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10 DOWNING STREET

From the Private Secretary

28 September, 1982.

Hong Kong: Sir Y.K. Pao

The Prime Minister saw Y.K. Pao at Government House in Hong Kong today. No one else was present at the meeting, but the Prime Minister gave an account of it afterwards.

Y.K. Pao explained that he had called on Deng Xiaoping during the afternoon of the day when the Prime Minister had held talks with him. Deng had made it clear that China must have sovereignty over the whole of Hong Kong and that there could be no continuation of the Lease. Talks with us would be conducted through diplomatic channels, but they would be limited to discussion of the transitional period. It was not Peking's intention to send anyone to govern Hong Kong; instead the Chinese Government intended to appoint a Hong Kong Chinese to the top post. They also intended to put "low level" Hong Kong Chinese into the future Government. There would be no change in the legal system except that there would be no provision for appeals to the United Kingdom. The free port and the Hong Kong Dollar would continue.

An announcement of these measures would be made in one or two years. The Chinese had already made their preparations for the possibility of financial turmoil. They would hope to buy up investments cheaply. They believed that money which had left Hong Kong would come back. The Chinese could run the administration, as they did in Singapore.

At present, according to Deng, China received \$7 b in foreign currency from Hong Kong each year. But \$2 b were attributable to re-exports. So the net benefit was \$5 b a year. The Chinese believed that they would increase this figure when they took over Hong Kong.

The Prime Minister said that she had told Y.K. Pao, after he had given this account, that he must make it clear to the Chinese that Hong Kong would be unworkable without British administration. We had one or two years to convince the Chinese that their plans could not be applied. If China went ahead with the plans it currently had in mind, it would court international disgrace.

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In giving the above account, the Prime Minister said that she found it significant that Deng had told Y.K. Pao as much as he had. Clearly, the Chinese were using him to give wider currency to the plan which Deng had announced to her.

I am copying this letter to Sir Edward Youde in Hong Kong and Sir Percy Cradock in Peking. The Governor, Sir Philip Haddon-Cave and Alan Donald were present when the Prime Minister described her talk with Y.K. Pao. There should therefore be limited need for further circulation of this letter. I should be grateful if you would ensure, as with all records on this subject, that this letter is circulated only to those who have a clear need to know.

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