bond issues: Maximum nominal rate	5.50
Charged by banks for loans (believed to average about 1¼ percent above costs of funds obtained from deposits and bond issues)	(7)

[1] Corresponding to 3.6 percent postpaid rate.
[2] Effective from Jan. 1, 1963.
[3] Current account deposit books with right to withdraw funds by check.
[4] Withdrawals are limited to: 100,000 lire at sight; 200,000 lire after 1 day's notice; 500,000 lire after 3 days' notice; over 500,000 lire after 10 days' notice.
[5] Withdrawals are limited to: 50,000 lire at sight and over 50,000 lire after 10 days' notice.
[6] 7 percent plus commission of ⅛ percent per quarter on maximum overdraft outstanding.
[7] Not available.

Source: Derived primarily from Bank of Italy sources.

Method of issue

Prior approval.—An issue must have prior approval from the Ministry of the Treasury, the Inter-Ministerial Credit Committee, or both, depending upon the size of the issue, whether or not the issuer is subject to banking legislation, whether the issue is to be made through a banking intermediary or is to be publicly quoted on an exchange. A stock exchange application must be accompanied by certified copies of the articles of incorporation, the balance sheets and profit and loss statements for the last 2 financial years, the report of the board of directors and of the auditors, a void facsimile of the securities, and a detailed report containing the financial history of the company or of the security. The chamber of commerce of the city in which the exchange is located is responsible for the investigation and approval of the application. The admission to official quotation may be revoked at any time by the competent authorities. The issuing companies may, in turn, withdraw the securities from quotation.

Cost of issue.—The major costs involved at the time of issue of new securities are: (1) bank commissions, believed to range from 1.5 to 4.5 percent; (2) the stamp tax on new issues, ranging from 10 lire on a security with a nominal value up to 5,000 lire to 1,200 lire on securities valued at over 750,000 lire; (3) annual stock exchange fees for quotations on the stock exchange; and (4) printing, publicity, and underwriting costs. Because of current depressed conditions in the security markets, new bond issues have been offered recently at a substantial discount. For example, most new issues during 1963 carried a coupon interest rate of 5.5 percent and offering prices ranged from 95 to 96.50, although more recent issues were offered at 95 or below in order to increase the attractiveness of new issues. In December an IRI issue was offered at 92.50. Tables XII and XIII show the stamp tax and listing fees.

TABLE XII.—*Stamp tax on the issuance of new securities*

[In lire]

Nominal value of each security:	
Up to 5,000	10
From 5,000 to 10,000	12
From 10,000 to 25,000	30
From 25,000 to 50,000	60
From 50,000 to 100,000	120
From 100,000 to 250,000	300
From 250,000 to 500,000	600
From 500,000 to 750,000	900
Over 750,000	1,200

NOTE.—The tax is applicable to both stocks and bonds issued by companies, local governments, and other entities.

Source: Decree Law No. 492, June 25, 1953.

TABLE XIII.—*Annual listing fees payable to the Rome Stock Exchange*

[In lire]

1. Fixed annual minimum fee	10,000
2. Variable fee payable on each million lire of nominal capital or fraction thereof:	
First 10 billion	50
Over 10 billion up to 15 billion	30
Over 15 billion up to 30 billion	25
Over 30 billion up to 50 billion	15
Over 50 billion	10

Source: "*24 ORE*" of Aug. 23, 1963, and Rome Stock Exchange.

Continuing costs to the security issuer include (1) the annual stock exchange fees referred to above; (2) the 0.5 percent annual tax on bonds in circulation on the basis of balance sheet valuations; and (3) any bank fees charged for redemption of the securities. The investor in securities may expect to incur costs as follows: (1) the stock exchange tax on sales and transfers of securities, ranging from 10 to 300 lire per 100,000 lire, depending upon the type of transaction; (2) the 15-percent withholding tax on dividends in cases where no refund is possible; and, of course, (3) the ordinary income tax (23 percent) and surcharges (3.45 percent) on dividend and interest income.

Method and pattern of sales.—New security issues, particularly those issued by the government or by very large government-owned or private companies, are widely available for subscription from ordinary commercial banks, popular cooperative banks, and savings banks. The four international issues placed in Italy in 1961 and 1962 were underwritted by small groups of banks drawn from the six banks of public law and the three banks of national interest, plus *Mediobanca,* a medium-term lending agency principally owned by the three banks of national interest. *Mediobanca,* along with *Efibanca* and *Centrobanca* are also prominent in the placement of other types of new issues.

The timing of new issues is primarily dependent upon current conditions in the market, although bond issues to finance certain long-term public development programs, such as the Green plan for agricultural development, cannot be readily postponed for any considerable length of time. The *Istituto Mobiliare Italiano* (IMI), which is the largest of the special credit institutes, typically places two or three public issues per year and also sells bonds on "tap" to other financial institutions. Such special factors as the termination on June 30, 1962, of tax reduction on new issues resulted in a concentration of new security sales in the first half of 1962.[3] Similarly, the placement of the latest tranche of Green plan bonds in January 1963 was timed to coincide with the redemption of a block of 9-year Treasury bonds, in order to facilitate the sale of the former. Overall supervision of the timing of new issues is in the hands of the Inter-Ministerial Credit Committee, which in effect approves the timing as well as the amount and terms of most new issues. The validity of the committee's approval is normally 4 months, although this may sometimes be extended to 6 months.

The Inter-Ministerial Credit and Savings Committee.—The Inter-Ministerial Credit and Savings Committee has been given legal authority to determine general policies regarding savings, credit, and foreign exchange. The Bank of Italy and the Ministry of the Treasury are largely responsible for policy implementation. Membership on the committee includes the Ministers of the Treasury (as chairman), Budget, Public Works, Commerce and Industry, Agriculture, Foreign Trade and State Holdings. The Governor of the Bank of Italy is also represented. Meetings of the committee are held as needed, on an approximately monthly basis.

The major factors considered in approving or rejecting an application are the amount, the interest rate and the maturity, measured against market conditions at the proposed time of issue. Qualitative considerations may become increasingly important as expanded public investment programs compete with private investment needs. This will be particularly true if the saving public continues to show reluctance to place its surplus funds in medium- and long-term securities.

Until the recent capital market difficulties required closer scrutiny of new security issues, the committee was chiefly concerned with the amount and interest rate in relation to the current absorptive capacity of the market and the current schedule of interest rates. As the potential growth in the volume of new issues became more evident, however, the authorities indicated that greater attention would have to be paid to the relative priority of the investments to be financed with the new issues and that some lower priority projects may have to be postponed.

In May 1963 the Bank of Italy published a list of guidelines which the committee is now generally following in its consideration of new security issues. The main points are (1) a minimum amount of 1 billion lire; (2) a maximum maturity for bond issues of 18 years; (3) a maximum grace period on bonds of 3 years; and (4) a maximum coupon rate of interest for long-term bonds of 5.5 percent. The offer price is to be determined by market conditions. The committee does not generally favor premiums, prizes, etc., but may make exceptions for bonds to finance particularly important public works projects (such as a recent *Autostrade* issue). The committee does not object to premium payments (*sovraprezzi*) on stock issues, but has shown some reserve regarding special features, such as the recent issue of *Finsider* convertible bonds.

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[3] A special 50-percent reduction in the category A (interest income) tax rate (from 23 to 11.5 percent) was granted on interest applicable to bonds and debentures issued by corporations and limited partnerships with shares, applicable to bonds issued between Dec. 15, 1959, and June 30, 1962.

The committee does not seem to be opposed to external issues by Italian borrowers (such as the recent *Fiat* preferred stock, and *Autostrade* and the city of Milan bond issues). In fact, insufficient demand for new issues in Italy may place increasing pressure on Italian firms to borrow in foreign markets and on the committee to approve such issues. The committee's attitude toward the sale of foreign issues in Italy has been liberal in recent years, aided by Italy's favorable balance-of-payments position until mid-1962. However, the prevailing high rates of interest and investor apathy have mitigated against any large or frequent foreign issues.

Terms of issue

The terms of new issues are closely circumscribed by the current criteria adopted by the Inter-Ministerial Committee (see above). In fact, most recent issues have borne nominal rates of interest of 5.50 percent except for multiyear Treasury bonds and some state-guaranteed bonds. Almost all outstanding bond issues bear nominal rates of 5 to 7 percent. (About 17 percent of outstanding issues bear interest at 5 percent, about 31 percent at 5½ percent, about 31 percent at 6 percent, about 8 percent at 6½ percent, and about 11 percent at 7 percent.) Except for 7- and 9-year Treasury bonds, the most common maturities are for 15 or 20 years, with relatively few issues maturing in the 25- to 35-year range. There is one issue of 1936 consolidated government bonds without a fixed maturity. An increasing number of bond issues will likely have 18-year maturities as a result of the present criteria adopted by the Inter-Ministerial Committee. As previously noted, all stocks except some issued in Sicily, Sardinia, and Trentino Alto-Adige are registered. However, trading in bearer certificates for a number of Italian issues is carried on in Switzerland. Almost all outstanding stocks are common stocks, although a few large firms, including *Snia Viscosa, Fiat, Olivetti,* and *Rinascenti* also have issued preferred stock. Most corporate bonds are bearer type, although government issues may be either registered or bearer bonds. The usual form of redemption involves periodic drawing by lot of a portion of the bonds outstanding in accordance with a fixed amortization schedule.

Special rights and incentives

The right to advance redemption or recall by the issuer is a regular feature of many bond issues. Special prizes awarded by lottery are also common. For example, a recent *Credito Industriale Sardo* issue offered gifts of credit cards up to a value of 250,000 lire for use on Alitalia domestic and international flights. *Autostrade* offered certificates for use on Italy's toll road system valued at 100,000 lire, and Lancia offered automobiles as prizes. A recent *Finsider* bond issue included an option permitting partial conversion of the bonds into shares of two of its subsidaries (*Italsider* and *Terni*) during the first 5 years after issue. While there have been a few precedents, *IRI Finelettrica* (electric power) and *IRI-STET* (national telephone company) for convertible bonds, they are not common. Adoption of this feature was apparently intended to overcome the reluctance of investors to purchase stocks while providing a hedge against continuation of recent inflationary pressures. The success of the *Finsider* convertible issue has encouraged a number of other large Italian firms to plan similar issues, e.g., Edison.

Special tax exemptions are provided for bonds issued by special credit institutes, whose fiscal treatment is defined by a particular law (law No. 1228 of July 27, 1962). For example, the central government tax on outstanding bonds, normally assessable at 0.5 percent on the balance sheet value of the bonds, is reduced to 0.125 percent in the case of special credit institutes. Complete tax exemption has been granted to issues of the IBRD, the Coal and Steel Community, and the European Investment Bank.

SECTION VI—INTERNATIONAL CAPITAL MOVEMENTS

GOVERNMENT REGULATIONS

Exports of capital

Italian issues abroad.—Approval for the issuance of both stocks and bonds abroad is required from the exchange office, following joint consideration of the application by the Ministries of Foreign Trade and Treasury. In the case of bonds, the authorization is designed to insure that foreign exchange will be available for interest and amortization payments and the ministries may impose conditions on the use of the loan. The securities may be denominated in lire or in foreign currency, but no exchange guarantee is given. In fact, foreign issues of Italian securities have been very rare, the only recent example being the simultaneous placement of Fiat preferred shares in Italy, the United Kingdom, France, and Germany in July 1963. Placement of Italian bonds have been more common, especially in the United States and Switzerland.

Purchase and sale of foreign securities by Italian residents.—Prior to a ministerial decree of March 8, 1963, individual Italian residents were not permitted to purchase foreign securities, except those issued by international financial institutions of which Italy is a member, plus those of the Inter-American Development Bank. However, a number of exceptions were made for certain financial and corporate entities in a limited field of operation.

The March 1963 liberalization further permits individual Italian residents to purchase and sell foreign securities (stocks, bonds, and mutual fund shares) issued or payable abroad and listed on foreign stock exchanges or by similar organizations (such as bank committees). Purchases and sales of securities must be made through the Bank of Italy or its agent banks which should assure that the exchange regulations of the foreign country in which the transaction is to take place permit the export of its securities, and the related transfers of capital and earnings. These transactions are to be made either in foreign exchange through a foreign exchange account (*conto valutario*) or in lire through a foreign account (*conto estero*). Foreign securities may also be traded among Italian residents through the agent banks with payment in lire.

Foreign securities purchased, whether or not quoted on an exchange, must be deposited in the name of the owner with an agent bank or with a foreign bank in the name of the agent bank. Italian bonds denominated in a foreign currency and acquired by juridical persons (under ministerial decree of December 10, 1959) as well as other foreign securities acquired previous to the March 1963 decree, must also be deposited with banks. Exempted from the deposit requirement are: (1) bonds having lost their value due to a monetary reform; (2) securities with only a nominal value, in aggregate no greater than 10,000 lire ($16) per owner; and (3) securities used as guarantee bonds for administrative purposes or by insurance companies to cover risks assumed abroad.

The deposit requirement is primarily designed to prevent avoidance of a new 15 percent withholding tax on dividend income which was enacted in December 1962. The tax applies to income from foreign as well as domestic securities and the banks are required to withhold the tax on the former.

Excluded from the liberalization is the purchase by individual Italians of securities not quoted on foreign exchanges, the purchase and sale of Italian bonds denominated in a foreign currency but payable in lire, and Italian stocks traded on foreign exchanges, even those for which bearer certificates are issued abroad. All transactions must be carried out through authorized banks under general license from the Exchange Office. General licenses are also given for: (1) the repurchase by juridical persons of their own bonds issued abroad; (2) advance repayment of their own bonds by Italian firms and by the two special credit institutes for public works (CCOP) and public utilities (ICIPU); and (3) the purchase by authorized banks of foreign short-term bonds.

Both the income from and the proceeds of liquidation of foreign security holdings must be repatriated. The funds must be credited to an account opened abroad through an Italian bank within 7 days and must be surrendered within 6 months, during which time the funds may be used for any authorized transaction under a general license.

Italian direct investments abroad.—Italian direct investment abroad in the form of purchases of stocks quoted on a stock exchange or similar organization may be made through Italian banks under general license. The stocks acquired must then be deposited with an Italian bank or with a foreign bank in the name of an Italian bank. Juridical persons may also effect direct foreign investments in enterprises in the same field of activity up to an amount not exceeding the paid-in capital of the Italian company. In all other cases authorization must be obtained from the Ministry of Foreign Trade (Directorate General for Foreign Exchange). In implementation of EEC capital market liberalization directives approval is granted for all cash investments in the EEC.

Income and liquidated capital from foreign investments must be repatriated by crediting the funds to an account opened abroad through an Italian bank. This must be done within 7 days and the funds must be repatriated within 6 months. In the interval they may be used for transactions permitted under a general license.

Italian loans abroad.—Foreign credit operations by Italian residents which are permitted under general license are the same as those which foreigners may extend to Italians under general license, except that there is no limit on the interest rate chargeable on financial loans to EEC countries. In addition, credits not related to a commercial transaction in which an Italian resident participates may be made under general license where the credits are made by Italian banks to foreign banks or foreign residents with repayment to be made within 6 months from the date the credit is disbursed. Prior approval from the Exchange Office is required for advance payments for imports to Italy made from more than 1 year up to 2 years from the date of delivery (except for 5-year advance payment in the case of imports from EEC countries). All other Italian credits and financial loans abroad (except for some financial credits to the EEC) must have prior approval from the Foreign Trade Ministry.

Imports of capital

Foreign issues in Italy.—Foreign issues of shares and bonds in Italy must be approved both by the Inter-Ministerial Committee and by the Exchange Office. No foreign shares have been issued in Italy, and only four foreign bond issues have been floated in the Italian market since World War II, all of which were by international institutions: the World Bank, the European Investment Bank, the Inter-American Development Bank, and the European Coal and Steel Community.

Purchase and sale of Italian securities by nonresidents.—Purchase and sale of Italian securities, whether or not quoted on securities exchanges, may be made under general license. However, all transactions must be effected through an authorized bank which is required to report such operations to the Exchange Office for statistical purposes. Income and liquidation proceeds from these securities may be freely repatriated.

Italian securities held by nonresidents may be freely transferred to other nonresidents or to residents of Italy. However, in the latter case the transaction and the transfer of funds must take place in Italy through a bank. Since nearly all Italian shares are registered, their transfer must be made either by the issuing company's inscribing the name of the new owner on the security itself and on the stockholder's register or, more commonly, by endorsement. However, the transfer by endorsement has full effect as regards the issuing company only when it has been entered on the shareholder's register against presentation of the security by the last endorser who can justify possession by a continuous series of endorsements.

For shares circulating in Italy, the endorsement must be dated, signed, and authenticated by a notary, a stockbroker, or a bank. The endorsement may also be made by proxy by the bank itself. For shares circulating abroad which bear a "circulating abroad" (*circolante all'estero*) stamp, the signature of the endorser may be authenticated by an Italian consul or by the office of an Italian commercial attaché. These shares may be returned to Italy and deposited in a foreign account in the name of the nonresident owner, but may not be sold in Italy until the "circulating abroad" stamp has been canceled by an authorized bank.[4]

Italian securities purchased by foreigners may be deposited for safekeeping with Italian banks, either in a special deposit for those purchased under the 1956 law or in a capital deposit. As in the case of direct investment, income and capital from securities deposited in a special deposit may be transferred to a special account (with the same transfer guarantees) from which transfers abroad may be made in foreign exchange at the official rate or by credit to a foreign account

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[4] Early in 1963 a bill was presented to the Parliament proposing authentication fee of 5 lire per 1,000 lire for transfers of title to Italian stocks circulating abroad. The fee was to be assessed against the nominal value of the stock. The bill was passed by the Chamber, but with a fee of only 1½ lire per 1,000, but not acted upon by the Senate before dissolution of the Parliament. The bill would now have to be resubmitted to both houses of the new Parliament. The main purpose of the proposed tax is to place transactions in Italian securities abroad on a more equal footing with those in Italy, which are subject to bank charges and a stamp duty.

in lire. Income and capital from securities deposited in a capital deposit (without the transfer guarantees) may be transferred to a capital account from which transfers abroad may be made at the free rate of exchange. Since January 1962 transfers between capital accounts and foreign accounts are permitted, which in effect, results in a unification of the official and the free exchange rates. While portfolio investment made outside the terms of the investment law does not have the transfer guarantees provided by the law, the latter exchange control liberalization now freely permits unlimited transfers of income and capital at the official rate of exchange.

Direct foreign investments in Italy.—Direct foreign investments in Italy may be freely made through Italian banks, which operate under general license. However, some restrictions are imposed on investment in the ownership of ships or aircraft, in operation of regular air transport services and in banking. Titles to assets may circulate abroad after having been stamped by an Italian bank. Nonresident title transfers to residents or to other nonresidents must be communicated to the Exchange Office of the Bank of Italy through a bank. Investments may be made either in cash or in kind. Income from investments and liquidation proceeds of investments may be freely transferred abroad or retained for use in Italy. Transfers may be made at the official rate of exchange.

Decree law 211 of March 2, 1948, and law 43 of February 7, 1956, designed to encourage foreign investment in Italy, provide for special guarantees for the transfer at the official exchange rate of capital and earnings on capital. Under article 1 of the 1956 law, capital and income from direct investment considered to be productive is guaranteed free transferability without limitation as to amount and time by transfer into foreign exchange at the official rate of exchange or by crediting a foreign account in lire. The regulations governing implementation of the law list productive enterprises as those which are intended for the production of goods or services operating in such fields as land reclamation and improvement, yards, manufacturing, power generation and transmission, digging of wells and tunnels, use of ships and aircraft, building construction including hotels and roadbuilding. However, the list is not all-inclusive and the Italian Treasury has authority to determine which additional enterprises are productive, based upon information supplied to it by prospective investors. This information is supplied prior to the investment after which a preliminary finding is made by the Treasury. The final determination by the Treasury is made after the investment has been effected.

Foreign loans to Italy.—The following types of loans may be granted by foreigners to Italy under general license:

(1) Commercial credits for operations in which an Italian resident participates where the credits are (*a*) from foreign exporters to Italian importers maturing up to 1 year from the date of shipment (or 5 years within the EEC), (*b*) from foreign banks to Italian banks or to Italian residents through Italian banks maturing within 6 months of the date of the credit, and

(c) in the form of advance payments for Italian exports up to 1 year from the date of delivery (or 5 years within the EEC);

(2) Credits from foreign banks to Italian banks for up to 10 days;

(3) Financial loans from EEC residents for up to 5 years, maximum of $80,000 and a maximum rate of interest of 6 percent.

All other foreign loans must have prior approval from—

(1) The Exchange Office for credits from foreign exporters to Italian importers with a maturity exceeding 1 year, but less than 2 years, and for advance payments for Italian exports more than 1 year before delivery (except for some credits and advance payments from EEC countries—see above);

(2) The Ministries of Foreign Trade and Treasury for all financial loans except mentioned above; and

(3) The Foreign Trade Ministry in all other cases.

The investments may be made through the establishment of new enterprises employing foreign capital only, both foreign and Italian capital, or the expansion of existing enterprises. Under article 2 of the law "nonproductive" investment (and portfolio investment) is guaranteed free transferability, at the official exchange rate, of interest, dividends, and profits up to a maximum of 8 percent per annum. (Transfer to investors residing in countries which are members of the OECD is unlimited.) The proceeds from liquidation of the investment, up to the amount of the foreign exchange originally invested, may also be transferred at the official rate of exchange after 2 years have elapsed from the date of the investment. These transfers of income and capital may be made in foreign exchange or by crediting a foreign account. Repatriation of income and capital in excess of these amounts may be credited to a capital account and then converted into foreign exchange at the free rate of exchange.

The 1956 law requires that any tax which may arise as a result of the operations of the investment enterprise must be paid prior to repatriation of the capital and income from the capital. Evidence of payment of the tax must be submitted, or if the tax has not been finally assessed, guarantees must be given. For transfer of income only, the guarantees may be waived. In any case, no more than 20 percent of the proposed transfer may be held in escrow pending a tax determination.

Since January 1962 transfers of lire may be freely made from capital accounts to foreign accounts, after which income and capital may be converted at the official rate of exchange. This has had the effect of unifying the rate in the two exchange markets and reducing the value of the transfer guarantees provided by the 1956 law.

TRENDS IN EXPORT AND IMPORT OF LONG-TERM CAPITAL

The inflow of capital

Balance-of-payments data show a fairly sharp rise in the total net flow of foreign medium- and long-term capital to Italy, reaching a level of 550 billion lire in 1962 and totaling 1,920 billion lire for the past 10 years (see tables XIV and XV). Most of the increase has been in the form of increased foreign investment, while the inflow of loan capital has been rather irregular and has grown at a slower pace. However, caution should be exercised in reviewing the sharp rise in foreign investment in the last 3 years. During this period political and economic uncertainties in Italy, plus certain tax considerations (especially passage of the dividend withholding tax law) appear to have stimulated a large contraband outflow of Italian banknotes, totaling $766 million in 1962, almost all of which have been repatriated to Italy from Switzerland. A small part of the notes were used for current account purposes including foreign travel by Italians and illicit purchases of gold for industrial purposes. A much larger part is used for disguised "foreign" investment in Italy by Italian residents and for genuine foreign investment by Italians. During 1960 and 1961, about 95 percent of these banknotes are believed to have been credited to foreign capital accounts by Italian residents as disguised "foreign" investment in Italy. In 1962 the comparable figure was about 75 percent. The remainder of banknote outflows during the 3 years is believed to represent genuine investment abroad by Italians through this means. The outflow of banknotes has not been included in the tables showing capital flows, except as a memorandum item. Nevertheless, the apparent sharp rise in the trend of foreign investment in Italy should probably be discounted to some extent, particularly in 1962.

TABLE XIV.—*Net flow of capital* [1]

[Billions of lire]

	1953	1956	1959	1960	1961	1962
A. Foreign capital to Italy:						
Loans (net)	−22.3	14.4	79.4	35.8	106.9	69.1
Investments (net)	9.4	65.1	141.9	275.9	308.3	482.2
Total (net)	−12.9	79.5	221.3	311.7	415.2	551.3
B. Italian capital to abroad:						
Loans (net)	5.3	3.3	−4.0	−3.9	30.6	86.0
Investments (net)	−2.2	−8.1	41.4	95.8	52.1	121.4
Total (net)	3.1	−4.8	37.4	91.9	82.7	207.4
C. Balance of capital flows:						
Loans (net)	−27.6	11.1	83.4	39.7	76.3	−16.9
Investments (net)	11.6	73.2	100.5	180.1	256.2	360.8
Total (net)	−16.0	84.3	183.9	219.8	332.5	343.9
Notes: Outflow of Italian banknotes	(2)	(2)	−39.0	−115.7	−206.0	−478.7

[1] Medium- and long-term only. Does not include short-term loans nor intergovernmental grants.
[2] Not available.

Source: Bank of Italy "Annual Reports" for the years 1954–62 (economic balance-of-payments data).

TABLE XV.—*Foreign capital flows* [1]

[Billions of lire]

	1953	1956	1959	1960	1961	1962
A. Foreign loans to Italy:						
1. Public loans [2]	10.2	27.2	67.1	51.8	53.2	46.5
Repayments [3]	(4)	−29.2	−41.9	−23.7	−21.6	−23.3
Net public loans	(4)	−2.0	25.2	28.1	31.6	23.2
2. Private loans		18.6	62.3	16.4	87.2	69.4
Repayments	(4)	−2.2	−8.1	−8.7	−11.8	−23.5
Net private loans	(4)	16.4	54.2	7.7	75.4	45.9
B. Foreign investment in Italy:						
1. Public investment (none)						
2. Private investment	(4)	(4)	263.6	529.8	489.2	663.2
Disinvestment	(4)	(4)	−121.7	−253.9	−180.9	−180.9
Net private investment	(4)	(4)	141.9	275.9	308.3	482.3
C. Total inflow:						
1. Foreign loans to Italy	10.2	45.8	129.4	68.2	140.4	115.9
Repayments	−32.5	−31.4	−50.0	−32.4	−33.4	−46.8
Net foreign loans to Italy	−22.3	14.4	79.4	35.8	107.0	69.1
2. Foreign investments in Italy	(4)	77.1	263.6	529.8	489.2	663.2
Disinvestments	(4)	−11.9	−121.7	−253.9	−180.9	−180.9
Net foreign investment in Italy	9.4	65.2	141.9	275.9	308.3	482.3
3. Gross foreign capital flows to Italy	(4)	122.9	393.0	598.0	629.6	779.1
Less repayments and disinvestments	(4)	−43.3	−171.7	−286.3	−214.3	−227.7
Net foreign capital flows to Italy	−12.9	79.6	221.3	311.7	415.3	551.4

[1] Medium- and long-term only. Does not include short-term loans nor intergovernmental grants.
[2] Includes the following amounts of short-term loans under Public Law 480 (in billions of lire): 1956, 13.2; 1957, 45.4; 1958, 17.6; 1959, 12.7; 1960, 4.4; 1961, 0.1.
[3] Includes the following repayments on short-term Public Law 480 loans (in billions of lire): 1956: 3.6; 1957, 19.6; 1958, 45.3; 1959, 11.7.
[4] Not available.

Source: Bank of Italy "Annual Reports" for the years 1954–62 (economic balance of payments data).

Foreign loans to Italy.—Despite the above qualifications, there is no question that the inflow of genuine foreign capital into Italy in the postwar period has been very substantial. During the early postwar period the major source of foreign capital was U.S. Government economic and military assistance (not included in referenced tables). By 1953 the U.S. aid program was virtually ended with relatively small amounts being received by Italy from earlier commitments. To some extent public grants were replaced by public loans (including short- and long-term loans under Public Law 480) and the emphasis was shifted from loans for reconstruction to economic development, especially in Italy's South. World Bank loans to the *Cassa per il Mezzogiorno* (fund for the South), Export-Import Bank loans to the *Istituto Mobiliare Italiano* (IMI), a medium- and long-term industrial relending institute and two Swiss loans for the Cassa and the railroads were particularly important. More recently, the EEC's European Investment Bank has become an important source of foreign public loan capital for southern development and the railroads. Despite a substantial gross inflow of medium- and long-term foreign public loans, the net flow of such funds has remained fairly stationary in the last 5 years averaging about 27 billion lire per year. Repayment on public loans during the past decade have been made primarily on the Public Law 480 loans, United States–Italy surplus property credit sales, Eximbank/IMI loans, U.S. Government loans (Maritime Commission and Marshall plan), and IBRD/*Cassa* loans.

The flow of private loans to Italy has been rather irregular during the last 10 years, although there has been a gradual increase. A small part of total loans have been by the European Coal and Steel Community to the Italian steel industry. The average net inflow of private capital was 45 billion lire for the 5 years, 1958–62.

Foreign investments in Italy.—Due to changes in the method of recording foreign investment in Italy it is difficult to assess adequately the relative importance of direct and portfolio investment. However, it is clear that foreign portfolio investment has risen rapidly, particularly since 1958. To some extent this may reflect portfolio investment by Italian residents disguised as "foreign" investment, and this is particularly true in 1961 and 1962. Nevertheless, the value of foreign public and private securities held abroad increased from 345 billion lire at the end of 1957 to 2,000 billion lire at the end of 1962 (see table XVI). (The increase in value is due in part to security price rises, since the data are based on current market value or estimates made by banks.) During the same period foreign medium- and long-term debts in the form of loans rose from 460 to 597 billion lire. Total foreign investment in Italy at the end of 1962, including both direct and portfolio investment, was estimated at 2,150 billion lire. About two-thirds of the total is recorded as investments from Switzerland and Liechtenstein, although it is clear that both disguised Italian "foreign" investment and genuine foreign investment from a number of other countries is also included.

TABLE XVI.—*Italy's outstanding foreign debt, end of: 1957–62*

[Billions of lire]

	1957	1958	1959	1960	1961	1962[1]
1. Short-term bank debt[2]	104.4	190.3	244.6	36.6	43.9	334.9
2. Medium- and long-term debt:						
a. Public debt	366.0	390.6	424.9	397.2	389.7	289.4
(1) Public or public-guaranteed loans	365.8	389.4	423.5	394.1	385.8	285.7
(2) Government bonds held abroad	.2	1.2	1.4	3.1	3.9	3.7
b. Private debt[3]	454.4	626.9	992.1	1,485.8	2,068.4	2,421.7
(1) Private loans	93.7	137.9	197.7	209.9	270.8	311.1
(2) Private securities held abroad:						
(*a*) Bonds	9.9	11.5	14.0	14.7	20.8	28.5
(*1*) Under investment loans[4]	(5)	(5)	(5)	(5)	(11.4)	(16.9)
(*2*) Other	(5)	(5)	(5)	(5)	(9.4)	(11.6)
(*b*) Stocks	335.3	456.3	747.2	1,217.7	1,711.9	1,976.7
(*1*) Under investment loans[4]	(5)	(5)	(5)	(5)	(947.0)	(1,196.0)
(*2*) Other	(5)	(5)	(5)	(5)	(764.9)	(780.7)
(3) Nonsecurity investment under investment laws[3]	15.5	21.2	33.2	43.5	64.9	105.4
c. Total medium-and long-term	820.4	1,017.5	1,417.0	1,883.0	2,458.1	2,711.1
(1) Loans	459.5	527.2	621.2	604.1	656.6	596.8
(2) Securities	345.4	469.1	762.7	1,235.4	1,736.6	2,008.9
(3) Other	15.5	21.2	33.2	43.5	64.9	105.4

[1] Provisional data.
[2] Net foreign debit/credit position of banks in foreign exchange and convertible lire.
[3] Loans and investments for which (1) no foreign exchange was received and (2) foreign exchange was used abroad, or (3) investment was effected through the importation of machinery.
[4] Law No. 211 of Mar. 2, 1948, and Law No. 43 of Feb. 7, 1956.
[5] Not available.

Source: "*Relazione Generale*" (1962), p. 303.

The outflow of capital

Italian loans abroad.—Italian medium- and long-term loans abroad were relatively unimportant from the immediate postwar period until as late as 1961 (see table XVII). As the Italian financial situation improved Italian banks have begun to extend both publicly guaranteed loans and private credits. The former category includes consolidation of loans or export credits to Egypt, Yugoslavia, and Turkey. Disbursements from new publicly guaranteed loans have recently been made to Brazil, Egypt, Yugoslavia, and Venezuela. The flow of both public and private medium- and long-term loans abroad will likely continue to rise as a result of the 1961 liberalizations of the export credit guarantee loan. The 1961 law now permits both exporter credits and untied financial loans to less-developed countries with maturities up to 10 years (or more when special approval is granted by the Foreign Trade Ministry and the Treasury after consultation with the Minister of Foreign Affairs). In part because of the relatively short maturities of old Italian public loans, repayments have averaged about 12 billion lire per year in the last 3 years, the major part of which have come from Argentina, Egypt, and Yugoslavia.

TABLE XVII.—*Italian capital flows abroad* [1]

[Billions of lire]

	1953	1956	1959	1960	1961	1962
A. Italian loans abroad:						
1. Public loans	5.3	3.3	−4.0	10.1	23.6	29.5
Repayments				−11.7	−12.1	−11.9
Net public loans	5.3	3.3	−4.0	−1.6	11.5	17.6
2. Private loans					20.6	71.1
Repayments				−2.2	−1.5	−2.7
Net private loans				−2.2	19.1	68.4
B. Italian investment abroad:						
1. Public investment	(2)	(2)	15.0	7.5		
Disinvestment	(2)	(2)				
Net public investment	(2)	(2)	15.0	7.5		
2. Private investment	(2)	(2)	35.3	116.6	94.9	140.2
Disinvestment	(2)	(2)	−8.9	−28.4	−42.9	−18.8
Net private investment	(2)	(2)	26.4	88.2	52.0	121.4
C. Total outflows:						
1. Italian loans abroad	5.3	3.3	−4.0	10.1	44.2	100.6
Repayments				−13.9	−13.6	−14.6
Net Italian loans abroad	5.3	3.3	−4.0	−3.9	30.6	86.0
2. Italian investment abroad	(2)	1.5	50.3	124.1	94.9	140.2
Disinvestment	(2)	−9.6	−8.9	−28.4	−42.9	−18.8
Net Italian investment abroad	−2.2	−8.1	41.4	95.7	52.0	121.4
3. Gross Italian capital flows abroad	(2)	4.8	46.3	134.2	139.1	240.8
Less repayments and disinvestments	(2)	−9.6	−8.9	−42.3	−56.5	−33.4
Net Italian capital flows abroad	3.1	−4.8	37.4	91.9	82.6	207.4

[1] Medium- and long-term only. Does not include short-term loans nor intergovernmental grants.
[2] Not available.

Source: Bank of Italy "Annual Report" for the years 1954–62 (economic balance-of-payments data).

Italian investments abroad.—Italian net investments overseas were negative in the postwar period, including the years 1953 to 1957. However, gross investment flow (both direct and portfolio) rose from 30 billion lire in 1958 to 140 billion lire in 1962. The rise in gross private investment was even sharper, since 39 billion lire in public investments ($60 million EIB quota payment and a $2 million purchase of IBRD bonds) were concentrated in 1958–60. Total Italian net private investment outstanding at the end of 1962 was estimated at 648 billion lire—about 36 percent of which was in banks and insurance companies; 23 percent in automobile, mechanical, metallurgy, and mining; 16 percent in chemicals; and 14 percent in petroleum. The breakdown by geographic area shows 42 percent of these investments to be in Europe and 38 percent in the Americas, with the largest amounts concentrated in Latin America (21 percent), the United States (14 percent), France (12 percent), and Switzerland (8 percent). No breakdown is available between portfolio and direct investments. However, exchange liberalizations permitting foreign portfolio investments, first by Italian business and financial institutions and then by individual Italians, did not begin to be implemented until 1961. It is reasonable to assume that the majority of Italian investment abroad through 1962 was direct investment.

CHAPTER X

THE CAPITAL MARKET IN SWEDEN

SECTION I—SUMMARY

Until 1960, the Swedish capital market was characterized by orderly and rather limited growth. Since 1960, however, interest in stocks and bonds has grown, and the amount of capital market financing in the last 3 years has been about 50 percent higher than in the preceding 3 years. Continued higher capital market activity is in prospect for the rest of the decade.

To a considerable extent the increased activity appears to be the result of an improvement in the supply of long-term capital. This increase in supply has come about largely through the expansion of the National Pension Insurance Fund which is coming to be the dominant accumulator of savings. It is significant, however, that this growth of the capital market has been at the expense of the short-term market. The credit market as a whole has probably no more than kept pace with the growth of GNP in recent years. There has been an increase in public interest in the capital market as well, but basically the public continues to prefer to keep savings in banks and insurance institutions rather than to invest them directly in stocks and bonds.

Since 1960 the supply of long-term capital has come closer to meeting the demand, thus easing to some extent a disparity which had been a chronic problem and hinderance to future capacity development. Since World War II most business investment has been self-financed but since 1960 the proportion of self-financing has declined and there has been a much more extensive use of the capital market as more funds became available. Nevertheless, there is still a waiting line in the capital market with many new issue applications awaiting *Riksbank* approval.

A change in the position of the central government budget has also contributed to the increased availability of funds for business investment. The government was an important borrower of long-term funds in the postwar period up to 1960 but since that time the budget has been balanced and a small surplus accumulated.

The growth of the public insurance fund as a source of long-term capital is bringing about a significant change in the pattern of channeling savings into investment in Sweden, markedly reducing the self-financing capabilities of industry and forcing enterprises to go to the capital market. Short-term credit has become very tight. Commercial banks may well do less long-term financing in the future than they did before this public insurance fund was established.

The central government remains a large accumulator and investor of funds and it exercises a good deal of control over both internal and external capital transactions. Thus the impact of market forces on the allocation of funds remains limited. The capital market has to some extent been segmented or compartmentalized by the preferential position accorded to the housing sector. The Government has consistently encouraged investment in housing and has channeled capital to this area both through mortgage institutions and through the banks. In recent years about one-fifth of total housing construction has been financed out of the budget, and undoubtedly these housing preferences and subsidies have limited the availability of funds to other sectors of the economy and affected the terms on which funds could be obtained. The provision of low-cost funds for residential construction appears to have been a major determinant of *Riksbank* policy, and access to both long- and short-term markets appears to be determined more by the policy of the *Riksbank* (which is made effective through portfolio recommendations to credit institutions and the control over new issues) than by free movement of interest rates in the market.

There also exists in Sweden a stamp tax on new issues of bonds which may have some impact on decisions to resort to the capital market for funds.

Although the National Pension Insurance Fund has authority to invest in gilt-edge bonds and other debt securities and has become a major purchaser of bonds, neither this Fund nor the commercial banks can acquire stock issues for their own accounts. Additionally Sweden's bond market instruments are characteristically secured by mortgages on real property to a high proportion of their face value which tends to reduce the ability of growing firms to raise adequate capital through the bond market.

Yields on industrial bonds in Sweden have not varied widely in recent years. They appear to be in the range of 5¼ to 5½ percent and the margin between the return to the lender and the cost to the borrower is quite narrow, suggesting that marketing facilities in Sweden are relatively efficient.

The Swedish Government maintains tight control over capital movements into and out of Sweden through a comprehensive exchange control system. The law is viewed by the Swedish authorities as a permanent device for controlling capital movements and for harmonizing foreign exchange movements with the *Riksbank's* monetary policy. In practice its effect is to insulate the domestic money and capital markets from external influences. If the controls were to be relaxed there might well be a substantial net inflow of capital under current conditions. The problems and challenges of European integration and the opposition of business to the continuance of these restrictions may bring a change over time, but there is no immediate prospect of substantial liberalization of these regulations.

SECTION II—THE PATTERN OF SAVINGS AND INVESTMENT

SAVINGS AND INVESTMENT

The structure of savings and investment in Sweden from 1954 through 1962 is shown in table I. This table reveals that from 1953 to 1960 a high proportion of savings was by households. Savings by central government and municipal authorities were lower, on the average. Central government savings showed a good deal of variation, reflecting the government's position as the most important cyclical counterweight.

TABLE I.—*Savings and investment*

[Millions of kronor [1]]

	1954	1955	1956	1957	1958	1959	1960	1961	1962
Savings:									
Saving by enterprises (excluding insurance)	1,602	1,340	1,911	2,516	2,453	3,492	3,010	2,353	732
Insurance saving	883	916	951	995	1,063	1,111	1,403	1,687	2,389
Saving by central government	49	1,133	1,111	581	649	265	1,313	2,659	3,040
Saving by local authorities	1,002	227	196	480	211	335	719	562	446
Savings by households	1,365	1,992	1,933	2,236	1,668	1,495	2,886	3,393	4,085
Net savings	4,901	5,608	6,102	6,808	6,044	6,698	9,331	10,654	10,692
Depreciation	4,677	5,080	5,540	6,117	6,418	7,032	7,124	7,548	8,375
Costs for repair and maintenance:									
Private	2,766	3,014	3,345	3,457	3,551	3,791	4,187	4,599	4,945
Public enterprises	706	748	850	978	1,001	1,016	1,135	1,281	1,414
Other public	649	718	772	853	864	925	925	1,025	1,097
Net borrowing abroad	166	414	127	95	280	34	588	--------	47
Gross savings	13,865	15,582	16,736	18,308	18,158	19,496	23,290	25,107	26,570
Investment:									
Private	8,029	8,420	9,251	9,623	10,457	11,129	12,910	14,391	15,331
Public enterprises	3,030	3,015	3,307	3,604	3,781	4,176	4,604	5,058	5,544
Other public	2,872	3,146	3,421	3,866	4,033	4,504	4,285	4,470	5,050
Changes in inventories	−66	1,001	757	1,215	−113	−313	1,491	1,121	645
Net lending abroad	--------	--------	--------	--------	--------	--------	--------	67	--------
Gross investment	13,865	15,582	16,736	18,308	18,158	19,496	23,290	25,107	26,570

[1] The Swedish krona is worth US$0.193.

Source: *Konjuncturinstitutet* (Business Cycle Institute), 1963.

Since 1960 and the establishment of the national insurance fund, savings through insurance have grown at the expense of business savings, as businesses became liable for the higher and rather unshiftable insurance premiums. Savings by the central government since 1960 have risen appreciably as the budget moved from deficit to surplus. There has been some increase in the rate of household savings since 1960, in keeping with the improvement in general economic conditions. Savings as a percentage of disposable income shows a steady increase, rising from 4 to 8.5 percent in the period 1957–62.

The figures point to a growing rate of insurance savings and a continuing high rate of household savings, making these two the most important sectors. Central government savings remain rather varied and difficult to predict. Business savings depend on profits which most government and many business and financial sources estimate will be less in the years ahead.

Gross investment figures show the private enterprise sector as the most important, with about 55 percent of gross investment during the period 1953–62. Since private enterprise had only restricted access to the capital market, much of this investment was self-financed. Accurate self-financing data are not available; much of the total lies buried in the depreciation category which is aggregated in table I.

As the figures show, the remaining investment was split about evenly between public enterprises and other public categories, with small inventory changes and negligible net lending abroad.

SIZE OF THE SECURITIES MARKET

In recent years recourse to the capital market has amounted to more than one-fourth of gross fixed capital formation:

	Capital market borrowing (net)[1] (1)	Gross domestic fixed capital formation (2)	Capital market borrowing as percent of capital formation ((1) ÷ (2))
	Billion kronor	*Billion kronor*	
1958	3.0	11.6	25.9
1959	3.3	12.8	25.8
1960	4.3	14.3	30.1
1961	4.3	15.7	27.4
1962	6.0	16.9	35.5

[1] Includes long-term bonds (over 6½ years), stocks, and long-term loans against borrower's notes.

The market value of Swedish stocks outstanding is about 18 billion kronor and the maturity value of bonds outstanding is about 28 billion kronor. Total stocks and bonds in circulation amount to about 56 percent of gross national product. Swedish securities issued in the period 1958–60 amounted to about 26 percent of gross savings.

Since 1960 stocks and bonds have increased in importance as a means of raising funds. This is illustrated in the following figures showing net capital raised through stocks and bonds as a percentage of total credit extended.

	Percent		*Percent*
1958	27.1	1961	53.5
1959	18.4	1962	56.7
1960	45.8		

OUTLOOK

The total volume of institutional credit in Sweden (short- and long-term) increased 159 percent between 1948 and 1961, an increase of 3.4 percent per year on constant prices. This is about the same as the rate of growth of the gross national product. The Swedish Long-Term Planning Commission predicts a 4-percent growth rate of GNP during the sixties. If the relationship between GNP and total volume of credit outstanding remains the same, total outstanding institutional credit will increase from 68 billion kronor in 1961 to some 80 billion kronor in 1965, and to nearly 100 billion kronor in 1970. The Government forecasts increases in investment that will use the available funds and keep the economy growing at capacity. The projected gross investment figures are given in table II.

TABLE II.—*Gross investment*,[1] *1951–65*

[Millions of kronor at 1960 prices]

	Total during the period—			Percentage shares—		
	1951–55	1956–60	1961–65	1951–55	1956–60	1961–65
1. Agriculture and forestry	3.0	2.5	2.8	5.7	3.7	3.2
2. Industry	9.9	12.6	18.6	18.6	18.2	21.0
3. Power and electricity	4.0	4.9	5.7	7.4	7.1	6.4
4. Housing	11.6	15.3	19.0	21.7	22.1	21.4
5. Communications	11.6	14.9	17.9	21.7	21.5	20.2
6. Retail and wholesale trade	1.2	2.7	4.0	2.3	3.8	4.5
7. Public services:						
Civil	6.0	8.5	11.7	11.2	12.2	13.2
Military	5.3	7.0	7.9	10.0	10.1	8.9
8. Other sectors	.7	.8	1.0	1.3	1.2	1.1
Total	53.3	69.2	88.6	100.0	100.0	100.0

[1] Excluding repairs and maintenance.

Source: Swedish Long Term Planning Commission Report for 1961–65.

The Swedish Long-Term Planning Commission, on a set of specific assumptions,[1] forecasts the following savings picture for 1965. The public sector, which has gone from a financial deficit in the 1950's to an approximate balance in the last few years, is expected to have a deficit in 1965 of about 1 billion kronor (out of a GNP of roughly 85 billion). Business firms will have a considerably increased financial deficit in 1965 because of expanded investment and smaller profits. Household savings should rise "appreciably," particularly in savings through insurance from 1.6 billion kronor in 1960 to 3.6 billion kronor in 1965. These figures suggest an important shift of the savings locus away from corporations and toward insurance, particularly the National Pension Insurance Fund.

The National Pension Insurance Fund, on the same assumptions, is expected to experience a large and rapid growth in loanable funds from about 1 percent of the institutional credit market in 1961 to roughly 25 percent or 25 billion kronor in 1970, giving it the same relative importance in the credit market as the commercial banks have at present. This accumulation of savings by a primarily long-term lending institution, much of it at the expense of the commercial banks (as the business sector makes payments to the fund that would have otherwise found their way to business bank deposits), means a strong growth in the capital market, largely at the expense of the short-term market. Given this increase in long-term funds and assuming the government's long-term borrowing will not rise to the levels of the last decade, the strong growth of the fund should make for a more closely balanced capital market able to function with in-

[1] The savings picture forecast for 1965 follows:
(1) Growth of the national product by 4 percent per annum.
(2) Unchanged price level.
(3) The same direct and indirect tax rates in force as in 1962.
(4) Contributions to the national supplementary pensions scheme are assumed to be increased to 8 percent of employers' wage bills in 1965.
(5) Firms' net profits will, after indirect taxes and pension fees, comprise an unchanged proportion of the value of production.
(6) Household savings (excluding savings through insurance) will be unchanged as compared with the fifties, or—according to statistical estimates—about 20 percent.
(7) The annual growth in savings by the private insurance companies will level off at about 1 billion kronor.

creasingly less governmental intervention. A more adequate and unfettered capital market is, of course, an important factor in any future consideration of changes in Swedish policy regarding international capital movements.

Growth of the long-term market could possibly cause a bottleneck at the short end of the market. The Swedish Long-Term Planning Commission in its report for 1961–65 recognizes the possibility of reversal of the imbalance which existed through most of the last 15 years. As mentioned before, banking sources foresee an increase in the relative amount of private sector financing to be arranged by credit. They base this on estimated lower profit margins in most branches of business and consequent reduced capacity for self-financing. Also, since the formation of the Fund, it has become impossible to use the company pension schemes as much as before as a means of keeping untaxed earnings in the company.

There are factors which offset the possibility of imbalance. With the growth of the long-term market, funds held in long-term housing loans by the commercial banks can more readily be shifted to more appropriate long-term lenders, and the funds released utilized in the more customary shorter-term bank credits to industry and business.

Under these circumstances, the banks are likely to put more emphasis on their role as brokers and intermediaries between borrowers and the securities markets. They will also help channel funds from the bond market to prospective borrowers through newly formed credit institutions which will give longer term loans to smaller enterprises (*Foretagskredit*), industries (*Industrikredit*), and exporters (*Svenska-Exportkredit*).

Finally, it is unlikely that the *Riksbank*, which can influence the supply of credit in the commercial banking system by means of ordinary credit policy instruments, will condone a chronic, large shortage of bank credit.

SECTION III—THE DEMAND FOR CAPITAL

The postwar level of investment in Sweden has been high. Gross investment grew from slightly over 20 percent of GNP in 1950 to about 23 percent in 1962. The persistent inadequacy of long-term investment funds in relation to desired expansion has caused inflationary pressures and brought up questions of investment priority among prospective users. Free interest rates determined by market forces would have, of course, equated the supply of funds with investment demand, but at a cost to the government's social objectives (principally the holding of housing rents at a suitably low level). The government acted in this situation to give investment preference to the housing and the central government sectors at the expense of industry, trade, and the local governments. The few private bond issues were largely by transport and power companies. This condition of chronic shortage has been changing since 1960, as the supply of funds has increased and as fiscal policies have eliminated the government as a substantial long-term borrower, thus making room for other borrowers.

CENTRAL GOVERNMENT

As indicated in table III, the government showed a surplus of 599 million kronor in 1962 after covering both its capital and current budget, including about 1 billion kronor of capital lent mostly for housing construction through the National Housing Board. There had also been a surplus in 1961 of 365 million kronor (table IV), the first after a long series of deficits. This conversion from a deficit position which was almost 2 billion kronor as recently as 1959 to a surplus in 1961 was an important factor in the changed pattern of demand for funds. This is illustrated in table V, which shows the government's share of issues in the new bond market, and table VI which gives the net capital raised in the bond market.

TABLE III.—*The credit market in 1962*[1]

[Millions of kronor]

Lender	Borrower (net flows)				
	Government	Local authorities	Housing	Rest of the economy	Total
Riksbank	−363		151	5	−207
Treasury bills	−417				−417
Bonds	54		151		205
Loans against borrowers' notes, etc				5	5
Commercial banks	1,068	95	179	1,971	3,313
Treasury bills and call money	395				395
Bonds	664	40	473	62	1,239
Shares				53	53
Loans against borrowers' notes	9	55	−294	1,856	1,626
Other banks [2]	−756	460	1,279	510	1,493
Treasury bills	−555				−558
Bonds	−138	135	239	237	473
Loans against borrowers' notes	−60	325	1,040	273	1,578
Private insurance and pension institutions [3]	−157	93	586	274	796
Treasury bills	1				1
Bonds and debentures	−158	6	469	182	499
Shares				13	13
Loans against borrowers' notes, etc		87	117	79	283
Public insurance and pension institutions [4]	74	212	723	560	1,569
Bonds and debentures	74	84	698	490	1,355
Loans against borrowers' notes, etc		128	25	70	214
General public (unspecified)	−465	45	−47	480	13
Treasury bills and call money	−13				−13
Bonds and debentures	−259	45	−47	111	−150
Shares				369	369
Loans against borrowers' notes, etc	−193				−193
All lenders	599	905	2,871	3,800	6,977
Treasury bills and call money	−592				−592
Short-term bonds	190		−100	5	95
Long-term bonds and debentures	47	310	2,092	1,077	3,526
Shares				435	435
Loans against borrowers' notes, etc	−244	595	879	2,283	3,513

[1] Borrowing by the government includes all forms of government borrowing. Lending to local authorities includes municipal loans proper and borrowing against bonds. Housing loans consist of loans against mortgages on residential property or residential and business property, building credits and bonds issued by mortgage institutions which finance housing (the City Mortgage Bank, the Residential Credit Bank, and the mortgage companies), the Post Office Bank loans for housing purposes backed by municipal guarantees, and municipally guaranteed loans provided by other lending institutions. The procurement of capital by the rest of the economy consists of other loans and the issue of securities (net) except when foreign countries or a lending institution are borrowers.

Bonds with an original currency up to 6½ years have been classified as short-term bonds. Savings bonds and government debentures are included in "Loans, etc."; short-term credits obtained by the National Debt Office from commercial banks and the Postal Giro Service have been grouped with Treasury bills.

[2] Savings banks, Postal Savings Bank, Postal Cheque Service, and agricultural credit associations.

[3] Private companies and the Swedish Municipal Employees Pension Fund.

[4] National Pension Insurance Fund and National Social Insurance Board.

Source: *Sveriges Riksbank* "Yearbook," 1962.

TABLE IV.—*Summary of the credit market, 1959–62*

[Millions of kronor]

Lender	Year	Government	Local authorities	Housing	Net flows rest of the economy	Total
Riksbank	1959	398		−4	1	395
	1960	1,171		85	2	1,258
	1961	−244		13	−2	−233
	1962	−363		151	5	−207
Commercial banks	1959	676	86	455	1,242	2,459
	1960	−647	−98	308	886	449
	1961	−6	57	123	422	596
	1962	1,068	95	179	1,969	3,311
Other banks	1959	674	185	1,226	200	2,285
	1960	−562	85	1,246	233	1,002
	1961	66	117	1,449	323	1,955
	1962	−756	460	1,279	510	1,493
Private insurance and pension institutions	1959	247	87	458	362	1,154
	1960	333	92	343	279	1,047
	1961	−130	81	527	274	752
	1962	−157	93	586	274	796
Public insurance and pension institutions	1959	−3	35	3	3	38
	1960	142	99	177	100	518
	1961	−32	118	435	201	722
	1962	74	212	723	560	1,569
Others	1959	−71	−42	40	78	5
	1960	642	67	68	347	1,124
	1961	−19	4	83	491	559
	1962	−465	45	−47	474	7
Total all lenders	1959	1,921	351	2,178	1,886	6,336
	1960	1,079	245	2,227	1,847	5,398
	1961	−365	375	2,630	1,709	4,351
	1962	−599	905	2,871	3,792	6,969

Source: *Sveriges Riksbank* "Yearbook," 1961, 1962.

TABLE V.—*Net bond issues, 1950–62*

[Millions of kronor]

Borrowing sector	1950–54	Percent	1955–59	Percent	1960	Percent	1961	Percent	1962	Percent
Central Government	5,562.7	67.1	6,611.9	59.9	1,315	48	670	26	969	22
Mortgage banks[1]	1,593.9	19.3	3,450.6	31.2	957	35	1,416	55	1,946	43
Local authorities	647.8	7.8	409.4	3.7	227	8	145	6	416	9
Private business	482.5	5.8	577.0	5.2	228	9	334	13	1,166	26
Total	8,286.9	100.0	11,048.9	100.0	2,727	100	2,565	100	4,497	100

[1] Mainly housing finance but also includes banks lending to agriculture and shipping.

Source: *Skandinaviska Banken* "Quarterly Summary" No. 1, 1963.

TABLE VI.—*Net cash receipts from bond issues* [1]

[Millions of kronor]

	1958	1959	1960	1961	1962
Issuers:					
Long-term bonds	1,074	935	2,082	1,629	3,406
Central Government	299	551	1,072	98	47
Local authorities	46	−55	84	50	310
Mortgage institutions	651	387	792	1,155	2,073
Industry and commerce	78	52	134	326	976
Short-term bonds	379	1,537	−275	−680	95
Central Government	331	1,197	−340	−732	190
Local authorities					
Mortgage institutions	6	305			−100
Industry and commerce	42	35	65	52	5
Total	1,453	2,472	1,807	949	3,501
Lenders:					
Banks	1,030	2,036	145	−28	1,917
Riksbank	−209	119	40	21	205
Commercial banks	867	1,759	−272	−341	1,239
Other banks	372	158	377	292	473
Other investors	423	436	1,662	977	1,584
Private insurance and pension funds	349	418	443	209	470
Public insurance and pension funds	−1	−1	404	561	1,285
Other (residential)	75	19	815	207	−171
Total	1,453	2,472	1,807	949	3,501

[1] Table includes only Swedish bond issues; capital raised through issue of savings bonds and certain state promissory notes are excluded.

Source: *Sveriges Riksbank*.

The government's borrowing in 1962 was largely short term. Preliminary data for 1962 show that maturing short-term bonds were repaid to the extent of 579 million kronor while new issues amounted to 769 million kronor. The difference, 190 million kronor, appears in table III. Government budget projections indicate a nearly balanced budget in the years immediately ahead. Barring a downturn which would call for expanded government spending, the government should not be an important competitor for long-term funds.

LOCAL AUTHORITIES

During the postwar period the local authorities have come after the central government and the housing sector on the preference scale for capital funds. The net amount actually raised by bond sales has been small, as table VI shows but the existence of strong demand is evidenced by the increase of borrowings in the more expansive capital market of 1962 and the increase in the proportion of new bond issues going to local authorities (table V). Net borrowings were 310 million kronor in 1962, as compared to 50 million in 1961. In addition to bond issues, local authorities also borrow at long term by selling their notes, particularly to insurance companies and banks other than commercial banks. In 1962 this amounted to approximately 595 million kronor, bringing total local authorities' borrowing to 905 million kronor as shown in table III. This compares to 375 million kronor in 1961 and less in earlier years (table IV).

HOUSING SECTOR

Demand for long-term housing credit required, at least until 1960, special attention by the government to insure adequate funds. This was particularly difficult because the Government wanted to keep down interest costs (and consequently rents) while obtaining capital at a rate fast enough to keep up with the burgeoning need for dwelling space. The amount of capital going into housing amounted to 5 billion kronor in the period 1949–52, 9,340 million in 1953–56, and 12,285 million in 1957–60. Capital thus invested in the last 4-year period was 2½ times greater than in the first. This also represented an increasing percentage of total credit, reaching almost 50 percent by 1961, as table VII indicates.

TABLE VII.—*Distribution of credit by borrower* [1]

[In percent]

	1948	1952	1956	1958	1960	1961
Housing and other building activity	44.0	43.5	46.5	46.7	47.8	49.1
Agriculture	8.4	7.7	7.5	7.2	6.6	6.6
Industry, trade, communications	18.4	19.1	17.4	16.9	17.6	18.1
Central Government	15.3	14.6	15.6	17.4	16.2	14.9
Local governments	7.5	9.7	8.9	8.3	8.3	8.0
Private persons	6.4	5.4	4.1	3.5	3.5	3.3
Total	100.0	100.0	100.0	100.0	100.0	100.0

[1] Stock, not flow, data.

Source: *Skandinaviska Banken* "Quarterly Review" No. 1, 1963.

Commercial banks have in the past held a substantial volume of long-term housing loans. They have often had to retain initial short-term building loans in their portfolios after the buildings were completed for want of long-term holders to which they could be shifted This type of commercial bank long-term lending has, however, declined in recent years. The possibilities of rapid funding by other long-term lenders has encouraged the banks to expand their new lending, and the supply of credit both for housing construction and for other building projects has been good.

The demand for housing funds, about two-thirds of which has been met by nongovernmental means (roughly one-third has been financed through the housing board of the central government with budgetary funds), has increased the importance of mortgage banks and companies as illustrated in table VIII. The increased importance of mortgage institutions has been at the expense of the commercial and savings banks. Since 1961 the mortgage institutions have more than held their own with regard to new bond issues and in net capital raised on the bond market. (See tables V and VI.)

TABLE VIII.—*Distribution of credit by lender* [1]

[In percent]

	1948	1952	1956	1960	1961
Commercial banks	29.2	28.7	27.6	27.5	26.9
Savings banks	25.3	23.6	24.2	23.7	23.8
Post Office Savings Bank	10.2	11.4	10.6	10.4	10.4
Insurance companies	21.5	23.1	23.2	21.5	20.9
Mortgage banks and companies	12.6	11.8	12.6	14.5	15.2
Agricultural credit associations	1.2	1.4	1.8	1.7	2.0
General pension fund				.7	.8
Total	100.0	100.0	100.0	100.0	100.0

[1] Stock, not flow, data.

Source: *Skandinaviska Banken* "Quarterly Review" No. 1, 1963.

Increases in the amount of permanent mortgage loans and changes in building advances outstanding have not resulted in any unusual growth of total net lending for housing purposes because of variations in funds provided by the housing board. Preliminary figures for 1962 show that 740 million kronor were lent by the housing board. This, together with nongovernment housing credit of 2,870 million kronor, totaled slightly more than 3.6 billion kronor, as compared with 2,630 million kronor from the bond market and about 825 million kronor from the housing board, or not quite 3.4 billion, in 1961. The increase between 1961 and 1962 was roughly the same as that between 1960 and 1961.

The Swedish Long-Term Planning Commission contrasts the pre-1960 period, when housing expansion plans outran funds, with the post-1960 period when funds have been more readily available but problems of straining the capacity of the housebuilding sector have been encountered. The Commission would like to see housebuilding expand rapidly, but doubts if the present rate of dwelling unit starts of 70,000 per year in 1960 can be increased to more than 85,000 by 1965 (about 4 billion kronor per year) without straining physical capacity and inflating construction costs. The increase in dwelling units will mean a 20 to 25 percent increase in housing expenditures, but total capital available is expected to increase enough to hold housing's share of total investment at about the level of the last decade.

BUSINESS SECTOR

As can be seen from tables V and VI the business sector's share of capital raised on the bond market in the postwar period was very small until about 1960. The existing demand was apparent, however, from the large number of unfulfilled requests for issue permits. The capital market began to ease after 1960, and the amount of private sector bond issues rose rapidly. New bond issues by the business sector rose from an average 5.2 percent of total issues in 1955–60 to 9 percent in 1960, 13 percent in 1961, and 26 percent in 1962 (table V). Net capital raised in the bond market, looking at the figures in table VI amounted to about 3 percent of the total in 1959, 11 percent in 1960, and 40 percent in 1961.

The growth which had taken place during 1960 and 1961 in business' procurement of long-term capital from external sources continued in 1962 although the amount derived from share issues fell back. Net share issues by enterprises including government-owned companies amounted to 621 million kronor in 1962 as against 747 million kronor in 1961 (table IX). Net bond issues amounted to 976 million kronor in 1962, as compared with only 326 million kronor in 1961.

A comparison of tables VI and IX will show the relative importance of the bond and stock markets as sources of capital in recent years and the increased use of equity financing. In 1960 net capital raised by business through stock issues was approximately double that of previous years, and in 1961 triple. Part of this growth has been due to favorable tax regulations on dividends on shares issued since 1961, but much of it is due to increasing public interest in the stock market and business' need for equity financing.

TABLE IX.—*Stock issues: Net amounts raised* [1]

[Millions of kronor]

	1958	1959	1960	1961	1962
Issuer:					
Commercial banks	9	44	40	90	8
Industry	96	94	232	398	379
Commerce	16	37	36	63	97
Other	35	80	78	196	237
Total	156	255	386	747	621
Investor:					
Commercial banks	3	−11	5	13	53
Insurance companies	67	71	84	152	13
Government		21		55	186
Other (residual)	86	174	297	527	369
Total	156	255	386	747	621

[1] Issues of government-owned companies included. Shares of government companies are purchased with government funds and held by the National Debt Office.

Source: *Riksbankens Förvaltningsberättesle för år 1962. Sveriges Riksbank* "Yearbook", 1962.

SECTION IV—THE SUPPLY OF CAPITAL

The supply of debt and equity capital has been growing since 1960, and it is expected to continue growing. The increase in 1962 was particularly striking. The capital supplied by the bond market (table VI) in 1962, 3.5 billion kronor, is more than 1 billion kronor higher than in any recent year. The most important suppliers were the commercial banks and the public pension and insurance funds, but the private insurance companies, the savings banks and the Post Office Bank also made considerable investments. The amount of share capital supplied dropped by about 300 million kronor compared to 1961, but still maintained a high level compared to pre-1961.

To bonds and stocks should be added certain long-term loans against borrowers' notes for housing and municipal governments. The Swedish central bank considers as long-term large portions of the loans against borrowers' notes of "other banks", and private and public insurance institutions (see captions in table III).

Long-term capital market investments, as defined by the central bank, amounted to 4.2 billion kronor in 1960, 3.9 billion kronor in 1961 and 5.4 billion kronor in 1962, making a total of 13.5 billion kronor (see table X). This was about 70 percent larger than the 3 preceding years (1957–59), when the corresponding total was roughly 8 billion kronor. Loans against borrowers' notes showed a tendency to fall after the beginning of 1960.

TABLE X.—*Net long-term capital raised*

[Millions of kronor]

	1958	1959	1960	1961	1962
Total long-term bonds [1] (table V)	1,074	935	2,082	1,629	3,406
Total stocks (table VIII)	156	234	386	724	427
Total long-term bonds and stocks	1,230	1,169	2,468	2,353	3,833
Approximate long-term loans against borrowers' notes	1,500	1,800	1,700	1,600	1,600
Total	2,700	3,000	4,200	3,900	5,400

[1] The Swedish Central Bank defines long-term bonds as those having an original maturity period of over 6½ years.

Source: *Sveriges Riksbank.*

Savings banks, insurance companies, and other credit institutions are the principal buyers of all types of new bond and debenture issues. Commercial banks purchase government bonds (especially short-term) and mortgage bank bonds, but not industrial bonds. The general public buys government bonds and industrial bonds but not as a rule bonds of the mortgage banks and municipalities.

Since the midfifties, differences in long-term interest rates have been comparatively small, with rates rising about one point since 1956 in most cases.

PRIVATE INSURANCE COMPANIES

Net new investments of the private insurance companies, which in 1959 reached 1,150 million kronor, amounted to about 779 million kronor in 1961 (table XI). The fall is explained by the decrease in the inflow of funds to the private pension insurance scheme after the national pension reform. Some stabilization is indicated in 1962; the investment total is about 800 million kronor for the year.

TABLE XI.—*Variation in assets of insurance companies and National Pension Insurance Fund*

[Millions of kronor]

	1959	1960	1961	1962
Insurance companies (nationwide companies):				
Cash and bank deposits	46	−26	27	34
Treasury bills	0	0	1	1
Bond and Government debt certificates	392	462	211	470
Deferred debentures	4	−15	−13	29
Shares	71	81	143	13
Loans	585	449	295	174
Policy loans	2	14	5	−3
Real property	50	29	110	89
Total	1,150	994	779	807
National Pension Insurance Fund:				
Cash and bank deposits	----------	0	0	1
Bonds	----------	406	579	1,268
Deferred debentures	----------	15	8	70
Loans	----------	60	134	194
Loans to contribution paying employers	----------	0	3	53
Total	----------	481	724	1,586

Source: *Sveriges Riksbank* "Yearbooks," 1961 and 1962.

PUBLIC INSURANCE INSTITUTIONS

Before 1960 the requirements of public insurance institutions for investment outlets were limited to some tens of millions of kronor per annum; but thereafter they rose vigorously, reaching about 1.6 billion kronor in 1962. The increase is explained by the growth of the new public insurance institution, the National Pension Insurance Fund. The assets of this Fund, after having grown by 481 and 724 million kronor, respectively, in 1960 and 1961, increased by 1,569 million kronor in 1962.

The establishment of the National Pension Insurance Fund in 1960 is the most important development on the supply side of the Swedish capital market. Assets of the Fund in mid-1963 were 3.7 billion kronor. According to official estimates assets will be 25 billion by 1970. The size of this figure and the impact on the capital market is brought out by comparison with total net short- and long-term borrowing on the entire Swedish credit market in recent years of 4–5 billion kronor per year. The national debt is at present 22 billion kronor and the market value of all outstanding bonded debt is 28 billion kronor.

The Fund is restricted to investment in gilt-edged bonds and other debt securities and loans to insurees. So far the Fund's investments have been almost exclusively in bonds. In 1962 approximately half the assets were composed of obligations of the housing sector, 22 percent of the business sector, 13 percent of municipalities, 5 percent of the central government and the remainder of agriculture, foreign borrowers, and insurees.

An important question is to what extent the Fund represents new savings and not solely a redirection of saving that had previously taken other forms. Much of the accumulation of capital in the Fund has taken place at the expense of other types of saving. Premium income of the important private institution for pension insurance is known to have dwindled drastically, as have allocations to companies' own pension funds. Furthermore, to the extent that the burden of the new pension contributions cannot be shifted by employers to wage earners through lower wages or to consumers through higher prices, it will result in a contraction of profit margins. Employer contributions are high and going higher. According to official estimates, the levies will correspond to 4.9 percent of total wage and salary payments in 1965 and 6.4 percent in 1969.

The 7 to 8 percent annual rise in the wage level during the past 2 years would not seem to indicate that the new pension scheme has had a dampening effect on wage increases. The price level too—apart from the effect of the turnover tax increase—has remained essentially stable. It is, therefore, possible that the accumulation of capital in the Fund has to some extent been achieved at the expense of company savings. The figures in table I indicate this.

It is difficult to judge how private savings will be affected. The view of Swedish experts has been that the transfer of income from the active group to the pensioner group will probably increase consumption and thereby reduce personal savings. Others maintain that the rapid rise in the standard of living in Sweden provides considerable scope for voluntary insurance of various kinds. The table below shows how savings through insurance have developed since 1957:

[Millions of kronor]

1957	1,000
1958	1,020
1959	1,080
1960	1,420
1961	1,430
1962 (estimated)	2,100

As can be seen from these figures, the start of the Fund in 1960 provoked a sharp increase in total savings through insurance, although the rapid rise was not repeated in 1961, and 1962 saw another major step forward, with a rise of about 700 million kronor. In sum, this form of saving has almost doubled between 1959 and 1962, and it has been estimated that it will amount to about 3,600 million kronor in 1965.[1]

While savings through insurance have developed in the way here described, the savings banks and, the Post Office Savings Bank have not faltered in their contribution to the long-term credit market; rather the reverse is true. Personal savings are showing a tendency to rise, which is entirely in keeping with a rising standard of living.

OTHER BANKS

Investments in bonds and in loans against borrowers' notes [2] by the institutions shown as "other banks" (see table XII for pre-1962 breakdown and table III for 1962 figures) exhibited on the whole a rising trend, although there was some variation from year to year as between the two kinds of investment. Investments in bonds were relatively large during 1960 and 1962, and smaller in 1961; lending against borrowers' notes varied in the opposite direction. Such institutions' total acquisition of bonds plus lending against borrowers' notes had been in the neighborhood of 1.5 billion kronor per annum during the late fifties, but in 1961 it exceeded 1.8 billion kronor and in 1962 was slightly less than 2 billion kronor.

[1] *Svensk Ekonomi*, 1960–65.
[2] Loans by other banks against borrowers' notes are primarily long-term housing loans and thus are considered to be capital loans.

TABLE XII.—*Variation in assets of savings banks, post office bank, and the agricultural credit association ("Other banks")*

[Millions of kronor]

	1959	1960	1961
Savings banks:			
Cash in hand and at banks	−85	222	−32
Treasury bills	0	2	3
Bonds and Government debt certificates	101	150	127
Loans	984	732	946
Other	29	42	36
Total	1,029	1,148	1,080
Post Office Bank:			
Cash in hand and at banks	190	−208	−79
Treasury bills	610	−580	110
Bonds and Government debt certificates	56	196	171
Loans	451	391	464
Other	8	7	20
Total	1,315	−194	686
Agricultural credit associations:			
Cash in hand and at banks	11	35	−13
Bonds	1	13	16
Loans	82	98	144
Other	2	2	4
Total	96	148	151

Source: *Sveriges Riksbank* "Yearbooks," 1961 and 1962.

Within the capital market investments of other banks there has been a shift away from the central government to local authorities, housing and the business sector. According to central bank sources, their liquidation of government bonds and other government securities amounted in 1961 to 0.2 billion kronor net, and in 1962 to 0.5 billion kronor net. Lending to local authorities, housebuilders and the business sector had reached net totals of 0.3, 2.5, and 1.3 billion kronor respectively in 1961; in 1962 the corresponding amounts were 0.8, 2.7, and 1.7 billion kronor.

COMMERCIAL BANKS

Commercial banks advances for housing construction grew during most of 1960 and 1961, but began to decline in the fourth quarter of the latter year, when mortgage institutions issued more securities and thus had the means for more long-term funding. The decline continued virtually without interruption until the autumn of 1962 when it gave way to a slight rise, in spite of considerable funding. New lending for the whole year 1962 amounted to 2,105 million kronor (against 2,039 million the year before), and funding to 2,399 million kronor (against 1,996, million). This left a net reduction in commercial banks, holdings of housing loans for 1962 of 294 million kronor in comparison to increases of 43 million in 1961 and 240 million in 1960.

The large increase in commercial bank short- and long-term bond purchases in 1962 merits some explanation (tables III and VI). During the boom year 1960, commercial bank liquid assets greatly decreased because of increases in their lending, improvement in the Government budget, increased Government borrowing outside the banks, and the deposits at the central bank by business firms of money allocated to government-sponsored anticyclical investment funds.

The downward trend in liquidity was halted in 1961, but it was early in 1962 before a real improvement occurred. When it did, the banks again purchased government and mortgage bonds to the extent of 1,200 million kronor, as shown in table III.

In 1962 the commercial banks were thus able to reduce their house-building advances and increase their holdings of liquid government and mortgage bonds. While this paper may be used at the central bank as the basis for credit expansion, the banks are already well supplied with collateral, and this aspect was secondary to the usual disposition of bankers to fund these advances without too much delay.

HOUSEHOLDS

Data for households are scarce. The income of households is estimated to have increased by 9 percent in 1962, compared to 8 percent in 1961. The rate of increase in consumption remained essentially the same, leaving 1962 savings by households slightly larger than in 1961. These savings largely took the form of bank deposits. The purchase of bonds and shares by households appears in the residual portion of tables VI and IX. The apparent large increase in holdings of bonds by individuals in 1960 is attributable in part to purchases after interest rates were raised in January 1960. The drop in bond purchases in 1961 and the large increase in stock purchases, are partly attributable to the better tax treatment of dividends on stocks issued after 1961.

Although there now appears to be a greater volume of public bond and stock purchases than in earlier postwar years, public interest is still limited. The investing habits of the public continue to be conservative; individuals prefer to put their savings in commercial or savings banks. These savings reach the securities market largely through these intermediaries, therefore, rather than directly.

SECTION V—INSTITUTIONAL STRUCTURE

As a neutral in World War II, Sweden did not experience the capital market calamities of so many of the belligerents. There were, however, some disruptions in savings and investment patterns which affected the capital markets. Central government spending was high at the expense of other borrowers in the economy. This was reflected in the relative positions of the two major borrowers. Before the war, mortgage bonds for housing was the largest category of bonds in circulation, with central government bonds second. As a result of heavy government borrowing during the war, government bonds took over first place. At present they constitute about 15 billion kronor of the outstanding total of 28 billion.

During the war Sweden experimented with low-denomination, interest-accumulating bonds in an attempt to reach small savers, and savings bonds were again offered in 1960 and 1961. These issues are, however, of only limited importance.

There have been no important institutional changes. The markets for both bonds and shares have developed over a long period of time. They seem to have entered a more active stage in recent years, as discussed elsewhere in this chapter.

BOND ISSUES

The issue of domestic bonds is controlled by the *Riksbank;* the commercial banks always consult the *Riksbank* when planning an issue. The *Riksbank* reserves for itself the right to control the conditions of the issue as well as the timing. In urgent cases where the *Riksbank* does not agree to an issue, loans are temporarily made to fill the need. In the case of government bonds, debt management is quite closely coordinated with the credit policy of the *Riksbank.*

Commercial banks (singly or in a consortium) may act either as underwriters, which is most common with issues of enterprises, or as agents, e.g., when marketing central government issues. The commission charges for issuing and underwriting ordinary industrial bonds are 1.5–2 percent. The total approximate cost of such an issue is illustrated in table XIII. The underwriting commission for local government bonds is three-fourths of 1 percent, for issuing without underwriting the charge is one-fourth of 1 percent. The commission on central government issues is about one-fifth of 1 percent.

The usual minimum bond issue is 5 million kronor. Industrial bonds are usually 20–25-year maturities, central government 10–20 years and local government 20–30 years. Borrowers have conversion rights after 10 years in most cases.

TABLE XIII.—*New bond issue underwriting and commission costs*

[Example: SKr20 000,000, 5½ percent issued at par: maturity: 20 years. Repayment: At least 1/20 of bonds redeemed at the end of each year, with borrower having right to call the total of outstanding bonds for redemption after 10 years]

ISSUE UNDERWRITTEN BY BANKS

(a) Initial costs:	*Percentage of face value*
Commission	2.000
Certificate stamp duty	.600
Commission on redeemed bonds (drawn and purchased) and commission on redeemed coupons	.250
Printing of bonds (SKr12,000)	.060
Stock exchange registration fee (SKr11,000)	.005
Total percentage	2.915
Nominal amount (100 percent) less initial costs	97.085

	Percentage of face value	Percentage of face value less initial costs (97.085 percent)
(b) Continuing costs:		
Annual interest	5.500	
Custody fee for pledged collateral	.050	
Difference between nominal amount of loan and amount actually received by borrower to be paid at time of redemption of bonds (2.915 percent of 1/20 of nominal amount)	.146	
Total	5.696	5.867

Source: *Stockholms Enskilda Bank.*

Between the end of the war and the end of 1962 there were one Danish and nine Norwegian bond issues in Sweden totaling 373 million kronor. In 1963 one Danish and one Norwegian loan of 50 million kronor each have been issued. Public interest in foreign issues in Sweden is limited. Yields on first class Swedish industrials, however, have been tending to fall since 1960 and since issue costs are not high Sweden is not an expensive market by international standards.

Government control of new foreign issues is strict. A few Swedish issues—totaling approximately 235 million kronor—have been placed in Switzerland.

STOCK ISSUES

There are no government restrictions on issues of domestic shares. There has been a sharp rise in such issues since the end of 1960. One reason for this is the 1961 law under which dividends up to 4 percent on stock issues since 1961 are deductible from taxable income.

Little is known about the buyers of stocks. Banks are not generally allowed to hold shares, except as collateral for loans. Insurance companies' purchases are moderate but have been increasing in recent years. Investment trusts do not play an important part in security ownership in Sweden.

There is only one organized stock exchange in Sweden, the Stockholm Stock Exchange. At the end of 1960 there were 19 members—12 commercial banks and 7 stockbrokers. There were 105 Swedish companies quoted on the exchange, and the total nominal value of their registered capital was 5.6 billion kronor. The market value of this registered capital was about 17 billion kronor at the end of 1960. The stock exchange is regulated by the Banks and Stock Exchange Inspection Board. Stock listings are restricted to companies with strong economic positions, a minimum share capital of 3 million kronor (5 million kronor in current practice), and a large number of shareholders. The value of share turnover was 1,028 million kronor in 1961.

SECTION VI—INTERNATIONAL CAPITAL MOVEMENTS

GOVERNMENTAL REGULATIONS

Sweden maintains several restrictions on capital movements. Exchange control regulations are tight. They operate on both the export and import of capital. Control is strictest on the most volatile types of capital transactions, the purpose being to avoid abrupt movements that would adversely affect exchange reserves. The basic law affecting capital movements was passed in 1939, originally to protect the country's foreign exchange reserves. This law was revised in 1959, when it was expanded from a wartime exchange protection measure to a permanent device for controlling capital movements and for harmonizing foreign exchange movements with the central bank's monetary policy. In practice its effect is to insulate the domestic money and capital markets from external influence. Under this law the structure of capital regulations given below has evolved:

I. Capital exports

A. Without restriction: No authorization needed nor declaration of amount required:

1. Day-to-day loans by Swedish banks out of their foreign exchange working balances.
2. Transfer of portfolio investment earnings.
3. Commercial loans and credits in which the creditor is a party to the business transaction.

B. Subject to authorization which is freely granted:

1. Resident purchase of Swedish securities from nonresidents (partly under general license).

2. Swedish direct investments abroad.

3. Transfer of direct investment earnings.

4. Liquidation by nonresidents of direct investments in Sweden and the transfer of proceeds.

5. Exercise by residents of subscription rights (up to 25,000 kronor) derived from foreign securities which they own.

6. Emigrant transfer of 100,000 kronor per person.

C. Subject to review and permission granted if the case has special merit, or certain conditions are met:

1. Commercial loans and credits in which the creditor is not a party to the business transaction.

2. Advance payments by importers under the following conditions: Under a general license resident importers may make advance payments up to—

(*a*) 50,000 Swedish kronor per transaction.

(*b*) One-third of the value of machinery or heavy equipment if more than the 50,000 kronor limit in (*a*).

(*c*) The full amount when shipment is imminent, even before receipt of documents.

The *Riksbank* is liberal regarding other advance payments that genuinely facilitate trade.

D. Normally not permitted:

1. Resident purchase of foreign securities from nonresidents (unless subscription rights are being exercised or the purchaser is using funds obtained from the sale of foreign securities to a nonresident within the preceding 6 months).

2. The issue of foreign bonds and stocks in Sweden. This represents a diversion of domestic savings abroad which the Government considers undesirable in principle.

3. Financial loans and credits other than day-to-day loans by banks mentioned above.

There is also indirect restriction of capital exports by means of the various regulations regarding the types of securities which credit institutions, insurance companies and pension funds may hold.

II. Capital imports

A. Without restriction:

1. Sale by a resident in Sweden of foreign portfolio securities to nonresidents. (Provided payment is in a convertible currency and proceeds are repatriated without delay. Otherwise authorization is required.)

2. Transfer of earnings and liquidation proceeds of direct and portfolio investments owned by residents.

3. Exercise by nonresidents of subscription rights derived from Swedish securities owned by them.

4. Advance payments from foreign importers, and suppliers' credits to Swedish customers.

B. Subject to authorization which is freely granted:

1. Direct investments in Sweden not in violation of the 1916 natural resources law.

2. Purchase and exercise by nonresidents of additional subscription rights to Swedish securities which they own.

3. Purchases of Swedish securities by emigrants as follows:

(a) Swedish nationals who emigrated before January 1, 1957, may purchase and export a maximum of 5,000 kronor worth of securities per calendar year.

(b) Swedish nationals who emigrated since January 1, 1957, may purchase an unlimited amount of securities provided they are held in safekeeping with an authorized Swedish bank.

C. Subject to review and permission granted if the case has special merit or certain conditions are met:

1. Swedish bond and stock issues abroad: In periods of strong internal demand, security issues abroad are seldom authorized. In less buoyant periods, when an inflow of such funds is compatible with internal monetary policy, permission is more often granted. There have been no applications to issue stock abroad.

2. Financial loans and credits.

3. Commercial loans and credits other than those fully liberalized.

D. Normally not permitted:

1. Sale of Swedish securities to nonresidents except where subscription rights are exercised, where insurance companies buy to meet deposit requirements, and, within certain limits, to emigrants.

(a) Nonresidents may purchase in Sweden through a Swedish authorized bank or broker Swedish bonds quoted on the Stockholm Stock Exchange, and issued in Swedish kronor, provided that the bonds are deposited with the bank or broker. Bonds deposited in this way must not be delivered without *Riksbank* permission (other than in connection with their sale within the country) or mortgaged or pledged within the country. The use of the yield and sales proceeds are restricted. These provisions are rigidly applied and as a result little use has been made of this facility.

TRANSACTIONS AND TRENDS

The present restrictive position taken by the Swedish authorities on both inward and outward portfolio investment does not appear to be changing. They want full control of the short-term credit and the capital markets and believe this requires restrictions on both portfolio and loan transactions with nonresidents. The authorities do not believe the advantages derived from foreign capital offset the disadvantages of foreign ownership, e.g., portfolio transactions are considered to be a vehicle for short-term capital movements, which they wish to avoid. The problems and challenges of European integration and the opposition of business to continued restrictions may bring change, but this will take some time. The prospects will be greatly influenced by the probabilities of future association with the EEC. The willingness of the authorities to license flotations on the Swedish market by other Scandinavian countries in 1963 may be significant and provides evidence of economic cooperation among the Nordic countries.

There has been little revival of the Swedish interest in foreign securities that existed before World War II. The data in table XIV indicate, however, that while Swedish investors have on balance reduced their commitments in foreign securities over the past 6 years, there seems to have been a revival of interest more recently. This experience contrasts with the balance of transactions in securities of Swedish issuers, which shows a decided trend toward repatriation although at much reduced levels beginning in 1960 when interest in Swedish stocks began to grow in the European and New York markets. Swedish yields are high and the supply of shares is restricted by Swedish regulations on exports of securities. The Swedish natural resources law of 1916 makes foreign acquisition of Swedish natural resources very difficult and limits ownership in all Swedish joint stock companies (the most usual business form) to two-fifths of share capital. The shares of several important Swedish companies with international reputations are traded on other exchanges at a premium over the Stockholm quotations. Financial sources believe there is a considerable potential foreign demand which could be developed if regulations permitted.

TABLE XIV.—*Net securities transactions entering the Swedish balance of payments*

[Millions of kronor]

Year	Domestic securities	Foreign securities	Net foreign exchange inflow (+) or outflow (−)
1957	−35.9	+39.6	+3.8
1958	−24.5	+9.4	−15.1
1959	−45.1	+26.2	−18.9
1960	−0.7	−53.5	−54.2
1961	+1.1	+58.7	+59.8
1962	−21.3	−18.9	−40.2

Source: *Sveriges Riksbank* "Yearbook," 1962.

CHAPTER XI

THE CAPITAL MARKET IN THE UNITED KINGDOM

SECTION I—SUMMARY

The effectiveness of the United Kingdom long-term capital market can be assessed in the answers to two questions: How much capital is supplied to domestic and oversea borrowers, and how efficiently is it channeled from lender to borrower?

The United Kingdom saves just under 20 percent of its GNP—high relative to the rate in the pre- and early post-war years—but lower than in certain other European nations such as Germany and Italy. Its savings are generated primarily in the private sector. From a resources point of view, the pattern in the past 2 years has been a high and rising level of personal savings in excess of personal investment, which, together with the net savings of the central government, has gone to finance an excess of investment over savings by the nationalized industries and the local government authorities. The company sector until 1960 also had an excess of savings, but during the past 2 years—with declining profit margins—it has only generated savings approximately equal to its investment, and has neither provided savings net to other sectors nor required savings net from other sectors. The savings of the domestic economy as a whole, plus grants from overseas governments in earlier years, have been large enough to permit the United Kingdom to invest overseas (net) during 11 of the past 15 years, which has meant an increase in the cumulative value of United Kingdom assets overseas by £1.1 billion, mainly in the form of direct private investment.

From the financing point of view, the pattern has been as follows:

(1) The central government normally runs a current surplus but regularly borrows from the public in order to finance the investment needs of the nationalized industries and meet other capital costs. During the past 5 years, however, this borrowing has been covered by the small savings contributions of individuals, and the central government has been able to reduce the marketable debt held by the public. In line with the government's general policy of extending the life of the debt when possible, it has utilized this opportunity to reduce the liquid, Treasury bill, portion of the marketable debt. During this period the government has acted more positively than before to affect long-term interest rates. The local authorities—also a part of the government sector—have borrowed long-term from the public through security issues and through the mortgage markets. The local authorities have also financed a substantial portion of their long-term investment requirements by borrowing short-term, using the Euro-dollar and other markets. However, limitations on local authority temporary borrowings have been announced by the Treasury, which should keep such financing arrangements down to acceptable amounts.

(2) Companies provide the financing for a large share of their own fixed investment and other capital needs—statistics on quoted companies indicate depreciation and other reserves provide one-half of capital funds. New issues provide a further one-fourth of capital requirements.

(3) Statistics for the personal sector are so inadequate that little can be said except that the savings appear largely to take the form of increased interests in life insurance and pension funds, deposits and shares in building societies, and national savings (which accrue to the Exchequer).

Institutionally, the heaviest suppliers of investment capital in the United Kingdom are the insurance companies, whose total assets amount to £7.7 billion. Next come the building societies with assets of £3.8 billion, followed by pension funds with £3.5 billion. The investment trusts and unit trusts have been growing rapidly and now control combined assets of £2.7 billion. It is contemplated that the suppliers of long-term funds will be looked to for increasing amounts of capital, as Britain's industrial growth targets and recognized housing and public service needs will require an increase of approximately 26 percent in fixed investment between 1961 and 1966. This means a level of fixed investment approximately £1.2 billion higher, or an average increase of £260 million per year.

The institutional structure of the London market is by all standards highly developed, well organized, and generally efficient—though the City itself recognizes there is room for improvement. It is commonplace to relate how the City of London has endured as a leading world capital market despite the change in the conditions which fostered and supported it—when Britain was politically, industrially, and commercially supreme, with the benefits of a fully convertible currency and little competition from other capital markets, when it had massive balance-of-payments surpluses and a large and continuous volume of savings from both domestic and foreign sources which was readily available for overseas investment.

Nevertheless, the City has adapted to the vastly different circumstances of today and continues effectively to provide long-term capital to those borrowers who—it must be added—are allowed access to its facilities. The City's reputation stands high in the financial world and its institutions are flexible and adaptable in operation. These institutions are generally free of direct governmental regulation—some might even say too free of regulation for the good of investors in what is required by way of information in prospectuses and balance sheets; however, the City considers that its technique, which places heavy responsibility on the integrity and judgment of the investment bankers and brokers, adequately protects investors' interests.

Such information as is available appears to bear out the generally accepted view that, disregarding the interest charges and looking only at the other costs of borrowing, overhead costs as of the end of 1962 were relatively low in London.

The British do not currently employ direct controls over new security issues as a weapon to regulate economic activity but use monetary and fiscal policy and other techniques. Local authorities are the only domestic borrowers required to obtain permission before floating new issues.

The timing of new issues for amounts in excess of £1 million is, however, managed by the Bank of England and the terms of fixed interest securities issued by public authorities in the United Kingdom and the Commonwealth are also subject to approval. These requirements appear to be imposed to facilitate debt management by the central government and to avoid market disruption. Foreign borrowing is controlled, however, with balance-of-payments needs as the principal determinant. As long as the British economy fails to generate sizable and continuing surpluses on current account, the ability of the United Kingdom, for all the efficiency of its capital market, to supply capital to foreign borrowers will be limited.

London is a traditional market for oversea borrowers, and the United Kingdom economy historically has generated a large proportion of these funds. However, United Kingdom net private long-term investment over the past 5 years has averaged only £ 50 million per year, and in the past 2 years there has been slight United Kingdom net disinvestment. This average conceals a sharp difference between United Kingdom investment in the sterling area and in the nonsterling area. With respect to the sterling area, where United Kingdom residents are permitted freely to invest in direct or portfolio investments, there has been a net flow of investment funds from the United Kingdom averaging £150 million per year. With respect to the nonsterling area, where United Kingdom investment is severely restricted but where investment flows in the opposite direction are strongly encouraged, there was a net flow of investment funds into the United Kingdom averaging £100 million per year. Thus, over the period the United Kingdom has received net private capital from the nonsterling area, and provided a somewhat larger net amount of private capital to the sterling area. This pattern clearly derives from the operation of governmental controls over transactions with the nonsterling area rather than from market forces.

In addition to these private flows there have been important intergovernmental loans. The United Kingdom government made or repaid (net) oversea loans at an average of about £70 million per year over the 5 years—of which nearly £50 million went to the sterling area, and £20 million went to the nonsterling area, largely to service the United States and Canadian loans.

At present, controls on capital movements to the nonsterling area are even more severe than those in effect 2 years ago. The continued regulations covering capital export to the nonsterling area stand in marked contrast to the virtual elimination of all the wartime imposed controls on the domestic and external economy.

The London financial community has understandably been anxious to make more effective use of its technical knowledge and facilities in arranging long-term international finance. Since the balance-of-payments position continues to limit the volume of capital which can be supplied to foreign borrowers by the United Kingdom, the market is largely limited to a role as an entrepot. Under the leadership of the Governor of the Bank of England, a new initiative has been launched to strengthen and refurbish the role as a financial entrepot by improving the attractiveness of the London capital market machinery to foreign lenders and foreign borrowers. Lord Cromer said in October 1962 that the time had come for the City once again to become—

> an international capital market where the foreigner cannot only borrow long-term capital but where equally important he will wish to place his long-term investment capital.

Since that time a number of significant steps have been taken. First, the Government of Iceland was permitted to float a loan in London; though it was still a loan to a sterling area member, this was the first new issue by a non-Commonwealth government in a decade. Next, the decision was announced that bearer securities would be generally permitted, ending a prohibition which had been retained since World War II as an exchange control and tax control measure. The stamp tax on original security issues and subsequent transfers was cut in half, which reduced significantly the costs of flotations—especially of bearer securities—and of trading in stocks and bonds. Legislation was adopted to facilitate transfers of securities and to eliminate certain cumbersome and anachronistic procedures. Member governments of the European Free Trade Area were allowed access to the London capital market, which added only Portugal and Austria to the list of potential borrowers, since the Scandinavian countries had gained access some years ago under UNISCAN arrangements and it would appear extremely unlikely that Switzerland would borrow in present circumstances. Most recently, the Government of Japan was permitted to float a new issue to refund a loan falling due, the first genuine new issue since before the war by a nonsterling country.

None of these actions in itself is of outstanding significance, but all help to reestablish London as an entrepot. The diversity of the measures taken and flotations arranged indicate that the authorities are testing various areas of the market in a careful and methodical way, with minimal risk. This approach also allows the City to gain experience in these operations step by step.

No doubt additional measures will be announced in the future. One measure under consideration which would make it easier for foreigners to do business in sterling, and possibly increase their willingness to utilize the City's financial facilities, would be for Britain to shift to a decimal currency. A commission recently examined alternative techniques of making the shift, and it is possible that a decision to move to a decimal system will come in the not too distant future.

Tax changes have also been suggested. Foreign investors reputedly have long been displeased with United Kingdom tax regulations which require withholding at source on interest and dividends, except where affidavits for exemption or relief are filed with the attendant risk that income and tax information may be revealed to the foreigners' own tax authorities.

In three other recent loans—the loan to the Belgian Government, to *Autostrade* and to the city of Copenhagen—the United Kingdom apparently acted purely as an entrepot. The first two issues were denominated in dollars. These issues apparently both contained variations of the attractive tax procedures mentioned above. It is not clear who, in the last resort, provided the dollars. Possibly the loans reduced potential borrowing in New York, and possibly they used European holdings of dollars. One London observer, in reporting the Belgian loan, commented that:

> The city should not delude itself that in arranging such lending it is responding to Mr. Dillon's pleas that Europe should assist the dollar by liberalizing its capital markets.[1]

Britain's ability to reestablish itself as a truly important entrepot may, however, depend on its ability to attract investment funds from all areas—which may in turn depend on Britain's willingness also to relax somewhat further its controls on international capital transactions and become a source of investment funds to all areas.

SECTION II—THE PATTERN OF SAVINGS AND INVESTMENT

SAVINGS AND INVESTMENT: THE FLOW OF REAL RESOURCES

A look at the flow of Britain's savings into investment on a national accounts basis provides a useful framework for examining the United Kingdom capital market and its institutions. (See table I.)

TABLE I.—*Gross savings and investment as percent of GNP*

Year:	*Percent*	Year—Continued	*Percent*
1938	11.5	1958	19.4
1946–50 average	13.5	1959	19.0
1951–55 average	17.1	1960	19.7
1956	19.5	1961	20.2
1957	19.8	1962	19.1

Source: Central Statistical Office, "National Income and Expenditure, 1963," tables 1 and 6.

Gross savings and investment in Britain in 1962 equaled about one-fifth of the gross national product. This represents the share of the economy's total output which is not used for current consumption purposes but is used to replace or expand the nation's fixed capital assets and to build up inventories. The ratio for Britain appears to be higher than for the United States, but considerably lower than for the German economy, which in recent years has experienced an extraordinarily high rate of capital investment.

For the United Kingdom the ratio has remained remarkably stable in recent years: between 19 and 20 percent of GNP has been saved and invested in every year since 1956. In earlier postwar years the ratio was lower, at 17 percent of GNP in the early 1950's and 13½ percent during the immediate postwar years 1946 through 1950. In the prewar period, characterized by widespread unemployment and low investment, the ratio was considerably lower—in 1938 United Kingdom savings and investment equaled only 11½ percent of GNP.

The private sector provides the bulk of the savings. As shown in table II, persons and companies together accounted for about 75 percent of all savings in 1962. On the investment side as shown in table III the private sector is relatively less important—accounting for 58 percent of total domestic investment in 1962. Thus the present broad structural pattern can be stated as follows: The private sector of the economy as a whole provides more savings than it uses for domestic investment, while the government sector as a whole provides less savings than it uses for domestic investment.

[1] "The Banker," June 1963, p. 377.

TABLE II.—*Savings*

[Millions of pounds]

	1957	1958	1959	1960	1961	1962
Persons	919	890	1,005	1,484	1,863	1,639
Companies	1,850	1,952	2,059	2,496	2,089	2,004
Total private	2,769	2,761	3,064	3,980	3,952	3,643
Public corporations	153	159	187	298	355	384
Central government	541	596	497	217	295	659
Local authorities	166	168	199	232	190	218
Total public	860	923	883	747	840	1,261
Residual error	207	244	81	−303	55	−136
Total savings	3,836	3,928	4,028	4,424	4,847	4,768

The par value of the pound sterling is $2.80.

NOTE.—Savings for each sector includes depreciation allowances, and dividend, interest, and tax reserves, and excludes stock appreciation.

TABLE III.—*Investment*

[Millions of pounds]

	1957	1958	1959	1960	1961	1962
Persons	573	589	692	842	930	913
Companies	1,557	1,495	1,619	2,239	2,147	1,830
Total private	2,130	2,084	2,311	3,081	3,077	2,743
Public corporations	713	730	768	767	895	926
Central government	209	237	242	239	225	225
Local authorities	568	535	567	609	684	800
Total public	1,490	1,502	1,577	1,615	1,804	1,951
Net investment abroad	216	342	140	−272	−34	74
Total investment	3,836	3,928	4,028	4,424	4,847	4,768

NOTE.—Investment for each sector includes gross fixed capital formation at home, plus value of physical increase in stocks and work in progress.

Source: Central Statistical Office; "National Income and Expenditure, 1963," tables 6, 25, 26, 31, 53, and 67.

However, as shown in table IV, not all parts of the public sector are net investors, and for the past 2 years part of the private sector has not provided significant net savings. In the private sector, the savings and investment of companies have during 1961 and 1962 been more or less in balance, although in earlier years companies provided substantial net savings to finance the investment of other sectors. In the public sector, the central government usually provides net savings while the local governments and public corporations (mainly the nationalized industries) are heavy net investors.

TABLE IV.—*The balance of saving over investment*

[Millions of pounds]

	1957	1958	1959	1960	1961	1962
Persons	346	220	313	642	933	726
Companies	293	457	440	257	−58	174
Total private	639	677	753	899	875	900
Public corporations	−560	−571	−581	−469	−540	−542
Central government	332	359	255	−22	70	434
Local authorities	−402	−367	−368	−377	−494	−582
Total public	−630	−579	−694	−868	−964	−690
Total	9	98	59	31	−89	210
Plus residual error	207	244	81	−303	55	−136
Equals net investment abroad	216	342	140	−272	−34	74

Source: Central Statistical Office, "National Income and Expenditure, 1963," tables 3 and 4.

Combining the public and private sectors, any net savings in the domestic economy as a whole provide funds to finance United Kingdom net investment abroad. Britain's net investment abroad—which is the same as the current account balance-of-payments surplus less any capital grants from overseas governments—has fluctuated sharply over the postwar years. Over the 15 years 1948–62, net investment abroad was recorded during 11 years and net disinvestment abroad during 4 years—1951, 1955, 1960, 1961. For the period as a whole there was a cumulative net investment abroad of about £1.1 billion. This means there was a net increase of £1.1 billion in the value of real and financial oversea assets of United Kingdom residents, which could have taken a number of forms—such as a higher level of United Kingdom gold and foreign exchange reserves, increased holdings of foreign securities or direct investments, a reduction in sterling liabilities, or a higher level of inventories overseas.

The personal sector

One of the major developments in recent years has been the increase in personal savings. As shown in table II, these savings have almost doubled since 1957 and now comprise nearly 35 percent of total savings. Throughout most of the postwar period there has been a broad tendency for the personal sector to increase its savings—not only in absolute amounts but also in relation to its total income. The percentage of personal income devoted to saving was about 5 percent in 1938, fell to 0 to 1 percent in 1948–50, and increased to 7 to 8 percent in 1961 and 1962.

In part, the continued increase in the rate of personal saving represents a return from what was an abnormally low level of personal saving just after the war. Interest rates in Britain were very low in the immediate postwar years, and the rise in interest rates during the 1950's may have had an important effect in changing people's willingness to save. However, the Radcliffe Committee reported that it had encountered extreme difficulty in testing the possibility that personal savings are directly affected by changes in interest rates.

The Committee suggested that "much the larger part" of the explanation for the increase in savings in the 1950's was that—

> During the war and postwar scarcities, homes as well as businesses suffered prolonged depletion of their equipment. As scarcities eased, deficiencies were made good as rapidly as possible. As this extraordinary call on incomes gradually exhausted itself—and exhaustion came after rather than before 1950—the proportion of unspent income materially rose, without any great effort of abstention.[2]

The company sector

While the personal sector has in the past 3 years provided a much higher level of net saving (in excess of its investment), the company sector, which comprises all privately controlled corporate business enterprises and accounts for the origin of approximately one-half of Britain's national income, has moved in the opposite direction. As shown in tables II and III, both savings and investment of companies rose between 1957 and 1960 but both declined in the past 2 years. This decline reflected the moderation in the pace of business expansion since 1960 which has been associated with narrower profit margins.

On the saving side the decline between 1960 and 1962 results from the fact that not only have profits declined, but companies have also paid higher dividends and interest—there was a reduction in gross trading profits of about £200 million and an increase in dividends and interest of about £200 million. This had a scissors effect on company savings.

On the investment side, most of the decline in the past 2 years represents a change in company inventory accumulation. Investment in stocks and inventories often moves erratically and the rate of inventory accumulation in 1962 was £500 million below the very high rate recorded during 1960. In addition to inventories, however, the rate of investment in fixed assets also declined in 1962, particularly in manufacturing which represents about three-fourths of Britain's industrial production.

As a result of these changes, the company sector as a whole, which formerly had an excess of savings to provide to other sectors, during the past 2 years has neither provided savings nor required savings from other sectors in any large amount. It has been approximately in balance, and has provided the savings needed to cover its own investment.

The government sector

The most noticeable development in the savings-investment picture of the government sector in recent years has been the change in the savings of the public corporations and in the savings of the central government.

These changes are partly ficticious, reflecting a new technique for financing the deficits of the nationalized transport industry. Before 1960 these deficits were financed by capital borrowing from the Exchequer. Since 1960 they have been financed by central government current account subsidy, amounting to about £120 to £150 million per year. The effect of adopting the new financing technique has been to make central government savings look lower since 1960 and to make public corporation savings look higher, thus distorting the trends in tables II and IV.

Central government savings have also been affected, however, by factors other than the change in the transport subsidy. Central

[2] "Committee on the Working of the Monetary System Report," Cmnd. 827, Augus 1959, pp. 156–158 (Radcliffe Report).

government savings on a national accounts basis are the current account budget surpluses (with certain adjustments), and they reflect changes in tax receipts and government expenditures. The lower level of central government savings in 1960 is partly attributable to the tax cuts introduced in 1959; the rise in 1962 reflects a spurt in tax revenue that year.

FINANCING THE MAJOR SECTORS OF THE ECONOMY

The comments above describe the flow of real resources from savings into investment among the sectors of the economy. This section discusses some of the monetary flows.

Financing the government sector

The government sector includes the central government, the local authorities (county and city governments), and the public corporations (nationalized industries, Bank of England Issue Department, British Broadcasting Corporation, etc.). The central government finances the expenditure of the others not only through various capital transactions but also in certain current account payments; in 1962 the central government paid currenr grants and subsidies to the local authorities amounting to V926 million and provided an operating subsidy to the transport industry of around V140 million.

The savings of the central government, shown earlier in table II, represent the current account budget surplus plus an adjustment for accrued taxes and subsidies. In calendar year 1962 it amounted to £659 million out of budget receipts of £8,241 million.

This current surplus of £659 million, plus receipts from taxes on capital (estate and inheritance taxes) amounting to £266 million, provided the central government with funds far in excess of amounts needed to finance its own capital formation. The central government's own direct capital investment, although spread over a variety of assets, including roads, post offices, health facilities and many others, is relatively small at just over £200 million. Thus the central government normally has funds available for other capital account uses.

There are a number of uses to which the funds are put. Most importantly, the nationalized industries receive large-scale loans from the central government—averaging almost £550 million annually since 1957. Secondly, there are loans and loan repayments to overseas governments and capital subscriptions to financial institutions such as the IMF and IBRD. Thirdly, the central government provides sterling to finance any increases in Britain's gold and dollar reserves. These and other requirements are in most years well in excess of the central government's current surplus, and the central government consequently is required to borrow from the public.

Shifting from a national income account to a financial basis, table V shows the financing of the Exchequer account, which is the central cash account of the government, kept by the Treasury at the Bank of England. Under United Kingdom law all money received by the central government must be paid into, and all payments authorized by Parliament must come out of, the Exchequer account. This covers: on the receipts side, all revenue receipts, interest and capital payments on loans made by the Exchequer, and the proceeds of government borrowing; and on the payments side, all the expenditure of government departments, whether capital or current, all consolidated fund services, including interest and capital payments on the government's debt, and loans to nationalized industries, the Public Works Loan Board and other projects authorized by Parliament.

The Exchequer accounts distinguish between (i) payments in respect of which Parliament has not given Treasury specific power to borrow, and receipts which Parliament has not given Treasury specific power to use for the service of debt, on the one hand, and (ii) payments in respect of which Parliament has given the Treasury specific power to borrow, and receipts which Parliament has given the Treasury specific power to use for the service of debt.

Payments and receipts of the first kind constitute the budget "above the line," which is similar to but not the same as the current account of the central government as defined in the national accounts. Transactions of the second kind constitute the budget "below the line," which is similar to but not the same as the capital account of the government.

In every fiscal year since 1946–47 the Treasury has achieved an above-the-line surplus, which has been available to finance the deficit below the line. However, there has typically been an overall deficit, varying in the past 5 years from a high of £394 million in 1960–61 to a low of £66 million in 1962–63. For the current fiscal year 1963–64, the "reflationary" budget looked toward an overall deficit of £687 million.

The financing of these deficits is shown in table V and the amounts borrowed from the public are indicated in the lower part of the table. From the point of view of Britain's capital market, it is interesting to note the great importance of nonmarketable debt—"small savings" and tax reserve certificates.

TABLE V.—*Exchequer financing*

[Million of pounds]

	1958-59	1959-60	1960-61	1961-62	1962-63
Above the line (net)	377	386	147	410	352
Below the line (net)	−559	−700	−541	−621	−418
Budget overall	−182	−314	−394	−211	−66
Net receipts from extra budgetary funds, etc.[1]	212	26	123	162	73
Net receipts from external transactions[2]	−250	−81	−289	123	−92
Increase in net indebtedness to Bank of England Banking Department[3]	12	38	145	53	−199
Increase in notes in circulation	65	84	115	29	23
Borrowing from the public:					
Increase in nonmarketable debt held by the public	347	304	296	96	137
(a) Small savings	303	339	275	78	180
(b) Tax reserve certificates	44	−35	21	18	−43
Increase in marketable debt held by the public	−204	−57	4	−252	124
(a) Increase in marketable Treasury bills	−133	462	−288	−220	−174
(b) Increase in marketable securities held by the public	−71	−519	292	−32	298
(i) Issues		353	1,070		1,220
(ii) Redemptions (including sinking funds)	−404	−377	−40	−627	−50
(iii) Decrease in holdings of Bank of England and national debt commissioners (increase −)	333	−495	−738	595	−872
Total borrowing from the public	143	247	300	−156	261

[1] Includes national insurance funds; proceeds of denationalization of steel industry; German arms deposit; etc.

[2] Includes sterling receipts of Exchange Equalization Act, transactions with IMF/IBRD; repayment of United States and Canada loans, etc.

[3] Includes certain transactions of Paymaster General, internal revenue, and customs and excise, national debt commissioners, etc.

Source: H. M. Treasury.

Throughout the postwar years the government has maintained an energetic policy of increasing the small savings of individuals through pressing sales of national savings securities and fostering the use of the savings banks. The policy is based both on the social motive of encouraging thrift and on the desire to reduce the need to sell marketable securities and Treasury bills. During the Fifties it was useful as a politically convenient means to restrain (slightly) the growth in consumer demand. The Radcliffe Committee reported that the general policy was to encourage these sales by publicity and educational effort rather than by offering higher interest rates, partly because of a skeptical view of the power of higher rates to stimulate additional saving.[3] Nonetheless there have been increases and decreases in the rate of interest paid. In November 1963 national savings certificates paid just over 3¾ percent tax free and defense bonds yielded just over 5 percent but only a portion of the return is tax free. Other small savings have slightly different rates of return and provisions.

The only other important nonmarketable instrument has been the tax reserve certificate, which is purchased in anticipation of tax payment. According to the Radcliffe Committee while the Treasury in varying the terms on these has deliberately followed market movements, not led them, the terms have been made "attractive enough to hold sums that have made a useful contribution to the Treasury's needs."[4] The certificates now pay 2¼ percent tax free.

During the 5 years covered in table V, these nonmarketable securities have exceeded the needs of the Exchequer to borrow from the public, so that there has actually been a net reduction of £385 million in the marketable debt held by the public. Virtually the entire reduction has been in Treasury bills, which have declined by £353 million. This is in line with the government's debt management policy (discussed further in sec. IV) of "funding," or extending the average life of, the national debt. (Note that in 1959–60, however, when credit was being eased, the trends were reversed, with a large increase in Treasury bills and a large reduction in marketable securities. For similar reasons, the authorities have tended to finance the emerging budget deficit for 1963–64 by expanding the Treasury bill issue.)

Since publication of the Radcliffe Report and the committee's rather critical views with respect to the authorities' record in arrangement of the public debt, the evidence suggests that the authorities have tended to draw the appropriate conclusions: they have shown a greater willingness to take a positive attitude toward affecting long-term interest rates (see sec. IV).

To turn to the public corporations, it is fair to say these can no longer be considered a separate entity in the capital market. Earlier many of the nationalized industries were authorized to issue their own securities, with Treasury guarantees as to interest and capital. In 1955, however, it became very difficult to sell to the public a number of these issues and the Exchequer was consequently required in effect to provide the financing with Treasury bills at a time when the central government authorities wanted to hold down the Treasury bill issue in order to curtail bank liquidity. This difficulty led to the

[3] Radcliffe Report, p. 205.
[4] Ibid., p. 206.

introduction of a new system under which the nationalized industries now borrow directly from the Exchequer, and they appear as a separate entity in the capital market only in paying off earlier issues.

The local authorities, like the nationalized industries, have large capital investment programs and large financial needs. They finance construction of houses, schools, roads and other public services, utilizing to a very limited extent their own revenues, but mainly the proceeds of various techniques of borrowing: [5]

(*a*) By issuing securities.
(*b*) By issuing short- or long-term mortgages.
(*c*) By short-term unsecured borrowing.
(*d*) From the Public Works Loan Board (which borrows from the Exchequer).

Over the period since 1945, the local authorities' techniques of obtaining capital have changed a number of times, as a result of changes in central government policy. From 1945 through 1953, the local authorities mainly financed their capital needs through PWLB loans (and thus the Exchequer) at rates equal to "gilt-edged" or government security rates for the same maturities. From 1953 to 1955 they had the option of borrowing either through PWLB or through issuing securities and mortgages, but still tended to rely heavily on PWLB. Beginning in 1955 they were permitted to borrow from PWLB (at rates equal to an average of prevailing market rates for local authority securities of the same maturity) only if they could not raise the money in the stock or mortgage markets. This reduced sharply the reliance on PWLB—in 1955 the local authorities borrowed net from PWLB £414 million, in 1956 only £91 million, in 1957 down to £43 million, and in subsequent 4 years there were net repayments to PWLB rather than net borrowing.

After 1955, the local authorities raised considerable sums on the mortgage market, but for several years did not raise much money on the securities market. The Radcliffe Committee, writing in 1959, stated:

> While somewhat more money has been raised by local authority stock issues since October 1955 than in the previous period, given the conditions prevailing in the gilt-edged market it has only been possible for a very small part of the funds required to be raised by this method. Local authorities who wished to make an issue have had to wait for a period of years before being allowed to go on to the market; a long queue of would-be borrowers developed, despite the monetary authorities' decision in May 1957 to shorten the queue by putting a minimum of £3 million on the size of issues. Authorities whose issues were postponed or frustrated by this difficulty of access to the stock market were forced to turn extensively to the mortgage market, despite the higher rates ruling in that market. After September 1957 many authorities were indeed content to make a virtue of this necessity, since they reckoned that interest rates were abnormally high, and went in for extensive short-term borrowing in the expectation of being able to fund their borrowing when long-term rates were lower.

Thus the local authorities began to be major users of Eurodollars and the attractive interest rates which these local authorities offered to foreign lenders undoubtedly became one of the significant elements in the movement of short-term capital to London. The local authorities borrowed short and invested long, presumably on the expectation that long-term interest rates would be lower or at least not higher in the future. Undoubtedly they also assumed that the Exchequer would come to their relief in one way or another if for some reason

[5] Radcliffe Report, pp. 31-32.

they were required to pay off, say, the Eurodollar borrowings on short notice.

The tendency for local authorities' borrowings to become too heavily weighted on the short side became, however, a source of concern to the market and to the government. After a period of discussions between the United Kingdom Government and the local authorities on possible changes in financing arrangements, a government white paper proposing new limitations and privileges for local authorities was issued in October 1963.

The proposed method of control limits temporary borrowing (money repayable within 12 months) to 20 percent of the authority's outstanding loan debt or, if higher, 1⅓ times its capital expenditure in the preceding 12 months. (Similar regulations further define the maximum amount of 3-month borrowing permitted.) In return, the local authorities will ultimately (in 4 years) be granted access to the PWLB for up to 50 percent of their annual long-term finance. This money will be made available at government lending rates, i.e., the rate at which the government itself borrows with a small addition to cover Exchequer costs.

Following the reductions in bank rate in 1962, local authorities showed renewed interest in market issues: net issues of quoted securities in 1962 totaled £135 million which compares with an average of about £40 million in each of the preceding 6 years.

Financing the company sector

It was noted above that the company sector as a whole, which formerly recorded an excess of savings over its investment, during the past 2 years has neither provided savings nor required savings from other sectors in any large amount. It has been more or less in balance, and has provided—essentially out of depreciation and retained earnings—the savings needed to cover its own investment.

This does not mean that all company investment was self-financed, since different companies were doing the saving and the investing. There is, however, a considerable amount of self-financing by British business enterprises. Table VI shows that in 1961 undistributed earnings represented almost 40 percent of companies' gross income (before depreciation). The Radcliffe Report stated that retained earnings have been the most important source of capital for industrial expansion in Britain, and noted that many firms rely completely on self-finance, in some cases because outside capital would be very expensive, and in other cases because of a "deep determination not to run what they regard as the risks of external indebtedness."[6] It was reported that for small businesses and private companies, accumulated reserves were the normal source of long-term funds. In view of the substantial improvement in the tax rules relating to depreciation rates contained in this year's Finance Act, it seems likely that the relative importance of cash flows based on depreciation charges may tend to increase in the future. (It should be recognized that "investment" as measured in United Kingdom national income statistics does not include the cost of net acquisitions of any assets from, or extensions of credits to, other sectors of the economy or abroad.)

[6] Radcliffe Report, pp. 108–9; 323.

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TABLE VI.—*Companies income and allocation of income, 1961*

[Billions of pounds]

Income:	
Gross trading profit	3. 5
Income earned abroad	1. 1
Nontrading income	. 8
Total	5. 4
Allocation of income:	
Dividends and interest	1. 7
Profits due abroad and taxes paid abroad	. 6
United Kingdom taxes	1. 0
Undistributed income	2. 1
Total	5. 4

Source: Central Statistical Office, "National Income and Expenditure, 1963", table 26.

On the other hand, the Radcliffe Committee also reported that the new issues market was a "far from marginal source of capital in the calculations of most of the larger British firms." [7] According to the Committee, nearly one quoted company in three had resort to a market issue between 1949 and 1953, and the total sum raised represented about one-third of net new investment by quoted companies during that period. The continued importance of the new issues market is also indicated in table VII, which shows the sources and uses of capital funds for those companies which are quoted on the stock markets. (Quoted companies account for about half of company income—current data on the sources and uses of capital funds of non-quoted companies are not available). Table VII shows that in 1960 and 1961, the quoted companies raised about one-quarter of their capital requirements through new issues. It remains true, of course, that more than half of the capital funds which they utilized for fixed investment and other capital purposes was provided through depreciation and retained earnings.

TABLE VII.—*Quoted companies—Sources and uses of capital funds during 1960 and 1961*

[Millions of pounds]

	1960	1961
Source of funds:		
Internal sources:		
Depreciation provisions, balance retained in reserves, etc	1,123	966
External sources:		
Increase in amount owing to banks	134	170
Additions to tax and dividend accruals	123	64
Receipts from issues of capital	445	583
Fall in holdings of cash and marketable securities, etc	93	112
Other items and adjustments	167	97
Total	2,085	1,992
Uses of funds:		
Expenditure on fixed assets	1,118	1,340
Increase in net trade and other credit	73	44
Increase in value of stocks	579	286
Expenditure on acquiring subsidiaries	315	322
Total	2,085	1,992

Source: "Board of Trade Journal" Dec. 7, 1962, table C.

[7] Radcliffe Report, p. 80.

Financing the personal sector.

It was noted earier that there has been a rapid increase in the level of personal savings in Britain. This increasing level of savings has as its counterpart an increasing rate of accumulation of net assets held by the personal sector. (The personal sector includes individuals, unincorporated businesses, nonprofitmaking bodies such as charities and trade unions, and the funds of life insurance companies and pension schemes.) Table VIII indicates some of the forms which the increase in assets has taken. Information on this matter is seriously incomplete, as indicated by the large unidentified item.

TABLE VIII.—*Capital account of the personal sector*

[Millions of pounds]

	1958	1959	1960	1961	1962
Part I:					
Net increase in assets	675	840	1,299	1,665	1,450
(a) Life insurance, pension schemes, etc	628	701	794	846	935
(b) Households and nonprofitmaking bodies	47	139	505	819	515
Part II:					
Households and nonprofitmaking bodies net increase in:					
1. Nonfinancial assets (gross fixed capital formation at home—stocks and work in progress)	589	692	842	930	913
2. Financial assets:					
National savings	200	390	338	214	238
Bank deposits	38	52	116	271	84
Building societies	200	207	209	209	372
Tax reserve certificates and other	19	10	13	12	−2
Total	457	719	689	713	724
3. Debt:					
Consumer credit	81	220	23	−18	−11
Loans on insurance policies	6	2	6	10	5
Housing loans	213	287	352	367	378
Total	300	509	381	359	372
4. Unidentified items	−699	−763	−645	−465	−750
Net increase in assets of households and nonprofitmaking bodies (1+2)−(3+4)	47	139	505	819	515

Source: Central Statistical Office, "National Income and Expenditure, 1963," table 25.

As shown in part I of table VIII, the increase in personal savings led to a net increase in personal assets of about £1,000 million between 1959 and 1961. The great bulk of the increase was in the assets held by "households and nonprofitmaking bodies." The assets of "life insurance, pension schemes, etc." showed no sudden jump but continued the rather steady increase shown over the past several years.

Part II of table VIII indicates, however, that a large portion of this increase between 1959 and 1961 in the assets of households (a group which also includes unincorporated businesses) and nonprofitmaking bodies cannot be identified. In fact the largest portion of the increase is covered by a change in "unidentified items." The change in unidentified items could mean a change in the holding of assets on which there are no data (unidentified items include holdings of marketable securities, bank deposits of unincorporated businesses, holdings of currency, and other important items). But also it may indicate that the estimates of personal savings are inaccurate, and that the growth in personal savings was not as large as estimated.

(Estimates of personal savings are the residual after subtracting estimated consumption expenditures, income taxes, and health policies payments from estimated personal incomes.)

Looking at the financial assets which can be identified, it is of significance to the capital market that of a total increase of £700 million in the most recent year, more than £200 million went directly to the government through nonmarketable securities and savings (national savings and tax reserve certificates) and an additional £372 million went to the building societies to finance housing. Less than £100 million was available (through increased bank deposits) to all other sectors of the capital market.

It was noted above that the personal sector of the economy has regularly supplied a large excess of savings over investment which is utilized by other sectors. Table VIII suggests that the whole of this net excess of saving represents an increase in the funds of life insurance companies and pension schemes. Excluding life insurance and pension funds, and looking at part II of table VIII covering households and private nonprofit institutions, it is noted that investment in fixed assets has exceeded savings in every year. Thus it can be said that except for savings of life insurance and pension funds, the personal sector uses its savings plus some of the savings of other sectors for its own capital formation, which primarily takes two forms: investment in fixed assets by unincorporated businesses and investment in new housing.

The increasing funds of life insurance and pension schemes provide a steady and substantial flow of new savings. These funds figure very importantly in the government securities market, the market for company stocks and bonds, the mortgage market—throughout all major elements of the United Kingdom long-term capital market.

SECTION III—THE DEMAND FOR CAPITAL

This section discusses domestic investment demand—the fixed investment requirements of United Kingdom persons, businesses, and governmental bodies, on which the demand for long-term capital financing is based. Section IV, which follows, describes a number of the United Kingdom institutions which provide capital to meet those demands, and section V discusses the new issues market, which plays such a major role in the provision of long-term financing to industry, and certain specialized bodies which assist in generating finance for industry.

The demand for fixed investment in the United Kingdom has expanded during most of the postwar period, at varying rates of growth, and further increases are expected during the coming years. Investment began to grow immediately after the war, when there were acute shortages of all capital assets—houses, factories, machinery, utilities. The rate of investment growth was slowed down initially by controls to give priority to exports and later by the competition of defense expenditure, but investment began to grow more rapidly beginning about 1953, with the active encouragement of the authorities. Since about 1956 the rate of growth has been more moderate, and investment has increased at about the same rate as GNP has increased. Gross fixed capital formation now accounts for about 18½ percent of Britain's GNP, as compared with 10 to 12 percent just after the war, and the increase has been a major factor in stimulating the reactivation and expansion of the London capital market during that period.

Both the public and private sectors have participated in this postwar expansion of fixed investment. Over the past half century there has been a major shift in the relative importance of public investment; during the past decade there has been a shift in the opposite direction. Public sector investment was less than half the level of private investment in 1938, rose to a level higher than private investment in the early 1950's when private investment was restricted by government controls and public investment was accorded priority, and has now tapered off at a level approximately two-thirds as large as private investment. (See table IX.)

TABLE IX.—*Gross fixed investment*

[Millions of pounds]

	Current prices						1961 prices—NEDC projection 1966
	1951	1955	1959	1960	1961	1962	
Manufacturing	519	689	867	1,021	1,239	1,126	1,500
Industries mainly nationalized	443	708	1,027	1,048	1,039	1,055	1,487
Agriculture	91	104	140	141	155	156	171
Distribution industry and other	406	641	977	1,086	1,263	1,333	1,597
Dwellings	376	619	658	754	824	881	950
Legal fees, etc	54	47	50	55	57	57	70
Total	1,889	2,808	3,719	4,105	4,577	4,608	5,775

Source: Central Statistical Office; "National Income and Expenditure, 1963," table 58; NEDC Report: "Growth of United Kingdom Economy to 1966."

HOUSING DEMAND

Housing, including both publicly and privately financed, accounts for almost 20 percent of Britain's investment demand, and utilizes a substantial share of the economy's savings and of the funds available to the capital markets. Housing does not, however, play the dominant role in investment which it played during the 1930's when industrial investment was very low. Nor does it account for as much of investment demand as in Germany or the United States.

In housing as in total investment, there has been a shift in emphasis from public to private financing. Public housing, which is constructed and operated by the local governments but with central government assistance in the form of construction loans and operating subsidies, has been cut back sharply in recent years from 240,000 completions in 1953 to 125,000 in 1962, while private housing has expanded rapidly from 65,000 to 175,000.

All indications are that the pace of building activity will quicken. The British Government estimates that there is at present a shortage of between half a million and a million houses, and with a rising population, 125,000 new houses will be needed each year to keep up with the growth of households. There is a need for homes for the elderly. There are 400,000 slums to be cleared, and vast numbers of older houses need improvement or replacement (nearly half of Britain's houses were built before 1919 and about 15 percent are more than

100 years old). The government's aim is to raise the level of house completions from the present 300,000 to the level of 350,000 per year, though no target date has been set.

Thus housing will continue to utilize a substantial share of available capital funds. The political implications of the serious deficiency in the stock of houses are obvious and the Conservative and Labour Parties are certain to place increasing emphasis on the sector. If the target of 350,000 is achieved in 1966 it would represent an increase of about 17 percent in the recent rate of completion. While this would be a substantial improvement, it would not imply any requirement for a heavier share of total real resources than at present if Britain's GNP grows by as much as 4 percent per year. (That is the growth target which was adopted by the National Economic Development Council and has been accepted by the Government as a national objective.) Nonetheless, under any foreseeable circumstances housing finance will continue to absorb a considerable portion of Britain's savings, channeling these funds into the mortgage market rather than the securities market or other capital markets.

OTHER INVESTMENT DEMAND

As in the case of housing, it is contemplated that other investment demand will increase substantially over the coming years. The National Economic Development Council in its report on the implications of a 4 percent growth rate for Britain, has prepared detailed projections of the possible increases in various sectors of the economy.

Although there has been a decline in manufacturing investment since 1961, NEDC projects a 21 percent expansion in manufacturing investment over the period 1961–66, with certain growth industries such as electronics showing much larger increases. The estimated rate of expansion would have been considerably higher but for a sharp reduction in investment by the iron and steel industry from an extraordinarily high level in the base year.

NEDC projects that fixed investment other than housing and manufacturing will rise much more rapidly, 32 percent above 1961 by 1966. This group includes the nationalized basic industries, some of which—in particular electricity—are expected to increase investment spending very sharply. This category of investment also includes investment in social services—such as schools and hospitals—where anticipated needs and in some cases announced government plans look toward substantial increases in fixed investment.

For total fixed investment, NEDC forecasts a substantial rise of 26 percent over the 5-year period. This rate of investment would require £1.2 billion more resources in 1966 than were used in 1961. Of this total addition about £125 million would be for increased housing investment, to be financed largely through the mortgage market; about £450 million would be for increased investment in the nationalized industries, which would require Exchequer financing; about £325 million for the distribution industry and other (of which social and public services would be over £200 million and financed by local authorities and the Exchequer); and about £300 million in manufacturing and other investment, requiring largely private sector financing through new issues, reinvested earnings and other means. This indicates very generally the potential domestic needs which the various capital markets may be asked to meet over the next several years.

SECTION IV—THE SUPPLY OF CAPITAL

Funds are supplied to the long-term capital market through a variety of institutions including the following:

Insurance companies.
Building societies.
Pension funds.
Investment trusts.
Unit trusts.

The insurance companies, pension funds, and building societies together control almost £15 billion in assets, and the Radcliffe Report cited these three as the dominant sources of long-term finance.[8] However, in recent years investment trusts and unit trusts have grown extremely rapidly and now control about £2.5 billion in assets. Each of these groups is discussed below.[9]

INSURANCE COMPANIES

According to the Radcliffe Report there are about 440 insurance companies in the United Kingdom. This includes a number of companies whose business is elsewhere; most of the domestic United Kingdom business is in the hands of about 100 companies.

These companies control a vast amount of assets—about £7.7 billion at the end of 1962. Nearly 90 percent of these are life insurance funds, and these are the funds which represent a supply of capital to the long-term market. (The remaining funds represent fire, accident, and marine insurance which are essentially short-term contracts and involve investment of contingency reserves only.)

As shown in table X, insurance companies increased their long-term investments during 1962 by £510 million. This included both new funds supplied to the capital market and reinvested income. This represented more than 10 percent of the total amount required to finance gross fixed capital formation, public and private, in the United Kingdom during that year, and more than 20 percent of net fixed capital formation.

TABLE X.—*Insurance companies investments*

[Millions of pounds]

	Balance sheet assets as of end 1962	Net acquisitions 1962
Cash and other current assets	106	−10
British Government and Government guaranteed securities	1,954	149
United Kingdom local authority securities	357	21
Overseas government, provincial, and municipal securities	112	−6
Company securities:		
Debentures	981	99
Preference shares	371	9
Ordinary shares	1,572	86
Loans and mortgages:		
United Kingdom:		
House purchase loans	715	61
Loans on companies' policies	77	5
Other	390	43
Overseas	21	2
Land, property, and ground rents	730	51
Agents balances, etc	263	
Other assets	39	2
Total	7,689	513

Source: Central Statistical Office, "Financial Statistics", August 1963, table 41.

[8] Radcliffe Report, p. 107.

[9] Much of the discussion which follows comes from ch. IV of the Radcliffe Report, which contains a comprehensive description of United Kingdom financial institutions as of 1959. No attempt has been made to footnote each reference to the report.

Evidence given before the Radcliffe Committee indicated the expectation that the life insurance companies will become an even more important factor in supplying capital to the long-term market. The view was taken that life funds will continue to grow relatively to the national income for three reasons: (1) The companies expect individual policyholders to catch up at least in part with the inflation that has undermined the real value of their insurance. (2) They expect the population to become "more insurance minded." (3) They expect a continued growth of "group business" in the form of pension schemes for business firms and other corporate bodies.

In addition to the funds arising from their insurance business, many insurance companies administer large trusts which also have an important effect on the capital market. Data presented to the Radcliffe Committee indicated that as of 1957 the insurance companies administered trusts and other funds of about £80 million, and acted as trustees for issue of stocks, bonds, and unit trusts amounting to £885 million.

In investing insurance funds "there is a broad bias in favor of matching liabilities with securities." Since the liabilities are commitments to pay fixed sums at dates years ahead, this would appear to point to investment in long-term bonds. However, since many insurance policies have bonus provisions under which policyholders share in the insurance companies' profits, the companies also have a strong desire to show a good profit record. This factor together with the increasing importance of "inflation mindedness" during the late 1940's and 1950's led the insurance companies too into equity shares. This tendency toward equities was also motivated by the desire to remove the distortion of portfolios that had occurred during the war when the companies were under pressure to put all funds into United Kingdom Government securities.

As part of the movement into common stocks and other industrial securities, the insurance companies have found it profitable to go heavily into the new issues market. They are active as underwriters, usually underwriting more than half of any new issue. Their willingness to hold the securities makes the issuing houses prefer the insurance companies to many other underwriters.

In the past 2 or 3 years there has been a tendency for the insurance companies in their investment programs to restrain the movement toward investment in common shares. During 1962 less than one-fifth of their new funds went into the equity investments, the lowest proportion for nearly 10 years. Having achieved their objective of increasing the ratio of ordinary shares to other investments, and with company profits lower and dividend increases less buoyant in the past 2 years, the insurance companies have shown less interest in purchasing common stocks.

The insurance companies have a large, and during the 1950's an increasing, part of the mortgage and real property markets. At the end of 1962 they had invested £715 million in house purchase loans, and an additional £730 million was invested in land, property, and ground rents. Unlike the building societies, the insurance companies tend to prefer to finance large blocks of office buildings, shops, and apartments rather than houses. The Radcliffe Committee reported, however, that in 1956, a period of tight credit, the insurance companies greatly extended their mortgages on house property to meet the demand (largely from their policyholders) from people and companies who were finding it difficult to get money from building societies or banks. But, when lending rates went to their peak in 1957 the insurance companies thought them "unconscionable" and preferred not to lend so freely. The report states that "on the long view, they expect their business to go down; they take opportunities brought to them but are not chasing the business."

BUILDING SOCIETIES

Building societies are second only to the insurance companies in the control of vast sums. As of the end of 1962 the societies held assets of almost £4 billion. In recent years their assets have been expanding at an average of £280 million per year, as table XI shows. There are more than 700 of these institutions and they provide financing for about two-thirds of private house building.

TABLE XI.—*Building societies—Assets and liabilities*

[Millions of pounds]

	1957	1958	1959	1960	1961	1962
Assets:						
Balance due on mortgages	2,040	2,190	2,416	2,658	2,881	3,150
Cash and investments	364	421	474	488	531	641
Other assets	19	22	31	34	37	40
Total	2,423	2,633	2,921	3,180	3,449	3,831
Liabilities:						
Shares and deposits outstanding	4,282	2,479	2,749	2,952	3,156	3,528
Government loans outstanding			8	45	91	82
Reserves and other liabilities	141	154	164	183	202	221
Total	2,423	2,633	2,921	3,180	3,449	3,831

Source: Central Statistical Office, "Financial Statistics," August 1963, table 43.

The first building societies, founded almost 200 years ago, were small clubs in which members paid fixed monthly sums, and the funds which gradually accumulated were used to acquire land and build homes. As the homes became ready for occupancy they were allotted. to members in an order usually determined by ballot or by payment of a premium. When every member had acquired a house and every house was paid for, the society was dissolved. In about 1850 a new type of building society came into existence in which the rigid link between the borrowing and the investing aspects of membership were relaxed, and this developed into the present institution.

The building societies rely on the small savings of the public. The societies offer both "shares" and "deposits." A share is practically the same as a deposit. It is not marketable but is withdrawable on terms not very different from deposits, and it carries a rate of interest about one-half of 1 percent higher than deposits. In recent years the shares have been far more popular with the saving public. The bulk of the funds are, of course, invested in mortgages—£3.2 billion out of total assets of £3.8 billion at the end of 1962. In addition, as a liquidity reserve against the contingency that withdrawals by shareholders and depositors and new requirements for borrowers may temporarily exceed the inflow of new funds and mortgage repayments, the societies hold trustee securities and cash totaling £641 million at the end of 1962. The Building Societies Association require liquidity reserves of 7½ percent of total assets, but in fact the 1962 level was 17 percent.

SUPERANNUATION AND PENSION FUNDS

The pension funds have in the past 30 years been a rapidly growing sector in the United Kingdom financial structure. A substantial number of these funds are reinsured with the life insurance companies and are covered in the discussion above. The self-administered funds of the private and public sector whose assets were estimated at about £3½ billion at the end of 1962 have become a major factor in the supply of funds to the long-term capital market. The investments are shown in table XII.

TABLE XII.—*Pension funds investments—Balance sheet as of end 1962*

[In millions of pounds]

	Local authorities	Other public sector	Private sector	Total
Cash and other current assets	7	5	32	44
British Government guaranteed securities	209	217	512	938
United Kingdom local authorities	323	51	106	480
Overseas government, provincial, and municipal securities	13	12	44	69
Company securities:				
Debentures	5	96	263	364
Preference shares	8	9	55	72
Ordinary shares	84	194	879	1,157
Unit trust shares			1	1
Investment trust securities	18		48	66
Loans and mortgages		209	33	242
Land, property, and ground rents		52	53	105
Other investments	2	3	3	8
Total	669	848	2,029	3,546

Source: Central Statistical Office, "Financial Statistics," August 1963, tables 38, 39, and 40.

The liabilities of the pension funds are to the prospective pensioners. Unlike life insurance policies these funds form no part of the liquid assets of the claimants and normally cannot be used by claimants to raise funds quickly. In the first 30 years of this century the trust deeds governing these funds usually restricted investment to trustee securities; more recently this restriction has broken down and the custom today is for funds to have the full power of an investor. In the inflationary world which existed in Britain during most of the postwar years, the pension funds, like other institutions, were under pressure to improve earnings and they moved increasingly into equity investments. Moreover, as compared with insurance companies there is a greater tax encouragement for the pension funds to invest in equities. At the end of 1962 pension funds held more than 30 percent of their total investments in the form of common stocks, and an additional 60 percent in securities of a fixed-interest nature.

INVESTMENT TRUSTS

There are about 300 investment trusts in the United Kingdom. Their assets are approximately £2.4 billion and during 1962 their combined assets increased by about £70 million in market value, of which new acquisitions were £40 million. (See Table XIII.)

TABLE XIII.—*Investment trust investments*

[Millions of pounds]

	Balance sheet assets as of end of 1962	Net acquisitions during 1962
Cash and other current assets	21	−16
British Government and Government guaranteed securities	63	29
United Kingdom local authority securities	2	2
Oversea government, provincial and municipal loans	3	−1
Company securities:		
United Kingdom:		
Quoted:		
Debentures	16	1
Preference shares	77	4
Ordinary shares	1,401	1
Total	1,494	6
Unquoted:		
Debentures	5	
Preference shares	5	1
Ordinary shares	54	5
Total	64	6
Total	1,557	12
Overseas:		
Debentures	8	−1
Preference shares	3	
Ordinary shares	688	21
Total	699	20
Total	2,256	32
Other investments	9	3
Total	2,361	48

Source: Central Statistical Office, "Financial Statistics," August 1963, table 47.

Investment trusts are corporations formed for the purpose of holding investments. Their capital is derived mainly from public issues of bonds, preferred shares, and ordinary shares which are quoted and dealt in on the stock exchanges. Until there is a further issue of capital the amount of a company's stock is limited and newcomers can obtain holdings only by acquiring from existing holders. Dividends are distributed annually out of the revenue received from the company's investment assets after allowing for the expense of administration which usually amount to one-half of 1 percent to 1⅓ percent of the company's capital.

In the past English and Scottish trusts have played an important part in overseas development by mobilizing private capital for employment in the Commonwealth countries, British dependencies, and certain foreign countries. Between 1870 and World War I they contributed much to the economic development of the United States.

During the postwar years there has been much greater interest in investment trusts, partly because they appear to offer a relatively safe hedge during periods of inflation. Until 1953 any growth in their assets came purely from capital appreciation since new issues were not permitted. In recent years, however, there has been no such limitation and their expansion has been rapid.

The trusts have altered their portfolios drastically since the war. Before the war about half the funds were in fixed-interest investments. After the war the conviction that inflation would continue caused them to shift over to equities. For example, of a sample of 150 trusts surveyed, equity holdings rose from 62 percent of total investments in 1949 to 89 percent in 1957.

A second change in their portfolios has been in favor of investments in North America. Possibly the most important reason is that the United States-United Kingdom tax treaty permits investment trusts to claim a large tax credit on U.S. shares. Another major factor is that American public utilities—which have shown attractive yields—offer an investment for which there is no counterpart since nationalization in Britain. The sample mentioned above indicated a shift in the proportion of dollar securities from 5 percent of total investments in 1939 to 31 percent in 1957.

UNIT TRUSTS

The unit trusts, or open-end trusts, were introduced into Britain in the early 1930's. They, like the investment trusts, have increased rapidly during the past few years but even now, as table XIV shows, their total assets are only £257 million, much less than the assets of the investment trusts and very small in comparison with open-end trusts in the United States. With respect to the relative lack of popularity in Britain, the Radcliffe Committee commented as follows:

> There is no obvious explanation, apart from the capital issues restriction, why the unit trusts movement should have developed so much more slowly here than in the United States. One reason would appear to be the greater reluctance [in the United Kingdom] to indulge in practices that might be interpreted as share-pushing. This may account for some of the antagonism with which the unit trusts were regarded in their earlier years, when they were the subject of inquiries by the Stock Exchange and the Board of Trade. Even before the war they never received evidence of official encouragement; indeed, they were brought under legislative control in the Prevention of Fraud (Investments) Act 1939. Moreover, the American trusts can also incur heavier advertising and selling expenses since they can charge up to 8 percent in the selling price of units to cover promotional expenses. In the United Kingdom the board of trade has been reluctant to allow unit trusts to charge more than 2 percent for this purpose. This limit has been regarded by the unit trusts as something of a hindrance. Until recently, therefore, the atmosphere has not been conducive to aggressive selling by the unit trusts.[10]

TABLE XIV.—*Unit trusts investment*

[In millions of pounds]

	Balance sheet assets-market value, end of 1962	Net acquisition during 1962
Cash and other current assets	4	1
British government and Government-guaranteed securities	4	1
United Kingdom local authority securities	1	
Overseas government, provincial and municipal securities		
Company securities:		
United Kingdom:		
Debentures	1	
Preference shares	6	3
Ordinary shares	226	24
Total	233	26
Overseas:		
Debentures		
Preference shares		
Ordinary shares	17	2
Total	17	2
Total	249	27
Total	257	30

Source: Central Statistical Office, "Financial Statistics", August 1963, table 46.

[10] Radcliffe Report, p. 96.

The increasing rate at which unit trusts are growing as a medium of investment is shown in the following table, taken from the "Financial Times," October 16, 1963:

[In millions of pounds]

Year to Sept. 30	Sales	Repurchases	Net investment
1963	69.0	15.7	53.3
1962	39.0	10.5	28.6
1961	18.3	15.1	3.2

SECTION V—INSTITUTIONAL STRUCTURE

THE NEW ISSUES MARKET

The business sector in the United Kingdom relies to an important degree on the new issues market for the provision of long-term capital. It is with the exception of self-financing the major source of companies' long-term funds, and is particularly important in the financing of larger businesses.

British industry has not always relied so heavily on security issues, however. During the early part of this century new issues in London were much more a medium for British investment abroad than at home. In the years just prior to World War I, long-term issues on foreign account averaged more than £200 million annually, while domestic issues were only about £30 or £40 million per year.[11] The handling of foreign long-term issues was the function of the great merchant banks and accepting houses, while the expansion of United Kingdom domestic industry was being financed largely by ploughed back profits or privately arranged investment.

After the First World War the shortage of investible funds in the hands of the very rich, plus the fact that technological practice made it necessary for some companies to expand to unprecedented size, increased the popularity of new issues for Britain's domestic industry. Foreign issues, on the other hand, declined in importance. Thus in the 1920's, according to Midland Bank statistics, average annual new domestic issues were about £150 million, while new overseas issues averaged about £180 million. During the depression years in the 1930's, domestic issues fell to about £110 million per year while foreign issues fell even more precipitously to £40 million.[12] And, although in recent years the level of new issues has risen impressively during the past 5 years the level of domestic issues reported by Midland Bank has averaged £460 million and foreign issues less than £50 million.

The shift over the half century has been very dramatic. First, foreign issues have declined from 85 percent of the total to 10 percent of the total. Secondly, the amount of new issues floated is now only little more than double the pre-World War I level, although Britain's gross national product has increased about tenfold during that period.

Nationalization is one factor which has tended to reduce the reliance of British industry on new issues during the postwar period. Before World War II some of the largest issues, and a high proportion of all

[11] Macrae, Norman, "The London Capital Market," London: Staples, 1957, p. 153.
[12] Ibid., pp. 153–154.

industrial issues were made by industries that have been nationalized and now obtain their capital from the Exchequer.

The Radcliffe Committee stated its view that the new issues market is "an effective and important mechanism for the raising of long-term capital by public companies." [13] It was noted that during the 5 years 1949 to 1953 nearly one quoted company in three had resort to a new issue. In recent years the new issues market has become a much more important investment channel. Gross new issues, at £630 million in 1962 as recorded by the Bank of England have doubled since 1956. Net issues (less redemptions) totaled £564 million of which £256 million were shares and £308 million loan capital.

The Radcliffe Committee did, however, refer to the difficulties of small companies obtaining financing through new issues. One way in which it has been attempted to meet this problem has been to develop facilities for smaller issues, especially by private placing with institutional investors. Over a 5-year period the issuing houses reported making 66 issues at £50,000 or less, and reported about 200 issues of under £250,000. These small issues were normally placed privately, for example with one or more insurance companies, at a cost of 2½ to 3 percent on a £100,000 issue. But the real cost to the company, according to the Radcliffe Report, is the high yield a company has to offer on securities sold this way, when the purchaser knows there will be neither a market quotation nor actual dealings and he will therefore be obliged to hold what he buys for an indefinite period.[14] There are, however, alternative institutional borrowing channels for small companies, some of which are discussed later.

The Borrowing (Control and Guarantees) Act of 1946 provides statutory authority for the Treasury to restrict the raising of capital in Great Britain by the issue of shares or other securities whether by residents or nonresidents. The Treasury is in most cases advised by the Capital Issues Committee in the administration of these powers. This Committee was the successor to the Foreign Transactions Advisory Committee which was established in 1936 as a means to supervise the export of capital; its task was to advise on proposed issues for foreign account with a view to strengthening sterling by limiting transfers across the exchanges.

The Capital Issues Committee consists of a Chairman and five members appointed on the basis of their experience and reputations in the field of finance and industry. While its role has been to advise the Treasury, it has in practice been most unusual for the Treasury not to follow the Committee's advice. From the period 1949 to 1959 the scope of the transactions brought within the Committee's activities has varied in accordance with the terms of letters of guidance it received from the Treasury. In general, these variations have conformed—with some time lag—to levels of investment demand generated by domestic economic activity, and they have taken the form of changes in the minimum amounts of new issues which were subject to consent by the Committee. In periods of high demand the amount was reduced to £10,000; subsequently this ceiling was raised to £50,000 when circumstances seemed to suggest some tendency toward underemployment.

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[13] Radcliffe Report, p. 80.
[14] Radcliffe Report, p. 81.

The current position was established in February 1959 when control of issues by residents (whether for expenditure in the United Kingdom or overseas) was, except for local authorities, suspended; as discussed in section VI, however, approval is still necessary for transactions by persons and companies resident outside the United Kingdom.

After the general consent was granted to United Kingdom residents, the importance of the Capital Issues Committee was greatly reduced. At present, in addition to its control over nonsterling borrowers, the Committee may be mainly useful in providing a convenient means for the authorities to keep an eye on the volume of flotations in the United Kingdom by companies in other sterling area countries. While access to the London capital market is open to Commonwealth Governments and substantial freedom exists for subsidiary bodies and private borrowers, the knowledge that applications will be scrutinized may deter some prospective issuers. Since consent is required for any capital flotations which exceed £50,000 in a year, the net has a very small mesh. The statutory authority and the Committee are thus both very much alive and if future circumstances should make it necessary, the Chancellor of the day would have no technical or legal difficulties if he should decide to reimpose the control in full.

As far as the Capital Issues Committee control on domestic borrowers is concerned, the Radcliffe Committee said that it was, and would be if introduced again, an ineffective method of regulating demand, that the way it worked was unsatisfactory, and that it continued to work at all only because of the diligence and good sense of the members of the Committee. The Radcliffe Report said:

> The Committee has not been asked to operate a quantitative control. It is possible to conceive a system whereby the authorities would decide how much borrowing in total was to be permitted in any given period and would then either allocate (or ask an advisory committee to allocate) this total among the applicants, or (if the restriction was to be only temporary) operate a system of priorities. This is not how the control has worked. The Treasury has from time to time given the Committee letters of guidance (the texts of which have generally been published), indicating in very broad and qualitative terms the purposes for which the Treasury approves of the raising of money and the purposes and the types of transaction for which the Treasury wants to discourage the raising of money. The Committee's task has been in effect to decide in which category an application falls, and to recommend giving or withholding consent accordingly. It has not been asked to choose the best candidates to fill a limited number of places, but to say whether or not a candidate meets certain very general qualifications; one reason for the inefficiency of the control has been that the qualifications have been so vague and general that very few applications have failed to satisfy them.[15]

Commenting that the control (as it affected domestic borrowers) was objectionable because it was "qualitative rather than quantitative," the Radcliffe Committee stated:

> We do not advocate the institution of a system of quantitative control of borrowing and capital issues as a permanent instrument of regulating the amount of resources available for investment. Such a system would be cumbersome to operate as well as irksome for the controlled; and, in a well-developed monetary system such as our own, such a control, though it would add to the general difficulty of borrowing, would not in the end prevent a determined borrower from raising the money he sought. But we do visualize * * * that a quantitative control of capital issues would have its place as an instrument to be used in an emergency, inevitably in a somewhat rough and ready way, in combination with other measures and for a limited period of time. The apparatus of control re-

[15] Radcliffe Report, p. 333.

quired for this task, which would be limited in scope and in time, need not be large or complicated, and could be quickly established if the need arose.[16]

The Committee said that as far as oversea borrowers were concerned, it is necessary to retain a control over new issues.

In addition to the control imposed through the machinery of the Capital Issues Committee, the Bank of England still operates the queue. Under this control, which is delegated to the Bank by the Treasury, the Bank's approval must be obtained on the terms and timing of certain new issues. The timing of all issues involving not less than £1 million requires the Bank's approval, and the terms of the issue of fixed interest securities, other than by companies, require similar approval. The control covers both residents and nonresidents. It is designed to help the Bank maintain an orderly market, and to permit control over issues which might adversely affect the Government's management of the public debt.

With respect to foreign capital issues, the United Kingdom control has had the effect of virtually denying access to the London market of all overseas borrowing except to the sterling Commonwealth. Table XV indicates the effect of this control and shows the extent to which the new issues market in Britain has dried up as a source of capital for foreign borrowers. It was noted earlier that new foreign issues in recent years amounted to about £50 million per year. However, if redemptions are subtracted from that figure, the picture becomes quite different. Table XV shows issues less redemptions by foreign borrowers obtaining over the past 5 years averages less than £7 million per year—with the preferred Commonwealth borrowers modest net new issuers and other countries almost consistently negative, indicating existing loans by non-Commonwealth borrowers were being repaid at a rate greater than new issues. Thus non-Commonwealth borrowers are supplying the London capital market with capital rather than borrowing. The oversea supply and demand for capital is discussed further in section VI below.

TABLE XV.—*Capital issues and redemptions in the United Kingdom* [1]

[Millions of pounds]

	1958	1959	1960	1961	1962
Gross issues	387	512	574	693	630
Gross redemptions	93	86	91	70	66
Issues less redemptions (by type of security)	295	425	483	623	564
Loan capital	194	164	145	184	309
Preference shares	--------	8	4	−1	3
Ordinary shares	101	254	334	439	253
Issues less redemptions (by location of borrower)	295	425	483	623	564
United Kingdom borrowers	279	420	477	614	566
Local authorities: quoted securities	52	34	46	38	136
Quoted public companies	225	386	431	576	430
Overseas borrowers	16	5	6	9	−2
Commonwealth	34	23	6	17	8
Other countries	−18	−18	--------	−8	−10

1 Excludes central government issues and redemptions.

Source: Central Statistical Office, "Financial Statistics," No. 16, August 1963, table 52.

16 Ibid, p. 335.

In addition to United Kingdom private companies and local authorities, and foreign bodies, the other major borrower in the new issues market is the United Kingdom Government. An indication of the relative importance of United Kingdom government securities in the market is that these issues, which currently total more than £15 billion, plus government-guaranteed issues, which account for an additional £3 billion, together represent about one-third of the total market value of all issues quoted on the London Stock Exchange. As recently as 1954 they accounted for more than half of the market value of all securities on the exchange. Marketable securities represent more than 50 percent of the debt of the central government. (The remainder is covered by treasury bills, national savings, and other nonmarketable issues, and external debt.)

The magnitude of the central government debt, at more than £28 billion, is such that its management has a major impact on the liquidity structure of the economy and provides the authorities with an important opportunity to influence total demand. Since a considerable portion of the debt is in the hands of oversea holders, the management of the debt also has an important balance-of-payments impact. The bulk of the debt rose, of course, during World War II—gross debt of the central government increased from just over £7 billion in 1935 to nearly £26 billion in 1952. Since the war the central government itself has been a substantial net lender—while its debt has increased, the increase is more than offset by loans to the nationalized industries and local authorities. For the public sector as a whole, however, total debt has continued to expand—though as a percent of national income it is lower today than it was before World War II.

Evidence submitted to the Radcliffe Committee indicated significant changes in the structure of the public sector debt between 1935 and 1958.[17] Marketable securities ("gilt-edged") became relatively less important, declining from two-thirds to less than half of total public sector debt, while Treasury bills increased from 5 to 10 percent of total. National savings, which were one-fifth as large as market securities before the war, increased to two-fifths by the end of 1958. Local authority debt, though it grew very rapidly between 1952 and 1958, in the latter year still represented a lower portion of total public sector debt than it did before the war.

From the debt management point of view, the most significant development was the shift toward shorter maturities. During the war the authorities sought to place new debt as cheaply as possible, and achieved this by pegged interest rates and short maturities. An attempt was made to continue this sort of policy in the early postwar years, but subsequently the attitude changed, and the authorities did not endeavor to press for minimum debt servicing costs but sought instead to increase the average life of outstanding securities. The Radcliffe Committee reported that:

> The history of debt management in the last 10 years has been essentially a search for a new equilibrium between a demand fundamentally different from that of wartime and a supply conditioned by the need to remove abnormal liquidity from the economy and so enable the authorities to regain control of the monetary situation.[18]

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[17] Radcliffe Report, p. 193.
[18] Radcliffe Report, p. 200.

The dominant motive has been to "fund," particularly to reduce reliance on short bonds, through the problem has been made more difficult by the fact that a firm institutional demand for short bonds had developed.

Through the postwar period up to 1957 the authorities were not prepared to force interest rates on longer issues upward to encourage switching from short to longer bonds. According to the Radcliffe Report their attitude toward long-term interest rates was "passive, indeed fatalistic." [19] The authorities argued that a deliberate marking down of prices at which the government broker was willing to sell would have been regarded in the market as arbitrarily juggling with the capital values of the government's own creditors, which would have seriously damaged "government credit," with repercussions on foreign confidence in sterling. The policy of the authorities thus was to unload longer issues on rising markets when they would not force prices down.

The Radcliffe Committee stated that the attitude of the authorities toward the long-term market changed in 1957, and that with the broad swing downward in interest rates from 1957 until the end of 1959 the authorities gave the market a positive lead and resisted the tendency of gilt-edged prices to rise sharply. A good description of the developments under these changed official tactics since 1957 has been published by Mr. E. Victor Morgan: [20]

> It is from the end of 1957 that the Radcliffe Committee detects signs of a more positive official policy and there is some confirmation of this both in the figures and in the brief comments which have appeared in the "Economic Surveys" and in the Bank of England's "Quarterly Bulletin." During the first three quarters of 1958 there were net sales of £267 million despite the maturity of £676 million of 4 percent conversion loan in June. This could be interpreted as no more than a continuation of the old policy of funding on a rising market, but there is little doubt that sales were pressed unusually hard with the definite intention of moderating the rise in prices. By the autumn of 1958, however, the accent was again on credit relaxation. The "Economic Survey" for 1960 comments that, during 1959, "the authorities did not seek to press sales upon the market, since it was though desirable not to take any action which might check the revival of business activity," though it hastily adds that "circumstances were not such as to lead the authorities to abstain from selling stock when opportunities offered." In the five quarters from September 1958, to the end of 1959 the authorities made net purchases of £431 million.
>
> By the beginning of 1960, the need for restraint was again apparent, but the authorities were faced with a weak market due to heavy bank sales to accommodate the big increase in the demand for advances which had followed the "liberation" of July 1958, and to some withdrawal of oversea funds from the market. The "Economic Survey" for 1961 comments that "although the authorities continued to maintain a market, they did not resist this tendency of prices to fall, since it was judged that a rise of interest rates was now appropriate." In fact, the government broker marked down his buying prices quite sharply in February but even so the departments absorbed £274 million of stock during the quarter, almost exactly the amount of the fall in clearing bank and oversea holdings.
>
> The banks sold a further £200 million of stock during the last three quarters of 1960, though there was an increase of £100 million in oversea holdings and a revival of demand from the nonbanking domestic sector. Prices continued to fall until August and then steadied, though "the departments were ready sellers, at current prices, to meet this demand, and there was in consequence very little rise in prices." [21] Official sales during the three quarters amounted to £422 million.

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[19] Ibid, p. 205.
[20] Morgan, E. Victor, *Funding Policy and the Gilt-Edged Market*, "Lloyds Bank Review," October 1962.
[21] Economic Survey, 1961, p. 33.

During the first half of 1961 the market again came under pressure from continued bank sales and renewed withdrawal of oversea funds. A further issue of £300 million of 4¾ percent conversion stock, 1963, was made, and the Bank commented in its "Bulletin" for June 1961, that this "made it easier for the authorities to restrict a fall in short-term rates." However, when the "tap" in 5 percent conversion, 1971, was exhausted it was not replaced, and the authorities gave considerable support to medium-term issues. This, together with the maturity of £796 million of 2½ percent funding loan, brought net departmental purchases during the first half of 1961 to over £400 million. Support on this massive scale seems rather out of line with the general economic policy of the time, and neither the Bank nor the Treasury has given any further explanation.

During the 4 years from the end of 1957 to the end of 1961, taken as a whole, the departments were net purchasers of over £250 million of securities. However, the clearing and Scottish banks reduced their holdings by more than £850 million and oversea official holdings fell by almost £100 million. There was a substantial rise in the holdings of the discount market but, even allowing for this, the non-banking public absorbed a further £400 million.

The policy of more positive official guidance to the market appears to have continued in more recent periods. During 1962 there was an easing of credit conditions and a reduction in short-term interest rates, accompanied by a fall in the long-term interest rates. The Bank of England states that—

> this fall reflected mainly a change in the underlying conditions of the market, but partly official operations in gilt-edge stocks, which were designed to allow a steady but sustainable fall in rates to take place.[22]

The budget presented in April 1963 looked toward a large overall deficit of £687 million and heavy borrowing requirements. Thus far the deficit has been slow to materialize although evidence of increasing expenditures is now beginning to appear. It has been reasoned that the authorities might be glad to resort to Treasury bill finance of the deficit in order to supply the banks with liquid assets to enable them to support additional advances required for reflation.[23] Thus far, the weekly Treasury bill issues have been exceeding the maturing bills—lately by as much as £20 million per week—suggesting that the authorities are following this policy. This policy has also had the effect of helping to hold up the yields on Treasury bills.

The first large market issue after the April 1963 budget—a £400 million 5-percent Exchequer stock 1976–78 issued at 96 providing a yield somewhat below the market level at the moment of the announcement—was taken as evidence that the authorities favored a downward trend in yields in spite of the deficit financing ahead. The most recent issue—a £490 million 4-percent 1968 stock issued at 98—was taken as an indication that the authorities thought present yields were about right.

Mr. E. Victor Morgan has commented on the more active funding policy of the authorities as follows: [24]

> These rather tentative steps toward a more active funding policy reflect partly a change in official attitudes but also a change in what is practically possible. In the first decade after the Dalton experiment the difficulty in meeting the government's financial needs without an inordinate rise in the floating debt created an overriding need to sell stock. Given the refusal of the authorities drastically to mark down the prices of their own securities. There was little

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[22] "Annual Report of Bank of England 1963," p. 2.
[23] "Banker," May 1963, p. 298.
[24] Morgan, E. Victor, *Funding Policy and the Gilt-Edged Market*, "Lloyds Bank Review," October 1962.

alternative to the policy actually pursued between 1948 and 1957. During the past few years, however, a larger budget surplus and the improved performance of the national savings movement have reduced the pressure to sell stock. The depletion of the banks' portfolios means that the authorities cannot again have to face, in the foreseeable future, bank selling on anything like the scale of 1959–61; and the nonbanking public has shown itself willing to absorb substantial quantities of stock at what it believes to be the right price.

All these changes give scope for greater flexibility, but so far the action taken by the authorities has been limited. They are prepared to use the timing and terms of new issues to influence market sentiment as well as to give the government broker room for maneuver. They are prepared to press sales in order to check an undesired fall in yields and, more reluctantly, to ease the pressure to permit a fall which is consistent with general economic policy. They are prepared to vary the degree of support given to a weak market, according to whether or not a rise in yields is thought desirable. But they are not prepared to initiate a change in prices or even to resist indefinitely a market trend. As recently as August 1961, the Bank reminded the market that "it was not the practice of the authorities to support the gilt-edged market in the sense of pegging it at any particular price level; that the authorities would continue to be concerned to insure orderly market conditions so that dealings at a price could continue; and that prices would continue to depend upon general market conditions." [25]

The new government issues which have been offered during the past 5½ years are listed in table XVI. It will be noted that in the period since United Kingdom fiscal year 1958–59, the government offered £4.3 billion of new cash issues, and almost £2.8 billion of conversions. These totals are extremely large in comparison with new capital issues of other borrowers in the London market, which amounted to £2.8 billion in the past 5 years. However, the figures on government issues are misleading in that the amounts shown are rarely if ever taken up by the market at the time of issue. Although every government issue is fully subscribed, this results from the fact that the government departments themselves subscribe all amounts not taken by the market. Similarly, large amounts of any maturing issues are usually bought up by the government before the date of maturity.

The figures in table XVI therefore give no indication of the actual amount of security transactions between the government and the public in a particular period. Amounts actually borrowed by the Exchequer from the public are shown in table V.

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[25] Bank of England "Quarterly Bulletin," September 1961, p. 12.

TABLE XVI.—*Exchequer financing, Government marketable securities—Issues and redemptions*

[Millions of pounds]

	New issues			Redemptions [2]		
	Name of security	For cash	By conversion [1]	Name of security	For cash	By conversion [1]
Jan. 14, 1958	5½ percent Exchequer stock, 1966	500				
Feb. 14, 1958	5½ percent funding loan, 1982–84	300				
June 15, 1958	4¾ percent conversion stock, 1963		353	4 percent conversion stock, 1957–58	24	652
Do	5¼ percent conversion stock, 1974		299			
Jan. 15, 1959	4½ percent conversion stock, 1964		250	2 percent conversion stock, 1958–59	342	250
Aug. 12, 1959	5 percent Treasury stock, 1986–89	154				
Oct. 15, 1959	4½ percent conversion stock, 1964		55	3 percent war loan, 1955–59	103	199
Do	5 percent Treasury stock, 1986–89		144			
Jan. 26, 1960	4½ percent conversion stock, 1964	199				
Feb. 15, 1960	5 percent conversion stock, 1971		414	2 percent Exchequer stock, 1960	139	309
Do				3 percent Exchequer stock, 1960		105
Mar. 3, 1960				do	95	
July 15, 1960	5½ percent Treasury bonds, 1962	297				
Oct. 5, 1960	5½ percent Treasury stock, 2008–12	475				
Feb. 3, 1961	4¾ percent Conversion stock, 1963	298				
Apr. 15, 1961	5½ percent Exchequer stock, 1966		483	2½ percent funding loan, 1956–61	313	483
Jan. 15, 1962	6 percent conversion stock, 1962		301			
Feb. 15, 1962	5½ percent funding loan, 1982–84		182	4½ percent conversion stock, 1962	275	483
May 9, 1962	5 percent Treasury stock, 1986–89	254				
June 20, 1962	5 percent Exchequer stock, 1967	392				
Sept. 5, 1962	5½ percent Treasury stock, 2008–12	475				
Oct. 4, 1962	4 percent Treasury stock, 1965	100				
Nov. 14, 1962	do		290	5½ percent Treasury bonds, 1962	9	290
Apr. 22, 1963	5 percent Exchequer loan, 1976–78	400				
June 14, 1963				3 percent Exchequer stock, 1962–63	341	
June 15, 1963				4¾ percent conversion stock, 1963	653	
Sept. 25, 1963	4 percent Exchequer loan, 1968	490				

[1] Excluding any cash payment in respect of the conditions of the conversion.
[2] Excluding sinking fund purchases.

Source: "Financial Statistics," October 1963, table 3.

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SUMMARY OF PROCEDURE FOR INTRODUCING A NEW SECURITY ISSUE

There are many different types of issues floated on the London market and the following is a generalized procedure for issues by prospectus. An issue by prospectus is the most elaborate form, though there are at least five other forms which are all somewhat different; e.g., offers for sales (where the entire issue is purchased by an issuing house and then sold), placings (privately arranged sales), introductions (listing of an existing firm's securities without new capital being raised), rights issues (to existing shareholders) and offers by tender (when bids are accepted at or above a minimum price). Nearly all issues of marketable government or government-guaranteed bonds are made by way of public prospectuses, and so are many issues of debenture and preference stocks by established public companies which already have some bonds or stocks quoted on the stock exchange. The illustration assumes that the issuer has established contacts with a commercial bank and a stockbroker.

(1) The first step is for the issuer, usually in consultation with his stockbroker and/or banker, to get in touch with an issuing house. The issuing house has an organization which is able to deal with a large number of applications, to advise on the form of issue most likely to meet with success in given market conditions, and assist in making other decisions necessary to determine the terms of issue.

(2) After the terms of issue have been tentatively agreed, those borrowers currently subject to capital issues control (all non-United Kingdom residents and United Kingdom local authorities) must apply for permission to float the new issue. Non-United Kingdom residents apply to the Capital Issues Committee, and United Kingdom local authorities apply to the Treasury. As noted earlier, consent is required for any capital flotations which exceed £50,000 a year by borrowers subject to the control.

(3) As described earlier, for all borrowers wishing to raise £1 million or more, permission of the Bank of England must be obtained with regard to time of the issue. Approval of the bank is also required as to terms on which certain securities are issued—broadly speaking these are fixed interest securities by public authorities in the United Kingdom and Commonwealth.

(4) The next step is likely to be a letter of application to the London Stock Exchange requesting a quotation for the securities. Negotiations for this request are usually handled by the issuer's broker and/or issuing house. It is also necessary that arrangements be made to secure the support of at least two jobbers in the appropriate market, and the issuer's representatives must be able to convince the Committee on Quotations that adequate arrangements have been made to supply the jobbers with sufficient shares to create a free market. The Committee requires that an advertisement containing all the information legally necessary in a prospectus along with certain other additions be published in two leading London daily papers and circulated to the Exchange Telegraph's and Moody's Statistical Services.

(5) In large issues it is common to arrange for an underwriter(s) who will undertake, for a commission, to buy any securities left unsold. Should the underwriter be the issuing house, there will probably be a number of subunderwriters (frequently investment trusts or insurance companies).

(6) Advertising of the prospectus is similar to but distinct from the advertising required by the Committee for a stock market quotation in the case of previously unlisted issues. The prospectus must contain the number, type, and price of the securities being offered; dates for the opening and closing of applications; and statements with respect to the issuers' business, history, and prospects. The purpose of this advertising is to attract subscriptions as well as to comply with the requirements of the Companies Act and of the stock exchange.

(7) If the issue is oversubscribed, and most successful ones are, then the issuing house makes the allotment to the applicants. Preference is usually given to applicants for a small number of securities and, when they can be detected, permanent investors. When a heavy subscription is expected for an issue, the issuing house may require the full price of the securities to be paid with the application in order to discourage "stags", speculators who apply for securities in the hope of quickly reselling them at a profit to more permanent investors.

ISSUE COSTS

On the assumption that an issuer proposes to make a public offer of £10 million debenture stock, the costs of issue might amount to about 2.5 percent or £250,000. The largest single item would, of course, be the commission paid to underwriters and this spread assumes a charge of 1.25 percent or £125,000. Brokers' commission and the issuing house's fee would add another 0.75 percent or £75,000. Additional costs include 0.125 percent for stamp duty and another eighth paid to brokers and banks in respect of any stock which they arranged to sell. Since it is usual for a proportion of a new issue to be sold without this help, it is assumed that brokerage would be paid on about two-thirds of the issue. The stock exchange quotation fee would cost £1,575 and newspaper advertising might be £6,500. The balance of £25,000 consists of printing costs (prospectus, application forms, letters of acceptance, trust deed, and certificates), legal and accountants fees, and payments to the receiving bankers.

After these initial costs of flotation are met, the issuer can expect to pay about £3,000 each year as the cost of maintaining the register and another £1,050 to the trustees.

If the issuer had chosen to raise capital by private placement with a quotation the spread might have amounted to only 1.25 percent of the money raised. The main reason for this sharp drop is the substantial saving in underwriters' fees. Since quotation is also to be arranged it is necessary for at least 10 percent of the issue to be made available to the general public. On the assumption that this minimum figure is met, some of the charges cited in the preceding example would be sharply reduced inasmuch as selling arrangements can be limited to this portion of the issue. Almost 70 percent of the cost of flotation would go to the issuing house as its fee for assisting the issuer.

Although costs associated with private placings are much less than those for underwritten issues, this advantage will be offset to the extent that the purchaser is not willing to pay as much for the issue as might be obtained from the public. Lack of marketability is the usual reason for this differential and issuers often combine quotation on the stock exchange with a private placement in an effort to mitigate this objection. Perhaps the most serious drawback, however, is the fact that this technique normally can be used only in connection with relatively small issues, say £3 million.

In these examples, no allowance has been made for the possibility that these issues might be sold at a discount since this is not usually considered to be an issue expense. The amount of discount, if any, is related to the coupon rate and it is usually in the range of 1 to 3 percent.

RIGHTS ISSUE OF ORDINARY SHARES

The cost of raising new capital by means of a rights offer to stockholders is illustrated in the following example which assumes an aggregate offering of 2 million ordinary shares priced at 100 shillings each in the ratio of, say, 1 new share for each 3 shares held. It is also assumed that there are 40,000 stockholders and the £10 million purchase price is paid in two installments.

Underwriters' commissions could be expected to amount to 1.25 percent or £125,000. The fee to brokers and payments to the issuing house might cost 0.25 percent and 0.50 percent, respectively. Printing and legal fees would likely total £4,050 and the stock exchange quotation fee would be £1,575. The banker who agreed to receive the applications could expect a fairly heavy administrative burden, and he might exact a fee of £18,500 which would include an allowance for expenses. On this basis, the cost of flotation would amount to about 2.25 percent of the aggregate offering price of £10 million. (In the event additional authorized share capital is required, the issuer must pay a further 0.50 percent in stamp duty on the nominal amount of the capital increase.)

The maintenance of the register might cost about £3,100 annually.

Costs of flotation for bearer issues are about the same as for registered securities with the important exception that stamp duty is levied at the rate of 3 percent on issues by United Kingdom companies and 2 percent by others. In addition, more elaborate certificates are required to help guard against counterfeiting and thus printing charges are higher. While there is no annual charge for keeping a register, the issuer must advertise each dividend.

SECTION VI—INTERNATIONAL CAPITAL MOVEMENTS

The United Kingdom system of exchange controls traces its origin back to the early days of World War II when the Government was faced with the necessity of taking action to restrict transactions between residents and nonresidents. The purpose of these restrictions was to reduce the impact of capital flight on the reserves and to husband all external earnings of United Kingdom residents with a view toward their management in a manner which would be most consistent with the financial requirements of a war economy.

The present statutory basis for the exchange control system is the Exchange Control Act of 1947, which brought together on a permanent basis the financial orders (defense finance regulations) issued during the war. These orders had been made on a more or less ad hoc basis with a view toward increasing the scope and effectiveness of the control. While during the evolutionary stages of the sterling system there was no necessity for defining its membership with precision, the situation was transformed with the adoption of controls. With the adoption of the 1947 act, sterling area countries and constituent groups were specified in one of the several explanatory schedules. Apart from the loss of two of the independent non-Commonwealth members (Egypt and Iraq) and the shift of a number of areas from dependency status to the status of independent Commonwealth countries, there has been remarkably little change in the list of the scheduled territories during the ensuing period of 16 years. Membership now consists of the following: all Commonwealth countries except Canada; British trust territories, protectorates, and protected states; and Burma, Iceland, Irish Republic, Jordan, Kuwait, Libya, South Africa and South West Africa, and Western Samoa.

The system basically assumes that members will hold most of their external reserves in sterling and through this community of interest will take such joint action as may be practicable to preserve the strength of that currency. In return, London has traditionally been looked upon as a chief source of supply for long-term capital. The control has therefore always provided that transfers from the center to any resident within the sterling area will be freely permitted whether the transaction is on current or capital account.

Transactions between United Kingdom residents and persons resident outside this area were, however, subject to controls varying in severity as the proposed expenditure moved down the list of priorities from, say, imports of critical raw materials to acquisitions of portfolio securities for private account. While very substantial progress was accomplished in the direction of liberalizing the controls affecting current account transactions—sterling current convertibility being formally recognized in the acceptance of IMF article VIII obligations in 1961—very much less has been done to free sterling for capital uses.

The authorities have been acutely aware of the significant contribution which net capital receipts (in the form of either direct or portfolio investment) from the nonsterling area can make to strengthening the United Kingdom external position and toward providing an offset to the outflow to the sterling area. Policy has thus tended to promote capital inflows, especially direct investments. A long-term basis for this policy is evident from the fact that even during the war, nonresident holders of United Kingdom assets were allowed to make current remittances of earnings derived from capital holdings blocked by the control. This freedom doubtless made a significant contribution toward the maintenance of the wartime credit standing of the United Kingdom, and did much to encourage the subsequent revival of inward investment in the postwar period.

The basic figures with respect to the way in which Britain's position on private investment account has developed over the past 5 years are presented in table XVII as direct investment abroad (excluding oil and insurance) showed a marked tendency to increase over the first 3 years and after reaching a high of £247 million in 1960 continued at about this volume in 1961 and 1962. The trend with respect to other investment was, in contrast, clearly downward. The explanation for this movement would seem to stem from reduced activity by the oil companies and sales of portfolio securities to finance direct investment. Although residents' total net investment in 1962 was 20 percent below the 1961 high, the average outflow for the period shown was £302 million.

TABLE XVII

Private investment—Abroad (net of disinvestment)

[In millions of pounds]

Year	Direct [1]	Other [2]	Total: Overseas sterling area	Total: Nonsterling area	Total: All areas
1958	−144	−154	−170	−128	−298
1959	−196	−111	−162	−145	−307
1960	−247	−66	−191	−122	−313
1961	−226	−100	−190	−136	−326
1962	−212	−47	−149	−110	−259

[1] Excludes oil and insurance industries.
[2] Includes portfolio investment and investment by oil and insurance industries.

Source: Central Statistical Office, "United Kingdom Balance of Payments, 1963," table 16.

Private investment—In the United Kingdom (net of disinvestment)

[In millions of pounds]

Year	Direct [1]	Other [2]	Total: Overseas sterling area	Total: Nonsterling area	Total: All areas	Private investment net
1958	+87	+78	−14	+179	+165	−133
1959	+146	+30	+30	+146	+176	−131
1960	+135	+93	+26	+202	+228	−85
1961	+236	+181	+57	+360	+417	+91
1962	+137	+137	+34	+240	+274	+15

[1] Excludes oil and insurance industries.
[2] Includes portfolio investment and investment by oil and insurance industries.

Source: Central Statistical Office, "United Kingdom Balance of Payments, 1963," table 16.

Nonresidents' net direct investment in the United Kingdom showed a more erratic movement mainly because of the impact exerted by extraordinary transactions, e.g., Ford Motor Co.'s £131 million cash purchase of the minority interest in British Ford features in the 1961 accounts. The large growth in "other" investments in the past 2 years is believed to be mainly attributable to portfolio securities acquisitions. The 5-year average net inflow on both components was £250 million or only about £50 million short of the amount required to offset the outflow.

The nonsterling area and sterling area accounts stand in marked contrast: Britain's annual average receipts from the nonsterling area were almost twice the amount of the outflow and the average annual adverse balance with the oversea sterling area amounted to £149 million.

UNITED KINGDOM DIRECT INVESTMENT OVERSEAS

All proposals by United Kingdom residents involving direct investment in the nonsterling area are subject to screening and approval by the authorities (i.e., the Bank of England and British Treasury). The Bank is the main operating institution and is in a position to exercise considerable administrative discretion. The Bank's powers are, however, formally derived by delegation of the authority extended to the Treasury under the terms of the Exchange Control Act of 1947 and decision will be jointly reached in those cases which may give rise to controversy. A prospective investor will normally seek the advice and guidance of his banker before presenting an application to the Bank of England.

During the period beginning 1958 through July 1961, new proposals for direct investment abroad by United Kingdom residents are understood to have been freely approved; subsequent experience was very different, at least until May 1962. In July 1961, a policy decision was announced which provided that approval for new direct investment would thenceforth be limited to applications which could show the prospect of a commensurate gain to the United Kingdom balance of payments over the short term. In these instances, the successful applicant was granted permission to arrange financing either through the official reserves or by short-term borrowing abroad. The authorities considered this severely restrictive policy to be necessary in the light of the then difficult external payments position and the apparent tendency for new direct investment proposals to grow at a sharply accelerated rate. (This growth was partly associated with prospects for closer United Kingdom association with the EEC.)

Fortunately, these criteria were in effect in their most restrictive form for only about 10 months (July 1961 to May 1962). The available statistical evidence (tables XVIII and XIX) suggests that the new policy may have acted to contain the rate of growth but that the absolute amount was almost untouched. The action to retrench appears also to have made a useful contribution to the all-around effort to restore confidence in sterling. There seems to have been a marked shift in the source of finance with rather more being derived from the investment of earnings and less from securities purchases, which suggests that a major effect was to afford a relatively more favorable status to existing foreign holdings as compared with firms aiming to establish their initial overseas ventures.

TABLE XVIII.—*Private direct investment, 1958–62 (excludes oil and insurance)—Overseas branches, subsidiaries, and associates of United Kingdom companies*

[In millions of pounds]

	1958	1959	1960	1961	1962
Unremitted profits of subsidiaries	−74	−93	−85	−74	−101
Net acquisitions of share and loan capital	−41	−52	−80	−82	−75
Change in branch indebtedness	−16	−34	−30	−36	−30
Change in intercompany accounts	−13	−16	−52	−34	−6
Total	−144	−196	−247	−226	−212

Source: Central Statistical Office, "United Kingdom Balance of Payments, 1963," table 18.

TABLE XIX.—*Private direct investment, 1958–62 (excludes oil and insurance)—Branches, subsidiaries, and associates of oversea companies operating in the United Kingdom*

[In millions of pounds]

	1958	1959	1960	1961	1962
Unremitted profits of subsidiaries	+44	+76	+67	+37	+67
Net acquisitions of share and loan capital	+21	+55	+35	+170	+42
Change in branch indebtedness	+11	−2	+3	+10	+3
Change in intercompany accounts	+11	+17	+30	+19	+25
Total	+87	+146	+135	+236	+137

Source: Central Statistical Office, "United Kingdom Balance of Payments, 1963," table 18.

While the evidence is too slight and the lifespan was too short to make very firm judgments as to the effects of these restrictive measures, the usefulness of including this policy step in the Chancellor's July balance-of-payments statement seems to have been accepted by most responsible observers. It appeared that investors' desires and objectives were far out of line with available resources and positive and clear action was necessary to redress the balance; nevertheless, this was a retrograde step and there was agreement (not only among disappointed firms) on the need to work toward a relaxation at the earliest date.

An interim solution was announced on May 18, 1962, against the background of a much-strengthened pound sterling. This action went part way toward restoring the rules to those effective in the pre-July 1961 period, but with one highly important exception. Applicants who were unable to satisfy the stiffer criteria and thereby gain permission to draw on the reserves but who could meet all the other tests (in essence, to show that the proposed investment would be of sufficient benefit to the United Kingdom) were henceforth granted authority to find their finance either in the form of investment dollars or to raise money in foreign markets on long term. (The term "investment dollars" refers to a pool of assets which was originally available only to residents who wished to invest in foreign portfolio securities. See also section below on resident portfolio investment.) The result of this move was to find a way to provide more scope for direct investment with no initial net adverse impact on the balance-of-payments position. In addition, as there is normally a premium associated with acquisition of investment dollars, the policy also provided an opportunity for the authorities to subject applications to a sort of market test. Firms wanting to invest abroad not only had to make a positive decision on the basis of the usual cost factors but in addition had to allow for a further one-time capital cost in the form of a premium of a magnitude which would vary and would be difficult to predict.

Presumably, a reasonable amount of finance can be raised from this source at any one time but it seems obvious that if no action is taken to increase the supply of investment dollars there will be a tendency for the marginal holdings of portfolio securities to be moved into a much more illiquid form. Indeed, one may imagine that at some point the residual portfolio holdings might be considered to be almost as firmly held as any direct investment for practical purposes. Marginal supplies will be exhausted despite a levering up of the premium.

If the premium should begin to show a fairly sharp upward trend which looked like approaching the record of 18 percent established in September 1957, there would no doubt be considerable official concern. In the meantime, the authorities may be well content to allow the market to determine the best use of these assets.

The administrative burden implicit in any system which essentially involves a rationing of resources is always onerous and doubtless the Government authorities were glad to be able to adopt a solution which seemed to them convenient from so many points of view. Permission still has to be given and this requires an administrative action but the critical decision now is not so much whether to refuse outright as merely to consent on the basis of access to a less desirable method of finance. It might be expected that proposals offering outstanding prospects for profits would be encouraged and the relatively less attractive schemes would be deterred.

The outlook is for continued close official supervision. At any stage no one would be surprised to see decisive action taken by whatever government might be in power to restrict further direct investment if it seemed to be putting too heavy a burden on sterling. The priority is clearly exports first with probably a rather secondary consideration being given to near term prospects for enhancing profits.

UNITED KINGDOM PORTFOLIO INVESTMENT OVERSEAS

Similarly, the United Kingdom authorities have always taken a firm position with respect to proposals for new portfolio investment. Official statements on this subject make the position quite clear: portfolio investment based on finance from the reserves is subject to approval which is given only very infrequently. While no fresh acquisition of foreign securities can be undertaken on this basis, the control has provided room for the establishment of a trading system based on the supply of foreign securities already held by residents.

Operations are restricted to a pool of foreign currency securities which must be held either in the name of or to the order of an authorized United Kingdom depositary. Proceeds from securities sales must be either reinvested or sold to another resident within 6 months.

Upon inception of this system in October 1947, residents were permitted to deal in foreign currency securities as such, but since October 1954 transfers of the foreign currency proceeds of these securities and the reinvestment right associated with them have also been permitted. The individual has discretion with respect to the management of his portfolio so long as all transactions are channeled through the authorized depositary and all holdings are securities traded on a recognized foreign securities exchange. Over-the-counter issues are thus normally excluded and this prohibition is understood to constitute one of the chief sources of dissatisfaction with these arrangements.

Investment is in practice undertaken by means of investment dollars which are derived from the sale of paper constituting the pool of foreign securities. A United Kingdom resident who wishes to purchase a foreign security must be willing to offer a price for investment dollars which will be sufficient to induce a present holder to give up his position. Since this demand (in the aggregate) is usually in excess of the supply, it is customary to see investment dollars quoted at a premium as compared with official dollars, although there have been periods in the fairly recent past when the two traded at par. While some provision is made for net additions to the pool, e.g., legacies, additions to the supply dependent on special capital receipts of this sort are obviously quite uncertain as to amount and timing. There is no occasion for investment dollars to be traded at a discount since it is always open to the owner to sell to an authorized dealer at the current market rate for official exchange. The size of the premium is therefore mainly conditioned by the view which United Kingdom investors tak" with respect to prospects for nonsterling securities. Obviously, if offerings of investment dollars are tending to dry up at any particular level of premium then demand will only be satisfied within the mechanism by raising the premium and thus inducing further sales by present holders.

While the relative investment merit of sterling securities would appear to be the main factor in determining the premium, on any occasion when the outlook for official sterling is thought to be in doubt, investment dollars will be bid simply as a convenient vehicle for arranging a resident hedge against a devaluation of the pound. This possibility was a noticeable factor, for example, in September 1957 when the premium rose to a record high of about 18 percent. (There is some reason to believe that in the absence of a significant amount of exchange control violation, the premium would have been even greater on that particular occasion.) If it be assumed that speculators make their decisions on rational grounds and the control is complete, one might expect that the premium would rise no higher than the amount of any expected devaluation. The control is not, however, completely effective and as the premium rises it may merely stimulate evasion.

While it is thus convenient to be able to look to the premium as a means of equating investors' interest, there is always a danger that either the direction of movement or the level may be viewed as a signal of some change in the market's attitude toward official sterling. Accordingly, when the decision was taken to put an additional demand, i.e., direct investment finance, upon the investment dollar pool, there seemed to have been some ground for questioning the soundness of this move: The resources within the pool were fixed, on past occasions the premium was large, and the effect of the new authority would be to reduce the size of the pool. While experience suggests that this additional demand helped to keep the premium relatively high, the authorities no doubt have taken comfort from the fact that at this level the system appears to be in reasonable equilibrium. Whether this apparent stability can be continued in less normal circumstances remains to be seen, although there was no noticeable increase in the premium earlier this year when official sterling was subjected to some market stress. During the third quarter of 1963 there was some tendency for the premium to fall back, but it has since risen to about 11 percent. Some reports have suggested that this mainly reflected an increased interest in North American securities.

The original stock of securities which furnished the basis for establishing the investment dollar market consisted of the portfolio investments which had been accumulated by British residents during the prewar period, apart from that portion which was taken over by the Treasury during the war and not later returned. Although the current amount involved in this latter holding is not known, official estimates give a very broad indication of the magnitudes. The latest estimate, as of December 1962, placed the value of the portfolio between $750 and $1,250 million. The amount of the private portfolio holdings also is not known, which seems surprising in the light of the requirements of the control, but the Radcliffe Committee report estimated that the size of the pool in 1959 was of the order of $4 billion. Firm data with respect to at least two of the more important institutional holders making up this pool are, however, available from the Bank of England's "Quarterly Bulletin." The June issue shows that 302 investment trusts reported total oversea investments amounted to £704 million as of end-year 1962. Of this amount £487 million was in U.S. issues while Canada and other nonsterling countries were represented to the extent of £76 and £55 million, respectively. Only £85 million was invested in sterling area securities. In addition to these very significant holdings, 54 unit trusts reported that as of the same date their oversea assets amounted to £16 million including £12 million in nonsterling countries. Since these investors tend to be firm holders, they are constantly faced with the fact that in order to enlarge their positions they must be willing to pay the going premium. In what apparently was an effort to take some of the strain off the demand side of the pool, the Bank of England gave permission earlier this year for at least two investment trusts to arrange long-term loans with a New York insurance company for the purpose of financing securities purchases. (Only one loan was completed; negotiations for the second were suspended because of the proposed interest equalization tax.)

INWARD DIRECT INVESTMENT

The official attitude toward inward direct investment is clearly positive and perhaps the most important step taken in the postwar period aimed at stimulating it dates from January 1, 1950. As from that date, any fresh investment approved by the Bank of England and Treasury is formally eligible at the time of any future liquidation for transfer at the official sterling rate. This undertaking extends not only to the original capital sum invested but to all sale proceeds.

During most of the postwar period the basic test applied by the authorities in considering applications for new investment was the potential benefit to the United Kingdom economy in the form of either export earnings or import savings. Since 1958, however, the importance attached to this aspect has been greatly reduced. The authorities also place much emphasis on insuring that plans for financing the investment make provision for the inward transfer of a reasonable proportion of the total capital cost. In other words, applications will not be approved unless there is a commensurate benefit to the reserves position. Approval will not be given to proposals which contemplate acquisition of an interest in a United Kingdom company based on an exchange of shares.

Particular care was initially exercised in considering direct investment applications inasmuch as approval carries with it a contingent claim against the reserves in the form of a future continuing requirement to finance transfers of earnings as well as the potential obligation to provide foreign exchange to finance the transfer of any liquidation proceeds.

On the basis of the available data, however, it would appear that perhaps too much emphasis may have been placed by the United Kingdom Government on these two contingencies. Table XIX shows that more than half of the current annual earnings of foreign subsidiaries operating in the United Kingdom have been reinvested in extensions to plant and/or equipment and the risk of long-term corporate decisions being so drastically reversed as to require the disposal of operating plant seems fairly remote. Indeed the amount of foreign direct investment in the United Kingdom has now grown to such importance as to make the official undertaking virtually inoperative in the aggregate. Although official United Kingdom figures are not yet available, the Commerce Department census reported that U.S. interests amounted to $3.8 billion in 1962 or $3.0 billion more than in 1950.

Whether or not large-scale corporate investors place major reliance on this particular undertaking, it would seem from statistical evidence that the authorities have been able to employ this condition along with other selling points to real effect. Certainly the growth in direct investment in the United Kingdom has been by most tests extremely good over the past several years and there is not much evidence of any appreciable slackening in the rate if allowance is made for exceptional transactions. One might suppose, however, that the scope for really outstanding transactions is now rather more limited.

Firm estimates as to the amount of the U.S. interest in the United Kingdom are available, as noted, only from the Commerce Department census. While the Board of Trade has undertaken its own inquiry, this survey has provided information only with respect to current flows; no official estimates are yet available as to the extent of aggregate nonresident direct investment.

Direct investments by nonresidents made prior to January 1, 1950, or made subsequently without permission, may be liquidated by the owners only through the mechanism of the switch sterling market. Apart from this possibility, all sale proceeds must be paid into a blocked account. This is also the position with respect to portfolio investment by nonresidents. When a security is disposed of through a market sale, proceeds are not eligible for transfer at the official rate even if the seller can show that the securities were originally acquired against external account sterling. Spot exchange transfers may be arranged only in those limited instances involving redemption of a matured issue. (Exceptions to these rules are made in the case of persons resident in Norway, Denmark, and Sweden: they benefit from the preferential UNISCAN arrangement.)

The switch sterling mechanism provides a convenient means for enabling nonresident holders of sterling assets to liquidate these positions without any cost to the current external position of the United Kingdom. The present ground rules permit the holder of sterling ineligible for transfer at the official rate either to invest his holdings in approved securities or to sell his position to another nonresident. Eligible securities are principally those traded on a United Kingdom stock exchange which are neither contractually repayable in less than 5 years nor denominated in a foreign currency. Current dividends and interest earnings on these securities may be freely remitted at the official rate; this is a feature of fundamental importance to the security sterling market as it constitutes the ultimate basis for providing willing holders of sterling securities. (Sterling earnings are available for transfer only after income tax at the standard rate, now 38.75 percent has been deducted by the issuer. Double tax conventions may afford a basis for obtaining a substantial measure of relief from this burden.)

Since the usefulness of switch sterling is clearly limited, it is ordinarily traded at a discount from official sterling. For example, in November 1956 the discount exceeded 11 percent but since then the discount has generally been much smaller. While the amount of the discount is partly related to the view the market may take at any time toward official sterling, the switch rate is also dependent upon the continuing attractiveness of sterling securities compared with those available in other centers. When investment opportunities seem especially good—as they may when sterling is in a recovery phase—nonresident interest may become so large as to wipe out the discount. Excess demand spills over into the official market and it exerts a positive impact on the spot sterling rate. While capital transactions which are limited to the switch market do not directly affect balances of payments, official market transfers tend in the ordinary way to strengthen sterling reserves and diminish the reserves of the country financing the investment.

Although in theory the absolute amount of security sterling is measured by the aggregate of portfolio securities in the hands of nonresidents, in practice the supply available for establishing the trading price (rate) is set by the marginal amounts involved in foreign investors' current decisions to switch out of sterling holdings into investments in other centers. Similarly, the demand side is mainly influenced by the interest of nonresidents in either establishing or enlarging their interest in sterling securities. Since the nonresident interest in United Kingdom securities has historically been an important feature in stock exchange dealings and as this interest has continued to grow since the war, the total volume of holdings has undoubtedly reached significant proportions. Despite the requirement that transactions are subject to exchange control supervision, no official estimates are released as to the size of this pool; one may only draw limited inferences from balance-of-payments estimates for new portfolio investment and the remittance of interest and dividends on the accumulated volume of investment both of which suggest the amount may be quite large. Table XX includes the available data. In addition, the clear reluctance on the part of officials to take any significant step toward relaxing the control on outward capital movements suggests that the pool is large enough to cause the authorities some concern.

TABLE XX.—*Interest, profits, and dividends*

[In millions of pounds]

Year	United Kingdom debits				United Kingdom credits				
	Direct investment	Portfolio investment	Other	Total	Direct investment [1]	Portfolio investment	Other	Total	Interest, profits, and dividends, net
1958	95	65	251	411	195	115	401	711	+300
1959	136	59	221	416	238	121	329	688	+272
1960	137	67	248	452	258	133	297	688	+236
1961	128	65	251	444	251	133	311	695	+251
1962	138	69	248	455	275	142	363	780	+325

[1] Excludes oil and insurance industries.

Source: Central Statistical Office. "United Kingdom Balance of Payments, 1963", table 10.

NEW CAPITAL ISSUES BY NONRESIDENTS

The control of new issues and the operation of the Capital Issues Committee was discussed in section V above. While there have been complaints regarding some aspects of the Committee's activities, there seems to be general recognition that it has been highly successful in preventing overseas borrowers from gaining access to the London market. Until recently, the only exceptions to this general restraint were in the case of three issues on behalf of residents of Denmark and Norway in 1946, 1947, and 1951. Sterling area members have, of course, continued to have access commensurate with their respective credit positions, though they were doubtless restrained by the high level of interest rates throughout most of the past decade.

Under the terms of the exchange control regulations, the issue and placing of securities by nonresidents on the United Kingdom capital market and the transfer of the funds raised require permission of the Treasury for whom the Bank of England act as agent, as noted earlier. Until quite recently, permission to issue was not normally given except that access had been offered to the Scandinavian countries pursuant to the UNISCAN agreement and to the International Bank for Reconstruction and Development. Since May 1963 access was also extended to the member governments of the European Free Trade Area. While the news of this relaxation was welcomed it was not expected to have any important impact on capital-raising patterns. The only EFTA countries considered likely to take advantage of this access in the present circumstances of London capital market were Portugal and Austria. (Norway, Denmark, and Sweden had previously arranged privileged access and Switzerland has been a source of capital for the United Kingdom.)

The official attitude toward security issues by nonsterling area residents has been negative because the demand for capital development at home and the overseas sterling area has exceeded supply. The external position of the United Kingdom throughout the postwar period has been officially considered to be too weak to support large-scale capital outflows to the nonsterling world.

LONDON AS A FINANCIAL ENTREPOT

Recognizing the Government's unwillingness under existing circumstances to allow a major relaxation of exchange controls and freedom for the United Kingdom capital market, the London financial community, with the encouragement of the Governor of the Bank of England, initiated a move in October 1962 to expand London's role as an entrepot of capital—to permit the City greater flexibility to act as a financial middleman, perhaps to play that role for all Western Europe. By reestablishing London as an entrepot, greater international use could be made of the City's capital market facilities without permitting substantial increases in capital outflows from the United Kingdom to the nonsterling world. To the extent the City could increase its activities in arranging loans of nonresident-owned funds to nonresident borrowers, there would be no drain on the United Kingdom's own balance of payments—in fact, there would be invisible balance of payments earnings for the banking services provided by City institutions—and also the City would be able to use its acknowledged financial expertise toward channeling foreign savings into foreign investment.

These moves to encourage use of London as entrepot have included some measures where the City acts purely as middleman—e.g., where a United Kingdom bank arranges a nonsterling security issue primarily for sale to nonsterling area residents—but have also included measures which allow slightly increased access to the United Kingdom capital markets. These latter measures represent genuine relaxations of the controls on United Kingdom capital outflow, and could have some effect on Britain's own balance of payments, although only limited relaxations of this nature have been made thus far—the EFTA governments have been given permission to borrow in London, and the Government of Japan was allowed to float a refunding issue on the United Kingdom market.

The first clear evidence of an official move to refurbish London in its traditional role as entrepot came in a speech by the Governor of the Bank of England on the occasion of the annual dinner given by the lord mayor to the bankers and merchants of the City of London on October 3, 1962, The essential paragraphs on this subject were spoken by the Governor as follows:

> I will be more specific with my thoughts. I want to see more foreign business attracted to our markets so that we can earn more foreign money. The time has now come when the City once again might well provide an international capital market where the foreigner cannot only borrow long-term capital but where, equally important, he will once again wish to place his long-term investment capital. This entrepot business in capital, if I may so describe it, would not only fill a vital and vacant role in Europe in mobilizing foreign capital for world economic development. It would be to the advantage of British industry in financing our customers. This type of business in general tends to be less volatile in its effects on the balance of payments than much other business now carried on.
>
> But if we are to make our markets attract more business we will need to provide a more complete service—a service at a comptetitive price providing what the customer wants. The capital market is a necessary element. The Stock Exchange of London still provides the widest and almost certainly the most efficient market of its kind in the world—not that there is no room for improvement. The level of stamp duty on transfers, increased when the practicability of foreign business was not a factor, is today surely a deterrent to foreign business. The foreign investor too prefers bearer certificates to the rather slow system of regis-

tration in general use in this country, and we used readily to provide them. Can we afford to discourage this foreign business or to require packaging which does not sell the goods? In the taxation field, in the exchange control field, in the exchange control field, and in market procedure too, we surely need a now look as one part of the policies we must adopt if we are determined in our desire to increase our oversea earnings.

A first step came with the announcement that the Icelandic Government had been given permission to offer for public subscription £2 million principal amount of sterling stock. The issue carried a 6½ percent coupon and was scheduled for final maturity in 1988. The stock was offered to the public on December 6 at a discount of 2½ points which brought the yield to final maturity up to an attractive 6.7 percent. The good reception which investors accorded the offering was encouraging, particularly as the issue was the first bond offering by a non-Commonwealth Government in more than 10 years and only the fourth since the war. It should be noted, however, that Iceland is a sterling area nember and the prohibition on borrowing by nonsterling countries was not breached.

The prospectus drew the attention of prospective investors to the fact that an application had been made to the authorities for permission to issue bearer certificates; subsequently on March 15 the managing underwriters issued a memorandum which noted that permission had been granted and gave instructions to holders who wished to have their securities take this form. This was a notable development as it marked a significant relaxation in exchange control policy.

Action on a broader front was initiated on April 4, 1963, when the Chancellor in his budget speech stated that it had been a mistake to double the stamp duty on stock transfers in 1947. At 2 percent the rate of duty was substantially higher than in any other country in either Europe or North America and the result had been to drive business—invisible earnings—from the City. Apart from providing a strong disincentive to investment of foreign funds in Britain, it discouraged investment in productive industry and tended to raise the cost of issuing capital. The Chancellor therefore proposed that the rate be restored to its previous level of 1 percent.

In a further effort to improve invisible earnings, the Chancellor proposed changed in the rules affecting bearer securities: The exchange control ban on them was removed and measures were taken to restore the right to exchange government securities into bearer form where this right originally existed. Existing rates on bearer securities were reduced respectively from 6 and 4 percent to 3 and 2 percent. These changes became effective on August 1, 1963.

On May 14 it was reported that a City of London consortium had completed arrangements for placing a $20 million loan on behalf of the Belgian Government. The loan took the form of bearer Belgian Treasury bonds with a coupon of 5 percent placed at par with a relatively few purchasers. (There were no plans for making a market in these securities.) The issue matures in 1966 and drew attention because it was the first nonsterling currency loan since the war and because it was financed on the basis of Eurodollars. Considerable emphasis was put on this latter aspect and it was widely suggested that this particular issue should be regarded as a successful pilot operation with the next step being to extend the maturity range.

The issue was also cited as another example of the ability of the City to act as a middleman profitably, acting in line with the Governor's suggestion that the City strive toward redeveloping its position as a capital entrepot.

The City did not have to wait long for the next development. On July 3 the London press included an advertisement which announced that a London merchant bank together with three banks located in Belgium, Germany, and the Netherlands had agreed to subscribe at 99 percent to $15 million principal amount of 5½ percent guaranteed bonds dated 1972/78 issued by *Autostrade*. (A private Italian company formed for the purpose of carrying on the business of motorway concessionaire and operator.)

In consideration of the banks' undertaking to buy the bonds, the company agreed to pay them a commission of 3 percent of the nominal amount or $450,000. The banks invited other selling groups to apply for the bonds at the issue price and offered to allow a concession of 1½ percent of the nominal amount of the bonds to accepting selling groups who in turn were permitted to reallow one-half of 1 percent. The banks also agreed to pay an underwriting commission of 1 percent to certain underwriters and to pay the fees of London brokers.

The difference in the $15 million principal amount of the issue and net proceeds of $14,345,000 to *Autostrade* amounted to $650,000 of which $150,000 reflected the one point price discount, $450,000 the three points commission to subscribing banks, and $50,000 for expenses incidental to obtaining quotations on the London and Luxembourg stock exchanges, legal and accounting fees, and printing and advertising costs including the cost of printing certificates.

The bonds were available for issue in bearer form only and apart from British and American paying agents, five continental banks were named as paying agents. The bonds will be redeemed by operation of a sinking fund which is scheduled to come into operation in 1969 with the purchase of at least $690,000 principal amount of the bonds. The further nine installments increase annually with the final payment in 1978 amounting to $2,310,000. (The bonds may be paid off earlier at any date beginning July 15, 1972, but at a premium.)

Although residents of the United Kingdom were given permission to purchase these bonds, they were required to do so against investment dollars which were quoted at about a 10 percent premium when the issue was first advertised; accordingly, there was no suggestion that the securities might have much attraction priced on this basis.

Since the bonds were to be issued in Luxembourg no stamp duty would be paid by nonresidents and no tax would be deducted in respect of interest payments due to nonresidents.

The issue was noteworthy as the first foreign currency industrial loan floated through London and the first dollar bearer security to be granted a London Stock Exchange quotation since the war. Finally, the exercise demonstrated clearly the practical possibility for arranging long-term dollar loans through London. Although no figures are available as to the final sources of funds employed—possibly some came in the form of fresh dollars from U.S. citizens—it is certain that many subscribers employed Eurodollars already in European hands. The usefulness of this flotation then from the standpoint of the

United States would seem to be mainly limited to a consideration of how the latter dollars were previously employed and whether action was taken subsequently by Europeans to replenish their dollar holdings. Unfortunately, no data can be developed on these aspects which would be reliable. It seems clear, however, that we can expect to see more of these flotations in the future.

It was not until August 6, however, that an offering of sterling bonds was made by a nonsterling area country. On that date, the Japanese Government went to the market with an offering of £5 million principal amount of 6 percent sterling bonds dated 1983/88. These securities were priced at 96 percent on the cash offer and provided a 6.3 percent gross redemption yield to final maturity date. The underwriting consortium received a commission of 2.375 percent of the total nominal amount out of which they paid a subunderwriting commission of 1.24 percent, an overriding commission of 0.25 percent, brokerage of 0.125 percent and their own legal expenses. In addition, the Japanese Government agreed to pay all other expenses of the issue including the cost of obtaining a London Stock Exchange quotation (£1,050 fee), stamp duty of 2 percent, printing costs of prospectus and definitive bearer certificates, and their own legal expense. As the full amount of these latter charges was not made public, a precise calculation of the actual net proceeds and cost of money to the Japanese Government is not possible. It might be estimated that these other costs would certainly not exceed a further one-eighth. If all the above charges are deducted from the price to the public, it seems possible that proceeds to the issue might have been about 91.5 net and on this assumption the effective interest rate works out at about 6.8 percent per annum. The cost of money will be further increased through the operation of a cumulative sinking fund which is to take effect as of December 31, 1968. Under its terms £50,000 in bonds must be redeemed by that date and each year thereafter unless Japan exercises an option to redeem the balance of the issue still outstanding on December 31, 1983, or on any interest date thereafter.

As subscriptions to the issue were to be applied toward the redemption of the outstanding Japanese Government 4-percent sterling loan of 1899, due December 31, 1963, holders of these bonds were invited to tender at par for the new issue and in addition receive a cash payment of £3 per £100 nominal value tendered. About £1,668,000 of the old bonds are reported to have been tendered in acceptance of this offer and the nominal balance of £3,332,000 of the new bonds may have produced cash proceeds of about £3,048,000. This amount is thought to be about equal to the 1899 bonds due to be redeemed in December.

Although the reception was very good indeed, applications amounted to £144 million, this sort of response is not unusual in the case of London flotations which look like opening in the market at a premium. In these circumstances, the short-term speculator will tender for an exceptionally large amount in the expectation that as the issue may be underpriced it is likely to be bid by investors who are unable to get the amount they wish for their portfolios on the initial offer.

The issue was mainly of interest because it was the first flotation by a non-Commonwealth nonsterling area country since the war apart from the minor issues by Norway and Denmark which have a special status roughly comparable to sterling area membership. In addition, the certificates were issued in bearer form at the outset. While the offering was advertised on the Continent, the response apparently was not exceptional and it was suggested that if provision had been made for a continental paying agent, investors' interest would have been greater.

The impact on the British balance-of-payments position is difficult to assess. In the past, Japan like other nonsterling area borrowers would have been expected to find the sterling to pay off the maturing 1899 issue. To the extent that holders were British there would have been a capital inflow. Payments to nonresidents would have flowed through London and at least been offset and there was the possibility that the funds might have been reinvested in sterling securities or kept on deposit for other uses. In the circumstances of the new issue about all one can suggest is that the potential for a net charge on the reserves was clearly established but the terms of the offering seem to have been sufficiently attractive to have kept the extent of possible loss within fairly narrow limits.

On the occasion of the Lord Mayor's dinner October 16, 1963—1 year after the Governor of the Bank of England had announced the move to refurbish London's role as a financial entrepot—the Chancellor of the Exchequer in his address praised London's capital market for the earnings it brings the nation and said, "For the future, foreign currency loans, i.e., those which are no drain on the reserves, are being allowed almost without restriction. In addition, we shall be as sympathetic as we can in regard to loans which promote exports." Thus the Chancellor gave no indication that the Government had any intention of permitting any further relaxations of controls over the outflow of United Kingdom investment funds to the nonsterling world, suggesting that further measures to improve the City's role as entrepot over the months ahead would be limited to measures which would at best help and at worst have no adverse impact on Britain's short-run balance of payments.

Subsequently, further nonsterling loans have been arranged by British banks. In October a syndicate of private banks in London, Amsterdam, Paris, and Brussels organized an international loan for the city of Copenhagen. The loan was an issue of bearer bonds of 60 million Swiss francs 1974–78 at 5 percent. The bonds were subscribed by the underwriters at 96 to be resold at par in the various capital markets of Europe. Permission to deal and quote was applied for in London and in Luxembourg. Although a small amount of the issue was to be offered in the London market, it was expected that the issue would not find any British subscribers since United Kingdom residents would have to pay in investment dollars at a premium about 9 percent at time of issue. It was expected that the bonds would be taken up mainly in the Scandinavian countries, in Germany, Belgium, Holland, and perhaps in France. It was thought to be the first occasion in over 50 years that Copenhagen had raised money through London. The Swiss authorities objected strongly at having the issue denominated in Swiss francs, on grounds this would interfere with domestic interest rates and controls over new issues in the Swiss market, and that it would tend to force on the Swiss franc an international status which the home economy could not support.

In December 1963 it was announced that another $20 million loan for the Government of Belgium was being arranged by a City consortium headed by Samuel Montagu—the same merchant bank which arranged the earlier dollar loan to Belgium. On this occasion the issue was a 5¼ percent Belgian Treasury bond due in 1966. It was reported that the entire issue would be placed with banks—chiefly in Europe and Canada. The bonds were not to be available for sale to the public and no market was to be created.

London banks have also participated in flotation of issues denominated in the European unit of account—a unit defined in terms of a number of European currencies on the basis of present exchange rates and gold parities. The unit of account is designed to minimize exchange risks by providing that the value to investors of the unit changes only in event of a change in the value of all of a long list of European currencies (though the unit of account issues floated thus far have varied in slight detail). Belgian banks have been in the forefront of European unit of account issues, but a number of United Kingdom institutions have participated in the underwriting. For example, in October 1963 an issue for 18 million units of account (equivalent to $18 million) for the *Cassa per il Mezzogiorno* of Rome was announced by an international consortium headed by *Banque Lambert* of Brussels and including British banks among the 31 underwriters.

While the arrangements have now been well established for issuing securities denominated in foreign currencies (or currencies other than the country of issue) and the unit of account, it is not clear how much scope there is for these new techniques. The total amount of these securities issued thus far remains comparatively small, and it has been reported that substantial portions of some of the issues have remained in the hands of underwriters.

One technique for mobilizing capital in Europe which has not yet been tried is the proposal that large security issues be floated internationally, with a portion of the issue being allocated to each of several European capital markets. The issue would be sold with the same interest rate and maturity in each of the various markets but would be sold at a different price in each market to compensate for different market conditions. The use of this technique would be eased if the widespread restrictions in the various European capital markets were reduced and the regulations harmonized.

CHAPTER XII

SOME NOTES ON THE SWISS CAPITAL MARKET WITH PARTICULAR REFERENCE TO FOREIGN LENDING

No attempt has been made to prepare a comprehensive study of the Swiss capital market which would be in any way comparable to the studies of other European markets incorporated in the previous chapters. This chapter mainly gathers some readily available information on the supply of funds to foreign borrowers and the role played by the government in affecting foreign lending.

SUMMARY

Switzerland has long been renowned as an international financial center. It has a well organized and efficient capital market but the Swiss economy cannot generate a volume of savings for use in investment abroad which would be large relative to foreign needs. In fact, since 1960 Switzerland has had a balance-of-payments deficit on current account of significant magnitude and thus has been a net recipient of capital from abroad during this period. The primary role of the Swiss capital market from the standpoint of the foreigner is that of an *entrepôt*. Because Switzerland has been a magnet for foreign funds for many years, it has had capital to invest abroad.

Between 1958 and 1962 the total amount of new issues of bonds and stocks on the Swiss market nearly doubled. In 1958, not quite $460 million was raised in the Swiss capital market, while in 1962, about $900 million in bonds and shares was issued.[1] The value of foreign flotations in the Swiss bond market has grown even more rapidly, from about $30 million in 1958 to about $150 million in 1962. In 1961, the peak year for foreign issues, the amount was about $230 million. It is estimated that outstanding loans to foreign borrowers by commercial banks doubled between 1958 and 1962.

The large increase in capital issues in 1961 and 1962 has been in part a response to the large volume of capital inflow in that period, which was related to various political and economic crises around the world. The National Bank, as part of its anti-inflationary policy, opened the market to foreign borrowers, particularly in 1961, to relieve the pressure on the domestic economy. Nevertheless, as a matter of policy, the National Bank carefully isolates the Swiss market, controlling the volume of new foreign bond issues with a view to preserving funds for Swiss borrowers and to preventing a rise in the traditionally low interest rates, which for political reasons must be kept low. In practice, the volume of new issues made available to foreign borrowers will probably vary from year to year depending mainly on the Swiss balance of payments and the domestic needs for capital.

[1] Swiss franc figures have been converted to dollars at the rate of $0.23 per franc.

This control over new issues is the only control on the movement of capital into and out of Switzerland. Volume of new issues is the chief concern. Restrictions on foreign borrowers are based primarily on economic and business principles rather than on political or national grounds. The Swiss resident is free to invest his money either at home or abroad.

Deficiencies in Swiss statistics and the secretive attitude in banking and business circles concerning most transactions make it necessary to rely on estimates. The average Swiss businessman and banker profess strong distrust of statistics-gathering by any government agency. Mainly for this reason, there is no complete balance-of-payments account. Only the trade and the gold and foreign exchange figures are based on statistical compilations; the service and invisible accounts are estimated by a group of experts and there is no way of computing the capital flows into and out of Switzerland with any degree of accuracy.

INTRODUCTION

The ratio of gross savings and investment to GNP appears to be relatively high in Switzerland—between 20 and 25 percent. Social insurance funds appear to be a major means of savings with business enterprises also accounting for a high percentage. Swiss savings placed with the banking system (including the savings banks), which are for the most part employed to finance mortgage credit, are also important. Perhaps half of gross savings and a quarter of net savings are accounted for by business. Governmental surpluses have been substantial also. The Swiss Confederation budget has been in surplus since 1953, and from 1958 to 1962 these surpluses have averaged about $70 million annually. In 1692 the surplus amounted to a record $111 million.

Most cantonal (state) and municipal government budgets have also run surpluses in recent years; for the cantons as a group, the net surplus in 1962 amounted to a little over $23 million, and for the municipal governments the figure in 1961 (data for 1962 not available) was just under $10 million.

Consumer or household savings are also significant although they may not account for more than one-fifth or one-sixth of total savings.

With respect to physical investment, the construction industry appears to be the most important user of savings. Both residential and commercial construction demands have been very high in recent years and the pressure continues to be so great that Switzerland has been described as "one vast building site." Probably one-half—perhaps 60 percent or so—of Swiss investment is in some form of construction—residential, industrial, or public.

ROLE OF THE BANKING SYSTEM

Although there are over 1,500 banks in Switzerland, only a very few engage to any extent in granting credit facilities to firms located abroad. Chief among the banks granting foreign credits are the "big three": the Swiss Credit Bank, Zurich; the Swiss Bank Corp., Basle; and the Union Bank of Switzerland, Zurich. Each bank has worldwide connections and they are involved in some way in most types of foreign lending, whether by jointly underwriting a foreign bond issue in the Swiss market, by acting as an intermediary for the listing of a new stock on the exchange, or by sharing with each other a large commercial credit to a foreigner.

Swiss banks prefer to extend a line of credit or overdraft facilities to a borrower, rather than to grant commercial loans of fixed terms, although such loans have increased proportionately in the last few years. The overdrafts are callable on demand, but in practice are frequently extended for long periods, particularly for the larger and better known Swiss firms. Such overdrafts thus can become medium- and even long-term credits. Large overdrafts (over $4 million) are usually shared with other banks.

Those American companies which have a top credit rating and are well known in the Swiss market have little difficulty in obtaining commercial loans in European currencies. Commercial banks, however, do not like to make what they call financial loans to American firms since such loans bring no return to banks in terms of related business and are viewed as somewhat riskier. They are first of all commercial banks and therefore prefer to engage in short-term financing, that is up to 3 or 6 months, rather than in medium-term financing. Commercial credits create a profitable side business for banks, such as foreign exchange transactions, letters of credit and collections.

It is impossible to say how many of the short- and medium-term loans listed in table I are made to foreigners. There is no statistical breakdown along those lines, but one of the largest Swiss commercial banks (Union Bank of Switzerland) publishes a division of balance sheet assets between "Swiss" and "foreign." In 1962, the item "Advances and loans" to foreigners accounted for about 12 percent of its total advances and loans.

TABLE I.—*Security issues and bank loans*

(In millions of U.S. dollars)

Item	1958	1959	1960	1961	1962
1. Bank loans outstanding at end of period [1]	5,302	5,800	6,601	7,626	8,505
2. Bank loans (net change during period)	+137	+498	+801	+1,025	+879
3. Gross security issues—bonds and stocks [2]	458	627	586	805	905
(a) Public issues of domestic bonds	214	203	211	250	296
(b) Private placement of domestic bonds	82	73	36	50	39
(c) Public issues of foreign bonds	32	111	128	221	151
(1) Issues of private companies	(23)	(46)	(47)	(147)	(100)
(2) Issues of governments and public entities	(9)	(65)	(81)	(74)	(51)
(d) Public issues of stocks	26	93	44	86	152
(e) Stocks privately placed	104	147	167	199	266

[1] Total of 62 Swiss banks; current account, term, and mortgage loans outstanding.
[2] Domestic issues include conversions, but foreign issues exclude conversions.

Source: Monthly bulletins of the Swiss National Bank.

THE BOND MARKET

The volume of foreign bond flotations varies considerably from year to year, and in the postwar period, it has ranged from a low of $3.7 million in 1957 to a high of about $230 million in 1961. In the late 1940's foreign bond issues of the order of $10 million annually were common; in the 1950's, the annual volume was approximately $50 to $70 million, and since 1959, the annual volume has averaged, with considerable fluctuation, about $120 million.

The data in table II give some indication of the importance of the Swiss bond market for international borrowers. Between 1947 and 1962, issues worth nearly $1.2 billion were floated in the Swiss market. Private firms and public bodies of some 20 countries, as well as several European organizations and the International Bank for Reconstruction and Development, borrowed money on the Swiss bond market in the postwar period. The International Bank, the most important single borrower, issued $166 million of its securities in the Swiss market. Firms and public organizations in the United Kingdom made use of the Swiss bond market to the extent of about $115 million. After the United Kingdom, in order of importance, were borrowers in Belgium, the United States, Italy, and South Africa. Companies and organizations in the United States tapped the Swiss bond market for $110 million between 1947 and 1962. For a listing of borrowers and terms of loans in the Swiss market in the last few years, see table III on page 274.

TABLE II.—*Foreign bonds issued publicly in Switzerland, 1947–62*

[In millions of U.S. dollars]

Country or organization	Total [1] 1947–62	1947	1948	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
Argentina	7.4															7.4	
Australia	55.2							13.8		13.8					13.8	13.8	
Belgium	112.8	11.5	11.5	11.5	11.5		11.5		9.2					[2] 11.5	[2] 11.5	[3] 23.0	
Denmark	46.0													15.0	11.5	5.8	13.8
Germany	62.6												[2] 2.8		[4] 11.5	18.4	29.9
Finland	6.9															6.9	
France	44.8								8.5	11.5			11.5			4.1	9.2
Great Britain	115.0													13.8	25.3	36.8	39.1
Italy	91.0									36.8	19.6					34.5	
Canada	24.4									2.5				5.8	13.8		2.3
Congo (formerly Belgian)	55.3				13.8		13.8	13.8			13.8						
Liechtenstein	1.8	1.2		.7													
Netherlands	23.0				11.5											11.5	
Norway	43.3									5.8	9.2			14.9	11.5	1.8	
Austria	41.4											1.2	9.2	3.5		21.8	5.8
Peru	6.0						.5	1.4		1.6		[2] 2.5					
Portugal	0.9															.9	
Sweden	43.7								25.3					9.2		9.2	
Union of South Africa	81.7				11.5		19.6		19.6	8.1				11.5			[2] 11.5
United States	110.4								17.3	6.9	11.5		11.5	11.5	[5] 25.3	13.8	13.8
European Coal and Steel Community	25.3										11.5						13.8
Interfrigo [6]	2.3													2.3			
IBRD	165.8					11.5	11.5	23.0	11.5	11.5				23.0	27.6	23.0	23.0
Total [1]	1,167.0	12.7	11.5	12.2	48.3	11.5	56.9	52.0	91.4	98.5	65.6	3.7	35.0	122.0	151.8	232.7	162.2

[1] Including conversions.
[2] Conversions.
[3] Of which $11,500,000 conversions.
[4] Of which $8,100,000 conversions.
[5] Of which $3,500,000 conversions.
[6] European company with seat in Belgium.

Source: Bulletin No. 1, Swiss Bank Corporation, February 1963.

TABLE III.—*Foreign bonds publicly issued in Switzerland* [1]

[In millions U.S. dollars]

Borrower	Nominal value	Issue rate	Interest rate	Date of maturity
1960:			*Percent*	
IBRD	$13.8	100	4½	1972
Commonwealth of Australia	13.7	99	4½	1975
British Petroleum Co	13.8	100	4½	1975
International Standard Electric Corp.[2]	8.1	100	4½	1970–78
Province of Saskatchewan	9.2	100	4½	1975
Badenwerk AG Karlsruhe	3.4	99–100	4½	1966–77
IBRD	13.8	100	4	1975
California-Texas Oil Corp.[2]	13.8	100	4¼	1975
City of Quebec	4.6	100	4½	1972–78
British Aluminum Co	11.5	100	4½	1965–75
Kingdom of Norway	11.5	100	4½	1975
Kingdom of Denmark	11.5	100	4½	1975
1961:				
IBM [2]	13.8	100	4¼	1976
SACOR	1.0	99	5¾	1963–78
N.V. Philips	11.5	100	4½	1979
British Petroleum Co	13.8	100	4½	1976
Commonwealth of Australia	13.8	100	4½	1976
IBRD	23.0	100	4	1971–79
Cassa per il Mezzogiorno	11.5	100	4½	1974
Aktieselskabet Dansk Svovlsyre-og Sueperphosphat-Fabrik	5.8	100	4½	1975
Aktiebolaget VOLVO	9.2	100	4½	1969–76
A.S. Vaksdal Møllе, Bergen	1.8	99	4½	1966–71
British Aluminum Co	13.8	100	4¼	1966–76
Société Concessionnaire Francaise pour la Construction et l'Exploitation du Tunnel Routier sous le Mont Blanc	4.0	100	4½	1969–73
Istituto Mobiliare Italiano	11.5	100	4½	1968–77
Robert Bosch Stuttgart	11.5	100	4½	1976
PETROFINA, Brussels	11.5	100	4½	1972–76
Republic of Argentina	7.0	95	6½	1967–73
Internationale Moselle GmbH Trier	6.9	100	4½	1970–79
Republic of Finland	6.9	100	5	1976
Tiroler Wasserwerk Innsbruck	9.2	100	5	1967–77
Societa per Azioni Acciaierie & Ferrierie Lombarde Falck, Milan	11.5	100	4½	1976
Hypothekenbank des Landes Vorarlberg, Bregenz	1.2	100	4½	1966–73
Electric & Musical Industries, England	9.2	100	4½	1966–76
Republic of Austria	11.5	100	5	1976
1962:				
IBRD	23.0	100	4	1973
Bowater Paper Co., London	13.8	100	4½	1977
Kingdom of Denmark	13.8	100	4½	1977
Cinzano Ltd., Montreal	2.3	100	5	1974
Rheinkraftwerk Saeckingen, Germany	6.9	100	4	1968–77
Mannesmann, Duesseldorf	11.5	100	4½	1967
International Standard Electric Corp.[2]	13.8	100	4¼	1980
Imperial Chemical Industries, London	13.8	100	4¼	1977
Albert E. Reed, London	11.5	100	4½	1977
Compagnie des Machines BULL, Paris	9.2	100	4½	1970–77
August Thyssen-Huette, Duisburg	11.5	100	4½	1977
European Coal-Steel Community	13.8	100	4½	1968–80
Steirische Wasserkraft- und Elektrizitaets AG, Graz, Austria	5.8	100	5	1968–77
1963 (through November):				
Cadbury Bros., Birmingham	4.6	100	4½	1971–78
Rheinkraftwerk Saeckingen, Germany	9.2	100	4	1969–78
Kingdom of Norway	13.8	100	4½	1981
Compagnie des Forges de Châtillon, Paris	6.9	100	4½	1970–79
Interfrigo, Brussels	3.5	100	4½	1971–78
Compagnie des Ateliers et Forges de la Loire	2.7	100	4½	1969
Compania Sevillana de Electricidad, Seville	4.6	99	5	1969–78
Association diocésaine de Besançon	.5	100	5	1968–73
Siemens & Halske, Berlin-Munich	13.8	100	4½	1978
Société Metallurgique de Knutange, Paris	6.9	100	4½	1970–79
A. S. Vaksdal, Mølle, Bergen	1.8	99	4½	1975
Sociéte Electrique de l'Our, Société Anonyme (SEO), Luxembourg	13.8	100	4½	1969–79
Joseph Lucas Ltd., Birmingham	11.5	100	4½	1970–78
Compagnie Francaise des Petroles, Paris	13.8	100	4½	1976–81
Association diocésaine de Besançon	.2	100	5	1968–73
Phoenix-Rheinrohr, Duesseldorf	11.5	99	4½	1978

[1] Excluding conversions.
[2] American companies.

Source: Monthly Bulletins of the Swiss National Bank.

A noteworthy feature of the Swiss bond market in the postwar period has been the relative stability of interest rates. Between 1947 and the mid-1950's, the average prime rate for foreign issues was about 4 percent; since then it has risen and has averaged about 4.5 percent. Rates in Switzerland have been and continue to be somewhat lower than those in New York. However, underwriting and other commissions are somewhat higher in Switzerland than elsewhere and on the average total about 3.5 percent of the nominal value of the issue. For shorter maturities, say less than 10 years, the charges would be higher; correspondingly, issues with maturities over 15 years would bear charges under 3.5 percent. In addition to the commission charges and issuing costs, there are also coupon taxes and other duties; the total of all costs amounts to approximately 6 to 6½ percent of the loan's nominal value. In other words, a good foreign firm would be able to float typically a Sw F60 million bond issue at about 4½ percent and would have to pay about 0.7 percent additional per annum to cover flotation charges, taxes, and duties.

Most foreign issues floated in the Swiss market have been first offered to the public at parity or a little under. Compared with New York, the maturity of foreign issues is somewhat less, and a foreign issue is rarely placed in the Swiss market with a maturity of over 15 years. Generally, the amount of each issue is also less than in New York, and on the average is about $9 to $12 million. The largest single issue in the last 3 years was a $23 million issue for the IBRD.

THE STOCK MARKET

The Swiss stock exchanges are among the most important on the Continent of Europe. The three exchanges of significance for foreign securities are Zurich, Basle, and Geneva, the most important of which is Zurich. In volume of business it is about the size of the exchanges in Paris and Amsterdam, and ranks ahead of Frankfurt and Milan, but behind London.

As of mid-1963, 91 Swiss companies and 65 foreign companies were listed on the Zurich Stock Exchange. Twenty-three U.S. corporations were among the foreign companies listed, while another three American issues were quoted only in Geneva. Before World War II, only eight U.S. stocks were listed on the Zurich exchange and the present number, although small, represents a substantial increase. The heavy demand for portfolio investments by Swiss financial organizations and the limited supply of domestic shares have prompted the rather large increase in the number of foreign issues on the Swiss stock exchanges. Turnover in American and other foreign securities on the Zurich exchange is often larger than the turnover in domestic shares.

There is no discrimination against the admission of foreign shares to the Swiss stock exchanges, but they must pass a rather rigorous admission procedure. First of all, there must be a great amount of Swiss interest in the particular shares being considered. That interest is usually reflected in the number of shares held by Swiss organizations and individuals. The application for admission must be filed by a Swiss bank, in practice one of the Big Three, which acts as the intermediary for the applicant. The application is filed with the

Schweizerische Zulassungsstelle, the central organization of the Swiss stock exchanges. The National bank is consulted by the *Zulassungsstelle* for consideration of the national interest in connection with the application. If the National Bank and the *Zulassungsstelle* approve, the individual exchanges may then consider the security for listing. The applicant is required to submit full information on its financial situation, which must be satisfactory in every respect. The security will only be considered by the individual exchanges if there is sufficient demand to warrant the rather expensive fees and charges for its listing.

The Swiss bank handling the application charges approximately $4,600 depending on the particular issue. In addition, the applicant must pay for the printing and distribution of prospectuses, which cost perhaps $2,300. Each stock exchange charges an admission fee of $115 for each type of share, or about $250 for admission to all Swiss exchanges. There is also an annual fee for a listing on all Swiss exchanges of about $500, as well as additional charges for stock splits, capital increases, etc.

Twenty-two American securities and brokerage firms have offices in Switzerland, 13 of which are operated by foreign representatives. These firms are restricted in their activities in Switzerland by their agreements of establishment, and particularly it is understood that they may not compete with Swiss banks by soliciting and holding accounts for clients here. The business of the American brokerage firms is therefore confined mainly to the handling of orders and the provision of advisory services for the Swiss banks.

INVESTMENT TRUSTS

A part of the savings of Swiss in the middle and upper income brackets find its way into domestic and foreign securities and other investments through the investment trusts. The open-end trust has been a part of the Swiss financial scene since the 1930's, and it has been a great success. During the last 10 years, the total assets managed by Swiss investment trusts have risen from $215 million to nearly $1.4 billion. At the end of 1962 investment trusts accounted for about one-quarter of the total in all the savings accounts at Swiss banks. However, a substantial part of the share ownership in Swiss investment trusts is in the hands of non-Swiss.

Part of the inflow of funds from other countries is placed in foreign stocks and other securities through Swiss banks and investment trusts. A well-informed official considers that funds invested in foreign securities by Swiss banks on behalf of foreign clients may amount to $2.5 billion.[2]

Swiss investment trusts, according to the Federal Statistical Department, numbered 138 at the end of 1962 and had total assets amounting to about $1.4 billion. This represents about a sixfold increase in the last 10 years. Sixty-three of the trusts held portfolios of Swiss and foreign securities amounting to about $786 million, while the remaining 75 trusts had invested solely in real estate to the amount of about $650 million.

[2] Other estimates are substantially higher.

INSURANCE COMPANIES

Insurance companies also have a significant role to play in the channeling of domestic savings placed in various kinds of insurance into the capital market. Funds received by these companies for life insurance policies are restricted to placement in a limited variety of Swiss investments, while receipts for casualty insurance and other nonlife varieties can be placed more freely by the companies. The amount of such funds placed abroad, the country, and the type of security in which they are placed will be governed by the financial commitments of the insurance company and the maximum yields obtainable in the range of securities suitable to the company's needs.

DIRECT INVESTMENT ABROAD

Total direct investment abroad by Swiss concerns was estimated 2 years ago to amount to just over $9 billion. The same source has estimated that direct investment has been growing on the average of 5 to 6 percent a year since then, or at about $50 million per year. The bulk of these funds came from business savings and the remainder was procured in the Swiss securities markets.

RESTRICTIONS ON CAPITAL MOVEMENTS

There are no legal or administrative restrictions on purchases of foreign securities by Swiss private investors. The Swiss private investor is free to place his money at home and abroad in whatever investment he chooses. His decision to invest is governed essentially by profit and safety considerations.

There is, however, one institutional restriction which may hamper his purchases of foreign securities. The typical private investor is generally obliged to make his purchases in Switzerland through a Swiss bank. Although he is free to open an account with a brokerage firm abroad (the more sophisticated investor does this if the volume of business warrants it), as a matter of practice the private investor would place his orders through a Swiss bank.

The Swiss banks charge rather heavy brokerage fees, and a Swiss who purchases a U.S. security must pay both Swiss and foreign brokerage fees. For example, a Swiss private investor wanting to purchase 100 Ford Motor shares at $58 would be charged:

New York brokerage (1/10 percent, $5.80; plus $39)	$44.80
Swiss bank brokerage (5/8 of New York charges)	28.00
Total charges	72.80

or about 1¼ percent of the purchase price.

The Swiss National Bank is required under article 8 of the banking law of 1934 to approve all foreign loans, purchases of shares of foreign companies, and investments abroad amounting to Sw F10 million or more that have terms of 1 year or longer. The National Bank consults with the interested Federal Departments in Bern, usually the Departments of Public Economy, of Finance, and of Political Affairs. The Federal authorities in Bern can override a favorable opinion by the National Bank on economic, political, or commercial grounds.

The cost factors which generally affect the decision to permit or reject a foreign capital issue or loan are the state of the capital market, including the capital needs of Swiss industry, and the effect the loan may have on the interest rate structure. In 1956 and 1957 for example, when credit conditions were tight and interest rates rose, the volume of foreign bond issues was cut sharply (see table II). Foreign borrowers were not permitted easy access to the Swiss bond market until August 1958, when the credit situation had eased.

Another factor is the state of the Swiss balance of payments. It is understood that as a matter of policy the National Bank is in principle prepared to export sufficient capital to avoid a surplus in its balance of payments under normal circumstances. The current account in the balance of payments has been in deficit since 1960 but the continued large gross inflow of capital, which has more than offset that deficit, has permitted the National Bank to allow a significant volume of new foreign issues.

The Swiss National Bank is also understood to believe that the capital market should be kept as free as possible subject to domestic needs for capital and the balance-of-payments situation. According to the bank's philosophy, foreign concerns should not be denied access to the Swiss capital market on the grounds that they are competitors to Swiss interests.

Certain national economic and political considerations may also affect the decision to make loans to a foreigner. For example, when the Common Market was formed, the Swiss Federal authorities decided that Common Market countries should not be able to obtain funds in the Swiss capital market. This decision was apparently taken on the ground that the members of the European Economic Community were trying to exclude Switzerland from the Common Market and to restrict its trade with the member countries. Subsequently, however, the market was reopened to EEC borrowers.

Effective control of international capital movements by the National Bank requires cooperation between that bank and the commercial banks. The previously mentioned exclusion of the EEC countries from the Swiss capital market could not have been effective without such cooperation. In fact, cooperation between the National Bank and the commercial banks, or "moral suasion," is one of the few effective weapons of monetary control which the National Bank has in its limited arsenal. Cooperation on a particular matter is usually set forth in a "gentlemen's agreement." The gentlemen's agreement of August 18, 1960, which has been renewed annually since that date and is still in effect, is aimed at restricting the flow of capital into Switzerland which might have inflationary consequences. Essentially it provides that banks after July 1, 1960, will no longer accept new funds in excess of Sw F50,000 ($11,500) for foreign accounts having a withdrawal notice of less than 3 months, with the exception of foreign funds converted into another currency or used to subscribe to foreign loans in Swiss francs or for the purchase of foreign securities.

Clearly, the effectiveness of such an agreement requires the wholehearted cooperation of the commercial banks. Generally, this cooperation has been forthcoming, although after over 3 years there is now some grumbling about loss of business to foreign banks, as well as reports of increasing evasion by some commercial banks. Nevertheless, the gentlemen's agreement as a technique of central bank monetary control seems to have been fairly effective, given the basic legal authority of the National Bank and the relatively small number of large commercial banks.

INTEREST RATE POLICY

The policy of maintaining low interest rates is another important consideration having a bearing on decisions by the National Bank affecting foreign borrowers. An obvious economic reason for a low interest rate policy is that it discourages the inflow of unwanted foreign funds, particularly short-term, or hot, money. Even with the low rates, the inflow of funds has been large enough to create problems of excess liquidity despite a heavy balance-of-payments deficit on current account. Perhaps a more important reason for the low interest rate policy lies in the fact that a rise in interest rates would raise mortgage rates with consequent effects on rents and farming costs, which would probably have important political repercussions. For these political-economic reasons, a low interest rate policy has become almost a tradition in Switzerland.

Swiss authorities have expressed strong opposition to the flotation in other markets of securities denominated in Swiss francs and they object to the inclusion of the Swiss franc in unit of account bonds and bonds with multiple currency clauses. The spread of these practices would make control over the volume of issues available to investors seeking securities denominated in Swiss francs more difficult and could force Swiss borrowers to pay higher rates to attract funds.

It is apparent that a major element in the maintenance of an interest rate structure isolated from those of neighboring countries rests on the traditional preference of Swiss investors for securities denominated in their own currency. Thus the strengthening of other European capital markets in a way which would encourage Swiss investors to place their funds in securities denominated in other currencies might make the isolation of the market more difficult.

ESTIMATED CAPITAL FLOWS

The estimated volume of capital inflow to Switzerland has increased greatly in recent years (see table IV). In 1960, it amounted to $167 million, in 1961 to $645 million, and in 1962 to nearly $460 million. Part of this money is repatriated Swiss funds, while the remainder is either money seeking safe haven from political and economic upheavals elsewhere in the world or is speculative money. Its volatility is probably high. In the first half of 1963 there was apparently a very sharp decline in the gross capital inflow, but in the second half of the year the rate shot up again although outflows have also been large and the net inflow for the year may turn out to be less than in 1962. Thus there can be very large and sudden fluctuations in the volume of funds moving into Switzerland and, in turn, marked fluctuations in the volume of capital available in Switzerland for investment abroad, despite the fact that a highly developed financial market exists.

TABLE IV.—*The Swiss balance of payments*

[In millions of U.S. dollars]

	1958	1959	1960	1961	1962
Trade balance surplus or deficit (−)	−158	−229	−349	−650	−784
Current account surplus or deficit (−)	221	174	94	−210	[1] −345
Changes in gold reserves and foreign exchange holdings (+) increase	+167	+3	+261	+435	+113
Capital, errors and omissions (−) net outflow (+) net inflow [2]	−54	−171	+167	+645	[1] +458

[1] Estimate.
[2] The difference between changes in gold and foreign exchange reserves and the current account balance.

Source: Monthly Bulletins of the Swiss National Bank.

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