Dialogue &co - Episode 2: Corporate financing

VOICE-OVER
Welcome to Dialogue &co, a podcast in which Banque de France experts discuss current economic issues. In this episode, we look at how changes in interest rates have affected the financing of French businesses since 2022. Agnès Benassy-Quéré, Deputy Governor of the Banque de France, answers questions from Vincent Bignon, an economist. Together, they explore the different mechanisms at play. Happy listening!

VINCENT BIGNON
Hello Agnès.

AGNÈS BÉNASSY-QUÉRÉ

Hello Vincent.

VINCENT BIGNON

Agnès, over the past two years, interest initially rose sharply. But since June this year they've been falling again. How have the interest rates paid by French businesses changed?

AGNÈS BÉNASSY-QUÉRÉ
The cost of new business loans increased as the ECB raised its key rates to tackle inflation. Then, over the past year, it has fallen again slightly in line with the cuts to ECB key rates. To give you a better idea, in February 2022, at the start of Russia's invasion of Ukraine, the rate on new business loans averaged 1.4%. In November 2023 it rose to almost 5% – 4.93% to be exact. It then eased back to 4.4%. In September 2024 we were still well above the February 2022 level.

VINCENT BIGNON
How are theses changes in interest rates affecting businesses?

AGNÈS BÉNASSY-QUÉRÉ
Imagine, Vincent, that you're the head of an SME. You've started making the ecological transition, so you're planning to replace your fleet of diesel vehicles with electric vehicles. The cost is 100,000 euro. You're wondering what to do because you've only got 10,000 euro of cash. That means you'll need to borrow 90,000 euro. But you've already got 100,000 euro of debt which you took out in 2021 at a rate of 1.4%. What are you going to do? Your decision will of course depend on how much you're planning to use the new vehicles. Whether they will help you to grow your business and increase your profits. But your decision will also depend on the level of interest rates. The return on your investment has to

be at least as high as the interest you're paying. So if interest rates rise, you'll scale back your investment, you'll rule out any investments that aren't going to be profitable enough.

VINCENT BIGNON
So that's the immediate effect of a rise in interest rates for all businesses.

AGNÈS BÉNASSY-QUÉRÉ
Precisely. All businesses are affected at the same time as soon as interest rates rise.

VINCENT BIGNON
But what happens to the 100,000 euro of debt that I took out in 2021? Will I have to pay more interest?

AGNÈS BÉNASSY-QUÉRÉ
If you're in France, Vincent, you probably borrowed at a fixed rate, which was a good move. You'll carry on paying 1.4% interest per year until your loan matures. For example, if your loan has to be paid back in 2026, you won't have been affected by the rate rises of 2022 and 2023, because in 2024, 2025, interest rates are falling. To pay back your loan in 2026, you can borrow again, probably at a higher rate than in 2021, but at a lower rate than in 2023. So it's this second impact of the rate hikes that's gradual, that depends on the structure of each business's debt. Is the debt fixed or variable-rate? Is it short or long-term?

VINCENT BIGNON
How have higher interest rates affected French and European businesses' debt burdens? Has the impact been the same in other European countries?

AGNÈS BÉNASSY-QUÉRÉ
French firms are like German and Dutch firms in that they carry a very high share of fixed-rate debt – around 80%. At the other end of the spectrum, you've got the three Baltic countries where only around 10% of corporate debt is fixed-rate. Between the two, we've got the full range of scenarios – in Italy, for example, it's 50%. So in France, Germany and the Netherlands, not only is a high share of debt at fixed rates, the average maturity is also long. At the end of 2021, what we call the residual maturity, which is the term remaining on the loans that still need to be repaid, was an average of about four years. So at the end of 2021, if you add another four years, that takes you to the end of 2025. On average, these debts have to be paid back at the end of 2025. The rate then will probably be higher than in 2021, but it will be much lower than in 2022 or 2023.

VINCENT BIGNON
Agnès, you said that the share of fixed-rate debt in the Baltic countries, Estonia for example, is 10%. What does that mean in practice for firms, in terms of financing?

AGNÈS BÉNASSY-QUÉRÉ
10% is fixed-rate debt, that means 90% is variable-rate. Variable-rate debt is debt on which the rate of interest changes, depending on the terms of the contract, but at the very least according to market rates. So the bank will immediately adjust its interest rates not just on

new loans to Estonian firms, but also on the existing loans on its balance sheet. That means that firms bore the full brunt of the rise in interest rates in 2022 and 2023. If they managed to weather that shock, with interest rates now falling, they'll also feel the full benefit of that, as banks automatically lower their rates when market rates fall. Of course these are all averages, Vincent. If we take the case of the 100,000 euro that you borrowed in 2021, maybe half of that has to be paid back in 2023, so after two years, and the other half in 2027, after six years. The average is of course four years, but after two years you've already renewed half of your debt. At the very high rates we had in 2023. But on the whole, the longer the maturity, the more slowly interest rate fluctuations, both upwards and downwards, are passed through to firms. That cushions the shock to their debt burden, to interest payments.

VINCENT BIGNON
So it depends on whether the debt is fixed or variable-rate. Did the rise in interest rates we just talked about affect small and large businesses in the same way?

AGNÈS BÉNASSY-QUÉRÉ
As I said before, interest rates for new investments rose for all firms, small and big alike. But, unlike small firms, large corporations tend to finance themselves in part on the markets, by issuing corporate bonds, so without going via the banks. Market interest rates reacted more quickly than those charged by banks. So the observed interest rate rise affected large corporations more quickly than small firms. But on the other hand, market interest rates also started to fall more quickly than bank rates. So today it's the large corporations that are benefiting the most from lower market rates. To give you an idea, the average market rate is currently 3.3%. That's the most recent figure we have, for September 2024. Bank loan rates are 4.4% on average.

VINCENT BIGNON
During the phase of rising interest rates, did large corporations' interest payments rise faster than those of smaller businesses, or more slowly?

AGNÈS BÉNASSY-QUÉRÉ
It's hard to compile statistics just for large corporations because, by definition, there aren't very many of them. But if we look at intermediate-sized firms, we can see that the cost of their outstanding debt rose at around the same pace as interest rates on new loans. If we look now at SMEs, so smaller firms, we find that rates on new loans rose at around the same pace as for intermediate-sized firms, but the cost of their existing debt rose very slowly.

VINCENT BIGNON
So why did SMEs' cost of debt rise more slowly?

AGNÈS BÉNASSY-QUÉRÉ
Because SMEs have a smaller share of short-term debt. It's clear, large corporations have more short-term borrowing than small firms, which generally have longer loan maturities. But if we also take into account differences in debt ratios, SMEs tend to have lower debt

ratios than large corporations, again speaking in average terms. So, on average, SMEs were better protected against the rise in interest rates, for two reasons. First, longer debt maturities; second – and more importantly – lower debt ratios. That doesn't mean SMEs are protected against all shocks. Like large corporations, they are also being affected by the different shocks to the economy, such as the rise in energy prices, deterioration in order books in some sectors, and so on.

VINCENT BIGNON
So is that everything for the differences between SMEs and large corporations in terms of debt?

AGNÈS BÉNASSY-QUÉRÉ
There's one last factor, Vincent, which is firms' cash surpluses. Firms have debts, but they also hold cash. When interest rates began to rise, SMEs had higher cash levels than large corporations. They were quickly able to shift the cash in their current accounts to term accounts earning higher interest. So the first impact of the rise in interest rates was to increase the rate of return on firms' cash surpluses, which at the time were abundant.

VINCENT BIGNON
So to sum up, regarding my investment?

AGNÈS BÉNASSY-QUÉRÉ
To sum up, Vincent, for your SME, what was the impact of the rise in interest rates? First, you postponed some of your investment in electric vehicles because it was too expensive, the new debt would have cost too much because rates were high. There was no immediate rise in the interest payments on your existing debt, the 100,000 euro you took out in 2021 but with a relatively long maturity. In terms of your assets, you had 10,000 euro in cash, and you were quickly able to move that to term accounts paying higher interest.

VINCENT BIGNON
But we know that when rates rise, banks tend to ration or limit the supply of credit, because it becomes harder for them to get liquidity and the value of the collateral that firms can pledge to secure their debt falls. Isn't there a risk that banks will ration or limit the supply of credit to these SMEs, which mainly rely on bank loans? Did we see that happen?

AGNÈS BÉNASSY-QUÉRÉ
In theory it's true, but the statistics we have today are fairly reassuring. The data shows there has been no significant rationing of credit, especially investment credit. According to Banque de France surveys, nearly 95% of SMEs are granted nearly all of the investment loans they request from their bank. Things are less positive for cash loans, in part for micro-enterprises. But at this stage, we can't really say that SMEs in general are struggling to get credit.

VINCENT BIGNON
But we've seen a rise in business bankruptcies since the end of 2021. If this rise isn't down to increased financing difficulties, then what's happening?

AGNÈS BÉNASSY-QUÉRÉ
We have to set this rise in bankruptcies in a historical context. In 2019, just before the pandemic, there were around 51,000 bankruptcies in France. That's relatively low compared with the long-term average, which was around 60,000 bankruptcies a year in the 2010s. In December 2021, the figure fell to 27,000 over 12 months. In October 2024, again over a 12-month period, we are just above the average for the 2010s, so around 64,000 bankruptcies for the past 12 months. It's not great, but it partly reflects the bankruptcies that should have occurred during and just after the pandemic, but which didn't because of government support and the temporary closure of our commercial courts.

VINCENT BIGNON
There's another factor.

AGNÈS BÉNASSY-QUÉRÉ
Yes, there's another factor that we observed in 2018 and up to 2021 – a sharp rise in business creations, of just over 14% to just over 17% per year. Statistically, we know that the risk of bankruptcy increases three years after creation. So we are also seeing the result of businesses created over that period and that didn't survive.

VINCENT BIGNON
OK, so that's what the figures say, but still, don't all these figures contradict what you said about French SMEs being left relatively unscathed by the interest rate rise?

AGNÈS BÉNASSY-QUÉRÉ
That's the difference between averages and individual situations. So far I've only talked about averages. The pandemic temporarily skewed the playing field in the productive sector. Some firms were hit harder than others, but were supported by the government. So as we just said, they didn't go bankrupt during the pandemic, and now the support is being withdrawn and they're in trouble. Others did well during the pandemic, and on top of that got government support. So there's been a big rise in the heterogeneity between individual situations. We can see it when we compare growth in turnover, profit, debt, for firms of the same size or within the same sector – we're obviously not going to compare the textile sector with agriculture. When interest rates rose in 2022 and 2023, heterogeneity between firms was falling, but was still high compared with 2019. So alongside the average, which was fairly resilient, there was an abnormal number of firms that were doing either really well or really badly. It's these firms that were doing really badly that are now becoming vulnerable and disappearing, and not those situated around the average. It's not a contradiction. Of course, all SMEs are being affected by the economic climate. I'm only talking about the effect of interest rates, of the pandemic, which on average terms had a relatively limited impact, but not necessarily on firms at the ends of the distribution.

VINCENT BIGNON
Right. Since June 2024, the ECB and Eurosystem have cut key rates several times. When will firms start to feel the benefits?

AGNÈS BÉNASSY-QUÉRÉ
Vincent, what's true on the upside is also true on the downside. Bond yields began to fall even before the ECB made its first rate cut in June 2024. Bank borrowing rates have also started to decline, but at a slower pace. So large corporations should benefit rapidly from the fall in market rates, especially those that refinanced their borrowing in 2022 and 2023 at shorter maturities. In other words, they replaced the debt that matured in 2022 and 2023 with shorter-term market borrowing, which is precisely what we observed – a shortening of the average maturity for large corporations over the period. Which was a good strategy because now those shorter-term loans are maturing and can quickly be replaced with loans at lower rates. So in general, firms will be able to borrow at increasingly low rates. And these new loans will replace the loans with very low rates that were taken out before 2022, but also loans at higher rates taken out in 2022 and 2023. Lastly, we shouldn't forget new loans to finance new projects. The Banque de France has compiled projections for 2025 and, on average, if we put everything together, we don't expect interest rates on outstanding bank debt to either rise sharply or fall sharply. In other words, overall, if we look at all the impacts, the effective rate on outstanding bank debt should, in average terms, continue to rise slightly and then remain stable over 2025. So it won't fall massively, but firms are refinancing at sufficiently low rates to keep effective rates stable.

VINCENT BIGNON
That's interest rates then, but what about lending volumes, the volume of loans?

AGNÈS BÉNASSY-QUÉRÉ
Yes, because since 2021, firms have been reducing their debt. Firstly, they've been paying back their state-guaranteed loans, and then, more generally, they've been reducing their debt, which is normal because interest rates are higher and they don't necessarily want to take on more debt. This is obviously going to lower the debt burden gradually. But we also know that French firms have much higher debt levels than those in other European countries, so it will be some time before they catch up with their European peers.

VINCENT BIGNON
Lastly, what can we learn from the cycle of interest rate hikes that lasted until June, and the cuts that began in June?

AGNÈS BÉNASSY-QUÉRÉ
I think there are basically two main takeaways from this episode. Firstly, European firms are very heterogeneous, but in the large countries, on the whole, they are fairly similar to French firms, with a high share of fixed-rate bank debt with a relatively long maturity. This means that the rise in rates had a delayed impact on the average debt interest burden for euro area firms, cushioning the shock to their interest payments, but the same is also true on the downside, so the past interest rate rises are going to continue to make themselves felt in bank balance sheets for some time. The second lesson is that, contrary to what we might expect, SMEs were relatively well protected during this episode, compared with large corporations and intermediate-sized firms. That's due to a combination of three factors. First, less debt. Second, longer-term debt than large corporations. And third, more cash, at

least when interest rates started to rise. In reality, SMEs are more vulnerable to shocks such as higher energy prices and to the economic climate than to interest rates.

VINCENT BIGNON
That’s good news. Thank you, Agnès, for a very enlightening chat.

AGNÈS BÉNASSY-QUÉRÉ
Thank you Vincent, and thank you to our listeners for staying with us right to the end.

VINCENT BIGNON
Join us again soon.

VOICE-OVER
Thank you to everyone who helped us prepare this episode. If you liked it, don't hesitate to subscribe to Dialogue &co and leave comments and stars. Join us again soon for another economic discussion with experts from the Banque de France.