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29 September 1983

Dear Andrew

HONG KONG

You asked Brian Unwin for notes on three points.

2. First, the proportion of Hong Kong's food that is imported. Around  $\frac{3}{4}$  Hong Kong's food is imported, largely from mainland China. All of the territory's rice is imported, 60% of vegetables and 50% of poultry. Roughly  $\frac{1}{7}$  of the territory's HK \$150 billion import bill is for food. (Incidentally, much of the territory's water is also imported from China).

3. Secondly, the effect of exchange rate changes on domestic prices. This proves to be a rather difficult question to answer. Food (largely imported, see above) accounts for around half of the main consumer price index, and altogether the import content of the consumer price index would seem to be around 50%. So one would expect exchange rate movements to have a quite substantial impact on prices. On the other hand, there is little sign that the fall in the exchange rate since last December, approximately 30% on the effective exchange rate index, has yet led to any acceleration in the rise in prices in Hong Kong. There may of course be lagged effects still to come, or there could have been offsetting factors. But although the figures fluctuate from month to month the underlying rate of inflation in Hong Kong seems to have stayed at around 10% over the period since last December.

4. Thirdly, you asked about the mechanism connecting the Hong Kong currency issue and the official exchange reserves. I attach a separate note on this.

Your ever

David

D L C PERETZ



## THE HONG KONG EXCHANGE FUND/CURRENCY MECHANISM

Hong Kong dollar bank notes are issued by the Hongkong and Shanghai Bank and the Chartered Bank. The "authorised issue" is limited by law to HK \$95 million, and is backed by British Government securities. The balance of the issue is backed by Certificates of Indebtedness (CI) issued by the Hong Kong Government Exchange Fund (EF).

2. From 1935 to 1972 CIs, which are denominated in HK dollars, were issued or redeemed against payments in London to and from the EF of the sterling equivalent of their face value, at the fixed exchange rate of the time. The funds of the EF were then invested in British Government securities. This arrangement worked in a period of very limited flows of capital, and under the exchange control regime in force in Hong Kong until 1971.

3. It could not, however, protect the value of the currency in the face of heavy capital flows, particularly after the abolition of exchange control and the development of the local foreign exchange market. In June 1972, in a period of heavy capital inflows the HK dollar was linked to the US dollar instead of to sterling, and Certificates of Indebtedness were henceforth issued against payment in Hong Kong in Hong Kong dollars. Since November 1974 the Hong Kong dollar has floated freely.

4. The Hong Kong Government Exchange Fund is thus now something of a hybrid, holding some of its assets in Hong Kong dollars (around US \$900 million worth), and the balance in foreign currencies, mainly US dollars (around US \$6 billion worth, of which a little over 5% is in sterling).

5. The only control over the size of the note issue is the fact that issuing banks have to pay market rates of interest on the HK dollar counterpart of the CIs issued by the exchange fund.

6. The assets of the exchange fund exceed the size of the note issue which stands at around HK \$14 billion (that is about US \$1.6 billion).

In practice the significance of the exchange fund nowadays lies mainly in its use to intervene in foreign currency markets.

7. The Hong Kong authorities are now considering a change of arrangements, under which Certificates of Indebtedness issued by the Exchange Fund would in future be denominated in US dollars. The main purpose of this would, presumably, be to help boost the size of the foreign currency reserves, in effect representing a redistribution of Hong Kong's foreign currency reserves from the banks to the official Exchange Fund.