Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

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Hong Kong: Potential Reaction to US Trade Pressure [redacted] 25X1

SUMMARY

We expect Hong Kong to resist any further pressure to reduce exports to the United States by claiming that the new bilateral textile accord will keep Hong Kong's trade surplus with the United States from growing significantly during the five-year agreement. We believe Hong Kong will also continue to strongly oppose any change in its exchange rate, which is pegged to the US dollar, because it fears that concerns over the transition to Chinese control would eventually force the local dollar's value to fall, damaging Hong Kong's trade-based economy. We believe Hong Kong can continue to maintain the peg indefinitely by manipulating interest rates. [redacted] 25X1

This memorandum was prepared by [redacted], Office of East Asian Analysis. 25X1
Information available as of 9 February 1987 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Economic Assessments Branch, China Division, OEA, [redacted] 25X1

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Worried About US Protectionism

Because Hong Kong's trade-dominated economy depends on access to US markets, Hong Kong businessmen and the government worry about rising protectionist sentiment in Washington. Over 40 percent of exports go to the United States,[1] and account for almost 22 percent of Hong Kong's GDP. Hong Kong's $6.1 billion trade surplus with the United States last year set a record, but Hong Kong's growth rate slowed considerably (see table). Sales of textiles and apparels--Hong Kong's leading export category--moderated. And although some electronics exports were up, radio sales dropped sharply. On the other side of the ledger, Hong Kong's imports of US agricultural products grew slightly, but US computer sales to the territory were down.

Table 1 — US data in billion US $, FOB.
US-Hong Kong Trade: 1981-86

	US Imports From Hong Kong	US Exports to Hong Kong	Hong Kong's Trade Surplus	Trade Surplus Growth Rate (Percent)
1986*	8.95	2.87	6.08	5.2
1985	8.39	2.61	5.78	8.0
1984	8.23	2.88	5.35	34.4
1983	6.39	2.41	3.98	22.8
1982	5.53	2.29	3.24	14.1
1981	5.34	2.50	2.84	

* Estimate based on January-November data

[1] Moreover, Hong Kong's role as a major Asian entrepot earns it additional revenues. Protectionist measures that would dampen trade through Hong Kong between the United States and other nations such as China would cut into those revenues as well, a prospect that only underscores Hong Kong's concerns about market access.

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We believe Hong Kong officials--in their routine conversations with US officials and businessmen--will try to avoid intensifying disagreements over bilateral trade issues, but instead will maintain their low-key approach, iterating their policies and concerns to calm business jitters and to parry US pressures. For examplem, we expect Hong Kong trade officials to explain to US counterparts that their trade surplus with the United States is unlikely to grow significantly during the next few years because the five-year bilateral textile agreement signed last summer allows for virtually no growth in exports. Textiles and apparel accounted for 45 percent of Hong Kong's exports to the United States last year. [redacted] 25X1

Moreover, Hong Kong officials will probably restate several arguments they have made against further US protectionist pressures. They will probably point out that Hong Kong has a totally unrestricted market--in contrast to other countries in the region, which run large trade surpluses with the United States--and therefore Hong Kong traders should not be restricted from US markets. In addition, Hong Kong may argue that its 5.5 million people buy more US goods per capita than any other US trading partner. Finally, Hong Kong probably will raise the need to maintain the territory's prosperity during the politically sensitive transition period leading to China's resumption of control in 1997. [redacted] 25X1

Hong Kong is also likely to seek forbearance because its manufacturing sector will have difficulty maintaining its share of the US market over the next few years. Other newly industrialized countries and LDCs in the region have become more competitive because of lower wage and property costs. In addition, Hong Kong's high-technology manufacturers do not have the government assistance enjoyed in other countries. [redacted] 25X1

Sheltering the Hong Kong Dollar

On the basis of official and public reactions, we believe the Hong Kong Government will continue to strongly resist suggestions that it revalue its currency against the US dollar. The Hong Kong dollar has been pegged to the US dollar since October 1983 at a rate of 7.8 to 1. Hong Kong fears that, if it demonstrates a willingness to adjust that rate, the uncertainty associated with the transition to Chinese rule would eventually cause a selloff of Hong Kong dollars, forcing a potentially destabilizing devaluation. Hong Kong has demonstrated its resolve before--it chose not to devalue in 1985 even though the high relative value of the local dollar caused a decline in Hong Kong's exports, resulting in a GDP growth rate below 1 percent. [redacted] 25X1

Can Hong Kong Maintain Its Exchange Rate?

The Hong Kong Government maintains the pegged exchange rate by manipulating interest rates on Hong Kong dollar accounts (see the inset). For example, Hong Kong raised its effective prime interest rate above 15 percent in 1983 and again in 1984 to stop selloffs of Hong Kong dollars. During the September 1983 dollar crisis, some overnight interest rates exceeded 30 percent. Of course, not even high interest rates

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can always stop a panic sellofff of dollars, nor could the local economy live with high interest rates for long. Thus, the peg remains somewhat vulnerable. 25X1

Barring such a selloff, we believe Hong Kong can continue to maintain the 7.8-to-1 peg against the US dollar:

- Hong Kong slashed its interest rate from 6.5 to 5 percent in mid-January to dampen speculative demand stemming from rumors of a pending revaluation (see chart). The new low rate combined with Hong Kong's 3.5-percent inflation created a negative effective interest rate for some Hong Kong dollar deposits; consequently, we expect transfers of funds to foreign currency accounts, which will relieve the demand.

- Hong Kong has no restrictions on holding or transferring foreign currencies, and more than half--53 percent--of the territory's money supply[2] is held in foreign currencies. 25X1

Hong Kong will probably also reject calls for a revaluation because its overall trade account was nearly balanced last year. According to preliminary Hong Kong trade data, the territory's total exports grew by 18 percent in 1986 to $35.4 billion, while imports grew by 19 percent to $35.3 billion. Hong Kong's trade surplus narrowed to $73 million, down from $478 million in 1985. 25X1

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[2] Based on the broadly defined measure, M-3 which includes currency, demand deposits, savings, and certificates of deposit. 25X1

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Hong Kong's Pegged Exchange Rate

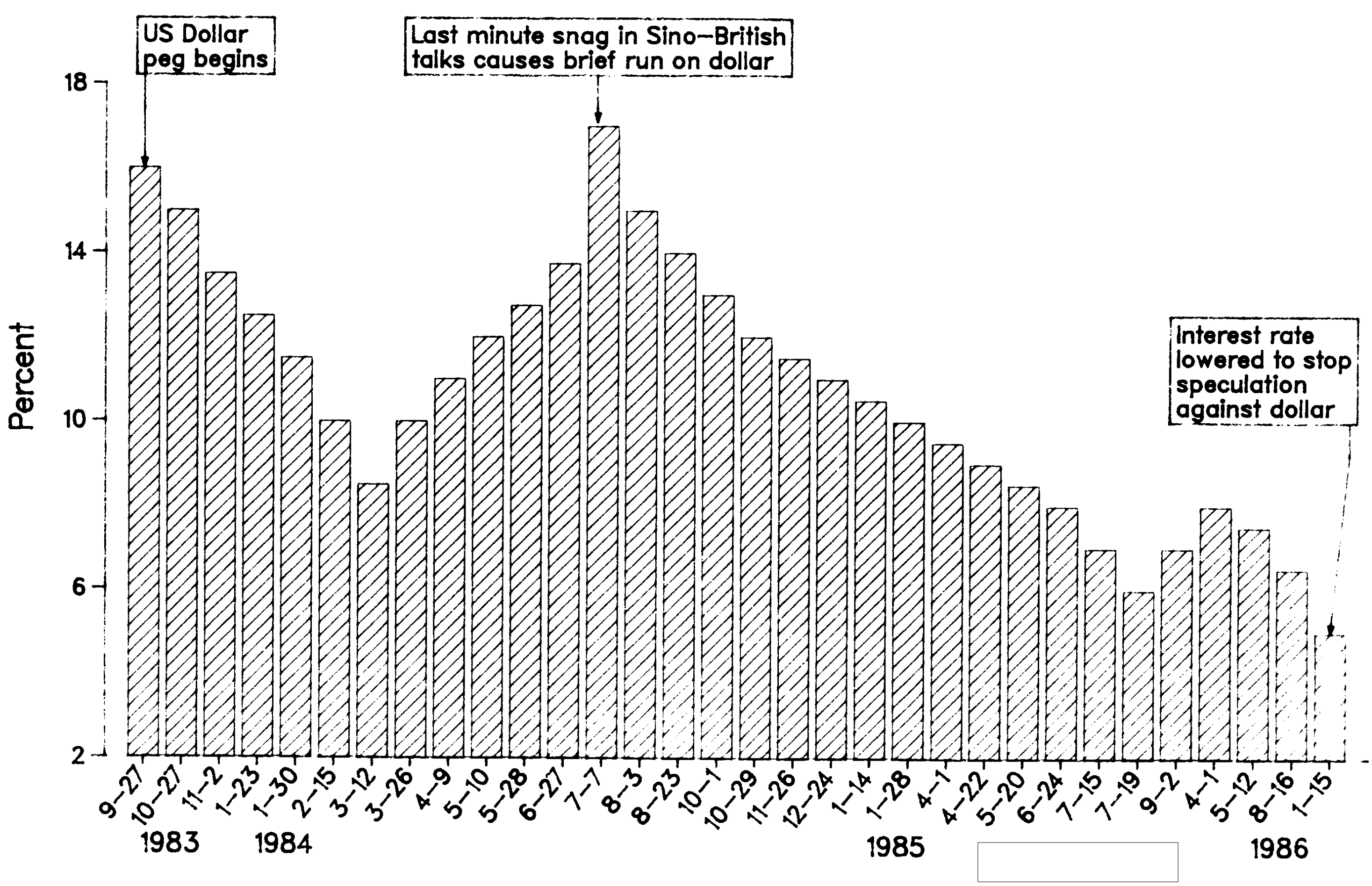
Hong Kong's dollar was pegged at the rate of 7.8 to 1 US dollar in October 1983 following months of downward speculative pressure created by the lack of progress in what were then the year-old Sino-British talks on the territory's future. Initial hopes in Hong Kong that the British could retain a role in Hong Kong after 1997 began to fade by mid-1983. Capital outflows and currency speculation grew under the existing free-floating exchange rate system. The exchange rate fell from an average of 6.5 to 1 US dollar in January 1983 to a low of 9.6 to 1 US dollar on 24 September 1983. 25X1

On 15 October 1983, the Hong Kong Government announced the imposition of the US dollar peg to stabilize the currency. Hong Kong's lack of a central bank forced the government to develop a unique system requiring the cooperation of Hong Kong's two private note-issuing banks (the Hong Kong Shanghai and Chartered) and the Hong Kong Association of Banks (HKAB), the cartel that sets Hong Kong's effective prime interest rate. We believe that Hong Kong's Financial Secretary essentially dictates interest rate changes to the HKAB. 25X1

To initiate the peg, the Hong Kong Government announced that thereafter the two note-issuing banks would be required to provide the government with US $1 or the equivalent foreign exchange to receive a certificate authorizing them to issue 7.8 Hong Kong dollars. Similarly, the banks could redeem these certificates to buy back foreign exchange from the government at the same rate. These transactions were to be conducted with the government's foreign exchange holdings, known as the exchange fund. The extent of these holdings is a tightly held secret known only to a handful of people inside the Hong Kong Government. 25X1

The key to the peg's success has been Hong Kong's ability to shift interest rates to reflect the supply and demand for the local dollar. The only time the local dollar threatened to slip out of the peg was in July 1984, when rumors of last-minute snags in the Sino-British talks caused a speculative selloff. The Hong Kong dollar briefly sold for as high as 7.94 in Europe, but a 3.25-percent increase in the prime rate to 17 percent quickly brought the exchange rate down closer to the peg (see graphic). The system also probably returned to the peg because the note-issuing banks found it profitable to sell Hong Kong dollars back to the govermment in exchange for foreign exchange still available at the 7.8-to-1 rate, thereby reducing the supply of Hong Kong dollars. 25X1

Hong Kong: Effective Prime Interest Rates
27 September 1983 to Present



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