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PRIME MINISTER

Covert Exchange Controls

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Lord Joseph has sent you a number of papers by Mr. Graham Bishop who is an economist working at Salomon Brothers who follows the European scene closely.

At first sight, the papers appear to support the contention that, while Germany has no formal exchange controls, it has not removed a number of quasi exchange controls, that the Madrid conditions have therefore not been satisfied, and that the UK is justified in withholding its agreement to join the Exchange Rate Mechanism.

In a piece written in May 1989 - Flag A - Mr. Bishop outlined the current restrictions on the German insurance industry. These work by specifying permitted assets and the effect is that insurance companies cannot invest in foreign currency assets except where they match foreign currency liabilities. There are a number of objections to this system. First, the restrictions go beyond what is strictly necessary on prudential grounds. Insurance companies in most other Community countries manage to operate safely under much freer conditions. Secondly, it gives the German Government a source of relatively cheap finance as its debt is included on the list of permitted assets. Thirdly, the system discriminates against companies like Salomon Brothers, who find it difficult to break into the German securities market as they are unable to trade overseas equities with German insurance companies.

Lord Joseph appears to be steering you towards the conclusion that this situation provides a justification for not entering into the ERM and appears to be quoting Mr. Bishop in support of this conclusion. I doubt if the proposition can be supported and doubt also whether Mr. Bishop believes it either.

- i. Although the rules do limit the flow across the exchanges through insurance companies, they are not very effective



in limiting total flows. As Mr. Bishop explains on page 9 of Flag A, German residents are free to purchase overseas bonds and have switched to them to a substantial degree. If the restrictions on insurance companies were having a material effect on total overseas flows, I would expect to see two results. First, there would be a difference between domestic DM interest rates and Euro DM rates as there was for the Franc and Lira before they began to dismantle exchange controls. This difference does not exist. Secondly, if capital outflow is to match the large current account surplus, one would expect to see a persistent tendency for the DM to appreciate, but what is remarkable is that, despite the large current account surplus and improving competitiveness, the DM has remained relatively undervalued.

- ii Action is already in hand to change the position. The Commission is working on an insurance directive and the German Government has produced draft regulations - Flag B - which will liberalise the position. An improvement in the position seems assured. One would be putting a great deal of weight on the difference between implementation and decision in principle if one were to bring this into the ERM discussion.

In a piece written at the end of March - Flag C - Mr. Bishop considered whether the Madrid conditions had been satisfied. His conclusion, see page 8, was that "the Community component of the UK conditions for ERM membership can now be regarded as satisfied". Thus, contrary to the impression being given by Lord Joseph, he is not advocating making covert exchange controls a condition of the UK's decision.

I have since spoken to Mr. Bishop who has confirmed to me that this is his view. He believes the German insurance industry is an important Single Market issue, but not one that can plausibly be brought into the ERM debate. He draws a different conclusion. The liberalisation of the German insurance industry, when combined with the removal of French and Italian exchange controls, will mean that capital will move



more freely around the EMS and make it more difficult to operate than it has been over the past ten years. In consequence he believes that Stage 2 should be kept short and that locked currencies should be introduced as soon as possible.

A minor issue to come out of these papers is that the UK also has its own skeletons. PEPs extend tax relief to unit trusts investing mainly in UK equities - see page 5 of Flag A.

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