



ORIGINAL ARTICLE

One country, two currencies: The adoption of the Hong Kong currency board, 1983

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Abstract

Currency boards have had an enduring attraction as a solution to exchange rate and monetary credibility for small open economies, despite few successful examples. In this context, the case of Hong Kong stands out for its longevity; it survived the handover to China, the Asian financial crises in 1997, and the global crises in 2007–8 and 2020. The 1983 currency crisis and the decision to link the exchange rate to the US\$ is usually treated as an outcome of local political uncertainty due to the Sino-British negotiations which set the framework for how Hong Kong would fit with the rest of China after 1997. We present fresh archival evidence from Hong Kong and London to reveal the year-long debates over Hong Kong's monetary system after a drop in the exchange rate in September 1982 and to demonstrate how most of the protagonists in Hong Kong and London came only reluctantly to accept the idea of re-pegging the dollar once public expectations had been raised. We also show how the mixture of currency and banking instability affected the terms of the negotiations in 1982 and 1983 and set the framework for the one country, two currencies system that prevails today.

KEYWORDS

Basic Law, currency board, exchange rate choice, Hong Kong, Hong Kong handover to China

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‘Political anxiety cannot be cured by monetary credicine’ [combination of credibility and medicine]’

D. K. Patel, Manager of Economic Research, HSBC, 28 Sept. 1983

Currency boards issue local currency fully backed by foreign exchange to ensure a stable fixed exchange rate, which suited the close commercial links between colonies and their metropolises in the nineteenth century. They thus became the standard monetary institution of colonialism, but few persisted after the end of the British Empire in the mid-twentieth century. In the 1990s interest in currency boards was renewed by their promise of delivering policy credibility with a stable exchange rate for emerging market economies, although the perils of crashing out of such a system were starkly revealed in the case of Argentina in 2002.¹ The longevity and stability of the monetary system in Hong Kong has been an exemplar for the benefits of operating a form of currency board for small open economies.² Introduced in 1935, it lasted for 40 years but was then suspended for 10 years in favour of floating before a new currency board system was created in 1983.³ It has persisted, albeit in modified form, into the present day. Although most modern currency boards emerged in the 1990s, Hong Kong adopted its monetary system a decade earlier at a time when many economies moved away from rigidly fixed exchange rates in the context of historically volatile global exchange rates. Hong Kong’s choice to align itself with US monetary policy was an important break with orthodoxy. Why the Hong Kong authorities made this choice has not been fully examined. Rather, the literature has emphasised the political causes for the rapid depreciation in the autumn of 1983 and the monetary and financial stability the currency board delivered in following decades.⁴ As in later cases such as Bulgaria and Argentina, it seemed that the Hong Kong authorities leapt to a currency board peg to extricate the economy from a sudden currency crisis. As [Williamson](#) suggests, currency boards are more likely to be implemented in a time of crisis, but paradoxically this context makes it even more difficult to gain the credibility needed to sustain the anchor peg.⁵ We examine how Hong Kong overcame this paradox in a particularly challenging political context. In the 1980s, Sino-British negotiations set the detailed framework for how Hong Kong would fit with the rest of China from the handover in 1997. The context of the 1980s was, therefore, crucial for the later relationship of the Hong Kong special administrative region (SAR) with Beijing and continues to influence institutions today. While the handover attracted considerable contemporary coverage, the historical treatment of these decades has been rather slow to develop. Moreover, the focus has mainly been on the political and constitutional conflicts rather than on the financial and economic terms.⁶

Using archive evidence from the Hongkong and Shanghai Banking Corporation (HSBC) in Hong Kong, the Bank of England, and government departments in Hong Kong and London, we reveal how a short-lived currency crisis in 1982 set in motion a year of private debates between

¹ See [Hanke and Schuler](#), *Currency boards*; [Wolf et al.](#), *Currency boards*; [Schwartz](#), ‘Currency boards’. Other prominent currency boards linked to the US\$ exist in Cayman Islands, Bermudian, and East Caribbean dollars.

² [Kwan and Lui](#), ‘Hong Kong’s currency’; [Genberg and Hui](#), ‘Credibility’; [Hamada and Takeda](#), ‘Choice’; [Blagov and Funke](#), ‘Credibility’.

³ [Schenk](#), ‘Evolution’; [Latter](#), *Hong Kong’s money*.

⁴ [Jao](#), ‘Working’; [Latter](#), *Hong Kong’s money*.

⁵ [Williamson](#), *What role*.

⁶ [Bueno de Mesquita et al.](#), *Red flag*; [Tsang](#), *A modern history*; [Luk](#), ed., *British*; [Carroll](#), *A concise history*.



banks and government officials about how to reform the monetary system well before the September/October 1983 crisis when the currency board was adopted. In this longer context we also demonstrate why the handover negotiations prioritised exchange rate stability, and how this was incorporated into the Joint Declaration and the Basic Law governing the constitutional relationship between the Hong Kong SAR and the People's Republic of China (PRC) for 50 years starting in 1997. We emphasise the fragile local banking system as well as political and monetary factors. Furthermore, we show that the currency board was not the only option considered, and it was not viewed unanimously as the best one.

Most accounts of the restoration of the currency board have been written by participants or rely on contemporary official accounts without providing direct evidence of how the system was constructed or how the choice of regime was determined.⁷ One exception is James, who has used the archive evidence from the Bank of England to establish the advice given by the Bank of England's staff to the Hong Kong authorities at the time. This evidence offers important insights into the banking and monetary instability in Hong Kong at the time and the options being considered, but it remains reliant on the London view and begins its narrative only the month before the currency board system was adopted in 1983.⁸ The contemporary and subsequent literature on the 1983 crisis focusses on the proximate political threats arising from the Sino-British negotiations over the eventual handover of Hong Kong to China.⁹ These talks seemed to hit an impasse in September 1983, prompting a possible capital flight and then a leap to a currency board to stop the rapid depreciation of the HK\$. Beers et al. suggested that although political pressure was likely the reason for the weakening HK\$, the Hong Kong government may have welcomed a weaker currency since that would ease pressures on bank balance sheets when property prices fell.¹⁰ We do not find any direct evidence for this claim. While the political story behind the abrupt policy change is tidy, we find that it is incomplete, neglecting a lengthy period of introspection about the weaknesses in the monetary system as well as scepticism about whether the currency board solution itself would restore currency confidence. Moreover, we amplify the role of the political pressures by drawing on the minutes of the Sino-British negotiations and their reception in Hong Kong to demonstrate China's own interest in a stable HK\$ and how currency instability was used by the Chinese to threaten the British position in Hong Kong as well as the way the currency board system was embedded into the eventual terms of the handover. Other detailed accounts come from contemporary participants, written decades later. Tony Latter, Hong Kong's Deputy Secretary for Monetary Affairs in 1982–5, described the lack of monetary control in the late 1970s and the benefits of the structure and operation of the restored board in the 1980s.¹¹ Goodstadt, a financial journalist in 1983, stressed the immediate pressure of political uncertainty on currency stability as a reason for the return to a currency board mechanism.¹² These narratives are focussed on the merits of the currency board in bringing about monetary stability after political uncertainty undermined confidence in the exchange rate, but they only briefly touch upon the wider international context of the appreciating US dollar

⁷ Schenk, ed., *Hong Kong SAR*; Nugee, 'A brief history'; Schenk, 'Evolution'.

⁸ James, *Making*.

⁹ See, for example Jao, *The Asian financial crisis*, p. 30.

¹⁰ Beers, Sargent, and Wallace, 'Speculations'.

¹¹ Latter, *Hong Kong's money*. Latter was at the Bank of England for many years, where he returned after his term as Deputy Secretary for Monetary Affairs ended. He later came back to Hong Kong as Deputy Chief Executive of the Hong Kong Monetary Authority from 1999–2003.

¹² Goodstadt, *Profits*.



that disrupted global markets. Our evidence thus opens up a fresh interpretation that emphasises the contested nature of efforts to reform Hong Kong's monetary system and the competing interests between banks and the colonial state during a time of currency, banking, and political instability.

Section I sets out Hong Kong's unusual monetary system and economic development in the early 1980s before examining the crisis of 1982 and start of the handover negotiations in Section II. The 1983 crisis is examined in detail on the basis of new archival evidence in Section III before we bring in the implications for the United Kingdom in Section IV. We conclude by bringing together the economic and political developments that led to the restoration.

I | HONG KONG'S MONETARY SYSTEM

A currency board system requires the issue of currency against 100 per cent foreign exchange backing at a fixed or pegged exchange rate. The credibility of the system comes from the complete cover for the note issue and the constraint on the issue of notes; the volume of currency will ebb and flow automatically with the supply of foreign exchange.¹³ Hong Kong operated a currency board anchored to sterling for 40 years starting in 1935, which underpinned the colony's rapid growth in manufacturing and commercial and financial services after 1950. The sterling anchor was retained through the devaluations of sterling in 1949 and 1967, but when the pound floated against the dollar in June 1972, the Hong Kong government announced along with other states that it would move to the US dollar as anchor.¹⁴ A year later, when the Bretton Woods system collapsed and the dollar floated down against the yen and European currencies, the dollar peg increased inflationary pressure, and in November 1974, Hong Kong (again like other countries) abandoned its dollar peg to try to restore price stability.¹⁵ The exchange rate anchor for monetary policy was abandoned, but unlike other countries that had central banks, in Hong Kong there was no move to create a central bank; the institutional structure continued to be based on the Exchange Fund but without a fixed exchange rate.

The mechanism was quite simple. From 1935, note-issuing banks paid sterling to the Exchange Fund in return for an equivalent amount of Certificates of Indebtedness against which to issue local currency.¹⁶ From November 1974 these banks were able to credit the Exchange Fund's account with Hong Kong dollars, marking the end of the rule of 100 per cent foreign exchange backing. The Exchange Fund invested in local- and foreign-exchange-denominated assets but did not have any of the tools needed for effective monetary control. Without the tie to foreign currency backing, the Exchange Fund no longer operated under currency board discipline, and both the exchange rate and the money supply were untethered.

Greenwood and Latter have shown that the means for Hong Kong to conduct effective monetary policy between 1974 and 1983 were absent.¹⁷ Until 1981 a sub-committee of the Exchange Banks Association, led by HSBC, set deposit interest rates while HSBC and Standard Chartered Bank jointly agreed on the best lending rate. This setup was reformed in 1981, giving a more

¹³ For a classic description see Hanke, 'Currency boards'.

¹⁴ Schenk, 'Evolution', p. 146. The sterling area was disbanded and most members broke their link to sterling in June 1972.

¹⁵ Schenk, ed., *Hong Kong SAR*, p. 68.

¹⁶ By 1975, the note-issuing banks were HSBC and Standard Chartered Bank. Mercantile Bank ceased issuing notes in 1974.

¹⁷ Greenwood, *Hong Kong's link*; Latter, *Hong Kong's money*.



formal status to the renamed Hong Kong Association of Banks (HKAB).¹⁸ The Hong Kong financial secretary sought to influence the HKAB's interest rate policy, but we shall see his wishes were not always respected. Interbank rates set by the market were beyond the government's influence and control; there was no discount window or local government securities to form the basis of a money market. Ultimately HSBC, as the dominant clearing bank, provided the main liquidity to local banks and had a powerful position in the system that sometimes led to a conflict between their commercial interests and public responsibilities. The authorities set minimum liquidity ratios of assets/deposits for financial stability purposes, but many banks could easily access liquidity from head offices overseas, so this tool was rarely binding. Hong Kong was left in a vulnerable position as a small, open economy when the world entered the inflationary spiral of the 1970s and the abrupt reversal of easy money in the United States under Paul Volcker's chairmanship of the US Federal Reserve from 1979.

Archival sources show that by early 1981 both banks and the Hong Kong government were concerned about HK\$ depreciation and inflation.¹⁹ At first, the government actively promoted property development to meet housing needs and so was sanguine about the accompanying credit growth. Towards the end of 1981, they became privately concerned about a property market bubble and considered various policy options to restrain it, but decided against any change in policy in November.²⁰ At the same time, Singapore was becoming an important financial centre in East Asia.²¹ In February 1982 Hong Kong's new financial secretary, Sir John Bremridge, removed the 15 per cent withholding tax on interest earned from foreign currency deposits in Hong Kong in an effort to recapture competitiveness against Singapore, while leaving a 10 per cent tax on HK\$ deposit interest. This led to an immediate increase in foreign currency deposits in Hong Kong banks. By the early 1980s, therefore, inflation, a local asset market boom, and credit growth driven by property development were prompting a transition in Hong Kong's financial sector. Broad money (M3) grew by 38 per cent in 1980 and by a further 15 per cent in the first half of 1981. In January 1981, HK dollars made up 87 per cent of M3. Two years later, the HK dollar share was down to 59 per cent. With the world economy in recession and US interest rates at 14–15 per cent, Hong Kong's economy suffered, and asset prices fell. Property prices reached a peak in the third quarter of 1981 before falling by 31 per cent by 1983.²² Property firms dominated the stock exchange, so the Hang Seng stock index fell by 50 per cent between July 1981 and November 1982. Against this background, by 1983, the government was ready to act to restore price stability, but as we shall see, there was no consensus on how it should be done.

From 1979, the shift in US Federal Reserve policy prompted a sharp increase in US interest rates that flowed through the global financial system. During the early 1980s the floating HK\$ depreciated sharply against the US\$, shown in figure 1, which unsettled Hong Kong financial markets and contributed to inflation. After the Latin American debt crises in the 1980s, many developing countries moved towards more flexible regimes. From 1976 to 1989 the proportion of

¹⁸ Schenk, 'Negotiating'.

¹⁹ Letter from General Manager Welsh of HSBC to Financial Secretary Haddon-Cave, 16 Jan. 1981; letter from HSBC Group Chairman Wrangham to Haddon-Cave, 30 Jan. 1981; letter from Chairman Mike Sandberg to Haddon-Cave, 2 Feb. 1981; letter from Haddon-Cave to Sandberg, 3 Feb. 1981; all HKO 096/038, HSBC Asia Pacific Archive, Hong Kong (hereafter HSBC APA).

²⁰ Letter from Bremridge to Sandberg, 3 Nov. 1981, Financial Secretary correspondence 1973–86, HSBC APA.

²¹ Schenk, 'Origins'.

²² Rating and Valuation Department, Hong Kong Government. https://www.rvd.gov.hk/en/publications/property_market_statistics.html. Accessed 25 March 2021.



FIGURE 1 HK\$/US\$ nominal rate, daily close. *Source:* Hong Kong Monetary Statistics. Hong Kong Monthly Digest of Statistics, Census and Statistics Department, Hong Kong

countries pegging their currencies to the US dollar declined from 43 per cent to 24 per cent.²³ The next section explores how Hong Kong's unusual constitutional constraints prompted a move in the opposite direction.

II | SINO-BRITISH NEGOTIATIONS AND THE CRISIS OF 1982

At the outset, the British goal was to concede that sovereignty would revert to China but to ensure that Hong Kong could remain under British administration to keep the free market, respect for law, and property rights that had been vital for the colony's economic success. Financial Secretary Bremridge and other business leaders in Hong Kong agreed with UK Prime Minister Margaret Thatcher and her advisers that, without continued British administration, business confidence in Hong Kong would collapse, which would not be in China's interests. Moreover, if no such agreement was reached early in the negotiations, Thatcher was warned that an exodus of people from Hong Kong would enter the United Kingdom, investments would be lost, and Britain would face the difficult (and expensive) task of governing a declining Hong Kong over the 15 years leading up to 1997.²⁴ The stakes were high, particularly coming out of Britain's war over the sovereignty of the Falkland Islands from April to June 1982.

From the first private, tentative discussions at the start of 1982, Chinese Premier Zhao Ziyang (赵紫阳) and Vice Chairman Deng Xiaoping (邓小平) asserted that full sovereignty over Hong Kong needed to pass to China, but they also emphasised that Hong Kong's prosperity must be maintained in the interim in China's own interest, including the free port and the international

²³ Aghevli, Khan, and Montiel, 'Exchange rate policy', p. 2.

²⁴ Memo by Brian Fall, Foreign & Commonwealth Office (FCO) to Thatcher, 26 July 1982, PREM19/789, TNA.



financial centre.²⁵ To this end, in July 1982 the Chinese Ambassador to the United Kingdom passed on his government's view that 'socialism would be the policy in the main part of China, capitalism could continue in Hong Kong'.²⁶ Thatcher thus went into the first formal discussions in September 1982 with a clear view of the Chinese position regarding one country, two systems and hoped for a compromise on the post-handover administration of the territory.

On 23 and 24 September, Zhao and Deng laid out the Chinese terms of the handover for Thatcher; they were not negotiable. The PRC government would appoint a Hong Kong Chinese person to govern Hong Kong, but there would be no changes to the legal system except to end the right to appeal to the UK courts. The free port and international financial centre would continue.²⁷ Specifically, Zhao stated 'the Hong Kong dollar would continue to be used and to be convertible'.²⁸ These terms did indeed become the basis of the final settlement two years later. Zhao made clear that 'if it came to a choice between the two, China would put sovereignty over prosperity and stability'; they would not consider allowing Hong Kong to administer itself or for the British authorities to be involved.²⁹ Thatcher clarified her view that the successful Hong Kong economy was built on three premises: 'a political system which was different from that of China; an assured legal system; and an independent currency'.³⁰ At this point, the Chinese yuan (RMB) was not convertible, and China depended on Hong Kong as its main port and as a key source of foreign exchange. A stable and distinctive Hong Kong currency was a valuable attribute for both the Chinese and the British from the start.

The next day, Deng threatened that 'if there were very large and serious disturbances in the next 15 years, the Chinese Government would be forced to consider the time and formula relating to the recovery of its sovereignty over Hong Kong'. When pressed on what kind of disturbances he meant, the British transcript shows that he alluded to HSBC:

No-one knew how many banknotes it had issued. [Hong Kong Governor] Sir Edward Youde said that we [the British government] knew. Mr Deng Xiaoping agreed that we knew but said that the Hong Kong people he talked to did not. In any event, it would be easy for some people to create disturbances.

Deng clearly had a monetary disturbance to the HK dollar in mind, although the note issue was published regularly in the Hong Kong government Gazette. Deng then stated that both governments 'should also prevent some businessmen from doing things which were detrimental to the prosperity and stability of Hong Kong'.³¹

Meanwhile, on 7 September 1982, two weeks before the Sino-British negotiations, there was a run on the Hang Lung Bank after the collapse of a gold jewellery shop to which it had links.

²⁵ Telegram, 8 Jan. 1982, Lord Privy Seal (Humphry Atkins) meeting with Zhao Ziyang. Record of conversation, Chinese Ambassador to London with MacLehose and Youde, 29 July 1982, PREM19/789, TNA.

²⁶ Record of conversation, Chinese Ambassador to London with MacLehose and Youde, 29 July 1982, PREM19/789, TNA.

²⁷ John Holmes memo, 'Hong Kong: Sir YK Pao', 28 Sept. 1982, PREM19/788, TNA. Thatcher remarked that Deng told her the same detail. Pao was a key go-between from the Chinese to the Hong Kong and UK governments. He was later vice chair of the committee drafting the Basic Law. In June 1982 Deng wrote on similar terms to Rayson Huang, Vice Chancellor of Hong Kong University; PREM19/792, TNA.

²⁸ Record of a conversation between Thatcher and Premier Zhao Ziyang, 23 Sept. 1982, PREM19/790, TNA.

²⁹ Ibid.

³⁰ Record of a conversation between Thatcher and Deng Xiaoping, 24 Sept. 1982, PREM19/790, TNA.

³¹ Ibid.

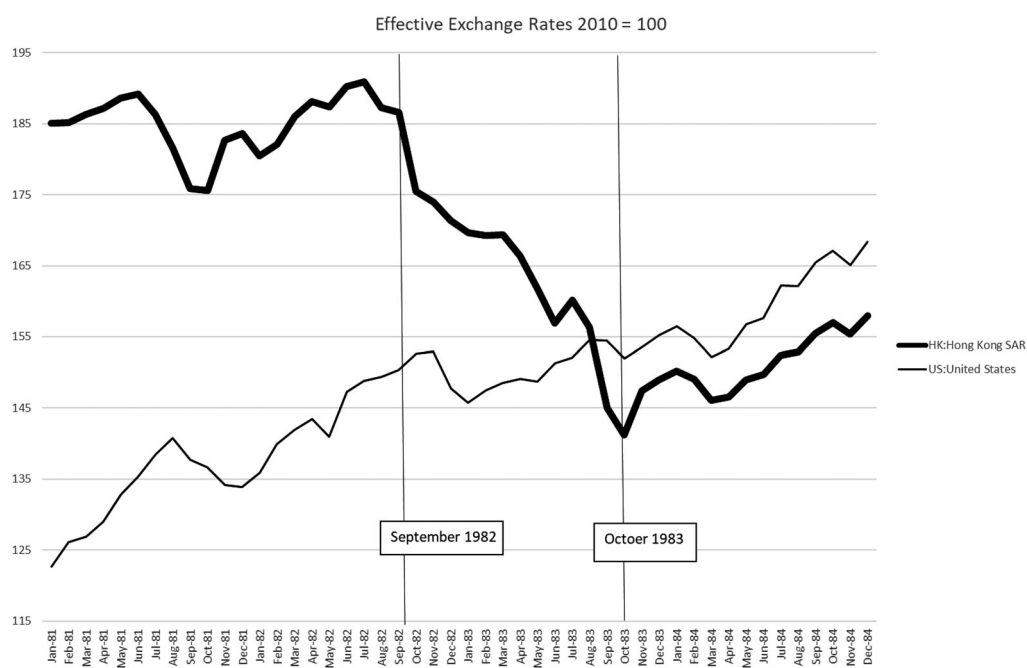


FIGURE 2 Effective exchange rates. *Source:* Bank for International Settlements, Statistics Explorer. Weighting using narrow basket., <https://stats.bis.org/statx/srs/table/i2?m=N> (accessed 25 March 2021)

Standard Chartered Bank publicly agreed to offer liquidity to Hang Lung Bank, and the run subsided. Hang Lung was a mid-sized bank with 28 branches, and the difficulties were later revealed to be due to fraud, unrelated to the local political situation.³² Just after meeting Thatcher, Deng told shipping tycoon (and unofficial go-between) Y. K. Pao (包玉剛) that the PRC government could use financial instability in the transition period as an opportunity to ‘buy up investments cheaply’. However, he also confirmed that Hong Kong was valuable to the mainland as a source of foreign exchange, which was estimated at US\$5 billion net per year.³³ The instability of the banking system and the volatility of the HK\$ meant that economic and monetary issues were clearly at the forefront of thinking in Beijing. The US\$ appreciated 11 per cent in 1981 and then a further 17 per cent in 1982 against the yen and the DM and 15 per cent against the HK\$. Figure 2 shows the appreciation of the US\$ in 1982 and 1983 against the falling HK\$. These were challenging times for Hong Kong’s floating currency, even without the local political context.

Reporting on the Beijing meetings to official members of the Executive Council of Hong Kong’s legislature, Thatcher deemed them a success. Her goal was to secure a communique signalling that both sides shared ‘a common aim of maintaining prosperity and stability’ without further

³² Hang Lung Bank was unable to honour HK\$148m in outstanding cheques. The subsequent investigation of the bank’s books and its links with a failed deposit-taking company (DTC) revealed fraud, and several executives were later arrested. See Official record of Proceedings, Hong Kong Legislative Council, 27 Sept., 1983, Hong Kong Hansard 1983.09.27. J. Wong, ‘Hong Kong cites \$21 billion kiting fraud – police investigating bank failures say they found scheme only by accident’, *Wall Street Journal*, 11 Oct. 1985.

³³ Note of meeting between Thatcher and Y. K. Pao, Hong Kong, 28 Sept. 1982, PREM19/788, TNA.



public mention of transferring sovereignty.³⁴ However, she also changed her view of how long the talks would take, from six months to 'many months, perhaps as long as two years'.³⁵ Bremridge warned Thatcher that 'the key to Hong Kong's financial centre was the strength of the Hong Kong dollar' and that 'confidence would not attach to a financial centre under the Chinese Government, in view of their recent history. If there was not external confidence in the Hong Kong dollar, it would fall and the value of Hong Kong to China would fall with it'.³⁶ Although the formal communique did not mention the transfer of sovereignty, the official Chinese press began to discuss it almost immediately after the talks.³⁷

Bremridge's warning reflected the falling HK\$ exchange rate. Local factors in the form of the Hang Lung Bank run and the negotiations, combined with high global interest rates and a strengthening US dollar, pushed the Hong Kong dollar down by 13 per cent against the US dollar from the end of August to the end of October (10 per cent against the RMB), while the Hang Seng index fell 17 per cent during the negotiations from 22 to 30 September. Depreciation against the RMB especially increased the cost of imported food consumed by those on lower incomes.

Gordon Richardson, Governor of the Bank of England, visited Hong Kong a few weeks later and gathered local views about September's market disruptions.³⁸ Bremridge and Youde reassured him that, even without Thatcher's visit, 1982 would have been a challenging year because it marked 15 years to the hand-over, which was the most common tenor of mortgage loans. Currency fluctuations had 'taken place against a background of very thin trading. He [Bremridge] said that the authorities had intervened in the exchange market and this had been successful in bringing the rate round'. All the same, Bremridge was concerned about 'the possibility of the Hong Kong dollar going out of control which he thought could happen very easily' and suggested that various local business personalities had been sending funds overseas. By December 1982 the HK\$ had recovered the loss in value from September. Nevertheless, as shown in figure 3, the path of depreciation in 1982 was of a similar scale to the run up to the crisis a year later, although there was a second peak in October 1983.

The events of September 1982 provoked a year-long (albeit at times desultory) discussion of how to regain control of the monetary system and inflation. With a floating exchange rate and open capital markets, the options were limited. HSBC suggested measures to curb liquidity by requiring more local deposits from foreign banks, but Bremridge found little merit in those proposals, which seemed self-interested on HSBC's part, and did not express any sense of urgency in introducing new controls or rules.³⁹ The banks and the government periodically returned to the question of how to impose more control on the monetary system but could not find a solution. Returning to a pegged exchange rate was not considered. However, the shudder in the dollar exchange rate in the week of the 1982 Sino-British negotiations demonstrated the vulnerability of the Hong Kong

³⁴ Note of meeting between Thatcher and officials of the Executive Council, Hong Kong, 26 Sept. 1982, PREM19/788, TNA. This common aim had been agreed on by the Chinese in July 1982. Record of conversation, Chinese Ambassador to London with MacLehose and Youde, 29 July 1982, PREM19/789, TNA.

³⁵ Thatcher aimed for six months in July 1982. Meeting of Prime Minister, Foreign and Commonwealth Secretary, and Governor Youde, London, 28 July 1982, PREM19/789, TNA.

³⁶ Note of meeting between Thatcher and officials of the Executive Council, Hong Kong, 26 Sept. 1982, PREM19/788, TNA.

³⁷ Telegram from the Governor of Hong Kong to FCO (passed to Thatcher), 5 Oct. 1982, PREM19/790, TNA.

³⁸ Note for the record, J. E. W. Kirby, 21 Oct. 1982, 4A110/4, Bank of England Archives, London (hereafter BoE).

³⁹ Letter from Bremridge to Sandberg, 29 Dec. 1982, HSBC Asia Financial Secretary correspondence file, HKO 196/038, HSBC APA. On HSBC's self-interested regulatory suggestions, see also Schenk 'Negotiating'. Sandberg of HSBC took three months to reply to Bremridge, which suggests that he did not find it urgent.

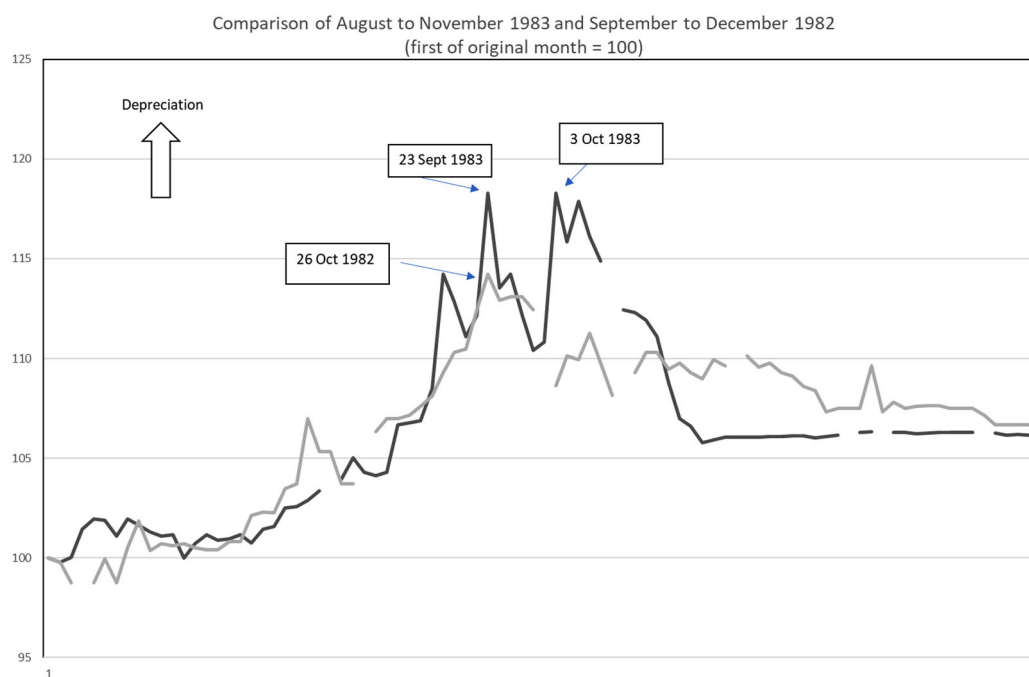


FIGURE 3 Comparison of exchange rate movements in 1982 and 1983 [Colour figure can be viewed at wileyonlinelibrary.com]

dollar to broader political tensions. On the one hand Deng had privately threatened to intervene in the case of a monetary crisis, while on the other hand he had suggested that Beijing might take advantage of any crisis to buy up assets. This set the stage for the next round of negotiations a year later when Hang Lung Bank and currency instability were again the backdrop.

III | CURRENCY CRISIS OF 1983 AND RESTORING THE CURRENCY BOARD

During the first quarter of 1983, the exchange rate continued to depreciate, the Hang Seng index declined, property prices fell, and a few deposit-taking companies (DTCs) faced liquidity problems, all demonstrating financial fragility. In May 1983, the rise in the US\$ drew in speculators, including some Hong Kong-based companies and banks such as the Bank of China.⁴⁰ This prompted concern in London as well as Hong Kong. Youde and Bremridge secretly began contingency planning for a currency crisis with a small group from Her Majesty's Treasury and the Foreign and Commonwealth Office (FCO) in London. At the end of May 1983, Youde and Bremridge

[did] not envisage using Hong Kong reserves in order to support the Hong Kong dollar in more than a tactical way in the face of a major political crisis, nor would they ask

⁴⁰ Memo by R. D. Clift, Hong Kong and General Department, 2 June 1983, FCO 40/1616, TNA.



the British Government to help in this way. The reserves would be kept essentially for emergency purchase of essential imports, in the face of hostile Chinese action.⁴¹

The British and Hong Kong governments were ready to abandon the currency if faced with a political crisis from the mainland.

At the same time as this secret planning was underway, in May 1983 the Banking Advisory Committee discussed a Hong Kong government paper laying out five options to better control monetary growth.⁴² The renewed weakness of the HK\$ was the main concern, but the committee felt a need to discuss 'broader questions of monetary control'. Several alternatives were presented and commented upon, such as a cash ratio and reserve requirements. The Hong Kong government's favoured proposal was to use the local loan to deposit ratio as a monetary policy tool while keeping the liquidity ratio for prudential purposes. During the meeting it was clear that there was no consensus. One member noted that 'the weakness of the Hong Kong dollar reflected uncertainty about the future' and that the proposed measures would not have 'any substantial effect on the exchange rate'.⁴³ Most of the bankers agreed that, while some monetary control was needed, capital flows should not be restricted since this would jeopardise Hong Kong's position as an international financial centre.⁴⁴

In July 1983, Latter laid out his ideas for a more active role for the Exchange Fund in what he entitled 'A personal view' on monetary policy to John Gray, Assistant General Manager at HSBC.⁴⁵ He found the existing tools (the interest rate agreement, the liquidity ratio, and foreign exchange market intervention) 'severely wanting'. He believed Hong Kong had managed quite well without adequate monetary policy tools so far because the public did not really understand how inadequate the tools were and owing to 'a sense of propriety and the regard for the perceived public interest' within the banking system. By the spring of 1983, it was clear that these fragile foundations were not sufficient. An intense discussion ensued between Latter and Gray and D. K. Patel, HSBC's Manager of Economic Research, about monetary policy options.

At the same time, in July 1983 high-level negotiations between Beijing and London resumed after the British accepted publicly that all of Hong Kong's territory would return to China under full Chinese administration. The currency continued to be a concern; the FCO reported that China earned about US\$4.75 billion in foreign exchange from Hong Kong in 1982, of which about US\$4 billion was probably in HK\$, so they stood to lose if the HK\$ depreciated. The total capital value of Chinese-owned real estate in Hong Kong was US\$1.099 billion, which would also fluctuate in value with the HK\$.⁴⁶ The exchange rate was a core issue for the handover.

Once again, the talks came at an inauspicious time in Hong Kong. Fresh rumours were circulating about Hang Lung Bank, which had been supported through a run a year earlier. After months of monitoring, Standard Chartered Bank's management refused to provide further support and was ready to announce this decision publicly on the morning of 27 September, 1983. To forestall a bank run, the Hong Kong government unprecedentedly took over the bank that very

⁴¹ Memo by Clift, Hong Kong and General Department, 31 May 1983, FCO 40/1616, TNA.

⁴² Memo for the Banking Advisory Committee meeting, 28 May 1983, 'Possible measure relating to the liquidity requirement', John Gray, HSBC Assistant General Manager, Monetary Policy file, HSBC APA.

⁴³ Ibid.

⁴⁴ Ibid.

⁴⁵ Letter from Latter to Gray, 13 July 1983, Monetary Policy file, HSBC APA.

⁴⁶ Letter from Clift to Private Secretary, FCO, 2 Sept. 1983, FCO 40/1615, TNA.



day, using Exchange Fund resources.⁴⁷ Meanwhile, food prices rose by 3–4 per cent in September alone (approximately 40 per cent on a per annum basis) and people were hoarding rice, toilet paper, and liquor as the HK\$ depreciated and import prices (including food from the PRC) rose.⁴⁸ The monetary authorities and HSBC had no solution to contain credit and monetary growth while the US dollar was strengthening, putting added pressure on the HK\$/US\$ rate.

As Latter and HSBC continued their private discussions, an outsider drew the discussions into the public sphere. John Greenwood was an economist with GT Management in Hong Kong who had been criticising the lack of monetary control for over a year through a newsletter to his clients. His calls for a central bank met with no enthusiasm in the administration, and in early September 1983 he instead published a plan to restore monetary discipline by re-pegging the exchange rate.⁴⁹ Goodhart, from the Bank of England, later related that ‘this young man, John Greenwood... gets under the authorities’ skin’.⁵⁰ Nevertheless, in these unusual circumstances, as the authorities cast about ineffectually for a solution to monetary control, Greenwood became a leading architect of the new currency board system. In developing his plan, he took advice from Thatcher’s monetarist adviser Alan Walters as well as Milton Friedman and Max Fry.⁵¹

As the HK\$ slumped (see figure 1), Secretary for Monetary Affairs Douglas Blye tried to take action by commanding interest rates. In the morning of 8 September 1983, Blye called William Brown of Standard Chartered Bank and P. J. Wragham at HSBC to report that ‘he and Bremridge had a sleepless night about the weakness of the Hong Kong dollar’.⁵² He told Wragham that the ‘[Hong Kong] Government felt most strongly that a special meeting of the HKAB should be called immediately with a view to raising interest rates by 3 per cent[age points]’. Brown and Wragham duly called a special meeting, but Wragham told the assembled bankers that he did not support an increase in interest rates.⁵³ He believed Blye and Bremridge were too much influenced by an overnight fall in the Hong Kong dollar, ‘which appeared to me to be based on speculation probably by large foreign banks’. Wragham may well have been concerned about the impact of an interest rate hike on the HSBC balance sheet, but the record suggests that he did not think there were solid economic reasons for the weak dollar. Opinion among other bankers present was mixed. The Bank of China sided with Blye, US banks suggested a 2 per cent increase, the Bank of East Asia was willing to go to 5 per cent, and the European banks agreed with HSBC. In the end, the meeting raised the rate by 1.5 percentage points to meet market expectations for some adjustment, since it was known that a special meeting had been called. The banks had defied the Hong Kong government. Blye ‘remonstrated most strongly that I [Wragham] had acted against the wishes of the government and he resented the major Note Issuing Bank acting against the stated wishes of Government’.⁵⁴ This is a key episode where HSBC broke with the government’s advice and

⁴⁷ Official record of Proceedings, Hong Kong Legislative Council, 27 Sept., 1983, Hong Kong Hansard 1983.09.27. <https://www.legco.gov.hk/en/index.html>. Accessed 25 March 2022. James, *Making*, p. 192.

⁴⁸ Rabushka, *The new China*. The HK\$ depreciated by 13 per cent against the RMB from 9 July to 25 Oct. 1982; this especially affected the price of food imports.

⁴⁹ *The Asian Monetary Monitor*, 7, 5 (Sept.–Oct. 1983), reprinted in Greenwood, *Hong Kong’s link*.

⁵⁰ C. Goodhart, ‘The background to my visit to Hong Kong’, 7 October 1983. BoE 13A218/2.

⁵¹ Greenwood, *Hong Kong’s link*, pp. 104–5; James, *Making*, pp. 192–3.

⁵² Note to file by Wragham, ‘Conversations with DWA Blye on 8 September 1983’, 9 Sept. 1983, Monetary Policy file, HSBC APA.

⁵³ *Ibid.*

⁵⁴ *Ibid.*



starkly exposed the lack of power of the financial secretariat to affect interest rates, even indirectly. Another route to monetary control had proved ineffective.

Turbulence in the markets continued with rumours of capital flight. On 15 September 1983, the *Financial Times* published an on-record interview with Zhou Nan (周南), PRC vice-foreign minister, in which he said, 'China is determined to recover complete sovereignty and administration of Hong Kong'.⁵⁵ The British effort to keep some control of Hong Kong was under public attack. Two days later the HKAB met again but made no change to interest rates. On the following Monday, the *Financial Times* reported the decision taken secretly four months earlier, that the Exchange Fund would 'not be used for large scale intervention in the face of a clear market trend'.⁵⁶ Moreover, hopes that Bremridge would take the opportunity in his half-yearly economic review to reduce the tax on interest paid on Hong Kong dollar deposits to make them as attractive as foreign currency deposits were disappointed. As noted above, Hang Lung Bank was under renewed pressure, leading to an unprecedented government rescue on 27 September.⁵⁷ On top of this collection of cracks in the system, the constitutional talks between London and Beijing resumed on 22–23 September 1983 and ended with only a vague promise that discussion would resume in the end of October – considerable attention was given to the absence of the phrase 'useful and constructive' in the communique, which suggested the talks had gone badly.⁵⁸

The following day, 24 September 1983, the HK\$ reached an all-time low, closing at 9.60 HK\$/US\$ after trading during the day as low as 9.90HK\$/US\$.⁵⁹ A year of debate between banks and colonial agencies about how to restore monetary control had resulted in no fresh options. The government called a summit of monetary officials and the two note-issuing banks on Sunday 25 September, inviting Greenwood to present his proposals for a linked exchange rate to them. HSBC's position going into the meeting was that they were prepared to support the government in any decision they chose although they had doubts about the likely effectiveness of Greenwood's programme. The plan to revert to a currency board was aimed at monetary problems that 'admittedly exist' but it would not have a big enough impact in the short term, given the political situation. They therefore advocated a massive Exchange Fund intervention in the foreign exchange market of US\$200–US\$500 million the following day. HSBC held that, to make this effective, the government should also announce that they would consider pegging the currency (either to the US dollar or a trade-weighted index) 'when it returns to a level which more accurately reflects the underlying strength of the currency', that is, not at the speculatively low rate then prevailing.⁶⁰ There is no record of the meeting itself, but there was no immediate change in policy. Instead, at 5:30 PM they agreed on the text of a statement Blye should make to try to reassure markets.⁶¹ The statement hinted at reforming the Exchange Fund and alluded obliquely to Greenwood's public suggestion:

One proposal which is being actively developed involves a substantial revision of the mechanics for issuing and redeeming certificates of indebtedness to the note-issuing

⁵⁵ M. Baker, 'Peking rules out UK administration in Hong Kong', *Financial Times*, 16 Sept. 1983.

⁵⁶ R. Cottrell, 'Hong Kong fears hit investment', *Financial Times*, 19 Sept. 1983.

⁵⁷ James suggests Blye was distracted by the Hang Lung Bank debacle during these critical days. James, *Making*, p. 192.

⁵⁸ Flowerdew, *The final years*, p. 35.

⁵⁹ 'Is the Hongkong dollar turning into funny money?', *Economist*, 289, 7309 (1 Oct. 1983).

⁶⁰ Memo, 'HSBC position at start of meeting on 26.9.83', Monetary Policy file, HSBC APA.

⁶¹ Draft as agreed 5:30 PM on 25 Sept. 1983, Monetary Policy file, HSBC APA.



banks in such a way as to produce an exchange rate which would more accurately reflect the fundamental strength of the economy...and mean the assumption by the Exchange Fund of a more significant role in the exchange rate determination mechanism.⁶²

Bremridge was in Washington, D.C., at annual International Monetary Fund (IMF) meetings at the time and not party to this statement. On his return on Monday 26 September, the press asked for a comment, and he dismissed the idea of restoring a currency board, seeming to contradict the public statement.⁶³ That same day, the HKAB finally agreed an ambitious increase in prime interest rate of three percentage points to 16 per cent.

Over the 12 months from September 1982 to September 1983, the Exchange Fund spent US\$800 million defending the HK\$ exchange rate, including \$200 million in September 1983 alone (US\$90 million in the week from 20 to 27 September), leaving the Exchange Fund with US\$5.6 billion.⁶⁴ This intervention was less than HSBC had wanted and suggests that the response to the 1983 crisis may even have been less than in 1982. The level of intervention was in line with the agreement not to run down Exchange Fund reserves massively to protect the currency's value. The hint of a return to a peg and modest intervention arrested the fall of the HK\$, but it was clear that this was likely to be a temporary calm.

Confusion ensued over what stabilising measures would be undertaken. Latter prepared a detailed proposal for a currency board, which was shared with HSBC and also sent to Alan Walters in Washington, D.C. Margaret Thatcher was visiting, and a meeting was called at the British Embassy on 28 September 1983, with Chancellor Lawson and Bank of England governor Leigh Pemberton among those present.⁶⁵ Thatcher wanted to know what could be done to stabilise the HK\$ before the resumption of talks with the Chinese on 19 October. A return to a currency board was discussed, and Thatcher asked Lawson and Leigh Pemberton to prepare a report on options by 4 October.

Intensive discussion began in London and Hong Kong around the proposal to fix the exchange rate either to the US\$ or sterling. Latter hammered out the details to require Certificates of Indebtedness to be issued to note-issuing banks at a fixed exchange rate and only in exchange for foreign currency deposits.⁶⁶ The plan did not introduce a pegged rate in the foreign exchange market; rather, the exchange rate would be stabilised through arbitrage. In theory, if the market rate deviated from the Exchange Fund rate, then banks or customers would arbitrage, bringing the market rate back to the official rate. They accepted that if the plan did not restore confidence and the public exchanged all their HK\$ deposits to US\$, this might lead to the demonetisation of the currency.

HSBC staff expressed concern at restoring an official pegged rate. Patel worried that a fixed rate would require active intervention and that the moment the Hong Kong Government could not support it, the system would collapse with severe implications for Hong Kong. He also noted that developed countries around the world were moving away from fixed rates. For him, 'political

⁶² Quoted in 'Is the Hongkong dollar turning into funny money?'.

⁶³ Greenwood, *Hong Kong's link*, p. 143; Goodhart, 'The background to my trip to Hong Kong'.

⁶⁴ Telegram from Youde to Private Secretary to Secretary of State for FCO, 27 Sept. 1983, FCO 40/1615, TNA.

⁶⁵ Letter from Robin Butler, principal private secretary to Thatcher, to John Kerr, Her Majesty's Treasury, 28 Sept. 1983, PREM 19-057, TNA.

⁶⁶ 'A plan for stabilising the exchange rate', 27 Sept. 1983, Monetary Policy file, HSBC APA.



anxiety cannot be cured by monetary credicine', by which he meant that he objected to relying on the public viewing the peg as credible as a medicine for a sick monetary system.⁶⁷ Peter Hammond, Deputy Chairman of HSBC, warned Blye that the proposal seemed to cover currency notes only, but in reality the Hong Kong government would be guaranteeing convertibility of deposits, as well, and this could quickly become unsupportable. He concluded that 'Frankly I have no better alternative for the short-term solution of the exchange rate problem. But it is essential that we all know what we are letting ourselves in for before we start the scheme and are prepared to face the consequences'.⁶⁸ Meanwhile, Governor Youde had a secret plan to fully replace the HK\$ with sterling in the event of a currency collapse.⁶⁹ Clearly there was no consensus about a return to a currency board or whether it would work, but at the same time, no viable alternative was presented. Instead, the government took the time to try to get further inspiration and guidance.

IV | THE VIEW FROM LONDON

With this impasse between the banks and the government's advisers, on 29 September 1983, Bremridge asked the Bank of England for advice.⁷⁰ In his history of the Bank of England, James devotes a full chapter to this episode, based mainly on Bank of England archives.⁷¹ In London, it was expected that continued political uncertainty would make periodic crises inevitable as the people of Hong Kong decided whether to transfer assets overseas during the next 15 years.⁷² The HK\$'s vulnerability to confidence crises meant that stabilising it would be a challenge, and the British reserves or taxpayers might have to pay the cost. A run on the HK\$ would necessarily imply the liquidation of deposits into cash or transfers abroad, and while Hong Kong's foreign exchange reserves were amply sufficient to back the note issue, they would not cover all HK\$ deposits as well. Any shortfall would need to be met by the Bank of England in sterling or dollars against claims in potentially worthless HK\$. In sum, the Bank of England's initial view was that 'a doubt must remain about whether the adjustment to a fixed rate... 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'.⁷³

The Bank of England sent Charles Goodhart, together with David Peretz from Her Majesty's Treasury, to Hong Kong for 4–6 October 1983, where they met with government officials and bankers over these few intense days. Goodhart's view was that the currency board proposal was technically feasible and would function on a form of autopilot once in place, and that a US dollar link would make more sense than a sterling link since the dollar was far more important for Hong Kong's economy as an intermediary in the growing trade and business relationship between China and the United States. He noted that neither HSBC nor Standard Chartered Bank were

⁶⁷ Memo prepared by D. K. Patel HSBC, 28 Sept. 1983, Monetary Policy file, HSBC APA.

⁶⁸ Letter from P. Hammond to D. Blye, 28 Sept. 1983, Monetary Policy file, HSBC APA.

⁶⁹ Memo by C. D. Elston, 'Advice for the Governor of the Bank of England', 30 Sept. 1983. 13A218/2, BoE.

⁷⁰ Telegram no. 1436, 29 Sept. 1983 from Bremridge to Clift, FCO, PREM19-1057 2, TNA.

⁷¹ James, *Making*, ch 7.

⁷² Memo by Elston, 'Advice for the Governor of the Bank of England'. The paper was based on discussions with Holland and Goodhart.

⁷³ *Ibid.*



enthusiastic about a currency board, but both banks thought it was the least bad option at the time, especially given Blye's public remarks (agreed on at the 25 September summit), which had raised expectations of this outcome.⁷⁴ In their respective reports both Goodhart and Peretz pointed out that the various proposals dealt only briefly with whether only notes in circulation or all local currency deposits should be covered by the currency board.

From the Treasury's point of view, Peretz noted that the Exchange Fund held some US\$5 billion in assets, which would be more than sufficient to cover the HK\$ notes outstanding (HK\$1.4 billion at the time).⁷⁵ The Treasury's legal analysis set out Britain's responsibilities for the liabilities of the Hong Kong government. Rather ominously, it made clear that 'the financial obligations of the Hong Kong government are in law debts of the Crown'.⁷⁶ The outcome, therefore, had implications for the British foreign exchange reserves.

The scheme was scheduled to be debated in the Hong Kong Executive Committee on Wednesday 12 October 1983, announced after close of business on Thursday 13 October, and introduced the following Monday 17 October after a bank holiday on the Friday. In the event, the announcement was delayed until Saturday 15 October. In the meantime, on 14 October, Thatcher wrote to Zhao 'expressing willingness to explore Chinese ideas and holding out the possibility of a settlement on those lines' (i.e. no continuation of British administration after 1997), and the British Ambassador also sent a reassuring message.⁷⁷ The overwhelming priority for the British government was to avoid the collapse of the negotiations. The very next day, Bremridge announced the new linked exchange rate regime to stabilise the HK\$ exchange rate. It is hard to imagine that these two events, which so fundamentally affected stability and prosperity in Hong Kong, were unrelated, particularly given the emphasis placed by Deng and Bremridge a year earlier on the importance of currency stability to the future of Hong Kong. At the same time, Bremridge finally removed the withholding tax on HK\$ deposits to make HK\$ deposits more attractive.⁷⁸

From Monday 17 October 1983 the two note-issuing banks paid for Certificates of Indebtedness in foreign currency, at a rate fixed at 7.80 HK\$ per US\$, and the Exchange Fund redeemed them at the same rate. The note-issuing banks in turn provided notes to other banks with a small margin, and the market rate was expected to converge towards the official rate through arbitrage. The Bank of England/Treasury mission from London to Hong Kong initially agreed with the consensus for a rate of about HK\$8/US\$1, which was lower than the rate prevailing before the political speculation, but in the end \$7.80 was chosen.⁷⁹

To operate the peg, HSBC opened US\$ accounts with each bank, and daily settlement took place through New York at the official rate. The exchange rate stabilised, but it was not on 'auto-pilot'. There was substantial intervention during the first weeks, mainly carried out by HSBC selling US\$ to the market. In the first day of operation, the dollar closed the day at \$7.96/US\$, and Bremridge admitted there was 'confusion and misunderstanding' about the new arbitrage system.⁸⁰ In the

⁷⁴ Goodhart, 'The background to my trip to Hong Kong'.

⁷⁵ Note by D. Peretz, 6 Oct., PREM 19-1058, TNA.

⁷⁶ Letter from Mr. J. M. Beastall, 28 Oct. 1983, T520-47, TNA.

⁷⁷ Flowerdew, *The final years*, p. 36.

⁷⁸ 'Government measures to stabilise the exchange rate: explanatory note', 15 Oct. 1983, statement issued by the Secretary for Monetary Affairs, Monetary Policy file, HSBC APA.

⁷⁹ C. Goodhart, 'Report on proposed exchange rate regime', 6 Oct. 1983, 13A218/2, BoE.

⁸⁰ A. Cass, 'Hong Kong currency markets uncertain', *Financial Times*, 18 Oct. 1983.



end, the system was designed to ensure a fixed exchange rate not for the general public's holding of HK dollars but only for the value of Certificates of Indebtedness issued by the Exchange Fund. Through the issue and redemption of currency notes, arbitrage was expected to draw the market rate close to the official rate for Certificates of Indebtedness.

In the first few days, banks ran substantial overdrafts with HSBC. Between 17 and 18 October 1983, they surged from HK\$374 million to HK\$1580 million, while banks' current accounts at HSBC fell from HK\$1213 million on 17 October to HK\$286 million the next day.⁸¹ The overnight interest rate peaked at 40 per cent on a per annum basis in the first week while the three-month interbank rate reached 23 per cent.⁸² In the first three days of the scheme, there was a net redemption of only HK\$25 million of Certificates of Indebtedness; the demand for US\$ was mainly met by HSBC and Standard Chartered Bank rather than going through the Exchange Fund.⁸³

HSBC concluded that the initial operations were successful partly because of the public's confidence (and perhaps relief) in the announcement and partly because the successful resumption of Sino-British talks released political pressure.⁸⁴ On 20 October 1983, the next round of Sino-British talks ended, and the reassuring words 'useful and constructive' reappeared in the communique.⁸⁵ In internal evaluations later in October, senior managers at HSBC disagreed over how the system worked, but they were clear that the note-issuing banks, and in particular HSBC, would end up paying the price of support rather than the Exchange Fund.⁸⁶ This prompted staff at HSBC to suggest that the Bank of China should become a note-issuing bank to 'lead to considerable reduction in our expenses'.⁸⁷ The Bank of China did indeed become the third note-issuing bank but not until 1994.

The Joint Declaration setting out the one country, two systems framework was signed in December 1984, 14 months after the currency board was re-established. In line with the first round of negotiations in 1982, it confirmed that 'The Hong Kong dollar will continue to circulate and remain freely convertible'.⁸⁸ Moreover, the Exchange Fund would continue to be 'managed and controlled by the Hong Kong SAR Government, primarily for regulating the exchange value of the Hong Kong dollar'.⁸⁹ The Joint Declaration cleared the way for the Basic Law that established the detailed constitutional position between Beijing and the Hong Kong SAR in April 1990.

The early drafts of the Basic Law (April 1986) replicated the Joint Declaration with respect to the currency but also obliquely referred to continuing the currency board: 'the issue of the Hong Kong currency must have full reserve'. In August 1987 the drafting committee replaced this sentence to be more specific: 'The issue of Hong Kong currency must have not less than 100 per

⁸¹ Memo by Hammond, 31 Oct. 1983, HK0192/101(2), HSBC APA.

⁸² *Far Eastern Economic Review*, 27 Oct. 1983.

⁸³ Internal memo by Patel, HSBC, 7 Nov. 1983, Monetary Policy file, HSBC APA.

⁸⁴ Memo by A. C. R. Chappell, General Manager Group Finances to Hammond, 24 Oct. 1983, HK0192/101(2), HSBC APA. James relates ongoing nervousness about the resilience of the system in London and periodic strains in the years that followed; James, *Making*, pp. 194–6.

⁸⁵ Tsim, 'Peking's strategy'.

⁸⁶ Internal memo from A. C. R. Chappell, General Manager Group Finances to Hammond, 24 Oct. 1983, memo from Hammond to Chappell, 31 Oct. 1983, and internal memo from D. K. Patel to Assistant General Manager Finance, 7 Nov. 1983, Monetary Policy file, HSBC APA.

⁸⁷ Internal memo T. W. O'Brien to Assistant General Manager Finance, 24 Oct. 1983, Monetary Policy file, HSBC APA.

⁸⁸ Art. 3 (7), *Joint Declaration*.

⁸⁹ Annex 1, Section VII, *Joint Declaration*.



cent currency reserve'.⁹⁰ By April 1988, 'The issue of Hong Kong currency shall be backed up by a reserve fund of no less than 100 per cent freely convertible foreign currency'. This ruled out backing by the RMB. In the summer of 1987, the PRC Consultative Committee considered the future exchange rate regime (fixed or floating) but in the end decided that this question 'would not be appropriate for discussion in the Basic Law'.⁹¹ The Special Group of Finance, Business, and Economy of the PRC Consultative Committee also considered 'the management of the Exchange Fund by an independent trust organisation', but their records from August 1987 noted that 'it would seem that it would not be necessary to include this point'.⁹² The final version of the Basic Law agreed on in April 1990 referred only to the convertibility of the Hong Kong dollar and stated 'The Exchange Fund of the Hong Kong SAR shall be managed and controlled by the government of the Region, primarily for regulating the exchange value of the Hong Kong dollar' (Article 113).⁹³

However, this was not the end of the story. The Bank of England was concerned about the vagueness of monetary arrangements after 1997. The UK Treasury and the FCO noted that the linked exchange rate was very fragile since the Hong Kong government did not promise to defend the exchange rate and it did not have the means to intervene in markets to do so.⁹⁴ The stable exchange rate had more to do with public perception and ignorance about the frailties of the system – indeed, Patel's 'credicine'. The Bank of England's view was that a more stable system had to be in place by 1997, and HSBC could not be expected to remain a *de facto* central bank after the handover. One alternative was to make the Bank of China take on some or all of HSBC's responsibilities, but at the time, this was considered politically as well as practically difficult. The Bank of China's increasing commercial commitment to Hong Kong was welcomed, but the financial community 'would almost certainly balk at the prospect of the currency and monetary policy being at the mercy of a bank controlled by Beijing'.⁹⁵ Their favoured alternative was to create a proper monetary authority and reduce the role of commercial banks in monetary policy matters. This was achieved in 1994 by a new Hong Kong Monetary Authority; in the same year, the Bank of China became a note-issuing bank.

V | CONCLUSION

To say that the currency board came about by accident is to overstate events, but the archival record definitely shows how the impasse between the banks, the monetary authorities, and an influential (if irritating) external observer was partly resolved by an interim joint statement that encouraged public expectations that the currency board would be adopted. In the context of political as well as economic uncertainty, the risks from disappointing these expectations led to the decision to adopt a dollar peg and to use HSBC's resources to create confidence in the ability

⁹⁰ China (People's Republic) Consultative Committee for the Basic Law of the Hong Kong SAR. Special Group of Finance, Business and Economy, Final report on finance, taxation, monetary system, and principles of the economic system, 8 Aug. 1987. <http://ebook.lib.hku.hk/bldho/articles/BL0344.pdf>.

⁹¹ Ibid.

⁹² Ibid.

⁹³ This formed Article 116 in the April 1988 draft.

⁹⁴ BoE memo, 'Hong Kong: Monetary Policy and 1997', Sept. 1985, T450/483, TNA.

⁹⁵ Ibid. See also James, *Making*, on the Bank of England's view of HSBC's role.



to hold it through the Exchange Fund. Williamson's paradox was turned on its head; the public expected a currency board, and so the authorities reluctantly had to provide it to recover confidence. The currency board was an option partly because the apparatus for it already existed as a legacy of the colonial system that had operated from the 1930s to 1974. However, this was not a snap decision; the problems of the monetary system for this small, open economy and proposals for its reform had been under discussion privately for a year since the exchange rate disruption of September 1982.

All the problems did not stem from Hong Kong's unique political situation. The flurry surrounding the illiquidity of Hang Lung Bank in September 1982, which was not related to the political situation, combined with US monetary policy to depress the HK dollar exchange rate on the eve of the negotiations. When Thatcher met with her Chinese counterparts in September 1982, therefore, the dollar was a core issue for discussion. Although quickly overcome, the currency instability at that time elevated the exchange rate into the centre of the political negotiations. Both China and Britain had strong incentives to ensure currency stability: China earned its foreign exchange from Hong Kong and held substantial assets denominated in HK\$; Britain faced millions of people entering the United Kingdom from Hong Kong if the talks faltered. They were also legally responsible for providing a currency for Hong Kong in the 15 years until the handover. By the time of the next round of negotiations in 1983, the final collapse of the Hang Lung Bank threatened another round of bank instability. By this time the exchange rate was well established as one of the crucial elements of any settlement between Britain and China. Thus, currency instability affected the political talks as much as the political talks affected the exchange rate. The September 1983 handover negotiations once again stressed the importance not of price stability in Hong Kong but rather exchange rate stability.

The design and introduction of the currency board were rushed and somewhat haphazard. Even HSBC as the primary note issuer was not fully convinced that this solution would work. The Bank of England, similarly, viewed it as a risky initiative but probably inevitable once public expectations had been raised. Even then, there was no strong consensus on how it worked, but public confidence was strong enough to avoid testing the system too vigorously. The removal of withholding tax on interest paid on Hong Kong dollar deposits most likely contributed to restoring confidence. This left a breathing space in the years that followed to build a stronger scaffolding for the Exchange Fund as the terms of the Joint Declaration were finalised. This fed through to the Basic Law, where it is still part of the constitutional foundation for the relationship between the Hong Kong SAR and the rest of China. The ambiguity in the system was recognised by the Hong Kong and British authorities at the time and resolved with the Accounting Arrangements of 1988 and the creation of the Hong Kong Monetary Authority in 1994, which also ended HSBC's dominant role in the monetary system. That is a process that remains to be fully explored and may provide further insights into the resilience of Hong Kong's unusual currency arrangements since 1997.

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