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Mr Coles ~~WRL 3/10~~ To note. AT 3/10

10 DOWNING STREET

From the Private Secretary

3 October, 1983.

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Hong Kong

The Prime Minister has noted but has not commented upon your letter of 30 September and its attachments.

I am sending copies of this letter to Brian Fall (Foreign and Commonwealth Office) and John Bartlett (Bank of England).

AT

J.O. Kerr, Esq.,
HM Treasury.

SECRET

MR.

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

30 September 1983

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew,

HONG KONG

Since the discussion with the Prime Minister in Washington reported in Robin Butler's letter of 28 September the Chancellor has considered the Hong Kong situation further with officials and with the Governor of the Bank of England and has asked me to let you know the conclusions he has reached and the action he is now taking.

Although the problem is fundamentally a political one, and the recent crisis was precipitated by intensified Chinese propaganda and anxiety at the absence of any reassuring element in the official communique on the talks in Peking on 22 and 23 September, the Hong Kong government are proposing to take action on the monetary front to try to resist further pressure on the exchange rate. The Chancellor thinks this right, for although the rate now appears to have stabilised at just below 8 Hong Kong $ to the US$, the situation remains fragile, and there can be no confidence that the present stability will last. He therefore agrees that action must be taken quickly, particularly since expectations have been raised by the announcement by the Hong Kong authorities last week that they were considering possible revisions in the mechanics for backing the note issue.

As the Prime Minister knows, the Chancellor had instructed Treasury officials to consider, with the Bank, a number of alternative responses. These included schemes along the lines suggested by Sir Alan Walters, together with:-

- pegging the Hong Kong $ against the dollar or sterling, with HMG being prepared to intervene heavily in support; Annex 1

- reimposition of exchange controls; Annex 2
- further action on interest rates (following the increase in prime rates to 16 per cent on 26 September); Annex 3
- removal of the 10 per cent withholding tax currently levied on interest paid on Hong Kong dollar deposits. Annex 4

For background, short notes on these latter possibilities are attached at annexes 1 to 4. The Chancellor does not think that any of the last three, either alone or in combination, would be effective (and the Hong Kong government have also indicated that they do not regard exchange control or removing the withholding tax as feasible options). From the UK point of view the objections to the first, or any arrangement under which UK backing might be given to defence of the Hong Kong dollar are, at this stage, overwhelming. We could all too easily be drawn quickly into either committing our own - limited - dollar reserves to support the Hong Kong dollar, or allowing sterling itself to take the strain. The downward pressure on sterling could be substantial.

The proposal which the Hong Kong government have devised, and wish to implement, does not have this disadvantage. The scheme, set out in telegram No 1435 of 29 September attached at Annex 5, is a practical version of the most recent scheme proposed by Sir Alan Walters which was discussed in Washington. Indeed it has benefitted from discussion with Sir Alan's Hong Kong contacts. In brief, it entails setting the price of Certificates of Indebtedness (CIs) - the backing for the Hong Kong currency - in terms of US$ at a fixed rate. This could, with the co-operation of the note-issuing banks, be implemented very quickly. Although the maintenance of the scheme might involve higher interest rates, it should stabilise the open market exchange rate in line with the CI rate.

Although on the basis of the knowledge available to us here it is not possible to evaluate the scheme thoroughly, and there are a number of points which we wish to clear up, it seems well worth trying, and quickly. But, arguably, the sooner an announcement of it is made, the better.

The Hong Kong authorities have however asked for technical advice on the implementation of their scheme. David Peretz from the Treasury (the Assistant Secretary in charge of the Balance and Payments Division) and Charles Goodhart from the

Bank (whose economic advice the Hong Kong Financial Secretary himself has asked for) will therefore fly to Hong Kong over the weekend.

It is of course important that this visit should be conducted with the utmost secrecy and discretion. Any impression that HMG were now actively intervening in the management of the Hong Kong financial system could radically change the nature of the current political negotiations with China. However, if - as it is not unlikely - the presence of Peretz and Goodhart in Hong Kong is observed, the line to take in response to any enquiries would simply be that they are visiting Hong Kong to acquaint themselves with the current financial situation. As Mr Luce made clear in a public statement in his recent visit to Hong Kong, the action to defend the value of the Hong Kong dollar is a matter for the Hong Kong government.

I understand that the Foreign and Commonwealth Secretary agrees with the Chancellor's reactions to the Hong Kong proposal, and to the immediate visit by Peretz and Goodhart.

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

Yours ever,

John Kerr.

J O KERR

Annex 1

Pegging the rate for the HK $

This would involve an undertaking by the Hong Kong authorities, possibly with explicit or implicit backing from HMG, to fix the exchange rate at some particular level against the dollar or against sterling, or against a basket of currencies.

2. To meet such an undertaking the Hong Kong authorities would have to be prepared in principle to engage in unlimited intervention in support of their currency. All the experience of such intervention in sophisticated financial markets like Hong Kong's is that very large sums indeed have to be spent if the speculative pressures are strong; and that heavy intervention can itself increase those pressures if speculators believe the authorities will eventually give way. A month's leading and lagging on trade payments alone could cost the HK authorities $2½ billion. If all or nearly all holders of reasonably liquid HK $s sought to convert them into other currencies - an extreme but not inconceivable case - there would be an outflow of $20 billion or so to meet.

3. Intervention would presumably, in the first case at least, be in US dollars, the currency that most sellers of HK $s wish to hold. Hong Kong's own foreign currency reserves stood at around $6 billion at the end of June and are probably still at a similar level. These might serve to hold the line for a while, but as they were depleted the Hong Kong authorities would have to consider the next step. In some circumstances they might be able to borrow in dollars on their own account, through in general one would expect it to be difficult to do so on any substantial scale, given the political uncertainties, without an HMG guarantee.

4. Beyond that, the only option would be, in effect, to begin to draw on the UK's reserves. Our own dollar reserves which currently stand at around $4½ billion would not last for long in the face of severe pressure, either. We would then have to consider some combination of sales of other currencies from our reserves and/or gold; or we could seek to borrow dollars on Hong Kong's behalf.

5. Alternatively, at that stage intervention might be in sterling, the more natural course if the HK $ rate were to be fixed in terms of sterling with explicit UK backing. In that case those who bought sterling as the HK authorities intervened could be expected to seek quickly to turn much of it into dollars. We would then have to chose between permitting the sterling exchange rate against the US dollar to take the strain, pulled down by the HK dollar; or intervening with our own reserves as in paragraph 4 above. It is difficult to judge how great the impact on sterling would be, but it could be quite substantial. Large holders of HK $s, who hitherto have held back for fear of turning the rate too far against them, could be expected to take the opportunity of getting out while the going was good. And sterling would be affected not just by the direct impact of these flows, but also by the knowledge in the markets generally that we would be taking the strain.

6. However such intervention were carried out, in the end either the Hong Kong authorities or HMG or both would be acquiring a possibly very substantial volume of HK $ claims - in return for the current Hong Kong reserves and some part of our current gold and dollar reserves, or financed by increased UK Government borrowing (either in sterling or dollars).

7. Perhaps, at first sight, the least unattractive form this option might take would be a statement that either we or the Hong Kong authorities would if necessary support the Hong Kong $ against sterling at some rate well below the current market rate. But it seems very likely that in current conditions such a statement would in itself immediately drive the HK $ down to the chosen level of defence. Investors and speculators would assume the authorities knew something they did not. It is arguably possible that if the chosen rate were low enough defending it might not prove too difficult. There might be enough buyers at that level to raise the HK $ above the floor again, for a time at least. But the risks would be very great; at any moment some new political development could require massive intervention to support the rate we would then be committed to, as discussed above.

Annex 2

Exchange Controls

1. For a nation with as sophisticated a financial sector and as open a trading sector as Hong Kong's, exchange controls are unlikely to be effective - and all too likely to be counter-productive. That is no doubt why the Hong Kong authorities have not themselves considered this option. Complete controls could not be erected. Partial controls could simply damage confidence and lead to accelerating outflows. There is evidence that much of the pressure is coming from currency movements by small investors and traders rather than the large institutions, who might be simpler to control.

2. To the extent that some pressures are, however, coming from speculative currency transactions by Hong Kong registered banks there is one relatively minor measure that might be worth considering. In many countries, including the UK, there are rules governing the currency exposure of banks, for purposes of prudential supervision. There are no such rules for Hong Kong banks at present. They are able to take large open positions against the HK $.

3. In the immediate circumstances, if a new rule were introduced to limit banks' exposed positions, or to prevent them changing, few would believe it was for prudential reasons. It would much more likely be seen as an exchange control measure and possibly the thin end of a wedge, encouraging preemptive sales of HK $s by those not affected (ie all other than banks). But at some point in the future when markets had settled down it might be a possibility to consider and introduce as a prudential measure, to match similar restrictions on banks elsewhere in the world.

Annex 3

Action on Interest Rates

The extent to which changes in the structure of local interest rates in the recent past have influenced the exchange rate may be an indication of the likely effectiveness of this form of control on the exchange rate in future. Prime rates have moved this year as follows:-

Date	Level	Exchange rate at time of change (HK $/$)
End-Dec '82	10.5%	6.50
19.4.83	11.5%	6.89
23.5.83	13.5%	6.99
6.7.83	12.5%	7.13
25.7.83	11.5%	7.20
9.9.83	13%	7.70
26.9.83	16%	8.25

2. Each change this year has apparently had only a small lasting effect on the exchange rate - though of course there is no way of knowing what would have happened had interest rates not risen. But certainly initial (reflex) reactions were generally shortlived. Following the 2 percentage point increase in May, for example, when the dollar parity was close to HK $7.00, the exchange rate came back to around 6.90 initially but fell to 7.10 in under a week. More recently, the rate recovered slightly to 7.60 from 7.70 after the 9 September increase but rapidly resumed its downward trend, recording 8.00 on 17 September. The latest move included a more dramatic recovery from around 9.5 to above 8.00 - though it is not easy to judge the effect of the interest rate change in isolation from the other supportive measures. The rate has stabilised in the past two days at around 8.5 but it is too early to judge whether the immediate pressure is off.

3. The latest increase brings real interest rates in Hong Kong up to, or slightly above, prevailing levels elsewhere. The trend level of inflation is around 10%, indicating real rates of around 6% (compared on the same basis with 5.5% in Japan and 6.7% in the US). Changes earlier this year left real interest rates well below those of major trading partners. Even so, it may be the case that the current political uncertainty requires a premium over levels prevailing elsewhere although, in the light of the extreme fluctuations in confidence which are likely to continue, this cannot easily be quantified.

4. On the other hand, if a substantial premium is required, changes of 2-3% in nominal rates may be neither here nor there in the present climate of uncertainty. But higher nominal rates (of up to 20% or more) couldbe counter-productive, both through their effect on the local economy, and if they were taken to indicate desperation by the authorities. Certainly if rates were to remain very high for a period there would be worrying implications for the highly-geared property market, already under considerable strain. The risks to the financial system of widespread failures in a sector which dominates the stock market and local activity, cannot be given too much emphasis.

5. On the other hand temporary movements in interest rate may in practice prove the only practical way of countering the periods of fluctuating confidence that can be expected from now on.

Annex 4

Removal of Withholding tax

At present withholding tax of 10% is levied on interest paid on Hong Kong dollar deposits. The rate was reduced in the 1982 budget from 15% to 10%, when a similar tax was removed altogether from foreign currency deposits held in Hong Kong; the latter move was designed to enhance Hong Kong's attractiveness as a funding centre - the government made no distinction between deposits held off or on on-shore - in relation to Singapore where the Asian Dollar Market was growing rapidly at the time.

2. It is argued that by keeping a withholding tax in place on HK dollar deposits only, with a differential (cet par) against local currency deposits, the government has encouraged the growth of a distinct US dollar-based economy in Hong Kong (eg exporters tend to keep earnings in US dollar accounts, even if held with local banks).

3. The US dollar transactions between Hong Kong companies have become commonplace - some companies keep their books entirely in US dollars - but it is debatable whether this trend has really been accentuated by the tax differential. Indeed as the differential is only equivalent to 1% of the value of a deposit (on an annual basis, where prevailing deposit rates are at 10%) a 1 percentage point different between nominal rates on US dollar and HK dollar deposits would be expected to compensate; the actual difference is currently of the order of 5 percentage points. This suggests that the benefit to the exchange rate would be, as the Governor argues, at best marginal. Banks may be discouraged from taking HK dollar deposits in the guise of US dollar deposits - a purely artificial book-keeping exercise to avoid the payment of withholding tax - but this is not likely to effect the volume of flows across the exchanges. Local dollar deposits would be recorded as such; any switching of these funds by the banks would have occurred whether or not the withholding tax were applied.

4. The main argument against the removal of the tax is perhaps not so much on the size of lost revenues (KS $0.6 billion in the current fiscal year, some 2% of projected recurrent revenues), as consideration of the equity of the tax base. At present, besides interest withholding tax the tax range comprises income tax, payable only by a minority of salary-earners (on account of the relatively high level of allowances) at the maximum effective rate of 15%, corporation tax of 16½% and a small contribution from excise and other taxes. However, the withholding tax is universally applied - virtually the only tax of this kind - and although a relatively small burden notionally affects all depositors equally.

10 DOWNING STREET

Prime Minister - To note

The scheme now being worked on is set out briefly in paras 5-14 of Annex 5.

Current action is to refine scheme and eliminate possible snags.

We will have a further report after visit of Peretz and Goodhart.

AT

30/9

[initials]

Noted but has not commented.