STABILISATION OF THE EXCHANGE RATE

Introduction

This memorandum describes a scheme to stabilise the exchange rate of the Hong Kong dollar, and seeks Members' advice as to whether it should be implemented immediately.

Background

2 Since 1974 the Hong Kong dollar has been a freely floating currency. Although the Exchange Fund has always possessed the capability of intervention in the foreign exchange market, such intervention has generally been limited to seeking to smooth out short-term fluctuations, acknowledging the experience of governments and central banks across the free world that intervention cannot resist more fundamental pressures. In brief, massive expenditure of foreign currency reserves is futile. A particular difficulty in Hong Kong has been the limited effectiveness of other policy instruments available to influence the domestic money supply in support of any intervention in the foreign exchange market.

3 Over the last nine years the floating exchange rate regime has served Hong Kong well. Its merit has been in assisting the automatic adjustment process towards the achievement of full employment and outstanding economic growth, but it has been accompanied by high rates of inflation at times - particularly recently - and by uncontrolled growth of the money supply.

4 During the past 12 months the exchange rate has become increasingly affected by political uncertainties and loss of confidence as opposed to current economic factors. The latter are excellent. Currency depreciation has nevertheless shown signs recently of feeding on itself, which has led to consternation and indeed a degree of panic amongst the public. The Government has been unable to control the slide, despite both substantial intervention by the Exchange Fund in the foreign exchange market and upward pressure on interest rates. The Administration has consequently explored the possibility of introducing fundamental structural changes to the exchange rate system, given that the free float, however successful in the past, may no longer be appropriate to Hong Kong's unique present circumstances. Great caution is clearly essential. We do not wish to leap from the frying pan into the fire.

Proposal

5 The central element in the scheme which is now proposed is that Certificates of Indebtedness, which are issued by the Exchange Fund to the note-issuing banks to be held as cover for their note issues, should henceforth be issued and redeemed against foreign currency (US dollars) at a fixed rate. At present they are issued against Hong Kong dollars, which normally subject to timing were used to purchase foreign exchange.

6 This proposal is neither novel nor untried. There are precedents here and further afield. For instance, an analogous arrangement existed in Hong Kong from 1935 to 1972, whereby Certificates of Indebtedness were issued and redeemed against sterling, but of course the environment in which the system then operated - sterling area and associated exchange controls, a predominance of fixed exchange rates around the world, and no political overhang in Hong Kong - was very different.

How the scheme would work

7 Although the price of Certificates of Indebtedness against US dollars would be the only formal, announced, fixed rate, the processes of competition and arbitrage within the monetary system should bring the market exchange rate to within a small range of the announced rate. The scheme maintains by arbitrage the exchange rate fixed in the first instance. Since a bank, or through a bank a bank customer, can always obtain foreign currency (say at US1 per HK$8), then any excess sales of HK dollars 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 Hong Kong dollars at 8.25 and pay for them in US dollars obtained by redeeming notes with the Exchange Fund at $8. Pure arbitrage will ensure that the rate must remain linked 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 dollars at the fixed rate, what prevents it continually changing more Hong Kong dollar deposts into Hong Kong dollar notes and thence into US dollars? The answer to that is that the shift out of HK dollar deposits into notes (whether Hong Kong 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 Hong Kong dollar deposits and loans to stem the drain.

8 If the new arrangement attracts total confidence and credibility - i.e. in the belief that it will endure - there will no longer be any incentive for people to rush out of Hong Kong dollars in the short-term, even though political worries if continued would occasion a steady outflow of capital over a number of years. In other words, confidence in the currency, but not necessarily in the future nor hence in Hong Kong assets, would have been restored, and the introduction of the scheme would not impose any intolerable strains.

9 In practice, however, there will probably be some initial scepticism and miscomprehension, however deftly the all-important presentation is handled. To the extent that people perceive the arrangement as a chance to get out of Hong Kong dollars quickly at a relatively generous rate, pressures could develop.

10 Essentially the scheme transfers the pressure of a run out of the local currency away from the exchange rate onto the banking system and thus to borrowers. 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 sharply. 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 realise that the extent to which domestic Hong Kong interest rates may rise will depend on confidence in the scheme itself. If bankers, businessmen, foreigners, etc., were really confident that a linked rate against, say, the dollar would be maintained for, say, six months, then they would bring in extra US dollar funds until the Hong Kong dollar six month interest rate was brought into line with the US

dollar six months rate ruling in Hong Kong. Currently the local Hong Kong dollar interest rates are above comparable US dollar rates, so that were confidence in the success of the scheme to be instilled then Hong Kong dollar rates would fall, not rise. Some proponents of the scheme believe that this is what would happen.

11 Public reaction might not, however, be limited to switching deposits. There could conceivably be a surge in demand for either HK dollars or US dollar banknotes. Steps will be taken to ensure supplies of Hong Kong dollar and of US dollar notes if the scheme proceeds, but such a demand could conceivably lead to pressure on banks' liquidity if it was more than shortlived. Meanwhile, if there was any sort of rush to the banks, either to draw notes or switch deposits between currencies, there might be another bout of rumour and panic directed against some local banks. In such circumstances the major banks will no doubt be willing to recycle additional funds coming to them, but the Exchange Fund will also need to provide liquidity to individual banks on a last-resort basis. The Financial Secretary will also stand ready temporarily to relax the statutory liquidity requirement for particular banks or bank groups.

12 While steps can be taken to provide relief in particular cases, the process of adjustment to the new scheme and the establishment of confidence in it will be frustrated if the Government were to act indiscriminately so as to avert the possible initial interest rate consequences.

The rate and the currency

13 Although the equilibrium exchange rate calculated purely by reference to current economic forces may be in the region of $7.00 or better, it is crucial for the success of the scheme that the chosen rate be credible to the market and to the public. A fair discount for the political bankground is therefore in order, but some improvement on the present market rate (8.41/46 at the time of writing) is both desirable and feasible, and will squeeze at least a few bears.

14 A rate of $8.00 is therefore presently suggested. The possibility of having a small spread between issue and redemption rates for Cs of I is being considered. The Financial Secretary will report.

15 The Financial Secretary will give Members at the meeting the Administration's final views on the appropriate rate. It will depend on the latest exchange rates.

16 The recommendation of a US dollar criterion follows from the fact that the US dollar is established as the main benchmark currency in both the markets and in the eyes of the public - as evidenced by the panic of 23/24 September - as the main refuge currency. The days of the Hong Kong dollar's sterling peg appear to be long forgotten and a return might provide ground for political speculation and misunderstanding.

17 By linking Certificates of Indebtedness to another currency Hong Kong would be tying itself, once things have settled down, to an arrangement by which domestic interest rates and domestic inflation will be substantially influenced by the behaviour of the economy to whose currency it is tied (the USA in this case). It was, in essence, the potential effect of such ties upon the Hong Kong economy which led to the abandonment of the sterling link in 1972 and then the US dollar link in 1974. One cannot be sure that similar pressures will not develop later under the present proposal, but at this juncture in Hong Kong's history the balance of advantage seems to be firmly in favour of accepting such pressures on the economy as a link to the US currency might bring, as against accepting the consequences of a continuing floating rate, the bounds of which appear to be virtually unlimited. While the fall of the Hong Kong dollar exchange rate mainly results from lack of political confidence, there will be no confidence without a relatively stable dollar. It is a classical chicken and egg situation.

18 A case can be made for fixing on a trade-weighted basis. This would be both complicated, since the rate against any individual currency would need to be continually adjusted, and unnecessarily refined given the scale of the Hong Kong dollar's recent slide against virtually every major currency. We must seek presentational simplicity. It is also absolutely critical that the rate be regarded as fixed indefinitely. Any statement which can be interpreted as hinting at the possibility of depreciating the announced rate would sabotage the scheme from the outset. It will be acceptable to indicate eventual possible appreciation in the event of confidence returning to such a degree as to produce unduly rapid monetary expansion, but such an indication must carry complete conviction that the rate would only ever be adjusted in that direction.

Consultation

19 Detailed discussions, both as to the advisability of this scheme and on the mechanics of its implementation,

have been held with the two note-issuing banks. Both are aware of the benefits which the scheme would bring if successful, and the problems that would loom it it was badly received. They believe that the Government has anyway worked itself into the position of having to do something and they have told the Administration that this scheme appears to be the best, if not only, immediate option. They have undertaken to co-operate fully should a decision be taken to proceed. Their approach has as always been responsible and helpful.

20 Selected academics and others have been consulted, displaying as might be expected some polarisation of views between extremes of enthusiasm and scepticism.

21 Senior and able monetary experts from the Bank of England and UK Treasury visited Hong Kong last week to study the proposal. Their conclusion was that the scheme was technically feasible and in many respects desirable. They underlined the risks involved, should the presentation fail to carry conviction. The decision is of course one for the Hong Kong Government, but they left us in no doubt what they would do if in our shoes. The Governor will mention his discussions with the Chancellor.

Legislation

22 Section 4(1) of the Exchange Fund Ordinance (chapter 66) states that the note-issuing banks should pay the face value of Certificates of Indebtedness to the Exchange Fund. The value of the Certificate is expressed on it in Hong Kong dollars. This might suggest that legislative amendment is required in order to operate the scheme, but in earlier years sterling was used without any such amendment. Since the note-issuing banks have agreed to co-operate in foreign currency payments, there does not appear to be any immediate need for legislation.

Costs

23 As outlined earlier, the thrust of the scheme is to shift the burden of adjustment to crises in confidence away from the exchange rate and onto the banks and hence borrowers. The scheme should not, in principle, involve any intervention by the Exchange Fund in the foreign exchange market, although there may be reason, at any rate in the initial phase, to intervene in order to ease the transition.. The formal commitment of the Exchange Fund will be limited to redeeming any amount of the note issue as the fixed rate. The note issue currently stands at HK$14½ billion (less than US$2 bn at a rate of $8.00). In the very worst circumstances this sum is at risk. The Fund's foreign currency holdings are very greatly in excess of this.

Timing

24 If the decision is taken to proceed, it is envisaged that the new arrangements would be announced by the Financial Secretary on the evening of Thursday 13 October. The following day is a bank holiday in Hong Kong. The Chairman of the Hong Kong Association of Banks has been consulted and considers that banks should be able to cope with opening as usual on Saturday. When this paper is discussed there may be reason for modification of this plan.

Presentation and public reaction

25 A recurrent theme in this memorandum has been the importance of the presentation of the scheme to the public. The Financial Secretary proposes to deliver a carefully prepared statement, followed by a press conference on Thursday evening. Briefing for banks will be prepared by both the Monetary Affairs Branch and the note-issuing banks with a view to obtaining their fullest and properly informed co-operation.

26 In order to avoid any complaints by (or against) the note-issuing banks to the effect that the scheme was unduly costly (or beneficial) to them, they will arrange that all other banks draw or surrender notes to them on exactly the same payment basis as they are subject to for Certificates of Indebtedness - i.e. against US dollars at the fixed rate. It is necessary to emphasise that the rate at which banks deal in foreign exchange with customers or in the inter-bank market will continue to be set by the forces of competition, and that, although the rate should settle close to the C of I rate, the public must not expect to find the rate fixed at precisely that level.

27 The initial public reception to a measure designed to stabilise the exchange rate is expected to be favourable. The success of the scheme depends, however, upon later financial reactions which cannot be predicted. If interest rates were to rise, even if only temporarily, certain sectors - particularly property companies and home buyers - would be hurt and could be expected to react accordingly.

Conclusion

28 The proposed scheme appears to be the only practical method of stabilising the exchange rate at this time. Its introduction would shift the burden of confidence crises onto banks and borrowers and thence asset prices, instead of onto the exchange rate and thence consumer prices. Inflation would be controlled.

The interest rate route could in the worst circumstances be painful, but would not possess the sort of apparent self-feeding instability that the exchange rate has exhibited on some recent occasions. In terms of longer-term economic consideration, the scheme would spell the end of the exchange rate as a dimension of adjustment, but would introduce another in-built automatic mechanism whereby the Hong Kong dollar money supply and interest rates would tend to adjust in a stabilising manner to balance of payments pressures, whether resulting from domestic or external developments. The benefits in terms of lower inflation rates might have to be paid for by lower growth rates. Risks are involved, but they seem far less than the risks of maintaining the status quo. In any case there is arguably a political need for action.

Interest Withholding Tax

29 The Administration considers that the impact of the scheme, and the degree of confidence it attracts, will be substantially enhanced if the interest tax on Hong Kong dollar deposits is simultaneously removed.

30 Examination of the further implications for revenue from profits tax and possible ways of preventing any erosion have not yet been completed. Indeed they have just started. It is therefore proposed that interest tax on Hong Kong dollar deposits with financial institutions should simply be exempted from tax with effect from Monday 17 October, prior to any more fundamental legislative changes which may be introduced in the budget next spring. The Financial Secretary will speak on how immediate legislation can be implemented.

31 The loss of revenue for the remainder of this financial year is estimated at $250 million. There are more severe implications qua profits tax for the future. Application has been made to the Secretary for State under Section 8 of the Exchange Fund Ordinance for this sum to be transferred to general revenue account from the Exchange Fund; such a move is considered to be especially justified in view of the fact that the zero-rating of interest tax would be introduced as part of the package specifically directed at stabilising the exchange rate. It is also essential to maintain confidence in budgetary control and discipline of the deficit.

Advice sought

32 Members are asked to advise whether the proposal with effect from 15 October to issue and redeem Certificates of Indebtedness only against US dollars at a fixed rate sould be implemented, and whether such a step should be accompanied by the zero-rating of interest tax.

(The Secretary for Monetary Affairs, Mr. D.W.A. Blye, the Deputy Secretary for Monetary Affairs, Mr. A Latter and the Deputy Secretary (Economic Services), Dr. A McLean will attend before the Council for the discussion of this item.)