

CONFIDENTIAL

FM UKMIS NEW YORK 261355Z SEP 83

TO IMMEDIATE HONG KONG

TELEGRAM NUMBER 005 OF 26 SEPTEMBER

INFO FCO, PEKING, OTTAWA (FOR PRIVATE SECRETARY TO THE PRIME MINISTER)

IN
ACTION COPY

FOLLOWING FROM PRIVATE SECRETARY.

PS/PM

YOUR TELNO 448 AND HONG KONG TELNO 9: BILATERAL MEETING WITH CHINESE FOREIGN MINISTER.

1. THE SECRETARY OF STATE WOULD LIKE AS FAR AS POSSIBLE TO BE ARMED WITH THE FACTS ABOUT THE HONG KONG DOLLAR ETC BEFORE HE MEETS THE CHINESE FOREIGN MINISTER TOMORROW. IN PARTICULAR HE WOULD LIKE TO BE ABLE TO REFUTE THE CLAIM MADE IN COMMUNIST NEWSPAPERS IN HONG KONG (HONG KONG TELNO 1409) THAT HONG KONG RESERVES ARE KEPT IN BRITAIN FOR BRITAIN'S BENEFIT.

ANY ADDITIONAL MATERIAL TO DEAL WITH OTHER CHARGES REFERRED TO IN THE SAME TELEGRAM WOULD ALSO BE HELPFUL.

2. THE SECRETARY OF STATE WOULD ALSO LIKE TO HAVE THE FIGURES FOR THE EXTENT OF DIRECT INTERVENTION IN THE FOREIGN EXCHANGE MARKETS TO SUPPORT THE HONG KONG DOLLAR (HONG KONG TELNO 11 TO OTTAWA), ALTHOUGH OF COURSE HE REALISES THAT THESE FIGURES COULD PRESUMABLY NOT BE REVEALED EITHER TO THE CHINESE FOREIGN MINISTER OR PUBLICLY. HE WOULD ALSO LIKE TO HAVE THE FIGURES ABOUT THE RAISING OF DEPOSIT INTEREST RATES ETC. IN RECENT MONTHS. PRESUMABLY THESE FIGURES ARE PUBLIC AND COULD BE USED IF NECESSARY.

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FM HONG KONG 260907Z SEP 83

TO FLASH OTTAWA (FOR PS TO PM)

TELEGRAM NUMBER 11 OF 26 SEPTEMBER

INFO IMMEDIATE*FCO, UKMIS NEW YORK (FOR PS TO S OF S), WASHINGTON
(FOR PS TO CHANCELLOR OF THE EXCHEQUER)

*(PERSONAL FOR CLIFT HKD)

FOR PRIVATE SECRETARY TO PRIME MINISTER FROM GOVERNOR.

FUTURE OF HONG KONG: FINANCIAL SITUATION.

AT THE CLOSE ON 23 SEPTEMBER 1983 THE HONG KONG DOLLAR/U.S. DOLLAR EXCHANGE RATE WAS 8.73 COMPARED WITH 6.12 A YEAR AGO, A DEPRECIATION OF 42.5 PERCENT. THE TRADE WEIGHTED EXCHANGE RATE INDEX STOOD AT 62.6 COMPARED WITH 87.3 A YEAR AGO, A FALL OF 28.3 PERCENT. THE EXTENT OF THE DEPRECIATION WAS PARTICULARLY SHARP IN OCTOBER LAST YEAR AND IN JUNE THIS YEAR, BUT IT IS THIS PAST WEEK WHICH HAS HAD A TRULY DRAMATIC AIR ABOUT IT: BETWEEN THE CLOSE ON 16 SEPTEMBER AND THE CLOSE ON 23 SEPTEMBER THE RATE FELL FROM 7.78 TO 8.73, OR BY 10.8 PERCENT. THE TRADE WEIGHTED INDEX FELL FROM 68.3 TO 62.7, OR BY 8.2 PERCENT. BY THE CLOSE AT NOON ON SATURDAY 24 SEPTEMBER THE RATE HAD PLUNGED TO 9.50 AND THE TRADE WEIGHTED INDEX TO 57.2.

2. THE HANG SENG INDEX ALSO DECLINED SHARPLY THIS PAST WEEK FROM 916 AT THE CLOSE ON 16 SEPTEMBER TO 786 AT THE CLOSE ON 23 SEPTEMBER, ON WHICH DAY IT DECLINED BY 63 POINTS. IN 1982 (MONTHLY AVERAGE) THE INDEX WAS 1106 AND IN THE FIRST HALF OF THIS YEAR WAS 967. TOTAL TURNOVER IN 1982 WAS HONG KONG DOLLARS 46 BILLION, COMPARED WITH 106 BILLION IN 1981 AND 19 BILLION IN THE FIRST SIX MONTHS OF THIS YEAR.

3. TO SOME EXTENT, THE WEAKENING TREND OF THE EXCHANGE VALUE OF THE HONG KONG DOLLAR OVER THE PAST YEAR HAS BEEN A REFLECTION OF THE STRENGTH OF THE US DOLLAR WORLDWIDE AND THERE HAS BEEN SOME SPECULATIVE ACTIVITY FROM TIME TO TIME, BUT ANXIETY ABOUT THE FUTURE HAS UNDOUBTEDLY BEEN THE MAIN FACTOR. CERTAINLY, THE RECENT COLLAPSE REFLECTS THE CUMULATIVE EFFECT OF THE BARRAGE OF CHINESE PROPAGANDA OVER THE PAST COUPLE OF MONTHS. THE MARKET IS NOW INDIFFERENT TO POSITIVE ECONOMIC NEWS, SUCH AS AN UPWARD REVISION OF THE GDP FORECAST FOR 1983: IT IS SUSCEPTIBLE TO RUMOUR-MONGERING AND UNHELPFUL COMMENTARY BY THE CHINESE: AND IT IS READY TO PLACE THE WORST POSSIBLE INTERPRETATION ON THE ABSENCE OF ANY AUTHORITATIVE STATEMENTS DEMONSTRATING THE PROGRESS OF THE NEGOTIATIONS. AT THE END OF LAST WEEK AND OVER THE WEEKEND THERE WAS SOMETHING AKIN TO PANIC IN THE AIR. THERE WAS A SCRAMBLE TO DUMP HONG KONG DOLLARS AND GO LONG IN U.S. DOLLARS AND GOLD. THERE WAS EVEN SOME DOMESTIC STOCK PILING OF BASIC FOODSTUFFS.

4. THE CHINESE HAVE ARGUED THAT THE WEAKNESS OF THE HONG KONG DOLLAR IS AN ECONOMIC PHENOMENON AND NOT A POLITICAL ONE: MORE RECENTLY THEY HAVE PERSISTENTLY ACCUSED THE HONG KONG GOVERNMENT EITHER OF INERTIA OR OF ACTUALLY ENGINEERING THE SITUATION WITH A VIEW TO INFLUENCING THE NEGOTIATIONS.

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5. THROUGHOUT THE PAST YEAR THE GOVERNMENT, THROUGH THE EXCHANGE FUND, HAS SOUGHT TO SMOOTH ERRATIC AND WAYWARD SHIFTS IN THE EXCHANGE RATE. THERE HAS BEEN SUBSTANTIAL DIRECT INTERVENTION IN THE FOREIGN EXCHANGE MARKETS IN HONG KONG AND SOMETIMES IN LONDON AND NEW YORK. THE EXCHANGE FUND HAS ALSO BEEN ACTIVELY BORROWING IN THE INTERBANK MONEY MARKET IN ORDER TO DRIVE UP MONEY MARKET INTEREST RATES. DESPITE UNDESIRABLE SIDE EFFECTS (E.G. ON THE PROPERTY MARKET AND MANUFACTURING COSTS), THE HONG KONG ASSOCIATION OF BANKS HAS RAISED DEPOSIT INTEREST RATES ON A NUMBER OF OCCASIONS IN ORDER TO MAKE THE HOLDING OF HONG KONG DOLLARS MORE ATTRACTIVE AND TO PUSH UP LENDING RATES (MAKING IT MORE EXPENSIVE FOR EXPORTERS TO BORROW HONG KONG DOLLARS TO MEET THEIR LOCAL LIABILITIES

INSTEAD OF REPATRIATING THEIR FOREIGN CURRENCY EARNINGS). BUT THESE EFFORTS HAVE ONLY HAD A LIMITED EFFECT. AT BEST, THE RATE OF DEPRECIATION HAS BEEN SLOWED DOWN. THE DEMAND FOR FOREIGN CURRENCIES TO HOLD (MOSTLY U.S. DOLLARS) HAS REMAINED STRONG, AND THERE HAS BEEN AN ABSENCE OF TWO-WAY TRADING. IN OTHER WORDS, SENTIMENT IN THE MARKET HAS BEEN PERSISTENTLY AGAINST THE DOMESTIC CURRENCY: DRAMATICALLY SO OVER THE PAST WEEK.

6. IT COULD BE ARGUED THAT UP TO LAST WEEK WE HAD EXPERIENCED NOTHING WORSE THAN A SERIES OF SLIPS AND THE WIDE SPREADS QUOTED FROM TIME TO TIME HAVE BEEN INDICATIVE OF A VERY THIN, ARTIFICIAL MARKET. ALSO, ALTHOUGH WE HAVE BEEN PRESSURISED FROM TIME TO TIME TO 'ACT' TO 'SAVE THE DOLLAR' AND PROTECT THE PEOPLE'S LIVELIHOOD, ETC., THERE HAS BEEN A RELUCTANT PUBLIC ACCEPTANCE THAT MARKET FORCES ARE INEXORABLE. HOWEVER, THIS HAS BEEN COMBINED WITH SOME BEMILDERMENT AND RESTLESSNESS ABOUT OUR PASSIVE PUBLIC RELATIONS STANCE IN RELATION TO THE NEGOTIATIONS IN THE FACE OF THE COMMUNIST CAMPAIGN, BUT WAS UNTIL LAST WEEK, CONTAINABLE.

7. BUT BY YESTERDAY (SUNDAY) WE HAD TO CONCLUDE THAT THE PRESENT SITUATION WAS SO DIFFERENT IN DEGREE AS TO BE DIFFERENT IN KIND TO THAT WHICH WE HAD EXPERIENCED SO FAR. SO WE DECIDED ON THE FOLLOWING MOVES IN AN ATTEMPT TO STOP REAL PANIC SETTING IN AT THE BEGINNING OF THIS WEEK:

(i) WE ISSUED A STATEMENT EXPRESSING GREAT CONCERN ABOUT THE QUITE UNREASONABLE RATES BEING QUOTED FOR THE HONG KONG DOLLAR ARGUING THAT THEY WERE QUITE INCONSISTENT WITH THE UNDERLYING ECONOMIC AND POLITICAL SITUATION AND URGING PEOPLE TO IGNORE RUMOURS AND UNHELPFUL COMMENTARY (AN OBLIQUE REFERENCE TO COMMUNIST PROPAGANDA).

(ii) THE ACTING FINANCIAL SECRETARY SUBSEQUENTLY ISSUED A FURTHER STATEMENT HINTING AT A REVISION OF THE PRESENT ARRANGEMENTS FOR ISSUING AND REDEEMING CERTIFICATES OF INDEBTEDNESS TO THE NOTE-ISSUING BANKS, WHICH MIGHT HAVE A HELPFUL INFLUENCE ON THE EXCHANGE RATE, AND HE STRESSED THAT THE EXCHANGE FUND WOULD OPERATE IN THE FOREIGN EXCHANGE AND INTERBANK MONEY MARKETS AS AND WHEN APPROPRIATE. SECRET -2- (iii)

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- (III) IF RUMOURS THAT SOME TRADERS ARE REFUSING TO ACCEPT HONG KONG DOLLARS FOR GOODS IN THE SHOPS PERSIST, ATTENTION WILL BE DRAWN TO THE FOREIGN NOTES (PROHIBITION OF CIRCULATION) ORDINANCE WHICH MAKES IT ILLEGAL TO ASK FOR, OR EVEN OFFER, FOREIGN NOTES FOR DOMESTIC TRANSACTIONS.
- (IV) IN AN ATTEMPT TO TURN THE MARKET ROUND AND GET TWO WAY TRADING ESTABLISHED, THE EXCHANGE FUND IS INTERVENING ON A SUBSTANTIAL SCALE AND, ALTHOUGH THE RATE AT MIDDAY HAD IMPROVED (HK DOLLAR 8.50 TO THE U.S. DOLLAR), VERY LARGE SPREADS WERE STILL BEING QUOTED, INDICATIVE OF AN ARTIFICIAL MARKET. THE SPREADS NARROWED SOMEWHAT AFTER THE LUNCH BREAK.
- (V) THE HONG KONG ASSOCIATION OF BANKS WAS PERSUADED TO RAISE DEPOSIT INTEREST RATES BY 3 PERCENTAGE POINTS AND LENDING RATES HAVE CONSEQUENTIALLY BEEN RAISED.

8. WE CANNOT, OF COURSE, GO ON COMMITTING LARGE TRANCHES OF U.S. DOLLARS TO THE MARKET INDEFINITELY. THE ONLY OTHER MEASURES WE COULD DEPLOY WOULD BE TO ABOLISH INTEREST TAX ON HONG KONG DOLLAR DEPOSITS (BUT THIS WOULD HAVE THE MOST MARGINAL EFFECT AND BE EXPENSIVE OF REVENUE): AND WE COULD TRY SOMEHOW TO PENALISE THOSE CUSTOMERS BORROWING HONG KONG DOLLARS AGAINST THE SECURITY OF FOREIGN CURRENCY ASSETS (BUT SUCH A DEVICE WOULD BE COMPLICATED TO POLICE AND COULD BE DAMAGING TO CONFIDENCE IN HONG KONG AS A FINANCIAL CENTRE).

9. IT REMAINS TO BE SEEN WHETHER WHAT WE HAVE DONE WILL HAVE ANY DURABLE EFFECT. BUT TO HAVE DONE NOTHING WOULD HAVE GRAVELY WEAKENED PUBLIC CONFIDENCE IN THE HONG KONG GOVERNMENT. I WILL REPORT FURTHER AS THE SITUATION DEVELOPS.

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FUTURE OF HONG KONG

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HD/FED
HD/PLANNING STAFF
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PS/MR LUCE
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MR WALKER RESEARCH D OAB 2/82

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H - K. Fulwider