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Part C

SECRET

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PO -CH /NL/0080



PART C

Chancellor's (Lawson) Papers:

ARRANGEMENTS FOR THE
TRANSITION OF THE
SOVEREIGNTY OF HONG KONG
IN 1997

PO -CH /NL/0080

PART C

PART C

Disposal Directions: 25 Year

Lawson

27/7/95

CONFIDENTIAL



FROM: JILL RUTTER

DATE: 1 March 1988

Handwritten initials, possibly "JR", in the top right corner of the page.

MR ROBSON

cc:
Chancellor
Mr Anson
Mr Mountfield
Mr Turnbull
Mr Fox
Mr Call

HONG KONG DEFENCE COSTS AGREEMENT: RENEGOTIATION

The Chief Secretary has seen your minute of 24 February. He has commented: "Well done".

Handwritten signature of Jill Rutter, written in cursive.

JILL RUTTER
Private Secretary

SECRETHONG KONG
DOLLAR: NOTE BY
PERETZ: 7/3

FROM: D L C PERETZ
DATE: 7 March 1988

CHANCELLOR

cc Sir P Middleton
Sir G Littler

VISIT OF PIERS JACOBS: HONG KONG DOLLAR

Miss O'Mara has let you have a note on the various other matters you might want to discuss with Mr Jacobs tomorrow. No doubt he will want to tell you about his budget.

2. You will also want to touch on the possibility of a shift in the Hong Kong dollar link. The case for a revaluation is fairly clear:-

(i) It was not envisaged in 1983, when the link was established, that it would remain at 7.80 for all time. We always envisaged that, as with other exchange rate links, once credibility had been established over a number of years the occasional upward (or downward) move could be contemplated.

(ii) After rising over the initial 18 months of the link, the US \$ has now fallen (see attached graph) to a point where it is some 25% lower in effective terms than when the link was established in 1983. Although Hong Kong officials argue that the economy is flexible enough to cope with this without strain, it is undoubtedly adding to inflationary pressures in Hong Kong.

(iii) Keeping to the link in these conditions has also posed substantial operational problems. Interest rates are now back up to 4% again, but at times have been at very low levels indeed (half to three quarters per cent); and holding the rate has required substantial official purchases of US dollars. A negative interest mechanism has been developed for use if necessary. And we know (my minute of 21 January) that the Hong Kong authorities have

behind

been considering further changes in their monetary control mechanisms to improve their defences against exchange rate pressures.

3. The problems with a move, of course, are first Chinese suspicions; and second the effect on domestic confidence, particularly in the context of 1997.

4. So far, as Jacobs knows, you have given him strong support against US pressure on Hong Kong to revalue. But what would be worth discussing with him, if he shows less than total resistance, is whether a context could be found for a move in which both Chinese suspicions and domestic confidence effects could be reduced.

5. One possibility, if it could be managed with US pressure, would be more or less simultaneous moves with Taiwan and Korea. This would put it in the general context of NIC exchange rates against the falling \$.

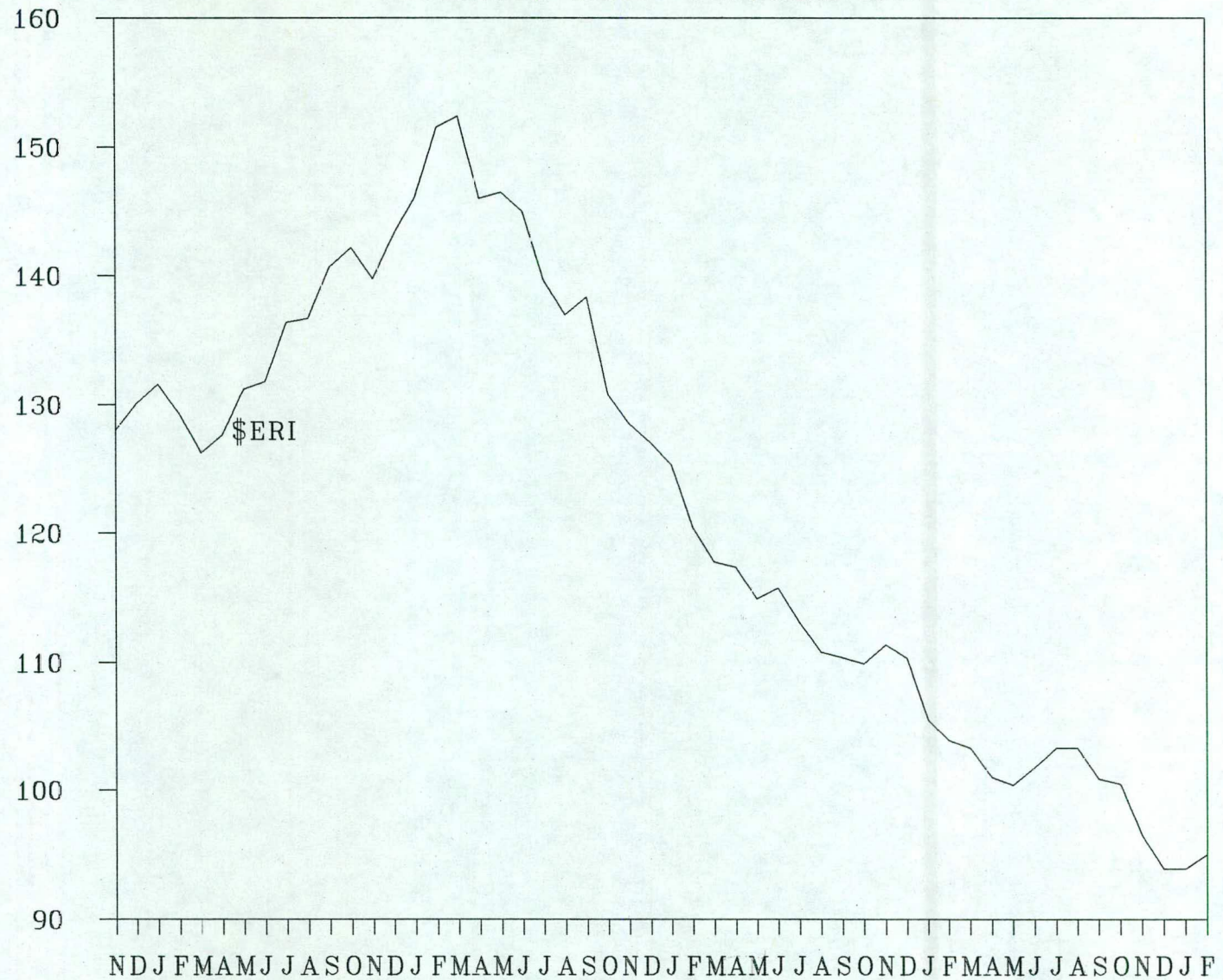
6. I have discussed this with Sir G Littler, and neither of us is clear how or if this could be managed. No doubt the subject will come up at the April Washington meetings. Perhaps the question to ask now is something like: if the move could be put in this wider context, and particularly if Korea and Taiwan could be persuaded to revalue at much the same time, would Hong Kong's resistance be less?

DLC

D L C PERETZ

DOLLAR EFFECTIVE RATE INDEX

NOVEMBER 1983 - FEBRUARY 1988



(MONTHLY RATES)

CONFIDENTIAL

FROM MISS M O'MARA
DATE 7 MARCH 1988

CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir G Littler
Mr Lankester
Mr H P Evans
Mrs Lomax
Mr Peretz

VISIT OF PIERS JACOBS: TUESDAY 8 MARCH

You have agreed to see Mr Jacobs, Hong Kong's Financial Secretary, at 3 p.m. on 8 March.

2. I attach a note on the Hong Kong economy, produced by IF2, together with more general briefing from the FCO on issues of current interest in Kong Kong and a brief personality note.

Hong Kong budget

3. Mr Jacobs presented Hong Kong's budget for 1988-89 on 2 March. You might like to ask Mr Jacobs about the prospect for introducing the broadly based sales tax, to which he referred in his budget speech.

Hong Kong dollar

4. However, the subject in which both you and Mr Jacobs have the greatest interest is the pressure from the US and others for a revaluation of the Hong Kong dollar. Mr Peretz is submitting a separate note on this.

Hong Kong Stock Exchange

5. The FCO have told us that Mr Jacobs would also like to brief you on recent Stock Exchange events. He probably wants to discuss Hong Kong's response to the stock market collapse in October when you will well recall that the Hong Kong Stock Exchange suspended

trading for four days and particular problems arose in the futures market. A package was finally agreed under which a support facility (initially of HK\$2 billion) was formed for the Hong Kong Futures Guarantee Corporation, enabling it to meet its guarantee commitments and to underwrite new guarantees, with contributions from local financial institutions, topped up from the Exchange Fund; those with short positions (mainly foreign institutions) were persuaded to support those with long positions (mostly local individuals) and the futures exchange was to be restructured with a new Chairman and the injection of new members. The support package was subsequently doubled, with half again coming from the Exchange Fund on a last in, first out basis, as before, and it was agreed that the Exchange Fund could inject a further HK\$1 billion, if necessary. Hong Kong's Governor also announced on 3 November a committee had been established to review the working of the futures and stock exchanges and the market regulatory agency. It is to publish its report in May.

6. It is clearly extremely unfortunate that the Hong Kong market got itself into this mess and that the Stock Exchange consequently set the rest of the world a bad example by closing. However, you will not want to enter into any detailed discussion of last October's problems with Mr Jacobs or express a judgement on whether the Hong Kong authorities were right to close the market but rather listen to what he has to tell you.

7. Mr Jacobs may also want to mention the various corruption charges involving Ronald Li, the Stock Exchange's former Chairman, and others, about which you saw telegrams at the turn of the year. Mr Li has now been charged but we have had no news of any further developments.

8. Other issues Mr Jacobs may raise are

(i) the Hong Kong defence costs agreement. The current agreement runs out at the end of this month. Negotiations for its renewal are not yet complete. The existing agreement provides for a 75/25 split in the UK Government's favour.

The Hong Kong Government has been pressing for a 65/35 split. Our position is that there is a case, in view of the settlement with China and the fact that the garrison's focus is increasingly that of internal security, for the Hong Kong Government to pay 100 per cent of the costs. Despite this, Ministers are prepared to see our contribution increase from 25 per cent to 30 per cent but the Hong Kong Government should be under no illusion that they will go further.

The negotiations are at a delicate stage. The Hong Kong Government has moved close to our position. The difference between the two sides is about £9 million over the life of the agreement. Hong Kong attributes this to its refusal in principle to pay UK VAT (which MOD meet on goods and services supplied to the Forces for use in Hong Kong and which is provided in the current agreement).

If the subject is raised, we suggest you should say:

a) the negotiations are the responsibility of the Secretary of State for Defence; but

b) Ministers are prepared to increase the UK's contribution from 25 per cent to 30 per cent but no further; and

c) there need be no issue of principle on VAT (ie we can let them off VAT) if Hong Kong puts another £9 million on the table;

(ii) balance of payments statistics. In the absence of any attempt by the Hong Kong government to collect comprehensive balance of payments statistics, the IMF have made their own stab at doing so. This has alarmed the Hong Kong authorities who have approached Mr Cassell in Washington in an attempt to ensure these 'misleading' figures are never published. It is just possible Mr Jacobs may try to lobby you on the same subject. Given our own interest in eliminating the global

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balance of payments deficit, we do not have a great deal of sympathy for Hong Kong. Nevertheless since it is not an IMF member itself, we have some moral obligation to ensure its views are heard. We have therefore suggested that Mr Cassell should simply pass on the Hong Kong government's concern (which it has already registered directly with the Fund), without commenting on the merits. We do not think that, in practice, publication of a current surplus for Hong Kong would advance the US case for revaluation of the Hong Kong dollar: published figures already show Hong Kong was running a surplus on trade in goods and services of 3-4% of GNP in 1986. If the US were to pray any IMF figures in aid, we would respond that it is much too simplistic to argue from the existence of current account or trade surpluses to a need for exchange rate changes.

9. Mr Jacobs will be calling on Sir Peter Middleton later in the afternoon.

MOM

MISS O'MARA

HONG KONG ECONOMY

1. Following a rare recession in 1985, the Hong Kong economy has grown at a rate well in excess of 10 per cent a year over the last two years.
2. Unemployment is very low (below 2 per cent) and the economy is close to overheating. The inflation rate has risen from below 3 per cent in 1986 to 6 $\frac{3}{4}$ per cent in the fourth quarter of last year.
3. Rapid economic growth over the past two years has been based to a large extent on a very rapid rise (over 20 per cent a year) in the volume of exports, which have gained competitiveness since 1985 as the Hong Kong dollar has followed the US dollar down.
4. Export demand is expected to slacken as domestic demand decelerates in the United States (Hong Kong's biggest market by far, taking almost a third of its exports). Largely for this reason, the official Budget forecast shows economic growth slowing to 5 per cent this year (though some independent forecasts are as high as 8 per cent).
5. Hong Kong's balance of goods and services was in modest deficit from 1978 to 1983, but has moved into modest surplus since 1984. Though full data are lacking, there is thought to be a deficit on net property income, bringing the current account overall probably close to balance - in contrast to the position of other East Asian NICs.

Hong Kong - Economic Indicators

	<u>1986</u>	<u>1987*</u>	<u>1988**</u>
Real economic growth (%)	11.0	13.6	5-8
Inflation rate (%)	2.9	5 $\frac{1}{2}$	5-7
Balance of goods and services (\$ billion)	1.5	1 $\frac{1}{2}$	1-1 $\frac{1}{2}$

* Estimates

** Broad range of forecasts.

The Budget

1. Following a nagging series of budget deficits up till 1985-86, public finances have been greatly strengthened by the two years of rapid growth. A budget surplus of HK\$7.6 billion is estimated for the financial year ending 31 March - three times the surplus projected at the time of last year's Budget.

2. In presenting this year's Budget to the colony's legislature on 2 March, Financial Secretary Piers Jacobs warned that uncertain international economic prospects call for fiscal caution. Nonetheless, tax cuts costing HK\$2.7 billion were proposed.

3. The rate of income tax is to be cut by one point, from 16½ to 15½ per cent, and personal allowances raised by 40 per cent. It is estimated that the tax bill for a family of four with a joint income of HK\$14,000 (about £1,000) a month will be almost halved. The rate of corporation ^{tax} is also to be reduced by one point, from 18 to 17 per cent. The tax cuts were expected and follow half-point reductions in both income and corporation tax rates last year.

4. A budget surplus of \$HK5½ billion is projected for 1988-89.

5. In his speech, Mr Jacobs acknowledged that the territory's tax base remained too narrow, and said that he intended to introduce a sales tax in due course, probably at the wholesale rather than the retail level.

THE
BUDGET

SHORT BACKGROUND BRIEF ON HONG KONG ISSUESConfidence in Hong Kong

1. Confidence in Hong Kong remains good. Economy is performing well - estimated 11% growth in GDP in 1986, at least 12% expected in 1987. Some signs of slowing down emerged before Stock Market collapse. Property prices remain stable.

Hong Kong Stock Exchange

2. Hang Seng index fell to about 2,000 in October and now stands at about 2,400, compared with high of about 3,900. The fall of almost 50 per cent was rather more than world average. Markets closed for four days after initial fall on Wall Street. Particular problem on Futures Exchange, resulted in two-part rescue package of up to HK\$ 4 billion. Action to arrest Ronald Li emphasises determination in Hong Kong to re-establish Hong Kong's good reputation as a financial centre.

Review of representative government by the Hong Kong Government

3. As promised in 1984, review of representative government was made in 1987. White Paper setting out the outcome of the review was published by Hong Kong Government on 10 February 1988. Most contentious issue is question of introduction of directly elected element into the legislature, on which the decision is to introduce 10 directly-elected seats in 1991.

No interference from Chinese. The review and in particular the question of direct elections has been the subject of very lively debate in Hong Kong.

BACKGROUND
BRIEF ON
HONG KONG
ISSUES.

Implementation of the Joint Declaration (JD)

4. Implementation continues well. Much progress is being made. Co-operation over Hong Kong's future lies at heart of present close and cordial relationship between UK and PRC. Many contacts between the two sides at various levels (Ministerial and official). The Sino-British Joint Liaison Group will be meeting in Hong Kong from 8-11 March.

Drafting of the Basic Law (BL)

5. Under the Joint Declaration, the policies of the PRC regarding Hong Kong will be stipulated by China's National People's Congress in a Basic Law. A Drafting Committee (appointed by the NPC and including people from Hong Kong) is at work. A first draft of the Basic Law is expected to be published in April/May 1988. HMG take the closest interest in the drafting of the Basic Law.

Vietnamese refugees in Hong Kong

6. The population of Vietnamese refugees in Hong Kong has increased from 8,000 at the beginning of 1987 to over 9,700 now. This has led to increased demands in Hong Kong that more must be done to resolve the problem. HMG have agreed to take 468 more refugees from Hong Kong over the next two years. UK has overall taken about 13,000 Vietnamese refugees from Hong Kong, behind only the US and Canada.

February 1988

PIERS JACOBS OBE

Financial Secretary

Born in 1933. Solicitor (Hons) Supreme Court of Judicature of England. Joined Hong Kong Civil Service 1962. Registrar-General 1976. Secretary for Economic Services 1982-85. Appointed to present post in June 1986. Married to Josephine, one daughter.

PIERS
JACOBS
OBE.
C.V.



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PRIME MINISTER

14/3/88.

HONG KONG DEFENCE COSTS: RENEGOTIATION

As foreshadowed in the exchange of Ministerial correspondence last month, Ministry of Defence officials returned to Hong Kong on 23rd February to resume the adjourned fourth round of negotiations on the future apportionment of defence costs. Discussions took place between 25th-29th February; the MoD team have reported following their return to the UK; and I have subsequently discussed the outcome with the Foreign and Commonwealth Secretary. This minute has been agreed with him.

2. As instructed, the MoD team pressed hard for an effective 70/30 apportionment, while being prepared to consider devices that would enable this to be presented as a 65/35 split in Hong Kong. After some tough negotiations, the Hong Kong side finally tabled proposals that went a long way towards meeting our requirements; these proposals (annotated to clarify the real value of the offer as far as the MOD is concerned) are outlined at Annex A. The MoD team, for their part, left with the HKG side a range of illustrative options that would have allowed our requirements to be met comfortably; these options are set out at Annex B. The team did not at that stage feel that an impasse had been reached, and were prepared to continue substantive discussions, but the HKG side were unwilling either to move beyond the position they had taken up or to discuss any further options. The MoD negotiators therefore undertook to return to London to put to Ministers the position that had been reached; and the HKG side, for their part, undertook to report to the Executive Council.



3. The proposal tabled by the HKG fell short of a true 70/30 apportionment by some £8-10 million, equivalent to just under 1% of the total estimated cost of the garrison to 1997 (although we do not yet have precise figures, this gap may have been increased by the effects of the recent HKG budget). The gap could easily be bridged by making use of any one of a number of devices, including or additional to those set out at Annex B. But it appears that the HKG are, for local political reasons, unwilling or unable to be seen to be conceding the whole amount at issue. Moreover, they perceive the difference between the sides as a point of principle as to whether they should pay a share of input VAT on military equipment and stores purchased in the UK for use in Hong Kong (this would cost them £7 million over the period of the DCA). This is evidently a point of particular importance for Exco.

4. In terms of an agreement lasting to 1997, the remaining difference between the sides may be small; but to neither side is it insignificant. We have already conceded that the apportionment should be changed from 75/25 to 70/30, which equates to an increased burden of some £53 million over the period to 1997 - a substantial sum in the context of current defence budgetary problems. Furthermore, the offer that the HKG have now made will require further calls on the defence budget. First, if future VAT is excluded from any new DCA the full cost will nevertheless fall to the defence budget. Second, £19 million of the compensating devices that the HKG have offered in return for an apparent 65/35 apportionment would be paid next financial year in final settlement of the 1987/88 accounts. This is less valuable to MoD in the form of an immediate lump sum than it would be if it accrued over future years, since it is not in FY 1988/89 that I expect the main pressures on the defence budget to arise. (There were, of course, alternative devices, some of which are set out at Annex B, which would have had an equivalent value to the proposed £19 million cash settlement and would have constituted a more satisfactory package from MoD's point of view).



5. It seems clear, from what the Governor has reported about the Exco discussion, that the HKG offer on the table is effectively a final one, and that it would be politically difficult, and in the Foreign and Commonwealth Secretary's view virtually impossible, for them to improve it. We must therefore accept that we are effectively at an impasse in the negotiations. If a roll-over of the present 75/25 agreement is politically impracticable, the possible courses of action open to us are as follows:

- a. to accept the HKG's 65/35 proposal, and the measures they have offered to move this towards a true 70/30 apportionment; but to insist on the full extent of movement towards 70/30, leaving the HKG to suggest ways of closing the remaining 1% - by, for example, drawing on any of the devices that are so far unexploited, including those at Annex B, or by agreeing to continue to share the costs of the Training Team Brunei and Nepal works services.
- b. if the HKG prefer not to find ways of closing the remaining gap, to require them to accept that the apportionment of the future DCA would not be 65/35 but (counting down from 70/30) a slightly less favourable split, such as 66/34;
- c. to accept the HKG offer as it now stands.

The third option would leave me in some difficulty in defending its impact, in defence budgetary terms, against auditors' and Parliamentary enquiries. This difficulty could of course be reduced if it were possible to find other ways of protecting the defence budget against the detriments referred to in paragraph 4 above. If this was not possible, the budgetary implications are such that I would have no option but to recommend that we press the HKG for further concessions (ie, a. or b. above), despite the limited likelihood of a successful outcome.



6. The Foreign and Commonwealth Secretary very much hopes that a solution to my budgetary difficulties can be found which will enable us to settle on the basis of Hong Kong's offer (c. above), perhaps by the Treasury agreeing to waive the VAT. Our negotiators have achieved a result which is very close indeed to our agreed objective of a 70/30 split. The remaining gap amounts to less than £1 million a year over the life of the next agreement covering a total estimate of over £1 billion.

7. He wishes to underline the point in paragraph 5 above about the political difficulties faced by the HKG; these are real and should not be underestimated. He believes that we would be running quite disproportionate political risks if we sought to push the HKG any further to bridge the remaining gap. In his judgement, the Governor has gone to the limits of what in local terms is politically feasible. He considers that it is of particular significance that Sir S Y Chung, the senior unofficial member of Exco, has already formally dissociated himself from support of the present HKG position precisely because that involves the concession of a compensating payment of the sum in dispute for VAT under the present DCA. This departure from consensus within Exco is highly unusual and demonstrates how close Exco is to outright rejection of the package. If we were to insist on further concessions, it is very likely that some members of Exco would refuse to commend the package, and as a consequence Legco would refuse to vote the necessary funds. The resulting open crisis between Hong Kong and London would weaken HMG's authority and local confidence at a time when it is vital for both to be sustained through the difficult years ahead. There would also be serious implications for the Governor's personal position.

8. I should be grateful for your views on the way forward. Once a solution is identified, officials will be instructed to reconvene with the HKG side in order to draw up Heads of Agreement which would be reflected in the necessary amendments to the existing MOU.



9. I am sending copies of this minute to the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer, the Secretary of States for the Home Department and for Trade and Industry, the Lord President, and the Attorney General and to Sir Robin Butler.

C.Y.

Ministry of Defence

14th March 1988

ANNEX A

<u>Offer Proposed by Hong Kong Government (€M)</u> (annotated by MoD)	<u>HKG Figs</u>	<u>(MoD Figs)</u>
Total Estimated Cost of Garrison to 1997	1,059	(1,069)
<u>Items to be funded by HKG</u>		
Works Services in Hong Kong	72	
Local taxes and beneficial services ("Revenue Forgone")	51	
<u>Items to be funded by MoD</u>		
Training Team Brunei ("TTB")	10	
Works Services in Nepal	<u>6</u>	<u>139</u> (+VAT @ 10)
Total Estimated Cost of New DCA	920	
HKG's Share @ 65%	598	
+ Cost of Works Services and Revenue Forgone	<u>123</u>	
Total Cost to HKG	<u>721</u>	
MoD's Share @ 35%	322	
+ Cost of TTB and Nepal Works Services	<u>16</u>	
Total Cost to MoD	<u>338</u>	(+VAT: 348)
<hr/>		
MoD's Required Share of Total Estimated Cost of Garrison = 30% of 1,059 (1,069)	318	(321)
Shortfall to be Made Up	20	(27)
<u>HKG Offer:</u>		
Payment Equivalent to Arrears of Past VAT	16	
Refund of Past Salaries Tax on Allowances	<u>3</u>	
	19	
Effective MoD Apportionment = $\frac{319}{1,059} = 30.1\%$	$(\frac{329}{1,069} = 30.8\%)$	

ANNEX BOptions Set Out by Ministry of Defence

The following proposal by the Ministry of Defence represents an illustrative DCA package that makes full use of all the elements that have individually been discussed. A variety of selections from these elements is possible to make up the full value of the compensating adjustments needed to allow movement from a true 70/30 apportionment to an apparent 65/35.

2. Items to be removed from the new DCA and wholly funded by one side or the other

Total Estimated
Cost (£M)

a. To be funded by the MoD

Works Services in Nepal	6
Training Team Brunei	10
UK Input VAT	10

b. To be funded by the HKG

Works Services in Hong Kong	72
Revenue Forgone	51

3. Payments to be made by the HKG outside the new DCA

Arrears of VAT (sum variable depending on the extent to which interest is included)	16-23
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Refund of past salaries tax on allowances	3
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4. Waiver by the HKG of claim for reimbursement of share of value of equipment and stores backloaded from Hong Kong to UK (estimated) 20

5. The cost of the items remaining in the DCA to be shared between the two Governments on a 65/35 apportionment.

pwp

FROM: S A ROBSON
DATE: 16 March 1988

CHIEF SECRETARY

cc **Chancellor**
Mr Anson
Mr Mountfield
Mr Turnbull
Mr Fox
Mr Call

HONG KONG DEFENCE COSTS: RENEGOTIATION

This submission recommends you do not oppose a settlement with Hong Kong on the basis set out in Mr Younger's minute of 14 March to the Prime Minister. Our aim at this stage is to avoid any claim on the Reserve.

2. The submission describes the position reached in negotiations and the options before us.

A. Negotiations

3. Under the Defence Cost Agreement (DCA), Hong Kong pay a share of the costs of the garrison stationed there. The present DCA expires this month. Under it Hong Kong pay 75% of the cost and the MOD pay 25%.

4. Negotiations have been going on for some months for a new DCA to run to 1997 (when Hong Kong is handed over to China). The UK started from the position that Hong Kong should pay at least 75% of the cost in this period. There was a good case for Hong Kong's share to rise. The settlement with China has significantly reduced the external threat to Hong Kong and, as a result, the garrison role will increasingly be focussed on internal security. It is reasonable for Hong Kong to carry the cost of its own internal security.

5. Back in December the Prime Minister said she did not rule out "some gesture to go a little way to meet the Hong Kong side" -

who were then saying they would only pay 50%. Mr Younger subsequently proposed the UK should offer a 70-30% split rather than 75-25% (at an additional cost of some £50 million to the UK over the period to 1997).

6. On 1 February Mr Younger reported that Hong Kong were holding out for a 65-35% split. He recommended, in rather weak terms, holding out for a substantive 70-30% but looking for devices which, to help the presentational position in Hong Kong, gave the appearance of a 65-35% split. Sir Geoffrey Howe said this could be explored but implied some substantial shift by the UK from 70-30% towards 65-35% was going to be needed.

7. You minuted on 2 February in terms which prompted the Prime Minister to say the UK should "negotiate tenaciously" for a 70-30% split.

8. Since then I have been attempting to manipulate events and put some spine into a rather wet MOD negotiating team. The FCO have, at the same time, been preaching appeasement.

9. The upshot is an outcome described in Mr Younger's minute. He says this falls short of 70-30% but some £7 million across the period to 1997. Hong Kong would pay the equivalent of just over 69%.

10. The package takes the following form:

(i) a basic split of 65-35%;

(ii) removal of certain items from the DCA. These would be funded in future 100% by Hong Kong or by MOD. The bulk of these items would fall to Hong Kong to pay;

(iii) an upfront payment by Hong Kong to MOD of £19 million.

Hong Kong have made the last £7 million an "issue of principle". In the current DCA, MOD forgot to mention explicitly that the cost

of stores and equipment brought in UK and used in Hong Kong should be the VAT inclusive price. Hong Kong have even since refused to pay the VAT element. They are similarly refusing for the new DCA.

12. The negotiations have focussed as an estimate of the cost of the garrison to 1997. MOD have put this at £1069 million. Hong Kong have focussed on the equivalent VAT exclusion figure which is £1059 million. The "missing" £7 million is Hong Kong 70% share of the £10 million difference between these figures.

13. Most of Mr Younger's letter consists of hand wringing . There are only a few points for you to note:

(i) in paragraph 4 he makes a rather delphic reference to the lump sum being less valuable to MOD than the same amount spread over a number of years. At first glance this is odd as Mr Younger himself first raised the idea of lump sum compensation. MOD now fear that the underspending in 1988-89 may exceed the ceiling on carry forward to 1989-90 (some £850 million) and so a lump sum received in 1988-89 could not be fully utilised. Their view on underspending is a useful point for the PES discussions but not something to react to in this context;

(ii) in paragraph 6, there is a suggestion that the Treasury might "waive" VAT. This apparently was put in by Sir Geoffrey Howe personally. MOD officials know it is a nonsense. The VAT in question is the VAT on defence suppliers' output. MOD pay such VAT on all their purchases of VATable supplies. The only way round this would be to declare the defence of Hong Kong to be an "export business" in which case MOD could reclaim this VAT. This is ruled out by the EC Sixth Directive on VAT.

B. Options

14. Mr Younger sets out the following:

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- (i) more negotiations with Hong Kong;
- (ii) roll forward the current DCA;
- (iii) accept the Hong Kong offer.

It is clear that both he and Sir Geoffrey have no stomach for (i) or (ii). Mr Younger says that, if we go for (iii), he needs protection from the implications for the defence budget; failing this he would recommend (i). In short he wants something else to provide the missing £7 million.

15. Sir Geoffrey has put a long passage (paragraph 15) into the minute on the political desirability of avoiding confrontation with Hong Kong. This is the real reason for not pressing Hong Kong for more. It is pretty clear from talking to Mr Powell (No 10) that the Prime Minister will share this view. I therefore see no point in you arguing for more negotiations.

16. Our aim must be to stop the Reserve paying for the missing £7 million. There is no reason for it to do so. Mr Younger could easily find this sort of money in his £20 billion budget.

17. There is also a good case for Sir Geoffrey Howe making a contribution towards it. In recent months he has consistently been urging that we spend money in pursuit of foreign policy objectives (Trigat, NFR 90, Wind Tunnel) without ever having to find the money from his own programme. We need to try and make it less easy for him to adopt this comfortably irresponsible position. I recommend you suggest he might make a payment to MOD from within his 1988-89 cash limits of part of this £7 million. We may not get far with this but it is at least a shot across his bows.

18. A draft is attached.

JAB

P.P

S A ROBSON

DRAFT MINUTE TO: PRIME MINISTER

HONG KONG DEFENCE COSTS: RENEGOTIATION

I have seen George Younger's minute of 14 March.

2. It is most unfortunate that the negotiations are still some £7 million short of a substantive 70-30% split. It would appear that neither George nor Geoffrey Howe have much enthusiasm to press Hong Kong any further.

3. George raises the possibility of some "waiver" of VAT. The VAT in question arises quite normally when MOD purchase equipment and stores from their suppliers. The fact that some of those purchases are used by the Hong Kong garrison provides no basis for a waiver. MOD officials are well aware of the legal position involved.

4. I would not press for further negotiation with Hong Kong if it is accepted that there should be no claim on the reserve in respect of the shortfall by comparison with a true 70-30% apportionment. As George says, the gap amounts to less than £1 million a year over the life of the Agreement. Such a sum must be containable within existing budgets. It does occur to me that, as the reasons for not pressing Hong Kong

any harder are essentially foreign policy ones, Geoffrey might like to consider making some compensatory payment to George out of the cash limits on the 1988-89 diplomatic and aid programmes.

5. I am copying to the Foreign and Commonwealth Secretary, the Secretaries of State for the Home Department and for Trade and Industry, the Lord President and the Attorney General and to Sir Robin Butler.

JM



FROM: CHIEF SECRETARY
DATE: 17 March 1988

cc:

Chancellor
Mr Anson
Mr Mountfield
Mr Turnbull
Mr Fox
Mr Robson
Mr Call

PRIME MINISTER

HONG KONG DEFENCE COSTS: RENEGOTIATION

I have seen George Younger's minute of 14 March.

2. It is most unfortunate that the negotiations are still some £7 million short of a substantive 70-30% split. It would appear that neither George nor Geoffrey Howe believe we should press Hong Kong any further.

3. George raises the possibility of some "waiver" of VAT. I am afraid that would not be possible. The VAT in question arises quite normally when MOD purchase equipment and stores from their suppliers. The fact that some of those purchases are used by the Hong Kong garrison provides no legal basis for a waiver.

4. I would not press for further negotiation with Hong Kong if it is accepted that there should be no claim on the reserve in respect of the shortfall by comparison with a true 70-30% apportionment. As George says, the gap amounts to less than £1 million a year over the life of the Agreement. Such a sum must be containable within existing budgets. It does occur to me that, as the reasons for not pressing Hong Kong any harder are essentially foreign policy ones, Geoffrey might like to consider making some compensatory payment to George out of the cash limits on the 1988-89 diplomatic and aid programmes.

5. I am copying this minute to Geoffrey Howe, Douglas Hurd, David Young, John Wakeham, Patrick Mayhew and Sir Robin Butler.

John Major

10 JOHN MAJOR

(Approved by the CST and signed
in his absence).

CONFIDENTIAL



✓ 17/3

EX-CHEQUER	
17 MAR 1988	
CST	
COPIED TO	

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

17 March 1988

Dear Brian,

HONG KONG DEFENCE COSTS: RENEGOTIATION

The Prime Minister has considered your Secretary of State's minute of 14 March, agreed with the Foreign Secretary, about the stage reached in the negotiations over Hong Kong defence costs. She takes the view that we cannot, in present circumstances in Hong Kong, press the Hong Kong Government for further concessions and that we must therefore accept their offer as it now stands. Since there appear to be insuperable legal obstacles to waiving payment of VAT, it will be for the Ministry of Defence and the Foreign and Commonwealth Office to finance the remaining shortfall and the two Secretaries of State should discuss the apportionment of this between them.

I am copying this letter to the Private Secretaries to the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer, the Secretaries of State for the Home Department and Trade and Industry, the Lord President, the Attorney General and Sir Robin Butler.

Yours sincerely,

C D POWELL

Brian Hawtin, Esq.
Ministry of Defence

CONFIDENTIAL

DRAFT

(ADACUS)

21/3/88.

MEMORANDUM FOR EXECUTIVE COUNCIL

NEW ACCOUNTING ARRANGEMENTS BETWEEN THE EXCHANGE FUND
AND THE HONGKONG AND SHANGHAI BANKING CORPORATION

The Problem

The existing framework within which monetary policies are conducted inhibits the effectiveness of action by Government and the Hongkong and Shanghai Banking Corporation (HSBC), as the Management Bank of the Clearing House of the Hong Kong Association of Banks (HKAB), to maintain stability in the exchange rate.

Recommendation and Advice Sought

2. It is recommended that the Agreement concerning new accounting arrangements between the Exchange Fund and HSBC, as annexed, which will greatly enhance the effectiveness of Government action, through the use of the Exchange Fund, to maintain stability in the exchange rate within the

framework of the linked exchange rate system, should come into effect as soon as practical arrangements have been put in place.

3. Members will be asked to advise whether this recommendation should be approved.

Background

4. Each licensed bank in Hong Kong maintains an account, either directly or through another bank (called Settlement Bank in the relevant HKAB rules), with HSBC, the Management Bank of the Clearing House of HKAB, for the purpose of clearing Hong Kong dollar cheques (drawn on one bank and deposited in another) and for settling interbank transactions involving the Hong Kong dollar. Balances on clearing accounts do not earn any interest. If, however, the clearing account of a bank is in debit, HSBC or the relevant Settlement Bank, as the case may be, charges interest on the amount "borrowed" to cover the debit position on the basis of a pre-determined formula specific to that bank. Banks with surplus Hong Kong dollar balances on their clearing accounts would, therefore, wish to lend those funds to banks which are in need of funds through what is known as the interbank market. The interest rates (interbank interest rates) at which these lending and borrowing

transactions are struck are determined by the forces of supply and demand. Banks with surplus Hong Kong dollar balances may also choose to use them to buy foreign currency from other banks at the market exchange rate, if they find it profitable to do so; for example, when a particular foreign currency earns a higher rate of interest and when they perceive that there is little exchange risk involved or a possibility of exchange gain. (Herein lies the nexus between interest rates and the exchange rate.) To the extent that these transactions do not involve HSBC or its customers, Hong Kong dollar balances are switched from the clearing account of one bank to another, so that the total supply of money in the interbank market is unaffected. Other things being equal, interbank interest rates are also unaffected.

5. As the Management Bank of the Clearing House, HSBC does not itself have a clearing account. Settlement of Hong Kong dollar transactions between HSBC and other banks are effected through HSBC crediting or debiting, as the case may be, the clearing accounts maintained by these banks with HSBC. The monetary consequences of this arrangement is that whenever HSBC or its customers carry out a transaction of a significant magnitude with other banks or their customers, the supply of money in the interbank market and interbank interest rates will be

affected. Specifically, the supply of Hong Kong dollars in the interbank market will increase/decrease and interbank interest rates will ease/firm when:

- (a) HSBC buys/sells foreign currency from/to another bank with/for Hong Kong dollars; or
- (b) HSBC lends/borrows Hong Kong dollars in the interbank market; or
- (c) a customer of HSBC pays/accepts Hong Kong dollars from/for his account with, or credit facility made available by, HSBC to/from another person banking with another bank.

Shortcomings of Present Arrangements

6. These present arrangements inhibit the effectiveness of action by Government and HSBC to maintain stability in the exchange rate. To illustrate, consider the case when the exchange rate is weaker than 7.80. Arbitrage between the fixed-rate market for Hong Kong dollar bank-notes and the foreign exchange market, or the threat of

arbitrage itself, contributes to maintaining stability in the exchange rate. At the same time and working in the same direction, the correct monetary policy stance must be to keep conditions in the interbank market tight, by creating and maintaining a shortage in the supply of Hong Kong dollars which would mean higher Hong Kong dollar interest rates relative to US dollar interest rates. To achieve this, the Exchange Fund, as a customer of HSBC, could be borrowing Hong Kong dollars, through HSBC, from the interbank market and placing the money at no interest with HSBC, while HSBC at the same time refrains from on-lending the money back to the interbank market. The Exchange Fund again through HSBC, and HSBC itself, could also be selling US dollars for Hong Kong dollars, both to support the exchange rate and to tighten liquidity in the interbank market.

7. If, however, customers of HSBC are at the same time switching out of Hong Kong dollars into US dollars, prudence dictates that as a commercial bank HSBC should cover the US dollars sold to its customers by recouping the corresponding amount from the foreign exchange market. HSBC, in its other capacity as Government's main agent to conducting monetary policy, would in practice experience great

difficulty in doing so, for fear of sending the wrong message to other market participants and at the same time putting pressure on the exchange rate. Given that the Exchange Fund is at the time a willing seller of US dollars, chances are that HSBC would in the end be recouping US dollars from the Exchange Fund. This neutralises the beneficial effects which a sale of US dollars by the Exchange Fund through HSBC was designed to produce. Even if HSBC were successful in quietly recouping US dollars from the foreign exchange market, HSBC would in the process be weakening the exchange rate, increasing the supply of Hong Kong dollars in the interbank market and depressing Hong Kong dollar interest rates. This again runs contrary to the requirements of monetary policy at the time and, through no fault of HSBC, frustrates earlier action to tighten conditions in the interbank market. This in turn necessitates continued exchange rate and money market intervention, possibly in larger volumes, in order to sustain tightness in the interbank market.

8. Customers of HSBC may also be taking advantage of the high Hong Kong dollar interbank interest rates available by withdrawing funds (in the form of HKAB-type deposits or drawdowns of existing borrowing facilities) from HSBC and placing those

funds with other banks in the form of deposits which attract interbank interest rates. This would again have the same frustrating effect on monetary policy operations.

9. The same arguments contained in paragraphs 5 to 7 apply to the case when the exchange rate is stronger than 7.80.

10. Thus present arrangements:

- (a) deprive Government of an effective mechanism for influencing the availability and price of money;
- (b) necessitate a greater degree of exchange rate and money market intervention to ensure stability in the exchange rate;
- (c) make the effectiveness of monetary policy operations in support of the exchange rate dependent upon the action of bank customers; and
- (d) put HSBC constantly in the difficult position of having to weigh between the

(often conflicting) wider public interest and the interest of the Bank and its customers in running its business.

New Accounting Arrangements

11. The Monetary Affairs Branch, working closely with HSBC, has been considering for some time how these shortcomings should be dealt with. It was recognised that on such a highly sensitive matter, proposals for change would need to be technically feasible and take full account of political and local sensitivities. Specifically, they should:

- (a) enable Government to exercise effective influence over the availability and price of money for the purpose of ensuring exchange rate stability;
- (b) involve minimum disturbance to the present monetary and banking framework;
- (c) involve no significant erosion of the position of HSBC in Hong Kong;

- (d) be capable of being put in place quickly;
- (e) involve an increase in demand on resources in Government that is manageable; and
- (f) not introduce rigidities which prevent further reform, should this be considered necessary.

12. Having regard to these considerations, new accounting arrangements between the Exchange Fund and HSBC have been developed. Under these new accounting arrangements, HSBC would maintain a Hong Kong dollar account with the Exchange Fund. It would also aim to maintain a balance (the "Balance") in that account no less than the net clearing balance of the rest of the banking system. As in the case of the clearing balances of banks maintained at HSBC, the Balance would be placed at no interest. If the Balance falls short of the net clearing balance of the rest of the banking system, HSBC would also pay interest, based on a pre-determined formula, to the Exchange Fund. The account would be used by the Exchange Fund, at its discretion, to effect settlement of its Hong Kong dollar transactions with HSBC and the rest of the

banking system. A copy of the agreement reached between the Financial Secretary as Controller of the Exchange Fund and HSBC is annexed.

13. The monetary consequence of putting these simple accounting arrangements in place is that Government would be assuming the role as the ultimate provider of liquidity to the interbank market and be able effectively to influence the availability and price of money in the interbank market. This will greatly enhance the effectiveness of Government action, through the use of the Exchange Fund, to maintain stability in the exchange rate.

14. The most significant effect of these arrangements on HSBC is that it will be no longer be able to create money, although HSBC has not in the past used that ability in a way contrary to the wider public interest. That ability, which is one of the most important functions of central banks and monetary authorities in other parts of the world, will be vested with the Financial Secretary as Controller of the Exchange Fund. In respect of running its own books, HSBC will thus have less obligation to take account of the wider public interest and will be operating just like any other bank. HSBC will be playing a somewhat different role

in monetary policy in future in that it will no longer feel itself under an obligation to take positions consistent with monetary policy objectives but it will be seen clearly and formally as the agent for the conduct of monetary policy for Government.

Consultation

15. The Bank of England and the U.K. Treasury have been consulted over the technical aspects of the proposal. They found it "attractive" and are satisfied that it "offers a considerable improvement on present arrangements". Although the proposal may be somewhat costly to HSBC, it has always held the view that the Government should have better control over the money supply. HSBC is satisfied that the proposal will achieve that purpose and, in the light of the wider public interest, is agreeable to adopting the new accounting arrangements. The Exchange Fund Advisory Committee has been consulted and Members of the Committee unanimously support the proposal.

16. In view of the sensitive nature of the matter, there has been no public consultation. It is proposed that after the Exchange Fund and HSBC have become familiar with the new arrangements, which will

be in, say, four weeks' time, or some other longer period as may be agreed for this purpose, they will be made public. A relatively low-key approach will be adopted, with the Financial Secretary or the Secretary for Monetary Affairs delivering a speech to, say, HKAB in their semi-annual dinner. A paper explaining clearly the new arrangements and their monetary effects will then be circulated to the relevant statutory committees and to all banks and deposit-taking companies. It will be circulated at the same time as a Legislative Council brief.

17. Before the arrangements are implemented and certainly before the public announcement, a suitable opportunity will be taken to inform the Chinese on the new accounting arrangements. The point will be made that these involve minimal change to the present arrangements and are introduced to strengthen the existing monetary system and enhance the ability of the Government to maintain exchange rate stability within the framework of the linked exchange rate system.

Financial and Staffing Implications

18. Under the new arrangements, there will inevitably be much greater interaction between the

Monetary Affairs Branch and the money and foreign exchange markets. There will be a need to establish a small dealing room in the Monetary Affairs Branch for conducting foreign exchange and money market operations. This will have to be developed over time. Meanwhile, the Branch can continue to call on the services of HSBC and other leading banks in Hong Kong. There will also be a staff exchange programme with these banks to assist Government in developing the relevant skills and to provide the banking community an opportunity to appreciate Government's thinking in respect of the conduct of monetary policy. As the proposal has the ultimate aim of ensuring stability in the exchange rate, any financial implications will be for the account of the Exchange Fund rather than the general revenue.

Public Reaction

19. To members of the public, this is a rather esoteric subject of no direct interest. But this will be of keen interest to the banking community who may not initially appreciate the full monetary implications of what appears to be a very simple proposal. After careful examination it is likely that they will welcome it. It is also likely that they would see this as a step taken by Government to

reinforce the link. There may be mixed initial reaction on HSBC's position. Some may see the proposal as locking HSBC more tightly into the monetary system of Hong Kong while at the same time putting HSBC on equal competitive position as other banks in respect of treasury type functions. Alternative interpretations are, however, possible because commercial bankers are not entirely conversant with the intricacies of monetary policy operations. The publicity proposals in paragraph 16 are therefore essential.

(The Secretary for Monetary Affairs, Mr D.A.C. NENDICK and the Deputy Secretary for Monetary Affairs, Mr JOSEPH YAM, will attend before the Council for the discussion of this item.)

First Draft 19.1.88

Second Draft 15.2.88

Dear Sirs,

Exchange Fund Account1. Parties:

The Financial Secretary in his capacity as controller of the Exchange Fund (the "Financial Secretary") and the Hongkong and Shanghai Banking Corporation ("HSBC").

2. Commencement Date:

- ("Commencement")

3. Purpose:

To enable the Financial Secretary by his use of the Exchange Fund to affect the exchange value of the currency of Hong Kong by more effectively influencing the availability and price of money in the Hong Kong interbank market.

4. Accounting Arrangements:

- (a) At Commencement HSBC shall open and maintain an account (the "Account") with the Financial

/Secretary

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Secretary acting for the account of the Exchange Fund.

(b) The Account shall be used in the absolute discretion of the Financial Secretary and in accordance with his instructions for the settlement ("Settlement") in Hong Kong Dollars of transactions including but not limited to foreign exchange contracts, deposits and other loan agreements, and agreements relating to the discounting of Hong Kong Dollar assets entered into between

(i) the Financial Secretary and HSBC
or

(ii) the Financial Secretary and member banks of the Hong Kong Association of Banks ("HKAB") other than HSBC.

(c) Settlement shall be effected as follows:-

(i) In the case of transactions falling within (b)(i) hereof by the Financial Secretary crediting or debiting the Account as appropriate.

/(ii)

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- (ii) In the case of transactions falling within (b)(ii) hereof by the Financial Secretary debiting or crediting the Account as appropriate and by HSBC correspondingly debiting or crediting the clearing accounts of the member banks of HKAB maintained with HSBC pursuant to the Rules relating to the Clearing House of HKAB effective from the 29th March 1982 as amended (the "Rules").
- (d) Instructions relating to Settlement may be given orally on behalf of the Financial Secretary by the Secretary for Monetary Affairs ("SMA") or the Deputy Secretary for Monetary Affairs ("DSMA") or by public officers authorised by them to do so, such authorisation to be confirmed by SMA in writing to HSBC. Oral instructions relating to same-day Settlement shall be given not later than 5 p.m. on the relevant day or at such other time as may exceptionally be agreed. All such oral instructions shall be confirmed in writing which in the case of HSBC may without limitation be by means of relevant computer print-outs

/or by

or by such other appropriate means as shall from time to time be agreed.

- (e) HSBC shall take all possible steps to maintain a closing balance in the Account (the "Balance") each day which shall be an amount not less than the aggregate amount of the net clearing closing balances ("NCB") for that day on the accounts of all of the member banks of HKAB, excluding HSBC, which use the clearing facilities provided and managed by HSBC pursuant to the Rules.
- (f) In respect of each day upon which the Balance is less than the NCB HSBC shall pay an amount to the Financial Secretary for the account of the Exchange Fund on the amount of that debit at a rate calculated in accordance with the schedule hereto (the "Schedule").
- (g) In respect of each day upon which the NCB is in debit HSBC shall pay an amount to the Financial Secretary for the account of the Exchange Fund calculated on the amount of that debit in accordance with the Schedule.

/5. Initial

5. Initial Balance:

(a) The initial balance in the Account (the "Initial Balance") shall be Hong Kong Dollars [X].

(b) (i) HSBC may constitute all or part of the Initial Balance by selling United States Dollars to the Financial Secretary for the account of the Exchange Fund for Hong Kong Dollars at the middle market exchange rate prevailing at Commencement.

(ii) Alternatively at HSBC's request the Financial Secretary shall place a deposit of monies drawn from the Exchange Fund with HSBC being an amount not exceeding either the Initial Balance or such part, of the Initial Balance as is not funded pursuant to paragraph 5(b)(i) hereof (the "Deposit") and the Deposit shall be used by HSBC to constitute the Initial Balance or such part thereof as is not funded pursuant to paragraph 5(b)(i) hereof as the case may be.

/The Deposit

The Deposit shall be placed with HSBC at no interest. The Deposit shall be maintained by HSBC free of all encumbrances. Of the Deposit Hong Kong Dollars [Y] shall be repayable by HSBC to the Financial Secretary on demand and Hong Kong Dollars [Z] shall be repayable by HSBC to the Financial Secretary in the event that this agreement is terminated pursuant to paragraph 8 hereof or for any other reason.

6. Information:

HSBC shall provide all information deemed necessary by SMA or DSMA for the purpose of operating the Account.

7. Transitional Period:

To enable the Financial Secretary and HSBC to adapt to the new arrangements contained in this agreement it is agreed that the Financial Secretary will not effect settlements of the type referred to in paragraph 4(b)(ii) hereof for a period of 4 weeks after Commencement or such other period as may be agreed between the parties.

/8.

8. Termination:

This agreement shall terminate forthwith in the event that HSBC ceases to be the Management Bank of the Clearing House of HKAB pursuant to the Rules or if the Financial Secretary gives notice of termination to HSBC. This agreement may otherwise be terminated by mutual agreement.

9. Law:

This agreement shall be governed by and construed in accordance with the Laws of Hong Kong.

Please signify your acceptance of the terms and conditions of this Agreement by arranging for the duplicate copy of this letter to be signed by authorised officials and returned to the writer.

(P. Jacobs)
Financial Secretary

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Schedule

For the purposes of this Schedule the following terms shall be construed as follows:

"BLR" - the Best Lending Rate offered by HSBC in Hong Kong.

"HIBOR" - The Hong Kong Interbank Offered Rate

(1) Pursuant to paragraphs 4(f) and 4(g) of the Agreement the rate payable by HSBC shall be as follows: -

(a) On amounts not exceeding - BLR or the highest Hong Kong Dollars [A] recorded HIBOR on the day, whichever is higher.

(b) On amounts exceeding BLR or highest Hong Kong Dollars [A] recorded HIBOR on the day, whichever is higher, plus 3%.

(c) The amount of Hong Kong Dollars referred to in (1)(a) and (b) hereof or any amount substituted therefore pursuant to this sub-paragraph may be varied either by agreement between

/the parties

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the parties or by the Financial Secretary
in the event that there is no such agreement
after consultation with HSBC.

- (2) The rates payable hereunder may be changed and replaced
by such rates as the Financial Secretary or the
SMA or the DSMA in their absolute discretion may
determine following consultation with HSBC.

* * * * *

To : Members of the Committee of the Hong Kong
Association of Banks

Members of the Banking Advisory Committee

Members of the Deposit-taking Companies Advisory
Committee

Chief Executives of all Authorised Institutions

New Accounting Arrangements between
the Exchange Fund and the Hongkong and
Shanghai Banking Corporation as the
Management Bank of the Clearing House
of the Hong Kong Association of Banks

Introduction

This paper describes new accounting arrangements recently entered into, with the approval of the Executive Council and the agreement of the Hongkong and Shanghai Banking Corporation (HSBC), between the Exchange Fund and HSBC as the Management Bank of the Clearing House of the Hong Kong Association of Banks (HKAB). It also explains how the new accounting arrangements are to be operated.

2. The purpose of the new accounting arrangements is to enable the Government, through the use of the Exchange Fund, to exercise more effective influence over the availability (and price) of money in the interbank market ^{and over short term interest rates.} ~~in order~~ better to ensure exchange

rate stability within the framework of the linked exchange rate system.

The Interbank Market

3. Each licensed bank in Hong Kong maintains an account, either with HSBC, the Management Bank of the Clearing House of HKAB, or with a Settlement Bank (as defined in Rules relating to the Clearing House of HKAB) which in turn maintains an account with HSBC, for the purpose of clearing Hong Kong dollar cheques and for settling interbank transactions denominated in Hong Kong dollar. Banks with surplus Hong Kong dollar balances on their clearing accounts lend those funds, through the interbank market, to banks which are short of funds. Deposit-taking companies and large corporate customers also make use of the interbank market, but settlement is effected through their accounts with licensed banks. Interbank interest rates are determined by the forces of supply and demand for funds in that market.

4. Before the introduction of the new accounting arrangements described later in this paper, HSBC as the Management Bank of the Clearing House, did not itself have a clearing account. Settlement of Hong Kong dollar transactions between HSBC and other banks are effected through HSBC crediting or debiting, as the

case may be, the clearing accounts maintained by these banks or by their Settlement Banks with HSBC. The Exchange Fund is a customer of HSBC and of a number of other banks. These arrangements had certain consequences on how the supply of money in the interbank market was determined. Specifically, the supply of Hong Kong dollars in the interbank market increased when:

- (a) HSBC bought foreign currency or other assets from another bank, or from customers banking with another banks with Hong Kong dollars; or
- (b) HSBC lent Hong Kong dollars in the interbank market; or
- (c) a customer of HSBC paid Hong Kong dollars from his account with, or credit facility made available by, HSBC to another person banking with another bank.

Similarly, the supply of Hong Kong dollars in the interbank market decreased when:

- (a) HSBC sold foreign currency or other assets to another bank, or to customers banking with another bank, for Hong Kong dollars; or
- (b) HSBC borrowed Hong Kong dollars in the interbank market; or
- (c) a customer of HSBC accepted Hong Kong dollars for his account with, or for reducing a credit facility made available by, HSBC from another person banking with another bank.

5. Thus when the Exchange Fund, as a customer of HSBC, carried out foreign exchange and money market operations to stabilize the exchange rate, the effectiveness of such action could stand to be gradually eroded.

6. To illustrate, consider the case when, for whatever reason, the exchange rate was weakening away from 7.80. Arbitrage between the fixed-rate market for Hong Kong dollar bank notes and the foreign exchange market, or the threat of it, would contribute to containing the deviation from 7.80. At the same time and working in the same direction, the correct monetary

policy response must be to keep conditions in the interbank market tight and interbank interest rates high relative to those of the US dollar. This could be achieved by the Exchange Fund selling US dollars for Hong Kong dollars or borrowing Hong Kong dollars, both through HSBC. If, however, other customers of HSBC were at the same time switching out of Hong Kong dollars into US dollars and to the extent that HSBC covered the short US dollar position by recouping the corresponding amount from the foreign exchange market, the tightness in the interbank market would inadvertently be relieved. Other customers of HSBC might also be taking advantage of the high Hong Kong dollar interbank interest rates available by running down HKAB-type deposits with, or drawing down BLR facilities made available by, HSBC and placing those funds with other banks in the form of deposits which attract interbank interest rates. This again would unhelpfully relieve tightness in the interbank market.

New Accounting Arrangements

7. Such erosion in the effectiveness of foreign exchange and money market operations carried out by the Exchange Fund (for the purpose of maintaining exchange rate stability) is clearly undesirable. The Government and HSBC have both recognised this for sometime. New

accounting arrangements between the Exchange Fund and HSBC, which effectively eliminate this shortcoming, have therefore been adopted. The details of the new accounting arrangements are as follows:

- (a) HSBC maintains a Hong Kong dollar account (the "Account") with the Exchange Fund;
- (b) HSBC aims to maintain a balance (the "Balance") in that account no less than the net clearing balance ("NCB") of the rest of the banking system;
- (c) no interest is paid on credit balances in the Account;
- (d) if the Balance falls short of the NCB, HSBC pays interest on the shortfall to the Exchange Fund;
- (e) if NCB is in debit, HSBC pays interest on the debit amount to the Exchange Fund;
- (f) up to a certain amount, the rate of interest payable by HSBC under (d) and (e) is BLR or HIBOR, whichever is

higher. Beyond that amount, the interest rate payable is 3% over BLR or HIBOR, whichever is higher. In exceptional circumstances, an alternative rate may be determined by the Financial Secretary, after consultation with HSBC;

(g) the Exchange Fund will use the Account, at its discretion, to effect settlement of its Hong Kong dollar transactions with HSBC;

(h) the Exchange Fund will also use the Account, at its discretion, to effect settlement of its Hong Kong dollar transactions with other licensed banks;

(i) in case of (h), the Exchange Fund will either credit or debit the Account and HSBC will correspondingly credit or debit the clearing accounts of banks dealing with the Exchange Fund.

8. Along with these new accounting arrangements between the Exchange Fund and HSBC, the Treasury also maintains a Hong Kong dollar account with the Exchange

Fund where money transferred from the General Revenue to the Exchange Fund in return for interest bearing Debt Certificates will be accounted for. This provides an additional mechanism for the Exchange Fund to influence the supply of money in the interbank market.

9. Thus under the new accounting arrangements, the supply of Hong Kong dollars in the interbank market will increase when:

- (a) the Exchange Fund buys foreign currency with Hong Kong dollars; or
- (b) the Exchange Fund lends Hong Kong dollars in the interbank market; or
- (c) Debt Certificates are redeemed from the Treasury and the balance in the Treasury's account with the Exchange Fund is reduced.

Similarly, the supply of Hong Kong dollars in the interbank market will decrease when:

- (a) the Exchange Fund sells foreign currency for Hong Kong dollars; or

- (b) the Exchange Fund borrows Hong Kong dollars in the interbank market; or
- (c) Debt Certificates are issued to the Treasury and the balance in the Treasury's account with the Exchange Fund is increased.

Practical effects of the new accounting arrangements

10. With the new accounting arrangements, the Exchange Fund is now in effect the ultimate provider of liquidity to the interbank market. It is capable of influencing effectively the availability and the price of money in the interbank market.

11. The new accounting arrangements have no effect on the day to day operation of licensed banks in Hong Kong, other than HSBC. Those which have had, or are likely to have, dealings with the Exchange Fund should, however, be aware that, in addition to the established practice for effecting Hong Kong dollar settlements with the Exchange Fund as a customer, the Exchange Fund may choose now to effect settlement through requesting HSBC to credit or debit, as the case may be, their clearing accounts maintained at HSBC. The Exchange

Fund will at the same time credit or debit the Account as appropriate.

12. Thus when the Exchange Fund sells US\$100 million to, say, the Standard Chartered Bank at 7.85, the Hong Kong dollar settlement may be effected through:

(a) the Exchange Fund debiting the Account HK\$785 million; and

(b) HSBC debiting Standard Chartered's clearing account with HSBC HK\$785 million.

The monetary effects of this transaction will be that, other things being equal, both the Balance and NCB will be reduced by HK\$785 million. Interbank interest rates will as a result (and by design) be driven higher, thus giving support to the exchange rate.)

13. Alternatively, in response to the exchange rate being at 7.85, the Exchange Fund may borrow Hong Kong dollars from the General Revenue, to the extent that there are surplus General Revenue balances in the banking system. Assuming that the Exchange Fund borrows HK\$500 million from the General Revenue and the Treasury meets that demand by withdrawing a HK\$300 million

deposit from the Hang Seng Bank and HK\$200 million deposit from the Overseas Trust Bank, the Hong Kong dollar settlements will be effected as follows:

- (a) the Exchange Fund credits Treasury's account with it by HK\$500 million and issues a Debt Certificates of that amount to the Treasury;
- (b) the Exchange Fund debits the Account HK\$500 million;
- (c) HSBC debits Hang Seng Bank's clearing account with itself HK\$300 million;
- (d) HSBC debits Overseas Trust Bank's clearing account with itself HK\$200 million;
- (e) Hang Seng Bank debits the Treasury's deposit account with itself HK\$300 million; and
- (f) Overseas Trust Bank debits the Treasury's deposit account with itself HK\$200 million.

The monetary effects of this transaction will be that, other things being equal, both the Balance and NCB will be reduced by HK\$500 million. Interbank interest rates will again be driven higher, giving support to the exchange rate.

14. The effect of the new accounting arrangements on the day to day operation of HSBC is, however, rather more significant. The undertaking by HSBC to maintain a balance on the Account no less than the NCB of the rest of the banking system means that it has in effect created for itself a clearing account. Thus, when HSBC purchases for its customers US dollars with Hong Kong dollars, NCB will increase. So that this will not result in the Balance falling short of NCB, it will be in the interest of HSBC to fund the US dollar purchase by borrowing Hong Kong dollars in the interbank market, in a manner identical to what any other licensed bank would have done. In doing so, the supply of Hong Kong dollars in the interbank market will not be affected.

Market information

15. Given the monetary effects of Exchange Fund operations under the new accounting arrangements, it will be useful to participants in the foreign exchange and money markets to have access to certain relevant information. As from _____, therefore, the

Exchange Fund will at appropriate times on each day put on page _____ of the Reuters screen the Balance at the close of the previous day and the net effect of operations carried out by the Exchange Fund during the day on the Balance. When considered appropriate, other information will also be put on the screen, such as the amount of "late assistance" provided and the interest rate at which this has been arranged.

15. Any request for clarification of the matters described in this paper should be addressed to the Deputy Secretary for Monetary Affairs who is in charge of the operation of the Account.

Monetary Affairs Branch
Government Secretariat
March 1988



MO 6/19/1L

CHIEF SECRETARY	
REC.	21 MAR 1988
ACTION	Ms Seaman
COPIES TO	Cx Mr Hansen
	Ms Mountfield
	Mr Robson Mr Tomball
	Mr Call

MINISTRY OF DEFENCE

MAIN BUILDING WHITEHALL LONDON SW1A 2HB

Telephone 01-218 2111/3

21st March 1988

Dear Robert,

HONG KONG DEFENCE COSTS: RENEGOTIATION

We spoke briefly on the telephone on Friday about Charles Powell's letter of 17th March conveying the Prime Minister's view on the next step in the renegotiation of the Defence Costs agreement. The Defence Secretary has noted the Prime Minister's view that we should now accept the Hong Kong Government's (HKG) offer as it stands, and has instructed officials to convey this decision to the Governor (who is currently in the UK on official business). We plan to ensure that the position is clearly understood in Hong Kong before the Defence Secretary arrives there next Tuesday.

Mr Younger has also noted the Prime Minister's view that he and the Foreign and Commonwealth Secretary should discuss between them how the shortfall between the HKG offer and the true 70/30 apportionment approved by Ministers is to be shared. As he has already pointed out, he has already conceded 5%, or some £53 million, from the defence budget over the period to 1997. The remaining shortfall, some £8-10 million, is not large, but would represent an unwelcome additional burden at a time of severe pressure on the defence budget. He hopes, therefore, that your Secretary of State will feel able to make this sum available from the Diplomatic or Aid Budget.

I am sending copies of this letter to Jill Rutter (HM Treasury) and to Trevor Woolley (Cabinet Office).

Yours sincerely

(I. C. F. ANDREWS)

Private Secretary

Robert Culshaw Esq
Foreign and Commonwealth Office



CH/EXCHEQUER	
REC.	23 MAR 1988
ACTION	CST
COPIES TO	

CONFIDENTIAL

Foreign and Commonwealth Office

London SW1A 2AH

22 March 1988

✓
23/3

PHW

Dear Ian

Hong Kong Defence Costs Agreement: Renegotiation

Thank you for your letter of 21 March.

I understand that arrangements are being made for the Governor of Hong Kong to take an agreed line with the press on his return to Hong Kong, to the effect that a satisfactory basis for an agreement on sharing defence costs has been reached. This will mean that the position is clearly understood before the Defence Secretary arrives in the territory.

On the financing of the remaining shortfall of £8-10 million, the Foreign Secretary understands why the Defence Secretary has put this request (in your letter) and appreciates the close consultation which has been maintained between MOD and FCO throughout these negotiations with Hong Kong. But he considers that it is both unreasonable and impossible for any contribution to be made from the FCO vote. The maintenance of the garrison in Hong Kong, like the defence of any other dependent territory, is properly, as it always has been, a responsibility of the MOD and a charge on its budget: in this particular case we have been, and still are, able (because of the wealth and special position of Hong Kong) to secure a substantial contribution from the Colony. The fact that considerations of foreign policy cannot be ignored, as in so many other areas of our external defence, has no relevance. In this case, the FCO has played its full part in helping to limit, to the extent now agreed, the UK's share of Hong Kong's defence costs. But the underlying position remains as it has always been. There is no resultant justification for seeking a contribution from the sums voted to the FCO for our overseas representation or foreign aid. Such a use of funds could lay the Government open to serious criticism, not least in Parliament. In any event both the Diplomatic Wing and the ODA votes are fully committed to activities falling properly within their scope.

I am copying this letter to Jill Rutter and to Trevor Woolley.

Jans
R N Culshaw

Ian Andrews Esq
PS/Secretary of State
for Defence
LB2AQW

(R N Culshaw)
Private Secretary

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SECRET



FROM: J M G TAYLOR

DATE: 28 March 1988

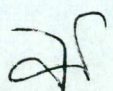
MR PERETZ

cc Sir P Middleton
Sir G Littler
Mrs Lomax
Miss O'Mara

**FOREIGN SECRETARY'S MEETING WITH CHINEESE FOREIGN MINISTER AT
CHEVENING: 11 MARCH: HONG KONG**

The Chancellor has read with interest the FCO's note of this meeting.

2. He has commented that it is clear from paragraph 3 of that note that Peking is, if anything, less hostile to a dollar/Hong Kong dollar realignment than are the FCO.


J M G TAYLOR

It is clear from para 3 that Peking
are & have lost the SECRET & / HKS & realign
than as to FCO

SECRETARY OF STATE'S MEETING WITH CHINESE FOREIGN MINISTER AT
CHEVENING: 11 MARCH: HONG KONG

List of those Present:

The Rt Hon

Sir Geoffrey Howe QC MP
Secretary of State for
Foreign and Commonwealth
Affairs

Mr Alan Donald

HM Ambassador-designate to
Peking

Mr David Gillmore

Deputy Under Secretary of
State, FCO

Mr Tony Galsworthy

Private Secretary of the
Secretary of State

Mr Robert Cooper

Head of Far Eastern Dept, FCO

Miss Pamela Major

Far Eastern Dept, FCO

Mr Alan Paul

Hong Kong Dept, FCO

HE Mr Wu Xueqian

Minister of Foreign Affairs of
the Peoples Republic of China

HE Mr Ji Chaozhu

Ambassador of the PRC to the
Court of St James

Mr Jiang Enzhu

Director of the Department of
West European Affairs, Ministry
of Foreign Affairs

Mr Wang Yihao

Counsellor of the Department of
West European Affairs, Ministry
of Foreign Affairs

Mr Yang Jiechi

Counsellor of the Department of
Translation and Interpretation,
Ministry of Foreign Affairs
(Interpreter)

Mr Yuan Zude

Secretary to the Minister of
Foreign Affairs

Mr Liu Junbao

Deputy Division
Chief of the Dept of West
European Affairs, Ministry of
Foreign Affairs

Mr Zhang Yijun

Counsellor, Chinese Embassy

Madame Cao Aihua

Miss O'Mara cc PPS
Sir P Middleton
Sir G Lither
Mrs Lomas
See paras 2 & 3, in particular
DUP 23/3

Joint Declaration

1. The Secretary of State said he was pleased with the smooth and

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steady implementation of the Joint Declaration (JD) and continued good progress in the Joint Liaison Group (JLG) and Land Commission. It was essential for maintenance of confidence in Hong Kong that cooperation was seen to continue. In the current JLG meeting in Hong Kong, we looked forward to further progress in areas such as Hong Kong's membership of international organisations, air services and extradition. These were complex technical matters of real practical importance to Hong Kong. It was good we had been able to address them well so far. From 1 July, the JLG would take Hong Kong as its principal base. This was an important step forward. Contact at all levels would become closer and more intense. Mr Wu agreed that cooperation for implementation of the JD was going well. We had been able to reach consensus on each issue. He hoped we would be able to resolve future problems in the same way. The permanent Chinese JLG team in Hong Kong after July would be basically the present team. Their duties would conform with Annex 2 of the JD. Mr Wu wondered whether it would still be necessary after July for the JLG to continue to meet in Peking and London. The Secretary of State said that we attached importance to meetings in all three venues each year. This was important for confidence and an important part of Annex 2. Mr Wu said this question could be discussed further.

Financial Issues

2. The Secretary of State thanked Mr Wu for the support of the Chinese government in the rescue of the Hong Kong Futures Exchange. The current review of the stock and future exchanges would be good for international confidence in Hong Kong as a financial centre. It was essential to get the machinery right and demonstrate determination to stamp out illegal practices. From the crisis the world would have noted two things: that the HKG took swift and decisive action; and that the PRC supported it. The crisis showed it was in the interests of all concerned that HKG continued to govern effectively until 1997 and to enjoy the confidence of the whole community. Mr Wu remarked that, due to our cooperation, the crisis had been resolved. He hoped we would be able to do the same in the future in similar circumstances.

3. Mr Wu noted that there had been discussion in Hong Kong of

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whether the link between the HK dollar and the US dollar should remain. This question deserved close consideration: the link boosted the prosperity of Hong Kong. Any change could affect the confidence of Hong Kong people in the value of the Hong Kong dollar and adversely affect the economy. If in the future we felt the change in the link was necessary he hoped we would inform the Chinese side well in advance. The Secretary of State said we considered the link desirable since it sustained economic and political confidence and the competitive position of Hong Kong internationally. We saw no reason to change. However, we could not of course predict what might happen in the future: events might develop suddenly and in ways which we could not control.

White Paper

4. The Secretary of State said that, in the publication of the HKG White Paper, HKG had had to take account of the views of the Hong Kong people and of the Chinese Government. It was an important example of the difficulty and sensitivity of an issue of this kind. We had benefited from close consultation and in the end the result had come out just about right. In Hong Kong the general reaction was balanced and reasonable and endorsed our position but a group of active and articulate people were sharply critical. These people formed the middle classes, essential to enterprise. We had to take account of their view. Reaction in the UK was mixed. In the House of Commons debate, there had not been a clear majority in favour. Views were divided within political parties and within the press. As we moved towards 1997, both groups would scrutinise more closely implementation of the JD. An example of this was the Consolidated Fund debate in the House of Commons the previous night. It was also related to UK media interest in Tibet: they tended to link one aspect of China with another.

5. Mr Wu said he had noticed Hong Kong concern about the 1987 review. HMG had made great efforts to understand the view of all sides. In the end the White Paper had come out well. Mr Wu reiterated that the Chinese Government did not at all oppose the gradual democratisation of Hong Kong nor direct elections in themselves. The Chinese position was that evolution in the democratic process should be suited to Hong Kong's conditions.

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According to the White Paper direct elections would not be introduced until 1991. Since the draft Basic Law would be made public for discussion in April there was no problem of convergence. The Chinese Government fully respected the views of HMG on the question of Hong Kong.

Basic Law (BL)

6. Mr Wu said that exchanges between legal experts on the drafting of the Basic Law had been useful to the Chinese side. The draft BL would be made public for discussion in April and the focus of attention of Hong Kong people would switch to this. The Chinese side would welcome friendly cooperation and coordination with us on the arrangements by which Hong Kong people would be consulted on the Basic Law draft. The Secretary of State said that arrangements for the participation of Hong Kong people in the work of the Basic Law Drafting Committee (BLDC) seemed to be going well.

First Hong Kong SARG

7. The Secretary of State said that one point causing us anxiety in the BL draft was the proposal for the establishment of a Preparatory Committee (PC) before 1997. We had recently handed over a paper on the subject and it had been discussed between Ambassador Ke and Mr McLaren in Hong Kong. We were fully committed to convergence and fully subscribed to the two fundamental principles of clearly marking the resumption of sovereignty by China and a smooth transfer of government. But we had noted Ambassador Ke's comments that the we seemed to be seeking to extend British influence beyond 1997. What we were in fact trying to do was to achieve continuity and, in discussion before 1997, to shape future institutions so that they could continue after 1997. If that was to be interpreted as the British retaining influence after 1997 then the other side of the coin was that the Chinese side would acquire influence over events before 1997. One could not have continuity without mutual influence of this kind. We wanted to achieve continuity through joint consultation whilst maintaining the integrity and authority of HKG before 1997 and establishing the integrity and authority of the SARG after 1997. We were dealing simultaneously with the two concepts of the reality of the resumption of Chinese sovereignty and the need for a smooth

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transition. The more the machinery could be formed jointly by both governments, the smoother the transition would be. An analogy, the aeroplane moving through 1997 would have to have been designed by both British and Chinese engineers if it was to cross the divide.

8. Our concern was that the establishment of a PC would give the impression of a complete break in 1997. This would undermine continuity and convergence. We had been grateful for Ambassador Ke's comment that the Chinese side envisaged full consultation with us to ensure continuity. However we saw the need for that consultation to be public. In return we were ready to involve the Chinese in discussions before 1997 which would help to provide continuity. Sovereignty and a smooth transfer of government were both important. If it was not possible to complete our discussions before the BL was published we hoped the BL could omit detail on this aspect. We believed the Maria Tam option under discussion in the BLDC embodied this approach.

9. Mr Wu said he thought that we were agreed on the principles but we expressed them differently. One principle should not be emphasised at the expense of the other. In principle our two sides were in agreement on the transfer of government in Hong Kong in 1997. But the Chinese side wished to stress that this transfer meant the transfer first to the CPG who would then authorise the SARG to carry out Government. It was important that this whole process did not disrupt the daily administration or social stability in Hong Kong. The Chinese Government favoured the proposal of some BLDC members for a Preparatory Committee to establish the first SARG. The PC would be appointed by the NPC as an expression of Chinese sovereignty. China would only start to resume the exercise of sovereignty on 1 July 1997. But in order to prepare for this, the procedure for establishing the first SARG had to be presided over by the CPG. The procedure would lead to the selection of a Chief Executive through consultation and election by people of various circles in Hong Kong, and to the formation of a legislature through elections. This conformed with the spirit of the JD. The PC would not interfere in the administration of Hong Kong prior to 1997, still less would it be a centre of power or shadow government. The PC would not exclude private consultations between the Chinese

and British sides on specific matters. These consultations could run in parallel with the PC's work. If we wanted a smooth transition, we had to choose the principal officials of the first SARG in advance through joint consultations. The team jointly chosen in this way might not be the exact team which emerged after the transition. But China did not wish to see a big change. Another issue which our two sides needed to discuss was how the people we jointly selected could obtain support from the Hong Kong people. However, Mr Wu stressed that the private consultations between us could not be made public or be written into the Basic Law.

10. Mr Wu referred to the Secretary of State's hope that the Basic Law would not include specific proposals on the establishment of the first SARG. He understood this wish. Maria Tam had put forward this proposal at the meeting of the BLDC Special Group on the Political System but, although the Chinese Government had tried to persuade BLDC members to support it, they had not succeeded. Members of the Special Group considered that such a step would run counter to progress in drafting the Basic Law and would lead to speculation among Hong Kong people. In the end, the proposal would go into an explanatory note, not the mainstream proposals. It would be difficult not to include specific proposals on the establishment of the first SARG in the draft Basic Law, to be made public in April. But this draft would be for discussion. Mr Wu considered that even if the draft contained specific proposals in an annex, it would not prevent further discussion between us on the subject.

11. The Secretary of State said he understood the limits of Chinese influence on BLDC members but we would still prefer this question to be left open in the Basic Law. We considered that the proposals about a PC would be disturbing to people when they appeared in the BL draft. He emphasised that the British side was in no way interested in trying to maintain beyond 1997 any symbolic residual manifestation of British authority. If one thing was certain, it was that in 1997 Chinese sovereignty would come into effect.

12. Mr Wu said he understood our good intentions but wished to emphasise three points:

(A) The Chinese side would have detailed consultations with us to reach consensus on the establishment of the first SARG but this had to be in private. Public consultation would bring unwelcome repercussions.

(B) Up until 1997 HKG would continue to govern in Hong Kong. The Chinese side would not interfere by establishing a shadow government.

(C) The Chinese side would seek British views through the JLG on how Hong Kong people should be consulted about the working procedures of the PC.

13. The Secretary of State repeated that it was relatively easy to advertise the transfer of sovereignty. It was more difficult to achieve continuity. We were seeking to reproduce before 1997 the mechanisms for formation of a legislature which were set out in the BL. There would be provision for Chinese participation in the supervision of elections. We needed a (not necessarily complete) continuity of people in important posts who could be perceived as representing British Government until 1997 and Chinese Government after 1997. There must be sufficient consultation for us both to be confident that they could do this. He referred to Ambassador Ke's comment in his meeting with Mr McLaren that "the establishment of a PC was the only suitable way to give expression to the principle of the resumption of exercise of sovereignty". What worried us in the statement was the equation between a Preparatory Committee established before 1997 and the expression of Chinese sovereignty. We did not object to the proposed functions of the PC, as a means of channeling Chinese thinking: what concerned us was that embodiment of those functions in the PC, which we feared would look wrong to people in Hong Kong.

14. Mr Wu commented that he did not know in what circumstances Ambassador Ke had made this statement but he repeated that the function of a PC was to prepare for the establishment of the first SARG in 1997 and not to exercise sovereignty in Hong Kong before 1997. Both sides agreed that we should continue the dialogue

elsewhere. Mr Wu undertook to convey our views to the Chinese leaders responsible for Hong Kong policy.

Human Rights

15. Finally, although there was not time for substantive discussion the Secretary of State mentioned to Mr Wu that we continued to be concerned about the articles concerning human rights in the Basic Law.

Distribution:

FED	PS
HKD	PS/Lord Glenarthur
Research Department	PS/Mr Eggar
PUSD	PS/PUS
Mr Fifoot, Legal Advisers	Mr McLaren
	Mr Gillmore

SECRET

cc
PPS
Sir P Middlebrook
Sir G Liller
Miss O Mann

SECRET
DEYOU/DEHOC/DEVIL
FM HONG KONG
TO IMMEDIATE FCO
TELNO 1293
OF 310950Z MARCH 88
INFO PRIORITY PEKING

FOLLOWING STRICTLY PERSONAL FOR HUM, HKD, FROM GOVERNOR
PEKING: DEHOC STRICTLY PERSONAL FOR AMBASSADOR/HEAD OF CHANCERY

YOUR TELNO 750: SECRETARY OF STATE'S TALKS WITH CHINESE
FOREIGN MINISTER: 11 MARCH 1988

YOUR TUR REPORTED WU'S CONCERN, EXPRESSED TO THE SECRETARY OF
STATE, THAT THE PROBLEMS WHICH HAD AFFECTED THE INTERNATIONAL
MONEY MARKETS LAST AUTUMN MIGHT RECUR, AND HIS PROPOSAL THAT
THE FINANCIAL MATTERS GROUP SHOULD MEET TO EXCHANGE VIEWS ON
THIS SUBJECT SO THAT THEY WOULD BE ALL THE BETTER EQUIPPED TO
DEAL WITH ANY SUCH RECURRENCE.

2. AS THE SECRETARY OF STATE HAS ALREADY INDICATED ASSENT, WE
FEEL THAT WE SHOULD FOLLOW UP SHORTLY WITH A MESSAGE FROM JACOBS
TO LU PING, THROUGH THE AMBASSADOR, SUGGESTING THAT A
MEETING BE ARRANGED FOR THE PURPOSE. SUBJECT TO YOUR VIEWS, THE
MESSAGE MIGHT MAKE THE FOLLOWING POINTS:

(A) SINCE THE MEETING OF THE FINANCIAL MATTERS GROUP IN
SEPTEMBER LAST YEAR, THERE HAVE BEEN DISTURBING EVENTS IN
INTERNATIONAL FINANCIAL MARKETS WHICH AFFECTED HONG KONG AND
REVEALED PROBLEMS IN ITS REGULATORY FRAMEWORK FOR THE SECURITIES
MARKETS.

/ (B)

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(B) WE AGREE IT WOULD BE USEFUL, AS SUGGESTED BY WU TO THE SECRETARY OF STATE, FOR THE FINANCIAL MATTERS GROUP TO MEET AND EXCHANGE VIEWS ON THIS SUBJECT.

(C) THE BEST TIME FOR A FURTHER MEETING WOULD BE AFTER THE SECURITIES REVIEW COMMITTEE HAS MADE ITS RECOMMENDATIONS FOR REFORM. THIS WILL BE AT THE END OF MAY. WE PROPOSE THAT THE GROUP SHOULD AIM TO MEET IN THE SUMMER.

(D) AT THE MEETING LAST SEPTEMBER, THE CHINESE MEMBERS OF THE GROUP INDICATED THAT THEY WOULD LIKE TO HAVE MORE TIME TO CONSIDER THE PAPERS PRESENTED AT THAT MEETING. IT WILL BE USEFUL TO HEAR FURTHER VIEWS FROM THEM AT THE FORTHCOMING MEETING.

3. BY THEN, THE NEW ACCOUNTING ARRANGEMENTS NOW BEING DISCUSSED WITH THE HONGKONG AND SHANGHAI BANKING CORPORATION (MY TELNO 1141) SHOULD HAVE BEEN PUT IN PLACE AND THE CHINESE INFORMED IN ADVANCE. IF SO, WE WOULD PROPOSE ALSO TO REVIEW WITH THE CHINESE HOW MONETARY POLICY OPERATIONS TO STABILIZE THE EXCHANGE RATE ARE BEING CONDUCTED UNDER THE NEW ARRANGEMENTS. IF WE HAVE RUN INTO DIFFICULTIES ABOUT THE NEW ARRANGEMENTS FOR ANY REASON (CHINESE OR OTHERWISE) WE COULD TAKE THE OPPORTUNITY TO DEAL WITH THE NEW ACCOUNTING ARRANGEMENTS.

4. WU'S REQUEST THAT THE CHINESE SIDE SHOULD BE INFORMED WELL IN ADVANCE OF ANY POSSIBLE CHANGE IN THE LINK OBVIOUSLY NEEDS GREAT CARE. I DO NOT SEE THAT WE CAN, OR SHOULD, GIVE SUCH AN UNDERTAKING. BUT A SPECIFIC RESPONSE AT THIS STAGE MIGHT BE COUNTER-PRODUCTIVE. WE PROPOSE TO REPEAT OUR FIRM VIEW AT THE SUGGESTED MEETING THAT WE HAVE NO INTENTION WHATSOEVER OF CHANGING THE LINK. WE WOULD ALSO REFER TO THE CLOSER INVOLVEMENT OF THE BANK OF CHINA IN THE FOREIGN EXCHANGE MARKET IN SUPPORT OF MAINTAINING THE LINK, WHICH WILL ARISE FROM THE INDEMNITY AGREEMENT FOR INTERVENTION NOW BEING NEGOTIATED (OUR TELNO 231), AND SAY THAT THIS SHOULD GIVE THEM A GREATER APPRECIATION OF HKG'S DETERMINATION TO MAINTAIN THE LINK. IF PRESSED, WE CAN SAY THAT WE UNDERSTAND THEIR DESIRE TO BE INFORMED IN ADVANCE OF ANY CHANGE IN THE LINK, IN THE UNLIKELY EVENT THAT THIS WAS CONSIDERED NECESSARY. BUT, AS WE MUST BE VERY CAREFUL THAT THE INFORMATION

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WILL NOT BE USED TO ANYBODY'S COMMERCIAL ADVANTAGE, WE CANNOT UNDERTAKE TO INFORM THEM WELL IN ADVANCE. IN ANY CASE, THE CONDITIONS WHICH MIGHT LEAD US TO ALTER THE LINK COULD BE SO UNEXPECTED AND URGENT THAT IT WOULD BE IMPRACTICABLE TO INFORM ANYONE WELL IN ADVANCE. WE WOULD NOT NECESSARILY BE ABLE TO INFORM LONDON.

WILSON

LIMITED DEVIL

HID HKD

PS

PS/LGRD GLENARTHUR

PS/PUS

MR GILLMORE

MR MC CLAREN

ADDITIONAL

MR A LOEHNIS,
BANK OF ENGLAND

MR D PERETZ,
HM TREASURY

SECRET



MO 6/19/1V

CHIEF SECRETARY	
REC.	- 6 APR 1988
ACTING	Ms Seaman
COPIES TO	Mr. Jensen
	Mr. Mansfield
	Mr. Robson
	Mr. Tremblay, Mr. Call

BF to W 874
PJP

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1A 2HB
Telephone 01-218 2111/3

21st March 1988

1
Dear Robert,

HONG KONG DEFENCE COSTS AGREEMENT: RENEGOTIATION

Thank you for your letter of 22nd March.

The Defence Secretary was disappointed that the Foreign and Commonwealth Secretary felt unable to make any contribution whatsoever towards the additional cost of the DCA arising out of the decision to accept the Hong Kong Government's latest offer. Her Private Secretary's letter of 17th March made clear that, in the Prime Minister's view, the shortfall between this offer and a true 70/30 apportionment should be financed by the Ministry of Defence and the Foreign and Commonwealth Office on a basis to be agreed between the two Secretaries of State. A nil contribution from the FCO does not seem to him to be consistent with this approach. Nor can he accept your Secretary of State's contention that, because Defence Votes bear the UK share of the garrison costs in Hong Kong, this would necessarily mean that a compensatory payment such as that suggested by the Chief Secretary in his letter of 17th March would breach any financial or Parliamentary propriety. However one looks at it, there was no defence reason whatsoever to accept any shortfall against the 70/30 apportionment approved earlier by Ministers and the sole reason for doing so was for foreign policy purposes.

Mr Younger does not believe therefore that the matter can rest on the exchange of letters between us. He would be grateful for your Secretary of State's agreement that officials should meet, perhaps with the Treasury also in attendance, to discuss the question further.

I am sending copies of this letter to Jill Rutter (HM Treasury) and to Trevor Woolley (Cabinet Office).

(I C F ANDREWS
Private Secretary)

Robert Culshaw Esq
Foreign and Commonwealth Office

From : D L C Peretz
Date : 8 April 1988

CHANCELLOR

cc Sir P Middleton o/r
Sir G Littler
Miss O'Mara

HONG KONG : MONETARY CONTROL SYSTEM

You may remember from my note of 21 January that the Hong Kong authorities have been considering a seemingly modest, but in fact fairly important, change to their mechanism for monetary control. Mr Jacobs may have mentioned this to you when you saw him on 8 March. I know that the Hong Kong Governor mentioned it to Sir Peter Middleton when he saw him recently.

2. The Hong Kong authorities now wish to implement this change, and I am attaching a lengthy draft paper prepared for EXCO, on which we are asked for comments. You do not need to read the papers. But I thought you would like to know where the proposal has got to.

3. The chosen option is the one favoured before. The HSBC will continue to maintain clearing accounts for other banks, but it will in turn hold a balance with the Exchange Fund equivalent to the clearing balances held with it by the rest of the banking system, and the Exchange Fund will cease holding an account with the HSBC. This will give the Hong Kong authorities much the same control over short-term interest rates that the Bank of England has here : they will be able to create market shortages - for example by foreign exchange market intervention - and then decide towards the end of each day the terms on which to relieve them. The current system is flawed in not providing any such means of setting interest rates; and in the way that it enables the banking system to offset the impact of intervention on interest rates.

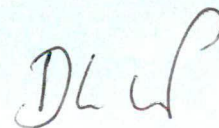
4. We and the Bank have some relatively minor drafting suggestions on the papers, which we will pass on - largely intended to make clear that better control over short-term interest rates is not only relevant to exchange market management.

5. The change makes sense whether or not the exchange rate link is changed (or indeed abandoned altogether) - though of course for presentational reasons the Hong Kong authorities will want to play up the relevance of new arrangements to helping maintain the link, at its current exchange rate.

6. The most difficult aspect of what is a thoroughly sensible proposal is how best to present it to the Chinese. Wrongly presented, it could touch a raw nerve: their worry about any change that might be thought to loosen the HSBC's ties with Hong Kong, and its position as "central bank". In this respect it is helpful that the form of proposal chosen will still involve other banks holding clearing accounts with the HSBC.

7. The current plan is to put the new arrangements into place one month before announcing them in public. The Chinese would be informed after they had started operating, but well before the public announcement. A meeting of the Hong Kong/Chinese "financial matters group" is in any event being planned for some time in the summer, and that would give an opportunity to review with the Chinese the working of the new arrangements, and to discuss them further.

8. FCO are considering whether anything more could or should be done to allay potential Chinese worries.



D L C PERETZ

FROM: B FOX

DATE: 8 April 1988

PS/CHIEF SECRETARY

cc: PS/Chancellor

Mr Anson
Mr Mountfield
Mr Robson (o/r)
Mr Turnbull
Mr Davies
Mr Call

HONG KONG DEFENCE COSTS AGREEMENT: RENEGOTIATION

The letter of 31 March from the Defence Secretary's Private Secretary to the FCO reports that Mr Younger is not prepared to accept that the FCO should make no contribution to the financial shortfall between the deal struck with the Hong Kong Government and a full 70/30 apportionment of costs under a new Hong Kong Defence Cost Agreement. He suggests that MOD and FCO officials meet, perhaps with Treasury officials also in attendance, to discuss the question further.

2. It is gratifying to see Mr Younger taking a robust line. There is no need for the Chief Secretary to intervene in the correspondence except in the unlikely event that Sir Geoffrey Howe should refuse to sanction a meeting. Assuming we are invited, both DM and AEF would attend. We would, of course, report to the Chief Secretary if the outcome of the meeting suggested that he was likely to become involved in a further round of discussion.

B FOX



MP

FROM: MOIRA WALLACE

DATE: 11 April 1988

MR PERETZ

cc Sir P Middleton
Sir G Littler
Miss O'Mara**HONG KONG: MONETARY CONTROL SYSTEM**

The Chancellor was grateful for your minute of 8 April. He is content with the way this issue is proceeding.

M. Wallace

MOIRA WALLACE



BF 2415
~~pps pl~~

MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

MO 6/19/1V

TELEPHONE 01-218 9000
DIRECT DIALING 01-218 1000

19H May 1988

CHIEF SECRETARY
REC. 23 MAY 1988
Mr. Seaman
Mr. Bar. F. Middleton
Mr. Anson, Mr. Muntfield
Mr. Rosen, Mr. Turnbull
Mr. P. Davis, Mr. Call

Dear Geoffrey,

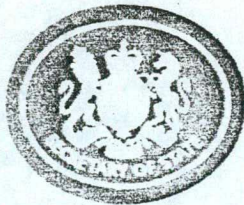
HONG KONG: DEFENCE COSTS AGREEMENT

I am becoming increasingly concerned at the slow progress of discussions aimed at implementing the measures approved by Ministers in late March for a new Defence Costs Agreement (DCA) between the Ministry of Defence and the Hong Kong Government (HKG).

My Department's position is, I believe, quite clear. Ministers have considered the issues and reached a decision on them. We are prepared to sign either Heads of Agreement recording the changes endorsed by Ministers and Exco; or a new Memorandum of Understanding consisting of the existing document amended to reflect these changes; or both. But if, as the HKG seem to wish, the agreement is to include additional points of substance, then these must be formally negotiated and submitted for Ministerial approval before any agreement can be signed.

Ever since the outline agreement was endorsed by Ministers, the HKG's aim appears to have been to unpick it and to secure additional financial or administrative advantages for themselves. If successful, this process would result in equivalent disadvantages to us. I am simply not prepared to accept the imposition of any further financial penalties on the Department, over and above those we have already conceded. In embarking on the further full round of

The Rt Hon Sir Geoffrey Howe QC MP



negotiations that now appears to be necessary, the MOD team will be instructed to negotiate tenaciously in order to preserve the position that Ministers have approved. If the HKG are insistent on introducing new issues of substance, there are numerous and significant points that we ourselves would intend to introduce. The negotiation of such important issues of substance cannot be undertaken by telegram, but we stand ready to welcome the HKG team to London once more.

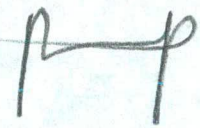
The HKG seem to have some difficulty in understanding this position and it is obvious to me that it needs spelling out to them again as unambiguously as possible. I hope you will agree that this should be done forthwith. I understand that you yourself will be visiting Hong Kong shortly and this will provide a useful opportunity to ensure that the HKG are in no doubt about HKG's position.

I am sending copies of this letter to the Prime Minister, the Secretaries of State for the Home Department and for Trade and Industry, the Lord President, the Chief Secretary, the Attorney General and Sir Robin Butler.

Yours very,

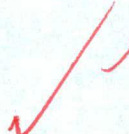
George Younger

CONFIDENTIAL



FROM: B FOX

DATE: 24 May 1988

- STK 24.5
1. MR ROBSON
 2. CHIEF SECRETARY
- 

cc: Chancellor
Mr Anson
Mr Mountfield
Mr Woodall
Mr Call

HONG KONG DEFENCE COST AGREEMENT

Mr Younger's letter of 19 May reports continuing difficulty with the Hong Kong Government in implementing the agreement approved by Ministers in March for a new financial basis to the Defence Cost Agreement with Hong Kong. The purpose of the letter is to ensure that the Foreign Secretary takes a robust line when he visits Hong Kong in the near future.

2. You will recall that after protracted discussion, agreement was reached with the Hong Kong Government on the basis of an effective 70/30 split of future costs. Since then, the Hong Kong Government has tabled a draft Heads of Agreement which goes well beyond the scope of the earlier discussions and includes a number of clauses which would have the effect of imposing further financial penalties on HMG: MOD estimate these to be at least £50 million and as much as £200 million between now and 1997 - ie up to a further 20% on the real 5% change in apportionment which Ministers have sanctioned.

3. Repeated rounds of telegrams with the Governor have failed to clear a way forward. MOD are taking the line that if the Hong Kong Government persists in its position, there must be a further full negotiation round. They are not prepared to negotiate by telegram nor on an agenda chosen by the Hong Kong Government. They are concerned that the Foreign Secretary, when he visits Hong Kong in the near future, should take a robust line and leave the Governor in no doubt about HMG's concern and resolve. The key messages to get across are that HMG has negotiated in good faith, strongly disapproves of tactics which appear to unpick the deal and will not go beyond the financial basis of that deal.

4. We have been consulted fully by MOD and agree with their line. It would be helpful if you could reinforce Mr Younger's position. If you are content, I attach a short draft letter for your consideration.

A handwritten signature in black ink, consisting of a large, stylized 'B' with a vertical line through it, and a 'F' below it.

B FOX

DRAFT LETTER TO:-

Rt Hon George Younger
Secretary of State for Defence

cc: Prime Minister
Foreign Secretary
Home Secretary
Secretary of State for Trade and Industry
Lord President
Attorney General
Sir Robin Butler

HONG KONG DEFENCE COST AGREEMENT

Thank you for copying to me your letter of 19 May to Geoffrey Howe.

I share your concern both at the slow progress being made to settle this issue and at the apparent attempt by the Hong Kong Government to unpick the basis of the outline agreement negotiated with them in good faith. As you say, it is necessary to make it crystal clear to the Governor that we disapprove of these tactics and are not prepared to accept any agreement which has financial or operational penalties beyond those we have already conceded: Geoffrey's impending visit to Hong Kong is a useful opportunity for ensuring that this message is clearly understood.

I am copying this letter to the Prime Minister, the Secretary of State for Foreign Commonwealth affairs, the Secretaries of State for the Home Department and Trade and Industry, the Lord President, the Attorney General and Sir Robin Butler.



FCS/88/106

SECRETARY OF STATE FOR DEFENCE

BF 26/5

CHIEF SECRETARY	
REC.	25 MAY 1988
ATTENTION	<i>Ms Seamer</i>
COPIES TO	<i>C. Sir P. Middleton</i>
	<i>Mr Dixon Mr Mountfield</i>
	<i>Mr Robson Mr Turnbull</i>
	<i>Mr P. Davis Mr Call.</i>

25/5/88.
Hong Kong: Defence Costs Agreement

1. Thank you for your minute of 19 May about the implementation of the measures approved by Ministers for a new Defence Costs Agreement (DCA) with the Hong Kong Government.
2. I share your regret that progress on this has been slow. I do not however believe that the Hong Kong Government would accept your description of their aim in the exchanges which have taken place since agreement was reached on the key features of the new DCA. It would in our view have been possible to make greater headway if expert discussions had been better prepared and there had been greater willingness to explore positions by telegram. But I understand that your negotiators are now in more effective contact with their Hong Kong counterparts and that a further round of negotiations is in prospect.
3. I hope it will be possible for the negotiations now to be brought quickly to a conclusion, without fresh issues of substance being raised on either side which would have the effect of causing the exchanges to drag on. Although I do not propose to involve myself in the detail of the matter, I shall certainly make this clear while I am in Hong Kong at the end of this week. I fully understand your concern to preserve the position that Ministers have approved.



4. I am sending copies of this minute to the Prime Minister, the Secretaries of State for the Home Department and for Trade and Industry, the Lord President, the Chief Secretary, the Attorney General and Sir Robin Butler.

A handwritten signature in black ink, appearing to be 'G. Howe', written in a cursive style.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
25 May 1988

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pm

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HONG KONG FOR PRIVATE SECRETARY
MY TELNO 1285 (NOT TO ALL) : PRESIDENT REAGAN'S VISIT TO
LONDON: THE US BACKGROUND
SUMMARY

1. A BAD PATCH AGAIN FOR REAGAN AT HOME, FROM WHICH FOREIGN POLICY IN GENERAL, AND THE MOSCOW SUMMIT IN PARTICULAR, OFFER THE BEST HOPE OF RECOVERY. A SENSE OF DRIFT AND DISAPPOINTMENT AS THE ADMINISTRATION GRADUALLY RUNS OUT OF STEAM. NEVERTHELESS, THE PRESIDENT IS LIKELY TO BE IN GOOD FORM. BUSH'S CHOICE BETWEEN IDENTIFYING HIMSELF WITH THE ADMINISTRATION AND DISTANCING HIMSELF FROM IT MORE ACUTE THAN EVER.

DETAIL

2. BEFORE PRESIDENT REAGAN VISITS LONDON, YOU MAY LIKE A SNAPSHOT OF THE POLITICAL SITUATION WHICH THE PRESIDENT LEAVES BEHIND HIM IN WASHINGTON.

3. BARRING AN UNFORESEEN UPSET IN MOSCOW, THE PRIME MINISTER IS LIKELY TO FIND THE PRESIDENT HIS USUAL CHEERFUL AND APPARENTLY RELAXED SELF, WITH GOOD REASON TO BE PROUD OF THE PROGRESS HE HAS HELPED MAKE IN US/SOVIET RELATIONS IN GENERAL, AND OF THE INF TREATY AND THE AGREEMENT ON AFGHANISTAN IN PARTICULAR. AT HOME, HOWEVER, APART FROM THE PERIOD IMMEDIATELY FOLLOWING THE REVELATION OF THE IRAN-CONTRA OPERATION IN NOVEMBER 1986, THE PAST FEW WEEKS HAVE BEEN AMONG THE MOST DIFFICULT OF HIS PRESIDENCY. THE PRESIDENT'S TROUBLES HAVE INCLUDED:

(A) THE CONTINUING EMBARRASSMENT OF POLICY TOWARDS PANAMA. AS BUSH, JIM BAKER AND OTHERS HAVE POINTED OUT, BOTH IN PRIVATE AND INCREASINGLY IN PUBLIC, THE ATTEMPT TO DROP CHARGES AGAINST (IN DUKAKIS'S WORDS) QUOTE A DRUG RUNNING DICTATOR UNQUOTE DID NOT SIT EASILY WITH THE ADMINISTRATION'S COMMITMENT TO A TOUGHER ANTI-DRUG POLICY, NOR WITH THE FIRST LADY'S JUST SAY NO CAMPAIGN.

ALTHOUGH THE BREAKDOWN OF NEGOTIATIONS WITH NORIEGA ON 25 MAY REMOVES THE PLEA-BARGAINING DIFFICULTY, IT LEAVES THE ADMINISTRATION WITH AN AWKWARD CHOICE BETWEEN ACQUIESCING IN THE PRESENT SITUATION OR SOMEHOW STEPPING UP THE PRESSURE ON NORIEGA, PERHAPS INITIALLY VIA OTHER LATIN AMERICAN COUNTRIES. I FOUND BUSH VERY PREOCCUPIED WITH THIS ISSUE WHEN I SAW HIM PRIVATELY EARLIER THIS WEEK.

(B) MEESE. THE INDEPENDENT COUNSEL'S REPORT ON THE WEDTECH AFFAIR IS EXPECTED EARLY NEXT MONTH, AND MAY WELL CRITICISE THE ATTORNEY GENERAL FOR ETHICAL LAPSES. BUT, WITHOUT SOME MAJOR NEW DEVELOPMENT, MEESE IS LIKELY TO CONTINUE TO BRAZEN THINGS OUT, AND THE PRESIDENT WILL REMAIN RELUCTANT TO PRESS HIM TO GO, THIS ALSO TO THE DISCOMFORT OF BUSH.

(C) ASTROLOGY. ALTHOUGH POLLS HAVE SHOWN THAT A SIGNIFICANT NUMBER OF AMERICANS SET SOME STORE BY ASTROLOGY, REGAN'S REVELATIONS HAVE EXPOSED THE PRESIDENT TO QUITE UNPRECEDENTED RIDICULE IN A WAY WHICH HAS BEEN WOUNDING TO HIM AND MRS REAGAN IN PERSONAL TERMS, AND EXTREMELY DAMAGING POLITICALLY. MRS REAGAN TOLD MY WIFE AND ME RECENTLY THAT THE PRESS HAD MADE THEIR LIVES MISERABLE, AND SHE CERTAINLY FEELS BITTERLY ABOUT IT. THE WHITE HOUSE'S HALF-HEARTED ATTEMPTS TO DISCREDIT REGAN'S ACCOUNT HAVE TENDED TO COMPOUND THE DIFFICULTY.

4. IN RECENT MONTHS, THE PRESIDENT'S APPROVAL RATING HAS BEEN HOVERING IN THE 48-52 PER CENT BAND. BUT TWO RECENT POLLS HAVE SHOWN IT DROPPING SIGNIFICANTLY TO 46 AND 43 PER CENT. FURTHER POLLS ARE EXPECTED IN THE NEXT FEW DAYS, AND WILL BE IMPORTANT INDICATORS OF WHETHER THE DAMAGE WHICH THE PRESIDENT HAS SUSTAINED IN RECENT WEEKS IS LIKELY TO HAVE LONGER-TERM IMPLICATIONS, NOT LEAST FOR BUSH.

5. AGAINST THE RATHER SOMBRE BACKGROUND OF RECENT EVENTS AT HOME, COMMENTATORS ARE ALREADY STARTING TO DRAW UP BALANCE SHEETS OF THE REAGAN YEARS. ALTHOUGH THE CONCLUSIONS THEY DRAW DEPEND LARGELY ON POLITICAL AFFILIATION, THERE IS AN INESCAPABLE FEELING OF DRIFT AND DISAPPOINTMENT ABOUT THE PRESIDENT'S PERFORMANCE IN HIS SECOND TERM. IN ADDITION, WITH LESS THAN 6 MONTHS TO GO BEFORE THE ELECTIONS, THERE IS A DISTINCT SENSE THAT THE ADMINISTRATION IS NOW GRADUALLY RUNNING OUT OF STEAM, AT LEAST ON DOMESTIC ISSUES. THE MAJOR SUCCESSES OF THE REAGAN YEARS - THE DEFENCE BUILD-UP, THE MASSIVE ECONOMIC EXPANSION, THE IMPROVEMENT IN US/SOVIET RELATIONS (OF WHICH THE INF TREATY AND THE WITHDRAWAL FROM

AFGHANISTAN ARE THE TWO MOST OBVIOUS FRUITS) - ARE IN MANY WAYS OFFSET, THE COMMENTATORS MAINTAIN, BY THE FAILURES - THE TWIN DEFICITS, THE IRAN-CONTRA AFFAIR, AND THE SUCCESSION OF SCANDALS INVOLVING PRESENT AND FORMER MEMBERS OF THE ADMINISTRATION. BOTH THE ACHIEVEMENTS AND THE FAILURES ARE ATTRIBUTED TO THE SAME PHENOMENON : THE PRESIDENT'S UNUSUAL, AND UNUSUALLY RELAXED, STYLE OF LEADERSHIP. AS ONE OF THE PRESIDENT'S FORMER ADVISERS (MARTIN ANDERSON) PUT IT IN A RECENT BOOK PRAISING REAGAN'S ACHIEVEMENTS, THE PRESIDENT'S QUOTE HIGH ROLLING, HIGH RISK ... UNIQUE MANAGEMENT STYLE HAD ENORMOUS POWER AND EFFICACY WHEN IMPLEMENTED PROPERLY ... BUT IT WAS A FLAWED STYLE WITH ... POTENTIAL FOR DISASTER UNQUOTE.

6. THESE MAINLY DOMESTIC DIFFICULTIES CONTRAST HOWEVER WITH THE BRIGHTER PICTURE OF COORDINATION OF US FOREIGN POLICY (WITH THE NOTABLE EXCEPTION OF PANAMA). THE ADMINISTRATION MACHINE IS NOW RUNNING VERY SMOOTHLY. WITH THE COMBINATION OF HOWARD BAKER AND HIS DEPUTY, AND OF SHULTZ, CARLUCCI AND POWELL, THE PRESIDENT HAS AT LAST FOUND A TEAM TO WHOM HE CAN COMFORTABLY DELEGATE THE DAY TO DAY RUNNING OF OVERSEAS AFFAIRS. THIS MACHINE MAY NOT PRODUCE ANY MAJOR SUCCESS IN THE REMAINING MONTHS OF THE ADMINISTRATION. BUT, EQUALLY, IT IS UNLIKELY TO COME TO A STANDSTILL. CENTRAL AMERICA APART, FOREIGN AND DEFENCE POLICY SHOULD CONTINUE TO BE MANAGED IN A COMPETENT AND POSITIVE FASHION, AND THE EFFORT TO MAKE PROGRESS TOWARDS A START AGREEMENT WILL, BARRING SURPRISES OUT OF MOSCOW, CONTINUE.

7. THAT SAID, AND AS SO OFTEN IN THE PAST, THE PRESIDENT MAY HAVE BEEN DOWN, BUT HE IS VERY FAR FROM OUT. ALTHOUGH THE ADMINISTRATION DOES NOT YET APPEAR TO HAVE ANY CLEAR IDEA OF HOW IT WILL BRING DOWN THE CURTAIN ON THE FIRST TWO-TERM PRESIDENCY IN NEARLY THREE DECADES, THERE ARE HIGH HOPES THAT THE MOSCOW SUMMIT WILL MARK THE BEGINNING OF A MORE UP-BEAT HOME STRETCH. THE PRESIDENT'S VISITS TO LONDON, AND TO TORONTO FOR THE ECONOMIC SUMMIT, MAY ALSO HELP TO DISTRACT ATTENTION FROM HIS DOMESTIC DIFFICULTIES. IN PERSONAL TERMS, THE PRESIDENT IS PHYSICALLY AS SPRITELY AND TEMPERAMENTALLY AS OPTIMISTIC AS EVER : AT A REPUBLICAN RALLY RECENTLY HE CLAIMED, IN CHARACTERISTIC FASHION, THAT RAMBO'S RETURN TO THE SCREEN IN A THIRD FILM ALMOST MADE THE PRESIDENT WISH HE COULD SERVE A THIRD TERM.

8. FOR BUSH, THE PRESIDENT'S DIFFICULTIES, NOTABLY OVER MEESE AND NORIEGA, HAVE SERVED ONLY TO DEEPEN HIS DILEMMA

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OF TRYING TO TAKE CREDIT FOR THE ADMINISTRATION'S ACHIEVEMENTS WHILE DISTANCING HIMSELF FROM ITS FAILURES. AS HE HAS FALLEN FURTHER BEHIND DUKAKIS IN THE POLLS, BOTH NATIONWIDE AND IN CALIFORNIA, SO THE PRESSURE ON BUSH FROM SENIOR REPUBLICANS TO CUT LOOSE FROM THE PRESIDENT HAS INCREASED. SO FAR, HOWEVER, HE AND HIS STAFF HAVE TAKEN ONLY TENTATIVE STEPS IN THAT DIRECTION (NOTABLY BY LEAKING ACCOUNTS OF WHITE HOUSE MEETINGS AT WHICH BUSH IS SAID TO HAVE DISAGREED WITH THE PRESIDENT), BUT ARE ALL TOO AWARE THAT THE BENEFITS OF SUCH A MOVE COULD WELL BE OUTWEIGHED BY A LOSS OF SUPPORT IN OTHER AREAS OF THE ELECTORATE WHICH REAGAN HAS DEVELOPED SO SUCCESSFULLY. BUSH GAVE ME THE IMPRESSION THAT HE HAS NOT YET SORTED OUT HIS POSITION ON A NUMBER OF ISSUES. THE FINAL CAMPAIGN IN THE PRESIDENTIAL ELECTIONS IS NOT YET JOINED, BUT HE MUST DO SO SOON.

ACLAND

YYYY

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cc:
 Chancellor
 Mr Anson
 Mr Mountfield
 Mr Robson
 Mr Fox
 Mr Woodall
 Mr Call

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon George Younger TD MP
 Secretary of State for Defence
 Ministry of Defence
 Main Building
 Whitehall
 London
 SW1A 2HB

MP

27 May 1988

Dear Secretary of State

HONG KONG DEFENCE COST AGREEMENT

Thank you for copying to me your letter of 19 May to Geoffrey Howe.

I share your concern both at the slow progress being made to settle this issue and at the apparent attempt by the Hong Kong Government to unpick the basis of the outline agreement negotiated with them in good faith. As you say, it is necessary to make it crystal clear to the Governor that we disapprove of these tactics and are not prepared to accept any agreement which has financial or operational penalties beyond those we have already conceded: Geoffrey's impending visit to Hong Kong is a useful opportunity for ensuring that this message is clearly understood.

I am copying this letter to the Prime Minister, Geoffrey Howe, Douglas Hurd, David Young, John Wakeham, Patrick Mayhew and Sir Robin Butler.

Yours sincerely

John Major

19 JOHN MAJOR

(Approved by the Chief Secretary
 and signed in his absence)



CHIEF SECRETARY	
REC.	20 JUN 1988
ACTION	Mr Fox.
COPIES TO	Cx Sir P Middleton Mr Hanson, Mr Mountfield Mr Robson, Mr Turnbull Mr P. Davis, Mr Call

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1A 2HB

Telephone 01-218 2111/3

20 June 1988

MO 6/19/1E

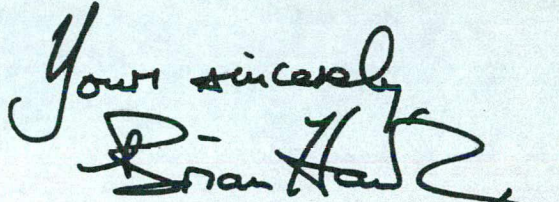
Dear Bob

HONG KONG: DEFENCE COSTS AGREEMENT

The Foreign and Commonwealth Secretary will wish to be aware of the outcome of the latest round of negotiations over the Hong Kong Defence Costs Agreement which took place last week in London.

The negotiations have been constructive and fruitful, and have resulted in a Memorandum of Understanding, agreed by both sides, that sets out the arrangements for financing the Hong Kong garrison between 1st April 1988 and 30th June 1997. We are satisfied that these arrangements are consistent with the outline agreement endorsed by Ministers in March, and in particular that they do not involve any further financial penalty to the Ministry of Defence. The MOU itself has been encapsulated in Heads of Agreement which, I understand, the Hong Kong Government will submit to the Executive Council for approval on 21st June.

I am sending a copy of this letter to the Private Secretaries to the Prime Minister, the Home Secretary, the Trade and Industry Secretary, the Chief Secretary, the Lord President, the Attorney General, and Sir Robin Butler.

Your sincerely


(B R HAWTIN)
Private Secretary

Bob Peirce Esq
Foreign and Commonwealth Office



[Handwritten signature]

MO 6/19/1L

CHIEF SECRETARY	
REC.	4 JUL 1988
ACTION	Mr Fox
	Mr Sir Edward Dutton
	Mr Hanson, Mr Mountfield
	Mr Robinson, Mr Turnbull
	Mr P. Dawson, Mr Cell

30th June 1988

Dear Geoffrey,

HONG KONG : DEFENCE COSTS AGREEMENT

Now that Heads of Agreement covering a new Defence Costs Agreement have been initialled by officials of my Department and the Hong Kong Government, I have been reflecting further upon the question of how the costs of the shortfall between a net 70:30 apportionment and the HKG's final offer should be borne.

We last discussed this issue at Chevening in April following an exchange of letters between our Private Secretaries. I do, of course, appreciate your reluctance to make funds available from FCO Votes to meet the shortfall. But the decision to accept the HKG's final offer was just one of a number of such decisions by colleagues which have resulted in additional unplanned expenditure for the Defence Budget; another, as you may recall, was that to continue UK participation in the European Transonic Wind Tunnel. The cumulative effect of these commitments is substantial.

As far as the DCA is concerned, I had already agreed to increase the MOD contribution to the cost of maintaining the garrison in Hong Kong by some £53 million up to 1997. The effect of the Prime Minister's decision to accept the HKG offer was to add a further £8-10 million to that figure, although I do not think it was her

The Rt Hon Sir Geoffrey Howe QC MP



intention that all of this should be borne by the Defence Budget. Charles Powell's letter of 17th March seems to me to be quite explicit on this point.

Having taken account of your representations, I accept that there is little alternative to the Defence Budget meeting the additional cost. But I have taken this decision with the utmost reluctance and must make clear that I can only find additional money at the expense of other important defence programmes. I am not prepared to contemplate any further settlements of this kind when there is no defence justification for doing so.

I am sending a copy of this letter to the Chief Secretary and to Sir Robin Butler.

Yours ver,

George Younger

dti

the department for Enterprise

CH/EXCHEQUER	
REC.	- 5 JUL 1988
ACTION	MISS O'MARA
COPIES TO	EST SIR P. MIDDLETON SIR G. LITTLER MR ANSON MR MOUNTFIELD MR PERETZ

5/7

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4/7/88.

PRIME MINISTER

HONG KONG

I visited Hong Kong from 19-22 June. The objective of the visit was to promote UK business interests generally and the UK interest in a number of projects. While in Hong Kong I made much of the fact that it was my only port of call (and not part of a longer trip) and this was undoubtedly warmly received.

2 I was encouraged by the widespread recognition of our economic achievements and of our increased international competitiveness. We are winning good project business in Hong Kong, some of it against Japanese competition. And there was much praise for the performance of UK companies carrying out the work. For instance, the Chairman of the Hong Kong Mass Transit Railway told me that he considered Westinghouse, who supply signalling equipment, to be technologically two or three years ahead of their international competition.

3 Hong Kong's position within China after 1997, combined with its geographical advantages and international outlook compared with Tokyo, suggests that it could play a significant new role in the region - almost a New York to Beijing's Washington. There are already many companies - such as IBM and Salomon Brothers - which are favouring Hong Kong over Tokyo for their Pacific basin headquarters.

4 Many new projects are now under consideration in Hong Kong. These include a new airport/port complex likely to cost £2-3 billion a third university and major road projects amounting to some £5 billion in the next five years. I am confident of the ability of UK companies to play a major part in these

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developments and pressed our interests accordingly.

5 I also paid a brief visit to Macao where I discussed with the Governor the UK's interest in participating in various projects there. The most significant of these is a major international airport.

6 Hong Kong is also a major market for consumer goods. Marks & Spencer recently opened their first branch in Asia there and they announced a second during my visit.

7 UK exports to Hong Kong last year exceeded £1 billion for the first time. Its fast-growing economy makes it a major market in its own right. And with the opportunities for onward sales into China, the potential further growth is extremely attractive both for visible exports and for invisibles. However, I believe that UK businessmen may well be discouraged from attacking the Hong Kong market by the emphasis in the UK media on the political aspects. The Press in other countries are likely to be less concerned with this. I therefore intend to stress to British companies that 1997 should not be viewed as a closing of an era but as the continuation and indeed the widening of the present trade and investment opportunities.

8 The Governor told me that Ian Hay-Davison's recommendations for reform of the financial markets had been generally well received and that they would be implemented as soon as was reasonably practical. I strongly, but informally encouraged him in that direction.

9 In addition to meetings with the Governors of the Hong Kong and Macao, I visited major project sites and had discussions with leading businessmen and bankers. I also addressed the Hong Kong British Chamber of Commerce.



the department for Enterprise

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10 I should like to express my appreciation for the hospitality of the Governor, Sir David Wilson, and for the arrangement and conduct of the programme by the Senior British Trade Commissioner, Mr Holloway.

11 I am copying this minute to Geoffrey Howe and Nigel Lawson.

D Y

4 July 1988

DEPARTMENT OF TRADE & INDUSTRY

DWLAGI





10 DOWNING STREET
LONDON SW1A 2AA

5 July 1988

H/EXCHEQUER	
REC.	5 JUL 1988
ACTION	MISS O'MARA
COPIES TO	EST. MIDDLETON
	Sir G. LITTLE
	Mr ANSON
	Mr MOUNTFIELD

Mr PERETZ

From the Private Secretary

HONG KONG

4? The Prime Minister has read with interest Lord Young's minute of 4 July about his visit to Hong Kong and Macao, which she finds generally reassuring. She has heard it said that we do not press the claims for British companies hard enough when it comes to major public works contracts in Hong Kong. She is therefore grateful for Lord Young's efforts reported in paragraph three of his minute, but hopes that these will be followed up very vigorously and in every possible way.

I am sending copies of this letter to Tony Galsworthy (Foreign and Commonwealth Office) and Alex Allan (Treasury).

(C. D. POWELL)

Neil Thornton, Esq.,
Department of Trade and Industry.

SECRET

DEVIL

GRS 380
SECRET
DEDIP/DEHOC/DEVIL
FM HONG KONG
TO IMMEDIATE FCO
TELNO 2686
OF 130900Z JULY 88
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*c Principal Private Secretary
Sir P Middleton
Mr Selstar
Mrs Harvey
Mr Peretz ad.*

STRICTLY PERSONAL FOR HUM, HKD FROM GOVERNOR

PEKING : STRICTLY PERSONAL FOR AMBASSADOR/HEAD OF CHANCERY

DIALOGUE ON FINANCIAL MATTERS: NEW ACCOUNTING ARRANGEMENTS FOR
MONETARY CONTROL

THE AGREEMENT TO ENTER INTO THE NEW ACCOUNTING ARRANGEMENTS FOR
MONETARY CONTROL WAS FORMALLY SIGNED ON 8 JULY. ITS IMPLEMENTATION
WAS CONDITIONAL ON IT BEING APPROVED BOTH BY THE EXECUTIVE COUNCIL
AND THE HKSBB BOARD.

2. ON THE MORNING OF 12 JULY, EXCO GAVE APPROVAL TO THE
IMPLEMENTATION OF THE NEW ARRANGEMENTS ON A DATE TO BE SPECIFIED
BY THE FINANCIAL SECRETARY. ON THE AFTERNOON OF THE SAME DAY, THE
BOARD OF THE HONGKONG AND SHANGHAI BANKING CORPORATION ALSO AGREED
TO THE BANK'S PARTICIPATION. THE WAY IS THEREFORE NOW CLEAR FOR
THE MONETARY REFORM ENVISAGED IN THE NEW ARRANGEMENTS TO BE
INTRODUCED.

3. EXCO WAS IN FAVOUR OF AN ANNOUNCEMENT AS SOON AS POSSIBLE FOR
FEAR OF LEAKS. THE HKSBB BOARD TOOK THE SAME VIEW, AS THE NEW
ACCOUNTING ARRANGEMENTS CONSTITUTE MATERIAL INFORMATION WHICH
COULD AFFECT THE SHARE PRICE OF HKSBB. HAVING DISCUSSED THE MATTER
WITH THE BANK AGAIN, WE HAVE AGREED THAT AN ANNOUNCEMENT SHOULD
NOW BE MADE AT CLOSE OF PLAY ON FRIDAY 15 JULY AND THAT THE NEW
ARRANGEMENTS SHOULD COMMENCE ON 18 JULY. THE PAPER FOR PUBLIC
CONSUMPTION WHICH HAS ALREADY BEEN CLEARED WITH YOU WILL BE
ISSUED AT THE TIME OF THE ANNOUNCEMENT. NENDICK AND YAM WILL GIVE
A BACKGROUND BRIEFING TO THE PRESS ON FRIDAY EVENING AND TO THE
COMMITTEE OF THE HONG KONG ASSOCIATION OF BANKS ON SATURDAY MORNING.
WE SHALL ALSO INFORM THE BANK OF CHINA BEFOREHAND.

WILSON

~~SECRET~~

DEVIL

SECRET

LIMITED
HD/HKD
HD/FED
PS
PS/LORD GLENARTHUR
PS/PUS
MR GILLMORE
MR MCLAREN

ADDITIONAL:
MR A LOEHNIS, BANK OF ENGLAND
MR D PERETZ, HM TREASURY

SECRET



18/7/88
JMF

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FCS/88/135

SECRETARY OF STATE FOR DEFENCE

CHIEF SECRETARY	
REC.	18 JUL 1988
ATTN	Mr Fox
Copies TO	Cx, Sir P Middleton, Mr Dawson, Mr Mansfield, Mr Robson, Mr Turnbull, Mr P. Demain, Mr Call

Hong Kong: Defence Costs Agreement

1. Thank you for your letter of 30 June confirming your willingness to meet all the costs of the UK share of the new Defence Costs Agreement from the Defence Budget. I am grateful for this. As you know, I believe this to be the only appropriate solution. I do however, understand the very real pressures on the Defence Budget at this time.
2. As you will by now be aware, the Finance Committee of the Legislative Council approved funds for the new DCA on 6 July. It is worth noting, however, that this result was achieved only after a lengthy and difficult debate, during which a number of speakers called for the new agreement to be rejected. In the end 5 members of the 30 member Committee voted against the agreement (a rare phenomenon in Hong Kong). The support of a significant number of other members remained in doubt to the last minute. By any standards it was very close run thing.
3. This result confirms my view that we secured the very best deal we could. I am convinced that such concessions as were made by the UK in the latter stages of the negotiations were the minimum necessary in order to achieve a politically viable agreement.

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4. Copies of this minute go to the Chief Secretary and to Sir Robin Butler.

A handwritten signature in black ink, appearing to be 'G. Howe', written in a cursive style.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
18 July 1988

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MP

CONFIDENTIAL

035337
MDHIAN 2028

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FM HONG KONG
TO IMMEDIATE FCO
TELNO 3232
OF 021215Z SEPTEMBER 88
INFO PRIORITY WASHINGTON

BARCLAYS BANK PLC - FEDERAL TRADE COMMISSION

THE COMMISSIONER OF BANKING IN HONG KONG HAS PASSED ON TO THE SECRETARY FOR MONETARY AFFAIRS A LETTER DATED 26 AUGUST FROM MR MARK TRESS, DIRECTOR OF THE HONG KONG BRANCH OF BARCLAYS BANK PLC. IN HIS LETTER MR TRESS INFORMED THE COMMISSIONER THAT THE BANK'S BRANCH IN HONG KONG HAS BEEN REQUESTED BY THE FEDERAL TRADE COMMISSION ('FTC') IN THE USA TO PROVIDE INFORMATION ABOUT AN ACCOUNT MAINTAINED AT THAT OFFICE BY A COMPANY CALLED DUNWISH LTD.

2. THE BACKGROUND TO THIS REQUEST IS AS FOLLOWS. THE ASSISTANT REGIONAL DIRECTOR OF THE FTC IN LOS ANGELES FAXED A LETTER DATED 19 AUGUST TO THE BANK ENCLOSING A COPY OF AN ORDER OF THE UNITED STATES DISTRICT COURT IN THE CENTRAL DISTRICT OF CALIFORNIA. THE ORDER IS AN INJUNCTION ARISING OUT OF LITIGATION BETWEEN THE FTC AND AN NUMBER OF CORPORATE AND INDIVIDUAL DEFENDANTS. THE FTC ALLEGES THAT THE DEFENDANTS ARE GUILTY OF DECEPTIVE TRADE PRACTICES IN CONNECTION WITH THEIR BUSINESSES WHICH RELATE TO THE SALE OF COINS IN THE USA. IN BRIEF THE INJUNCTION FREEZES THE ASSETS OF THE NAMED DEFENDANTS AND THEIR AFFILIATES AND SUBSIDIARIES AND APPOINTS A RECEIVER IN RESPECT OF THE ASSETS OF THE CORPORATE DEFENDANTS AND THEIR AFFILIATES AND SUBSIDIARIES. CLAUSE XII OF THE INJUNCTION PROVIDES INTER ALIA THAT

'..... ALL BANKS..... WHICH ARE SERVED WITH A COPY OF THIS ORDER SHALL COOPERATE WITH ALL REASONABLE REQUEST OF THE RECEIVER RELATING TO THE IMPLEMENTATION OF THIS ORDER, INCLUDING TRANSFERRING FUNDS AT HIS DIRECTION AND PRODUCE RECORDS RELATED TO DEFENDANTS' AND ALL AFFILIATES' ACCOUNTS.'

ACTING ON THE PREMISE THAT THIS ORDER APPLIES TO BARCLAYS BANK PLC BECAUSE THE BANK HAS A BRANCH IN THE USA AND BECAUSE THE HONG KONG BRANCH NOW HAS NOTICE OF THIS ORDER THE FTC HAS MADE ITS REQUEST FOR INFORMATION.

3. DUNWISH LTD IS NOT ONE OF THE DEFENDANTS NAMED IN THE US PROCEED-

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MDHIAN 2028

INGS. THE RECEIVER HAS POWERS TO GET IN THE ASSETS AND TAKE CONTROL OF ALL PAPERS RECORDS OF ACCOUNT ETC. IF THE FTC CAN ESTABLISH THAT DUNWISH LTD IS AN AFFILIATE OR SUBSIDIARY THE ORDER MAY WELL BE WIDE ENOUGH TO REQUIRE BARCLAYS TO GIVE THE INFORMATION SOUGHT. THE FTC LETTER DOES NOT SUGGEST AN AFFILIATE OR SUBSIDIARY RELATIONSHIP. IT MAY BE ASSUMED HOWEVER THAT THE FTC BELIEVE THERE IS A CONNECTION BETWEEN THAT COMPANY AND THE DEFENDANTS AND THAT ASSETS ARISING FROM THEIR COIN DEALING ACTIVITIES HAVE FOUND THEIR WAY TO THAT ACCOUNT. THE FTC WISHES TO KNOW THE NAMES OF THE INDIVIDUALS WHO ARE THE ACCOUNTS SIGNATORIES OR OTHERWISE AUTHORISED TO MAKE WITHDRAWALS. THE FTC ALSO WISHES TO KNOW THE CURRENT BALANCE AND WHETHER THERE ARE CORPORATE DOCUMENTS ON THE BANK'S FILE. FURTHER DETAILS OF TRANSFERS AND WITHDRAWALS ARE REQUIRED AND THE BANK IS SPECIFICALLY REQUESTED TO STATE WHETHER A LIST OF INDIVIDUALS AND CORPORATIONS, SOME OF WHICH ARE NAME IN THE INJUNCTION, HAVE RECEIVED PAYMENTS OUT OF THAT ACCOUNT. THE FTC ARE ALSO INTERESTED, AMONGS OTHER THINGS, IN WHETHER DUNWISH LTD MAINTAINS OTHER ACCOUNTS WITH THE BANK.

4. THE RESPONSE OF THE BANK TO THIS REQUEST HAS BEEN TO INFORM THE FTC OF ITS DUTY TO PRESERVE CONFIDENTIALITY IN RELATION TO ITS CUSTOMERS' BUSINESS. THE BANK HAS ALSO INFORMED THE FTC THAT IF IT WISHES TO MAKE A REQUEST OF THIS TYPE THE APPROPRIATE METHOD IS BY MEANS OF LETTERS ROGATORY. HAVING CONSULTED WITH OUR LEGAL ADVISERS WE ARE OF THE VIEW THAT THAT WAS THE CORRECT COURSE TO TAKE. IF THESE INQUIRIES RELATE TO ALLEGATIONS OF FRAUD, ENFORCEMENT OF AN ORDER MADE ON THE BASIS OF FRAUD MAY BE ENFORCEABLE IN HONG KONG. IT MAY ALSO BE POSSIBLE FOR THE FTC TO USE THE LETTERS OF REQUEST PROCEDURE IN HONG KONG IN VIEW OF THE PROCEEDINGS COMMENCED IN THE USA.

5. ONE FURTHER POINT ARISES WHICH DOES NOT DIRECTLY CONCERN HONG KONG BUT WHICH YOU MAY WISH TO BE AWARE OF. IN CLAUSE III(2) OF THE INJUNCTION THE DEFENDANTS AND THEIR ASSOCIATES ARE RESTRAINED FROM WITHDRAWING ASSETS OR OTHERWISE DEALING WITH FUNDS HELD IN A NUMBER OF BANK ACCOUNTS. ONE SUCH ACCOUNT IS WITH CLYDESDALE BANK PLS IN PICCADILLY, LONDON.

6. AT PRESENT HKG HAS NOT BEEN REQUESTED BY THE BANK TO TAKE ANY ACTION IN THIS MATTER. THE BANK HAS APPROACHED US MERELY TO KEEP US INFORMED. THE BANK IS AWARE THAT WE ARE PASSING THIS INFORMATION ON TO YOU, HOWEVER PLEASE TREAT THE SAME AS CONFIDENTIAL. AT PRESENT WE FEEL THAT THERE IS NO NECESSITY FOR HKG TO TAKE ANY ACTION. IT IS TO BE HOPED THAT THE FTC WILL NOW ADOPT THE PROPER PROCEDURE

PAGE 2
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MDHIAN 2028

FOR OBTAINING THIS INFORMATION. WE WILL HOWEVER KEEP THE MATTER UNDER CONSTANT REVIEW AND INFORM YOU OF DEVELOPMENTS.

7. THE PAPERS PROVIDED BY THE BANK ARE QUITE EXTENSIVE. IF YOU REQUIRE A COPY, PLEASE LET US KNOW.

WILSON

YYYY

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ADDITIONAL 1

MR WICKS NO 10 DOWNING ST

NNNN



2/9/88

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PM/88/045

PRIME MINISTER

CH/EXCHEQUER	
REC.	02 SEP 1988
ACTION	Mr MOUNTFIELD
COPIES TO	EST. CST. Sir G. LITTLE Mr LANKESTER Mr H.P. EVANS Mr P.G.F. DAVIS Mr REVOLTA

Vietnamese Boat People in Hong Kong

1. Charles Powell's letter of 7 June recorded your agreement that the Hong Kong Government should introduce a new policy to deal with boat people from Vietnam. From 16 June new arrivals have been screened to distinguish between those who are genuine refugees and those who are in effect economic migrants.
2. The new policy has now been in operation for almost three months. The influx of boat people in Hong Kong has however continued at a disappointingly high level. Many new arrivals had set out in order to anticipate a rumoured change in policy. Others were simply unaware that a new policy had been introduced, despite all our efforts to publicise this. There is now a slight fall in the rate of arrivals, but it remains difficult to detect any clear trend.

/3.

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3. There are now in Hong Kong almost 16,000 boat people who arrived before the new policy came into effect, and a further 9,000 who have arrived since. Housing and feeding such numbers is putting a considerable strain on the Hong Kong Government's resources.

4. The change in policy has however secured an important advance on another front. In July the Vietnamese Government told us that they wanted to hold talks on the return of boat people from Hong Kong. A first round took place in Hanoi in early August. This produced agreement that the Vietnamese would take effective measures to limit the outflow of boat people; and also agreement in principle that some boat people in Hong Kong should be returned to Vietnam. But the Vietnamese are saying at present that they will take only those who volunteer to go back. And they have made it clear that they are looking for some form of limited financial assistance to reintegrate returnees into their communities.

5. We judge that the present Vietnamese focus on voluntary returnees is essentially tactical. The Vietnamese must privately recognise that a repatriation programme will have to go far wider. We shall press them hard to act quickly on the hundred or so who have asked to go back, since this would be a powerful deterrent to other would-be emigrants. But sooner or later the question of reintegration assistance is likely to be a sticking point.

/6.

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6. We are keeping up our pressure on the Vietnamese to live up to their undertaking to reduce departures, but as yet there is no evidence that they are taking effective action to that end. I am convinced that the only way of lightening the heavy burden which Hong Kong already bears is through agreement on a comprehensive scheme for the return of economic migrants to Vietnam. This means treating them no differently from the illegal immigrants trying to enter Hong Kong from China - or indeed illegal immigrants the world over - who are simply sent back to their country of origin. There has been a very general acceptance, both in Parliament and in the media, that the Hong Kong Government have no feasible alternative. We have made it clear that we would need assurances that those returned would be treated humanely. But we have to recognise that many boat people could physically resist being returned to Vietnam against their will. There is a strong likelihood that we shall face criticism of an emotive nature - for example analogies, however far fetched, with the treatment of the Cossacks after World War II - when the time comes to enforce the policy of involuntary repatriation in the full glare of publicity.

7. The request of the Vietnamese for financial assistance to resettle their own people is a distasteful one. But I see no prospect of resolving this intractable problem in Hong Kong unless we go a little way to meet them. Those who leave Vietnam usually sell all they

/possess

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possess. The bankrupt Vietnamese Government claims it has no funds to help them. There could be no question of providing development aid, or of making money directly available to the Vietnamese Government. But I believe we should be prepared to indicate that if a comprehensive repatriation programme can be drawn up for the return of substantial numbers of boat people we may in principle be ready to contribute to a UNHCR programme providing modest assistance, probably largely in kind rather than cash, to returnees and their immediate communities. This would be in line with the way minds are moving in UNHCR, in other Western governments and in other countries such as Malaysia with populations of boat people. We would urge our partners to make a contribution. The Hong Kong government would also be ready to seek authority to make matching contributions of their own.

8. In any event the sums involved would be small. Planning for an eventual repatriation operation is at a very preliminary stage: but UNHCR's initial ideas would involve expenditure of a few hundred dollars per family, up to a total of no more than US\$ 5 million in the first year for a programme which would not be limited to Hong Kong. UNHCR would approach a number of governments to seek contributions. We do not need to decide at this stage what size our own contribution should be.

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9. If you are content that we should proceed on that basis, we shall tell the Vietnamese that we are ready for a second round of talks. By convention this should be in the other capital, London (or in Hong Kong). The Hong Kong Government are understandably concerned that the holding of the talks in the territory could give rise to unrest among those Vietnamese detained pending repatriation. I therefore believe we should be ready to offer London as the venue, recognising that this offers the Vietnamese a modest diplomatic gain and seeking to exert the maximum leverage in return. This would offer an opportunity for us to put across very forcefully our views on broader Vietnamese policies.

10. I am copying this minute to John Wakeham, Nigel Lawson, George Younger, Douglas Hurd, David Young, John Belstead and Patrick Mayhew.

A handwritten signature in dark ink, appearing to be 'G. Howe', written in a cursive style.

(GEOFFREY HOWE)

Foreign and Commonwealth Office

2 September 1988

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3/9

CH/EXCHEQUER	
REC.	05SEP1988
ACTION	Mr MOUNTFIELD
COPIES TO	EST. CST Sir G. LITTLER Mr LANKESTER Mr H.P. EVANS Mr PGE DAVIS Mr REVOLTA

10 DOWNING STREET
LONDON SW1A 2AA

5 September 1988

From the Private Secretary

Bf. 19/9

VIETNAMESE BOAT PEOPLE IN HONG KONG

The Prime Minister has considered the Foreign Secretary's minute of 2 September proposing that we should discuss with the Vietnamese Government a comprehensive scheme for the return of economic migrants from Hong Kong to Vietnam, and at the same time be prepared to contribute to a UNHCR programme to provide modest assistance in kind to returnees and their immediate communities.

The Prime Minister agrees to these proposals, although with some reluctance given that the Vietnamese are in effect going to profit from having made conditions so miserable for their own people. She has commented that if we and other industrial countries are in practice prepared to give some sort of endowment to these economic migrants, there might be countries other than Vietnam which would be prepared to accept them. You will wish to consider this.

I am copying this letter to the Private Secretaries to the Lord President, the Chancellor of the Exchequer, the Defence Secretary, the Home Secretary, the Trade and Industry Secretary, the Lord Privy Seal and the Attorney General.

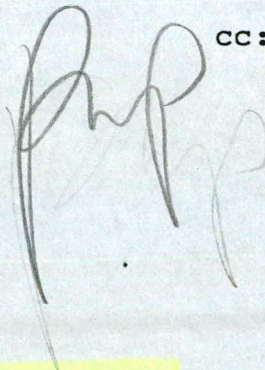
(C. D. POWELL)

J. S. Wall, Esq.,
Foreign and Commonwealth Office.

CONFIDENTIAL

CONFIDENTIALFROM: J C MAY
DATE: 13 September 1988

PS/CHIEF SECRETARY


cc: PS/Chancellor
PS/Economic Secretary
Sir G Littler
Mr Lankester
Mr H P Evans
Mr Mountfield
Mr Davis
Miss O'Mara
Mr Revolta**VIETNAMESE BOAT PEOPLE IN HONG KONG**

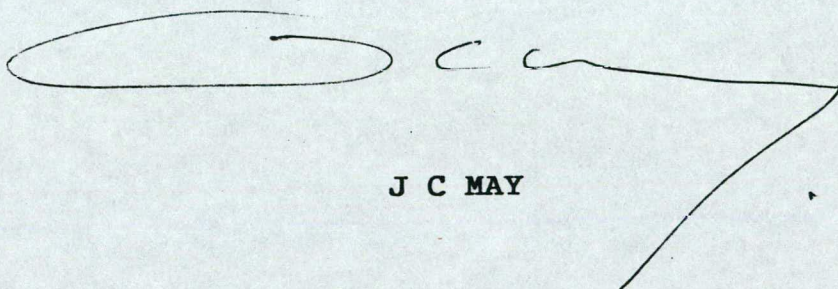
The Foreign Secretary minuted the Prime Minister on 2 September, copied to the Chancellor, proposing that we should discuss with the Vietnamese Government a comprehensive scheme for the return of economic migrants from Hong Kong to Vietnam, while at the same time being prepared to contribute to a possible United Nations High Commissioner for Refugees (UNHCR) programme to provide modest assistance to returnees and their immediate communities. Charles Powell then wrote to Mr Wall on 5 September recording that the Prime Minister agreed to the proposals although with some reluctance.

2. The main concern here is diplomatic, namely how to reach a workable agreement with the Vietnamese on the treatment of those people in Hong Kong who are in effect economic migrants rather than genuine refugees. There are a number of potential difficulties in this which the paper outlines. The Foreign Secretary feels that the only way forward is via a comprehensive scheme for the return of economic migrants, treating them in effect as illegal immigrants, and that if this is to work some kind of financial assistance may well be necessary. A UNHCR programme provides the most likely route for which there may well be support from other Western governments. Given our involvement in the colony, the UK would need to make a contribution but current indications are that this is likely to be small.

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3. If things proceed along the lines currently envisaged we could expect ODA to meet the costs of any eventual UK contribution from within existing resources: I have discussed the matter with ODA officials and they confirm that view. ODA currently provide about £15 million each year to special appeals for refugees with much of the monies channelled through the UNHCR. This, plus the contingencies fund which ODA operate, should provide adequate resources for any costs arising from these proposals.

4. No bid is being made or is envisaged by ODA and, as such, there is no need for reply either at Ministerial or PS level.



J C MAY

RESTRICTED

FROM: S D H SARGENT
 DATE: 22 September 1988

MR PERETZ
 MR BOTTRILL
 MR B FOX
 MR G JORDAN

cc

PPS
 Sir T Burns
 Sir G Littler
 Dame Anne Mueller
 Mr Anson
 Mr Lankester
 Mr Monck
 Mr C D Butler
 Mr A Edwards
 Mr H P Evans
 Mr Robson
 Mr L Harris
 Mr C W Kelly
 Mrs Lomax
 Mr Moore
 Mr Mountfield
 Mr Gieve
 Miss Noble
 Miss O'Mara
 Mr S N Wood

PS/Sir Robin Butler
 Mr G T Morgan OMCS

VISIT TO HONG KONG AND CHINA BY SIR PETER MIDDLETON: 10-15 OCTOBER

I attach a copy of the programme for Sir Peter Middleton's visit impending visit to Hong Kong and Peking. The Foreign Office, who have of course arranged the programme, will be providing some general briefing, but I should be grateful if Mr Peretz could provide some more specific material on the Hong Kong economy, and if Mr Bottrill could provide a note on the Chinese economy.

2. I should also be grateful if Mr G Jordan could provide a draft of the talk which Sir Peter is to give at the Chinese Ministry of Personnel on 15 October. I understand that this is to be a fairly informal occasion with an audience of some 30-40 people; it is envisaged that there should be a question and answer session after the talk. Sir Peter would be grateful for a draft combining the main themes of his recent CIPFA speech on improving financial management in government, and

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Sir Robin Butler's speech earlier this week to the IPM on the Civil Service (copies of both speeches attached for Mr Jordan only).

3. Please could Mr Fox provide a short note on the Hong Kong Defence Costs Agreement and could he also (and/or Mr Wood) let me know if there is anything Sir Peter should be aware of when he visits PSA in Hong Kong.

4. I have asked the Bank of England to provide any appropriate briefing on the People's Bank of China.

S D H Sargent

S D H SARGENT

PROGRAMME FOR SIR PETER MIDDLETON'S VISIT TO HONG KONG AND PEKING

Sunday 9 October

11.00am Depart from Gatwick on CX200 for Hong Kong

Monday 10 October

9.30am Arrive Hong Kong

12.00 Call on Commissioner of Banking

1.00pm Lunch with Secretary for Monetary Affairs followed by meeting

3.30pm Call on Mr William Purves

4.30pm Call on Financial Secretary

5.30pm Call on Senior British Trade Commissioner

8.15pm Dinner at Government House

Tuesday 11 October

10.30am Visit to Thomas De La Rue at Taipo Industrial Estate
(by helicopter)

12.00 noon Call on Mr David Li, Bank of East Asia, followed by lunch.

2.30pm Call on Sir Q W Lee, Hang Seng Bank

3.30pm Call on Mr John Mackenzie, Standard Chartered Bank

4.30pm Call on the Governor

Evening Dinner hosted by Financial Secretary.

Wednesday 12 October

9.10am Depart Government House

9.30 Arrive PSA Regional Headquarters Causeway Bay for briefing by the PSA Hong Kong Regional Management Group

10.45 Presentation by the Regional manager. The Crown Suppliers on current TCS business and products in Hong Kong

11.30 Depart PSA RHQ for Stanley Fort

12.00 Arrive Stanley Fort and drive through the Camp

12.10pm Meet Commanding Officer

12.30 Luncheon in the Officers' Mess Stanley Fort

2.00 Depart for PSA/RHQ

2.30 Closing discussions at PSA/RHQ

3.00 Depart PSA/RHQ

Evening Races at Happy Valley

Dinner hosted by Sir Q W Lee

Thursday 13 October

10.00am Depart Hong Kong on flight CX328

12.50pm Arrive Peking

Afternoon Sightseeing (private)

Evening Dinner at Residence

Friday 14 October

Morning Call on Ministry of Finance

12.30pm Working Lunch at Residence (with Chinese Interlocutors)

3.00 Call on People's Bank of China

Evening Banquet hosted by Ministry of Finance

Saturday 15 October

8.30am Meeting with Ministry of Personnel
Sir Peter Middleton's talk at Ministry of Personnel

Afternoon Sightseeing hosted by Ministry of Finance (Great Wall with Lunch at Ming Tombs)

9.30pm Depart Peking Flight CA937

Sunday 16 October

9.10am Arrive Gatwick

S E C R E T

MP

From : D L C Peretz
Date : 5 October 1988

SIR P MIDDLETON

cc PPS
Sir G Littler o/r
Miss O'Mara

HONG KONG : NEW MONETARY CONTROL ARRANGEMENTS

*1 v. m. x.
copy with X.*

Joseph Yam, David Nendick's No. 2 in the Monetary Affairs Department in Hong Kong, was in London last week and came to see me and Margaret O'Mara. He reported experience so far with the new monetary control/interest rate setting mechanism; and raised some questions about future development that he had been discussing with the Bank of England - and that you will undoubtedly also be asked about by Piers Jacobs when you are in Hong Kong.

2: Miss O'Mara will be letting you have further briefing material for your visit, separately.

Monetary control mechanism

3. The new mechanism, under which in effect all Hong Kong banks maintain clearing balances with the Exchange Fund (EF), has been operating informally for some months. It has been in full public view since 1 September. Operations are published each day, and appear on Reuters (HKEF). The arrangements have been working well, although it has hardly been a testing period. The HK dollar has been under no real strain whatsoever, in either direction; and HK dollar interest rates are almost identical with US dollar interest rates.

4. A perceived difficulty with the arrangements is that there are rarely changes in the balances held by bankers with the EF, since the Hong Kong Government's day by day transactions are carried out through commercial banks and do not therefore affect the EF balance, the balance is not affected by variations in the note issues, which are made by the two large private sector banks.

Nor is there any Hong Kong Government borrowing. So the "operations" published every day are very boring, always the same, as follows :-

Closing balance in the account on previous day : 1100 million

Forecast effect of settlements on current day : neutral

The Exchange Fund has not operated in the market today.

In fact the EF has only operated in the market on one day since 1 September, to withdraw funds from bankers' balances through 150m of exchange market intervention when the exchange rate weakened slightly. The effect, as theory predicts, was quickly to raise market interest rates somewhat.

5. Operations, when they do occur, may thus come as something of a shock to the market. Mr Yam has been considering whether there is anything that can be done to make them less high profile. In particular he has been considering a proposal that, although there is no borrowing need, the Exchange Fund should issue Treasury bills probably called Exchange Fund bills - which could be tapped out, redeemed (and purchased) on a regular basis. He asked what we thought of this idea, and I am sure you will be asked too.

6. I said that although the Bank of England operated in the market every day here, it still came as a surprise when it sought to change interest rates by changing its dealing rates. However, I could see there could be other arguments for issuing Treasury bills, as well. For example it would become possible to signal a level of preferred interest rates in the rates at which the EF was prepared to deal in Treasury Bills. At present, although they knew that withdrawing funds from the market would raise interest rates, there was no control over the size of the increase.

7. Mr Yam said he rather agreed that the monetary arguments for Treasury bills were not strong. But he could see two quite compelling, if secondary arguments :-

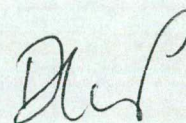
- i) the operation ought to be profitable. The EF could deploy the funds at higher rates than it paid for them, even after taking suitable security to contain credit risk.
- ii) a market in Hong Kong Treasury bills might help to develop the Hong Kong financial market generally.

8. We will need to consider this proposal when it is put to us formally. But I said my own personal view was that there seemed some arguments for going ahead, and practically no arguments against, and on that basis I doubted whether we would want to stand in its way.

9. As I say, I am sure you will be asked about the proposal next week - by when Hong Kong thinking may have developed further, and they will have had a little more experience of operating the new arrangements.

Exchange Rate Peg

10. I should also report that in the course of conversation Mr Yam indicated an even stronger commitment to the current 7.80 exchange rate peg than on previous occasions. He said that rather than revalue, or shift to a "basket" peg he would prefer to see a return to free floating. This may only be a personal view: but there was just a hint of a line of thought that the improved domestic monetary control mechanism could if necessary be used as an alternative to the exchange rate peg. I cannot myself see that it could possibly carry the necessary market credibility, given the prospective difficulties over the period to 1997. X



D L C PERETZ



12/12
BF 2/12

CH/EXCHEQUER	
REC.	24 NOV 1988
ACTION	MR PGF DAVIS - 24/11
COPIES TO	PS/CST, PS/EST SIR P MIDDLETON SIR G LITTLEIR MR ANSON MR LUCE MR MOUNTFIELD MR MAY

FCS/88/205

24/11/88

CHANCELLOR OF THE EXCHEQUER

Hong Kong: General Compensation Scheme

1. I mentioned to you on 9 November that I would be writing to you on this subject. In March 1985 OD(K) considered a number of aspects of the treatment of members of Her Majesty's Overseas Civil Service (HMOCS) in Hong Kong, in the light of the constitutional change in prospect. It was agreed that we should aim for arrangements whereby these officers would be eligible for compensation from local revenue. In my minute of 2 May 1985 I agreed that if HMG had at the end of the day to accept these commitments the vote responsibility would naturally fall to the FCO/ODA. For the reasons set out in this minute I believe we now need to consider further what compensation should be offered to these officers; how this should be financed; and when a decision should be taken and announced.

THE SCALE OF THE PROBLEM

2. There are likely to be 300-400 members of HMOCS in Hong Kong working in Hong Kong in 1997 for whom the question of compensation arises. The majority of these are in the Royal Hong Kong Police.



THE FORM OF COMPENSATION

3. HMG have an obligation to see that HMOCS officers are appropriately compensated for the change in their status arising from the transfer of sovereignty in 1997. This obligation was enshrined in a White Paper of 1960, which set out the general principles governing the treatment of HMOCS officers in territories moving towards constitutional change (see Annex). There are precedents for the granting of compensation in the case of every other dependent territory moving along that path. Since 1960 HMG have invariably made substantial contributions to, and in most cases fully funded, compensation schemes. Hong Kong HMOCS officers expect comparable treatment.

4. In the past, General Compensation Schemes have offered HMOCS officers the option to retire at independence with immediate payment of pension and compensation. Since 1960, officers opting to stay on remained eligible to retire with immediate payment of pension, and received compensation over a six year period. Hong Kong's circumstances are of course very different from previous cases because it will not become independent. We have entered into a binding treaty commitment with the Chinese government to bring about a smooth transition in 1997. We are determined to uphold our commitment to Hong Kong. Any scheme should therefore be designed to offer a positive inducement to members of HMOCS to stay on. I envisage that those who leave around



the change of sovereignty should receive only very limited compensation; full compensation would be payable only to those who stay on for a period of, say, 10 years after 1997, rather than leave in that year. Those who left within the 10 year period would receive an appropriate portion of the maximum sum, which would vary according to individual circumstances. A very rough average might be in the area of £40,000 per officer, on the basis of the provisions of the Hong Kong Government's own compensation schemes (para 7 below). An "incentive" scheme on these lines would fall short of what HMOCS officers in Hong Kong would hope to receive, but it would be defensible and would be consistent with the intentions of the 1960 White Paper.

5. The cost of such a scheme would depend on how many HMOCS officers decided to stay on after 1997. We estimate that the total sum would be between £10 and £20 million, spread over 10 years from 1997 (ie an average of £1-2 million a year over the period). It would be significantly less than a scheme offering full compensation in 1997.

HOW THE SCHEME SHOULD BE FINANCED

6. I have considered very carefully whether it would be right or feasible, as matters have developed since 1985, to ask the Hong Kong Government to bear the costs of a



General Compensation Scheme on the lines indicated above. I have concluded that it would not, for the following reasons:

a) the obligation is one for HMG, not the Hong Kong Government. The officers in question belong to a special overseas service and formally speaking they enjoy HMG's protection;

b) it is now clear that if the Hong Kong Government sought to introduce such a scheme for expatriates only it would place itself in a politically untenable position. Such a scheme would be highly divisive within the Hong Kong Civil Service because it would leave without any form of compensation the large number of local members of the Hong Kong Civil Service who (unlike their expatriate colleagues) will almost all have no option but to remain in Hong Kong. For these reasons it would also arouse very strong opposition in the community as a whole if the Hong Kong Government were asked to bear the cost. As you will know from their behaviour over the defence costs agreement and other matters, the Legislative Council are increasingly prone to criticize HMG for failing to live up to our commitments. It is the Governor's firm view that the Legislative Council would not vote funds for a locally financed scheme for expatriates only;

c) a Hong Kong funded scheme would also almost certainly be unacceptable to the Chinese Government, who would find the discrimination in favour of expatriates equally



unpalatable. There would be no way to proceed without their agreement, because the greater part of the funds would not be paid until after 1997 and would therefore have to come from the Hong Kong Special Administrative Region.

7. The Hong Kong Government are already making a substantial contribution to the total cost of compensation arising from the change of sovereignty in 1997. Two schemes to meet very particular requirements have been set up. A limited compensation scheme will facilitate the localisation before 1997 of senior civil service posts. The money will go to expatriates who have been required to retire early to make way for local officers. In addition, a covert extension of the scheme will cater for Special Branch officers (expatriate and local) required to retire in advance of 1997 because of the very sensitive nature of their work. The cost to the Hong Kong Government of these two schemes (which are of course essentially different from the General Compensation Scheme in that they benefit local as well as expatriate officers) is likely to be almost £40 million, substantially more than the estimated cost to us of our proposed General Compensation Scheme. I believe it is right for HMG to play their part by funding what will be an exclusively expatriate scheme.



THE TIMING OF A DECISION

8. Pressure among HMOCS officers in Hong Kong for an early decision is growing. The Hong Kong Government have given those Police officers at present on contract terms until the end of March 1989 to decide whether to transfer to pensionable terms (ie to membership of HMOCS). This deadline has already been extended twice. And if a decision cannot be reached in time we may have to ask the Governor to extend it again. This will cause increasing unhappiness: the officers concerned argue with justification that they cannot properly exercise the option to transfer to pensionable terms until they know whether there will be a General Compensation Scheme. The provisions of the 1960 White Paper envisage discussion with staff associations before any scheme is put into place.

9. Failure to announce a Scheme soon, or worse still an announcement that there will be no scheme at all, would have a serious effect on the morale of expatriate officers. This would be particularly marked in the police force, which will have a key role to play in the maintenance of order in the run up to the change of sovereignty in 1997. Our ability to retain expatriate staff in the years up to 1997 would be seriously weakened. We would rightly be accused of not facing up to our responsibilities towards the territory at a time when there is a crucial need to preserve confidence and stability.



FINANCIAL ARRANGEMENTS

10. A decision taken now to accept the obligations to finance a scheme would be a most unusual one. It would amount to a formal and public political commitment to expenditure which would not begin for ten years. But for the reasons given I do not believe that we can leave a decision to take its normal place in the PES cycle. I propose that the scheme should be managed by the ODA and borne on the ODA's Overseas Superannuation Vote, which meets existing HMG commitments in this field. I could not defend publicly diversion of funds from the Aid Vote to a territory which does not qualify for aid. I hope that you can agree that the starting point for the PES negotiations for the years in question should include sums to cover the additional costs of the scheme.

11. I am sending copies of this minute to the Chief Secretary and to Chris Patten.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
24 November 1988

HONG KONG: GENERAL COMPENSATION SCHEME

1. The 1960 White Paper set out the main elements which should apply to general compensation schemes at times of constitutional / change. The relevant extract is attached. The key points are:

(a) When the Secretary of State's control passes to an executive Public Service Commission an overseas officer should be entitled to retire with compensation calculated on the basis of age, salary and length of service.

(b) Where officers are free to continue in service compensation should not be paid in a form which would constitute an inducement to retire early.

(c) The method adopted for the payment of compensation should only be decided upon after full discussion with the staff association concerned and in agreement with the local Government.

(d) An inducement should be provided to encourage individual officers to continue to serve as long as their services are required. This could be achieved by the payment of compensation by instalments where officers can continue to serve if they wish or by an additional payment to those who elect to stay.

1960 White Paper

17. The preceding paragraph describes some of the main aspects of existing compensation schemes, but the terms of future schemes must remain, as has been the case in the past, a matter to be settled between Her Majesty's Government and the Government of the territory concerned, after consultation with the local staff association and in the light of the circumstances prevailing in the territory. The time for this is normally when the Secretary of State's ultimate responsibility for the Service is transferred to local hands through the establishment of an executive Public Service Commission, but compensation may need to be paid earlier in individual cases for loss of office or premature retirement owing to constitutional change. It may need to be paid also to any local officer appointed by the Secretary of State or on his behalf who is able to show to the satisfaction of the Secretary of State that his career in the public service has been prejudiced by constitutional change, or that, because of such change, he has reasonable grounds for anxiety about his career. The problems to be solved vary from territory to territory and it would therefore not be proper, even if it were possible, to seek to anticipate the discussion of future schemes by prescribing their details in advance. Nevertheless, there are certain broad principles which in the opinion of Her Majesty's Government should be applied in any future compensation scheme in order to reflect the interests of both the officers and the Government concerned. Among those principles are the following:—

- (a) When the Secretary of State's control passes to an executive Public Service Commission, overseas officers should be entitled to retire with compensation calculated with actuarial advice and taking account of age, salary and length of service. Where officers are free to continue in service, it is undesirable that compensation should be paid in a form which would constitute an inducement to retire, as has been the case in some earlier schemes. The method adopted for the payment of compensation may well vary from territory to territory in accordance with local conditions, and would only be decided upon after full discussion with the staff association concerned and in agreement with the local Government;
- (b) Officers who are required to retire as a result of constitutional change are in any case entitled to the payment of compensation in one lump sum at the time of retirement, and the principles for arriving at the scale of compensation would result in a rate somewhat higher than that established for those who are free to continue to serve;
- (c) Whatever the circumstances in which an officer retires as a result of constitutional change, it would normally be desirable that salary changes made after the introduction of the compensation scheme but before the officer retires should be reflected in the sums payable;
- (d) Compensation schemes should also provide an inducement to individual officers to continue to serve so long as their services are required. This might be done by a variety of means, such as the payment of compensation by instalments where officers can continue to serve if they wish or an additional payment to those who elect to stay.

Procedure and cost

18. On the basis of the actual number of officers employed at the beginning of each year and taking account of contract renewals, promotions,

Phy

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Handwritten notes:
[unclear] & PS/CST
[unclear] 12/12

FROM: J C MAY
DATE: 9 December 1988

CHANCELLOR

cc: Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Anson
Mr Luce
Mr Mountfield
Mr Davis
Miss O'Mara
Mr Rayson
Miss Walker

Handwritten notes:
Do you want to reply - since
Foreign Sec. raised this with you personally
- at leave to EOI. Are you content
with the reply?
25 9/12

HONG KONG : GENERAL COMPENSATION SCHEME

(attached for you only)

The Foreign Secretary's minute of 24 November outlines the proposals he believes are necessary to compensate members of Her Majesty's Overseas Civil Service (HMOCS) serving in Hong Kong following the transfer of sovereignty to the Chinese in 1997, his views on how such compensation should be financed and the need to announce an acceptable compensation scheme soon. He ends by asking you to agree that whatever is the final cost of the scheme it should be treated, in effect, as an agreed bid in the PES round covering expenditure for 1997 and beyond.

Background

2. We have discussed this issue before at official level with ODA and are aware of the background.
3. The members of HMOCS in question are primarily members of the police force, with a further number on contract terms who have the option to transfer to HMOCS. The deadline for taking that option has been set for March 1989: this is the third such deadline.
4. The Foreign Secretary believes that a decision needs to be taken on compensation now in order to allow those with the option to transfer to do so in the knowledge of what is being offered. The proposed scheme would act as a positive inducement to members of HMOCS to stay on post 1997, thus providing stability following

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covering SECRET

the transfer of sovereignty while maintaining the morale of those remaining. This, the Foreign Secretary believes, will meet the commitment given to the Chinese to bring about a smooth transition in 1997.

5. A limited compensation scheme has already been introduced covering senior members of HMOCS who will lose their jobs when their posts are "localised" in the run up to 1997. The introduction of this scheme and the decline in the Hong Kong dollar - which has reduced the attractiveness of the salaries paid to those on contract terms has led to pressure by existing and potential members of HMOCS and their lobby to agree a general compensation scheme.

6. There are precedents for the introduction of such compensation schemes when colonies reach independence. The general principles were outlined in the 1960 White Paper which the Foreign Secretary mentions. It is worth noting however that Hong Kong was specifically excluded from these arrangements due to its unique position. Nonetheless, the notion that such schemes might be introduced to induce HMOCS members to stay on remains valid.

7. The cost of the proposed scheme is of the order of £10-20 million spread over ten years from 1997, or £1-2 million a year at current prices. The precise cost would depend on the number of people remaining in Hong Kong in 1997 and the duration of their stay thereafter. The Foreign Secretary believes it would be neither right nor feasible for the Hong Kong government to bear the costs of any such scheme, in part because it would be politically impossible to persuade the Hong Kong or successor government to pay. Under earlier schemes, HMG has met part of the costs due to the financial circumstances of the newly independent territories. Hong Kong's financial circumstances are very different so the arguments for HMG meeting the costs here are essentially political.

HMT Position

8. We cannot argue against the desirability of HMOCS members staying on in Hong Kong after 1997 to provide for continuity. What is more questionable is whether an inducement is required to that end and, if so, its size.

9. The relevant considerations here are:

- a) the staff concerned are not suffering a loss of job or career as such. The transfer of sovereignty provides for British and foreign nationals to continue to serve at all save the very highest levels of the public service after 1997;
- b) until recently the salaries paid to HMOCS staff could be considered a sufficient inducement to stay but their recent decline in sterling terms may make this more doubtful; a promise of compensation after 1997 may not answer this if salaries continue to decline relative to sterling;
- c) HMOCS members have expectations that a general compensation scheme will be introduced: this creates pressure. However, no commitment has been given;
- d) the type of scheme proposed falls well short of what its beneficiaries might expect, thus its introduction might serve equally to create dissatisfaction and resignations as much as an inducement to stay on. The proposals are certainly likely to lead to pressure for an improved scheme by the HMOCS pensions lobby.

(!) On balance, the arguments for the proposed scheme are unproven.

10. However, the Foreign Secretary is in a difficult position. If he offers nothing it will create an uproar. An offer along the lines of his current proposals is unlikely to satisfy everybody, nor can we be sure it would act as an inducement to stay on nor even that such inducement is necessary. The attitude of the Chinese, and any assurances they can give about future salaries,

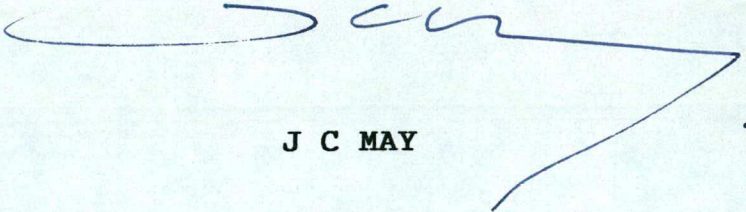
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covering SECRET

conditions and prospects must be equally important, and they should have at least an equal interest in maintaining stability post 1997. But the Foreign Secretary is in the best position to judge what if anything needs to be done and how far he should go. We are not well placed to give him much help with that judgement.

11. We would wish to see a solution which meets our obligations to HMOCS members and the diplomatic objectives and does so at minimum cost. If we were to offer at this stage to, in effect, pick up the bill at some future date, the Foreign Secretary and his officials are likely to err on the side of generosity in solving this problem. The details of the scheme have yet to be worked out and its full costs will not be known before 1997 at the earliest. In these circumstances, it would be unwise to agree to his request on the financing of his proposals. The costs of whatever agreement is reached should be a first claim on the Foreign Offices resources at the time they occur and should be dealt with under the normal PES procedures.

12. The Diplomatic Wing are leading the negotiations on this issue. ODA fear their own resources may eventually be used to meet the costs. It may be worth agreeing with the Foreign Secretary's view that funds should not be diverted from the aid programme for such purposes. (Hong Kong is not eligible for aid). This could help to stiffen the FCO's resolve in negotiations even if, in the end, the then Foreign Secretary will have to decide from where in his empire the funds should come.

13. The Foreign Secretary initially raised this topic with you at one of your recent meetings and I take it you will wish to reply even though it is primarily a public expenditure issue. I attach a draft reply which is sympathetic to the Foreign Secretary's position but offers no commitment as to how his proposals might be funded.



J C MAY

DRAFT REPLY TO THE FOREIGN SECRETARY**HONG KONG: GENERAL COMPENSATION SCHEME**

Thank you for your minute of 24 November outlining the measures you consider necessary to compensate members of Her Majesty's Overseas Service (HMOCS) following the transfer of sovereignty to the Chinese in 1997.

2. I recognise that it is desirable that sufficient numbers of HMOCS should stay on in Hong Kong after 1997 to ensure adequate continuity in public administration. But deciding whether a further inducement is necessary, and, if so, what form of inducement would be materially effective are clearly difficult matters of judgement. However I understand your reasons for believing that a general compensation scheme for expatriate officers should be drawn up and announced shortly, and that the scheme should be funded by HMG. I note that you expect it to cost between £10 and £20 million over the 10 years from 1997.

3. As you have acknowledged, the vote responsibility would naturally fall to the FCO/ODA. I think you are right to suggest that the costs should be borne on the ODA's Overseas Superannuation Vote, and that diversion of aid funds to a territory not qualifying for aid would not be defensible. But I do not think I can give any undertaking on the source of the funds so far in advance of requirement. If we commit ourselves to a financial obligation our successors will naturally recognise the

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force of that commitment. But I am sure that they will want to agree precisely how to meet it in PES terms in the light of the circumstances then prevailing.

4. I should be most grateful to be kept in touch with progress.
5. I am copying this to John Major and Chris Patten.

NIGEL LAWSON

SECRET**HONG KONG: GENERAL COMPENSATION SCHEME**

1. The 1960 White Paper set out the main elements which should apply to general compensation schemes at times of constitutional / change. The relevant extract is attached. The key points are:

(a) When the Secretary of State's control passes to an executive Public Service Commission an overseas officer should be entitled to retire with compensation calculated on the basis of age, salary and length of service.

(b) Where officers are free to continue in service compensation should not be paid in a form which would constitute an inducement to retire early.

(c) The method adopted for the payment of compensation should only be decided upon after full discussion with the staff association concerned and in agreement with the local Government.

(d) An inducement should be provided to encourage individual officers to continue to serve as long as their services are required. This could be achieved by the payment of compensation by instalments where officers can continue to serve if they wish or by an additional payment to those who elect to stay.

TO be attached to Foreign Secretary's minute of 24 November to CHEY

Action: Mr PGF Davis

CC: PS/CST, PS/EST

SIR P MIDDLETON

SIR G LITTLER

MR ANSON

MR LUCE

MR MOUNTFIELD

MR MAY

1960 White Paper

17. The preceding paragraph describes some of the main aspects of existing compensation schemes, but the terms of future schemes must remain, as has been the case in the past, a matter to be settled between Her Majesty's Government and the Government of the territory concerned, after consultation with the local staff association and in the light of the circumstances prevailing in the territory. The time for this is normally when the Secretary of State's ultimate responsibility for the Service is transferred to local hands through the establishment of an executive Public Service Commission, but compensation may need to be paid earlier in individual cases for loss of office or premature retirement owing to constitutional change. It may need to be paid also to any local officer appointed by the Secretary of State or on his behalf who is able to show to the satisfaction of the Secretary of State that his career in the public service has been prejudiced by constitutional change, or that, because of such change, he has reasonable grounds for anxiety about his career. The problems to be solved vary from territory to territory and it would therefore not be proper, even if it were possible, to seek to anticipate the discussion of future schemes by prescribing their details in advance. Nevertheless, there are certain broad principles which in the opinion of Her Majesty's Government should be applied in any future compensation scheme in order to reflect the interests of both the officers and the Government concerned. Among these principles are the following:—

- (a) When the Secretary of State's control passes to an executive Public Service Commission, overseas officers should be entitled to retire with compensation calculated with actuarial advice and taking account of age, salary and length of service. Where officers are free to continue in service, it is undesirable that compensation should be paid in a form which would constitute an inducement to retire, as has been the case in some earlier schemes. The method adopted for the payment of compensation may well vary from territory to territory in accordance with local conditions, and would only be decided upon after full discussion with the staff association concerned and in agreement with the local Government;
- (b) Officers who are required to retire as a result of constitutional change are in any case entitled to the payment of compensation in one lump sum at the time of retirement, and the principles for arriving at the scale of compensation would result in a rate somewhat higher than that established for those who are free to continue to serve;
- (c) Whatever the circumstances in which an officer retires as a result of constitutional change, it would normally be desirable that salary changes made after the introduction of the compensation scheme but before the officer retires should be reflected in the sums payable;
- (d) Compensation schemes should also provide an inducement to individual officers to continue to serve so long as their services are required. This might be done by a variety of means, such as the payment of compensation by instalments where officers can continue to serve if they wish or an additional payment to those who elect to stay.

Procedure and cost

18. On the basis of the actual number of officers employed at the beginning of each year and taking account of contract renewals, promotions,



FROM: A C S ALLAN

DATE: 12 December 1988

Handwritten initials, possibly 'AJ' or 'AV', in the top right corner.

PS/CHIEF SECRETARY

cc Mr J C May

HONG KONG: GENERAL COMPENSATION SCHEME

The Chancellor would be grateful if the Chief Secretary could deal with this issue, since it is primarily a public expenditure one.

A large, stylized handwritten signature of A C S Allan.

A C S ALLAN

CH/EXCHEQUER	
REC.	21 DEC 1988
ACTION	MR. Brook
COPIES TO	CST, FST SIR P. Middleton MR. Anderson, MR. Monck MR. Buzner, MR. S. Cade MR. Stevens
From the Private Secretary	



10 DOWNING STREET
LONDON SW1A 2AA

Handwritten notes:
+ (L) (U)
p/c (L) to (L) (U)
(in (L) of (L) (U)
concluded (L) (U)

20 December 1988

Dear Philip.

HONG KONG BUSINESSMEN

The Prime Minister and the Home Secretary had a further discussion this afternoon on the subject of settlement of businessmen from Hong Kong prepared to invest substantially in the United Kingdom.

The Prime Minister noted that the Home Secretary had already agreed to use his discretion to reduce the qualifying period for settlement in cases where someone was ready to invest £150,000 or more to three years. She thought that, in cases where significantly larger sums of investment were involved and the people concerned were able to contribute in a major way to Britain's interests and prosperity, the Home Secretary should be ready to reduce the qualifying period for settlement further still, for instance to two years.

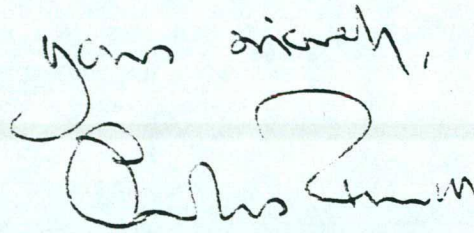
The Home Secretary recalled that the Immigration Rules required a period of four years' residence to qualify for settlement. He did not think it practicable to change the rules. But they did give him some flexibility and he would be ready to use that. The process of approaching people and encouraging them to seek settlement in the United Kingdom would have to be conducted very discreetly. If it was done too openly, it might be subject to challenge in the courts. Subject to this, he would be prepared to use his discretion in the way suggested by the Prime Minister including acceptance of a two-year qualifying period in special cases. But he would not wish to refer explicitly to the two-year option in print. It should not, therefore, be included in the written statement of the flexibility available to him, which was currently being revised, and could be handed to selected people in Hong Kong.

The Prime Minister was grateful for the Home Secretary's assurance. Taken with the other points already agreed and the regular reports on implementation requested in my letter of 19 December, she regards this as representing a satisfactory strengthening of our efforts to attract enterprise and investment from Hong Kong to this country.

Handwritten initials: AB

I am writing separately on the question of Vietnamese boat people.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office), Neil Thornton (Department of Trade and Industry), Alex Allan (Treasury) and Trevor Woolley (Cabinet Office).

Yours sincerely,


C. D. POWELL

Philip Mawer, Esq.
Home Office

FROM: K S WRIGHT
DATE: 21 DECEMBER 1988

1. MR REVOLTA ^{OR 21/2}
2. CHANCELLOR

cc: Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mrs Case
Mr Monck
Mr Burgner
Mr Stevens
Miss O'Mara

Agreed.

HONG KONG BUSINESSMEN

1. The Home Secretary wrote to the Prime Minister on 2 December in response to her concern that in the run up to 1997 Hong Kong's business, managerial and entrepreneurial talent is being attracted to countries such as Canada, Australia and the USA rather than to the UK. The Prime Minister had suggested, in particular, that consideration might be given to counting time spent in Hong Kong towards the residence qualification for British citizenship.

2. The Prime Minister has subsequently accepted that it would not be practical to amend existing legislation and that the Government must proceed by using the discretion which is vested in the Home Secretary within the existing law in such a way as to ensure that the individuals concerned will have no difficulty in fulfilling the requirements for settlement and eventually citizenship. The Home Secretary was asked to consider further a number of points which were aimed at establishing whether he could exercise greater discretion within the existing statutory framework and rules and his Private Secretary's letter of 16 December indicated that it would indeed be possible to grant settlement under the Immigration Rules after less than four years in appropriate cases.

Recommendation

3. In general, this approach is likely to be of net benefit to the UK economy, and the public expenditure costs would be negligible. The proposals seem acceptable from the Treasury point of view, and we see no need for you to contribute to the correspondence.

Background

4. The provision of the British Nationality Act (BNA) about the acquisition of citizenship are cast in terms of period of residence in the UK. Under existing Immigration Rules and Nationality legislation a hypothetical businessman investing £150,000 here, and creating at least two jobs, would experience no difficulty in obtaining entry clearance, which would allow him to enter and carry on his business in this country, and to come and go freely. When he entered, he would be admitted initially for a year, and could then expect to have his stay extended for a further three years, achieving settlement at the end of four years, assuming that his business activities in the UK continued. Thereafter he could retain settled status indefinitely; travelling outside the UK as much as he wished, provided he was not away for longer than two years at a time. He could, if he wished, apply for citizenship a year after being granted settlement. The BNA stipulates a total of five years' residence with no more than 450 days' absence, but the Home Secretary has discretion to accept longer absences and frequently does so.

5. The Government has to be careful about businessmen who only want the convenience of a British passport without living, paying tax or maintaining any long term investment in this country; but where a businessman is genuinely based here the Home Secretary often allows as much as two years' absence in the five year period. Where the facts of the case justified it, and did not call into question of the genuineness of residence, he could allow even more. Where the residence criterion is satisfied, a British Dependent Territories citizen (which category includes the great majority of those concerned) is entitled to British citizenship.

6. Results of enquiries about residence qualification for citizenship in other countries revealed that the UK's arrangements are not unattractive in comparison and it is believed that some businessmen who have contacted members of the Government may simply have been exerting deliberate and quite understandable

pressure to get the UK to relax its practice even more in their favour or to change the law. Nonetheless, the Home Secretary recognises that there is considerable confusion and misunderstanding in Hong Kong about immigration and nationality requirements and in particular the extent to which he has discretion and that it would be right to make the position better understood, both in Hong Kong and this country.

K S Wright

K S WRIGHT



21/12/88
Mr Wright

MR BROOK
EST. EST
SIR P MIDDLETON
MR ANDERSON
MR MOWLER
MR BURTON
MRS CASE
MR J STEWART

PRIME MINISTER

HONG KONG BUSINESSMEN

You told me, on 10 November, about your concern that in the run up to 1997 Hong Kong's business, managerial and entrepreneurial talent is being attracted to countries such as Canada, Australia and the USA rather than to this country. You suggested, in particular, that we might consider counting time spent in Hong Kong towards the residence qualification for British citizenship.

2. The present law would not allow us to do that. The provisions of the British Nationality Act (BNA) about the acquisition of citizenship are cast in terms of periods of residence in the United Kingdom. It would be rash to try to amend legislation which, even if it could be confined to Hong Kong, would re-open much of the argument about the citizenship provisions of the agreement between ourselves and the Chinese which were embodied in the Hong Kong Act. We should, for example, be pressed hard again about the position of persons of Indian descent now living in Hong Kong.

3. But we can use, and make more widely known, the flexibility which is already available within the existing law. Without running the risk of being seen publicly to encourage emigration from Hong Kong (which would be damaging to confidence in the Colony) there is a considerable amount within the existing Immigration Rules and nationality legislation which we can do to help. The following paragraphs show how.

4. A hypothetical businessman investing £150,000 here, and creating at least two jobs, would experience no difficulty in obtaining entry clearance, which would allow him to enter and carry on his business in this country, and to come and go freely. (Those figures are likely to be revised upwards, but not to an extent which would be significant for the kind of businessman we have in mind.) When he entered, he would be admitted initially for a year, and could expect then to have his stay extended for a further three years, achieving settlement at the end of four years, assuming that his business activities here continued. Thereafter he could retain settled status indefinitely; travelling outside the United Kingdom as much as he wished, provided he was not away for longer than two years at a time. The same would apply, throughout the period, to his wife and minor children who could come and go as they pleased, together or separately.

5. He could, if he wished, apply for citizenship a year after being granted settlement. The BNA stipulates a total of five years' residence with no more than 450 days' absence, but I have discretion to accept longer absences and I frequently do so. We have to be careful about businessmen who want only the convenience of a British passport without living, paying tax or maintaining any long term investment in this country; but where a businessman is genuinely based here I often allow as much as two years' absence in the five year period. Where the facts of the case justified it, and did not call in question the genuineness of his residence, I could allow even more. Where the residence criterion is satisfied, a British Dependent Territories citizen (which category includes the great majority of those concerned) is entitled to British citizenship.

6. In short, many businessmen are content to come and go as business visitors without bothering to seek settled status. Those who have established themselves in business here find no difficulty in achieving settled status, which gives them security with maximum flexibility as to travel and they can apply for citizenship on the basis described above.

7. We have made some enquiries about the practice in other countries. The results are set out in the Annex to this minute and I believe our arrangements are not unattractive in comparison. Some of those who have tackled you (and me and other colleagues) on this subject may simply have been exerting deliberate and quite understandable pressure to get us to relax our practice even more in their favour or to change the law.

8. All that said, I recognise that there is considerable confusion and misunderstanding in Hong Kong about our immigration and nationality requirements and in particular the extent to which I have discretion in dealing with individual cases. Certainly Algy Cluff (with whom you are corresponding about his proposal to set up a Trust to promote two-way investment between the United Kingdom and Hong Kong) expressed this view when I explained the position to him.

9. Because nationality law is complex any description of its provisions framed in general terms sounds somewhat daunting. But specific advice related to the circumstances of a particular individual or family would often show it to be much less so. I therefore propose that we should seek to get across a more accurate, and a more favourable, understanding of our law in the following ways:

- (i) Ministers' Private Offices (especially in DTI and FCO) and senior officials in those Departments should be enabled to contact a senior member of the Nationality Division of my Department, who would be in a position to offer speedy and authoritative advice on the position of a particular individual who might, for example, be complaining that "the Canadians do it so much better";
- (ii) we shall provide briefing material, and the same point of contact, to the Hong Kong Trade Commission and any other contacts from whom

more general enquiries are received. My officials are in touch with those concerned in the DTI and the FCO to arrange for this to be done. Such briefing will be kept up to date, relying on the FCO and our own immigration contacts to warn of changes in procedures in competing countries.

10. I hope you and colleagues will agree that this is the best way to proceed.

I am sending a copy of this minute to the Chancellor of the Exchequer, the Foreign and Commonwealth Secretary, the Secretary of State for Trade and Industry and to Sir Robin Butler.

*N. J. Sanderson
(approved by the Home Secretary and signed in his absence)*

2 December 1988

OTHER COUNTRIES

We have concentrated our enquiries on the USA, Canada and Australia (which, we understand, would often be the first choice for many Hong Kong businessmen and investors for economic reasons).

2. We understand that investment and residence in the USA gives a businessman no avenue to citizenship however long his residence. Australia appears to be more in line with us in requiring three years' residence before application for citizenship, followed by a further two years' residence. The Australians recognise, as we do, that businessmen may have to travel abroad and the two year period need not be continuous. Periods of residence can be aggregated to make up the two years. In addition, businessmen are expected to meet requirements relating to good character and commitment to Australia. They need an initial investment of half a million Australian dollars, a proven track record and sufficient funds to cover settlement costs.

3. Canada appears to have one important difference compared with us (and others). It is still a country of immigration, and the normal terms of entry are to receive landed immigrant status on arrival. This is nearly equivalent to what we call settlement, but the fact that it is available immediately means that the person concerned can immediately resume residence in Hong Kong. The financial requirements for initial entry are stiffer than ours, and the qualifications for citizenship appear no more favourable than ours. Landed immigrant status is available to certain categories of self-employed (in the arts, sport or consultancy fields), to entrepreneurs (who must employ at least one Canadian and have been able to generate \$500,000 by their own efforts) and to investors (in the areas of tourism, high technology and development). They too need to show that they can generate \$500,000 of income and are required, in addition, to invest a sum in the region of \$250,000 for three years. These practices vary from province to province, with Quebec asking for a \$500,000 investment for five years.

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Thereafter the immigrant must have three years' residence in a five year period and must apply to a Court of Citizenship if he wishes to become Canadian. The Court expects, among other things, a knowledge of the official languages of Canada and evidence of the immigrant's commitment to the country. There is a right of appeal against refusal but apparently no flexibility or scope for discretion in applying the criteria.



FROM: J M G TAYLOR
DATE: 3 January 1989

A handwritten signature in dark ink, appearing to be "JMG".

MR K S WRIGHT

cc PS/Chief Secretary
PS/Financial Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Burgner
Mrs Case
Mr Revolta
Mr Stevens
Miss O'Mara

HONG KONG BUSINESSMEN

The Chancellor has seen your minute of 21 December. He agrees that there is no need to contribute to the correspondence.

A handwritten signature in dark ink, appearing to be "JMG".

J M G TAYLOR