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Prime Minister
Relevant background for your various pre-Madrid discussions.
RRC6 16/6

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PRIME MINISTER

16 June 1989

GERMANY'S COVERT EXCHANGE CONTROL

You were interest in FRG's covert exchange controls. Here are three samples:-

1. **Restrictions on Insurance Companies holdings of foreign assets.**

The law on insurance supervision (VAG) specifies the assets required to meet contractural insurance liabilities:

(i) The list of prescribed assets does not allow holdings of any foreign currency assets;

(ii) The law also requires an exact matching of assets and liabilities which implies all Dmark holdings;

(iii) Severe restrictions apply to equity holdings, eg less than 5 per cent may be in "foreign corporations" and must be traded domestically and denominated in Dmarks;

(iv) Comparing with insurance companies in the UK in 1984, we find the following portfolio composition:-

	Loan Stock	Government debt	Mortgages	Equities
		%		
FRG	39	24	21	5
UK	5	27	6	41

In the UK we are entirely neutral between sterling and other currencies.

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2. Restrictions on Foreign Currency Bonds

Section 3 of the Currency Act prevents German residents from issuing and buying domestic bonds denominated in a foreign currency (including ECU).

3. Federal Debt

Although most securities are now open to non-residents, the FRG still does not allow foreigners to buy certain bonds with less than two year maturity (Treasury financing notes and Federal Savings Bonds).

4. Compatibility with Capital Liberalisation Directive (CLD)

The FRG rationalises the insurance company restrictions on the grounds of "prudential" supervision. This is recognised as legitimate in the CLD. But there are clear grounds for arguing that such currency restrictions go well beyond any prudential requirement.

Both the restrictions on foreign currency bonds and on foreign holding of federal debt clearly violate the CLD.

5. CONCLUSION

It would be useful to ask the Treasury to examine the extent and effectiveness of covert exchange controls in all Community countries.

ALAN WALTERS

SECRET

~~Paul~~ You were concerned about the same point as the writer.

A

June 8th 89

→ PA

~~Andrew~~ Turnbull

~~Andrew~~ In case you missed it, I attach the 1st leader from todays Evening Standard'. I do not know who wrote it, but it is the most sensible piece on exchange rates and monetary policy that I have seen in the British press.

AW

Evening Standard

THURSDAY, 8 JUNE, 1989

Double-digit inflation?

THE Government's overriding objective, said Nigel Lawson in the Commons yesterday, is to bring inflation back down. "To do that we will keep interest rates at whatever level is necessary for as long as is necessary." That is the right policy. The Chancellor, who now says that inflation will exceed the ceiling of 8 per cent which he forecast in his Budget, was right to rule out credit controls as a way of discouraging the borrowing that has helped to fuel inflation in the past year and more. The simplest and most effective control on credit is a high interest rate, which makes borrowing more expensive. If there is too much borrowing, then the Chancellor should—and will—put up interest rates until the excess borrowing stops. Besides, direct credit controls, which distort the market in a number of undesirable ways, will no longer be permitted under the Single European Act. By 1992 those EC countries which still have them will be required to abandon them.

Though the Chancellor did not use the words "exchange rate stability" in his Commons speech, leading some commentators to suspect that he had at last abandoned it, he said that "we will not allow the firmness fo our monetary stance to be undermined by a depreciation of the exchange rate." In other words, he still considers the external value of the pound (measured by the exchange rate) to be at least as important as its internal value (measured by inflation). This is a mistake. Attacking the exchange rate rather than the inflation rate is like pruning a poisonous tree rather than hacking it out by the roots. In the long run, the external value of the pound will come to reflect its internal value, and not the other way about. If the pound inflates faster than other major currencies, its value against them will eventually fall, regardless of any attempts to stop it. It is only when the Chancellor has the humility to admit this truth that the markets can have any confidence in his ability to prevent double-digit inflation.

CONFIDENTIAL

FROM: A SHARPLES (FIM2)
DATE: 5 June 1989
EXT: 4482

1. MR ILETT
2. CHANCELLOR

There is some useful material here, particularly on restrictions on bond issues. It will be difficult to move the Germans where they quote prudential requirements in support of investment restrictions; everybody does some of this, the Germans just do more.

cc PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Mr Wicks
Mr Scholar
Mr Lankester
Mr Peretz
Mr Odling-Smee
Mrs Brown
Miss O'Mara
Mr Melliss
Mr Williams
Mrs Chaplin
Mr Tyrie

Mr Isaac IR
PS/IR

GERMAN "HIDDEN EXCHANGE CONTROLS"

This minute sets out the information we have obtained on three forms of restriction on the free movement of capital operated by West Germany:

(i) restrictions on overseas investments by insurance companies;

(ii) restrictions on foreign currency bond issues by German residents; and

(iii) restrictions on sales of certain government bonds to non-residents.

2. It deals with the questions raised in Mr Taylor's minute to Mr Ilett (16 May) and to Mr Melliss (2 May). It incorporates material from Mr Melliss on foreign currency bonds and Mr Williams on government debt.

3. In brief restrictions (ii) and (iii) above appear to infringe the capital liberalisation directive (CLD); (i) is more complex, as all EC states (including the UK) regulate investment by insurance companies as part of their prudential supervision and this is provided for in the CLD.

Controls over investment by insurance companies

4. Graham Bishop of Salomon Brothers argued in his speech "1992 and beyond" that the German law on insurance supervision prevents the dominant part of long term West German savings from going abroad. He said that this is economically equivalent to an exchange control and should therefore be abolished.

5. In practice, the position is not as clear cut as Mr Bishop suggests. First, all EC member states regulate the assets that can be held by insurance companies as part of their normal prudential supervision. The restrictions imposed in West Germany are certainly stricter than those applied in the UK but are not entirely different in kind. Second, the capital liberalisation directive provides an exception (Article 4) for measures 'to prevent infringement of laws in the field of prudential supervision of financial institutions'. This recognises of course, that exchange rate risk and country risk can be legitimate prudential concerns.

6. German insurance companies are regulated by the law on insurance supervision (VAG) which specifies that assets required to meet contractual insurance liabilities (the 'coverage fund') and other 'committed' assets should be held in one of twelve specified types of investment. Within this framework, the following restrictions are applied:

(i) no more than 20 per cent of guaranteed liabilities may be invested in equities. The maximum limit for "other committed assets" is 25 per cent;

(ii) no more than one quarter of equity holdings may be in 'foreign corporations' and those must be shares traded on a domestic stock exchange;

(iii) no more than 25 per cent of prescribed assets may be held in property;

(iv) bonds issued abroad may not exceed 5 per cent of committed assets; and these must be denominated in Deutsche Marks and traded on a domestic exchange.

(v) where equity stakes are held they may not exceed 5 per cent of the capital of that company.

7. The list of prescribed assets does not appear to allow any foreign currency assets to be held. The law also requires that there should be exact matching of assets and liabilities in foreign currencies unless the insurance supervisors grant a specific dispensation.

8. The distribution of assets held by German insurance companies, in part the consequence of these restrictions, is very different to that in the UK. In 1984, 39 per cent of assets was held in loan stock, 24 per cent in Government debt and 21 per cent in mortgages. Only 5 per cent was held in equities. (In the UK in the same year the corresponding figures were 5 per cent, 27 per cent and 6 per cent with 41 per cent in equities.)

9. Turning to the UK, regulations made under the Insurance Companies Act 1981 lay down certain requirements for the balance sheets of insurance companies. The key features of this regime are that:

(i) assets must exceed liabilities to policy holders (technical reserves) by a prescribed amount - the required solvency margin.

(ii) certain assets may be taken into account only to a limited extent when calculating solvency margins. For example an investment in the equity of any one company may only be counted up to 2½ per cent of the value of relevant assets. Similar limits are applied to individual investments in land, debt, unlisted shares etc. These limits appear to be neutral as between UK and overseas assets and between sterling and other currencies.

(iii) unlike most other EC states, the UK does not impose maximum or minimum levels for investments in specific categories of assets.

(iv) the UK does apply a currency matching requirement: assets must be held in a specific currency to cover at least 80 per cent of the company's liabilities in that currency.

(v) furthermore there is a "localisation" requirement that sterling assets held to meet the "matching" requirement for sterling liabilities should be "held" in the UK.

10. Are these regulations an active constraint on investments by UK insurers? To the extent that the insurers hold assets which substantially exceed the minimum solvency margin, then they will not be actively constrained by these regulations in decisions on investment of new funds. However, where actual solvency margins are close to the required level, the pressure to invest only in "admissible" assets will grow. The regulations certainly provide a broad backdrop against which investment decisions are made.

11. Therefore it appears that the investment restrictions imposed on insurance companies by the German authorities are intended to contribute to prudential supervision in much the same way as the UK regulations, and as such the ground for complaint would be that the German rules go further than is necessary for that purpose (and so incidentally are against the interests of German investors). Two aspects of the German regulations are particularly objectionable:

(i) the effective requirement for 100 per cent currency matching;

(ii) the requirement to invest only in German listed securities.

12. Both appear to be unnecessary and discriminate against investment elsewhere in the Community.

13. We understand that the German regulations are currently under review, and some amendment to the list of permitted investments has been proposed, but the requirement for full currency matching is likely to remain. We understand (from the National Association of Pension Funds) that similar investment restrictions are applied to German pension funds which are allowed to invest no more than 5 per cent of assets in overseas securities and these must be listed in Germany.

Is this compatible with the capital liberalisation directive?

14. The capital liberalisation directive (CLD) states (article 4) that:

> "this directive shall be without prejudice to the right of member states to take all requisite measures to prevent infringements of their laws and regulations, inter alia in the field of taxation and prudential supervision of financial institutions ..." However, it goes on "application of those measures may not have the effect of impeding capital movements carried out in accordance with community law".

15. The Commission's explanatory memorandum acknowledges that financial institutions manage funds entrusted to them by the public and "there may be some justification for imposing certain rules on their investments or borrowings in order to protect those savings. Such rules will cover, for example, the composition of the assets that ... an institutional investor may hold in its portfolio ...." The Commission went on to say that each case must be assessed individually, but suggested two general criteria which might be used to justify investment restrictions. The first is where such restrictions are necessary to avoid exchange risk, and the second is to take account of the 'guarantee' offered by various investments. Both of these criteria point towards allowing certain restrictions on the type of investment allowed, but not the country in which it takes place.

16. Hence the principle of currency matching would appear to be compatible with the CLD, although it might still be argued that

the requirement for a hundred per cent matching is an unnecessary restriction on capital movements. Restrictions on investments in certain types of instruments appear to be allowed, but a requirement that such securities be listed in the country concerned would appear to infringe the directive.

Restrictions on foreign currency bonds

17. In his note of 28 April on the IMF Occasional Paper on Germany Mr Melliss implied that there is a prohibition on German residents holding foreign currency bonds. Mr Melliss advises that in fact the restrictions apply to the <u>issue</u> of foreign currency denominated bonds on German markets.

18. We have been told by the Bundesbank that under section 3 of the Currency Act, the issue of foreign currency bonds where both the issuer and the <u>first</u> holder are German residents requires a licence, the granting of which is the responsibility of the Bundesbank. Since the Bundesbank views the use of foreign currencies for domestic bonds by resident issuers as being undesirable from the monetary policy point of view, no licenses are, or ever have been, granted. For these purposes the ECU is deemed to be a foreign currency so the same restriction applies.

Andrew ? Then surely a similar restriction should be necessary for us for monetary purposes

19. Where either one or other of the issuer or first purchaser is a non-German resident then section 3 does not apply. This effectively means that foreign currency borrowing by German residents is done off-shore through non-resident issuers.

20. Between 1949 and 1961 there was an absolute prohibition on German residents holding or issuing foreign currency bonds. This was to protect the Deutsche Mark since there was a fear that German residents would wish to hold dollars. The present arrangements date from 1961.

21. This would appear to be an infringement of the CLD.

Federal debt

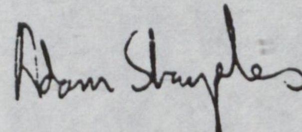
22. From 3 October 1988 Germany has allowed non-residents to participate in the secondary markets for Bundesobligationen, non--callable five year bearer bonds issued by the Federal government. As a result most types of securities in Germany are now open to non-residents.

23. There are however two types of bonds for which sales are still restricted. The restrictions flow from Article 52 of the Foreign Trade Ordinance Act which does not allow the sale to non-residents of bonds with a life to maturity of two years or less at issue, or which can be redeemed within two years, without Bundesbank permission (which is not given).

24. The first restriction is on Treasury financing notes (Finanzierungs-Schatze). These are one or two year Federal bonds issued specifically to finance government expenditure.

25. The second restriction is on Federal savings bonds (Bundesschatzbriefe). These are savings bonds with a maturity of six or seven years at issue, which can only be held by private persons and non-profit entities. The savings bonds are not traded on the stock exchange and can be redeemed at par any time one year after issue. The result of this latter feature is that they cannot by sold to non-residents under Article 52.

26. The barriers in Article 52 would appear to breach the Directive in spirit and, probably, letter. The consequences of these restrictions on overseas purchases of Federal debt are probably not large since the instruments account for a relatively small part of outstanding DM securities.



A J SHARPLES

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