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DESKBY FCO 131200Z
DESKBY PEKING 140100Z
FM HONG KONG 131050Z OCT 83
TO IMMEDIATE FCO
TELEGRAM NUMBER 1522 OF 13 OCTOBER
INFO IMMEDIATE PEKING (PERSONAL FOR CHARGE)

FOLLOWING STRICTLY PERSONAL FOR CLIFT (HKD)
MIFT.

STABILISATION OF EXCHANGE RATE.

FOLLOWING IS TEXT OF STATEMENT WHICH THE FINANCIAL SECRETARY
WILL MAKE AT NOON HONG KONG TIME SATURDAY OCTOBER 15.

1. I WANT TO TELL YOU ABOUT TWO STEPS WHICH THE GOVERNMENT IS TAKING
NOW TO STABILISE THE EXCHANGE RATE OF THE HONG KONG DOLLAR.

2. FIRST LET ME GIVE YOU SOME BACKGROUND. FOR 37 YEARS FROM
1935 TO JULY 1972 THE HONG KONG DOLLAR WAS PEGGED TO STERLING.
IN THOSE DAYS THE STERLING AREA EXISTED AND FOR MOST OF THAT
PERIOD THE INTERNATIONAL MONETARY SYSTEM WAS CHARACTERISED BY
FIXED EXCHANGE RATES. FROM 1972 TO NOVEMBER 1974 THE HONG KONG
DOLLAR WAS PEGGED TO THE US DOLLAR. SINCE 1974 HONG KONG IN
COMMON WITH OTHER MAJOR MARKET ECONOMIES HAS HAD A FREELY FLOATING
EXCHANGE RATE. THIS FLOATING SYSTEM HAS SERVED US WELL. IT HAS
GIVEN US A MEASURE OF INSULATION FROM THE UPS AND DOWNS OF OTHER
ECONOMIES, AND UNDER IT HONG KONG HAS RECORDED VERY HIGH RATES
OF ECONOMIC GROWTH. LIVING STANDARDS HAVE RISEN ACCORDINGLY.

3. TOWARDS THE END OF LAST YEAR THE EXCHANGE RATE STARTED MARKEDLY
TO WEAKEN, REFLECTING AMONGST OTHER FACTORS UNCERTAINTIES ABOUT
HONG KONG'S FUTURE.

4. BEFORE THE GOVERNMENT ANNOUNCED THREE WEEKS AGO THAT IT WAS
CONSIDERING PROPOSALS TO STABILISE THE EXCHANGE RATE CURRENCY
DEPRECIATION WAS TENDING INCREASINGLY TO FEED ON ITSELF IN AN
UNSTABLE AND IRRATIONAL MANNER. THIS DEPRECIATION WAS NOT JUSTIFIED
BY EITHER CURRENT ECONOMIC DEVELOPMENTS OR FUTURE PROSPECTS.
THE ECONOMY HAS REBOUNDED AND IS DOING VERY WELL. THERE IS LITTLE
UNEMPLOYMENT AND EXPORTS ARE BOOMING. HONG KONG HAS SUBSTANTIAL
FOREIGN CURRENCY RESERVES, A GENERALLY LIQUID BANKING SYSTEM
AND VIRTUALLY NO GOVERNMENT DEBT.

5. THE GOVERNMENT HAS BEEN CONCERNED BY THE FALLING EXCHANGE RATE
AND HAS DONE EVERYTHING IN REASON, WITHIN THE ESTABLISHED FRAMEWORK,
TO ATTEMPT TO STABILISE IT. THESE EFFORTS HAVE ACHIEVED ONLY
LIMITED SUCCESS.

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6. THE CIRCUMSTANCES OF HONG KONG PRECLUDE EXCHANGE CONTROL. AFTER A THOROUGH EXAMINATION OF REALISTIC OPTIONS, WE HAVE NOW DECIDED TO ALTER THE FRAMEWORK WITHIN WHICH THE EXCHANGE RATE IS DETERMINED. WITH EFFECT FROM MONDAY 17 OCTOBER, THE TWO NOTE-ISSUING BANKS WILL PAY THE GOVERNMENT'S EXCHANGE FUND FOR ADDITIONAL CERTIFICATES OF INDEBTEDNESS, WHICH THEY ARE REQUIRED TO HOLD AS BACKING FOR ANY INCREASE IN THEIR NOTE ISSUES, IN FOREIGN EXCHANGE AT A FIXED RATE OF HK DOLLARS X.XX EQUALS US DOLLARS 1.

7. FROM THE SAME DATE, WHEN NOTES ARE WITHDRAWN FROM CIRCULATION AND THE NOTE-ISSUING BANKS SURRENDER CERTIFICATES OF INDEBTEDNESS THE EXCHANGE FUND WILL PAY THEM THE EQUIVALENT FOREIGN EXCHANGE AT THE SAME FIXED RATE. IT IS OUR INTENTION TO HOLD THIS RATE UNCHANGED.

8. THE RATES OF EXCHANGE WHICH A BANK CUSTOMER WILL OBTAIN, WHETHER EXCHANGING BANK NOTES OR MAKING ANY OTHER FOREIGN CURRENCY TRANSACTIONS, WILL CONTINUE TO BE DETERMINED BY MARKET FORCES, BUT WILL IN PRACTICE BE CLOSE TO THE FIXED RATE OF HK DOLLARS X.XX EQUALS US DOLLARS 1. THIS WILL BE THE CASE BECAUSE FROM NEXT MONDAY MARKET FORCES WILL OPERATE AGAINST THE BACKGROUND OF THE FIXED RATE FOR CERTIFICATES OF INDEBTEDNESS. I MUST EMPHASISE THAT THESE NEW ARRANGEMENTS WILL MEAN BUSINESS AS USUAL BETWEEN BANKS AND THEIR CUSTOMERS AT STABILISED RATES.

9. YOU WILL ASK ABOUT THE IMPLICATIONS FOR THE ECONOMY OF STABILISING THE EXCHANGE RATE IN THIS WAY. IN THE SHORT TERM THERE MAY BE SOME UPWARD PRESSURES ON HONG KONG DOLLAR INTEREST RATES. ONCE THE STABILITY OF THE EXCHANGE RATE BECOMES EVIDENT AND ACCEPTED, INTEREST RATES SHOULD FALL BELOW PRESENT LEVELS. LOOKING FURTHER AHEAD CHANGES IN THE EXCHANGE RATE WILL NO LONGER BE AN ELEMENT IN OUR ECONOMY'S ADJUSTMENT PROCESS. FACTORS SUCH AS INTEREST RATES AND MONEY SUPPLY WILL ADJUST TO BALANCE OF PAYMENTS PRESSURES AUTOMATICALLY WITHOUT GOVERNMENT INTERVENTION.

10. THE GOVERNMENT BELIEVES THAT THIS NEW ARRANGEMENT MUST NOW BE PREFERRED TO THE FREELY FLOATING EXCHANGE RATE SYSTEM. WE CANNOT RUN THE RISK OF FURTHER SPIRALLING DEPRECIATION, WITH THE RAMPANT INFLATION AND DISTRESS WHICH THAT WOULD BRING TO ALL OUR COMMUNITY. A RETURN OF CONFIDENCE IN OUR CURRENCY IS ESSENTIAL.

11. I SAID THAT I HAD TWO MEASURES TO ANNOUNCE. THE SECOND IS THIS. AS FROM MONDAY 17 OCTOBER INTEREST ON HONG KONG DOLLAR DEPOSITS WITH FINANCIAL INSTITUTIONS WILL NO LONGER BE TAXED. THIS MEANS THAT THERE WILL NO LONGER BE A TAX ADVANTAGE IN HOLDING FOREIGN CURRENCY DEPOSITS OR IN HOLDING HONG KONG DOLLAR DEPOSITS OFFSHORE.

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12. AS I SAID LAST MONTH, THE GOVERNMENT IS WORRIED ABOUT POSSIBLE SERIOUS EROSION OF PROFITS TAX REVENUE ARISING FROM THE REMOVAL OF INTEREST TAX. WE ARE STILL STUDYING THIS COMPLEX ISSUE. IN REMOVING INTEREST TAX ON HONG KONG DOLLAR DEPOSITS WITH FINANCIAL INSTITUTIONS, WE ARE DOING THE MOST THAT IS POSSIBLE, PENDING THE OUTCOME OF OUR STUDY. I HOPE TO BE IN A POSITION TO PROPOSE MORE LASTING REFORMS IN THESE FIELDS OF TAXATION IN THE BUDGET NEXT FEBRUARY.

13. THESE MEASURES ARE DESIGNED TO STABILIZE THE EXCHANGE VALUE OF THE HONG KONG DOLLAR, AND THUS TO PROVIDE A CLIMATE FOR GROWING PROSPERITY WITH RESTRAINED INFLATION. THE GOVERNMENT HAS CONFIDENCE IN THE STABILISED EXCHANGE RATE. SO CAN THE PEOPLE OF HONG KONG. LET US NOW GET ON WITH OUR BUSINESS.

YOUDE

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HD/HKD
HD/ERD(MR APPELYARD)
PS/
PS/MR LUCE
PS/PUS
MR GIFFARD
MR EVANS
MR DONALD

COPIES TO:
MR BURROWS LEGAL ADVISERS
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H. Cole (No 10)

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DESKBY FCO 131200Z

DESKBY PEKING 140100Z

FM HONG KONG 131100Z OCT 83

TO IMMEDIATE FCO

TELEGRAM NUMBER 1521 OF 13 OCTOBER

INFO IMMEDIATE PEKING (PERSONAL FOR AMBASSADOR)

FOLLOWING STRICTLY PERSONAL FOR CLIFT (HKD)

MY TELNO 1501 (NOT TO PEKING)

STABILISATION OF THE EXCHANGE RATE

EXECUTIVE COUNCIL ACCEPTED THIS MORNING (IF SOMEWHAT PASSIVELY) THAT THE PROPOSED STABILISATION SCHEME SHOULD BE IMPLEMENTED FROM MONDAY, OCTOBER 17; AND THAT AN ANNOUNCEMENT SHOULD BE MADE AT 12 NOON HONG KONG TIME ON SATURDAY OCTOBER 15.

2. THE ONLY "DECLARATION OF POSITION" WAS MADE BY SIR S.Y. CHUNG WHO SAID THAT HE THOUGHT THAT THE SCHEME WOULD IN THE LONG TERM BE DETRIMENTAL TO THE FUTURE OF HONG KONG BUT IF THE ADMINISTRATION FELT THAT THERE WAS A NEED TO PROCEED FOR SHORTER TERM ECONOMIC REASONS HE WOULD NOT WISH TO STAND IN OUR WAY. (HE DID NOT EXPLAIN HOW IT WOULD BE DETRIMENTAL BUT MAY HAVE HAD IN MIND HIS VIEW THAT ECONOMIC DIFFICULTIES IN HONG KONG ARE THE STRONGEST PRESSURE ON THE CHINESE TO COMPROMISE ON ADMINISTRATION). SANDBERG HAD EARLIER INDICATED THAT HIS PREFERENCE WOULD HAVE BEEN TO DO NOTHING; BUT DID NOT SPEAK AT THE END. (THE HONG KONG BANK'S VIEW WAS RECORDED IN PARA 19 OF MYTEL UNDER REF.)

3. THE TEXT OF THE FINANCIAL SECRETARY'S STATEMENT WHICH WILL BE MADE ON SATURDAY IS IN M.L.F.T.

4. WE HAVE APPROVED THE IMPLEMENTATION OF THE SCHEME FOR THE REASONS SET OUT IN PARA 28 OF THE MEMORANDUM. ALTHOUGH THE RISKS ARE APPARENT WE CONSIDER THAT THERE ARE FAR GREATER RISKS IN INACTION. OVER THE PAST YEAR THERE HAS BEEN A SERIES OF DOWNWARD LURCHES IN THE DOLLAR RATE AND THE LAST ONE BROUGHT WITH IT "A WHIFF OF PANIC". IF ANXIETY BUILDS UP AROUND NEXT WEEKS TALKS AS IT DID ON 23 SEPTEMBER AND/OR THE CHINESE FAIL TO AGREE TO AN ENCOURAGING COMMUNIQUE THERE COULD BE ANOTHER SEVERE AND POSSIBLY IRREVERSIBLE SLIDE IN THE EXCHANGE RATE. IT COULD WELL BE THAT IT IS ONLY BEING HELD NOW BY THE EXPECTATION IN THE MARKET THAT THE GOVERNMENT IS ABOUT TO COME UP WITH A PLAN. IN ANY CASE THERE REMAINS THE REAL RISK THAT WE SHALL REACH ANOTHER IMPASSE WITH THE CHINESE SOMEWHERE ALONG THE LINE; AND ALL THE EXPERT ADVICE IS TO THE EFFECT THAT IT IS BETTER TO ACT WHEN THE RATE IS RELATIVELY STATIC THAN WHEN IT IS FALLING.

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5. I SHALL ALSO COMMENT POSITIVELY ON THE SCHEME AND PRESENT IT AS AN EXPRESSION OF OUR CONFIDENCE IN THE CURRENCY AND THE ECONOMY UNDERLYING IT.

6. SATURDAY NOON WAS CHOSEN TO ENSURE THAT THE FIRST IMPACT OF THE SCHEME WILL BE ON THE HONG KONG MARKET ON MONDAY AND NOT ON MARKETS ABROAD AS WOULD BE THE CASE IF THERE WERE AN ANNOUNCEMENT TONIGHT.

YOUDE

LIMITED MR GIFFARD
HD/HKD
HD/ERD(MR APPELYARD)
PS/
PS/MR LUCE MR EVANS
PS/PUS MR DONALD

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