Prime Minister

Agree X? Paras 7 & 8 of the attached note set out the pros and cons. The case for linking with US $ rather than £ seems strong

AT 6/10

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Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

6 October 1983

MT.

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew,

HONG KONG

As you will recall from my letter of 30 September, David Peretz from the Treasury and Charles Goodhart from the Bank of England have been in Hong Kong to look at the scheme the Hong Kong Government have devised for stabilising the Hong Kong dollar, and to give technical advice on its implementation.

The Chancellor thought the Prime Minister would like to see the attached summary report produced by David Peretz, who arrived back in London this morning. Charles Goodhart is staying in Hong Kong for a further 24 hours to write up a more detailed technical appreciation of the scheme at the request of the Hong Kong authorities.

The Chancellor thinks that Peretz and Goodhart have done a good job, and we know that the Hong Kong Government found their visit and advice most helpful.

In brief, the conclusions are:-

i. The present Hong Kong monetary system is unsatisfactory. Since 1974 there has been no effective form of monetary discipline either through control of the money supply or through the exchange rate.

ii. The scheme the Hong Kong Government have under consideration is technically feasible. It does not prevent further falls in asset values: no such scheme could, for the roots of the present problem of confidence are political not financial. And it entails risks, for it means taking the pressures, which could be intense, on interest rates. But these risks have to be weighed against those of a self-feeding collapse in the currency, if nothing is done.

iii. Given the novelty of the scheme and the risks of quite sharp reactions, at least temporarily, it is most important that the Hong Kong Government should have thought through all the things that could go wrong, and have contingency plans ready for dealing with them. Good presentation at the outset will also be important.

iv. The obvious currency to provide the link required in the scheme is the US dollar, which is already for many purposes a second currency in the Colony. If the scheme were introduced with a sterling link it would have less chance of success since most Hong Kong residents would prefer to hold US dollars; and presentation would be more difficult. In the worst case it could also lead to wider pressures on sterling.

v. On timing, although there is a case for going ahead as quickly as possible, the Governor is clear that he would need to consult his Executive Council on a matter of this kind. The authorities have a good deal more preparatory work and planning to do. And a weekend launch has considerable operational advantage. These factors all tend to point towards Friday 14 October, which is a public holiday in Hong Kong.

vi. The scheme is the only one being considered in Hong Kong, and therefore ready for early implementation. Although the final decision must be for the Hong Kong authorities, there seems a strong case for their going ahead. But it would be wrong for us to try to persuade them to go ahead against their own judgement, and could carry awkward implications about our own commitment to help if things went wrong.

X The Governor, who appears to favour the scheme, will be calling on the Chancellor tomorrow, and the Chancellor plans not to dissuade him from going ahead with it.

I am copying this letter and enclosure to Brian Fall (FCO) and John Bartlett (Bank of England).

Yours ever,

John Kerr

J O KERR

VISIT TO HONG KONG

Charles Goodhart (from the Bank of England) and I spent 4 and 5 October in Hong Kong. We went at the request of the Hong Kong Government to give technical advice on the proposal they have been developing to improve monetary control and stabilise the exchange rate for the Hong Kong dollar. Goodhart is writing up his detailed technical appreciation for the Hong Kong Government, and will bring a copy back to London on 7 October. This note describes the scheme, gives a summary assessment of it, how it might best be implemented, and how it compares with other possible options.

2. In the course of our visit we had discussions with those most concerned at a technical level in the Monetary Affairs Branch; with the Financial Secretary, the Chief Secretary and the Governor; with two leading bankers; and with outside economists, including Sir Alan Walters' contact Mr John Greenwood, who have been involved with developing the proposal.

Monetary Policy in Hong Kong

3. The striking feature of Hong Kong's monetary system is that the Colony has survived since 1974 with neither a fixed exchange rate nor any means of enforcing domestic monetary control. It is perhaps a comment on the underlying strength and adaptability of the economy that inflation has remained within bounds over the period. The points that John Greenwood made in this respect are obviously right. It is a message that visitors from the Bank of England have been conveying to the Hong Kong administration for many years. The scheme now proposed would, if implemented, provide a mechanism of monetary control of a kind that has been missing up to now.

The Scheme

4. The proposal as it has been developed is basically what is known as a "currency board" arrangement. It is also very similar

to the proposals made by Greenwood, who has been quite active in helping officials to work it up.

5. The essential elements are:-

(a) The official Exchange Fund (EF) guarantees the US $ (or other foreign currency) value of UK $ notes - through the mechanism of issuing so called certificates of indebtedness to note-issuing banks. The foreign currency in the EF - now around US $5 billion - comfortably exceeds the present HK $~~14~~ 1.4 billion note issue. If extra notes are issued this will only be against the deposit of equivalent foreign currency with the EF. This means, in effect, that HK $ notes will be convertible into foreign currency at an exchange rate stated by the authorities; and the HK Government's liability is confined to the size of the existing note issue.

(b) Opportunities for arbitrage mean the market exchange rate will never move far from this "official" exchange rate.

(c) If there are pressures therefore they will fall not on the exchange rate or on the Exchange Fund, but on banks. We assumed, and this assumption was shared by all who we spoke to, that banks at all costs would want to maintain convertibility between HK $ bank deposits held with them and bank notes. In a society like Hong Kong's, where queues to withdraw cash are not uncommon at times of uncertainty, no bank could risk the blow to public confidence in it that a refusal to permit cash withdrawals could bring about.

(d) Banks would then have a choice. HK banks (or rather the banking system as a whole) could either switch foreign currency into Hong Kong dollars, so as to acquire extra HK $ notes to meet any extra demand (or banks could permit customers to switch from HK $ deposits to US $ deposits without themselves seeking to make a corresponding switch in the currency of their assets). Or they could bid HK $ interest rates up to the point where customers no longer wished to move into notes or foreign currency.

6. There are a number of circumstances favourable to the scheme in Hong Kong. The HK banking system at present has a substantial net foreign currency position, so it should in principle be prepared to make some switch into HK $s (there is a particularly strong position at the Hongkong and Shanghai Bank). The presence of a number of major foreign banks would also be a potential source of strength if they were prepared to switch into HK $s, as they might have to if they wished to continue in business in Hong Kong. It is also a source of strength that many HK businesses are thought to have built up large US $ holdings (through leads and lags on trade payments) over recent months, and that the Colony is to a large extent already on a dual currency basis. Rather than borrow at very high HK $ interest rates they might prefer to draw on their US $ holdings, or borrow at lower rates in US $s against them, or against expected future $ earnings, thereby reducing the pressure on HK $ interest rates.

Arguments for and against

7. It is hard to predict what effect the scheme would have in practice, but there are certainly serious risks. There could easily be teething problems, with the possibilities of runs on local Chinese banks, or huge demand for US $ notes - both of which the authorities would need to be ready to meet. At best the scheme would help restore confidence generally, maybe even reducing interest rates. With the exchange rate seen to have been stabilised there would be little if any upward pressure on interest rates. At worst there would be a rush to try to get out of the HK $ while the rate was thought to be "pegged". The way the scheme works this would put the main strain first on banks; and then on interest rates - which could rise very sharply indeed. The effect of this could (some said would) be to precipitate further collapses in the already weakened property sector. It would also be uncomfortable for the many individuals who have financed house purchase with floating rate loans. In the end however, if everyone became convinced the peg would last there should in principle be no difference between US $ and HK $ interest rates - though rates on both currencies might be higher in Hong Kong than elsewhere to reflect the political risk.

8. Against these possible outcomes has to be weighed the risk of inaction: the effect of a continuing, possibly accelerating, fall in the exchange rate, and the impact that would have on prices. Rising prices have caused riots before in Hong Kong, and could do so again. There are strong memories there of Shanghai in 1948. Such unrest could increase the political uncertainties, bringing further pressure on the exchange rate: a vicious circle.

Assessment

9. Nearly all those we met, including the commercial bankers, thought that in the circumstances it was right to go ahead with the scheme. One consideration is the need for some action now that expectations have been raised. Some thought that in principle better ideas might have been devised. But there is nothing else at anything like such an advanced state of readiness; or that could be introduced with so few institutional changes.

10. The balance of risks described in paragraphs 7 and 8 above is easier for those in Hong Kong to judge than for outsiders. The decision is one for the Hong Kong Government to take, and during our visit we made it clear that we could only advise on technical merits and practicalities. But there does seem a strong case for going ahead with the scheme, particularly if proper contingency arrangements can be devised in advance for handling forseeable risks and potential teething problems, and if a variety of other detailed improvements we were able to suggest can be incorporated.

The choice of currency link

11. Those who have been involved with working up the scheme have assumed that the link would be with the US \$. There is also fairly general agreement that the right rate to go for is HK \$8 to the US \$. Anything higher would look over-ambitious, particularly with further political uncertainties ahead. Anything much lower would risk locking in an unnecessary degree of inflation.

12. The possibility of a link with sterling was mentioned, but the arguments against are strong:-

(a) The US $ is already a second currency in the Colony. A sterling link would both be less natural, and tend to make the scheme harder for the population to understand and accept.

(b) There may be a political aspect vis-a-vis the negotiations with the Chinese.

(c) Since most HK residents probably want to hold US $s rather than sterling (reflecting in part the direction and denomination of their trade) it could tend to put downward pressure on sterling.

Timing

13. We met the Governor on 4 October. After we had explained our technical appreciation of the scheme to him it sounded very much as if he had decided to go ahead. But he was clear he could not proceed on a matter of this kind without first consulting his Executive Council, which could not be until their return from London next week. Meanwhile a paper for the Executive Council is being prepared for the Governor's return on Monday. There are strong operational and market reasons for making changes of this kind over public holidays and weekends. There is also a good deal of necessary contingency planning and preparation to be done before the Hong Kong Government is ready for a properly prepared launch. So exchange markets permitting, there is a good reason for delaying an announcement until late on Thursday 13 October, just before a long weekend starting with a Hong Kong public holiday on 14 October.

D L C PERETZ

HM TREASURY
6 October, 1983

SECRET

cc FCO
Gov/BofE

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10 DOWNING STREET

From the Private Secretary

7 October 1983

Hong Kong

You attached to your letter of 6 October David Peretz's report on the scheme which has been devised for stablising the Hong Kong dollar. The Prime Minister has noted that the Hong Kong Government now wish to introduce this scheme and that the Chancellor is in agreement with this.

I am copying this letter to Brian Fall (Foreign and Commonwealth Office) and John Bartlett (Office of the Governor of the Bank of England).

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John Kerr, Esq.,
H.M. Treasury.

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