EBD/83/264

October 18, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Hong Kong - Exchange System

The Secretary has received the following memorandum dated October 17, 1983 from Mr. Wicks:

> I have been asked by my authorities to draw to the Board's attention the following statement, issued at noon on Saturday, October 15, 1983 by the Financial Secretary to the Government of Hong Kong.
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>> I want to tell you about two steps which the government is taking now to stabilise the exchange rate of the Hong Kong dollar.
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>> First, let me give you some background. For 37 years from 1935 to July 1972 the Hong Kong dollar was pegged to sterling. In those days the sterling area existed and for most of that period the international monetary system was characterised by fixed exchange rates. From 1972 to November 1974 the Hong Kong dollar was pegged to the U.S. dollar. Since 1974 Hong Kong in common with other major market economies has had a freely floating exchange rate. This floating system has served us well. It has given us a measure of insulation from the ups and downs of other economies, and under it Hong Kong has recorded very high rates of economic growth. Living standards have risen accordingly.
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>> Towards the end of last year the exchange rate started markedly to weaken, reflecting amongst other factors uncertainties about Hong Kong's future.
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>> Before the government announced three weeks ago that it was considering proposals to stabilise the exchange rate, currency depreciation was tending increasingly to feed on itself in an unstable and irrational manner. This depreciation was not justified by either current economic developments or future prospects. The economy has rebounded and is doing very well. There is little unemployment and exports are booming. Hong Kong has substantial foreign curency reserves, a generally liquid banking system and virtually no government debt.

The government has been concerned by the falling exchange rate and has done everything in reason, within the established framework, to attempt to stabilise it. These efforts have achieved only limited success.

The circumstances of Hong Kong preclude exchange control. After a thorough examination of realistic options, we have now decided to alter the framework within which the exchange rate is determined. With effect from Monday, 17 October, the two note-issuing banks will pay the government's exchange fund for additional certificates of indebtedness, which they are required to hold as backing for any increase in their note issues, in foreign exchange at a fixed rate of HK$7.80 = US$1.

From the same date, when notes are withdrawn from circulation and the note-issuing banks surrender certificates of indebtedness the exchange fund will pay them the equivalent foreign exchange at the same fixed rate. It is our intention to hold this rate unchanged.

The rates of exchange which a bank customer will obtain, whether exchanging bank notes or making any other foreign currency transactions, will continue to be determined by market forces, but will in practice be close to the fixed rate of HK$7.80 = US$1. This will be the case because next Monday market forces will operate against the background of the fixed rate for certificates of indebtedness. I must emphasize that these new arrangements will mean business as usual between banks and their customers at stabilised rates.

You will ask about the implications for the economy of stabilising the exchange rate in this way. In the short term there may be some upward pressures on Hong Kong dollar interest rates. Once the stability of the exchange rate becomes evident and accepted, interest rates should fall below present levels. Looking further ahead changes in the exchange rate will no longer be an element in our economy's adjustment process. Factors such as interest rates and money supply will adjust to balance of payments pressures automatically with government intervention.

The government believes that this new arrangement must now be preferred to the freely floating exchange rate system. We cannot run the risk of further sprialling depreciation, with the rampant inflation and distress which that would bring to all our community. A return of confidence in our currency is essential.

I said that I had two measures to announce. The second is this. As from Monday, 17 October interest on Hong Kong dollar deposits with financial institutions will no longer be taxed. This means that there will no longer be a tax advantage in holding foreign currency deposits or in holding Hong Kong dollar deposits offshore.

As I said last month, the government must take account of the possible erosion of profits tax revenue arising from the removal of interest tax. We are still studying this complex issue. In removing interest tax on Hong Kong dollar deposits with financial institutions, we are doing the most that is possible, pending the outcome of our study. I hope to be in a position to propose more lasting reforms in these fields of taxation in the budget next February.

These measures are designed to stabilise the exchange value of the Hong Kong dollar, and thus to provide a climate for growing prosperity with restrained inflation. The government has confidence in the stabilised exchange rate. So can the people of Hong Kong. Let us now get on with our business.

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