

PO-CH/NL/0268
PART A

Part A

SECRET

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Begins: 1/4/87.
Ends: 12/12/88.



PO -CH /NL/0268



PART A

Chancellor's (Lawson) Papers:

HONG KONG AND CHINESE
TALKS ON FINANCIAL
MATTERS

on Financial Matters

Disposal Directions: 25 Years

11/10/95.

9270/NL/0268

PO -CH

PART A

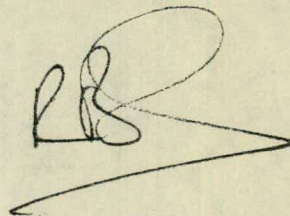
From: R B SAUNDERS

Date: 1 April 1987

MR C KELLY

cc PPS
Sir G Littler*BF reset
REM
material*HONG KONG: DIALOGUE ON FINANCIAL MATTERS

Sir Peter Middleton has seen the telegrams from the acting Governor of Hong Kong. He has commented that this all fits very oddly with the desire to do nothing to change the role and domicile of HKSB.



R B SAUNDERS
Private Secretary

psm

2-20 9.1.18
24

2-20 9.1.18

GRS 400

Rules

SECRET
DEYOU/DEVIL
FM HONG KONG
TO DESKBY 301200Z FCO
TELNO 1276
OF 301035Z MARCH 87
INFO PRIORITY PEKING

PEKING : STRICTLY PERSONAL FOR AMBASSADOR

FOLLOWING STRICTLY PERSONAL.

~~BOUKEBRESOBEK~~ FOR HUM, HONG KONG DEPARTMENT FROM
ACTING GOVERNOR

YOUR TELNO 902 : DIALOGUE ON FINANCIAL MATTERS

1. WHILST NOTING THAT WE MAY EXPECT TO HEAR SHORTLY WHETHER JACOBS AND NENDICK MAY STILL VISIT PEKING NOTWITHSTANDING LIU'S COMMITMENTS, YOU SHOULD BE AWARE OF TWO FURTHER DEVELOPMENTS WHICH STRESS THE IMPORTANCE OF INITIATING A DIALOGUE WITH THE PEOPLE'S BANK AS SOON AS POSSIBLE.

2. THE FIRST IS A DISCUSSION WHICH JOSEPH YAM, DEPUTY SECRETARY FOR MONETARY AFFAIRS, HAD RECENTLY WITH TWO OFFICIALS FROM CITIC. MIFT CONTAINS A NOTE FOR RECORD OF THIS MEETING. THE SECOND IS A CONVERSATION WHICH NENDICK HAD LAST FRIDAY 28 MARCH WITH THE CURRENT CHAIRMAN OF THE HONG KONG ASSOCIATION OF BANKS (MACKENZIE, AREA MANAGER, STANDARD CHARTERED BANK). IN THE COURSE OF HIS USUAL WEEKLY VISIT TO DISCUSS INTEREST RATES, MACKENZIE MENTIONED THE RESENTMENT BUILDING UP IN THE BANKING SYSTEM AT THE BEHAVIOUR OF HKSB IN RESPECT OF TWO RECENT HEAVILY OVER-SUBSCRIBED SHARE ISSUES. HE CLAIMED HKSB HAD TAKEN ADVANTAGE OF ITS DUAL ROLE OF RECEIVING BANK FOR THE PROCEEDS OF THE SHARE ISSUES AND SETTLEMENT BANK FOR THE LOCAL CLEARING.

/3. HE THEN

SECRET

3. HE THEN WENT ON TO SAY THAT ON RECENT VISITS TO PEKING HE HAD BEEN MADE AWARE OF THE STRONG DISSATISFACTION OF THE AUTHORITIES THERE AT THE DOMINANT POSITION IN HONG KONG OF HKSB (FUELLED, HE BELIEVED, BY FRUSTRATIONS EXPRESSED BY THE BANK OF CHINA WHO IS SEEKING TO BUILD UP ITS BUSINESS HERE). HE SAID THAT IT APPEARED TO BE THE PREVALENT VIEW IN PEKING THAT HKSB WAS ABUSING ITS POSITION AS THE CLEARING BANK IN COLLABORATION WITH THE HONG KONG GOVERNMENT. HE ADDED THAT HE HAD DONE HIS BEST TO DEFUSE THE SITUATION BOTH LOCALLY AND IN PEKING BUT FELT THAT VIEWS WERE BECOMING UNHEALTHILY POLARISED. EXTRAVAGANT COMMENTS ON THE SUBJECT WERE CIRCULATING AT HIGH LEVELS IN THE PEOPLE'S BANK AND THE HONG KONG AND MACAU OFFICE.

4. WE MUST, OF COURSE, TREAT WITH SOME RESERVE COMMENTS COMING FROM A NOT DISINTERESTED PARTY (STANDARD CHARTERED CANNOT BE ENVIDIOUS OF HKSB'S DOMINANT POSITION HERE) BUT WE DO NOT BELIEVE THEY ARE WITHOUT SUBSTANCE. THEY ECHO WHAT DAVID LI HAS BEEN SAYING FOR SOME TIME IN PUBLIC AND IN PRIVATE. THE SOONER THEREFORE WE CAN ESTABLISH A DIALOGUE ON THE RIGHT LINES THE BETTER AS THERE CLEARLY MUST BE A DANGER THAT PEKING MAY LOSE PATIENCE AND START TAKING SOME INITIATIVES THEMSELVES.

5. SEEN FROM HERE, IN THE LIGHT OF PARA 6 OF YOUR TELNO 902, SOME CLARIFICATION SHOULD BE SOUGHT SOON OF THE POSITION BY THE AMBASSADOR.

AKERS-JONES

YYYY

HMLNAN 0849

LIMITED.

HO HKD.

HO. FED.

MR. GILLMORE.

PS.

PS/PUS

PS/MR. RENTON

COPIES TO:

MR. A. LOEHNIS, BANK OF ENGLAND

C.W. KELLY, H.M. TREASURY.

-2-
SECRET - DEYOU/DEVIL-

SECRET

SECRET
DEYOU/DEVIL
FM HONG KONG
TO DESKBY 301200Z FCO
TELNO 1277
OF 301035Z MARCH 87
INFO PRIORITY PEKING

PEKING : STRICTLY PERSONAL FOR AMBASSADOR
FOLLOWING STRICTLY PERSONAL FOR HUM, HONG KONG DEPARTMENT FROM
ACTING GOVERNOR

MIPT : DIALOGUE ON FINANCIAL MATTERS

1. THE FOLLOWING IS THE RECORD OF THE MEETING OF MR JOSEPH YAM WITH TWO OFFICIALS FROM CITIC:
2. QUOTE I WAS INVITED TO DINNER ON 24 MARCH BY A CONTACT MR CHOW ON-KUI WHO IS INVOLVED IN A JOINT VENTURE WITH THE PRC TO MEET TWO FRIENDS FROM CHINA.
3. THE TWO GENTLEMEN FROM CHINA WERE IN THEIR LATE THIRTIES AND EARLY FORTIES. ONE MUTTERED A NAME WHICH I CANNOT RECALL NOR CHECK. THE OTHER WAS A MR LI XIANG-LU, VICE PRESIDENT OF CHINA INTERNATIONAL ECONOMIC CONSULTANTS, INC. ACCORDING TO CHOW, LI HAD RECENTLY WORKED FOR FOUR YEARS AS PRIVATE SECRETARY TO ZHAO ZI-YANG. BOTH ARE NOW WITH CITIC.
4. BOTH SHOWED A KEEN INTEREST ON ECONOMIC, FINANCIAL AND MONETARY AFFAIRS OF HONG KONG. IT WAS OBVIOUS, HOWEVER, THAT THEIR TARGET SUBJECTS WERE THE HONG KONG GOVERNMENT'S RELATIONSHIP WITH HKSB, THE BANK'S LONGER TERM INTENTIONS AND HONG KONG'S MONETARY SYSTEM. THEY WERE TECHNICALLY VERY COMPETENT AND VERY FAMILIAR WITH HOW OUR SYSTEM OPERATED HERE. THEY APPRECIATED FOR EXAMPLE WHY THE HONG KONG DOLLAR'S LINK TO THE US DOLLAR WAS IMPORTANT TO HONG KONG AND WHAT WOULD BECOME OF HONG KONG IN THE ABSENCE OF THE LINK. THEY APPRECIATED THAT THERE WAS A LACK OF MONETARY POLICY DURING 1972 TO 1983 AND THE FACT THAT WE EFFECTIVELY HAD A SYSTEM WHERE THE MONETARY VARIABLES WERE INDETERMINATE.

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SECRET - DEYOU/DEVIL

/S. SENSING

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5. SENSING THAT THEY WOULD PROBABLY ASK ME SENSITIVE QUESTIONS THAT I DID NOT HAVE AN OFFICIAL ANSWER TO, I ADOPTED PRE-EMPTIVE TACTICS BY ASKING THEM AS TO WHAT IN THEIR OPINION WERE THE MAJOR AREAS THAT WE SHOULD DEVOTE OUR ATTENTION TO IN THE COMING YEARS IN THE MONETARY AFFAIRS FIELD. THEY EVADED MY QUESTION BUT OFFERED SOME INTERESTING OBSERVATIONS. FIRST WAS THAT HKSMB WOULD MOST PROBABLY BE REDUCING THEIR DEPENDENCE ON THEIR OPERATIONS IN HONG KONG THROUGH THE ESTABLISHMENT OF Footholds ELSEWHERE. SECOND WAS THAT BECAUSE OF THEIR SPECIAL POSITION, HKSMB COULD DO A LOT BEHIND OUR BACKS TO THEIR OWN BENEFIT. (THEY WERE NOT ABLE TO GIVE EXAMPLES BUT MENTIONED THE POSSIBILITY OF IMPRUDENT ISSUING OF BANK NOTES). THIRD WAS THAT HKSMB COULD, NO MATTER HOW UNLIKELY, DECIDE SUDDENLY TO RETREAT FROM AND CAUSE CHAOS TO HONG KONG. (IN THIS CONNECTION, THEY FELT THAT THE BRITISH GOVERNMENT MIGHT, AS IN 1945 (1941?), EVEN ENCOURAGE THIS SHOULD CONDITIONS DETERIORATE NEARER TO 1997.) FOURTH WAS THAT THE LINKED EXCHANGE RATE SYSTEM WAS NOT INFALLIBLE.

6. I WAS THEN ASKED TO COMMENT ON THESE OBSERVATIONS. IN RESPONSE, I MADE THE GENERAL COMMENTS THAT ANYTHING WAS POSSIBLE AND THAT ONE SHOULD IDEALLY PUT ONESELF IN A POSITION TO DEAL WITH THESE IMPORTANT MATTERS AND PERHAPS BE PREPARED FOR THE WORST. I EMPHASISED TO THEM THAT HKSMB WAS VERY MUCH A PRIVATE INSTITUTION AND THAT THE PROFIT MOTIVE WAS IN MY OPINION THE MOST IMPORTANT DETERMINANT OF THEIR FUTURE INTENTIONS. I EXPLAINED TO THEM THE ACTUAL MECHANICS OF THE NOTE ISSUE, THE MONETARY AND ECONOMIC EFFECTS OF CHANGES IN THE AMOUNT OF NOTES IN CIRCULATION, AND THE FACT THAT HKSMB HAD NOTHING TANGIBLE TO GAIN BY BEING IMPRUDENT IN THEIR NOTE-ISSUE OPERATION. I ALSO EXPRESSED DISBELIEF THAT THERE WAS ANY CONSPIRACY BETWEEN THE BRITISH OR HONG KONG GOVERNMENT AND HKSMB TO PROTECT BRITISH INTERESTS AND EXPLOIT HONG KONG INTERESTS.

7. THEY ALSO ASKED WHETHER IT WOULD BE APPROPRIATE FOR THE BANK OF CHINA TO BECOME A NOTE ISSUER. I SAID THAT ONE WOULD HAVE TO CONSIDER VERY CAREFULLY HOW FINANCIAL MARKETS AND FINANCIAL INSTITUTIONS WOULD REACT TO THIS AND WHETHER THERE WAS A NEED FOR AN ADDITIONAL ISSUER.

8. ALSO DISCUSSED, ALBEIT RELATIVELY BRIEFLY, WERE INDUSTRIAL DEVELOPMENT, BUDGETARY STRATEGY, TAXATION POLICY, WELFARE 'MOVEMENT' AND MORALE OF THE YOUNGER CIVIL SERVANTS. UNQUOTE.

AKERS-JONES
HMLNRN 0850

LIMITED.
HO HKD.
HO FED.
MR GILLMORE.

PS.
PS/PUS
PS/MR RENTON

COPIES TO:

MR. A. LOEHNIS, BANK OF EN
C.W. KELLY, H. M. TREASURY.

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SECRET DEYOU/DEVIL SECRET

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FM FCOLN TO HOKON
281200Z MAR
GRS 540

HK

a Sir Galloway Letter
Self

Sir Peter Middleton
You make the two. Highest sign of
progress if para 8 is to be taken.

Cur
30.7

SECRET
DEYOU/DEVIL
FM FCO
TO IMMEDIATE HONG KONG
TELNO 902
OF 281200Z MARCH 87
INFO IMMEDIATE PEKING

FOLLOWING STRICTLY PERSONAL FOR ACTING GOVERNOR FROM HUM HKD
PEKING STRICTLY PERSONAL FOR AMBASSADOR
MEETING BETWEEN THE SECRETARY OF STATE AND THE CHINESE FOREIGN
MINISTER BERNE. 27 MARCH

HONG KONG DIALOGUE ON FINANCIAL MATTERS

1. THE SECRETARY OF STATE SAID IT WAS VERY IMPORTANT TO ESTABLISH A CHANNEL OF COMMUNICATION OF HIGH EXPERTISE AND GREAT SECRECY TO DEAL WITH FINANCIAL QUESTIONS. BOTH GOVERNMENTS WERE CONSCIOUS OF THE IMPORTANCE OF HONG KONG AS A FINANCIAL CENTRE AND THE SENSITIVITY OF FINANCIAL MARKETS TO ALL FACTORS WITH A BEARING ON ECONOMIC CONFIDENCE.
2. WE HAD SUGGESTED THAT THIS DIALOGUE MIGHT BE OPENED BETWEEN THE FINANCIAL SECRETARY OF HONG KONG AND THE FIRST DEPUTY CHAIRMAN OF THE PEOPLES BANK OF CHINA. VICE MINISTER ZHOU NAN HAD TOLD SIR R EVANS THAT THIS WOULD BE WELCOME. WE HOPED THE VISIT COULD TAKE PLACE VERY SOON. JACOBS COULD VISIT PEKING IN THE LAST PART OF APRIL, BUT WOULD HAVE OTHER COMMITMENTS IN MAY.
3. IN OUR VIEW THERE WAS A NEED TO PROMOTE A COMMON UNDERSTANDING BETWEEN THE BRITISH AND CHINESE GOVERNMENTS OF THE COMPONENTS MAKING UP HONG KONG'S FINANCIAL SUCCESS AND VITALITY.

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SECRET DEYOU/DEVIL SECRET

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THE QUESTION WAS HOW HONG KONG COULD ADAPT TO A VERY FAST MOVING FINANCIAL WORLD WITHIN THE CONTEXT OF CHANGE TAKING PLACE UNDER THE JOINT DECLARATION. HE ENVISAGED THAT DISCUSSION MIGHT COVER SUCH AREAS AS THE WORKING OF THE PRESENT FINANCIAL AND MONETARY SYSTEMS IN HONG KONG, THEIR POSSIBLE EVOLUTION AND THE ROLE PLAYED IN THAT CONNECTION BY THE VARIOUS BANKS IN HONG KONG.

4. THE SECRETARY OF STATE EMPHASISED THAT THIS WAS A VERY DELICATE AND MARKET-SENSITIVE MATTER. IT NEEDED TO BE HANDLED SEPARATELY FROM THE JLG OR ITS SUB-GROUPS, ON A PRIVATE CHANNEL BETWEEN FINANCIAL AUTHORITIES. THE NUMBER OF PEOPLE IN LONDON AND HONG KONG WHO KNEW OF OUR PROPOSAL WAS VERY RESTRICTED INDEED.

5. WU SAID THAT HE WELCOMED THIS POSITIVE PROPOSAL. HE AGREED THAT FINANCIAL AND ECONOMIC ISSUES, INCLUDING MONETARY ISSUES RAISED IMPORTANT AND SENSITIVE QUESTIONS. HE AGREED THAT A CHANNEL FOR DISCUSSION SHOULD BE ESTABLISHED AS EARLY AS POSSIBLE TO ENABLE OFFICIALS WITH AUTHORITY AND EXPERTISE TO DISCUSS THESE MATTERS. HE AGREED THAT THE DIALOGUE SHOULD REMAIN HIGHLY CONFIDENTIAL. THE CHINESE SIDE WERE CONSIDERING WHO BEST SHOULD BE DESIGNATED TO PARTICIPATE IN THE DIALOGUE

6. AS FOR THE VISIT BY THE FINANCIAL SECRETARY, THE INVITATION FROM THE FIRST DEPUTY CHAIRMAN OF THE PEOPLE'S BANK STILL STOOD. HOWEVER LIU WAS FULLY ENGAGED IN THE FIRST HALF OF THE YEAR. AS SOON AS A DECISION HAD BEEN REACHED ON THE APPROPRIATE INDIVIDUALS TO UNDERTAKE THE DIALOGUE, THE BRITISH SIDE WOULD BE NOTIFIED.

7. THE SECRETARY OF STATE SAID THE SOONER CONTACT WAS ESTABLISHED THE BETTER, JUST IN CASE SOMETHING WENT WRONG IN THE FINANCIAL WORLD. WU SAID HE SHARED THAT VIEW.

8. COMMENT. WU DID NOT EXPRESS HIMSELF VERY CLEARLY. WE BELIEVE HE INTENDED TO SAY THAT BECAUSE LIU HONGRU WOULD NOT BE AVAILABLE FOR SOME TIME, ANOTHER OFFICIAL WOULD ACT AS JACOBS HOST IN THE FIRST INSTANCE SO THAT THE DIALOGUE COULD GET UNDERWAY WITHOUT UNDUE DELAY.

HOWE

OCMIAN 4975

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PS

PS/MR RENTON

PS/PUS

MR GILLMORE

COPIES TO:

MR. A. LOEHNIS, BANK OF ENGLAND

MR. C. KELLY, H.M.T.

-2-

SECRET - DEYOU/DEVIL -

SECRET AND PERSONAL

Prup

FROM: C W KELLY

DATE: 27 April 1987

Chancellor,
✓
SIR PETER MIDDLETON*Not essential reading,
but you might like
to see that the
new Governor is
pushing ahead on this one*cc Sir G Littler
Mrs Lomax

HONG KONG : DIALOGUE WITH ON FINANCIAL MATTERS WITH THE CHINESE

You may like to have a sight of the draft steering brief and speaking notes prepared in consultation with the Bank and myself for Piers Jacobs visit to Beijing.

2. These have now gone to the Foreign Secretary for his approval. But I doubt that you will want to bother the Chancellor with them?

CWK

C W KELLY

encS

13.

GRS 160

Secret

SECRET
DEYOU/DEVIL
FM HONG KONG
TO DESKBY 241430Z FCO
TELNO 1600
OF 241040Z APRIL 87
INFO PRIORITY PEKING

STRICTLY PERSONAL FOR HUM, HONG KONG DEPARTMENT FROM GOVERNOR
PEKING: STRICTLY PERSONAL FOR AMBASSADOR

MY TELNO 1535 : DIALOGUE ON FINANCIAL MATTERS

1. MY FOUR IFTS CONTAIN:
 - (A) A DRAFT STEERING BRIEF SEMICOLON
 - (B) A REVISED DRAFT OF THE SPEAKING NOTE ON THE OFFICIAL MONETARY ROLE IN HONG KONG, WHICH TAKES INTO ACCOUNT THE COMMENTS IN YOUR TELNO 1110 SEMICOLON
 - (C) A REVISED SPEAKING NOTE ON THE FUTURE OF HONG KONG'S MONETARY SYSTEM, WHICH TAKES INTO ACCOUNT THE COMMENTS IN YOUR TELNO 1111 SEMICOLON
 - (D) A REVISED SPEAKING NOTE ON BANKING SUPERVISION, WHICH TAKES INTO ACCOUNT THE COMMENTS IN YOUR TELNO 1112.

2. YOU WILL SEE FROM THE LAST PARAGRAPH OF THE STEERING BRIEF WE THINK IT WOULD BE WORTH MAKING A POINT ABOUT THE WORK OF THE BASIC LAW DRAFTING COMMITTEE. ANOTHER SPEAKING NOTE IS BEING PREPARED ON THIS AND A DRAFT WILL BE SENT TO YOU ON 27 APRIL.

WILSON

YYYY

HMLNAN 1954

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PS/MR RENTON
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MR MCLAREN

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FM HONG KONG
TO DESKBY 241430Z FCO
TELNO 1601
OF 241040Z APRIL 87
INFO PRIORITY PEKING

STRICTLY PERSONAL FOR HUM, HONG KONG DEPARTMENT FROM GOVERNOR
PEKING: STRICTLY PERSONAL FOR AMBASSADOR

MIPT : DIALOGUE ON FINANCIAL MATTERS

1. DRAFT TEXT OF STEERING BRIEF IS AS FOLLOWS:

BEGINS

STEERING BRIEF FOR TALKS IN CHINA

1. THERE ARE IMPORTANT ISSUES TO BE CONSIDERED WITH THE CHINESE AUTHORITIES, IF STABILITY OF THE FINANCIAL AND MONETARY SYSTEM OF HONG KONG IS TO BE EFFECTIVELY MAINTAINED IN THE YEARS RUNNING UP TO 1997 AND BEYOND.
2. THESE ARE HIGHLY SENSITIVE ISSUES WHICH HAVE LONG TERM IMPLICATIONS FOR HONG KONG. THERE IS, THEREFORE, A NEED TO ESTABLISH A CONTINUOUS, CONFIDENTIAL DIALOGUE WITH THE CHINESE AUTHORITIES TO CONSIDER THESE ISSUES AND AGREE ON HOW THEY ARE TO BE DEALT WITH, OUTSIDE THE SCOPE OF THE JOINT LIAISON GROUP. THE VISIT WILL BE THE FIRST STEP OF AN ATTEMPT TO BUILD UP A RELATIONSHIP WHEREBY SENSITIVE MONETARY ISSUES CAN BE DISCUSSED WITH TRUST.
3. IT IS NOT THE INTENTION OF THE PRESENT VISIT TO IDENTIFY AND DISCUSS SPECIFIC ISSUES, BUT IT WILL BE USEFUL TO GIVE THE CHINESE SIDE A FLAVOUR OF WHICH ASPECTS OF THE PRESENT INSTITUTIONAL FRAMEWORK OF HONG KONG'S MONETARY SYSTEM ARE POTENTIALLY UNSTABLE.
4. THE SPEAKING NOTE ON 'THE FUTURE OF HONG KONG'S MONETARY SYSTEM' WHICH SHOULD UNDERLINE NEXT WORD NOT BE HANDED OVER, ADDRESSES THIS ISSUE.
5. THERE IS A DANGER THAT THE CHINESE AUTHORITIES MAY MISUNDERSTAND THE PRESENT INTENTION AS A PLAN TO ENABLE HKSB TO RETREAT FROM HONG KONG GIVEN THERE IS STILL THE MISCONCEIVED FEELING AMONGST SOME CHINESE OFFICIALS THAT THE HONG KONG GOVERNMENT COLLABORATES WITH HKSB TO THE BENEFIT OF BRITISH INTERESTS. WHILST THIS MATTER SHOULD NOT BE RAISED, EVERY OPPORTUNITY SHOULD BE TAKEN TO EXPLAIN THE REAL NATURE OF THE PRESENT RELATIONSHIP BETWEEN THE HKG AND HKSB.

Secret

6. IT IS NOT CLEAR WHETHER THE INTERLOCUTORS ON THE CHINESE SIDE ARE SUFFICIENTLY FAMILIAR WITH HONG KONG'S MONETARY SYSTEM TO APPRECIATE AND RESPOND TO THE VARIOUS POINTS TO BE MADE.
7. IT WILL BE USEFUL, THEREFORE, TO START THE TALKS, OR SUPPLEMENT THEM, WITH A SESSION ON THE RELEVANT FACTS CONCERNING THE NORMAL CENTRAL BANKING FUNCTIONS CARRIED OUT IN DEVELOPED CAPITALIST ECONOMIES AND HOW SIMILAR FUNCTIONS ARE CURRENTLY CARRIED OUT IN HONG KONG. THE SPEAKING NOTE ON 'THE OFFICIAL MONETARY ROLE IN HONG KONG' IS TO SERVE THIS PURPOSE. THE NOTE SHOULD BE LEFT WITH THE CHINESE SIDE FOR PERUSAL.
8. IT IS INTENDED THAT THE OPPORTUNITY BE TAKEN ALSO TO ESTABLISH CONTACTS WITH THE BANKING SUPERVISORY AUTHORITY IN CHINA IN VIEW OF THE GROWING IMPORTANCE OF CHINESE INTEREST IN HONG KONG BANKING. THE SPEAKING NOTE ON 'BANKING SUPERVISION' IS TO SERVE THIS PURPOSE. THE NOTE SHOULD ALSO BE LEFT WITH THE CHINESE SIDE FOR PERUSAL. IT IS THE PEOPLE'S BANK OF CHINA, RATHER THAN THE BANK OF CHINA WHICH IS RESPONSIBLE FOR BANKING SUPERVISION SO IT MAY BE MORE APPROPRIATE TO PASS THE NOTE DIRECTLY TO THE PEOPLE'S BANK IF, AS HOPED, A VISIT TO THAT BANK IS ON THE PROGRAMME.
9. IT WILL BE NECESSARY TO WORK OUT WITH THE CHINESE AUTHORITIES HOW BEST THE DIALOGUE CAN BE CONTINUED. AS IT WILL BE IMPRACTICABLE TO INVOLVE THE FINANCIAL SECRETARY AND LU PING IN DISCUSSIONS ON A CONTINUOUS BASIS, IT SEEMS BEST IF THE CHINESE COULD AGREE TO THE SETTING UP OF A CONFIDENTIAL LIAISON GROUP ON MONETARY MATTERS CONSISTING OF FAIRLY SENIOR AND TECHNICALLY COMPETENT PEOPLE FROM HONG KONG AND CHINA RESPONSIBLE FOR SUCH MATTERS. (NO PUBLICITY WOULD BE GIVEN TO THE FORMATION OF THE GROUP OR TO ITS DELIBERATIONS - BUT THOUGHT WILL NEED TO BE GIVEN AS TO HOW VISITS HERE BY CHINESE OFFICIALS ARE PRESENTED TO THE PUBLIC IF QUESTIONS ARE ASKED.)
10. THE CONFIDENTIAL LIAISON GROUP ON MONETARY MATTERS SHOULD BE AN ORGAN FOR LIAISON. DECISIONS ON FINANCIAL AND MONETARY POLICIES ARE FOR THE HONG KONG GOVERNMENT (OR THE HONG KONG SPECIAL ADMINISTRATIVE REGION GOVERNMENT AFTER 1997, AS PROVIDED FOR IN THE JOINT DECLARATION). LIAISON IS VERY IMPORTANT TO ENSURE NECESSARY CHANGES CAN BE IMPLEMENTED WITH THE FULL KNOWLEDGE OF THE RELEVANT AUTHORITIES IN CHINA AND IN A MANNER FULLY CONSISTENT WITH THE JOINT DECLARATION.
11. IT IS PROPOSED THAT THE HONG KONG AUTHORITIES WOULD PREPARE PAPERS FOR DISCUSSION IN THE LIAISON GROUP ON MONETARY MATTERS WHICH SHALL PREFERABLY HOLD MEETINGS IN HONG KONG TO PROVIDE THE CHINESE MEMBERS USEFUL OPPORTUNITIES TO SEE AND EXPERIENCE HOW THE HONG KONG SYSTEM OPERATES.
12. THE CHINESE SIDE SHOULD BE ASKED TO CONSIDER NOMINATING MEMBERS AS SOON AS POSSIBLE SO THAT AN INVITATION TO THEM TO VISIT HONG KONG FROM THE FINANCIAL SECRETARY CAN BE ARRANGED.

13. THE FIRST FEW MEETINGS OF THE LIAISON GROUP ON MONETARY MATTERS WILL BE DEVOTED TO 'TEACH-IN', WITH THE AIM OF ARRIVING AT A CLEAR AND COMMON UNDERSTANDING OF THE CHARACTERISTICS OF THE PRESENT MONETARY SYSTEM OF HONG KONG. IT IS HOPED THAT IN THE PROCESS POTENTIAL PROBLEM AREAS CAN BE IDENTIFIED OR DRAWN TO THE ATTENTION OF THE CHINESE MEMBERS. PROPOSALS FOR TACKLING THESE PROBLEM AREAS WILL THEN BE DISCUSSED AND DECISIONS CO-ORDINATED IN SUBSEQUENT MEETINGS.

14. THE PROVISION IN THE JOINT DECLARATION THAT 'THE MONETARY AND FINANCIAL SYSTEMS PREVIOUSLY PRACTISED IN HONG KONG SHALL BE MAINTAINED' MAY PROVE TO BE A DIFFICULTY IF THE CHINESE ARGUE THAT THE PRESENT SYSTEM SHOULD BE PRESERVED IN ASPIC. BUT IT SHOULD BE POSSIBLE TO ARGUE SUCCESSFULLY THAT ANY CHANGES TO HONG KONG'S MONETARY SYSTEM WILL BE CONSISTENT WITH THE OVERALL OBJECTIVE OF MAINTAINING STABILITY AND PROSPERITY IN HONG KONG.

15. IT WILL BE PARTICULARLY IMPORTANT TO ENSURE THAT DEVELOPMENTS IN OTHER FORA - FOR INSTANCE THE BASIC LAW DRAFTING COMMITTEE WHICH IS SHORTLY TO TURN TO FINANCIAL SUBJECTS - DO NOT PRE-EMPT DISCUSSION IN THE LIAISON GROUP. HONG KONG MEMBERS OF THE BLDC WHO HAVE BEEN ADDRESSING FINANCIAL MATTERS HAVE SO FAR SHOWN A BASIC LACK OF UNDERSTANDING OF ISSUES AND HAVE SOUGHT TO INTRODUCE UNDESIRABLE RIGIDITIES INTO THE BASIC LAW. IT HAS BEEN THE CHINESE SIDE THAT HAS STRESSED THE IMPORTANCE OF RETAINING FLEXIBILITY. THE OPPORTUNITY SHOULD BE TAKEN TO PERSUADE THE CHINESE THAT THE SENSIBLE COURSE IS MERELY TO ENSHRINE IN THE BASIC LAW THE RELEVANT STATEMENTS ON FINANCIAL AND MONETARY SYSTEMS IN THE JOINT DECLARATION. THE SPEAKING NOTE ON 'FINANCIAL AND MONETARY MATTERS, AND THE BASIC LAW' IS TO SERVE THIS PURPOSE. THE NOTE SHOULD NOT BE HANDED OVER TO THE CHINESE SIDE.

ENDS

WILSON

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HMLNAN 1955

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FM HONG KONG
TO DESKBY 241430Z FCO
TELNO 1602
OF 241040Z APRIL 87
INFO PRIORITY PEKING

STRICTLY PERSONAL FOR HUM, HONG KONG DEPARTMENT FROM GOVERNOR
PEKING: STRICTLY PERSONAL FOR AMBASSADOR

MY SECOND IPT : DIALOGUE ON FINANCIAL MATTERS

1. REVISED DRAFT SPEAKING NOTE IN THE OFFICIAL MONETARY ROLE
IN HONG KONG IS AS FOLLOWS:

BEGINS

THIS NOTE DESCRIBES THE NORMAL CENTRAL BANKING FUNCTIONS
CARRIED OUT IN DEVELOPED CAPITALIST ECONOMIES AND HOW SIMILAR
FUNCTIONS ARE CARRIED OUT IN HONG KONG.

CENTRAL BANKING FUNCTIONS

2. CENTRAL BANKING FUNCTIONS NORMALLY CARRIED OUT IN DEVELOPED
CAPITALIST ECONOMIES INCLUDE SOME OR ALL OF THE FOLLOWING.

(A) CURRENCY ISSUE

PROVISION OF A NATIONAL CURRENCY INVOLVES ITS ISSUE, USUALLY
AGAINST SPECIFIED SECURITY, THE PRODUCTION AND DISTRIBUTION
OF NOTES AND COINS.

(B) OPERATION IN FOREIGN EXCHANGE MARKETS

THESE ARE UNDERTAKEN TO INFLUENCE THE CURRENCY'S RATE OF
EXCHANGE WITH OTHER CURRENCIES AND THUS TO GUIDE THE NATIONAL
CURRENCY'S EXTERNAL VALUE.

(C) MANAGEMENT OF THE RESERVES OF FOREIGN ASSETS

SOUND MANAGEMENT TO PRESERVE THE VALUE AND ADEQUATE LIQUIDITY
OF THE RESERVES OF FOREIGN CURRENCY ASSETS IS NECESSARY IN ITS
OWN RIGHT BUT IS ALSO AN ADJUNCT TO OPERATIONS IN THE FOREIGN
EXCHANGE MARKETS.

(D) THE ROLE OF PRINCIPAL BANKER TO THE GOVERNMENT

THIS FUNCTION INCLUDES MAINTAINING THE PRINCIPAL REVENUE AND
EXPENDITURE ACCOUNTS FOR GOVERNMENT AND PROVIDING SHORT-TERM
BORROWING FACILITIES TO THE GOVERNMENT. IT ALSO INVOLVES
GIVING ADVICE TO THE GOVERNMENT ON MONETARY AND FINANCIAL
POLICY AND MAY ALSO INCLUDE ACTING AS FISCAL AGENT AND
UNDERWRITER FOR GOVERNMENT LOANS.

SECRET

(E)

- (E) THE ROLE OF BANKER TO DOMESTIC COMMERCIAL BANKS
THIS FUNCTION NORMALLY INCLUDES THE ACCEPTANCE OF DEPOSITS WHICH SERVE AS THE PRUDENTIAL FIRST LINE OF RESERVE FOR THESE BANKS AND WHICH ARE USED FOR THE NET SETTLEMENT OF TRANSACTIONS ARISING OUT OF THE INTERBANK CLEARING SYSTEM. IT ALSO INCLUDES THE PROVISION OF THE BANKS' DAY TO DAY LIQUIDITY REQUIREMENTS USUALLY EITHER BY SHORT-TERM SECURED LOANS OR BY THE DISCOUNTING OF SHORT-TERM GOVERNMENT OR COMMERCIAL PAPER, THAT IS TO SAY, ACTING AS LENDER OF LAST RESORT TO THE BANKING SYSTEM. IT MAY ALSO INVOLVE THE MANAGEMENT OF THE CHEQUE CLEARANCE SYSTEM.
- (F) THE REGULATION OF DOMESTIC FINANCIAL INSTITUTIONS
THIS ACTIVITY INVOLVES ENSURING THAT COMMERCIAL BANKS AND OTHER COMPARABLE FINANCIAL INSTITUTIONS CONDUCT THEIR BUSINESS ON A SOUND BASIS, GENERALLY WITHIN A STATUTORY PRUDENTIAL FRAMEWORK. IN A NUMBER OF COUNTRIES, IT INCLUDES THE MONITORING OF ANY RESERVE RATIO REQUIREMENTS AND THE SUPERVISION OF BANKING CONDUCT. (IN MANY COUNTRIES FORMAL RESPONSIBILITY FOR THE SUPERVISION OF INDIVIDUAL BANKS IS VESTED IN A STATUTORY BODY WHICH IN EFFECT IS AN ARM OF GOVERNMENT BUT IN SUCH CASES THE CENTRAL BANK GENERALLY RETAINS RESPONSIBILITIES FOR THE INTEGRITY OF THE BANKING AND FINANCIAL SYSTEM AS A WHOLE.)
- (G) THE OPERATION OF MONETARY AND CREDIT POLICY
THIS FUNCTION INVOLVES THE USE OF MONETARY AND CREDIT POLICY INSTRUMENTS TO ACHIEVE THE GOVERNMENT'S CHOSEN MACROECONOMIC STRATEGY AND/OR CONSTITUTIONALLY MANDATED OBJECTIVES. IN A NUMBER OF COUNTRIES THIS TASK MAY REQUIRE INTERVENTION IN THE MARKETS TO INFLUENCE MONETARY AGGREGATES, EXCHANGE RATES, INTEREST RATES, AND/OR THE DISTRIBUTION OF CREDIT.

OFFICIAL MONETARY FUNCTIONS IN HONG KONG

3. HONG KONG HAS NO CENTRAL BANK. MOST OF THE FUNCTIONS DESCRIBED IN PARAGRAPH 2 ABOVE ARE CARRIED OUT BY DIFFERENT INSTITUTIONS IN BOTH THE PUBLIC AND PRIVATE SECTORS.
4. CURRENCY NOTES ARE ISSUED BY TWO COMMERCIAL BANKS, THE HONGKONG AND SHANGHAI BANKING CORPORATION (HSBC) AND THE STANDARD CHARTERED BANK (SCB), AGAINST NON-INTEREST BEARING CERTIFICATES OF INDEBTEDNESS ISSUED BY THE HONG KONG GOVERNMENT'S EXCHANGE FUND. UNDER THE PRESENT LINKED EXCHANGE RATE SYSTEM, THESE CERTIFICATES ARE ISSUED OR REDEEMED AGAINST PAYMENT TO OR BY THE EXCHANGE FUND IN US DOLLARS AT THE FIXED RATE OF HKDOLLARS 7.20 = US DOLLAR 1. COINS ARE ISSUED BY THE GOVERNMENT.
5. THE BULK OF THE GOVERNMENT'S AVAILABLE CASH RESOURCES ARE DEPOSITED BY THE TREASURY WITH THE EXCHANGE FUND AGAINST THE ISSUE OF INTEREST-BEARING DEBT CERTIFICATES. THE ASSETS OF THE FUND COMPRISE A VARIETY OF LOW RISK, SHORT AND MEDIUM TERM, SECURITIES AND OF DEPOSITS WITH MAJOR BANKS DENOMINATED IN A NUMBER OF MAJOR INTERNATIONAL CURRENCIES. APART FROM THE CERTIFICATES OF INDEBTEDNESS ISSUED TO THE NOTE-ISSUING BANKS AND DEBT CERTIFICATES

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/ISSUED.

ISSUED TO THE TREASURY, THE EXCHANGE FUND'S LIABILITIES WILL FROM TIME TO TIME INCLUDE SHORT TERM BORROWINGS FROM BANKS ARISING OUT OF THE IMPLEMENTATION OF MONETARY POLICY. THE EXCHANGE FUND RETAINS THE NET INCOME ARISING FROM ITS INVESTMENTS AND ITS OPERATIONS IN THE FINANCIAL MARKETS AFTER MEETING ALL ITS OWN OPERATING EXPENSES (INCLUDING STAFF).

6. THE EXCHANGE FUND IS ESTABLISHED UNDER THE EXCHANGE FUND ORDINANCE AND IS A FUND UNDER THE CONTROL OF THE FINANCIAL SECRETARY WHICH "SHALL BE USED FOR SUCH PURPOSES AS THE FINANCIAL SECRETARY THINKS FIT AFFECTING, EITHER DIRECTLY OR INDIRECTLY THE EXCHANGE VALUE OF THE CURRENCY OF HONG KONG". AN EXCHANGE FUND ADVISORY COMMITTEE IS ALSO ESTABLISHED UNDER THE ORDINANCE TO ADVISE THE FINANCIAL SECRETARY, WHO IS THE CHAIRMAN OF THE COMMITTEE, ON THE CONTROL OF THE FUND. THE SECRETARY FOR MONETARY AFFAIRS IS AN EX-OFFICIO MEMBER OF THE COMMITTEE. OTHER MEMBERS, APPOINTED ON A PERSONAL BASIS, INCLUDE MR WILLIAM PURVES, CHAIRMAN OF HSBC, MR JOHN MACKENZIE, AREA GENERAL MANAGER OF SCB, DR KIM CHAM, CHAIRMAN OF THE HONG KONG FUTURES EXCHANGE AND LEGISLATIVE COUNCIL MEMBER, AND MR DAVID K.P. LI, DIRECTOR AND CHIEF MANAGER OF THE BANK OF EAST ASIA AND LEGISLATIVE COUNCIL MEMBER. THE DAY-TO-DAY MANAGEMENT OF THE FUND'S RESOURCES LIES WITH THE MONETARY AFFAIRS BRANCH OF THE HONG KONG GOVERNMENT.

7. NO INSTITUTION IS THE EXCLUSIVE BANKER TO THE GOVERNMENT BUT HSBC HOLDS THE PRINCIPAL REVENUE AND EXPENDITURE ACCOUNTS OF GOVERNMENT AND IS ALSO THE PRINCIPAL BANKER TO THE EXCHANGE FUND.

8. THERE IS NO FORMAL PROVIDER OF DAY TO DAY LIQUIDITY TO THE BANKING SYSTEM IN HONG KONG OR LENDER OF LAST RESORT AS IT IS OFTEN CALLED. HOWEVER, HSBC, AS THE SETTLEMENT BANK FOR THE INTERBANK CLEARING SYSTEM, IN NORMAL CIRCUMSTANCES PROVIDES SUCH LIQUIDITY TO OTHER BANKS. HSBC OPERATIONS IN THE MONEY MARKETS ARE A CRUCIAL DETERMINANT OF OVERALL MONETARY CONDITIONS AND ARE CONDUCTED IN CONSULTATION WITH THE MONETARY AFFAIRS BRANCH OF GOVERNMENT WITH A VIEW TO SUPPORTING THE PREVAILING POLICY OBJECTIVES.

9. IF A DEPOSIT-TAKING INSTITUTION WAS TO GET INTO DIFFICULTIES, THE GOVERNMENT, ACTING THROUGH THE MONETARY AFFAIRS BRANCH, WOULD NORMALLY TAKE A LEAD IN MAKING THE ARRANGEMENTS NEEDED TO MINIMISE ANY DAMAGE TO THE FINANCIAL SECTOR AND TO DEPOSITORS AND WHEN CONSIDERED APPROPRIATE, THE EXCHANGE FUND HAS ACTED, IN EXCEPTIONAL CIRCUMSTANCES, AS LENDER OF LAST RESORT EITHER BY PROVIDING LINES OF LIQUIDITY OR BY GUARANTEEING CREDIT EXTENDED BY COMMERCIAL BANKS. LENDER OF LAST RESORT HERE REFERS TO THE PROVIDER OF EMERGENCY ASSISTANCE TO A TROUBLED INSTITUTION RATHER THAN SUPPLIER OF LIQUIDITY TO THE SYSTEM AS A WHOLE.

10. HSBC ADMINISTERS THE INTERBANK CLEARING HOUSE UNDER A MANAGEMENT CONTRACT WITH THE HONG KONG ASSOCIATION OF BANKS.

11. SUPERVISION OF BANKS AND DEPOSIT-TAKING COMPANIES IS THE STATUTORY RESPONSIBILITY OF THE COMMISSIONER OF BANKING, WHOSE OFFICE IS A SEPARATE SELF-CONTAINED UNIT WITHIN THE MONETARY AFFAIRS BRANCH. THE SECURITIES COMMISSION, THE COMMODITIES TRADING COMMISSION AND THE OFFICE OF THE COMMISSIONER FOR SECURITIES AND COMMODITIES TRADING HAVE STATUTORY RESPONSIBILITY FOR SUPERVISING SECURITIES AND COMMODITIES TRADING. THE REGISTRAR GENERAL'S DEPARTMENT IS RESPONSIBLE FOR REGULATION OF INSURANCE BUSINESS AND FOR COMPANY LEGISLATION. ALL THESE ACTIVITIES ARE CARRIED OUT UNDER THE POLICY UMBRELLA OF THE MONETARY AFFAIRS BRANCH.

12. THROUGH THE FINANCIAL SECRETARY, THE MONETARY AFFAIRS BRANCH IS RESPONSIBLE FOR ADVISING THE GOVERNOR IN COUNCIL ON MONETARY POLICY, AND FOR DEALING WITH QUESTIONS RELATING TO PUBLIC SECTOR DEBT OR DEBT GUARANTEED BY THE GOVERNMENT. SINCE THE ADOPTION OF THE LINKED EXCHANGE RATE SYSTEM IN OCTOBER 1983, THE PRIMARY OBJECTIVE OF MONETARY POLICY HAS BEEN TO STABILIZE THE HONG KONG DOLLAR AGAINST THE US DOLLAR. UNDER THE SYSTEM, CHANGES IN HONG KONG DOLLAR INTEREST RATES AND MONEY SUPPLY IN RESPONSE TO MARKET CONDITIONS ENABLE THE ECONOMY TO ADJUST TO PRESSURES ACROSS THE EXCHANGES. THE FINANCIAL SECRETARY, THROUGH THE MONETARY AFFAIRS BRANCH, CAN INFLUENCE INTEREST RATES THROUGH THE INTEREST RATE RULES OF THE HONG KONG ASSOCIATION OF BANKS. AS CONTROLLER OF THE EXCHANGE FUND, AGAIN THROUGH THE MONETARY AFFAIRS BRANCH, HE CAN ALSO INTERVENE IN THE MONEY AND FOREIGN EXCHANGE MARKETS. IN NORMAL CIRCUMSTANCES THIS WILL BE THROUGH THE EXCHANGE FUND'S PRINCIPAL BANKER, HSBC.

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TO DESKBY 241430Z FCO

TELNO 1603

OF 241040Z APRIL 87

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PEKING: STRICTLY PERSONAL FOR AMBASSADOR

MY THIRD IPT : DIALOGUE ON FINANCIAL MATTERS

1. REVISED DRAFT SPEAKING NOTE ON THE FUTURE OF HONG KONG'S
MONETARY SYSTEM IS AS FOLLOWS:

BEGINS

1. A SUCCESSFUL FINANCIAL AND MONETARY SYSTEM IS VITAL TO
HONG KONG'S CONTINUING PROSPERITY.
2. ITS CONTINUING STATUS AS AN INTERNATIONAL FINANCIAL CENTRE
IS ASSURED IN THE SINO-BRITISH JOINT DECLARATION WHICH ALSO PROVIDES
THAT HONG KONG WILL DECIDE ITS MONETARY AND FINANCIAL POLICIES
ON ITS OWN AND THAT THE HONG KONG DOLLAR SHALL CONTINUE TO
CIRCULATE AND REMAIN FREELY CONVERTIBLE.
3. BUT ANY FINANCIAL SYSTEM MUST EVOLVE OVER TIME IF IT IS TO
REMAIN VIGOROUS AND SUCCESSFUL, ESPECIALLY IN THE CURRENT
WORLDWIDE EVOLUTION IN FINANCIAL SERVICES, WHICH IS LEADING TO
RAPID CHANGE IN GLOBAL MARKETS.
4. AT THE SAME TIME THE "AUTHORITIES" MUST BE IN A POSITION
TO CONTINUE TO EXERCISE EFFECTIVE CONTROL OVER THE SYSTEM BOTH
TO MAINTAIN THE SYSTEM'S INTEGRITY AND TO IMPLEMENT MONETARY
POLICY.
5. THIS GIVES RISE TO THE "AUTHORITIES" INTERVENING AS
NECESSARY IN FOREIGN EXCHANGE AND MONEY MARKETS, PROVIDING THE
FINANCIAL SYSTEM WITH ITS DAY-TO-DAY CASH REQUIREMENTS THAT IS
ACTING AS LENDER OF LAST RESORT.
6. THESE FUNCTIONS ARE COMMONLY EXERCISED BY THE CENTRAL BANK

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OR MONETARY AUTHORITY OF A COUNTRY BUT IN HONG KONG, WHICH CURRENTLY HAS NEITHER, IT IS UNDERTAKEN IN PART BY THE HONG KONG GOVERNMENT USING THE RESOURCES OF THE EXCHANGE FUND AND IN PART BY THE HONG KONG AND SHANGHAI BANKING CORPORATION (HKS^B). IN ADDITION THE HKS^B AND THE STANDARD CHARTERED BANK ISSUE NOTES BACKED BY CERTIFICATES OF INDEBTEDNESS ISSUED BY THE EXCHANGE FUND.

7. THE HKS^B CURRENTLY UNDERTAKES A NUMBER OF QUASI-CENTRAL BANKING FUNCTIONS. IT IS THE SETTLEMENT BANK FOR THE HONG KONG DOLLAR CLEARING AND THE DEPOSITS OF OTHER BANKS WITH IT ARE TANTAMOUNT TO CASH. HKS^B IS THUS ABLE TO INFLUENCE THE AVAILABILITY OF MONEY WITHIN THE BANKING SYSTEM. IN PRACTICE, IT EXERCISES THIS INFLUENCE IN CLOSE CONSULTATION WITH THE MONETARY AFFAIRS BRANCH OF THE HONG KONG GOVERNMENT. IT ALSO INTERVENES IN THE FOREIGN EXCHANGE MARKETS AT THE DIRECTION OF THE MONETARY AFFAIRS BRANCH USING THE RESOURCES OF THE EXCHANGE FUND.

8. IT IS IMPORTANT THAT ANY CHANGES TO THE PRESENT SYSTEM WHICH MAY BE CONSIDERED NECESSARY OR DESIRABLE ARE CAREFULLY PREPARED. TO MAINTAIN CONFIDENCE AND AVOID DISRUPTION TO THE FINANCIAL MARKETS, IT WILL BE VITAL TO AVOID PREMATURE DISCLOSURE THAT CHANGES ARE UNDER DISCUSSION. THEIR INTRODUCTION IN PRACTICE WILL NEED TO BE FULLY EXPLAINED TO THE FINANCIAL COMMUNITY OF HONG KONG.

9. THERE HAS ALREADY BEEN SOME PUBLIC CRITICISM IN HONG KONG OF THE DOMINANT ROLE ENJOYED BY THE HKS^B AND THE POTENTIAL CONFLICTS OF INTEREST WHICH ARISE WHEN A COMMERCIAL BANK UNDERTAKES A NUMBER OF CENTRAL BANKING FUNCTIONS. THIS HAS LED TO SUGGESTIONS THAT THESE FUNCTIONS SHOULD BE ASSUMED BY A CENTRAL BANK OR MONETARY AUTHORITY SOONER RATHER THAN LATER.

10. ALTHOUGH THE HONG KONG GOVERNMENT HAS SO FAR REFRAINED FROM PUBLIC PARTICIPATION IN THIS DEBATE, IT IS ITSELF CONVINCED THAT SOME CHANGES ARE DESIRABLE. MOREOVER THE HONG KONG GOVERNMENT BELIEVES THAT THE HKS^B WILL INCREASINGLY PERCEIVE A CONFLICT BETWEEN, ON THE ONE HAND, ITS NATURAL WISH TO PURSUE POLICIES WHICH IT SEES AS IN THE BEST INTERESTS OF ITS SHAREHOLDERS AND, ON THE OTHER, ITS QUASI-CENTRAL BANKING ROLE. THE HONG KONG GOVERNMENT'S THINKING IS AT AN EARLY STAGE AND NO DECISIONS HAVE BEEN TAKEN. THE GENERAL FEELING IS THAT IN THE PARTICULAR CIRCUMSTANCES OF HONG KONG THE CREATIONS OF A NEW INSTITUTION, A CENTRAL BANK, TO CARRY OUT OFFICIAL MONETARY FUNCTIONS MIGHT NOT BE APPROPRIATE. IT IS POSSIBLE THAT ENLARGEMENT OF THE ROLE OF THE EXCHANGE FUND WOULD BE MORE APPROPRIATE AND PRACTICABLE.

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11. IT IS PROPOSED THAT THESE ISSUES SHOULD BE ADDRESSED IN THE DIALOGUE WHICH HAS NOW BEEN ESTABLISHED, ON A STRICTLY CONFIDENTIAL BASIS, BETWEEN THE BRITISH AND CHINESE SIDES. THIS DIALOGUE SHOULD BRING TOGETHER THE AUTHORITIES IN HONG KONG RESPONSIBLE FOR FINANCIAL AFFAIRS AND THEIR COUNTERPARTS IN THE PEOPLE'S REPUBLIC OF CHINA. IT WILL NEED TO ADDRESS MATTERS OF DETAIL AS WELL AS QUESTIONS OF PRINCIPLE.

12. ANY CHANGES CAN THUS BE IMPLEMENTED WITH THE KNOWLEDGE OF THE RELEVANT AUTHORITIES IN THE PEOPLE'S REPUBLIC OF CHINA AND IN A MANNER FULLY CONSISTENT WITH THE JOINT DECLARATION. THIS WOULD HELP TO AVOID THE DAMAGE TO FINANCIAL STABILITY AND CONFIDENCE WHICH COULD RESULT FROM UNPLANNED CHANGES IN HONG KONG'S MONETARY SYSTEM.

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MY FOURT IPT : DIALOGUE ON FINANCIAL MATTERS

1. REVISED DRAFT SPEAKING NOTE ON BANKING SUPERVISION IS AS
FOLLOWS:

BEGINS

BANKING SUPERVISION IS CONDUCTED IN HONG KONG UNDER THE BANKING ORDINANCE, 1986. THIS ORDINANCE GIVE THE AUTHORITY TO THE COMMISSIONER OF BANKING AND HIS OFFICE TO SUPERVISE BANKS AND OTHER DEPOSIT-TAKING COMPANIES IN HONG KONG, WHETHER FOREIGN OR LOCALLY INCORPORATED, TO ENSURE THAT THESE FINANCIAL INSTITUTIONS MEET THE REQUIREMENTS OF THE ORDINANCE AND CONDUCT THEIR AFFAIRS IN A PRUDENT AND EFFECTIVE MANNER. THE AIM OF THE ORDINANCE IS MAINLY TO PROVIDE A MEASURE OF PROTECTION TO DEPOSITORS AND TO PROMOTE THE GENERAL STABILITY AND EFFECTIVE WORKING OF THE BANKING SYSTEM. IN ADDITION, HONG KONG ACCEPTS AND PRACTISES THE PRINCIPLES OF WORLD-WIDE CONSOLIDATED SUPERVISION OF BANKING GROUPS AS SET OUT IN THE REVISED CONCORDAT ISSUED BY THE COMMITTEE ON BANKING REGULATIONS AND SUPERVISORY PRACTICES, BASED IN BASLE, SWITZERLAND AND ONLY EXPECTS TO ACCEPT INTO HONG KONG BANKS FROM COUNTRIES WHO SIMILARLY ADHERE TO THESE PRINCIPLES.

2. TO MAINTAIN THE REQUIRED STANDARD OF PRUDENTIAL SUPERVISION, THE COMMISSIONER RECEIVES INFORMATION ON A REGULAR BASIS FROM ALL THE INSTITUTIONS AUTHORISED UNDER THE BANKING ORDINANCE. HE CAN, AND DOES, ASK FOR OTHER INFORMATION FROM TIME TO TIME IF HE REQUIRES THIS INFORMATION BETTER TO UNDERSTAND THE BUSINESS OF A PARTICULAR INSTITUTION. IN ADDITION, HE MAINTAINS A REGULAR SYSTEM OF DETAILED EXAMINATION OF ALL BANKS AND DEPOSIT-TAKING COMPANIES WITH PARTICULAR EMPHASIS ON THOSE INSTITUTIONS INCORPORATED IN HONG KONG. WHERE AN EXAMINATION SHOWS ACTION IS REQUIRED FOR THE PRUDENTIAL MANAGEMENT OF THE BANK, THE COMMISSIONER IS EMPOWERED TO REQUIRE THE BANK CONCERNED TO TAKE APPROPRIATE ACTION E.G. TO MAKE PROVISION FOR DOUBTFUL DEBTS.

3. THE GOVERNOR IN COUNCIL IS THE LICENSING AUTHORITY FOR BANKS AND HAS THE POWER:

(A) TO GRANT LICENCES

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- (B) TO IMPOSE CONDITIONS ON LICENCES
- (C) TO REVOKE LICENCES.

THE CRITERIA FOR BEING GRANTED A BANK LICENCE ARE REVIEWED ANNUALLY. THE CURRENT CRITERIA ARE ATTACHED. THE COMMISSIONER IS RESPONSIBLE FOR EXAMINING APPLICATIONS FOR LICENCES IN PREPARATION FOR CONSIDERATION BY THE GOVERNOR IN COUNCIL.

4. LICENCES OF EXISTING BANKS MAY BE TRANSFERRED BY THE SALE OF THE EQUITY OF THE BANK TO NEW OWNERS. FROM 1ST SEPTEMBER 1986, ANY PERSON BUYING 10 PER CENT OR MORE OF A BANK OR DEPOSIT-TAKING COMPANY REQUIRES THE CONSENT OF THE COMMISSIONER BEFORE HE CAN EXERCISE THE RIGHTS VESTED IN THE EQUITY TRANSFERRED TO HIM. SIMILARLY, ANY NEW CONTROLLER OF A BANK OR DEPOSIT-TAKING COMPANY HAS TO BE ACCEPTABLE TO THE COMMISSIONER WHO ALSO HAS TO AUTHORISE THE APPOINTMENT OF ANY NEW DIRECTOR OR SECRETARY OF AN INSTITUTION.

5. MOST OF THE BANKS OPERATING IN HONG KONG ARE EITHER BRANCHES OF BANKS INCORPORATED OUTSIDE HONG KONG OR LOCALLY INCORPORATED SUBSIDIARIES OF BANKS AND OTHER FINANCIAL INSTITUTIONS INCORPORATED OUTSIDE HONG KONG. IT FOLLOWS, THEREFORE, THAT MUCH OF THE WORK OUTLINED ABOVE (AND PARTICULARLY IN PARAGRAPHS 3 AND 4) HAS TO BE CONDUCTED IN CLOSE CONSULTATION WITH THE SUPERVISORY AUTHORITIES OF THE COUNTRIES IN WHICH THE BANKS, OR THEIR PARENT INSTITUTIONS, ARE INCORPORATED. IT IS, FOR INSTANCE, IN THE INTERESTS OF THESE SUPERVISORY AUTHORITIES TO BE FULLY AWARE OF THE OPERATIONS OF ANY OF THEIR BANKS IN HONG KONG. SIMILARLY, IT IS VITAL FOR THE COMMISSIONER TO BE ASSURED THAT THESE OPERATIONS IN HONG KONG ARE BEING CONDUCTED WITH THE FULL KNOWLEDGE AND CONSENT OF THE RESPECTIVE SUPERVISORY AUTHORITIES. IN ADDITION, ANY NEW APPLICANT WISHING TO ESTABLISH OR TAKE OVER A BANK IN HONG KONG IS REQUIRED TO HAVE THE SUPPORT OF HIS HOME SUPERVISORY AUTHORITY BEFORE ANY APPLICATION CAN BE CONSIDERED BY THE HONG KONG AUTHORITIES. FOR THESE REASONS, CLOSE CO-OPERATION AND CONSULTATION BETWEEN SUPERVISORY AUTHORITIES IS A NECESSARY INGREDIENT IN THE MAINTENANCE OF HONG KONG'S REPUTATION AND STANDING AS A WELL CONDUCTED AND SUCCESSFUL INTERNATIONAL FINANCIAL CENTRE.

6. NORMALLY, THIS IS ACHIEVED BY:

- (A) VISITS TO HONG KONG FROM SUPERVISORY AUTHORITIES ELSEWHERE TO EXAMINE THE BRANCHES OR SUBSIDIARIES OF THEIR BANKS UNDER JURISDICTION AND BY THE SAME TOKEN VISITS ABROAD BY THE HONG KONG SUPERVISORY AUTHORITIES TO VISIT BRANCHES OF HONG KONG BANKS SEMICOLON
- (B) A REGULAR FLOW OF INFORMATION AND ENQUIRIES BETWEEN THE RESPECTIVE SUPERVISORY AUTHORITIES SEMICOLON
- (C) PARTICIPATION IN MEETINGS ARRANGED UNDER THE BASLE CONCORDAT.

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7. IT IS PARTICULARLY IMPORTANT TO ESTABLISH CO-OPERATION AND CONSULTATION ON THIS BASIS WITH THE PEOPLE'S BANK OF CHINA BECAUSE OF THE GROWING IMPORTANCE OF MAINLAND INTERESTS IN HONG KONG BANKING. THERE ARE NOW 6 BANKS INCORPORATED IN HONG KONG (TWO OF THEM LISTED IN THE HONG KONG STOCK EXCHANGE) WHICH ARE OWNED BY MAINLAND ENTITIES. IN ADDITION, THERE ARE 9 OTHER BANKS WHICH ARE LOCALLY REGARDED AS FALLING WITHIN THE "BANK OF CHINA GROUP". THERE ARE ALSO 17 DEPOSIT-TAKING COMPANIES OWNED BY THESE BANKS OR BY OTHER MAINLAND INTERESTS. ALTOGETHER THE BANKS CONCERNED HAVE 284 BRANCHES IN HONG KONG I.E. ABOUT 20 PER CENT OF THE TOTAL BRANCH NETWORK OF HONG KONG - A LARGER PRESENCE IN THE HONG KONG DOMESTIC MARKET THAN OF ANY OTHER GROUP OF BANKS DOMICILED OUTSIDE HONG KONG.

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FM HONG KONG

TO DESKBY 241430Z FCO

TELNO 1599

OF 241040Z APRIL 87

INFO PRIORITY PEKING

STRICTLY PERSONAL FOR HUM, HONG KONG DEPARTMENT FROM GOVERNOR
PEKING: STRICTLY PERSONAL FOR AMBASSADOR

YOUR TELNO 1142 : DIALOGUE ON FINANCIAL MATTERS

1. MY COMMENTS ON THE POINTS IN TUR ARE AS FOLLOWS:

(A) IT SHOULD READ ''FINANCIAL'' SEMICOLON

(B) (I) AMENDMENT AGREED SEMICOLON

(II) I WOULD RATHER KEEP THIS AS A DEFENSIVE POINT.

(III) ''WIDE-RANGING'' AGREED. I ALSO AGREE THAT WE SHOULD
SHORTEN THE LIST OF GOVERNMENT BODIES TO BE VISITED. THE
SENTENCE MIGHT READ ''.... COURTESY CALLS ON CITIC, THE
MINISTRY OF FINANCE AND OTHER RELEVANT MINISTRIES.''

2. IN VIEW OF THE SHORTAGE OF TIME, AND THE NEED TO MAKE THE
NECESSARY TRAVEL AND VISA ARRANGEMENTS, IT WOULD BE HELPFUL IF THE
AMBASSADOR COULD PRESS THE CHINESE TO CONFIRM DATES FOR THE VISIT
AS SOON AS POSSIBLE.

3. YOU MAY WISH TO BE AWARE THAT DAVID NENDICK, THE SECRETARY
FOR MONETARY AFFAIRS, WAS APPROACHED BY A FOREIGN BANK TODAY WHICH
CLAIMED TO BE ARRANGING A PROGRAMME FOR TWO OFFICIALS FROM THE
PEOPLE'S BANK OF CHINA, GUO XIAO-PING (STATE MINISTRY OF EXCHANGE
CONTROL) AND HAN CHEN-COI (RESEARCH DIVISION OF INTERNATIONAL
DEPARTMENT). NENDICK WAS TOLD THEY WISHED TO DISCUSS MATTERS
RELATED TO ''CENTRAL BANKING AND RESERVE MANAGEMENT'' ON 1 MAY OR
THE WEEK FOLLOWING. THIS REINFORCES OUR BELIEF THAT THE PEOPLE'S
BANK OF CHINA DOES HAVE AN INTEREST IN WHAT IS LIKELY TO BE
DISCUSSED IN PEKING AND THAT IT WOULD BE USEFUL TO INCLUDE A VISIT
TO THE PEOPLE'S BANK IN JACOBS' PROGRAMME. IT WOULD BE HELPFUL
IF THE AMBASSADOR COULD FIND OUT WHERE GUO AND HAN'S VISIT HERE
FIT INTO THE SCHEME OF THINGS.

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4. IN SPEAKING TO THE CHINESE ABOUT DATES WE SHOULD NOW ALSO TELL THEM THAT WE WOULD LIKE CLIFT TO ACCOMPANY JACOBS IN THE SAME WAY THAT POLITICAL ADVISERS ACCOMPANIED PREVIOUS FINANCIAL SECRETARIES VISITING PEKING.

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REC.	13 NOV 1987
ACTION	CW Kelly
COPIES TO	EST
	Sir P Middleton
	Sir G Hittler
	Mr. [unclear]
From the Private Secretary	

SECRET (ORIEL)



[Handwritten signature]

10 DOWNING STREET
LONDON SW1A 2AA

12 November 1987

HONG KONG AND SHANGHAI BANK AND MIDLAND BANK

Thank you for your letter of 12 November describing the arrangement reached between the Hong Kong and Shanghai Bank and the Midland Bank. Subject to the views of the Chancellor, the Prime Minister sees no objection to this. She very much agrees, however, that we should inform the Chinese informally in advance of any announcement and would like urgent instructions sent in this sense.

I am sending a copy of this letter to Alex Allan (H.M. Treasury)

CHARLES POWELL

A. C. Galsworthy, Esq., C.M.G.,
Foreign and Commonwealth Office.

SECRET (ORIEL)



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CH/EXCHEQUER	
REC.	12 NOV 1987
ACTION	Clu Kelly
COPIES TO	Sir P Middleton
	Sir G Hittler
	Mrs Lormoux

Foreign and Commonwealth Office

London SW1A 2AH

12 November 1987

Dear Charles,

[Handwritten signature]

Hong Kong and Shanghai Bank and Midland Bank

The Bank of England have informed us that the Hong Kong and Shanghai Bank (HKSB) and the Midland Bank have just reached agreement on the price at which HKSB can purchase 14.9% of the equity of the Midland Bank. An announcement can be expected on 13 November. The Foreign Secretary was informed of this in a preliminary way overnight, but I have not been able to clear this letter with him yet because of his involvement in talks with the Greek Foreign Minister. I understand that the Chancellor is already aware of the plans.

The Bank of England advise that as part of the agreement Midland Bank will make a new share issue worth £400 million. This will considerably strengthen the Bank's equity base and put an end to its vulnerability to an unwanted takeover. The agreement will also have significant collaborative advantages for both banks, enabling them to complement each other's current activities in Europe and Canada. The agreement therefore makes very good sense in commercial and banking terms.

Officials here believe that the agreement also falls within the limits of what Ministers have previously told the Chairman of HKSB would be acceptable to us in political terms. Ministers asked HKSB not to proceed with their proposed merger with Midland Bank in 1986; but we have indicated that a proposal that HKSB should buy into a UK bank would not be open to the same objections. It is quite clear that what is now proposed would not remove control of HKSB from Hong Kong, which was the reason for our serious reservations about the merger idea.

We cannot of course be sure of future developments. But one useful element of the proposed agreement is that there would be a public statement to the effect that HKSB would not increase its proportional share of the Midland Bank for a certain period (probably 3 years) without the consent of the Midland Bank Board. In practice, any increase in HKSB's share would exceed the 15% controlling interest limit stipulated in the Banking Act and would therefore also require the approval of the Bank of England. This would

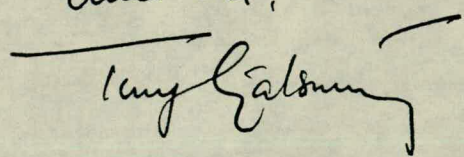
/give



give Ministers a further opportunity to take account of the political implications, should that be necessary.

Sir David Wilson has been consulted: his preliminary view is that there are unlikely to be grounds to object to what the HKSB are proposing. We expect that Sir William Purves will inform Sir David formally of the agreement later today. Sir David also advises that it would be sensible to inform the Chinese informally in advance of any announcement. The Joint Liaison Group meeting now going on in Peking provides a very convenient opportunity for an informal low key approach to be made. Suitable instructions are being prepared for issue later today.

I am sending a copy of this letter to Alex Allan.

Yours ever,


(A C Galsworthy)
Private Secretary

C D Powell Esq
10 Downing Street

FROM: G J ROBERTS

DATE: 13 November 1987

1. MRS LOMAX
2. MR GUNTON
- Re 13711*

cc PS/Chancellor
PS/Economic Secretary
PS/Sir P Middleton
Sir G Littler
Mr Cassell
Mr R I G Allen
Mr Kelly
Miss Noble
Mr Board o/r

HONGKONG AND SHANGHAI'S 14.9% STAKE IN MIDLAND BANK

As you know, Hongkong and Shanghai Bank announced this morning that it was taking a 14.9% stake in Midland Bank. It will do this by subscribing to new shares in Midland at a price of 475 pence per share (the audited value at 30 June 1987). The two banks also plan to embark on selective integration and rationalisation of their international businesses. Midland also gave notice to Hongkong and Shanghai that it intended to make a further general provision of £100m in 1987.

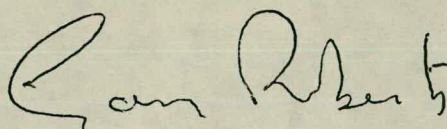
2. As I understand it the Bank of England Press Office is taking the line that the Bank were consulted over this development and raised no objection. In point of fact, of course, the Bank have no powers to object as the proposed stake in Midland (still subject to an EGM) since it falls short of the 15% controlling interest power in the Banking Act.

3. There is no need for us to comment at all. If pressed, you can simply note that if Hongkong and Shanghai go above 14.9% then they will need Bank of England approval. Most of the questions that may be put to you concerning 'takeover', 'merger', 'controlling interest', 'foreign ownership', 'reciprocity' do not yet arise. Under Banking Act terms this is a simple purchase of shares in Midland Bank, which requires notification to the Bank of England, but no more.

4. It appears from the press release that Hongkong and Shanghai have agreed not to increase its proportionate interest in Midland

or dispose of its share holding (if approved by the EGM) within a period of three years, except with the consent of Midland.

5. As a matter of interest, you might like to know, that Hongkong and Shanghai are to pay 475 pence per share against last night's closing price of 358 pence. Midland's share price opened higher and at mid morning stood around the 390 pence mark.

A handwritten signature in dark ink, appearing to read "Gary Roberts". The signature is written in a cursive style with a large initial "G" and "R".

GARY ROBERTS



See X: An awful mild threat. ~~at the~~ etc.

Spoke Mr Kelly

Nothing to add to earlier brief.

HKSB / Midland

25/18/11

A line on this is included in the "Hong Kong" brief prepared by Mr Kelly in the folder for your meeting with the Chinese Ambassador. This telegram arrived this p.m. - I will ask Mr Kelly in the morning whether he has anything to add in the light of it.

25/17/11

SECRET

SECRET
DEYOU/ORNEL

13/11/87

WH 112
WH 112

F
M PEKING
TO DESKBY 131400Z FCO
TELNO 2006
OF 131258Z NOVEMBER 1987
INFO DESKBY 140100Z HONG KONG

*Present Paul Secretary
Sir Paul ...
Sir ...
Mrs ...
Mr ...
Self*

FOLLOWING STRICTLY PERSONAL FOR PAUL, HKD, FROM MCLAREN.
HONG KONG STRICTLY PERSONAL FOR GOVERNOR.

MY TELNO.1994: HONG KONG AND SHANGHAI BANK (HKS).

1. DURING THE AFTERNOON I RECEIVED A MESSAGE THAT KE ZHISHUO DID INDEED WANT TO SEE ME AGAIN. WE MET AT 1830 LOCAL AT THE AMBASSADOR'S RESIDENCE, WITH THE SAME PARTICIPANTS AS THIS MORNING.
2. KE SAID THAT AFTER HE HAD LEARNT THAT THE HKS WAS GOING TO PURCHASE A PERCENTAGE OF THE EQUITY IN THE MIDLAND BANK HE HAD IMMEDIATELY REPORTED TO THE AUTHORITIES CONCERNED. HE HAD NOW BEEN AUTHORISED BY HIS SUPERIORS TO CONVEY THE FOLLOWING VIEWS OF THE CHINESE GOVERNMENT TO THE FOREIGN OFFICE AS QUICKLY AS POSSIBLE.
3. SPEAKING FROM A PREPARED TEXT, KE SAID THAT AT PRESENT THE CHINESE GOVERNMENT WERE NOT CLEAR ABOUT THE PRESENT PLANS OF THE HKS. THEY KNEW THAT IN THE PAST THE HKS HAD HAD A PLAN TO MERGE WITH THE MIDLAND BANK AND TO MOVE TO LONDON. AT THAT TIME THE CHINESE GOVERNMENT TOOK THE VIEW THAT IT WAS A MATTER OF GREAT SENSITIVITY WHICH WOULD HAVE VERY NEGATIVE EFFECTS. THEY HAD MADE EXPLICITLY CLEAR (SIC) THEIR POSITION THAT THEY DID NOT AGREE WITH THE PLAN. THE CHINESE GOVERNMENT KNEW THAT THE BRITISH PRIME MINISTER WAS AWARE OF THE PLAN, AND THAT SHE WAS IN FULL AGREEMENT WITH THE CHINESE POSITION.
4. THE CHINESE GOVERNMENT HAD KNOWN NOTHING ABOUT THE PRESENT PLAN IN ADVANCE. THE CHINESE SIDE COULD HAVE BEEN INFORMED IN ADVANCE: THERE WERE NUMEROUS CHANNELS FOR THIS. AT PRESENT THE HONG KONG ECONOMY FACED SOME DIFFICULTIES AND WAS RATHER FRAGILE. THE PRESENT DEVELOPMENT COULD HAVE SOME UNFAVOURABLE EFFECTS. ALTHOUGH THIS WAS A MAJOR ISSUE THE CHINESE SIDE WAS NOT INFORMED OR CONSULTED IN ADVANCE. IF THERE WERE NEGATIVE EFFECTS OR IF PROBLEMS EMERGED THIS WOULD BE THE BRITISH GOVERNMENT'S RESPONSIBILITY.

SECRET

SECRET

X 5. THE CHINESE GOVERNMENT HAD ALREADY CLEARLY INDICATED THAT THEY HOPED THE HKSBB WOULD CONTINUE TO PLAY AN IMPORTANT ROLE IN HONG KONG AFTER 1997. THEY DID NOT KNOW THAT THE NEXT DEVELOPMENT WOULD BE. IF THE HKSBB WITHDREW FROM HONG KONG OR MOVED ITS DOMICILE THE CHINESE SIDE COULD NOT BUT RECONSIDER ITS POLICY TOWARDS THE BANK. THE CHINESE GOVERNMENT HOPED THE BRITISH SIDE WOULD PROVIDE FURTHER INFORMATION ON THE DETAILS OF THE PRESENT DEVELOPMENT.

6. HE SAID THAT THE MESSAGE WHICH HE HAD CONVEYED WAS AN IMPORTANT AND SERIOUS ONE. IT WOULD BE IMMEDIATELY TRANSMITTED TO THE BRITISH GOVERNMENT, AND HE WAS SURE IT WOULD BE TREATED WITH DUE SERIOUSNESS. IN THE MEANTIME HE WOULD COMMENT BRIEFLY. MY UNDERSTANDING WAS THAT THE BRITISH GOVERNMENT AND THE GOVERNOR OF HONG KONG HAD LEARNT ONLY VERY RECENTLY OF THIS NEW DEVELOPMENT, WHICH WAS ESSENTIALLY A COMMERCIAL DECISION BY THE HKSBB. THE STAKE WHICH THE HKSBB WAS TAKING IN THE MIDLAND BANK FELL JUST SHORT OF THE 15% WHICH WOULD HAVE REQUIRED FORMAL APPROVAL FROM THE BANK OF ENGLAND. THUS NO SUCH APPROVAL HAD BEEN REQUIRED.

7. HE NOTED THAT HE HAD COMMENTED ON EARLIER IDEAS WHICH THE HKSBB MIGHT HAVE HAD. HE COULD TELL HIM IN CONFIDENCE THAT THE CHAIRMAN OF HKSBB HAD GIVEN THE GOVERNOR OF HONG KONG AN ASSURANCE THAT THE MOVE WAS NO MORE THAN AN INVESTMENT BY HKSBB AS PART OF A PLAN TO EXPAND ITS ACTIVITIES OVERSEAS. HE HAD ASSURED THE GOVERNOR THAT THERE WAS NO QUESTION OF A CHANGE OF DOMICILE FOR THE HKSBB, NOR WAS THIS INVESTMENT THE PRELUDE TO SUCH A CHANGE. HE HOPED THAT WHAT HE HAD SAID WOULD HELP TO REASSURE THE CHINESE AUTHORITIES. HE WAS SURE THAT THEIR MESSAGE WOULD IN DUE COURSE RECEIVE A FORMAL REPLY.

8. HE THANKED ME FOR MY UNDERSTANDING OF CHINESE CONCERNS AND FOR THE ADDITIONAL INFORMATION HE HAD PROVIDED. HE WOULD TRANSMIT THIS AS QUICKLY AS POSSIBLE TO THE AUTHORITIES CONCERNED. HE WOULD BE MOST GRATEFUL IF OUR REPLY COULD BE SENT TO HIM QUICKLY.

EVANS.

PAUL, HKD

HD / HKD

PS

PS / Lord GLENARTHUR

PS / PHS

MR GILLMORE

MR MC LAREN

cc MR A LOEHNIS B

MR CW KELLY HM

SECRET

SECRET

SECRET

DEYOU/ORIEL

FM FCO

TO DESKBY 180030Z HONG KONG

TELNO 3016

OF 171830Z NOV 87

*Pl. copy to Sir P. ...
Sir ...
The ...
No ...
18.11*

✓
Py

STRICTLY PERSONAL FOR GOVERNOR FROM MCLAREN
YOURTELS NOS 4315 AND 4333: HONG KONG AND SHANGHAI BANK

1. LIKE YOU. WE (AND THE BANK OF ENGLAND AND TREASURY) ARE PERPLEXED BY KE'S REFERENCE TO THE EARLIER PLAN FOR A MERGER BETWEEN THE HKSAB AND THE MIDLAND. WE HAVE CAREFULLY REVIEWED OUR FILES BUT SO FAR HAVE FOUND NOTHING WHICH SHEDS ANY LIGHT ON THE MATTER. IT IS OF COURSE POSSIBLE THAT THE CHINESE MAY HAVE PICKED UP SOME SCENT OF THE DEAL FROM MARKET GOSSIP AT THE TIME: THE BANK OF CHINA ARE PRESUMABLY WELL PLUGGED IN THROUGH THEIR CITY CONTACTS. BUT THIS HARDLY EXPLAINS KE'S SPECIFIC REFERENCE TO THE OPPOSITION OF THE PRIME MINISTER TO A MERGER. NOR DO WE KNOW HOW. OR TO WHOM. THE CHINESE MADE THEIR OWN POSITION 'EXPLICITLY CLEAR'

2. I AGREE THAT THE SUBSTANCE OF OUR RESPONSE TO THE CHINESE MESSAGE WILL PROBABLY NEED TO BE BUILT AROUND THE ELEMENTS IN YOUR PARAGRAPH 4. ALTHOUGH I HAVE ALREADY MADE MOST OF THESE POINTS TO KE IN MY INITIAL REACTION TO HIS MESSAGE. THE FORMAL RESPONSE WILL OF COURSE CARRY MORE AUTHORITY AND WE MAY BE ABLE TO INCLUDE SOME BUTTRESSING ARGUMENTS.

3. AS I MENTIONED WHEN WE MET IN HONG KONG ON 4 NOVEMBER I AGREE THAT THERE WOULD BE MERIT IN LETTING PURVES KNOW OF THE CHINESE REACTION TO THE ACQUISITION OF A STAKE IN THE MIDLAND. NOT ONLY BECAUSE THE CHINESE MAY EXPRESS THEIR CONCERNS DIRECTLY TO THE HKSAB. BUT ALSO BECAUSE THE HKSAB THEMSELVES ARE BEST PLACED TO ALLAY CHINESE SUSPICIONS ABOUT THE IMPLICATIONS OF THEIR MOVE AND THEIR LONGER TERM INTENTIONS. FOR THE REASONS YOU GIVE. I AGREE THAT IT WOULD MAKE SENSE FOR YOU TO SEE PURVES BEFORE THE AMBASSADOR SPEAKS TO KE.

4. WE ARE NOW PREPARING A DRAFT SPEAKING NOTE WHICH WE WILL TELEGRAPH TO YOU FOR COMMENT AFTER CLEARANCE WITH THE BANK AND THE TREASURY. WE SHALL THEN NEED TO SUBMIT TO MINISTERS BEFORE SENDING INSTRUCTIONS TO SIR R EVANS, WHO WOULD BE ASKED TO AWAIT CONFIRMATION THAT YOU HAD SPOKEN TO PURVES BEFORE TAKING ACTION. THE TIMING WOULD MEET THE CONSIDERATIONS IN PARA 3 OF YOUR 2ND TELEGRAM UNDER REFERENCE.

HOWE

LIMITED
HD / HKD
PS / LORD GLENARATHUR
PS / PWS
MR GILLMORE
MR Mc'CLAREN

cc MR LOEHNIS B/E
MR C W KELLY TREASURY

SECRET

*Sir G Little**PPS
Sir P Middleton*

SECRET

DEYOU/ORIEL

FM HONG KONG

TO DESKBY 251200Z FCO

TELNO 4472

OF 251035Z NOVEMBER 87

INFO IMMEDIATE PEKING

STRICTLY PERSONAL FOR HUM, HKD, FROM GOVERNOR
PEKING : STRICTLY PERSONAL FOR AMBASSADOR

HP

PEKING TELNO 2060 : HONGKONG AND SHANGHAI BANK

1. CLEARLY THIS SUBJECT IS GOING TO COME UP DURING MY VISIT TO PEKING. I HAVE BEEN TIED UP ALL DAY IN EXCO AND LEGCO AND HAVE NOT THEREFORE HAD AN OPPORTUNITY TO CONSIDER IN DETAIL HOW I SHOULD REACT. MY PRELIMINARY VIEW IS THAT I MUST BE IN A POSITION TO ACKNOWLEDGE THE EXISTENCE OF THE EARLIER PLAN AND THEN TO SAY THAT

(A) AT THE REQUEST OF MINISTERS IT HAS NOT BEEN TAKEN FURTHER SEMICOLON AND

(B) THE PRESENT PLAN IS DIFFERENT IN NATURE AND OBJECTIVE.

2. IN ADDITION WE NEED TO REFLECT ON WHETHER I SHOULD TAKE THIS OPPORTUNITY TO POINT TO SOME OF THE REAL PROBLEMS INVOLVED LONGER TERM, I.E. THE HKSB NEED TO FIND WAYS OF LOOKING AFTER ITS NON-HONG KONG ASSETS SEPARATELY BECAUSE OF THE WAY IN WHICH REGULATORS ELSEWHERE, PARTICULARLY THE UNITED STATES AND THE MIDDLE EAST, WOULD BE LIKELY TO REACT TO MAJOR LOCAL BANKS BEING UNDER THE CONTROL OF A CENTRAL OFFICE BASED IN WHAT WOULD THEN BE PART OF CHINA. THIS IS OBVIOUSLY A VERY DELICATE ISSUE.

3. I SHALL REFLECT FURTHER ON THESE ISSUES TOMORROW. MEANWHILE, IT WILL BE HELPFUL TO HAVE YOUR OWN PRELIMINARY COMMENTS.

4. IN ADDITION I HOPE WE CAN NOW TRY TO ESTABLISH MORE CLEARLY WHERE THE CHINESE HAVE GOT THEIR INFORMATION FROM ON THE EARLIER PLAN. UNTIL WE ARE CLEARER ON HOW MUCH THEY KNOW AND FROM WHERE, IT IS DIFFICULT TO KNOW HOW TO REACT. SHOULD WE NOT NOW APPROACH THE MIDLAND BANK AND ASK THEM POINT BLANK WHETHER THEY HAVE SPOKEN TO THE CHINESE; IF SO WHAT DID THEY SAY AND WHY DID THEY DO IT?

WILSON

NNNN

SECRET

SECRET

SECRET
DEYOU ORIEL
FM FCO
TO DESKBY 260100Z HONG KONG
TELNO 3102
OF 251700Z NOVEMBER 87
INFO IMMEDIATE PEKING

FOLLOWING STRICTLY PERSONAL FOR GOVERNOR FROM HUM, HKD
FOLLOWING STRICTLY PERSONAL FOR AMBASSADOR

YOUR TELNO 4472: HONG KONG AND SHANGHAI BANK

1. OUR IMMEDIATE REACTION AT OFFICIAL LEVEL IN THE FCO IS THAT IT WILL BE A VERY DELICATE MATTER TO GO MUCH BEYOND THE EXPLANATIONS ALREADY GIVEN TO THE CHINESE BY MCLAREN AND SIR R EVANS. WE MUST AVOID REINFORCING THE ERRONEOUS CHINESE IDEA THAT WE ARE CONSULTED ABOUT ALL THE BANKS' ACTIVITIES AND PLANNING, AND MOREOVER HAVE TOTAL CONTROL OVER THEM. WE DO NOT HOWEVER SEE PARTICULAR DIFFICULTY IN YOUR ACKNOWLEDGING IN GENERAL TERMS THAT WE WERE MADE AWARE OF THE EARLIER MERGER PLAN, SINCE THE CHINESE ALREADY KNOW. YOU MIGHT ADD (SUBJECT TO MINISTERS' VIEWS) THAT MINISTERS MADE IT PLAIN THAT THEY WOULD DISAPPROVE OF ANY ARRANGEMENT BETWEEN THE TWO BANKS WHICH WOULD RESULT IN A CHANGE OF DOMICILE FOR HKSB: THE EARLIER PLAN WAS NOT PURSUED. THIS GAINS US THE KUDOS FOR THE POSITION WE TOOK ON THE EARLIER PLAN, BUT PERHAPS IT WOULD BE AS WELL FOR THE STANDING OF THE TWO BANKS WITH THE CHINESE (PARTICULARLY THE HKSB) NOT TO IMPLY DIRECTLY THAT THEY WOULD HAVE GONE AHEAD IF MINISTERS HAD NOT POSITIVELY PREVENTED THEM.

2. WHERE YOUR POINT 1(B) IS CONCERNED, PERHAPS YOUR STRONGEST LINE IS TO REPEAT THE ASSURANCE GIVEN TO YOU PERSONALLY BY PURVES: YOU MIGHT ADD THAT IT IS CLEAR FROM THAT ASSURANCE THAT THE PRESENT PLAN IS QUITE DIFFERENT FROM THE EARLIER PLAN. IT MAY BE UNWISE TO MAKE A CATEGORICAL COMMITMENT ABOUT LONG TERM OBJECTIVES.

3. WE HAVE SOME RESERVATIONS ABOUT THE IDEA THAT YOU MIGHT GO ON TO POINT TO SOME OF THE LONGER TERM PROBLEMS. FOR YOU TO DO SO SO SOON AFTER THE ANNOUNCEMENT OF THE NEW ARRANGEMENTS BETWEEN THE TWO BANKS COULD TEND TO RAISE CHINESE HACKLES RATHER THAN TO REASSURE. WE ARE INCLINED TO THINK THAT WE SHOULD MAKE USE OF THE THREE YEAR BREATHING SPACE WHICH WE NOW HAVE, AND BROACH SUCH DELICATE LONGER TERM ISSUES ONLY WHEN WE ARE SURE THE TIME IS RIPE. IDEALLY WE NEED TO BE CLEARER ABOUT THE LONGER TERM OBJECTIVES OF THE BANKS IN RELATION TO THE QUOTE TRIAL MARRIAGE UNQUOTE. WE WOULD HOPE TOO THAT OUR EDUCATION OF THE CHINESE ON BANKING MATTERS IN HONG KONG WOULD HAVE GONE CONSIDERABLY FURTHER BY THEN.

4. NOW THAT WE ARE ALREADY ENGAGED IN EXCHANGES WITH THE CHINESE ABOUT THE EARLIER PLAN THE QUESTION OF HOW MUCH THEY KNOW AND FROM WHERE MAY BE BECOMING RELATIVELY ACADEMIC. WE ARE HOWEVER MAKING ARRANGMENTS FOR A DISCREET ENQUIRY OF THE MIDLAND BANK.

5. WE LOOK FORWARD TO YOUR FURTHER VIEWS. IF YOU DECIDE IT WOULD BE HELPFUL FOR YOU TO MENTION TO THE CHINESE THE EARLIER ACTION TAKEN BY MINISTERS, YOU WILL UNDERSTAND THAT WE SHALL HAVE TO SEEK MINISTERIAL AUTHORISATION FOR YOU TO DO SO.

HOWE

HD/HKD

PS

PS/LORD GLENARTHUR

PS/PUS

MR GILLMORE

MR MCLAREN

COPIES TO.

MR. KOEHNIS. B.O.E.

MR. C.W. KELLY

TREASURY.

SECRET

DEYOU/ORIEL

FM HONG KONG

TO DESK^KBY 261200Z FCO

TELNO 4493

OF 261045Z NOVEMBER 87

INFO IMMEDIATE PEKING

STRICTLY PERSONAL FOR HUM, HKD, FROM GOVERNOR
PEKING: STRICTLY PERSONAL FOR AMBASSADOR

not copied to us.
YOUR TELNO 3102 : HONGKONG AND SHANGHAI BANK

1. I AGREE THAT IT WOULD BE WISE AT THIS STAGE TO TAKE A CAUTIOUS APPROACH WITH THE CHINESE. BUT WE HAVE VIRTUALLY BEEN PUT ON NOTICE THAT I CAN EXPECT MORE DETAILED QUESTIONING THAN THE CHINESE WOULD HAVE THOUGHT APPROPRIATE FOR EITHER THE AMBASSADOR OR MCLAREN. I THINK THE MINIMUM I CAN SAY IS THAT:

(A) WE WERE MADE AWARE OF THE EARLIER PROPOSAL FOR A MERGER BETWEEN THE HKSB AND THE MIDLAND. ALTHOUGH THE TWO PARTIES NEVER AGREED ON A FIRM PROPOSAL WE UNDERSTOOD THAT THE SCHEME WOULD HAVE RESULTED IN A CHANGE OF DOMICILE FOR THE HKSB SEMICOLON

(B) MINISTERS MADE IT PLAIN THAT THEY WOULD DISAPPROVE OF ANY SUCH ARRANGEMENT. THE TWO BANKS DID NOT PURSUE THE IDEA SEMICOLON

(C) THE PRESENT ARRANGEMENT IS OF A DIFFERENT NATURE. IT CONSISTS MERELY OF A COMMERCIAL INVESTMENT BY THE HKSB IN THE MIDLAND BANK. I HAVE BEEN ASSURED BY THE CHAIRMAN OF THE HKSB THAT IT WOULD NOT INVOLVE A CHANGE OF DOMICILE.

2. I BELIEVE HOWEVER THAT I WILL NEED TO GO A LITTLE BIT FURTHER IF THE CHINESE PRESS ME ON THE PREVIOUS PROPOSALS OR THE IMPLICATIONS OF THE PRESENT PLAN. THEY MAY, FOR EXAMPLE, ASK WHY THE HKSB WAS THINKING OF A CHANGE OF DOMICILE. TO BE EVASIVE WOULD RUN THE RISK OF AROUSING THEIR SUSPICIONS ABOUT BOTH THE BANK'S AND HMG'S MOTIVES. ON THE OTHER HAND, I WILL CLEARLY HAVE TO AVOID, SO FAR AS IS POSSIBLE, INFRINGING CHINESE SENSITIVITIES ABOUT CONFIDENCE IN THEIR ATTITUDE TO THE FUTURE OF HONG KONG.

3. I WOULD LIKE TO BE ABLE TO SAY DEFENSIVELY, IF NECESSARY THAT, WHILE I CANNOT SPEAK FOR THE HKSB, MY BELIEF IS THAT THEY ARE FIRMLY COMMITTED TO HONG KONG WHERE THEY HAVE A VERY SUBSTANTIAL

2- PART OF THEIR BUSINESS. MY IMPRESSION IS, HOWEVER, THAT THEY ARE CONCERNED ABOUT THE ATTITUDE WHICH MAY BE TAKEN TO SOME OF THEIR OVERSEAS SUBSIDIARIES BY SOME FOREIGN REGULATORY AUTHORITIES WHEN THE PARENT BANK FACES A CHANGE OF SOVEREIGNTY IN 1997.

4. IF PRESSED ABOUT HMG OR THE HONG KONG GOVERNMENT'S ATTITUDE, I WOULD CONFINE MYSELF TO SAYING THAT OUR CONCERN IS THAT THE HKSB SHOULD REMAIN FIRMLY COMMITTED TO HONG KONG AND THAT NOTHING SHOULD BE DONE WHICH MIGHT DAMAGE THE FINANCIAL AND ECONOMIC STABILITY OF HONG KONG.

5. IF NECESSARY I WOULD POINT OUT THAT WE CANNOT EXPECT TO CONTROL THE HKSB'S COMMERCIAL DECISIONS. WE WILL ALWAYS USE OUR INFLUENCE TO ENSURE THAT THE INTERESTS OF HONG KONG AS A WHOLE ARE TAKEN INTO ACCOUNT AND WE BELIEVE THE HKSB ALSO SEE THAT WIDER INTEREST. IF PRESSED ON HOW THE HKSB MAY TRY TO DEAL WITH THE PROBLEM OF ITS OVERSEAS SUBSIDIARIES I WOULD SAY THAT I DO NOT KNOW OF ANY PRESENT PLANS: IF THERE ARE REAL DIFFICULTIES WHICH MIGHT IN TURN DAMAGE THE POSITION OF THE HEADQUARTERS BANK AND THEREFORE HONG KONG, SOME WAY OF RESOLVING THEM WILL CLEARLY HAVE TO BE FOUND. IF FURTHER PRESSED I WOULD KICK FOR TOUCH BY SAYING THAT THESE ARE THE SORT OF ISSUES WHICH COULD BE DISCUSSED IN THE VERY CONFIDENTIAL DIALOGUE ON FINANCIAL MATTERS WE HAVE NOW ESTABLISHED.

6. I CANNOT AGREE THAT THE WAY IN WHICH THE CHINESE GOT THEIR INFORMATION ON THE MERGER PLAN IS NOW ACADEMIC. AT OFFICIAL LEVEL IN BOTH LONDON AND HONG KONG WE HAVE IMPOSED MOST STRINGENT PRECAUTIONS TO ENSURE THAT NEWS OF THE PLAN DID NOT LEAK AND CAUSE ALARM TO THE CHINESE. WE NOW DISCOVER THAT THE CHINESE KNEW ANYHOW. ALSO THAT THEY GAVE A STRONG NEGATIVE REACTION PRESUMABLY BELIEVING THAT IT WOULD BE PASSED ON SEMICOLON BUT IT NEVER WAS. WE MUST SURELY DO EVERYTHING POSSIBLE TO FIND OUT EXACTLY WHAT THEY WERE TOLD, BY WHOM, AND WHEN. WE NEED THIS INFORMATION BOTH TO DEAL WITH WHATEVER CONCERNS THEY MAY HAVE AS A RESULT OF THE INFORMATION THEY WERE GIVEN AND SO THAT WE CAN HAVE A BETTER CONTROL OVER SENSITIVE INFORMATION IN FUTURE.

7. I AM LEAVING HONG KONG ON THE MORNING OF 30 NOVEMBER AND WILL NEED TO BRIEF PURVES BEFORE I GO IF I AM TO SAY ANYTHING SUBSTANTIVE ABOUT THE HKSB. IT WOULD BE EXTREMELY HELPFUL IF I COULD RECEIVE AUTHORITY FOR THE LINE ABOVE DESKBY 280100Z. IF YOU HAVE ANY FURTHER COMMENTS AT OFFICIAL LEVEL THAT YOU WOULD LIKE TO MAKE BEFORE SUBMITTING TO MINISTERS, I WOULD BE GRATEFUL IF THEY COULD REACH ME DESKBY 270100Z.

WILSON

OUT TELEGRAM

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2 SECRET
3 DEYOU ORIEL
4 FM FCO
5 TO HONG KONG DESKBY 280100Z
6 TELNO
7 OF 261650Z NOVEMBER 87
8 INFO IMMEDIATE PEKING

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FOLLOWING STRICTLY PERSONAL FOR GOVERNOR FROM HUM, HKD
PEKING STRICTLY PERSONAL FOR AMBASSADOR
YOUR TELNO 4493: HONG KONG AND SHANGHAI BANK

1. We have consulted Ministers on the line which you should take with the Chinese. The Governor of the Bank of England and the Chancellor of the Exchequer have also been consulted.

2. Ministers are content that you should make the points in paras 1(a), (b) and (c) of TUR, amended to read as follows:

(a) we were made aware of the earlier idea of a merger between the HKSB and the Midland, although this represented preliminary thinking between the two parties and never amounted to a firm proposal:

(b) Ministers made it plain that they would disapprove of any such arrangement which would have resulted in a change of domicile for the HKSB. The two banks did not pursue the idea.

(c) The present arrangement is of a ~~new~~ different nature. It

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YYYY
MAIN
ADDITIONAL
NNNN

		Catchword:	
File number	Dept HKD	Drafted by (Block capitals) C O HUM	Telephone no 270 2647
Authorised for despatch by:		Initials	Date/time
For COD use only	Comcen reference	Telegram number	Processed by

SECRET

DEYOU ORIEL

DESKBY

<<<<

consists of a commercial investment by the HKSB. I have been assured by the Chairman of the HKSB that there ^{is} ~~was~~ no question of a change of domicile for the HKSB, nor ^{is} ~~was~~ this investment the prelude to such a change.

3. You might also draw defensively on the first sentence of para 3, para 4 and the first two sentences of para 5. We feel that these points together constitute a defensible position, which does not appear unduly evasive.

4. Ministers do however have some misgivings about your suggestion that you should be ready to refer defensively to overseas subsidiaries of the HKSB. They feel that to touch on this aspect at this stage could well be less rather than more reassuring for the Chinese. It would involve you in new and complicated areas of exchange with the Chinese for which neither we (nor probably the HKSB) are really prepared. Effectively it amounts to speaking for the HKSB, despite your proposed disclaimer.

5. We note that you plan to brief Purves before you leave Hong Kong. We suggest you might enquire what Purves is planning to do, given the evident concern of the Chinese, to reassure them through his own banking channels. If he does not have this in mind, surely he should. It would also evidently be helpful if you, having told the Chinese of the assurances which Purves has given to you, could be able to add that you understood he was in direct touch with them through banking channels in order to convey the same assurances.

6. We share your concern about the leak of the earlier merger plan. Sir C McMahon has now assured the Governor of the Bank of England that there was no contact between the Midland Bank and the Chinese. You will recall however that the Midland revealed to us at the time that a number of their executives were privy to the plan, including a French and an American directors of Midland subsidiaries. We expressed our concern that the

For distribution order see Page

Catchword:

OUT TELEGRAM (CONT)

Classification
SECRET

Content
DEYOU ORIEL

Precedence
DESKBY

1 <<<<

2 information should be more closely protected within the bank.

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4 **HOWE**

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8 **MAIN**

9 **HD/HKD**

10 **PS**

11 **PS/LORD GLENARTHUR**

12 **PS/PUS**

13 **MR GILLMORE**

14 **MR MCLAREN**

15
16 **ADDITIONAL**

17 **MR LOEHNIS, B OF E**

18 **MR D PERETZ, TREASURY**

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20 **NNNN**

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For distribution order see Page

Catchword:

YF37

pay

From : D L C Peretz
Date : 26 November 1987

PRINCIPAL PRIVATE SECRETARY

cc Sir P Middleton
Sir G Littler

HONG KONG AND SHANGHAI BANK

*1 Suspense by Sir G Littler
by Sir G Littler
you see
or from Sir P Middleton*

The Chancellor should, I think, see the attached telegrams.

2. As you may recall, when the Chinese were told (just ahead of the event) of the HKSB/Midland link they referred to the earlier proposal for a complete merger in terms that suggested they thought that : we had told them about it; they had in turn given a negative reaction to us; and that our subsequent action owed something to their negative reaction. This is all rather puzzling since we did not tell them; and both Midland Bank and HKSB deny having done so.

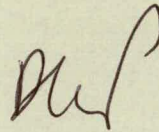
3. The question now is how far the Governor should go in acknowledging the existence of the earlier plan when he sees the Chinese next week. His advice is in telegrams no. 4472 of 25 November and 4493 of 26 November.

4. I have discussed this with the Bank of England (who have consulted the Governor) and FCO. Our joint advice is that the Governor (of Hong Kong) should go as far as suggested in paragraph 1 of telegram no. 4493; and if necessary use the first sentence of paragraph 3, paragraph 4, and the first 2 sentences of paragraph 5. But that beyond that he should if possible say no more than that the earlier plan never reached anything beyond a very preliminary stage, and was then withdrawn; so that we never pursued the details and reasoning behind it with the banks concerned. This is reflected in the attached draft telegram on which the FCO are consulting the Foreign Secretary overnight.

5. In the circumstances it can only be helpful in our relations with the Chinese to confirm that we did make it plain we would disapprove of the earlier plan. And since the Chinese believe (or

Highlighted

are prepared to pretend to believe) that we told them about it at the time it looks as if we can acknowledge this without getting into any further difficulty.



D L C PERETZ

CONFIDENTIAL



pm

FROM: A C S ALLAN

DATE: 27 November 1987

MR PERETZ

cc: Sir P Middleton
Sir G Littler

HONG KONG AND SHANGHAI BANK

The Chancellor was grateful for your minute of 26 November, and is content with the line proposed.

A handwritten signature in black ink, appearing to read 'A C S Allan', with a long horizontal flourish underneath.

A C S ALLAN

a PPS
Sir P Middleton

SECRET
TELETYPE
FM PEKING
TO DESKBY 270930Z FCU
TELNO 2073
OF 270830Z NOVEMBER 1987
INFO IMMEDIATE HONG KONG.

7 Sir P (C...?)
T3 see X
DUP
27/11

STRICTLY PERSONAL FOR HUN, HONG KONG DEPT., FROM AMBASSADOR.
HONG KONG: STRICTLY PERSONAL FOR GOVERNOR.

HONG KONG TELNO'S 4472 AND 4493 AND YOUR TELNO.3102 TO HONG KONG :
HONG KONG AND SHANGHAI BANK.

1. I HAVE SEEN BY NO MEANS ALL THE CORRESPONDENCE ON THIS SUBJECT.
IT WAS CHIEFLY FOR THIS REASON THAT I ADDED NO COMMENTS TO MY REPORT
OF THE CONVERSATION I HAD WITH KE ZAISHUO ON 24 NOVEMBER (MY TELNO.
2060). BUT THE 3 TELEGRAMS TO WHICH THIS ONE REFERS PROMPT ME TO
OFFER SOME THOUGHTS.

2. IT WAS VERY CLEAR FROM WHAT KE SAID TO ME ON 24 NOVEMBER THAT
THOSE CONCERNED ON THE CHINESE SIDE HAD KNOWN FOR SOME TIME ABOUT
WHAT HE CALLED THE QUOTE ORIGINAL PLAN UNQUOTE. HE DID NOT GIVE
ME ANY CLUE AS TO HOW THE CHINESE HAD HEARD ABOUT IT, BEYOND SAYING
THAT KNOWLEDGE ABOUT IT HAD NOT BEEN ACQUIRED THROUGH QUOTE
ESTABLISHED CHANNELS UNQUOTE. BUT HE DID MUTTER TO ME AS I WAS
GOING OUT THAT SOME QUOTE BRITISH LEADERS UNQUOTE KNEW THAT
LEADERS ON THE CHINESE SIDE WERE IN THE KNOW ABOUT IT. I PLANNED TO
PASS THIS ON TO THE GOVERNOR WHEN I SAW HIM NEXT WEEK. BUT IT NOW
SEEMS TO ME THAT HE COULD BE LED INTO SAYING SOMETHING WHICH WOULD
STRIKE THE CHINESE AS DISINGENUOUS IF I DID NOT REPORT IT BEFOREHAND
(LEST YOU SHOULD WONDER, I CAN CONFIRM THAT I REPORTED EVERY OTHER
POINT WHICH KE MADE TO ME).

3. IT WAS ALSO VERY CLEAR FROM WHAT KE SAID THAT THERE WAS DEEP
CHINESE SUSPICION ABOUT WHAT THE HONG KONG AND SHANGHAI BANK
(HKSB) HAD BEEN UP TO AND NOW WANTED TO DO. IT IS NOW CLEAR TO
ME THAT THE CHINESE KNOW THAT THE QUOTE ORIGINAL PLAN UNQUOTE
WOULD HAVE ENTAILED A CHANGE OF DOMICILE FOR THE HKSB. IN THIS

SITUATION, I TOO BELIEVE THAT THE GOVERNOR CAN HARDLY SAY LESS THAN HE RECOMMENDS IN PARAGRAPH 1 OF HONG KONG TELNO.4493.

4. THERE IS ANOTHER ANGLE. GIVEN THAT THE CHINESE KNOW THAT THE QUOTE ORIGINAL PLAN UNQUOTE WAS ABANDONED BY THE TWO BANKS AFTER MINISTERS HAD EXPRESSED THEIR DISAPPROVAL, AND GIVEN THAT WE HAVE MADE SOME PLAY OF THE FACT THAT THE SHAREHOLDING ACQUIRED BY THE HKSIB IN THE MIDLAND BANK IS JUST BELOW THE LEVEL WHICH WOULD REQUIRE BANK OF ENGLAND APPROVAL, IT COULD BE DANGEROUS TO MAKE TOO MUCH OF THE LINE THAT HMG ARE NOT CONSULTED ABOUT THE ACTIVITIES OF BANKS AND DO NOT IN ANY CASE HAVE TOTAL CONTROL OVER THEM (PARAGRAPH 1 OF YOUR TELNO.3102 TO HONG KONG). THE CHINESE WILL BELIEVE THAT, WHENEVER A MOVE WHICH MIGHT INVOLVE ANYTHING AS IMPORTANT AS A CHANGE OF DOMICILE BY THE HKSIB IS UNDER DISCUSSION WITHIN THE BANKING WORLD, HMG WILL BOTH KNOW ABOUT IT AND ULTIMATELY HAVE A POWER OF VETO.

EVANS

LIMITED

Additional: -

Ad HKD

Mr LOEHNIS Bx / ENGLAND

PS / Lord GLENARTHER

Mr C W KELLY, HM TREASUR

PS / PLS

Mr GILLMORE

Mr Mc LAREN

SECRET

SECRET

SECRET
DEYOU ORIEL
FM HONG KONG
TO IMMEDIATE FCO
TELNO 4818
OF 171040Z DECEMBER 87
INFO PRIORITY PEKING

STRICTLY PERSONAL FOR HUM, HKD, FROM GOVERNOR
PEKING STRICTLY PERSONAL FOR AMBASSADOR

MIPT: HONG KONG AND SHANGHAI BANK

1. THE FOLLOWING IS THE TEXT OF THE NCNA PRESS RELEASE:

ON 13 NOVEMBER, THE HONG KONG AND SHANGHAI BANKING CORPORATION AND MIDLAND BANK ANNOUNCED THAT HONG KONG BANK WOULD PURCHASE 14.9 PERCENT SHAREHOLDINGS OF THE MIDLAND BANK WITH 680 MILLION US DOLLARS. ON THE DAY THE ANNOUNCEMENT WAS MADE, THERE WERE STRONG RESPONSES FROM THE BRITISH FINANCIAL SECTOR AND THE MEDIA. PEOPLE FELT THAT THIS QUOTE HISTORICAL UNQUOTE MOVE HAS GIVEN SUPPORT TO MIDLAND BANK WHICH WAS IN A WEAK POSITION AND HAS ALSO EXTENDED HONG KONG BANK'S INFLUENCE AND STRENGTH. THERE WERE ALSO SOME COMMENTS SAYING THAT THIS WAS HONG KONG BANK'S FIRST STEP IN ITS PLAN TO QUOTE EVACUATE FROM HONG KONG UNQUOTE BEFORE HONG KONG IS GIVEN BACK TO CHINA IN 1997.

OUR REPORTER WENT TO HONG KONG BANK'S LONDON OFFICE TO INTERVIEW MICHAEL BROADBENT, EXTERNAL RELATIONS MANAGER OF HONG KONG BANK'S HEAD OFFICE. HE SAID THAT THE ACQUISITION BY HONG KONG BANK OF MIDLAND BANK'S (ONE OF THE FOUR BRITISH CLEARING BANKS) SHAREHOLDINGS WAS NOT INTENDED TO EVACUATE FROM HONG KONG BUT TO FURTHER STRENGTHEN THE BANK'S POSITION AS AN INTERNATIONAL BANK.

BROADBENT WAS IN THE UK TO PARTICIPATE IN ACTIVITIES CONNECTED WITH THE ANNOUNCEMENT OF THE ACQUISITION. HE SAID THAT SOME PEOPLE THOUGHT THE MOVE WAS A STEP IN HONG KONG BANK'S EVACUATION FROM HONG KONG. THIS WAS BECAUSE THESE PEOPLE WERE FAR AWAY FROM HONG KONG AND DID NOT FULLY UNDERSTAND THE SITUATION OF HONG KONG. HE EMPHASIZED: QUOTE WE HAVE CONFIDENCE EVER SINCE THE SINO-BRITISH JOINT DECLARATION ABOUT HONG KONG'S FUTURE WAS SIGNED UNQUOTE.

①
SECRET

ACCORDING/

SECRET

ACCORDING TO BROADBENT, HONG KONG'S ECONOMIC GROWTH IN THE PAST TWO YEARS HAVE REACHED TWO DIGITS AND THEY HAVE NO INTENTION WHATSOEVER OF EVACUATING THE HEAD OFFICE FROM HONG KONG.

HE TOLD OUR REPORTER THAT HONG KONG BANK HAS NOW BECOME ONE OF THE LARGEST BANKS IN ASIA AND RANKED 31ST IN THE INTERNATIONAL BANKS IN TERMS OF TOTAL ASSETS. IN THE US, HONG KONG BANK IS THE LARGEST FOREIGN BANK. HOWEVER, THE BANK'S OPERATION IN EUROPE IS NOT SIGNIFICANT. DISTRIBUTION OF HONG KONG BANK'S ASSETS IN ASIA, NORTH AMERICA AND EUROPE ARE APPROXIMATELY IN THE RATIO OF 4:4:2. BROADBENT SAID THAT HONG KONG BANK'S CURRENT STRATEGY WAS TO UTILIZE MIDLAND BANK'S STRENGTH IN EUROPE TO EXPAND ITS EUROPEAN OPERATION AND GRADUALLY ADJUST THE GEOGRAPHICAL DISTRIBUTION OF ITS ASSETS TO ONE THIRD EACH IN ASIA, NORTH AMERICA AND EUROPE. HE EMPHASIZED: QUOTE THE EXPANSION OF AN INTERNATIONAL BANK'S OPERATION IN ONE PLACE DOES NOT MEAN A REDUCTION IN ANOTHER PLACE. UNQUOTE

WILSON

HD/HRD

PS

PS/LORD GLENARTHUR.

PS/PUS.

MR GILLMORE

MR MCLAREN

COPIES TO.

MR HOEHNIS B. OF ENG
MR. PERETZ . TREASURY

②

SECRET

SECRET

GRS 125

SECRET

DEYOU ORIEL
FM HONG KONG
TO IMMEDIATE FCO
TELNO 4817
OF 171035Z DECEMBER 87
INFO PRIORITY PEKING

Memo Mura
✓

M
cc PPS
Sir P. Middleton
Sir G. Little.

STRICTLY PERSONAL FOR HUM, HKD, FROM GOVERNOR
PEKING STRICTLY PERSONAL FOR AMBASSADOR
HONG KONG AND SHANGHAI BANK

1. MIFT CONTAINS A PRESS RELEASE THAT NCNA ISSUED ON 12 DECEMBER.
IT IS INTERESTING THAT THE CHINESE SHOULD GO TO THESE LENGTHS TO
DAMPEN DOWN SPECULATION ABOUT THE HKSB'S MOTIVES IN ACQUIRING
14.9 PERCENT OF THE MIDLAND BANK AND THAT THEY DID SO IN THIS FORM
FOLLOWING MY PEKING VISIT.

2. THE RELEASE WAS PICKED UP IN 6 LOCAL CHINESE-LANGUAGE NEWSPAPERS
ON 12/13 DECEMBER - CHUNG PO, THE ECONOMIC JOURNAL, MING PAO, THE
NEW EVENING POST, WAH KIU MAN PO AND WEN WEI PO.

WILSON

HD / HKD
PS
PS / LORD GLENARTHUR.
PS / PUS
MR GILMORE
MR MCLAREN

COPIES TO .
MR ~~HOEHNIS~~ B. OF ENG
MR ~~PERETZ~~ TREASURY

SECRET



London SW1A 2AH

Handwritten initials

Sir Patrick Wright KCMG
Permanent Under-Secretary of State

1 February 1988

Robin Leigh-Pemberton Esq
Governor of the Bank of England
Threadneedle Street
LONDON EC2

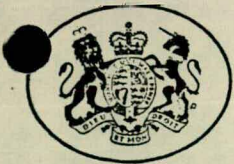
RECEIVED	
- 2 FEB 1988	
Action	MRS Lomas
Copies	PPS, PS/EST
To	Sir G Little Mr Scholten

Dear Robin,

Handwritten notes: You know v. r. s. -

HONG KONG BANKING: STANDARD CHARTERED BANK

1. When you came to see me on 20 January to talk about the Standard Chartered Bank (SCB), I said I would let you have our considered views on the implications of a takeover of the SCB by Sir Y K Pao, or a significant increase in his shareholding in the bank.
2. We have consulted the Governor of Hong Kong and our Ambassador at Peking on a strictly confidential basis. The Governor believes that there is general recognition in Hong Kong that the present position in relation to the SCB's share ownership is unsatisfactory, and needs resolution. In his view, any sensible solution to this problem will therefore create a sense of relief in financial circles in Hong Kong. He has also pointed out that there has already been considerable press speculation that Sir Y K Pao might increase his shareholding in the SCB: such a move is therefore unlikely to come as any great surprise. He believes on balance that the news would be well received in Hong Kong. He does not think it would be interpreted in a negative sense, such as, for example, a flight of capital from Hong Kong: unless of course Sir Y K Pao were to dispose of major parts of his local investments to fund the purchase (which seems most unlikely).
3. We asked the Governor to consider whether there were any implications for the Hong Kong and Shanghai Bank (HKSB). His assessment is that there would be none of any significance: in particular he does not think that any developments relating to the SCB would affect the HKSB's plans regarding the Midland Bank.
4. The Governor has suggested that the Hong Kong based operations of the SCB are likely to be the main attraction to Sir Y K Pao: he might be planning to hive them off from the rest of the bank and then buy them out. We imagine that



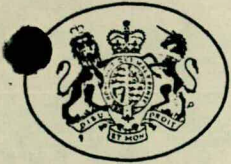
such an outcome, which would leave the Bank of England with supervisory responsibility over the rump of the SCB, would be undesirable from your point of view. It would also be undesirable in the eyes of the Hong Kong Government: any major structural change of this sort would oblige them to examine the SCB's continuing role as a note issuing bank, which would in turn open up wider issues. We therefore recommend that you should seek an assurance from Sir Y K Pao that no such change would be contemplated.

5. The Governor sees little likelihood of problems with the Chinese Government over such a move, providing they were informed in advance: they do not of course regard the SCB as a Hong Kong bank in the same way as the HKSB. Richard Evans shares this general assessment. He has however noted that Sir Y K, although close to the Chinese leadership, may not be regarded by them as totally reliable. He has also drawn attention to the Chinese aversion to any drastic change in the banking status quo in Hong Kong.

6. We think it likely that Sir Y K Pao would himself speak to his Chinese contacts before his share application became public knowledge. But we are on balance inclined to recommend that, although we are under no strict obligation to do so, HMG should also speak in advance to the Chinese Government about the acquisition, through our Ambassador at Peking. This would ensure that our own position (in particular any condition which we attached to discourage major restructuring) was clearly on the record. It would also meet the point about the extreme Chinese sensitivity to change in the structure of banking in Hong Kong, to which both the Governor and the Ambassador have drawn attention.

7. We have considered whether there would be any implications for the SCB's presence in certain black African countries. We have concluded that there are none: we would be content to leave the handling of the SCB's African operations to the commercial judgement of the bank.

8. We have also considered whether there is any Brunei aspect which you ought to take into account. As far as we can see there is not: the Sultan of Brunei has recently confirmed to Lord Fanshawe that the reputation of the SCB has not been damaged in his eyes by Khoo Tek Puat's holding. We can see no reason why the Sultan should be concerned if Sir Y K Pao were to increase his stake.



SECRET AND STRICTLY PERSONAL

9. To sum up, our advice is that there is no reason from the FCO's point of view why you should turn down an application by Sir Y K Pao to increase his shareholding in the SCB. It offers the prospect that the bank can be built up as an important vehicle for three-way commercial and financial contacts between London, Hong Kong and Peking: a development which could benefit all three centres. We suggest however that you might seek a clear assurance from Sir Y K that his future plans for the bank will not involve major structural change in Hong Kong. We recommend that the Chinese Government should be informed in advance of the announcement of such a move: we will therefore need to be in touch about this aspect at the appropriate time.

10. I am sending a copy of this letter to Peter Middleton.

Yours a.

Patrick

Patrick Wright

JR1AIA

SECRET AND STRICTLY PERSONAL

Secret

SECRET

DEYOU/DEVIL

FM PEKING

TO IMMEDIATE FCO

TELNO 523

OF 180910Z MAR 88

INFO IMMEDIATE HONG KONG

PPS
cc Sir P Middleton
Sir G Lither
Miss O Meara

FCO STRICTLY PERSONAL FOR HUM, HKD.
HONG KONG STRICTLY PERSONAL FOR JACOBS.

HONG KONG TELNO.981: VISIT TO CHINA BY PURVES.

1. I WENT TO THE DINNER GIVEN FOR PURVES BY CHEN MUHUA ON 17 MARCH. NOTHING OF PARTICULAR INTEREST TRANSPIRED.
2. PURVES CALLED ON ME THIS MORNING (18 MARCH), TOGETHER WITH RUSSELL AND LAU. HE BRIEFED ME VERY FULLY ON THE MEETINGS HE HAD HAD WITH JI PENGFEI AND (SEPERATELY) WITH SENIOR OFFICIALS OF THE PEOPLE'S BANK OF CHINA. HE WILL PREPARE A WRITTEN REPORT FOR THE GOVERNOR AS SOON AS HE RETURNS TO HONG KONG.
3. MEANWHILE, I AM SENDING YOU AND JACOBS THIS SHORT REPORT ABOUT WHAT TRANSPIRED BETWEEN JI AND PURVES ON MATTERS TO DO WITH THE HONG KONG BANK. A FULL REPORT OF WHAT PURVES SAID TO ME, ON THIS AND OTHER MATTERS, WILL FOLLOW BY BAG TO YOU IN LONDON AND THE GOVERNOR IN HONG KONG.
4. JI STARTED BY TELLING PURVES THAT THE CHINESE GOVERNMENT WOULD LIKE TO SEE THE LINK BETWEEN THE HONG KONG DOLLAR AND THE US DOLLAR MAINTAINED. IT HAD SUBSEQUENTLY EMERGED THAT THIS MEANT BOTH THE LINK ITSELF AND THE PRESENT EXCHANGE RATE BETWEEN THE TWO CURRENCIES.
5. PURVES HAD REPLIED THAT THE DEGREE OF PRESSURE ON THE HONG KONG DOLLAR HAD DEPENDED, AND WOULD DEPEND, ON WHAT HAPPENED TO THE US DOLLAR. THERE HAD BEEN LITTLE OR NO OFFICIAL AMERICAN PRESSURE FOR THE DISSOLUTION OF THE LINK. BUT THE MEDIA IN HONG KONG HAD INTERPRETED REMARKS BY SOME VISITING AMERICANS TO MEAN THAT SUCH PRESSURE EXISTED. HE HIMSELF WAS NOT IN FAVOUR OF THE HONG KONG

-) -
Secret

DOLLAR)

Secret

DOLLAR BEING ALLOWED TO FLOAT. IF IT WERE, IT WOULD BECOME THE "PLAYTHING" OF FOREIGN EXCHANGE DEALERS WORLDWIDE. NOR DID HE THINK THAT THE PRESENT RATE OF EXCHANGE BETWEEN THE TWO CURRENCIES OUGHT TO BE CHANGED IN PRESENT CIRCUMSTANCES. IF IT WERE TO BE CHANGED, PRESSURE WOULD RAPIDLY BUILD UP IN THE FOREIGN EXCHANGE MARKETS TO FORCE FURTHER CHANGE. IN THAT SITUATION, THE HONG KONG DOLLAR WOULD AGAIN BECOME A "PLAYTHING".

6. PURVES HAD ADDED TO JH THAT IT WOULD NOT BE POSSIBLE TO MAINTAIN THE PRESENT RATE OF EXCHANGE IF "THE US DOLLAR WERE TO FALL OUT OF BED". SHORT OF THAT, HOWEVER, HE FAVOURED THE MAINTENANCE OF THE STATUS QUO.

7. SPEAKING WITH EMPHASIS, JH HAD SAID THAT THE HONG KONG BANK WOULD HAVE A MOST IMPORTANT ROLE TO PLAY IN HONG KONG BOTH BEFORE AND AFTER 1997. HE HAD THEN REFERRED TO ITS QUASI-CENTRAL BANK FUNCTIONS AS A NOTE-ISSUING BANK AND AS A CLEARING HOUSE. IT WAS THE VIEW OF THE CHINESE GOVERNMENT THAT IT SHOULD CONTINUE TO PLAY ITS PRESENT ROLE IN THE TWO AREAS AFTER 1997. THE PEOPLE'S BANK OF CHINA WOULD NOT (REPEAT) NOT OPEN A BRANCH IN HONG KONG AFTER 1997.

9. JH ADDED THAT THERE WOULD BE AN IMPORTANT ROLE FOR THE HONG KONG BANK IN CHINA AS WELL AS IN HONG KONG, BOTH BEFORE AND AFTER 1997.

EVANS.

Limited

Nd / HKD

Nd / FED

PS

PS / Lord of Kenarthur

PS / PUS

Mr Gillmore

Mr McLaren

Additional

Mr A Loehris

Bk / England

Mr D Peretz

HM Try

- 2 -
Secret

S E C R E T

Peretz

From : D L C Peretz
Date : 12 December 1988

PRINCIPAL PRIVATE SECRETARY

Handwritten notes:
[]
Good, [unclear]
[unclear] (iv)
[unclear]

cc Sir Peter Middleton
Sir G Littler
Mr Odling-Smee
Miss O'Mara

HONG KONG/CHINESE TALKS

The Chancellor might be interested to see the attached telegram (no. 4508 of 12 December) reporting the discussion, just completed, between Chinese and Hong Kong officials, on financial matters.

2. The Chinese side :-

- i) supported the new interest / rate / monetary control arrangements in Hong Kong.
- ii) re-emphasised the importance they attach to the exchange rate peg, and took the opportunity to say that they very much hoped they would be consulted if there were any proposal to change it.
- iii) said that they were not pressing for the creation of a monetary authority in Hong Kong, while not entirely excluding the idea.
- iv) stressed the importance (paragraph 7) they attach to the HSBC's continued position in Hong Kong.

DLCP

D L C PERETZ

SECRET / DEYOU

GRS 1000

SECRET
DEYOU/DEVIL
FM HONG KONG
TO IMMEDIATE FCO
TELNO 4508
OF 081012Z DECEMBER 88
INFO IMMEDIATE PEKING

PPS

cc Sir Peter Middleton
Sir G Litter
Mr Odling - see
Miss O Mara

FOLLOWING STRICTLY PERSONAL FOR PAUL, HKD FROM GOVERNOR
PEKING STRICTLY PERSONAL FOR AMBASSADOR/MISS BAILES

MIPT: DIALOGUE ON FINANCIAL MATTERS

SUMMARY

A VERY USEFUL MEETING HELD IN A GOOD ATMOSPHERE. NO AREAS OF DISAGREEMENT, BUT THE CHINESE REMAIN CONCERNED THAT THE ROLE OF THE HONGKONG AND SHANGHAI BANKING CORPORATION (HSBC) IN HONG KONG SHOULD NOT BE DIMINISHED. THEY ALSO STATED A WISH TO BE CONSULTED SHOULD OUR LINK TO THE US DOLLAR BE CHANGED.

DETAIL

2. DETAILED NOTES OF THE MEETING ARE BEING PREPARED AND WILL BE SENT TO YOU BY BAG. THE MAIN POINTS DISCUSSED WERE AS FOLLOWS:

3. THE CHINESE SIDE OFFERED FOR OUR CONSIDERATION COMMENTS THAT THEY HAD RECEIVED ON THE PROGRESS IN THE IMPLEMENTATION OF REFORMS IN THE SECURITIES INDUSTRY, ADDING THAT THESE DID NOT NECESSARILY REFLECT THEIR OWN POSITION. THE COMMENTS WERE GENERALLY ABOUT THE DANGERS OF OVER-REGULATION. LU PING LATER MENTIONED THE NEED FOR CONSISTENCY IN THE ENFORCEMENT OF THE LAW AGAINST THOSE WHO HAD VIOLATED IT. WHILE MAKING IT CLEAR THAT HE WAS NOT ATTEMPTING TO DEFEND THE POSITION OF ANYBODY IN PARTICULAR, HE DREW ATTENTION TO COMMENTS THAT WE HAD BEEN LENIENT IN THE PAST BUT VERY STRICT IN MORE RECENT CASES.

4. THE CHINESE SIDE WERE FULLY SUPPORTIVE OF THE NEW ACCOUNTING ARRANGEMENTS FOR MONETARY CONTROL AND FELT THAT THEY REPRESENTED A UNIQUE SOLUTION FOR HONG KONG. THE ARRANGEMENTS WERE HELPFUL IN REDUCING CRITICAL COMMENTS ABOUT THE PRIVILEGED POSITION OF HSBC, BUT ALSO USEFULLY INCREASED THE ROLE OF HSBC IN HONG KONG. THE CHINESE ALSO EMPHASISED THE NEED TO BE CONTINUOUSLY VIGILANT. THE NEW ARRANGEMENTS SHOULD BE COMBINED WITH OTHER MEASURES TO STABILISE THE EXCHANGE RATE EFFECTIVELY. THEY SUPPORTED FULLY THE IDEA OF ISSUING EXCHANGE FUND BILLS, ON THE UNDERSTANDING THAT THE PROCEEDS WERE NOT USED TO FINANCE BUDGET DEFICITS.

5. ON THE LINKED EXCHANGE RATE SYSTEM, THE CHINESE SIDE REITERATED THE IMPORTANCE OF EXCHANGE RATE STABILITY FOR HONG KONG. THEY REPEATED RATHER FORCEFULLY THEIR HOPE THAT THE HKG WOULD CONSULT THE CHINESE GOVERNMENT AS SOON AS POSSIBLE IF FOR ANY REASON WE WISHED TO CHANGE THE LINK. LU PING SAID THAT HE MADE THIS REQUEST UPON THE INSTRUCTIONS OF THE CHINESE GOVERNMENT AND HOPED THAT HKG WOULD GIVE PRUDENT CONSIDERATION TO IT. THE CHINESE GOVERNMENT SUPPORTED THE LINK AND EVERY CHINESE ORGANISATION THEREFORE TOOK SUPPORTIVE ACTION. HE DID NOT WISH TO SEE THE NATIONAL INTEREST

SECRET / DEYOU

(1)

DF /

OF THE CHINESE GOVERNMENT ENDANGERED BY A MOVE IN THE EXCHANGE RATE. JACOBS NOTED THE REQUEST.

WHILE NOT EXPLICITLY ACCEPTING THE OBLIGATION TO CONSULT THE CHINESE, HE AGREED TO GIVE PRUDENT CONSIDERATION TO LU'S REQUEST. HE NOTED, HOWEVER, THAT EVENTS IN THE FINANCIAL MARKETS COULD MOVE VERY SWIFTLY INDEED.

6. THE CHINESE SAID THAT THEY HAD NO INTENTION OF SUGGESTING THAT A CENTRAL BANK OR A MONETARY AUTHORITY SHOULD BE ESTABLISHED IN HONG KONG. THEY AGREED WITH THE CONCLUSION OF OUR PAPER THAT THE VARIOUS ROLES WERE BEING SATISFACTORILY PERFORMED UNDER THE EXISTING INSTITUTIONAL ARRANGEMENTS IN HONG KONG. THEY RECOGNISED THE POSSIBLE MANPOWER PROBLEMS THAT WE HAD POINTED OUT IN OUR PAPER, BUT WERE OF THE VIEW THAT THESE DID NOT CONSTITUTE A STRONG ENOUGH REASON FOR SETTING UP A MONETARY AUTHORITY. THIS MIGHT GIVE AN IMPRESSION NOT CONDUCIVE TO STABILITY AND PROSPERITY. LU PING EMPHASISED THAT THERE SHOULD BE NO CHANGE UNLESS CHANGES WERE CONSIDERED TO BE ABSOLUTELY NECESSARY AND WERE CLEARLY IDENTIFIED AS BENEFICIAL TO THE MAINTENANCE OF STABILITY AND PROSPERITY OF HONG KONG. THE CHINESE GOVERNMENT DID NOT WANT THE ROLE OF THE HSBC TO BE, OR SEEN TO BE, REDUCED AND HOPED THAT THE HSBC WOULD CONTINUE TO PLAY ITS PART IN THE RUN UP TO 1997 AND BEYOND. JACOBS AGREED THAT IT WAS IMPORTANT NOT TO LOSE SIGHT OF THE POLITICAL ASPECTS. HE SAID THAT WE WOULD REVERT TO THE CHINESE IF WE WISHED TO DEVELOP OUR THOUGHTS FURTHER IN THIS AREA.

7. OUR FACTUAL PAPER ON THE POSITION OF THE HSBC WAS HANDED OVER TO THE CHINESE SIDE UNDER ANY OTHER BUSINESS. AFTER GOING THROUGH THE PAPER, THE CHINESE SIDE MADE THE FOLLOWING POINTS:

A) THE HSBC HAD A LONG HISTORY AND HAD CONTRIBUTED MUCH TO GROWTH AND STABILITY IN HONG KONG. ITS INFLUENCE ON HONG KONG'S MONETARY SCENE SHOULD NOT BE IGNORED AND THE MAINTENANCE OF ITS POSITION WAS MOST IMPORTANT FOR HONG KONG BOTH BEFORE AND AFTER 1997. NO OTHER BANK COULD TAKE THE HSBC'S PLACE. A STRONG AND PROFITABLE HSBC WAS BENEFICIAL TO STABILITY AND PROSPERITY.

B) COMPETITION WAS INEVITABLE AND THE BANK OF CHINA HAD ACHIEVED A CERTAIN POSITION IN HONG KONG. BUT THERE WAS NO INTENTION THAT IT SHOULD REPLACE THE HSBC AND IT WOULD CONTINUE TO PLAY A SUPPLEMENTARY ROLE. LU ASKED FOR THIS MESSAGE TO BE CONVEYED TO THE HSBC.

C) IT WAS NORMAL FOR THE HSBC TO TRY AND DEVELOP INTERNATIONALLY. THE CHINESE RECOGNISED THAT IT WOULD BE PRUDENT FOR THEM NOT TO PUT ALL EGGS IN ONE BASKET. BUT THEY WERE NOT SURE WHETHER THE HSBC WAS CONSIDERING MOVING ITS BASE BECAUSE OF ANXIETY ABOUT 1997. THEY FOUND THE ASSURANCE IN THE PAPER THAT HSBC WAS FIRMLY COMMITTED TO HONG KONG VERY ENCOURAGING.

8. THERE WAS NO OPPORTUNITY FOR JACOBS TO FOCUS ON THE PROBLEMS IDENTIFIED IN THE DEFENSIVE SPEAKING BRIEF. NEITHER THAT NOR THE Q AND A BRIEF WERE THEREFORE USED. DURING THE SHORT DISCUSSION ON THIS ITEM, JACOBS EMPHASISED THAT THE HSBC'S PROBLEM WAS NOT RELATED TO 1997. RATHER IT HAD TO DO WITH THE SIZE OF THE BANK AND ITS GLOBAL POSITION.

SECRET / Deyou

COMMENT

9. AS EXPECTED, THE CHINESE HELD THE VIEW THAT THE LINKED EXCHANGE RATE SHOULD NOT BE ALTERED, DESPITE INFLATIONARY PRESSURES. WE WERE SURPRISED THAT LU PING EXPRESSED THIS IN SUCH STRONG TERMS AS THE NATIONAL INTEREST OF CHINA.

10. THE SUPPORT GIVEN BY THE CHINESE TO THE PROPOSED ISSUE OF EXCHANGE FUND BILLS WAS ENCOURAGING. THEY CLEARLY APPRECIATED THE DISTINCTION THAT WE WISHED TO DRAW BETWEEN THE ISSUE OF BILLS FOR THE ACCOUNT OF THE EXCHANGE FUND FOR PURPOSES OF MONETARY POLICY AND THE ISSUE OF TREASURY BILLS FOR FINANCING FISCAL DEFICITS.

11. ON THE CONCEPT OF A MONETARY AUTHORITY FOR HONG KONG, OUR INTENTION ON THIS OCCASION WAS SIMPLY TO RESPOND TO THE CHINESE SIDE'S REQUEST TO DISCUSS THE MATTER AND TO TAKE THE OPPORTUNITY TO PUT DOWN A MARKER FOR FUTURE DISCUSSION, SHOULD THE NEED ARISE. THE CHINESE MADE IT CLEAR THAT THEIR REQUEST TO DISCUSS THE MATTER DID NOT IMPLY A WISH FOR A MONETARY AUTHORITY TO BE ESTABLISHED IN HONG KONG, BUT THEY HAVE NOT ENTIRELY EXCLUDED SUCH A POSSIBILITY. THIS IS USEFUL.

12. AS WE DID NOT HAVE THE OPPORTUNITY TO DRAW THE CHINESE SIDE'S ATTENTION TO THE PROBLEMS RELATING TO THE POSITION OF THE HSBC, WE ARE STILL NOT SURE TO WHAT EXTENT THEY ARE AWARE OF THEM. THEY RECOGNISE THE HSBC'S NEED TO INVEST OVERSEAS BUT DO NOT SEEM TO UNDERSTAND THE DIFFICULTIES THAT ITS INCREASING SIZE CREATES FOR HONG KONG.

WILSON

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

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