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DESKBY 290800Z
FM HONG KONG 290550Z SEP 83
TO IMMEDIATE FCO
TELEGRAM NUMBER 1436 OF 29 SEPTEMBER

14101
SOA

STRICTLY PERSONAL FOR CLIFT (HONG KONG DEPARTMENT) FROM BREMRIDGE.

IN THE LIGHT OF THE EXCHANGE RATE PROBLEMS EXPERIENCED AT THE END OF LAST WEEK, WE HAVE BEEN CONSIDERING A PROPOSAL FOR A SUBSTANTIAL REVISION OF THE MECHANICS FOR ISSUING AND REDEEMING CERTIFICATES OF INDEBTEDNESS TO THE NOTE-ISSUING BANKS IN SUCH A WAY AS TO PRODUCE AN EXCHANGE RATE WHICH WOULD MORE ACCURATELY REFLECT THE FUNDAMENTAL STRENGTH OF THE ECONOMY. A CHANGE OF THIS NATURE WOULD MEAN THE ASSUMPTION BY THE EXCHANGE FUND OF A MORE SIGNIFICANT ROLE IN THE EXCHANGE RATE DETERMINATION MECHANISM.

2. THE IMPLICATIONS OF SUCH A MAJOR CHANGE IN EXISTING PRACTICE NEED THE MOST CAREFUL EXAMINATION. THE DOWN SIDE RISKS MUST BE EVALUATED AND WE ARE PARTICULARLY CONCERNED THAT WE MAY TRANSMUTE A POTENTIAL RUNAWAY EXCHANGE RATE INTO A LEVEL OF INTEREST RATES WHICH WILL HAVE EQUALLY DAMAGING EFFECTS ON THE ECONOMY. POSSIBLE EFFECTS ON THE EXCHANGE FUND MUST ALSO BE EVALUATED AGAINST A BACKGROUND OF LOSS OF CONFIDENCE.

3. AFTER CONSULTATION, ADVICE IN HONG KONG IS CONFLICTING. THE HONG KONG BANK ARE NOT ENTHUSIASTIC, THOUGH THEY ACCEPT THAT IF THE EXCHANGE RATE AGAIN RUNS AWAY THE COURSE PROPOSED MAY CONCEIVABLY BE THE LESSER OF EVILS. MUCH WOULD DEPEND UPON THE CROSS-RATE TO THE U.S. DOLLAR INITIALLY SET.

4. I REPEAT HOWEVER THAT WE CANNOT RISK A LEAP IN THE DARK. NOR IS THERE A NEED FOR PRECIPITOUS ACTION AT THIS JUNCTURE, THOUGH CLEARLY THE SITUATION COULD CHANGE QUICKLY.

5. I AM CONSEQUENTLY SENDING YOU TWO PAPERS PRODUCED IN MONETARY AFFAIRS BRANCH WHICH EXPLAIN THEIR GENERAL THINKING.

6. WOULD YOU PLEASE IN THE PRESUMED ABSENCE OF THE GOVERNOR OF THE BANK OF ENGLAND IN WASHINGTON DISCUSS THIS TELEGRAM WITH KIT MCMAHON OR EQUIVALENT AND REQUEST THAT WITH THE MAXIMUM ACCEPTABLE DESPATCH CHARLES GOODHART OR A MAN OF EQUIVALENT STATURE SHOULD FLY TO HONG KONG TO ADVISE US ON THE SITUATION AS IT NOW PRESENTS ITSELF. THE PURPOSE OF TELEGRAMMING THE FULL TWO PAPERS IS INTER ALIA SO THAT THE BANK OF ENGLAND AND THE MAN WHO IS COMING OUT HAVE TIME TO REFLECT ON THE ISSUES EN ROUTE.

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SECRET
 DESKBY 290800Z
 FM HONG KONG 290515Z SEP 83
 TO IMMEDIATE FCO
 TELEGRAM NUMBER 1435 OF 29 SEPTEMBER

STRICTLY PERSONAL FOR CLIFT (HONG KONG DEPARTMENT) FROM BREMIDGE.

THE TWO PAPERS FROM MONETARY AFFAIRS BRANCH ARE AS FOLLOWS:

THE EXCHANGE RATE.

1. FIRST I DO NOT BELIEVE THAT THERE CAN BE ANY REAL DOUBT AS TO THE VALIDITY OF THE SCHEME (NEXT TWO WORDS UNDERLINED) IN PRINCIPLE. ALAN MCLEAN AND I HAVE INDEPENDENTLY SPENT A LOT OF TIME THINKING IT THROUGH, AND NOW STEPHEN CHEUNG APPEARS TO HAVE ACKNOWLEDGED THE THEORY. IN OTHER WORDS, THE SCHEME CAN "WORK". I UNDERSTOOD YOU TO SAY THAT PETER HAMMOND HAS SAID THAT IT WOULD NOT WORK, BUT IF HIS VIEW IS BASED ON ANYTHING LIKE THE SAME RATHER CONFUSED PERCEPTION WHICH APPEARED IN A LETTER FROM PETER WRANGHAM TO SMA YESTERDAY (WHICH I SAW ONLY VERY BRIEFLY), THEN HIS OBJECTION DOES NOT STAND UP. OF COURSE, THE CRUCIAL QUESTION CONCERNS THE (NEXT WORD UNDERLINED) PRACTICAL MANIFESTATION OF THE SCHEME IN TERMS OF MONETARY AND REAL ECONOMY CONSEQUENCES. IN THIS RESPECT CHEUNG'S WARNING COMES AS NO SURPRISE. THE POSSIBILITY OF A SEVERE CONSEQUENCES IS ADMITTED IN PARAGRAPH 14 OF MY PAPER, AND I SAID WHEN I SAW YOU YESTERDAY THAT THIS ASPECT REQUIRED STILL GREATER EMPHASIS. MCLEAN IS OF THE SAME OPINION. THE POINT IS THAT THE CONSEQUENCES COULD BE EXTREMELY SEVERE IF THE PUBLIC AND THE MARKETS DID NOT BELIEVE THAT THE RATE WOULD HOLD. IT IS PROBABLE, HOWEVER, THAT AFTER AN INITIAL SPELL OF UNCERTAINTY THE SQUEEZE WOULD QUITE SOON EASE, PROVIDED THAT WE HELD THE LINE. MONEY MIGHT REMAIN TIGHTER AND INTEREST RATES HIGHER (COMPARED WITH THE SITUATION WITHOUT THIS SCHEME), BUT NOT NECESSARILY TO AN INTOLERABLE DEGREE (ON THIS POINT GREENWOOD IS CONSIDERABLY LESS WORRIED THAN EITHER MCLEAN OR MYSELF).

2. AS I SEE IT, WE HAVE A STRAIGHT CHOICE BETWEEN ALLOWING THE EXCHANGE RATE TO SPIRAL DOWNWARDS INDEFINITELY, WITH REPEATS OF THE PANIC SEEN AT THE END OF LAST WEEK, OR INTRODUCING THIS SCHEME AND RIDING OUT THE MONETARY CONSEQUENCES. THESE CONSEQUENCES ARE LIKELY TO BE LESS SEVERE, THE LESS AMBITIOUS THE RATE WHICH IS SET. IN OTHER WORDS, IF WE ARE PARTICULARLY NERVOUS, WE MIGHT CHOOSE 8.00. EVEN THIS WOULD FULFIL OUR ANNOUNCED HOPE OF RESTORING STABILITY AT A RATE CLOSER TO THAT JUSTIFIED BY FUNDAMENTALS THAN WHEN THE STATEMENT WAS MADE ON SUNDAY.

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3. I AM VERY CONCERNED AT THE POSSIBLE CONSEQUENCES OF NOT PROCEEDING NOW. WE HAVE BUILT UP HOPES, AND EVEN THIS MORNING ON RTHK SMA HAS QUOTED AS HAVING SAID THAT THE SCHEME WOULD BE READY SOON.

4. I HAVE BEEN THINKING OVERNIGHT ABOUT THE QUESTION OF CONSULTING THE BANK OF ENGLAND. I DO NOT BELIEVE THAT ANY FURTHER LIGHT WOULD BE THROWN ON THE PRINCIPLES OF THE SCHEME (SINCE FOUR ECONOMISTS HERE, CHEUNG, MCLEAN, GREENWOOD AND MYSELF) - OF WIDELY VARYING BACKGROUNDS - APPEARED TO BE IN AGREEMENT ON THE THEORY. WHETHER OR NOT AN OUTSIDER WOULD BE ABLE TO GIVE ANY FIRMER INDICATION THAN WE CAN AS TO THE PRACTICAL CONSEQUENCES MUST ALSO, I THINK, BE DOUBTED. HOWEVER, I EXPECT THAT AN AUTHORITY OPINION AND ADVICE WOULD CERTAINLY HELP TO SET OUR OWN MINDS AT EASE, WHICHEVER WAY THE ADVICE POINTED. I MYSELF WOULD CERTAINLY WELCOME THE OPPORTUNITY TO DISCUSS THE MATTER, BUT I THINK THAT MY MOTIVE WOULD BE TO SHARE THE BLAME FOR ANY EVENTUAL DECISION RATHER THAN HOPING TO RECEIVE MUCH ADDITIONAL ENLIGHTENMENT. THE PROBLEM IS, OF COURSE, THAT TIME HAS ALMOST RUN OUT.

A PLAN FOR STABILISING THE EXCHANGE RATE.

INTRODUCTION.

FOR ABOUT A DECADE HONG KONG HAS HAD A FLOATING EXCHANGE RATE. DESPITE SOME LACK OF MONETARY DISCIPLINE DOMESTICALLY FROM TIME TO TIME, FLOATING IS GENERALLY JUDGED TO HAVE BEEN QUITE SUCCESSFUL: THE "AUTOMATIC ADJUSTMENT PROCESS" INHERENT IN FLOATING HAS PROBABLY CONTRIBUTED TO THE RAPID REAL ECONOMIC GROWTH THAT HAS BEEN ACHIEVED, ALTHOUGH INFLATION HAS OFTEN BEEN SOMEWHAT TOO FAST FOR COMFORT.

2. THE PROBLEM NOW IS THAT THE FUNDAMENTAL ECONOMIC FORCES OF THE ADJUSTMENT PROCESS ARE NO LONGER HOLDING SWAY. EXCHANGE RATE DETERMINATION HAS BEEN TAKEN OVER BY THE POLITICAL CONFIDENCE FACTOR. DESPITE THE PRESENT RESERVE THE POTENTIAL FOR DECLINE IN THE RATE APPEARS TO REMAIN BOUNDLESS. GOVERNMENT IS LOSING CREDIBILITY AND PEOPLE ARE THUS LOSING FAITH IN IT: RAMPANT INFLATION LOOMS; AND SOCIAL DISORDER IS BECOMING A VERY REAL THREAT. THE EXCHANGE RATE IS NOW (NEXT WORD UNDERLINED) THE CENTRAL ISSUE.

3. CLEARLY SOMETHING HAS TO BE DONE. EXCHANGE CONTROLS ARE RULED OUT ON BOTH POLICY AND PRACTICAL GROUNDS. EXCHANGE MARKET INTERVENTION HAS BEEN SEEN TO PROVIDE AT MOST TEMPORARY SUPPORT. INTEREST RATES CANNOT ULTIMATELY BE SET AGAINST MARKET FORCES.

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4. IT IS IMPORTANT TO DISTINGUISH BETWEEN LOSS OF CONFIDENCE IN HONG KONG'S FUTURE ON THE ONE HAND, AND THE VALUE OF THE CURRENCY ON THE OTHER. THE FORMER DEPRESSES THE PERCEIVED LONG-RUN (NEXT WORD UNDERLINED) REAL RATE OF RETURN ON ASSETS IN HONG KONG, AND CANNOT BE ARRESTED BY MONETARY POLICY. MONETARY POLICY OUGHT, HOWEVER, TO BE CAPABLE OF INFLUENCING THE VALUE OF THE CURRENCY - I.E. THE PRICE OF REAL ASSETS AND OF FOREIGN EXCHANGE IN TERMS OF THE DOMESTIC CURRENCY - INDEPENDENTLY OF THE CONFIDENCE FACTOR. THE QUEST FOR A MEANS TO STABILISE THE VALUE OF THE CURRENCY NEED NOT THEREFORE BE ENTIRELY HOPELESS.

THE PLAN.

5. THE EXCHANGE FUND WOULD SET THE PRICE OF CERTIFICATES OF INDEBTEDNESS IN TERMS OF FOREIGN CURRENCY (SAY U.S. DOLLARS). THIS WOULD BE INTENDED AS A FIXED PEG, ALTHOUGH IT WOULD BE UNDERSTOOD THAT THE PEG MIGHT BE ADJUSTED FROM TIME TO TIME IN ORDER TO MAINTAIN A STABLE TRADE-WEIGHTED INDEX. A SMALL SPREAD MIGHT BE ESTABLISHED BETWEEN THE PREVAILING BUYING AND SELLING RATES FOR C.H.S.

6. THE ABOVE WOULD BE THE SUBSTANCE OF THE SCHEME. NO OTHER EXPLICIT ACTION WOULD BE TAKEN BY THE GOVERNMENT. THE NOTE-ISSUING BANKS WOULD UNDERTAKE TO CONTINUE TO TREAT OTHER BANKS FAIRLY IN RESPECT OF NOTE TRANSACTIONS, BUT WHETHER THIS INVOLVED RETENTION OF EXISTING PROCEDURES, OR EXCHANGING NOTES AGAINST FOREIGN CURRENCY AT A RATE ALMOST EQUAL (ALLOWING FOR A SMALL SERVICE CHARGE PERHAPS) TO THE C.H. RATE, WOULD BE FOR THE BANKS TO AGREE AMONGST THEMSELVES.

7. THE POSSIBILITY OF THE EXCHANGE FUND GUARANTEEING THAT A C.H. ISSUED AT A PARTICULAR RATE WOULD BE REDEEMABLE AT THAT RATE HAS BEEN RAISED. THIS DOES NOT SEEM RIGHT IN PRINCIPLE. IT IS NOT USUAL FOR GOVERNMENT TO COMPENSATE FINANCIAL INSTITUTIONS FOR THE CONSEQUENCES OF MONETARY POLICY ACTIONS. AT PRESENT THE BANKS MAY SUFFER LOSSES WHEN, FOR INSTANCE, INTEREST RATES ARE ALTERED AT THE GOVERNMENT'S INITIATIVE, BUT THERE IS NO QUESTION OF COMPENSATION. UNDER THE PROPOSED SCHEME THERE WOULD PROBABLY BE FEWER OFFICIAL INITIATIVES ON INTEREST RATES, SO IT WOULD NOT BE UNREASONABLE TO EXPECT THE NOTE-ISSUING BANKS TO ACCEPT POSSIBLE RISKS ON C.H.S. INSTEAD. ANYWAY, THE RISKS WOULD BE TWO-WAY. MOREOVER, THE MAIN EXPOSURE OF THE BANKS WOULD BE THE EXISTING STOCK OF C.H.S, WHICH DO NOT CARRY AN ISSUE PRICE THAT COULD BE THE BASIS FOR A GUARANTEE.

EFFECT ON THE EXCHANGE RATE.

8. MARKET FORCES WOULD, THROUGH ARBITRAGE, TEND TO BRING THE EXCHANGE RATE IN THE OPEN MARKET INTO LINE WITH THE C.H. RATE. AN ILLUSTRATION OF THE CONVERGENCE PROCESS IS AS FOLLOWS.

9. SUPPOSE THE MARKET RATE WAS DOLLARS 8, BUT THE GOVERNMENT NOW ANNOUNCES A C.H. RATE OF DOLLARS 7. SUPPOSE A CUSTOMER WANTS TO BUY USD. SUPPOSE HE IS STILL QUOTED A RATE OF DOLLARS 8 BY HIS BANK.

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10. THE CUSTOMER WITHDRAWS HIS HKD DEPOSIT FROM HIS BANK IN CASH, BECAUSE HE KNOWS THAT THE NEXT BANK DOWN THE STREET WILL TAKE THE NOTES OFF HIM AT DOLLARS 7.10 IN ORDER TO REDEEM THEM AT THE EXCHANGE FUND AT DOLLARS 7, MAKING A NICE TURN. MEANWHILE THE FIRST BANK HAS HAD TO BUY CASH FROM THE EF AT DOLLARS 7 IN ORDER TO MEET THE CUSTOMER'S WITHDRAWAL. CLEARLY THE FIRST BANK WOULD HAVE BEEN BETTER ADVISED TO QUOTE THE CUSTOMER A RATE OF DOLLARS 7.10 IN THE FIRST PLACE.

11. THUS THE MARKET RATE TENDS TOWARDS THE CIB RATE. IN PRACTICE IT WILL NOT BE NECESSARY FOR CUSTOMERS TO CART LOADS OF BANKNOTES AROUND TOWN IN ORDER FOR THE ARBITRAGE PROCESS TO WORK. THE SIMPLE FACTS (1) THAT BANKS GUARANTEE THE CONVERTIBILITY OF DEPOSITS INTO CASH, AND (2) THAT THE EXCHANGE FUND GUARANTEES CONVERTIBILITY (LIMITED IN DIRECT ACCESS TO NOTE-ISSUING BANKS, BUT PRESUMED TO BE EASILY ACCESSIBLE FOR THE WHOLE BANKING SYSTEM) OF CASH TO FOREIGN CURRENCY, SHOULD BE SUFFICIENT TO MAKE THE PROCESS WORK.

12. INITIALLY WHEN THE SCHEME WAS INAUGURATED, ARBITRAGE MAY NOT BE PERFECT, SINCE THERE WILL BE A LEARNING PROCESS AND HENCE CAUTION, AND POSSIBLY SOME RIGIDITIES ON ACCOUNT OF LARGE DEALS COMING TO MARKET. EVEN SO, THE MARKET RATE WOULD TEND TOWARDS RATHER THAN AWAY FROM THE CIB RATE.

WHERE'S THE CATCH?

13. SO FAR, IT ALL SOUNDS TOO GOOD TO BE TRUE. WHERE'S THE CATCH? WHERE DO THE COSTS OF ACHIEVING STABILITY FALL?

14. UNDER THIS SCHEME, UNLIKE UNDER PRESENT ARRANGEMENTS, AN INCREASE IN THE DEMAND FOR FOREIGN CURRENCY WOULD TEND AUTOMATICALLY TO PUT A CONTRACTORY PRESSURE ON THE MONEY SUPPLY. THIS WOULD IN TURN, IN THE SHORT-TERM, TEND TO MEAN HIGHER INTEREST RATES AND SOME DEPRESSANT EFFECT ON ECONOMIC ACTIVITY UNTIL LOWER COST/PRICE LEVELS WERE ESTABLISHED. IF THE SCHEME SUCCEEDED IN RESTORING CONFIDENCE IN THE EXCHANGE RATE, THE PRESSURE OF DEMAND FOR FOREIGN CURRENCY WOULD SUBSIDE AND ANY MONETARY CONTRACTION WOULD BE ALLEVIATED. IT IS, OF COURSE, IMPOSSIBLE TO PREDICT THE IMPACT, BUT VIRTUALLY ANYTHING WOULD BE TOLERABLE FOR A SHORT WHILE IN THE INTERESTS OF STABILISING THE EXCHANGE RATE.

DECISIONS AND ACTION.

15. IF THE SCHEME IS TO BE IMPLEMENTED, THE CHIEF DECISION TO BE TAKEN CONCERNS THE CIB RATE. IDEALLY ONE MIGHT WISH TO RE-ESTABLISH IMMEDIATELY A RATE CALCULATED TO BE APPROPRIATE, SOLELY BY REFERENCE TO ECONOMIC FUNDAMENTALS. THIS WOULD PERHAPS BE IN THE RANGE 6.50 TO 7.00. HOWEVER, IF ONE FAILED TO WIN 100 PERCENT CONFIDENCE IN THE DURABILITY OF THAT RATE, THE PRESSURES OF MONETARY CONTRACTION MIGHT BE UNDULY SEVERE. A RATE OF 7.50 MIGHT BE MORE CREDIBLE, OR PERHAPS 7.25 ON THE GROUNDS THAT THIS WAS THE LAST RESTING POINT ON THE RECENT DOWN TREND.

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16. AS REGARDS OTHER PRELIMINARIES, FIRST IT WOULD BE NECESSARY FOR THE NOTE-ISSUING BANKS TO AGREE ANY REVISIONS TO THEIR ARRANGEMENTS FOR PROVIDING NOTES TO THE OTHER BANKS.

17. NEXT IT IS PARTICULARLY HARD TO PREDICT PUBLIC REACTION, SO ALL POSSIBLE CONTINGENCIES HAVE TO BE PROVIDED FOR. THE PUBLIC MIGHT SEIZE UPON THE ASSURANCE OF THE CONVERTIBILITY OF HKD NOTES INTO FOREIGN CURRENCY, BUT FAIL TO APPRECIATE THE CONTINUING CONVERTIBILITY OF DEPOSITS INTO NOTES. IF THIS HAPPENED THERE COULD BE, SOMEWHAT PERVERSELY, AN INITIAL, ALBEIT SHORTLIVED, SURGE IN DEMAND FOR HKD NOTES. ADEQUATE SUPPLIES WOULD NEED TO BE AT HAND.

18. MORE PROBLEMATICALLY, THE PUBLIC MIGHT TEST THE CONVERTIBILITY, AS THEY PERCEIVE ITS MEANING, OF THE HK NOTES BY DEMANDING FOREIGN NOTES IN EXCHANGE. THIS COULD BE DISCOURAGED TO SOME EXTENT BY PERSUADING THEM OF THE ADVANTAGES OF A FOREIGN CURRENCY DEPOSIT AS OPPOSED TO A BANKNOTE, AND BY DRAWING ATTENTION TO THE LAW CONCERNING THE USE OF FOREIGN NOTES IN HONG KONG. NEVERTHELESS, IT WOULD BE DESIRABLE FOR BANKS TO HAVE PLENTY OF U.S. NOTES AVAILABLE. IT WOULD BE IMPORTANT FOR THE SCHEME TO WIN MAXIMUM CREDIBILITY: ANY STORIES OF BANKS NOT BEING ABLE TO HONOUR THE SUPPOSED CONVERTIBILITY, AS INTERPRETED BY THE MAN IN THE STREET, WOULD BE MOST UNFORTUNATE.

COST TO GOVERNMENT.

19. AFTER ANY SHORTLIVED INITIAL SURGE, IT IS LIKELY THAT THE NOTE-ISSUE WOULD CONTRACT (OR AT LEAST BE LESS THAN IT OTHERWISE MIGHT BE) DURING THE PERIOD OF ADJUSTMENT TO THE NEW RATE. THE WORST SCENARIO WOULD BE FOR THIS CONTRACTION TO CONTINUE, IMPLYING A CONTINUAL LACK OF CONFIDENCE IN THE STABILITY OF THE CURRENCY, UNTIL (IN THEORY ANYWAY) THE HKD MONEY SUPPLY (FOR WHICH CASH IS THE ULTIMATE RESERVE) DISAPPEARED TO ZERO, ALTHOUGH SUCH DEMONETISATION MIGHT BE NO BAD THING IF CONFIDENCE WAS INDEED SO PERSISTENTLY POOR.

20. THE COST OF ANY REDUCTION IN THE NOTE ISSUE IS THE LOSS OF SEIGNORAGE, WHICH IS ACCEPTABLE IF IT REFLECTS A RETURN OF MONETARY DISCIPLINE: ANNOYING, BUT ACCEPTABLE, IF IT SIMPLY REFLECTS MORE ECONOMICAL USE OF CASH: AND STILL MORE ANNOYING, BUT INEVITABLE, IF IT ARISES FROM A SHIFT TO USE OF OTHER CURRENCIES AND HENCE DIVERSION OF SEIGNORAGE TO ANOTHER GOVERNMENT (UNLIKELY UNLESS THE PROHIBITION ON USE OF FOREIGN NOTES IS REPEALED).

21. ADDITIONALLY, GOVERNMENT MAY RESENT REDEEMING CASH FOR FOREIGN CURRENCY AT A RATE LESS FAVOURABLE TO GOVERNMENT THAN THE LAST PRE-SCHEME MARKET RATE. HOWEVER, JUDGED OVER A LONGER PERIOD, GOVERNMENT WOULD PROBABLY FIND THAT IT HAD MADE HANDSOME EXCHANGE GAINS FROM INVESTING CASH PROCEEDS.

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22. ALL IN ALL, THE POSSIBLE COST TO GOVERNMENT IS STRICTLY FINITE, WITHIN A TOLERABLE BOUND.

POLITICS AND PRESENTATION.

23. THERE SHOULD BE NO POLITICAL PROBLEM IN IMPLEMENTING THIS SCHEME. CHINA HAS CONTINUALLY BEEN CALLING FOR ACTION ON THE EXCHANGE RATE AND CAN HARDLY BE CRITICAL OF THE FIXING OF THE C/R RATE BY REFERENCE TO THE U.S. DOLLAR - AND BY IMPLICATION AGAINST OTHER CURRENCIES - SINCE CHINA ITSELF QUOTES MOVABLE PEGS AGAINST THE U.S. DOLLAR AND OTHER CURRENCIES. IT CAN BE EXPLAINED THAT THE U.S. CURRENCY IS USED SIMPLY AS A VEHICLE AND REFERENCE POINT, AND NOT IN ANY CONSTITUTIONAL SENSE: IF NECESSARY IT CAN BE ARRANGED THAT THE EXCHANGE FUND WOULD ACCEPT OR PAY ANY OF A NUMBER OF LEADING CONVERTIBLE CURRENCIES AGAINST HKS, AT PREVAILING RATES BASED ON THE ANNOUNCED U.S. DOLLAR RATE.

24. IT HAS BEEN SUGGESTED THAT THE PEG SHOULD BE SET AGAINST STERLING, FOR CONSTITUTIONAL REASONS, BUT THIS DOES NOT SEEM NECESSARY AND MIGHT BE MISINTERPRETED POLITICALLY.

25. THE SCHEME WOULD HAVE TO BE VERY CAREFULLY PRESENTED SO AS TO ACHIEVE MAXIMUM IMPACT ON CONFIDENCE. AN OBVIOUS POINT OF EMPHASIS WOULD BE THAT THE FOREIGN CURRENCY RESOURCES AVAILABLE TO THE EXCHANGE FUND ARE VASTLY GREATER THAN THE LIABILITY NOW BEING EXPLICITLY ACCEPTED IN RESPECT OF C/Rs, AND THAT THESE RESOURCES ARE IN VERY LIQUID FORM. IT HAS BEEN SUGGESTED THAT, ADDITIONALLY, THE BANK OF ENGLAND SHOULD VOICE SUPPORT TO ASSIST WITH PROVIDING LIQUIDITY, IF NEEDED. IF POLITICALLY FEASIBLE, THIS WOULD CERTAINLY HELP, BUT IT IS NOT ESSENTIAL.

26. THE ANNOUNCEMENT WOULD HAVE TO STRIKE A CAREFUL BALANCE BETWEEN EMPHASIZING THE CONVERTIBILITY AND ASSET-BACKING OF THE HK DOLLAR AND AVOIDING ANY ENCOURAGEMENT FOR PEOPLE ACTUALLY TO CONVERT: AND IT WOULD HAVE TO BE MADE CLEAR THAT THE EXCHANGE FUND CONTINUED TO DEAL ONLY IN C/Rs WITH THE NOTE-ISSUING BANKS, SO THAT THE RATE OF EXCHANGE TO THE PUBLIC WOULD NOT NECESSARILY BE IDENTICAL TO THE PEGGED RATE (THOUGH IT WOULD IN ALL LIKELIHOOD BE CLOSE).

27. AS NOTED EARLIER THE SUCCESS OF THE SCHEME IN RESTORING THE STABILITY WITH THE MINIMUM OF MONETARY SQUEEZE DEPENDS ON ITS CREDIBILITY. THUS THE UTMOST CARE HAS TO BE TAKEN IN ITS PRESENTATION.

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CONCLUSION.
28. THIS SCHEME COULD, WITH THE AGREEMENT OF THE NOTE-ISSUING BANKS, BE IMPLEMENTED VERY QUICKLY. NO ALTERNATIVE HAS BEEN SUGGESTED. THE POTENTIAL COST TO GOVERNMENT IS NOT EXCESSIVE. AT BEST THE SCHEME WOULD SUCCEED IN STABILISING THE EXCHANGE RATE AT ONLY MODEST OR NEGLIGIBLE COST TO THE REAL ECONOMY. AT WORST, CONFIDENCE IN THE CURRENCY WOULD NOT BE FULLY RESTORED AND THE MONETARY CONTRACTION MIGHT CONSEQUENTLY BE INTENSE. AT THAT STAGE A DECISION COULD BE TAKEN EITHER TO ACCEPT AND INDEED ENCOURAGE DEMONETISATION, OR TO ABANDON THE SCHEME. EVEN WITH THIS WORST SCENARIO, IT IS DIFFICULT TO IMAGINE THAT WE WOULD BE IN A MORE PARLOUS STATE THAN WE ARE AT PRESENT.

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