



Another "French Paradox": Explaining why interest rates to microenterprises did not increase with the change in French usury legislation

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Abstract

Conventional wisdom indicates that the growth of credit may not materialize if credit rates remain capped by usury laws, as had long been the case in France. France therefore abolished usury ceilings on loans to microenterprise in an effort to increase financing for microenterprises. This should have led to an increase in interest rates and increase in microcredit. However, it did not and this is therefore a paradox. This paper provides possible explanations for the paradox in terms of classical equilibrium analysis as well as behavioral and institutional analysis and softer institutional reasons.

Keywords: Microfinance, Microcredit, usury, behavioral finance, law and economics, institutional analysis, interest rate

Jel classification : B52, B59, E4, G21, K00

Introduction

Even developed countries like France can draw from the experiences of developing economies. To continue its development, France is encouraging microcredit. There is a growing advocacy to increase microfinance through the repeal of usury laws (Helms and Reille, 2004; Honohan, 2004). In line with this, to increase availability of finance for small entrepreneurs, France took off usury laws, but there was no great spurt in microcredit. Classical economics is not able to explain this. Over the last few years, other schools of thought which go into behavioral explanations (Kahneman and Tversky, 1979; Tversky and Kahneman, 1991; Shleifer, 2000; Shefrin, 2002) and those that go into institutional explanations (North, 1990; Rodrik, 2003) have grown in importance. This paper examines if these alternative explanations can explain the paradox of why neither supply of microcredit nor interest rates have increased.

This paper is divided into three parts. Part I briefly explains the economic background to French change in usury legislation. The limitations of the French State interventionist model in a globalized economy, as reflected by low growth and high unemployment, have led France to look into entrepreneurship as a source of dynamism. But the entrepreneurial ventures, necessarily risky, require funding that banks do not necessarily wish to bear if the rate of credit is capped by usury law. At the same time, the growth of microfinance in the world has shown that innovative techniques can increase the availability of credit, without unduly increasing the risk. Nevertheless, the growth of credit may not materialize if credit rates remain capped by usury laws, as had long been the case in France. France therefore abolished usury ceilings on loans to microenterprise. This legislative change is described in part II. This should have led to an increase in interest rates. However, it did not and this is

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