SECRET AND PERSONAL 11.10.83

MR BLUNDEN
(FOR THE DEPUTY GOVERNOR'S COMMITTEE)

1. warmth / opposition to £?
2. concern of SCB

CHANGES IN HONG KONG MONETARY ARRANGEMENTS

As you and members of the Committee will be aware, there has been urgent contingency planning going on in Hong Kong over the past two weeks or more about a possible scheme to modify the existing monetary arrangements in Hong Kong with a view to preventing any further depreciation of the currency resulting from loss of confidence about the ability of the UK authorites to reach satisfactory arrangements with the Chinese about the future of the Colony. Mr Goodhart, accompanied by Peretz (HMT), spent most of last week in Hong Kong advising the authorities there on the feasibility of the plan they had devised, very much (I understand) at the instigation of an ex-pupil of Sir Alan Waters, John Greenwood.

By the time we meet on Thursday it should be known whether the Hong Kong authorities have decided to implement the scheme, which is to be debated in a special meeting of Exco on Wednesday, 12 October. If they agree to go ahead, the scheme will be made public after hours on Thursday, 13 October, and come into full operation (Friday being a Bank Holiday for Hong Kong) on Monday, 17 October.

In order that members of the Committee should be aware of the nature of the scheme, and the risks involved, I am circulating two papers:-

(a) A note by Mr Goodhart "Background to my visit to Hong Kong" dated 7 October which puts the scheme into historical perspective; and

(b) Mr Goodhart's report to the Hong Kong authorities "Report on proposed exchange rate scheme" dated 6 October which describes its operation, the considerations that might lead to its adoption, and some reflections on what the consequences might be.

Until it has been publicly announced that the scheme is coming into effect, these papers must remain strictly secret and personal, since they are market sensitive.

You may wish to consider inviting Mr Goodhart to be present when the Committee discusses this item.

ADL

11 October 1983

ADL

MR HOLLAND

Copies to Mr Loehnis
Mr C Elston
Mr P W Allsopp
GPS
DGPS

BACKGROUND TO MY VISIT TO HONG KONG

The story begins in 1974. At that time, the HK$, which until 1972 had been linked to sterling, and from then until 1974 was linked to US$, came under strong upwards pressure from capital inflows. Rather than inflate, the then Financial Secretary, Sir Philip Haddon-Cave, decided to float the exchange rate. However, without a central bank, or any organisation carrying out a central bank role, the financial anchor that had been provided by an exchange rate link was broken: and no other form of financial anchor, eg in the form of control of any kind over monetary growth, was provided instead; moreover, the authorities' ability to control interest rates was, and has remained, tenuous in the extreme.

Nevertheless, despite the lack of any form of financial anchor, Hong Kong prospered under the flexible and undisciplined system. More recently, a young man, an economist from GT Management, who writes a publication known as the Asian Monitor, has been claiming that the system, being without a financial anchor, is liable to catastrophe should disturbances arise. This young man, John Greenwood, [redacted] He gets under the authorities' skin, particularly of Sir Philip Haddon-Cave who was responsible for the introduction of this system, or lack of system, and also of Douglas Blye, the Secretary for Monetary Affairs. This annoyance is, perhaps, made more acute by some realisation that Greenwood may be right in his criticism. Possibly because of this latter awareness, a large number of schemes to give the Monetary Authorities greater clout have been considered in recent years; I was told that something like 34 schemes have at one time or another been under consideration, but it appears that they all, for varying reasons, were found lacking. Indeed, Peter Allsopp, who was previously there on secondment as Blye's deputy, himself is credited with having found flaws in virtually all of them.

Anyhow, the next stage in the story comes with the sharp weakening of the HK$, as a result of political uncertainty, culminating in the very sharp decline in the course of September. At this time everyone in the Monetary Affairs Branch was racking their brains as to how best to proceed. At this juncture John Greenwood came up with a scheme for a return to a Currency Board system of a kind that was traditionally utilised. Partly because it was Greenwood that had advocated it, initially Douglas Blye and others would have nothing to do with it. Tony Latter, however, insisted that the idea did have some merit. After waiting a week, during which the exchange rate deteriorated even further, the officials in the Monetary Affairs Branch - notably Blye - were sufficiently concerned to overcome their distaste for Greenwood, and to hold a lengthy seminar to discuss the matter. Eventually there was, indeed, agreement that the scheme was practicable and workable. Moreover, nothing else was in sight.

At that point the Financial Secretary, Sir John Bremridge, left for the IMF, virtually unaware of the above discussions going on in Hong Kong. Then, the exchange rate really did collapse, falling like a stone towards $9.50. At that point it was decided that something reassuring had to be said, and Douglas Blye was asked to make a statement. Whether inadvertently, or not, Blye not only stated that something might be done, but actually went so far as to give a rough outline of the kind of Currency Board scheme actually under consideration. It is not, perhaps, without irony that the person most temperamentally opposed to Greenwood, should be the one who by a public statement happened largely to commit the Government to it.

Unawares of what had been said, and what was being considered back in Hong Kong, Bremridge returned post-haste because of the worsening exchange rate position. He was met at the airport with a question whether indeed the Government was proceeding with a Currency Board-type scheme, and denied it out of hand. Thereafter, he did receive some of the papers that Latter had prepared, but really had virtually no time to read them whatsoever before getting embroiled in the Hang Lung affair. Accordingly, he sent off the telex, which was received here, in favour of the scheme, virtually sight unseen.

At that point certain doubters and opponents of a fixed exchange rate scheme began to make their views known, and put pressure on the Financial Secretary, [redacted] Moreover, many senior people in Hong Kong, both bankers and officials, have a very strong attachment to free and flexible market rates, including a flexible exchange rate. There is a general distaste for refixing the exchange rate except as a, almost, last alternative. So, at this point, the battle of lines were fixed. There were various professors on both sides. Tony Latter was in favour. Douglas Blye, in a sense, was neutralised by his previous statement. Sir John reckoned that he did not know, and the previous Chief Secretary, Sir Philip Haddon-Cave, was to say the least sceptical, if not down-right hostile, to the idea.

Under the pressure of these conflicting views, and strongly-held positions, often with a large personal content, the Financial Secretary thought that it would be a good idea to try to get some independent, not previously committed, advice on what might be done. Indeed, for the short duration of our intensive discussions during our stay, it did appear that we were almost in the position of an arbitrator from outside, without full knowledge of local details, of this vital decision. I think, perhaps, that the views of David Peretz from the Treasury and myself were most coloured by our talk with Peter Hammond, of the Hong Kong and Shanghai Bank. Although clearly reluctant to move to a fixed exchange rate system, he thought that it was probably the least bad option available, and that it was workable. Bill Brown of the Standard & Chartered was, if anything, even more unhappy with the scheme, but he too felt that it was now inevitable that something along these lines had to be introduced, in particular given the prior virtual commitment to something of this kind which had been actually provided by a

Governmental spokesman. Against that background, along with the general view that it was likely to be the case that further declines in exchange rates would indeed set off a serious inflationary spiral with political and social consequences, together with the fact that clearly a scheme of this kind was exactly what London at a high level was keen to see, led us to the view that it was also probably the least bad. We indicated that, although we made it very clear that the decision was absolutely one for the Hong Kong authorities.

Furthermore, we tried to grill Tony Latter, and the bankers, as hard as we could about the practical details, and I think that we satisfied ourselves to a large extent, though I also hope and believe that we gave them some additional ideas about which to think. My final report is attached to this note.

How things will go from now on is, of course, uncertain and will depend both on the outcome of the London meeting, and on market developments. Meanwhile, the Governor asked for a paper to be prepared against a meeting of Exco to discuss the possibility of the adoption of this scheme. I would expect the Governor to come down reluctantly in favour. But I do not think that, unless he gets a strong push from London, it is necessarily out of the question though that there might be sufficiently strong opposition in Exco to prevent its adoption. It is entirely unclear what line the bankers and others in Exco, nicely known as the "unofficials", will take. Moreover it is quite clear that Sir Philip Haddon-Cave will at best be a cold neutral, ready to pounce on failure should that occur.

As for what might happen, were the scheme to be introduced, I have tried to set out my thoughts on that as clearly as possible in the accompanying Report.

I dictated the above into my Memocord before my final appointment with Sir John Bremridge on Thursday evening. He sounded more confident - than the above may indicate - that the scheme will go through. The preferred timetable now is:

Exco consultation	-	Wednesday 12 October
Announcement	-	pm Thursday 13 October [Friday is a local holiday]
Kick-off	-	Monday 17 October

but markets could force an acceleration of the programme.

CAEG

C A E Goodhart (HO-P)
7 October 1983

REPORT ON PROPOSED EXCHANGE RATE SCHEME

Introduction

Mr. David Peretz (HMT) and I were invited by the Hong Kong authorities to come to assess a scheme for stabilizing the exchange rate, as provisionally set out in Tel No. 1435 of Sept 29 1983, Bremridge to Clift, to consider its practicality and to advise on details of its possible operation. While distance may lend useful perspective, it still remains the case that both of us were not conversant with the institutional details and peculiarities of conditions in Hong Kong. Despite the unfailing and courteous willingness of all those we met to answer our questions fully and frankly, we are conscious of our remaining lack of local knowledge, and the errors that may arise therefrom. Moreover, our respective schedules required that this was written after Mr. Peretz had returned to London; so it reflects continuous discussions with him, but he is not responsible in detail for my comments.

This Report is in three parts. First, there remains some ~~continuing~~ uncertainty how a general scheme of this kind works; I was specifically asked to describe its working again on paper. This description is set out in Part 1. This section begins, therefore, with some general economic and analytical comments about this kind of scheme, but it does lead on to certain considerations pertinent to the particular conditions of Hong Kong.

This sets the scene for some general and fundamental considerations that might be taken in mind by the Hong Kong authorities in their decision whether, or not, to proceed with the implementation of the scheme. These general considerations, pros and cons, form the subject of Part 2, together with a discussion of the choice of two crucial parameters of the scheme, i.e. the currency on which to fix and the cross-rate to choose for fixing.

The third section turns to the more detailed questions of the practical operation of the scheme, not only in the immediate future but also over a longer term horizon. It is in some respects a check list of points to consider, if it is decided to put such a scheme into operation. The points mentioned here vary between those that were clearly familiar and already agreed by the Monetary Affairs Branch here, to others that are much more speculative and debatable, and represent no more than my own personal view.

The Scheme

The scheme involves setting the price of certificates of indebtedness in terms of a specified foreign currency (see Tel No 1435, Para 5), and standing ready always either to issue certificates in exchange for foreign currency, or to redeem them in that foreign currency, at the request of a note-issuing bank (subject to a handling

SECRET

charge, see later) at that fixed rate. It needs to be said that the system of note issue by special note-issuing banks on the basis of C.Is is peculiar to Hong Kong. Describing the system for public, journalistic and foreign consumption in those terms may easily mislead - a point which I can personally confirm - and for general purposes it would probably be better to describe the scheme more simply as one in which notes will in future be issued, and redeemable, against a specified foreign currency; and thus for all practical purposes as good as that currency (though care would have to be taken not to allow simple people to believe that in future HK$1 = US$1).

Such a scheme is not a novel and untried academic or theoretical idea: it represents, instead, a reversion to the classical principles on which a fixed exchange rate is maintained. Thus, in the 19th century the gold standard was maintained primarily by allowing the note issue to expand or to contract in line with flows of gold into, or out of, the note issuing authority; mutatis mutandis, it was the principle behind the 1844 Bank of England Act. Subsequently in the 20th century many countries within the Sterling Area maintained their local currencies linked to Sterling via a similar 'Currency Board' system, whereby the local note issuing authority issued notes against deposits of sterling with itself by the banks (and the ability of the banks to obtain additional sterling provided flexibility to the local note issue).

This system maintains the exchange rate fixed in the first instance by arbitrage. Since a bank, or through a bank a bank customer, can always obtain foreign currency (say at US$1 per HK$8), then any excess sales of HK$ on the foreign exchange market driving it below $8, say to $8.25, will, subject to transactions costs, induce the bank, or its customer, to buy HK$ at 8.25 and pay for them in US$ obtained by redeeming notes with the Exchange Fund at $8. Pure arbitrage will ensure that the rate must remain fixed, so long as the public has the wherewithal (in notes or foreign currency) to trade with the Exchange Fund.

The public, of course, can renew its note holding by shifting from bank deposits to notes, so long as convertibility remains. If, then, the public wants to move into, say, US$ at the fixed rate, what prevents it continually changing more HK$ deposits into HK$ notes and thence into US$? The answer to that is that the shift out of HK$ deposits into notes (whether HK or US) puts pressure on the available liquid reserve base of the banks. Initially they may be able to draw on surplus available liquid foreign currency assets, but if the drain continues they have to react more forcefully. Their reaction will take the form either of bringing in to Hong Kong additional foreign currency, if the return and risk prospects merit it, and/or raising interest rates on HK$ deposits and loans to stem the drain. [There remains, however, a danger that in certain extreme conditions of panic and uncertainty neither course works well enough to stem the drain and the banks are forced to sell off illiquid HK assets. This is considered further in Section 3.]

/Essentially ....

SECRET

Essentially the scheme transfers the pressure of a run out of the local currency away from the exchange rate onto the banking system. The level of local currency interest rates has to rise to a point where the continuing outflow into foreign currencies by residents is matched by an offsetting inflow by banks and other speculators. If the banks will not increase their exposure in Hong Kong, and the public's desire to diversify into foreign currency is very strong, then interest rates would have to rise very sharply.* /_ N.B. without any such scheme, however, in such circumstances the exchange rate would be falling sharply, and that would also lead to domestic interest rates rising markedly, though perhaps not so quickly._/

It is essential to realize that the extent to which domestic HK interest rates may rise will depend on confidence in the scheme itself. If bankers, businessmen, foreigners, etc, were <u>really</u> confident that a fixed rate against, say, the $ would be maintained for, say, six months, then they would bring in extra US$ funds until the HK$ six months interest rate was brought into line with the US$ six months rate ruling in Hong Kong. Currently the local HK$ interest rates are above comparable US$ rates, so that were confidence in the success of the scheme to be instilled then HK$ rates would <u>fall</u>, not rise; some proponents of the scheme believe that this is what would happen.

One may doubt that happy outcome, at least initially. Political fears, fears about certain segments of the Hong Kong economy, fears about the direction and resolve of Government policy inevitably interact, and may initially find expression in higher (possibly much higher) interest rates. Again it needs stressing that a firm, resolute and confident presentation of the scheme can itself affect confidence, and therefore bring less high interest rates. Moreover, if the scheme was to be adopted, the whole basis of credibility and confidence necessary for its successful achievement would be virtually destroyed by <u>any</u> subsequent depreciation of the exchange rate for a considerable length of time. If, then, the domestic interest rate and financial pressures did become intolerable, they should be met if at all possible by other forms of alleviation (returning to the gold standard analogy, a suspension of the Bank of England Act): what that might mean in practice is discussed further in Section 3.

On a happier note the presentation of such a scheme could, indeed, be made in a confident vein. Apart from the political overhang, most features of the Hong Kong economy are remarkably favourable. A government without internal or external debt; relatively massive foreign exchange reserves; a generally liquid banking system; an

/export .....

---

*It is sometimes said that the increase in the demand for foreign currency automatically contracts the money supply (see Tel No 1435, Para 14). This is not exactly right. The initial switch from HK deposits into HK notes or foreign currency notes actually leaves the public's money holdings (HK + f.c.) unchanged. Instead it puts pressure on the banking system's reserves, and the banks' reaction to that, raising interest rates, making credit less available, then at the next stage contracts the money stock.

export boom and a balanced current account; an economy of legendary flexibility. Compared with most other parts of the world this represents a position of enormous strength for an exercise in restoring financial confidence.

Section 2

In Section 1,how such a scheme might work was described (at some pedantic length and in general terms). It is, for the reasons set out above, a practicable scheme. That does not mean that it is the best option to choose. In this Section some of the more fundamental considerations relevant to that choice are put forward.

The worsening political uncertainties inevitably lowered Hong Kong capital values and also, equally inevitably, led to a capital outflow, a portfolio shift. The question is whether the decline in the exchange rate that naturally resulted has now taken on a momentum of its own. Are businessmen, for example, not repatriating foreign currency - not because they intend to keep those assets permanently abroad - but because they expect to get a better rate from a further depreciating HK$ by waiting longer? Worse still, is a cycle of exchange rate depreciation, inflation, political instability, exchange rate depreciation, ..., becoming visible? Is fear feeding on fear? Moreover, certain expectations about a scheme for stabilizing the exchange rate have become widespread: what happens to the markets if those expectations are dashed, and nothing put in its place?

Against that, the (managed) floating exchange rate can provide (and has provided in recent years) a useful degree of flexibility to the economy. The choice of an exchange rate at which to fix is bound to be largely an arbitrary guess (more or less) and may cause future difficulties. If the exchange rate is fixed, it forces the pressures of adjustment elsewhere on the economy, which may be even more vulnerable.

This latter point is the crux. In the last few months the pressures have predominantly fallen on the exchange rate. If that is fixed, and confidence (initially and primarily in the maintenance of that fixed exchange rate, but ultimately and fundamentally in the future of Hong Kong) does not recover, or worsens, then the pressures must fall on domestic interest rates and the local availability of credit*. In crude terms is it better

/to .....

---

*Even then, high HK$ interest rates and restricted HK$ credit will not necessarily severely affect those local borrowers who are able and willing to borrow in US$ - where the interest rates should not rise, or at least not nearly so much, - and take the exchange risk themselves. This, however, requires that the businessman has to be more willing to absorb the exchange risk than the banker.

to have the (political) pressures affect the price of rice or the price of property (and the Hang Seng index), on consumers or mortgagees and construction workers?

The Choice of Currency

In principle, the scheme outlined in Section 1 could be used to fix to any other currency, basket of currency, gold, etc. In practice, the currency in which most of Hong Kong's trade, financial, entrepot and tourist dealings are now denominated is the US$. Of those we asked, almost everyone thought that on economic grounds it would be most sensible, simple and straightforward to peg directly on the US$. We agree. There may, however, be other wider, political considerations that we are not competent to consider.

The Rate to Adopt

It is possible to carry out certain calculations, assuming that the exchange rate earlier in 1982 was in equilibrium, to estimate what an equilibrium exchange rate, vis a vis the US$ might now be, on the basis of comparative underlying inflation in the USA and Hong Kong, if political uncertainty had not intervened. We did not take these exercises (which seemed to give answers of around HK$7 (or even 6.50) to US$1) seriously, since we considered that it would be essential, to foster confidence, to set a duly cautious and plainly plausible cross rate. On the other hand, there is some general agreement that the exchange rate has recently overshot, and it would be desirable to impose some loss on bear speculators. The general consensus among those we asked - as of Oct 6th - was that HK$8 to US$1 would be about right. This seems sensible to us, but it would need to be subject to reconsideration in the light of subsequent market moves.

Section III - The Operation of the Scheme

A. The Reactions of the Public

It is impossible to foretell how the Hong Kong residents (and foreigners abroad) would react to the scheme; again it would partly depend on its presentation. Local experience and expertise may help to advise. It would, in any case, though be best to be prepared for the worst. This would involve:-

(1) a shift into holding foreign currency notes

(2) a shift out of HK$ deposits into HK$ notes

(3) a shift out of HK$ deposits into US$ deposits in banks

(4) a shift of deposits out of local Chinese banks into the note issuing banks.

Moreover all such responses would be likely to recur whenever political, or domestic economic, worries revived, often suddenly.

B. The Role of the Exchange Fund

The Fund's one essential role under such a scheme is always to stand ready to exchange US$ currency for HK$ notes (or rather for C.I. to be precise). It would be deplorable and incompetent if there were physical failure to live up to that promise. Sizeable stocks of US note would be necessary in advance of the scheme's introduction, and adequate stocks thereafter. An emergency stand-by arrangement (perhaps with the FRB San Francisco) could be considered. A sufficient proportion of the Fund's foreign exchange reserves/need to be kept liquid. The commercial banks are not likely to bear the cost of keeping a reserve of unused US$ notes (though the HSBC, we were told, currently does hold a sizeable total); the Fund would have to bear the responsibility and cost. There would be a case for the Fund imposing a handling charge (or small spread between buying and selling rates) in order to offset this cost.

/ would

Under the scheme there <u>should</u> be no need at all for any further direct intervention at all by the Fund in the exchange market. Private arbitrage should do the job perfectly without official assistance. Until, however, the authorities were confident that the scheme was working smoothly, for the first few days at least, there would be a case for monitoring and offsetting any significant deviation in foreign exchange markets (abroad as well as here) from the fixed rate. Again the purpose is to maintain confidence.

This raises the question of what might be said about the size of the available reserves relative to the HK$ note obligations. The reserves are such that their publication would probably increase confidence, but their publication now implies a future commitment to publish at possibly less opportune times. But at the least some strong <u>qualitative</u> statement would have to be made.

If the introduction of the scheme was to cause an increased demand for HK$ notes, the Exchange Fund's foreign exchange reserves would rise. Although the deposit of such extra US$ holdings might usefully be via accounts held in the HSBC and SCB, such reserves must be capable of subsequent liquidation without concern about the effect of that on the HSBC and SCB; so preferably only working balances should be held with them.

Again in order to maintain confidence, it would help if the foreign currency reserves backing the note issue were to be held, and be seen to be held, inviolate. It would not be confidence inspiring to raid the foreign currency reserves to meet a fiscal deficit - not that that, we were informed, was likely or currently foreseeable.

/C. The .....

C. The Reactions of the Banks

(i) The Foreign Banks.

Faced with the reactions of the public as outlined in A above, these banks can choose whether to switch in funds from abroad, or cut the size of their books by raising HK$ interest rates. That is their commercial choice. Some may plead that 'prudential' requirements prevent any further switch-in. Apart from a general scepticism, it may be replied that the fixing of the HK$ should lessen the exchange and prudential risks of switching-in. They should be able to cope unaided.

(ii) The Local Banks

These are, perhaps, particularly vulnerable to the public's reactions and do not have the access to extra resources available to the foreign banks. It would be desirable to have a contingency plan for special assistance to them ready before the start of such a scheme. This could take the form of the Exchange Fund placing HK$ deposits with them (i.e. recycling their lost deposits) on terms that do not require 100% offsetting holdings of liquid assets.

(iii) ~~The~~ Note Issuing Banks

As far as we were able to tell the HSBC is, fortunately, in a strong liquidity position, well able to absorb the initial perturbation. We do not have the information to be quite so sure about the SCB. Also there could, perhaps, be a question in their case about prudential willingness to allow the SCB to replenish its foreign currency liquidity. This may need further exploration here and in London.

D. Interest Rates

As indicated earlier, no one can foretell the effect on HK$ interest rates of the introduction of the scheme; it depends on the context, presentation, etc. They might even fall, or rise a lot. Initially there will be great uncertainty and probably considerable short-term volatility. The HK$ interbank market may, temporarily, freeze up.

Against such uncertainty, there would be a case, after discussion with the HKAB, for a temporary suspension of the interest setting cartel. Nevertheless some, e.g. savings deposit, rates would have to be posted. One might advise two possible alternatives, either no change, to suggest confidence in continuity, or a small rise, as a precaution.

E. Panics and Crises

If the scheme should get off to a bad start, presumably because of a worsening political background, the rush to get out of HK$ assets into US$ could drive interest rates to totally unacceptable

/levels, ...

levels, and bring about the generation of a self-sustaining domestic financial panic. If the political position does worsen, it is arguable that some increase in domestic interest rates is inevitable and appropriate. Nevertheless the Monetary Authority must maintain the integrity of the financial system. When to step in with relief is a matter of judgment.

If the scheme has, however, been introduced, it would not - I believe - be right to respond to such a crisis by allowing a depreciation in the exchange rate. That would, very likely, make everything worse by adding fear of depreciation on top of other fears, as well as undermining governmental credibility. The right response would be to create additional liquidity, by depositing Exchange Fund holdings of HK$ deposits with threatened banks and by a general lowering of liquidity ratios.

Emboldened by a belief that the present structure of liquidity ratios, etc., was devised by an earlier Bank of England official, I would suggest that they look somewhat arbitrary, dated and dubiously suited to the modern financial system developing in Hong Kong. I would hope that they could be varied for macro-economic purposes of maintaining monetary stability. This would have to be discussed with Mr. Martin who was absent when we were here. Moreover if political tensions lift sufficiently to allow for a longer perspective, there could be a case for a complete review of the form and adequacy of the present prudential ratios, etc.

F. A Dual Currency System

Nothing is more damaging to the health of a currency than continuing depreciation. So, successfully fixing the value of the HK$ to the US$, making it as good as US$, in a crucial sense preserves the validity of the HK$. It would , instead, be in conditions when the exchange value of the HK$ was plunging that ordinary people would not want to be paid in HK$, supermarkets to accept them, etc.

On the other hand this scheme, in another sense, does encourage the further development of a dual currency system. The likely shift of HK residents out of HK$ deposits into US$ deposits may induce banks - in order to prevent portfolio mismatch - to be relatively keener to lend in US$ form rather than in HK$. Spreads between deposit and lending rates in HK$ may well widen relative to US$, encouraging an (already increasing) proportion of financial intermediation to be done in US$ terms. In the circumstances of Hong Kong this shift seems, to me, to be perfectly reasonable. I cannot see a strong case for preventing the further extension of the, already existing, dual currency system. It would give a wrong sign, by indicating lack of confidence in the HK$, to repeal formally the law against the use of foreign currency, but that law might happily be left to wither on the vine by benign neglect. Similarly, if things were to go reasonably well, there would be a case for quietly approaching the HKAB, say in six months time, to discuss the abandonment of their prohibition on foreign currency checking accounts.

/Given .....

Given that the introduction of this scheme would probably have the effect both of raising interest rates, especially HK$ rates, and also of probably shifting the balance of advantage away from financial intermediation in HK$, there must be a case for considering whether this is not a particularly opportune moment to sugar the pill by removing the 10% interest withholding tax, though that obviously has wider fiscal implications.

G. The Exchange Rate Link: Forever?

Probably it would maximise confidence to indicate that the exchange rate link with the US$ would last into the indefinite future, though a nuance that in the unlikely occurrence of an adjustment that would certainly be an appreciation could be helpful. Nevertheless circumstances can be envisaged when an adjustment or even a reversion to a managed float - possibly with the Exchange Fund at the same time adopting more of the features of a Central Bank - might be desirable. But, perhaps, enough unto the day!

H. Conclusions

While the core of the scheme simply involves setting the price of C.I. in terms of foreign currency, noone in the Monetary Affairs Branch, or elsewhere, would have imagined that that was all there was to it in practical terms. I would again emphasize the enormous importance of presentation. Besides that, there is a considerable amount of contingency planning both individually and in conjunction with the HKAB that the Monetary Affairs Branch will need to do.And there are additional questions of accompanying steps, if any, such as temporary suspension of the HKAB cartel and removal of the 10% interest withholding tax to consider.

C.A.E. Goodhart

6 October 1983

****