

SECRET

cc Andrew Turnbull
Charles Powell a
Paul Gray
Brian J. Hillis

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 contractual 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:-

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

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

SECRET

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