Collection: Laux, David N.: Files
Folder Title: China – Foreign Relations – Hong Kong (02/26/1983-05/04/1983)
Box: RAC Box 13

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name LAUX, DAVID: FILES

Withdrawer
CAS 6/10/2010

File Folder CHINA-FOREIGN RELATIONS-HONG KONG (2/26/83-5/4/83)

FOIA
M09-299/1
COLLINGS

Box Number 13

13

ID	Doc Type	Document Description	No of Pages	Doc Date	Restrictions	
92416	CABLE	260132Z FEB 83 ***D 12/20/2017 M299/1***	1	2/26/1983	B1	B3
92417	CABLE	260109Z FEB 83 ***D 12/20/2017 M299/1***	1	2/26/1983	B1	B3
92418	CABLE	281932Z FEB 83 ***D 12/20/2017 M299/1***	1	2/28/1983	B1	B3
92419	CABLE	012233Z MAR 83 ***D 12/20/2017 M299/1***	1	3/1/1983	B1	B3
92420	CABLE	022205Z MAR 83 ***D 12/20/2017 M299/1***	1	3/2/1983	B1	B3
92421	CABLE	042230Z MAR 83 ***D 12/20/2017 M299/1***	2	3/4/1983	B1	B3
92422	CABLE	HONG KONG 04068 ***R 6/21/2012 M299/1***	2	3/8/1983	B1	
92423	CABLE	RE HONG KONG ***D 12/20/2017 M299/1***	10	3/21/1983	B1	B3
92424	REPORT	RE HONG KONG ***D 12/20/2017 M299/1***	2	3/23/1983	B1	B3

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name LAUX, DAVID: FILES

Withdrawer
CAS 6/10/2010

File Folder CHINA-FOREIGN RELATIONS-HONG KONG (2/26/83-5/4/83)

FOIA
M09-299/1
COLLINGS

Box Number 13

13

ID	Doc Type	Document Description	No of Pages	Doc Date	Restrictions	
92425	REPORT	RE HONG KONG (ATTACHMENT TO 92424) *PAR 12/20/2017 M299/1*	15	ND	B1	B3
92426	REPORT	241839Z MAR 83 *D 12/20/2017 M299/1*	1	3/24/1983	B1	B3
92427	REPORT	RE HONG KONG *PAR 12/20/2017 M299/1*	7	4/6/1983	B1	B3

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name	*Withdrawer*
LAUX, DAVID: FILES	CAS 6/10/2010
File Folder	*FOIA*
CHINA-FOREIGN RELATIONS-HONG KONG (2/26/83-5/4/83)	M09-299/1 COLLINGS
Box Number	
13	13

ID	*Document Type* *Document Description*	*No of pages*	*Doc Date*	*Restrictions*
92416	CABLE 260132Z FEB 83	1	2/26/1983	B1 B3

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name	*Withdrawer*
LAUX, DAVID: FILES	CAS 6/10/2010
File Folder	*FOIA*
CHINA-FOREIGN RELATIONS-HONG KONG (2/26/83-5/4/83)	M09-299/1 COLLINGS
Box Number	
13	13

ID	*Document Type* *Document Description*	*No of pages*	*Doc Date*	*Restrictions*
92417	CABLE 260109Z FEB 83	1	2/26/1983	B1 B3

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name	*Withdrawer*
LAUX, DAVID: FILES	CAS 6/10/2010
File Folder	*FOIA*
CHINA-FOREIGN RELATIONS-HONG KONG (2/26/83-5/4/83)	M09-299/1 COLLINGS
Box Number	
13	13

ID	*Document Type* / *Document Description*	*No of pages*	*Doc Date*	*Restrictions*
92418	CABLE 281932Z FEB 83	1	2/28/1983	B1 B3

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name	*Withdrawer*
LAUX, DAVID: FILES	CAS 6/10/2010
File Folder	*FOIA*
CHINA-FOREIGN RELATIONS-HONG KONG (2/26/83-5/4/83)	M09-299/1 COLLINGS
Box Number	
13	13

ID	*Document Type* *Document Description*	*No of pages*	*Doc Date*	*Restrictions*
92419	CABLE 012233Z MAR 83	1	3/1/1983	B1 B3

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name LAUX, DAVID: FILES	*Withdrawer* CAS 6/10/2010
File Folder CHINA-FOREIGN RELATIONS-HONG KONG (2/26/83-5/4/83)	*FOIA* M09-299/1 COLLINGS
Box Number 13	13

ID	*Document Type* *Document Description*	*No of pages*	*Doc Date*	*Restrictions*
92420	CABLE 022205Z MAR 83	1	3/2/1983	B1 B3

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name
LAUX, DAVID: FILES

Withdrawer
CAS 6/10/2010

File Folder
CHINA-FOREIGN RELATIONS-HONG KONG (2/26/83-5/4/83)

FOIA
M09-299/1
COLLINGS

Box Number
13

13

ID	*Document Type* *Document Description*	*No of pages*	*Doc Date*	*Restrictions*
92421	CABLE 042230Z MAR 83	2	3/4/1983	B1 B3

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

~~CONFIDENTIAL~~

92422

INCOMING TELEGRAM

NATIONAL SECURITY COUNCIL MESSAGE CENTER

PAGE Ø1 OF Ø2 AMCONSUL HONG KONG 4Ø68 DTG: Ø81ØØ6Z MAR 83 PSN: ØØ2Ø84
EOBØ92 ANØØ9366 TOR: Ø67/15Ø5Z CSN: HCE892

DISTRIBUTION: CHLD-Ø1 FORT-Ø1 MYER-Ø1 SIGU-Ø1 GUHN-Ø1 LAUX-Ø1
DUR-Ø1 /ØØ7 A1

EXDIS EXDIS EXDIS EXDIS

WHTS ASSIGNED DISTRIBUTION:
SIT:
EOB:

DECLASSIFIED
NLRR M299 # 92422
BY KML NARA DATE 6/21/12

HK

ROUTINE
STU3574
DE RUMJNG #4Ø68 Ø671ØØ6
R Ø81ØØ6Z MAR 83
FM AMCONSUL HONG KONG

TO SECSTATE WASHDC 58Ø9

INFO AMEMBASSY BEIJING 4318
AMEMBASSY LONDON 444Ø
AIT TAIPEI
AMEMBASSY TOKYO 899Ø

~~C O N F I D E N T I A L~~ HONG KONG Ø4Ø68

EXDIS
E. O. 12356: DECL: OADR
TAGS: PGOV, PREL, UK, HK, CH
SUBJECT: SINO-BRITISH DIALOGUE HITS STUMBLING BLOCK

1. C - ENTIRE TEXT.

2. HONG KONG POLAD IN A CAREFULLY WORDED CONVERSATION WITH CONGENOFF ON MARCH 7 HAS IMPLIED THERE ARE SERIOUS PROBLEMS IN CURRENT SINO-BRITISH TALKS ON HONG KONG'S FUTURE. RESPONDING TO CONGENOFF'S QUESTION ON WHETHER TALKS HAD RESUMED, POLAD STATED THAT WHILE "CONTACTS" CONTINUED, THE CHINESE HAVE NOT YET BEGUN "SUBSTANTIVE DISCUSSIONS" ON THE 1997 QUESTION. HE DECLARED THE CHINESE HAVE ADOPTED A TRADITIONAL NEGOTIATING TACTIC, PRESSING FOR ACCEPTANCE OF THEIR UNDERLYING PRINCIPLE OF CHINESE SOVEREIGNTY OVER HONG KONG, BEFORE CONSENTING TO TALK ABOUT MODALITIES. ON THE LOCAL SCENE, POLAD NOTED THAT THE UNITED FRONT OFFICIALS WERE ACTIVE IN ARTICULATING THE PRC POSITION ON SOVEREIGNTY. (DEPARTMENT WILL HAVE ALREADY SEEN FBIS HKØ3Ø655 MARCH 83 WHICH PROVIDES A WEN WEI BAO EDITORIAL ON THE NECESSITY FOR BRITAIN TO ACKNOWLEDGE CHINESE SOVEREIGNTY.)

3. WHEN QUESTIONED ABOUT GOVERNOR YOUDE'S VISIT TO LONDON CONCURRENT WITH ARRIVAL OF AMBASSADOR SIR PERCY CRADDOCK FROM BEIJING, POLAD STATED UNCONVINCINGLY THAT VISITS WERE PART OF THE REGULAR DIALOGUE ON THE 1997 ISSUE. (COMMENT: DIPLOMATIC OBSERVERS HERE, HOWEVER, HAVE TAKEN NOTE OF SIR EDWARD'S TWO EARLIER TRIPS IN THE NOT SO DISTANT PAST AND HAVE CONCLUDED THAT A TRIP AT THIS TIME COULD ONLY BE BASED ON CONCRETE DEVELOPMENTS OR PROBLEMS. THESE OBSERVERS HAVE ALSO BEEN STRUCK BY THE SLOW RATE OF PROGRESS IN THE TALKS TO DATE AND SPECULATE THAT ONE SIDE OR THE OTHER MUST BE PRESSING FOR A BREAKTHROUGH. END COMMENT)

4. POLAD STATED THAT HE BELIEVED LOCAL EXPECTATIONS

~~CONFIDENTIAL~~

9

NATIONAL SECURITY COUNCIL
MESSAGE CENTER

INCOMING TELEGRAM

OR HOPES FOR AN EARLY SETTLEMENT OF HONG KONG'S FUTURE HAD SOMEWHAT DIMINISHED, THEREBY LESSENING THE PRESSURES. HE EXPLAINED THAT PRC STATEMENTS HAD MORE OR LESS REASSURED PEOPLE THE SITUATION WOULD NOT CHANGE BEFORE 1997 AND THAT THERE WAS STILL TIME LEFT TO CARRY ON REGULAR BUSINESS ACTIVITIES. HE DECLARED CHINA'S REASSURANCES THAT HONG KONG'S "SYSTEM" WOULD BE PRESERVED HAD ALSO BEEN BENEFICIAL (HK 3287).

5. COMMENT.
POLAD'S WORDS WERE CAREFULLY CHOSEN SO AS NOT TO REVEAL THE SUBSTANCE OR NATURE OF THE DISCUSSIONS. HE NEVERTHELESS CONVEYED THE IMPRESSION THAT ALTHOUGH THE NEED FOR PROGESS ON THE TALKS WAS LESS URGENT THAN SEEMED THE CASE A FEW MONTHS AGO, THE BRITISH REMAINED TROUBLED BY CHINA'S TOUGH INSISTENCE THAT ITS SOVEREIGNTY OVER HONG KONG BE ACKNOWLEDGED BEFORE ANY SPECIFICS CAN BE DISCUSSED.
LEVIN
BT

EXDIS EXDIS EXDIS EXDIS

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name
LAUX, DAVID: FILES

Withdrawer
CAS 6/10/2010

File Folder
CHINA-FOREIGN RELATIONS-HONG KONG (2/26/83-5/4/83)

FOIA
M09-299/1
COLLINGS

Box Number
13

13

ID	*Document Type* / *Document Description*	*No of pages*	*Doc Date*	*Restrictions*
92423	CABLE RE HONG KONG	10	3/21/1983	B1 B3

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name
LAUX, DAVID: FILES

Withdrawer
CAS 6/10/2010

File Folder
CHINA-FOREIGN RELATIONS-HONG KONG (2/26/83-5/4/83)

FOIA
M09-299/1
COLLINGS

Box Number
13

13

ID	*Document Type* / *Document Description*	*No of pages*	*Doc Date*	*Restrictions*
92424	REPORT RE HONG KONG	2	3/23/1983	B1 B3

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

EO 13526 3.3(b)(1)>25Yrs

92425

CONFIDENTIAL ~~CONFIDENTIAL~~

HONG KONG

CONFIDENTIAL

I. Economy

A. GENERAL POLICY MICROFILMED

1. POLICY ENVIRONMENT: A TIME OF TROUBLES.

a. THE GLOBAL RECESSION. Hong Kong is wallowing in recession. Merchandise export revenues and volumes have been depressed by global recession. Slumping world trade also cut invisible export receipts, e.g., from shipping, insurance, and tourism.

Heavy losses among shipping firms had a wider impact. Many Hong Kong shipping firms are part of large, real estate-based conglomerates. Shipping losses weakened the parent firms. Most of these firms had borrowed heavily from banks, collateralizing the loans with property. This was fine so long as rents and prices kept rising. However, such highly leveraged firms were quite exposed financially to the high world interest rates which accompanied this trade slump (see below).

b. BOOM + HIGH RATES = BUST. Unlike most developing countries, Hong Kong has almost no debt. Thus, unlike Mexico, high rates did not cause a debt-service crisis in Hong Kong. However, the external slump combined with high rates collapsed the latest property boom. The property market drives the internal economy. By end-1981 the property market - bloated by too much construction and steadily rising prices - had begun to weaken. Lower economic growth and high rates eroded real estate demand and prices. The Hang Seng stock market index - dominated by property shares - reflected this trend. It topped 1,800 in July 1981. By end-year it was down to 1,400.

c. THAT SINKING FEELING. The economy's growing weakness in 1982 relentlessly depressed office occupancy rates, rents, and prices. Property development firms' revenues fell. Debt service costs soared, driven by high rates. Moreover, falling prices cut the collateral value of property use to back bank loans. Those who had bought in order to re-sell quickly at a higher price were disappointed. Some property firms failed. They dragged along with them a few second-tier financial institutions. This

CONFIDENT

DECLASSIFIED IN PART
NLRR M299/1 #92425
BY RW NARA DATE 12/20/17

sequence of events in some ways parallels developments in the U.K. in 1974-75.

d. THE LAST STRAW. An external jolt brought the crisis to a head. After lengthy preparation, in mid-September 1982 the British and Chinese premiers met to discuss Hong Kong's post-1997 future. The Chinese insisted on getting both sovereignty and the right to administer Hong Kong as soon as the lease expired (see below). Beijing left open the possibility of a long transition period and the grant of broad local self-government powers. Unreassured, Hong Kong investors shuddered. The stock market - already well-down from its end-1981 level - nose-dived. At end-September, shares lost 12 percent of their value in the two trading days following the Sino-British meetings. The Hong Kong dollar plummeted, hitting what may have been a 25-year low against the U.S. dollar.

e. THE CRUNCH. By end-October 1982, two large real estate firms failed to meet their obligations. So far, six second-tier financial institutions - deposit-taking companies, DTCs - have failed. These DTC's were not bank subsidiaries. They were either part of property firms or had extended credit to such firms. The failed mainly because they depended on money market lines for funding.

Bankers' tightening of lending policies - much as they had in the case of Latin American sovereign borrowers earlier in the year - was too much for tottering DTC's. There was a risk of wider failures. The Hongkong and Shanghai Bank (HSBC) - which although a private sector commercial bank functions as the central bank - stepped in. It offered to help any basically sound DTC short on liquidity. To re-assure investors about Hong Kong's long-term future, the HSBC also offered 20-year mortgages. These loans would expire after the date on which China intended to resume control of Hong Kong.

f. EPITAPH TO A BOOM. The government is Hong Kong's largest landlord. It also suffered from the property sector bust. Property revenues became a big part of total revenues (see below). Weak prices cut these revenues. Early in November, the auction of a prime central Hong Kong site failed to draw any acceptable bids. The government had hoped to realize U.S. $150 million. Further, plans to finance subway system expansion with property development revenues had to be delayed. The venture had become unprofitable. In this fiscal year (FY1982-83, ending 31 March), Hong Kong will have its first budget deficit since 1974-75.

2. ECONOMIC GROWTH. The FY1982-83 budget assumed 8 per cent real GDP growth. The estimate was twice reduced, ultimately to 4 percent. This result contrasts sharply with 11 percent real growth in 1981. Weak exports underlay most of this slump. The investment rate dropped thanks to political uncertainties. If 4 percent growth is achieved, it will be the lowest recorded since 1974-75, when only two percent real growth was managed.

In October, financial secretary John Brembridge said that in framing the budget, he had assumed 1 percent real growth in the U.S. By October, he expected as much as a 2 percent contraction in the U.S. economy. He is now preparing the FY 1983-84 budget. Given the OECD's most recent forecast of 1.5 percent real growth for its members in 1983, a 5 percent growth rate for Hong Kong would be a reasonable target.

3. BUDGET AND PUBLIC FINANCE.

a. RECENT TRENDS.

(1) A GROWING PUBLIC SECTOR. Between FY1977-78 and FY1981-82 government outlays rose an average of 16.5 percent each year. Real GDP rose by only 10.7 percent, on average. The public sector's share of resources has grown steadily, except in FY 1978-79. Over this period it has grown from 15.4 percent to 22.9 percent of GDP. Government land sales revenues fuelled this explosive growth. Even so, the ratio is low by world standards. In Sweden, for example, it is close to 60 percent. Brembridge - in announcing the FY1982-83 budget - expressed concern, and said he hoped to reverse this trend.

(2) SPENDING. Spending patterns have also changed. Outlays on infrastructure (roads, transport, civil engineering, etc.) rose from 23.9 percent in 1977-78 to 27.3 percent of outlays in 1981-82. Social services spending fell fractionally to 41.6 percent in 1981-82. However, housing outlays rose from 11.2 percent of total spending in 1977-78 to 16.4 percent in 1981-82. All other spending fell from 34

percent to 31.1 percent. These changes reflected the governments' desire to improve the quality of life.

(3) REVENUES. In this five-year period, direct taxes - those on income and profits - gained in importance vis-a-vis indirect (e.g., excise) taxes. Even so, the personal income tax is set at 15 percent; corporte profits tax is 16.5 percent. These are low rates by world standards.

Generally, because non-tax revenues (fees and charges) have risen in line with tax receipts, taxes' contribution to revenues changed only a little. In 1981-82, taxes brought in about 70 percent of government revenues. During this period, land sales revenues rose sharply, from 15 percent in 1976-79, to 35 percent in 1978-81.

(4) CHRONIC SURPLUSES. For each of the past 10 fiscal years, Hong Kong has recorded surpluses on the budget current account. These have more than sufficed to cover chronic capital account deficits. Only in FY 1974-75 was there an overall deficit, which had to be carried forward.

b. 1982: THE BEST LAID PLANS. The collapse of the property market de-railed Brembridge's financial plans for 1982-83. First, the 12 percent rise in spending far exceeded real economic growth, despite Brembridge's desire to close this gap. The public sector's share of GDP probably rose to 25 percent. The government counted on realizing U.S. $2 billion from its property sales, about one-third of total revenues. At best half that amount probably was earned. Although a $365 million budget current account surplus was forecast in February 1982, a deficit of up to $800 million may result. A $1.2 billion surplus carried over from 1981-82 will cover this deficit. In addition, the government has disposable fiscal reserves of some $2.5 billion.

c. 1983-84 AND BEYOND. The property market is likely to remain depressed. There is a massive over-supply. Cash-short firms will try to liquidate assets whenever the market permits. As a result, the government cannot expect a sustained near-term rebound in its land sales revenues. Unless taxes are raised and/or spending cut sharply, Hong Kong might actually record two successive overall deficits. While capital spending will be trimmed, current spending - on infrastructure, housing, schooling, social services, and law enforcement - cannot be slashed. Tax rises are equally problematic. Higher taxes would diminish Hong Kong's appeal as an international business center. Moreover, higher taxes would further strain corporate balance sheets, weakened by recession.

Brembridge faces no soft choices. Accepting repeated deficits suggests government borrowings. Hong Kong could issue debt: buyers would probably be plentiful. Equally, bank borrowings would be possible. One suspects that in the first instance, Brembridge will draw on the reserves in the hope that the economy will pick up before the reserves run down.

4. **MONEY SUPPLY / INFLATION.**

a. **MONEY SUPPLY.**

(1) **DEFINITIONS.** Hong Kong's development into a world-scale financial center has required the the authorities to re-shape the money supply statistics. Such refinements reveal new trends which affect policy-making. Broader definitions with more detailed data have been adopted. While this helps the authorities, it hinders those seeking a longer-term perspective. A series going back to 1977 must be based on M-2 (M-1 [cash held by non-financial sector public + demand deposits with licensed banks] + licensed banks' time and savings deposits).

Beginning in 1978, a broader measure, M-3, was introduced. It consists of M2 plus deposits with deposit-taking institutions (second-tier financial institutions). In August 1981, the authorities re-shaped the statisctics, dividing each aggregate to show the Hong Kong dollar element. This component most accurately reflects domestic economic trends. However, it only extends back to December 1980. It thus is not easy to follow a consistent trend in Hong Kong's recent money supply data.

(2) **RECENT TRENDS.** Heavy bank borrowings fuelled the property boom. This underpinned rapid money supply growth rates during the past three years. Hong Kong $

M-3 data show that recessive conditions in the export and property sectors have sharply reduced money supply growth rates. This doubtless reflects the fall in bank loans to the private sector.

b. **INFLATION.** The second oil price shock more than doubled Hong Kong's inflation rate. Since its 1980 peak of nearly 15 percent, the growth rate has gradually decelerated. The decline has been retarded by internal and external factors. The depreciation of the Hong Kong dollar - particularly vis-a-vis the U.S. dollar - offset some of the fall in U.S. dollar-denominated commodity prices. Import prices tended to rise in 1981. Moreover, rapid economic growth through 1981 pushed up domestic demand. As a result, there was an internal cost-push element to price rises. During 1982, the HK dollar's depreciation also retarded the fall in consumer prices. This may have been offset at least in part by the impact of the local recession on domestic demand. Even so, retail price rises may have dropped into single digits for the first time since 1978.

5. **LABOR MARKET.** As a rule, the recession has pushed up unemployment rates to post-World War II record levels in most countries. Hong Kong is an exception. Seasonally adjusted unemployment in June stood at 3.4 percent, up from 3.1 percent in December 1981. Two factors are significant. First, there were few lay-offs in the industrial sector and service sector employment rose markedly. Second, the average number of hours worked in manufacturing fell. In second-half 1982, the economy's continued weakness probably caused lay-offs to increase. The financial sector slump suggests that unemployment rose sharply.

6. **FINANCIAL MARKETS.** Hong Kong interest rates have come down during 1982, in line with world rates. Weak domestic demand growing out of the property market slump and sagging exports also is a major factor. During the first-half, leading banks' profits rose in real terms (basis first half 1981. For example, the Hong Kong and Shanghai Bank's (HSBC) profits rose by 18.1 percent. The Hang Seng Bank's profits rose by 19 percent.

The second-half picture is likely to be much less rosy. Nervousness about the future touched off a run on a small Bank early in September. Prompt help from other Banks caused the run to fail. However, property market-related failures among Hong Kong's

CONFIDENTIAL

[redacted]

second-tier financial institutions - the deposit-taking companies - will surely depress Bank earnings. Loan losses will rise, although most of these will be covered from hidden reserves.

7. **THE CORPORATE SECTOR.** As detailed above, property firms have been the most conspicuous casualties of Hong Kong's recession. However, shipping firms have also been sinking in red ink. The problems here are in a sense more severe than in the property sector. There is massive world-wide over-capacity in shipping, particularly in oil tankers. So large is the surplus that even with higher scrapping rates some analysts expect no relief until the latter part of the decade. In addition, many developing countries seek international agreement to the allocation of shipping market shares between national carriers and third country carriers (e.g., a Greek ship carrying Hong Kong exports to Japan). They want to eliminate operators using "flags of convenience". This effort may fail. Even if it does, competition in shipping is likely to remain keen. Proftis will be depressed, unless there is a strong, sustained up-turn in world trade.

Hong Kong manufacturers - particularly those in the textiles and toys sectors - have been hit by slumping export sales. This is the inevitable result of recession in the OECD members who are Hong Kong's main trading partners. Higher interest rates probably have damaged corporate balance sheets in Hong Kong much as they have everywhere else. However, the limited rise in unemployment suggests that corporate failures have had limited impacts.

All of the property sector's problems probably have not yet surfaced. Allowing for that, it appears that the impacts will be limited. The same may be true for the financial sector. So far, only six of the more than 300 deposit-taking institutions have failed. These problems, made worse by political uncertainty, seem to date to have been contained.

8. **OUTLOOK.** The shake-out in the property/financial sector could create a sound basis for future growth. The damage is deep, but not broad. Theworld economy probably is now beginning a gradual climb towards recovery. If so, this should translate into a modest upturn in orders for Hong Kong manufacturers. This sector should thus lead the upturn. The large surplus over-hanging the real estate and shipping markets suggests that these sectors will remain depressed for much of 1983.

[redacted]

CONFIDENTIAL

9. EXTERNAL ACCOUNTS. Hong Kong is among the most foreign trade-dependent places in the world. It has been hard hit by prevailing global trends:

- o the long recession in the OECD member states' economies;
- o generalized protectionist pressures, keenly felt in the textiles and garments sectors;
- o intense competition for shrinking markets.

Hong Kong is both a manufacturer of export goods and a regional transit center, mainly for China's exports and imports. Therefore, Hong Kong trade data distinguish between domestic exports and re-exports. The former are made or processed in Hong Kong. The latter merely pass through Hong Kong. China has become the single largest source of Hong Kong's re-exports.

In 1981, the most recent year for which there are full data, three items - clothing, toys, and watches and clocks - made up 51.8 percent of total exports. The share of clothing and toys fell only slightly during the decade ending in 1981. By contrast, watches and clocks have grown steadily. In terms of export markets, the U.S. remains by far the largest, although its importance declined by about 5 percent over the tne years to 1981. Even so, non-OECD member markets are still relatively unimportant.

In recent years, China has adopted an extroverted economic policy. Hong Kong has benefited. In the first five months of 1982, exports to China had risen by 71.5 percent (basis year-earlier period). China mainly has imported raw materials and semi-finished goods for processing. The products have been returned to Hong Kong for export.

Hong Kong offsets its trade account deficits with substantial earnings from invisible exports. These include financial services, shipping, insurance, and tourism. It is the region's largest banking and financial services center.

a. THE TRADE BALANCE. In 1981, the impacts of global recession depressed both exports and imports. The trade deficit grew to a record level. However, the deterioration wasmuch smaller than that recorded in 1980 (basis 1979). The available evidence for 1982 suggests that the deficit actually narrowed slightly. Both imports and exports appear to have fallen in real (inflation-adjusted) terms. The intensity of the down-turn is clear: even the Hong Kong dollar's depreciation - especially vis-a-vis the U.S. dollar - did not suffice to keep exports from contracting.

[redacted]

Hong Kong should benefit from the gradual world economic recovery likely to begin in 1983. The up-turn will flower first in the U.S., if restrictive policies are not again imposed. This should translate into increased demand for U.S. exports. As, however, commodity prices - especially oil - may rebound less vigorously, Hong Kong's terms of trade might rebound. This, combined with a recessive hang-over which will restrain import growth, should produce a further narrowing of the trade deficit in 1983.

b. THE CURRENT ACCOUNT. Hong Kong's external accounts data are not fully compatible with those issued by the International Monetary Fund. However, it seems clear that invisible earnings in 1981 sufficed to offset the large trade balance and to leave a current surplus. In 1982, continued recessive conditions probably reduced services revenues. Tourism receipts, may have risen, as the number of arrivals was up slightly in the first eight months of 1982, vis-a-vis the year-earlier period. As, however, the trade deficit apparently has shrunk, Hong Kong's external surplus probably has only fallen slightly.

10. EXCHANGE RATE. During 1981, the Hong Kong dollar's depreciation against the U.S. dollar mainly was explained by the latter's strength. The H.K. dollar kept about even with the currencies of Hong Kong's other trading partners. In 1982, lower rates in the U.S. made the U.S. dollar less strong. However, political worries in Hong Kong caused the H.K. dollar to depreciate broadly. This probably helped to reduce import outlays. The prospects for 1983 are mixed. While the dollar seems likely to depreciate, political worries could drive down the Hong Kong currency. In the context of a world trade recovery, this could boost exports.

B. SPECIAL SECTOR: HONG KONG VS. THE PROTECTIONISTS

1. FRAMEWORK. Hong Kong is the world's largest garment exporter. This sector employs about 40 percent of the industrial workforce. The present recession has intensified already strong political pressures in the U.S. and Europe to limit further import competition. In fact, trade in garments and textiles has been controlled since 1973.

In that year, the first Multi-Fiber Arrangement (MFA) was set up under the auspices of the General Agreement on Tariffs and Trade (GATT). Geneva-based GATT seeks to broaden world trade by organizing talks to reduce tariffs and non-tariff trade barriers.

The MFA was a set of bilateral pacts, e.g., between the U.S. and Korea, or the E.E.C. and Brazil. Under this four-year arrangement, American and European capacity in the was to be closed in an orderly fashion. At the same time, developing countries' exports were to rise by 6 percent annually, on average. These good intentions have not been translated into real facts. When in 1978 the MFA was revised, developing countries - particularly the more advanced ones such as Taiwan and Hong Kong - found the U.S. and the E.E.C. much less receptive to taking more of their exports. The guarantee of six percent average annual export growth was dropped.

At end-1981, 51 nations met at Geneva under the auspices of the GATT to revise the MFA. After five weeks of intense talks they agreed to extend the MFA until 30 July 1986. The new pact gave the industrialized countries greater latitude to curb surges in imports. It also limited the practice whereby exporters who had used up their quotas trans-shipped goods through small exporters with spare export capacity under quotas.

From textile-exporting countries' viewpoint, 1982 was the worst time to bilateral deals under the new MFA. Unemployment at post-World War II levels in the U.S. and Europe set the context for the talks.

2. HONG KONG'S POSITION. Hong Kong's interest are clear. It needs larger access to markets. The going was rough at points. At end-March 1982 the U.S. and Hong Kong agreed a six-year deal. This was possible because the U.S. had previously announced that it would seek no quota cut-backs. About two thirds of Hong Kong's exports were to be regulated by quotas. Permitted growth ranged from 0.5 to 2 percent per year, depending on the item. The 18 most restricted categories were limited to only 0.5 percent growth. These lines amounted to 55 percent of Hong Kong's 1981 exports to the U.S. Such growth rates were well below the six percent MFA guideline.

The E.E.C. - Hong Kong's second largest trading partner - was far tougher and demanded quota cuts. The talks opened on 1 June in Brussels. The EEC held that because Hong Kong, Taiwan, and South Korea were, "dominant suppliers", their exports should be pared most heavily. Hong Kong recoiled at the prospect of its most vibrant export sector being strait-jacketed for five years to come. The damage

CONFIDENTIAL

[redacted] to textile manufacturers, their suppliers, and to government revenues would have been large. The battle was joined.

CONFIDENTIAL

The E.E.C. demanded quota cuts of up to 12 percent in sensitive items, those where import competition cut the keenest (e.g., T-shirts, blouses, trousers). Hong Kong and its neighbors balked. The E.E.C. threatened unilateral import controls. After drawn-out, bitter talks, in December 1982 Hong Kong and the E.E.C. came to terms. Cuts in quotas for sensitive items ranged between 6.3 and 8.3 percent. This should ensure no drop in real terms in Hong Kong's exports to the E.E.C. in 1983. In the longer term, growth for sensitive items is to be limited to 0.5 percent.

3. PROSPECTS. Hong Kong's textile sector is going to be squeezed. On one side is importing nations' desire to protect employment. On the other side, is lower-cost competition from, say, Sri Lanka. While some Hong Kong firms will successfully move up market - into product lines with higher value added which are less "sensitive" - many will not make the change. Even if the world begins to pull out of recession, Hong Kong's garment sector may have a hangover.

CONFIDENTIAL

[redacted]

CONFIDENTIAL

[redacted]

II. DIPLOMACY

A. THE POSITION. British control of Hong Kong is based on three treaties:

- Nanking (1842) by which China ceded Hong Kong Island to Britain in perpetuity;
- Peking (1860) by which China leased 3¼ square miles of the Kowloon Peninsula (on the mainland, opposite the island) to Britain in perpetuity;
- Peking (1898) under which Britain got a 99-year lease to 365 square miles of territory on the mainland (about 90 percent of the Colony).

The 1898 lease expires on 30 June 1997. Hong Kong is not viable without links to China, which supplies food and water. Hong Kong could not survive the loss of the New Territories, as most of the population lives there. Because the lease now has less than 15 years to run - less than a normal Hong Kong mortgage - investors now are uncertain.

B. RECENT DEVELOPMENTS. In the Autumn of 1982, the British and Chinese premiers met to discuss full-scale talks on Hong Kong's future.

1. CHINA'S POSITION. The present Beijing regime has always rejected the treaties on the ground that Britain extorted them. Thus, the Chinese declared at once to British premier Thatcher their intent to exercise sovereignty over Hong Kong. They intended to install a Chinese governor and to hoist China's flag. However, they also wanted the Hong Kong economy to retain its vibrancy. These goals probably conflict.

2. BRITAIN'S POSITION. The British feel obliged to negotiate Hong Kong's fate, even though they consider valid the first two of the treaties listed above. As noted, Hong Kong cannot survive without the leased New Territories. In contrast with the Falklands Islands, Britain cannot hope even to deter a Chinese take-over. In fact, London does not want to arouse Chinese hostility. That would move many Hong Kong Chinese to flee. They are not welcome in the U.K. U.K. immigration laws have been changed such that Hong Kong Chinese (and other ex-colonials) lose any right to settle in England. Britain thus seems to seek a pact whereby the Chinese would fly their flag but not impose their political values.

C. PROSPECTS. The talks started in November. They are unlikely to reach a quick solution. The Chinese have through unofficial channels offered a number of alleys by which they could take and exercise control. None of

[redacted]

~~CONFIDENTIAL~~

~~CONFIDENTIAL~~

these "proposals" has re-assued Hong Kong investo[redacted] The Chinese probably will not make any abrupt moves. They will go on expanding their economic position in Hong Kong. First, they will continue buying property. Second, they will continue to direct much trade through Hong Kong, described as "the finest harbor in South China". Over time, China can take-over economically. At the same time, China will develop other ports and the new economic zones along its southeast coast. This will reduce its dependence on Hong Kong. If, ultimately, the Hong Kong entrepreneurs decide to go, China's economic interests will not be damaged heavily.

[redacted]

~~CONFIDENTIAL~~

~~CONFIDENTIAL~~

HONG KONG

Values = Millions of U.S. $'s / = ** = Millions of Natn'l Curr
(period average exchange rates used in conversions)

	1977	1978	1979	1980	1981	1982
A GDP(current prices)	12,787	14,824	17,870	22,405e	24,450e	24,788f
B Real GDP Growth(%)	10.2	10.3	12.8	10.3e	11.0e	4.1f
C GDP/Cap(curr prices)	2,835	3,225	3,663	4,447e	4,744e	4,737f
D Growth Real GDP/Cap(%)	8.6	8.2	6.2	6.8e	8.5e	2.5f
E Fixed Invest/GDP(%)	21.8	24.1	27.5	27.6e	28.6e	
1. Dir Inv/Fixed Inv(%)						
F Consumer Price Rise (%)	5.1	5.6	12.6	14.8	14.4	12.1#
G Wholsl Price Rise (%)						
H Money Suppy Growth (%)						
1 Narrow Aggregate (%)	28.4	22.3	3.7	15.7	4.1	11.1&
2. Broad Aggregate (%)	20.9	25.5	13.2	28.7	21.2@	3.5@°
I Govt Surplus(-Deficit)						
1. Surp(-Def)/Expend (%)						
2. Surp(-Def)/GNP (%)						
J BALANCE OF PAYMENTS						Jan-Aug
1. Mchdse Exports(FOB)	9,624	11,497	15,147	19,720	21,830	13,008e
a. % Change	12.9	19.5	31.7	30.2	10.7	-5.7e
2. Mchdse Imports(CIF)	-10,457	-13,449	-17,139	-22,403	-24,772	-14,724e
b. % Change	17.7	28.6	27.4	30.7	10.6	-8.1e
3. BALANCE OF TRADE	-833	-1,952	-1,992	-2,683	-2,942	-1,716e
4. Services (net)	1,300	1,494	1,585	1,624	1,568	
5. Transfers (net)						
6. CURRENT ACCT BALANCE	467e	-458e	-407	-1,059e	1,374e	
7. Net Capital Flows						
a. Direct Invest						
b. Portfolio Invest						
c. Other Short-term						
d. Other Long-term						
8. Errors & Omissions						
9. SURPLUS (-DEFICIT)						
K International Reserves						
1. Foreign Exchange						
2. Gold						
a. Stock (mil Tr oz)						
L Reserves/Imports (mos)						
M Exchg Rate ($/Loc Curr)	0.215	0.213	0.020	0.200	0.018	0.159*
N Population (millions)					5.1	
1. Growth Rate (%)						

CONFIDENTIAL

° M-2 up to 1980; Hong Kong $ M-3 after 1980.
@ Hong Kong $ M-3, Nov 82/Nov 81
& M-1 throughout.
* end-QIII rate
# Aug 82/Aug 81. Hang Seng Index, all items (Index revised in 1981. Data for following periods not comparable with those for previous years).
e estimate

HONG KONG

TRADE DATA

MAIN TRADE PARTNERS (VALUES IN U.S. $ MILLIONS; % IN PARENTHESES)
(EXPORTS F.O.B. / IMPORTS C.I.F.)

1978 Exports	1978 Imports	1979 Exports	1979 Imports	1980 Exports	1980 Imports	1981 Exports	1981 Imports
US 3,490(30)	JAP 3,072(23)	US [illegible]44(27)	JAP 3,858(23)	US 5,157(26)	JAP 5,142(23)	US 6,056(28)	JAP 5,756(23)
GER 989(9)	CHI 2,249(17)	GER 1,[illegible](9)	CHI 3,021(18)	GER 1,615(8)	CHI 4,401(20)	CHI 1,964(9)	CHI 5,272(21)
JAP 882(8)	US 1,605(12)	UK 1,267(8)	US 2,068(12)	UK 1,527(8)	US 2,653(12)	UK 1,540(7)	US 2,589(10)
UK 856(7)	SING 687(5)	JAP 1,026(7)	SING 961(6)	CHI 1,249(6)	SING 1,481(7)	GER 1,372(6)	SING 1,901(8)
SING 532(5)	UK 634(5)	SING 642(4)	UK 866(5)	JAP 909(5)	UK 1,094(5)	JAP 1,022(5)	UK 1,125(5)

CONFIDENTIAL [redacted]

CONFIDENTIAL

CONFIDENTIAL

CONFIDENTIAL

WITHDRAWAL SHEET

Ronald Reagan Library

Collection Name
LAUX, DAVID: FILES

Withdrawer
CAS 6/10/2010

File Folder
CHINA-FOREIGN RELATIONS-HONG KONG (2/26/83-5/4/83)

FOIA
M09-299/1
COLLINGS

Box Number
13

13

ID	*Document Type* / *Document Description*	*No of pages*	*Doc Date*	*Restrictions*
92426	REPORT 241839Z MAR 83	1	3/24/1983	B1 B3

Freedom of Information Act - [5 U.S.C. 552(b)]

B-1 National security classified information [(b)(1) of the FOIA]
B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
B-3 Release would violate a Federal statute [(b)(3) of the FOIA]
B-4 Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
B-6 Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
B-7 Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
B-8 Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
B-9 Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

38

Central Intelligence Agency

Washington, D.C. 20505

HK

[redacted]

DIRECTORATE OF INTELLIGENCE

6 April 1983

Hong Kong: The Coming Year

Summary

We expect little progress this year in the Sino-British talks on Hong Kong, which are deadlocked over the sovereignty question. London is withholding recognition of Chinese sovereignty over the colony in an effort to obtain satisfactory terms for the transfer of authority. The Thatcher government clearly hopes to persuade Beijing to let Britain continue to play a role - at least in running the economy - after 1997 to bolster its domestic political position and to help calm local concerns. [redacted]

Chinese leaders, however, have not yet decided on a plan for administering Hong Kong. To keep their options open and maintain pressure on the British, they are insisting that Britain cede sovereignty before substantive negotiations begin. Meanwhile, Beijing is trying--without much success--to reassure the colony's residents by floating an autonomy plan that would allow Hong Kong to retain its present social and economic system. We believe the Chinese offer also is intended to encourage Taiwan to consider negotiating similar arrangements. [redacted]

[redacted]

Despite this standoff, the colony's economy is beginning to recover from the slump that followed the Thatcher visit. Prospects this year for Hong Kong's export driven economy are good, although the recovery probably would be stronger if the political situation were more predictable. Ironically, Beijing may misinterpret this recovery as a sign that the colony's investors accept their autonomy proposal, and thus may become even less willing to consider a compromise.

Neither Beijing nor London now appears ready to adopt a more flexible negotiating stance, although British leaders may feel freer to compromise on the sovereignty question after Britain's next general elections. Should Britain unexpectedly cave in, existing US agreements with the colony could become invalid.

The Thatcher Visit

Prime Minister Thatcher's discussions with Chinese leaders last September over Hong Kong were contentious. Deng Xiaoping told Thatcher that China would recover its sovereignty in 1997 and declared the issue non-negotiable.

The Chinese infuriated the British by adding a line to the joint statement reiterating their position on the sovereignty issue. After Thatcher subsequently told a press conference in Hong Kong that the three treaties establishing the colony were still valid, Beijing lashed out in a strongly-worded Xinhua commentary, restating China's position that Hong Kong is Chinese territory.

The unsuccessful talks prompted a sharp downturn in the mercurial Hong Kong stock market. The Hang Seng index, already slipping as a result of worldwide recession, dropped more than 300 points between 1 September and 31 October. More importantly, Hong Kong's international financial market--third largest in the world and a major source of capital--reacted negatively. Singapore, Thailand and the United States reportedly all received major injections of Hong Kong capital in late 1982. The Hong Kong dollar also depreciated 12 percent in September and October alone. Visa applications and inquiries also rose sharply as Hong

Kong residents sought to insure themselves against the uncertainties associated with a Chinese takeover. [redacted]

This near-panic, coming at a time when the domestic economy was already reeling from the effects of the worldwide economic recession, hit several deposit-taking companies and major land companies hard, forcing them to default on loans totalling over $1 billion. Without the determined efforts of several of Hong Kong's leading financial institutions, most experts believe that other large industrial and financial institutions would have followed suit. Even so, bankruptcies reached a 20-year peak in 1982 and were up more than 50 percent from the 1981 level. [redacted]

The Current Hiatus

[redacted]

Neither side seems disturbed by the lack of progress. The British are using the interlude to educate the Chinese on the complexities of administering Hong Kong, hoping to convince China to allow London to continue to play a management role after 1997. The British have used Hong Kong businessmen travelling to Beijing to get across their message. The Chinese seem content to stand pat and are trying to gain public support in the colony to put pressure on the British. As part of this effort, China initiated a propaganda offensive in Hong Kong last fall designed to calm local jitters and to float various proposals for the colony's future. [redacted]

Beijing is currently promoting the notion of Hong Kong becoming a special administrative zone in 1997 under Article 31 of China's recently enacted constitution. Hong Kong would basically retain its existing social and economic structure and would be locally administered. The details remain vague. At a minimum, the British governor and flag would be removed, but Beijing has indicated it would allow some British civil servants to remain to help with the transition. [redacted]

Thus far, Beijing's efforts to reassure the Hong Kong public have not gone well. In one case, Premier Zhao Ziyang had to disavow the statements of the leader of a visiting overseas Chinese delegation who reported that China might retake Hong Kong before 1997. [redacted]

In the meantime, the Hong Kong economy has recovered somewhat from its November nadir as investors have come to realize that there will be no quick solution to the 1997 problem. The stock market bottomed out in November, picked up steam in December, and then jumped more than 100 points in January--back to pre-Thatcher visit levels. Overall economic growth was about 2.4 percent in 1982, good by Western standards but well below Hong Kong's 10 percent average for the past decade.

Economic prospects for 1983 are brighter. As the West moves out of recession Hong Kong's export-led economy is likely to turn upward. The increase should be enhanced by falling oil prices which will generate increased demand for Hong Kong consumer goods. The improvement could lead to real increases of as much as 6 percent in GDP for the year. Price pressures may also ease as signs of domestic prosperity and lower international interest rates increase the flow of foreign funds into the now undervalued Hong Kong currency.

Constraints on China's Hong Kong Policy

In formulating plans for the future of Hong Kong, Chinese leaders will have to reconcile several potentially conflicting interests. Foremost of these is their concern over the impact of a takeover on the colony's economic vitality. Sizeable amounts of Western equipment, technology, and managerial skills continue to be funneled through Hong Kong into China and, by its own account, fully 31 percent of China's annual foreign exchange revenues originate in the colony. In order to satisfy the colony's residents, China will have to offer credible guarantees that the colony's economic and social systems will not be dismantled. Beijing may also be concerned over the impact negotiations with the British could have on prospects for reunification talks with Taiwan. Beijing wants to demonstrate to Taipei that it is willing to let two different social and economic systems operate under one flag. [redacted]

Growing nationalistic feelings may circumscribe the room Deng and his supporters have to maneuver. Some Chinese probably are more concerned about obtaining a settlement that restores China's honor than they are about the colony's economy. We believe that this is a factor in China's demand that London acknowledge Chinese sovereignty over the colony. To some extent Deng could also be vulnerable to sniping by ideological conservatives concerned about the spread of "decadent" foreign influences in China as a result of the open door policy. Conservatives probably are already disturbed by suggestions in Hong Kong's leftist press that China will allow such activities as horse racing and dancing to continue once the colony reverts to Chinese control. [redacted]

No Settlement Likely This Year

We believe China and Britain are unlikely to reach a settlement this year. The Thatcher government will be in no mood to concede on the sovereignty issue until after the next British elections, which must be held before June 1984. Nor is Britain likely to concede sovereignty until it has received at least some general assurances about arrangements for the transfer of authority. The British want to reassure the colony's residents that London intends to stand by them. Giving in too soon on the sovereignty issue could destroy business confidence in Hong Kong and possibly precipitate a panic. Even when the sovereignty stalemate is broken, we expect the negotiations over the transfer of authority to be lengthy and contentious. [redacted] British economic stakes and considerations of potential refugee problems, however, mean that the policies of these parties if they were in power probably would not be fundamentally different from those of the Conservatives. [redacted]

If, as we expect, economic conditions in Hong Kong continue to improve, Beijing is unlikely to relax its demand that Britain acknowledge Chinese sovereignty. We believe Chinese leaders have overestimated their ability to play a larger role in Hong Kong affairs after 1997 without seriously harming the economy during the intervening years. Chinese leaders probably will interpret a sharp economic upturn in 1983 as a sign that Hong Kong investors share this belief, reinforcing Beijing's myopic perspective. [redacted]

Possible Problems

Although we believe Hong Kong's prospects for economic and political stability in 1983 are good, miscalculation by either side could upset the relatively calm atmosphere. For example, a premature British concession on the sovereignty issue or alternatively a serious breakdown in discussions, if mishandled, could lead to major capital flight. Large outflows would have long-term detrimental effects on growth prospects. Even small domestic investors would probably hedge their bets by turning to ventures elsewhere.

The Hong Kong government probably would intervene in the economy if major capital outflows threatened the system. Beijing's Hong Kong branch of the Bank of China also would step in to stabilize the economy. The Bank has already been involved in several major land deals--including a $200 million 75-year renewable lease on land for a new office building--as part of its effort to assuage investors fears about the colony's future. In late 1982 the Bank of China also actively defended the Hong Kong dollar against downward speculative pressures. In its most recent gesture, the bank last month began offering Hong Kong's small manufacturers unsecured cut-rate loans.

The development of local interest groups in Hong Kong favoring a particular solution could complicate the quest for a solution. One such group, called Meeting Point, was recently formed. Composed mainly of academics, journalists, social workers, lawyers, and businessmen, this relatively small group has come out in support of Beijing's basic plan. Its members, however, also favor greater democracy for the colony. The activities of Meeting Point could eventually encourage other groups less well disposed toward China to demand a voice both in running Hong Kong and in the talks over its future--a development Beijing would not welcome.

Thus far, Taiwan has not used its influence in Hong Kong to impede negotiations; Taipei has simply said it will not recognize any transfer of sovereignty to Beijing. Taiwan businessmen, who have a large economic stake in the colony, might line up quietly with local interests to try to obtruct the talks with the aim of extracting maximum Chinese concessions. Although Taipei might favor such footdragging to delay an agreement, the government would be loathe to become enmeshed in the negotiations.

<u>US Interests</u>

We believe US interests in Hong Kong will remain largely unaffected over the short run, unless the British unexpectedly concede sovereignty over Hong Kong. Existing US agreements with Hong Kong could then become invalid. For example, quotas for US textile imports from Hong Kong, which exceed those from China, might have to be renegotiated. US-British agreements for naval port calls and the use of Kai Tak airport might also become invalid. Many of the approximately 150,000 residents of Hong Kong who currently hold valid US visas could decide to flee to the United States. Some of Hong Kong's other 5 million residents would almost certainly seek to come to the United States.

Further Down the Road

In the absence of fundamental changes in the policy stance of London and Beijing, we expect Hong Kong gradually will lose its economic vitality. With the 1997 deadline still 14 years away, investors probably continue to see sizeable short term opportunities in the Hong Kong market. But as a Chinese takeover looms larger, we expect Hong Kong businessmen to begin placing their funds increasingly in more secure markets such as Singapore, Japan, and the United States.

A gradual economic downturn--especially one that occurs at a time when China's traditional trade competitors are making continuous gains--will probably encourage Beijing to seek greater British cooperation. However, the extent to which Britain will play a role in the post-1997 government, and the firmness of Chinese guarantees against intervention in Hong Kong business affairs, probably will depend on how much Beijing believes it has to pay to maintain Hong Kong's economic viability.