Mr Elston

SECRET

30. 9.83

THE GOVERNOR'S PRIVATE SECRETARY

Copies to Mr Loehnis
Mr Holland
Mr Goodhart
Mr P W Allsopp

HONG KONG

I attach a paper on the situation in Hong Kong and on the various schemes that have been suggested to solve the problem of potentially ever-decreasing confidence, ever-increasing conversion of Hong Kong dollars into other currencies and therefore an ever-depreciating exchange rate.

The schemes put forward come first from John Greenwood, an economist with GT Management in Hong Kong and editor of the Asian Monetary Monitor; secondly a variant on this scheme indicated by Professor Alan Walters in his manuscript comments on the Greenwood scheme; and thirdly from the Hong Kong Government. They are all broadly similar in that they guarantee the convertibility, though to differing degrees, of the Hong Kong dollar, Greenwood into sterling and the Hong Kong Government into US dollars. Walters appears to suggest the convertibility only of bank notes; Walters and Greenwood assume fixed rate convertibility; the Hong Kong Government allows for the possibility of adjusting the peg.

The attached paper has been put together almost entirely from points made by Mr Holland and Mr Goodhart. Their comments form only a preliminary, very tentative and probably incomplete reaction to the papers which we have just received and which are attached for reference.

If there is any misrepresentation in this paper of Messrs Holland's and Goodhart's comments, the fault is mine.

CME

30 September 1983

C D Elston

THE CRISIS IN HONG KONG

The Setting

From this distance, it is easy to underestimate the loss of confidence in Hong Kong in the week or so up to last weekend. The most obvious manifestation was a sharp fall in the exchange rate; but there was also some panic buying and hoarding. Government action has succeeded for the moment at least in restoring an uneasy calm. But there is a clear expectation that further action is imminent. And if some action is not forthcoming that calm could probably be quickly shattered.

There is general acceptance that the underlying cause of the unease was political. The barrage of disturbing propaganda from China, coupled with the inability of the Hong Kong Government to say anything at all encouraging about the progress of the negotiations, were deeply unsettling. During periods of relative calm, such as the first half of this year, when the nervousness which began last autumn seemed to have passed, the appreciation that Hong Kong after 1997 is likely to be very different from the present Hong Kong, and that 1997 can cast a very long shadow forward, might slip quickly to the back of people's minds. But the re-emergence of acute anxiety now is a sure indication that confidence is very fragile, and it seems safer to assume that this fragility will increase.

In assessing possible reactions to this crisis, it is important to note that it is not a one-off episode. Indeed it seems realistic to anticipate that there will be a series of crises, some more serious than others, spread over whatever number of years have to pass before mobile people and their even more mobile assets elect to stay in Hong Kong or leave. It is probably not unreasonable to suppose that the movement of assets will be predominantly outwards, with each bout of uncertainty dislodging another tranche: the cumulative movement, first perhaps out of the Hong Kong dollar and then out of Hong Kong altogether, is liable to be very large. Even the Hong Kong dollar-denominated liquid assets counted in M3 cover some US$ 19 bn. The owners of some considerable proportion of these assets may well have it in mind to convert to another currency at some stage; and there is of course a very large stock of less liquid assets which the owners may well seek to liquify and convert.

Another characteristic is liable to be a weak and uncertain response to economic incentives and pressures which might be powerful in more politically stable circumstances.

A combination of weak responses with bursts of movement in the same direction poses peculiarly difficult problems for economic policy. Suppose the exchange rate of the Hong Kong dollar continues to float. Although the rate may well rise during the intervals of comparative calm, the pressures of outflows during crisis periods will tend to ratchet the rate downwards. An anticipation that latter conversions into other currencies could be on ever-worsening terms might lead to panic rush at a particular point of time, with the rate plummeting. Some must have felt that last weekend was just such a point in time. The conventional response is to increase the attractiveness of holding the currency under pressure - in this instance, the increase of interest rates on Hong Kong dollars by 3%. The response to this increse may have been weak, but at least the fall seems to have been halted at rates well above the low points reached. (The partial recovery may also reflect an anticipation encouraged by statements that measures would be taken to bring the exchange rate under firmer control: a cheque that has yet to be cashed.)

If the Hong Kong dollar should continue to float, it must be possible if not likely that new lows will be plumbed at the next crisis, and that even higher interest rates will be seen. A currency with ever-fewer willing holders can fall a long way. Apart from the purely economic effect, in the present situation in Hong Kong, with a large number of over-borrowed companies, particularly in the property sector, spiralling interest rates would be particularly serious.

This prospect is without appeal. It is however not at all easy to see a different propsect if Hong Kong has to rely entirely on its own resources. With able management, it should however be possible to orchestrate the demise of a currency in such a way as does not involve the destruction of the economy. One way perhaps would be to encourage the spreading use of a more acceptable currency as a store of value and medium of transaction.

It has, however, been suggested that there is an alternative. It is claimed that a technique is available which could peg the value of the Hong Kong dollar without assistance from outside Hong Kong. This claim is examined in the next section.

Suggested Schemes

In theory possible solutions to the problem range from being able to rely solely on Hong Kong's own resources without recourse to outside help, to imposing a potentially massive cost on HMG. The precise potential cost which it would be justifiable to incur can only be judged in relation to the risk of seeking to avoid the cost. If by going for a no-cost solution the necessary boost to confidence were not to be forthcoming, then the consequent loss of confidence could be all the greater. The judgment might be largely a political one but it might be considered safer to go for a potentially high-cost option in the hope that confidence would be restored and that little or no actual cost would be incurred.

Three main variants of a solution have been proposed - the Greenwood scheme (Annex 1), the Walters' scheme (see manuscript comments on Annex 1) and the Hong Kong Government scheme, called for ease of reference the Youde scheme (Annex 2).

It is the primary intention of each scheme to prevent any further collapse of the Hong Kong dollar exchange rate. While this objective is clearly desirable, all the schemes suffer from the disadvantage that the rate chosen for pegging the Hong Kong dollar to an outside currency (whether sterling, the US dollar or possibly a basket of currencies) would be arbitrary and therefore possibly inappropriate. The Youde scheme suggests the possibility of an adjustable peg, but knowledge of the possibility of adjustment would increase its likelihood and the scheme would not achieve its objective.

Greenwood and the Youde scheme are similar in that both involve pegging the Hong Kong dollar through the use of the existing foreign currency holdings of the Exchange Fund.

The Youde scheme suggests pegging in terms of US dollars, and the Greenwood scheme in terms of sterling. Since Hong Kong naturally uses the US dollar more than sterling, and far more of its trade and financial dealings are with the USA than the UK, the Youde scheme is economically preferable in this respect, but political factors might tell in favour of the Greenwood scheme. In both schemes Hong Kong dollar notes are effectively made convertible into US dollars/sterling at the pegged exchange rate. Both schemes also imply that Hong Kong banks would retain complete normal convertibility between Hong Kong currency and Hong Kong dollar deposits. This means, in effect, that all Hong Kong money holdings, ie bank deposits and currency, would be made convertible at the pegged rate into either dollars or sterling. The immediate question then arises whether the Exchange Fund's foreign currency reserves are sufficient to finance the potential massive, and continued, demand for diversifying out of Hong Kong currency and into foreign assets that is quite likely to persist and increase at times of political doubt up to 1997.

The Greenwood scheme argues, on page 2, that the fact that Hong Kong foreign exchange reserves are a multiple of outstanding Hong Kong dollar bank notes means that foreign exchange reserves are sufficient. This argument is invalid. The total amount of foreign exchange that the Hong Kong authorities might have to provide to residents trying to escape from the Hong Kong dollar amounts, not only to the total outstanding volume of bank notes, but also to the total outstanding volume of existing bank deposits, and beyond that to such further claims on Hong Kong monetary assets as could be obtained by borrowing Hong Kong dollars from the banks at any future time when the scheme remained extant. So, the potential total sum at risk is a large multiple of the outstanding Hong Kong currency.

Professor Alan Walters has appreciated this point, but has failed to understand the key elements of the Greenwood scheme as presented. Walters, in his manuscript cover note, believes that the liability of the UK Government would be limited, because the potential call on the foreign exchange assets of the Exchange Fund would be strictly limited to bank notes outstanding. But this could only be done by limiting the convertibility of bank deposits in Hong Kong and making deposits inconvertible into existing Hong Kong bank notes. Walters clearly envisaged this in his notes, and argues that forcing inconvertibility on to the banking system in Hong Kong would be temporary and relatively painless. His analogy with the US experience in 1907, however, is invalid and the painlessness of the Walters' variant is strictly open to doubt. Thus, the Walters' variant would seem to be a non-starter. It should be noted, however, that the Walters' variant differs from the Greenwood/Youde scheme, both of which emphasise that convertibility will be positively maintained.

How, then, do Messrs Greenwood and Youde believe that they have sufficient foreign exchange reserves to ride out the storm? In part, this depends on the size of Hong Kong's existing foreign exchange reserves. Beyond that, the Youde scheme suggests that the drain on the foreign exchange reserves might be limited by encouraging Hong Kong residents to hold foreign currency deposits with Hong Kong banks, rather than withdraw foreign assets in bank note form. This involves a misapprehension on two counts. First, the Hong Kong banks will presumably wish to hold foreign currency assets against these foreign currency deposits, and will effectively withdraw foreign exchange from the Monetary Authority in order to obtain such foreign currency assets. Second, the wish of the Hong Kong residents, no doubt, is to get their funds out of the potential hands of an incoming Chinese Government. If so, certainly at some future stage if the political scene remains murky, the Hong Kong resident will not only wish to hold his worth in foreign currency form, but actually to have it physically deposited well outside the boundaries of Hong Kong itself. So, what is the final backup to enable the Hong Kong authorities to replenish their foreign exchange, should that be depleted? In both schemes, it is the Bank of England.

Both Greenwood and Youde appear to regard the present problems as a temporary panic in the foreign exchange market. There seems at least a possibility that such desires to diversify funds into currency out of Hong Kong will reappear on future occasions in the run-up to 1997. There seems a real likelihood that rational Hong Kong residents would, by 1997, want to hold the bulk of their assets outside Hong Kong. If any such wholesale flight occurs, the Hong Kong Exchange Fund is bound to run down foreign exchange reserves. This would mean that the Bank of England would have to provide them. What assets would we be obtaining in return? This latter is made clear in the Greenwood scheme, though not clear in the Youde scheme. Under the Greenwood scheme, as Hong Kong residents moved out of Hong Kong dollar-denominated assets into foreign currency, the local banks pledged Hong Kong assets, to an amount equivalent in nominal terms to 120% of the value of the deposit withdrawn with the Exchange Fund, in exchange for the additional foreign exchange.

Thus, what is happening is that the Exchange Fund is giving a commitment to allow the residents of Hong Kong to transfer assets into foreign currency by absorbing the Hong Kong denominated assets in return. When it runs out of foreign currency, it would turn to the Bank of England, and we would provide sterling, or dollars, and obtain in return claims equivalent in nominal terms to 120% of the value of the liabilities in Hong Kong dollar assets. Actually, of course, the risks in all this for the Bank, were we to accept this application, would be potentially enormous, because the <u>real</u> value of the Hong Kong assets which we would be taking over might fall effectively to zero in 1997. Essentially, the Bank might be subsidising the flight of Hong Kong residents from the Hong Kong currency, leaving us with potentially worthless assets.

Perhaps all this is taking a grim view, but it would be a sensible one if there were a serious possibility that assets held by residents in Hong Kong might be subject to expropriation of one kind or another in 1997. So long as that fear exists, there must be a continuing potential desire to shift funds out, and the process of rational expectations tends to mean that if the expected value of the currency is zero in 1997, then it will inevitably fall to zero very quickly, because you do not wait to see that happen. If anything like such a grim view is realistic, then such an analysis raises the question of whether the continued separate existence of an independent Hong Kong currency is possible or desirable. The Youde scheme papers clearly recognise this possibility, though they put it in rather odd terms. Thus, it is stated that "such demonetisation might be no bad thing if confidence was indeed so persistently poor" because with "such a continual lack of confidence in the stability of currency ... the Hong Kong dollar money supply [would] disappear to zero".

There may be a case, therefore, for a more radical solution, which involves just that, the disappearance of the separate Hong Kong money supply. How would such a scheme work, and what would it involve? The disappearance of the separate Hong Kong money supply would mean that on an appointed day (obviously after a weekend), the existing monetary assets and liabilities of the Hong Kong monetary system would simply be transformed, at the existing exchange rate, into sterling equivalent terms. The Hong Kong outstanding bank note issue would be replaced by sterling (or potentially dollar) bank notes, on a one-for-one basis. Effectively, that would immediately specify the desire of Hong Kong residents to shift their assets into foreign currency form. There might still be runs on Hong Kong banks as 1997 approached, in order to shift funds out of Hong Kong physically, but that would be a separate problem. Hong Kong dollar deposits, after the change, would no longer be as good as sterling - they would be sterling!

If the Bank of England then issued additional notes to Hong Kong, to replace the outstanding Hong Kong note issue, what assets would the Bank obtain? It would presumably take over the assets held by the existing Exchange Fund against the present Hong Kong note issue. There would also be a question of how the Hong Kong banking system would obtain additional notes. Again, the answer would be that the banks in Hong Kong would draw notes from the Bank of England in the usual way, either by running down balances held with the Bank, or by drawing notes from a clearing bank in the UK which was running down its balance. Obviously, one solution would be to obtain a branch of the Bank of England in Hong Kong in which the Hong Kong banks could hold balances.

Indeed, the Bank - or rather the Treasury - would obtain additional seigniorage (though the monetary base would increase). What would be the risks? First, as noted earlier, Hong Kong residents would probably find it easier and more sensible to move into a US dollar area, rather than a sterling area. So, if forced into a sterling area, they would probably sell quite a proportion of sterling in order to diversify into dollar assets. This would tend to depress the value of sterling, unless offset by sales from the foreign exchange holdings which would accrue by taking over the reserves from the Hong Kong Exchange Fund. Effectively, it would be better if the Federal Reserve would take Hong Kong under its wing, but that might be politically difficult. Equally, of course, the effective reabsorption of the Hong Kong monetary system into the sterling area might be seen as a move backwards into the colonial past, and be clearly distasteful from that point of view. The other reason, of course, is that any involvement in Hong Kong as 1997 comes closer, is bound to be subject to uncertainty.

However, if Hong Kong by then is fully assimilated into either a dollar or a sterling area, the Chinese Government is, perhaps, less likely to take extreme steps that would disrupt financial conditions for fear of the wider political implications it would have on relations with the rest of the world.

Another problem which could well arise with the transformation of the Hong Kong monetary system from having independent currency to returning within the sterling area, would be that with monetary assets and liabilities now transformed into sterling form, there would be a question of renegotiating contracts concerning interest payments, etc. This would raise a range of legal problems because pre-arranged contractual arrangements might be reopened in many cases. It is possible that the Hong Kong authorities could have the legal powers to make a change of this kind, but it would no doubt be administratively and legally more difficult than trying to continue with the existing Hong Kong currency form.

Finally, reverting to the question of the implications for interest rates of the various schemes, again the Youde paper is incorrect.

This paper argues at a couple of points that the attempt by Hong Kong residents to switch out of Hong Kong dollars into foreign currency would cause a reduction in the Hong Kong money supply, and that this would therefore tighten interest rates. This is incorrect. Given the higher degree of substitution between Hong Kong currency and foreign currency assets, once a peg is introduced, the substitution between the two brings about no reduction in the money supply; indeed, an individual having undertaken the transfer is in a better position, and sees his own liquidity as having increased. Taking that, together with the improvement of confidence that should arise from stopping the collapse of the foreign exchange value of the Hong Kong dollar, Hong Kong dollar interest rates should fall slightly, rather than rise, as the Youde paper incorrectly suggests. If the more radical scheme, essentially to demonetise the separate Hong Kong dollar and return to sterling, were to receive any favour, then one could be more specific about the implications for interest rates. Interest rates in Hong Kong would then be the equivalent of euro-sterling interest rates, together with any additional spread that might be regarded as necessary by banks for the extra risk now pertaining specifically to Hong Kong. If the extra spread was, say, 2% and euro-sterling rates stood now at about 9 1/2%, then nominal interest rates would fall from their present level of 16% to about 11 1/2%.

Conclusion

The key issue to be addressed is almost certainly not whether such a scheme 'works' in a technical, mechanical, sense. It is a form of automatic pilot, and provided you are politically, socially and economically willing to go wherever the pilot tells you, then it works.

But there are two rather different questions which it is necessary to have a view on. The first is whether it will work tolerably smoothly. There must be a perceptible risk that it will not. It could be that the announcement of a fixed peg, coupled with the knowledge that the resources of the Exchange Fund exceed the note issue, will generate such confidence in the Hong Kong dollar that the machinery is not tested. Given the view expressed earlier in this paper that confidence will remain fragile and that there will be bouts of peculiar nervousness, it seems more likely that there will be times when holders of Hong Kong dollars - not just holders of notes - will feel happier in other currencies. At those times, the automatic pilot adjusts, primarily through interest rates and economic activity. Surges of lack of confidence could well be associated with surges of interest rates; the basic dilemma cannot be entirely evaded. Some of those who have given their blessing to such a scheme are noted for their confidence (?faith) that economies will react quickly and resiliently if only the right signals are quickly and consistently given. Those who are not so convinced would have to admit that Hong Kong is one of the most resilient and adaptable economies in the world, and that there is therefore a better chance of achieving there the adjustments needed. But a doubt must remain about whether the adjustment to a fixed rate (if the peg is moveable, as is suggested, a large part of the benefit of a supposedly automatic scheme must surely be lost) is possible or acceptable against the background that the value of the Hong Kong currency might be expected to fall towards zero in the now foreseeable future.

A further reason for doubt relates to the possible weakness of economic signals in times of political strength. If signals are ignored, it is not at all difficult to visualise that the plan could be tested to destruction.

The second question is whether the plan might require major external support from HMG. In the plan as presented, external support ("Bank of England should issue support to assist with providing liquidity if needed") is an optional extra. Suppose the Exchange Fund runs out of foreign currency and/or that the shortage of local currency in circulation becomes so acute that banks cannot meet the demands of their customers. In the latter case the problem becomes one of a run on the banks throughout Hong Kong, which clearly must be avoided. But either case would be a major crisis of economic management, and the plan could only be rescued by external intervention.

Whether or not external support is available is a political question; the consequential economic question is whether any support which is available is best deployed in support of the plan.