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CONFIDENTIAL

PRIME MINISTER

AT 20/10

HONG KONG - MONETARY REFORM

During the four days in which the Currency Board system has been in operation, we may take some comfort from the behaviour of the markets. On the first day the Hong Kong dollar traded on the markets at a slight discount creating many opportunities for arbitrage. But as we went from Monday to Thursday the rate moved until it was centred on the posted parity of \$7.80 to the US dollar. The market rate now seems to be firmly anchored at the quoted parity.

There has been no sign of a run on the banking system at all. In the early days the Chinese banks felt aggrieved because of the arbitrage operations, primarily by the international banks with the note issuing banks. But this seems to have ceased. As you will recall in Washington we argued that there would not be a run because it would be widely appreciated that any such run could be easily and swiftly contained by the system itself. This confidence appears, at least so far, to be justified.

As expected, overnight interest rates increased considerably during the first days of the new scheme. The arbitrage profits were a temptation and the overnight money rates reflected this. Today, however, they are down to 20% and still falling. Most important the spreads have narrowed very considerably so that uncertainty has been very much reduced. The Hang Seng index is up.

There are some minor technical deficiencies of the new Currency Board system, but I expect they will be eliminated or minimised in the next week or two. On the whole it should settle down with very few teething troubles. There is, however, one important rigidity which will prevent the system from functioning as efficiently as it should. That is the interest rate cartel by the main banks. Our advice was that this be dismantled, but <sup>rem</sup> Baird decided that he should not eliminate the cartel at this stage. But with the cartel in place it will make the adjustments rather more jerky and less speedy and smooth than we would wish. But I must confess that I do not think that it is anything like a fatal flaw in the system.

/I do not believe

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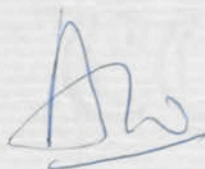


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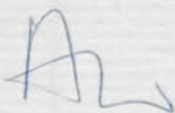
I do not believe there will be any serious confidence crisis provided that parity is maintained. But there are likely to be a number of problems of equity between the different forms of banks. These are, I think, entirely the responsibility of the Hong Kong government and we should have virtually no role at all in the resolution of these problems.

The reform of the Hong Kong monetary system was handled with astonishing speed and I believe remarkable efficiency. The Chancellor, supported by the Bank, did an excellent job.



ALAN WALTERS  
20 October 1983

P.S. I reviewed the Mansion House speech. It  
seemed to me to be excellent. I could  
find no fault!



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