

sent
By Boq, Washington

10 DOWNING STREET

From the Principal Private Secretary

28 September, 1983

Dear John,

The Prime Minister held a meeting at the British Embassy in Washington this evening about the financial situation in Hong Kong. The Chancellor of the Exchequer, the Governor of the Bank of England, Sir Robert Armstrong, Sir Antony Acland, Sir Oliver Wright, Sir Terry Burns, Sir Alan Walters, Mr. Littler and Mr. Loehnis were also present.

The Prime Minister said that she had wanted an early discussion on measures which could be taken to stabilise the Hong Kong dollar since, even if there was no further fall in the meantime, there could be one following the next round of talks on Hong Kong with the Chinese government on 19 and 20 October. Sir Oliver Wright reported that the Foreign and Commonwealth Secretary had spoken to the Chinese Ambassador but had received only the response that the problems of the Hong Kong dollar had nothing to do with the actions of the Chinese government and were solely attributable to British intransigence.

The Chancellor and the Governor reported on the latest situation in Hong Kong, following the measures taken by the Hong Kong authorities earlier in the week. The Hong Kong dollar had now regained the ground which it had lost a week ago. This had been partly achieved by high interest rates and partly by intervention, believed to have been substantial at times, in a thin market. Such measures were bound to be a palliative since the origin of the the problem was political and the solution would also have to be political. Nevertheless, although measures of this sort involving high interest rates would be damaging if they had to be sustained, Hong Kong was a market-orientated economy and there was likely to be a point at which the market would take the view that Hong Kong's assets were worth holding even for fourteen years.

The Prime Minister said that she was concerned about the effect of a fall in the dollar on the ordinary people of Hong Kong, since so much of Hong Kong's food and other essentials were imported. Sir Alan Walters added that intervention to support the Hong Kong dollar did not reduce the money supply. To the extent that intervention was

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successful, people were encouraged to convert more assets out of Hong Kong dollars and a vicious circle was created. One approach to the problem was through controlling the currency by means of a currency board or monetary base system. If the Hong Kong dollar was backed one for one by the United States dollar - and the Hong Kong reserves of the US dollars were big enough to make this possible - people would be willing to hold the Hong Kong dollar and confidence would be maintained.

In discussion it was argued that a scheme of this sort would not necessarily give adequate backing for banking deposits denominated in Hong Kong dollars, which were many times as large as the Hong Kong currency. A similar scheme in the United States in 1907 had led only to a very small discount on bank deposits, but this might not apply in the different circumstances which were causing the current fears in Hong Kong. It was inevitable that a Chinese takeover would ultimately lead to a substantial fall in the value of Hong Kong assets: nevertheless, it was right to look for a financial mechanism which would, if possible, prevent a precipitate collapse in confidence. But there was a distinction between action by the Hong Kong authorities and action directly involving Her Majesty's Government: the latter might be very expensive and the Foreign and Commonwealth Secretary had expressed concern about the effect that it could have on the Chinese Government.

Summing up the discussion, the Prime Minister said that it was necessary to consider the options urgently. The Hong Kong Executive Council would be making a further visit to the United Kingdom in the following week. She asked the Chancellor of the Exchequer, in consultation with the Governor, to consider the studies which were being prepared for their return and to let her have a paper on Tuesday, 4 October as a basis for a further meeting the following day.

I am copying this letter to Brian Fall, (Foreign and Commonwealth Office), Tim Allen (Governor of the Bank of England's Office) and Richard Hatfield (Cabinet Office).

GIVEN BY HAND 25/9

Yours ever,

Robin Butler

John Kerr, Esq.,
HM Treasury