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# WITHDRAWAL SHEET

## Ronald Reagan Library

**Collection Name** LAUX, DAVID: FILES

**Withdrawer**

CAS 6/10/2010

**File Folder** CHINA-FOREIGN RELATIONS-HONG KONG (6/16/83-8/18/83)

**FOIA**

M09-299/1

**Box Number** 13

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16

ID	Doc Type	Document Description	No of Pages	Doc Date	Restrictions
92436	CABLE	162347Z JUN 83 <b>D 12/20/2017 M299/1</b>	1	6/16/1983	B1 B3
92437	CABLE	170134Z JUN 83 <b>D 12/20/2017 M299/1</b>	1	6/17/1983	B1 B3
92438	CABLE	170015Z JUN 83 <b>D 12/20/2017 M299/1</b>	1	6/17/1983	B1 B3
92439	CABLE	170024Z JUN 83 <b>D 12/20/2017 M299/1</b>	1	6/17/1983	B1 B3
92440	CABLE	210342Z JUN 83 <b>D 12/20/2017 M299/1</b>	1	6/21/1983	B1 B3
92441	CABLE	211925Z JUN 83 <b>D 12/20/2017 M299/1</b>	1	6/21/1983	B1 B3
92442	REPORT	RE HONG KONG <b>PAR 12/20/2017 M299/1</b>	8	6/23/1983	B1 B3
92443	CABLE	300218Z JUN 83 <b>D 12/20/2017 M299/1</b>	2	6/30/1983	B1 B3
92444	CABLE	080006Z JUL 83 <b>D 12/20/2017 M299/1</b>	1	7/8/1983	B1 B3

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92445	CABLE	RE HONG KONG <b>D 12/20/2017 M299/1</b>	18	7/14/1983	B1 B3
92446	CABLE	282243Z JUL 83 <b>D 12/20/2017 M299/1</b>	1	7/28/1983	B1 B3
92447	CABLE	RE HONG KONG <b>D 12/20/2017 M299/1</b>	3	8/8/1983	B1 B3
92448	CABLE	120149Z AUG 83 <b>D 12/20/2017 M299/1</b>	1	8/12/1983	B1 B3
92449	CABLE	131654Z AUG 83 <b>D 12/20/2017 M299/1</b>	2	8/13/1983	B1 B3
92450	CABLE	HONG KONG 14714 <b>R 6/21/2012 M299/1</b>	1	8/16/1983	B1
92451	CABLE	182041Z AUG 83 <b>D 12/20/2017 M299/1</b>	1	8/18/1983	B1 B3

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92440	CABLE 210342Z JUN 83	1	6/21/1983	B1 B3

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92441	CABLE 211925Z JUN 83	1	6/21/1983	B1 B3

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Central Intelligence Agency

EO 13526 3.3(b)(1)>25Yrs  
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Washington, D. C. 20505

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NLRR M299/1 #A2442

BY RW NARA DATE 1/20/17

DIRECTORATE OF INTELLIGENCE

23 June 1983

Hong Kong: Deteriorating Economic Conditions

The economic climate in Hong Kong has deteriorated sharply during the past two months. Investor confidence has waned as political uncertainty has mounted over the form of a Chinese takeover in 1997 and is the major factor in the slide. The Hong Kong dollar broke the psychological barrier of \$7 HK/\$1 US in May and continued to weaken despite government open-market intervention and a two percentage point increase in interest rates. The Hong Kong stock index, which had been on upward trend since last December, turned sharply downward in May. Efforts to rescue several failing financial companies and three large property concerns are also meeting little success.

Short term prospects for an economic rebound are nevertheless good. Speculative pressure against the currency has shown signs of easing somewhat and Hong Kong exports have begun to respond to Western economic growth. Inflation, however, will remain a major problem owing largely to the currency depreciation.

Over the next five to seven years, the continued political uncertainty surrounding 1997 will retard positive economic growth and deepen economic downturns. Unless London and Beijing can reach some agreement for takeover that reassures investors, we expect cyclical fluctuations to become more severe. The currency will probably continue to weaken over time and the Hong Kong stock market will reflect increasing investor uncertainty.

Economic Upturn and Investor Uncertainty

Hong Kong began 1983 with most major economic indicators improving. Exports--the engine of growth in the colony--were up an estimated 5 percent in real terms during the first four months after a 2 percent decline in 1982. Bankruptcies, mostly tied to

This memorandum was prepared by [redacted] of the China Division of the Office of East Asian Analysis. Questions and comments are welcome and may be directed to the author [redacted]

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the major slump in the property market during 1982, were easing somewhat as residential buyers returned to the market. Reflecting the overall improvement, the Hang Seng index of stocks climbed 235 points--30 percent--from 1 January to 30 April of this year. [redacted]

Despite these positive indications of economic recovery, the local currency has been gradually losing its foreign purchasing power since January this year. The strengthening US dollar probably explains much of the early decline; most other Asian currencies were also losing ground during this period. But waning investor confidence took over in May cutting more than 5 percent off the currency's value against the 15 major currencies and nearly 10 percent off its value against the dollar in a one month period. By 10 June, a nadir of \$7.5 HK per US dollar was struck, and since then the currency has strengthened only slightly. [redacted]

China plans to take control of Hong Kong in 1997 and local investors are jittery about economic prospects under a communist regime. Although Beijing has gone to great lengths to publicize its intention to leave the colony's social and economic status quo unchanged after takeover, local businessmen remain unconvinced. Moreover, talks between London and Beijing, that most Hong Kong residents hoped would bring some form of continued British presence in the colony after takeover, have not gone well. After making virtually no progress for the past eight months, the talks are only now apparently getting underway again. [redacted]

No figures for capital flight are available. Bankers in Singapore, Thailand, Sri Lanka, the United States, and Canada reported increasing injections of Hong Kong capital late last year when a similar bout of nervousness sent the Hong Kong dollar into a less severe tailspin. These same countries were probably major recipients during the most recent scare. In addition, local savers are shifting out of Hong Kong dollar deposits in favor of foreign currencies and gold. We estimate that about 60 percent of Hong Kong bank deposits are now being held in foreign currencies compared with 38 percent a year earlier. Although figures for 1983 gold imports are unavailable, purchases from Western Europe reportedly jumped 50 percent in 1982 to more than 135 tons. With the exception of Singapore, other Far Eastern countries reportedly experienced declining gold imports during the same period. [redacted]

#### Government Attempts to Restore Stability

Thus far the Hong Kong Government's efforts to stem the flow of currency and to bolster sagging confidence have met with little success. The government probably attempted to support the currency with small-scale open market purchases of Hong Kong dollars in mid-May and early June; with only an estimated \$3-4 billion in its foreign currency reserve fund, long-term, large-

scale intervention is impossible. By mid-month the government resorted to a more drastic measure to halt the outflow, pressuring the Hong Kong Association of Banks (HKAB) to raise interest rates two percentage points. HKAB's announcement of the upcoming rate increase bolstered the currency for two days. By the time the increase actually went into effect, however, the dollar was once again sinking to new lows. [redacted]

Nor was its failure to halt the downward slide of the currency the only negative aspect of the rate increase. Hong Kong's always volatile stock market plunged, as a result of investor fears that the rate increase would stymie economic recovery. The market lost 40 points (5 percent) on 23 May, the day the increase went into effect. Two of Hong Kong's largest textile manufacturers are among the many industrial firms currently attempting to stave off bankruptcy with short term borrowing. Major property companies--among the biggest investors in the Hong Kong stock market--are also in need of significant amounts of short-term funds. [redacted]

#### Outside Support

The largest foreign holder of Hong Kong currency is probably China's official foreign exchange bank--the Bank of China. Although no figures are available on total Bank holdings, Beijing's exports to Hong Kong in 1982 alone amounted to \$ 5.4 billion, almost entirely paid for in Hong Kong dollars. [redacted]

The holdings have put Beijing into a difficult situation. By holding Hong Kong dollars Beijing is suffering a sizable loss in purchasing power. Converting to foreign currency, however, would exacerbate the decline in the Hong Kong dollar and could contribute to instability that Beijing is trying to discourage. [redacted]

Hong Kong could probably also turn to the Bank of England for support. Although such a move would be unprecedented, we believe that the Bank would be willing to work out some type of swap\* arrangement if the economic deterioration was deemed extreme. Bank of England support would probably give investor confidence a major boost and, at least temporarily, could discourage speculative pressure on the currency. [redacted]

\* Under a swap agreement, the Bank of England would make pounds Sterling available to the Hong Kong Government in exchange for an equivalent amount of Hong Kong dollars at an agreed rate. The pounds Sterling could then be used in open market operations.

Prospects

In the short run, we believe Hong Kong's prospects for economic recovery are good. During the past few days the currency has shown signs of leveling-off at about \$7.0 HK/\$ 1 US. Stronger than expected recovery in the West bodes well for sharp increases in exports this year. Major gains in the export sector would help bolster confidence colony-wide and could contribute to overall economic stability during the remainder of the year. With the 1997 deadline still 14 years away, investors probably continue to see sizable short-term opportunities in the Hong Kong market. Although the recent hike in interest rates will hinder growth somewhat, we expect to see GDP rise 5 percent by yearend on the strength of exports. Unemployment should fall below its current peak of 5.1 percent to perhaps as low as 3-4 percent.

Because the colony is totally dependent on imports for food, energy, and industrial raw materials, we expect the recent depreciation will hamper efforts to arrest inflation. Gasoline prices jumped nearly 2 percent in May alone, and other increases are imminent. By yearend the consumer price index will probably be at least 15 percent above last year's level. In fact, the price increase will probably offset any beneficial effect of the depreciation on Hong Kong exports. Although the currency should regain some of the ground lost recently we do not expect it to approach the 1982 average rate of \$6 HK.

As long as residents remain uncertain about the Colony's future, long-term economic prospects for Hong Kong remain gloomy. A large number of the Colony's residents are making efforts to get at least one member of their immediate family established overseas; Hong Kong's most highly trained workers are likely to be among the most successful in leaving the colony. Moreover, investors, even those publicly praising the current Chinese leadership and its policies, are diversifying their investments and moving capital offshore.

The drain on investment funds and skilled workers will constrain Hong Kong's long-term growth. Although we expect a generally upward trend over the next 5 years, Hong Kong's growth rate will fall far short of historic levels and probably remain well below rates being achieved by its traditional competitors in the area. Nor will the increase be smooth. Cycles--spurred by investor uncertainty and fueled by speculation--will probably be more frequent and of increasing magnitudes. Potential for economic collapse will be at its peak during these cycles.

We believe that, in the long run, the floundering economy will pressure Beijing to exhibit flexibility in its negotiations with the British. At present, however, Beijing appears convinced that it can pacify Hong Kong investors and maintain economic vitality without a significant British presence and, hence, will probably continue to take a hardline approach. Beijing's

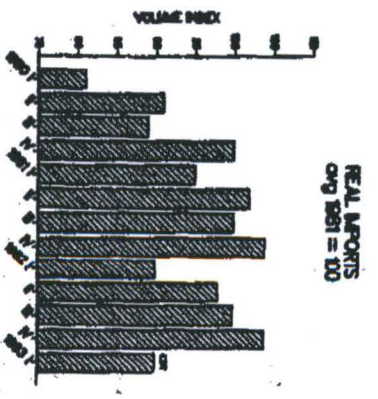
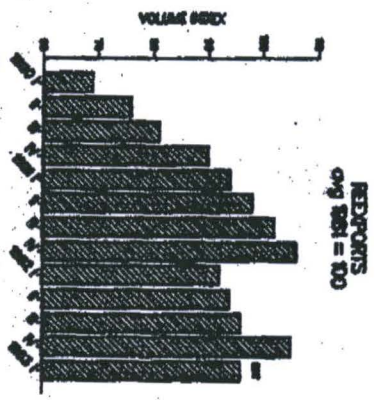
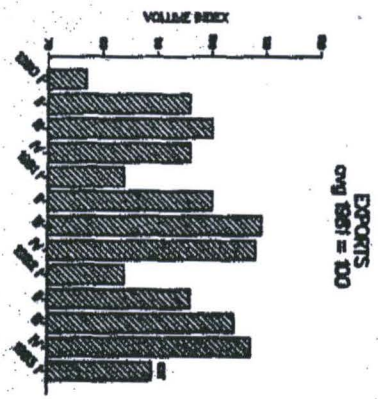
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recognition that this approach is causing severe problems and modifications in Chinese demands might not, however, come until investor confidence in Hong Kong has been irreparably damaged.

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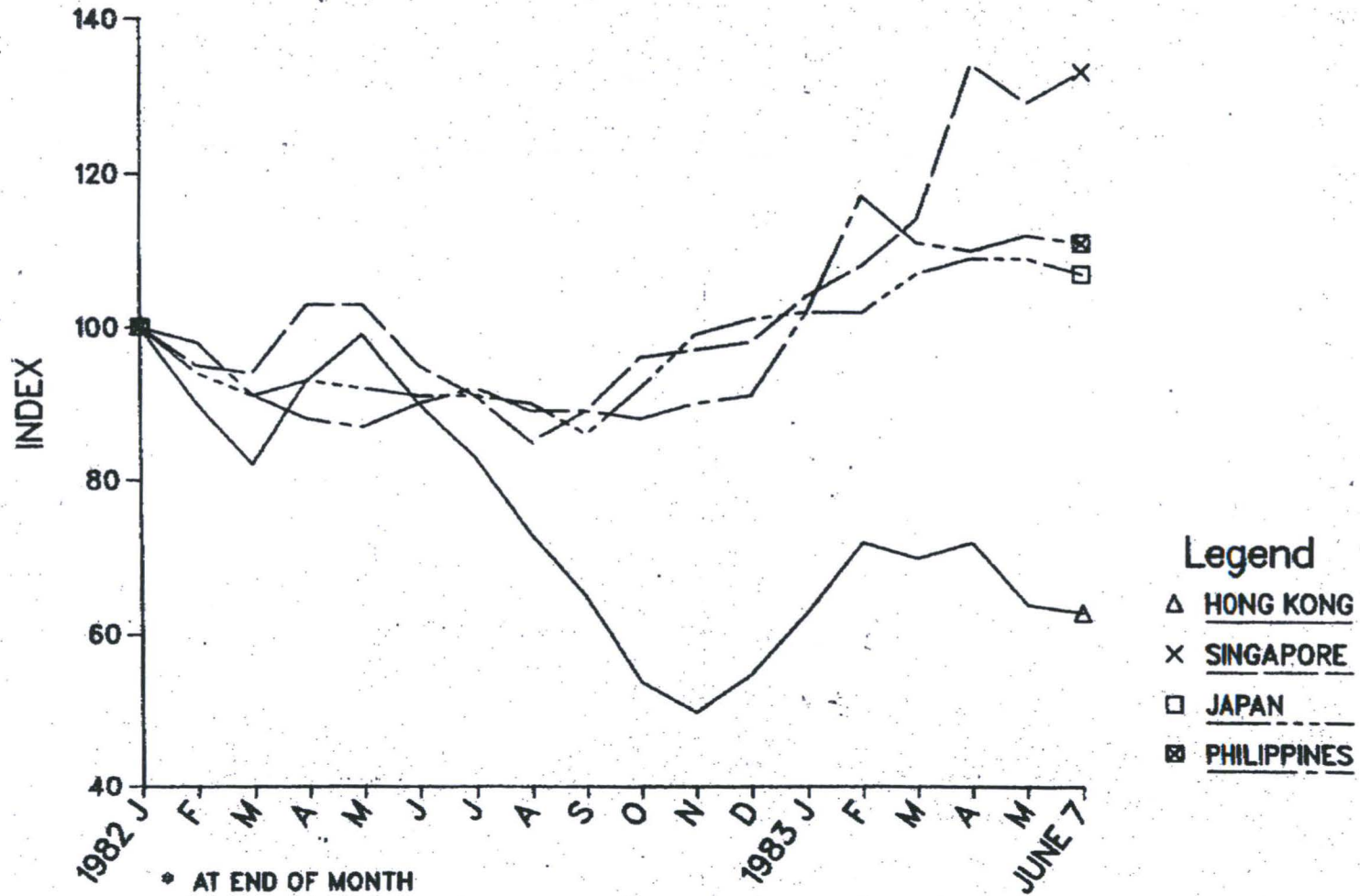
# HONG KONG: VOLUME OF TRADE



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# STOCK INDEXES FOR SELECTED COUNTRIES\*

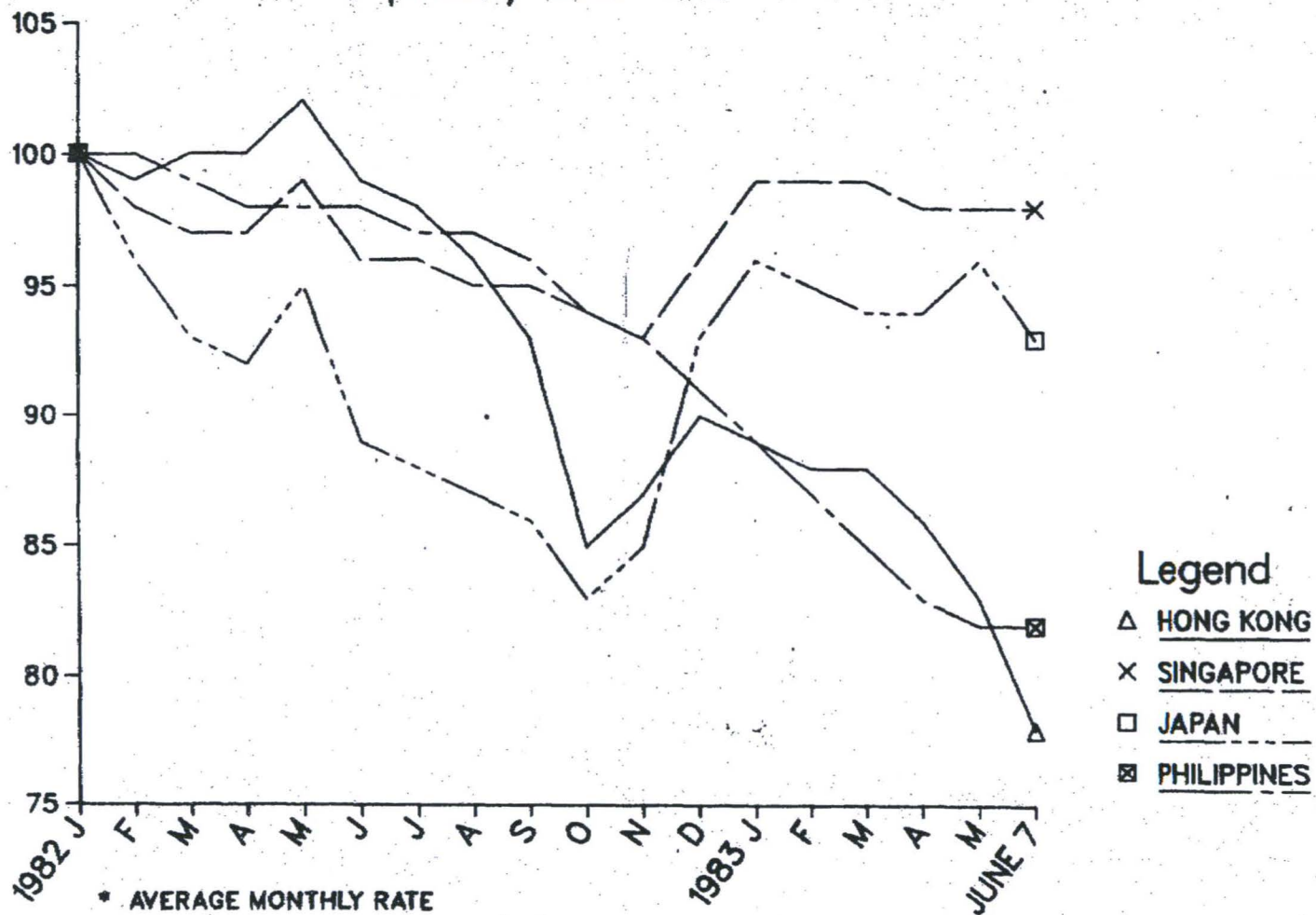
January 1982 = 100





FOREIGN EXCHANGE RATES FOR SELECTED COUNTRIES  
IN DOLLARS PER UNIT OF CURRENCY \*

January 1982 = 100



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The Sino-British talks on Hongkong enter a crucial phase

# Forward to Square Two

By Derek Davies and Mary Lee



Sino-British talks on Hongkong's future entered a new and probably crucial phase in Peking on July 12 amid signs that there are still pitfalls, apart from the controversial issue of sovereignty, which will need careful circumventing.

Hongkong was not expecting much from the joint statement at the end of the two-day talks — but got rather better than it thought. The negotiations were described as "useful and constructive." This undoubtedly reflects a new awareness on Peking's part of the fragility of confidence in Hongkong, its markets and its currency, which all slumped back in the days when various Chinese spokesmen were painting threatening scenarios, and which all climbed back sharply with the news a few weeks ago that the talks were to be resumed in an evidently improved atmosphere.

The news that the talks will be resumed within two weeks at the most is also encouraging — evidence that the negotiations have indeed acquired a new momentum, reflecting the desire of both sides to minimise uncertainty and reach an understanding as soon as possible.

China clearly displayed its sensitivity — but over who represented Hongkong's interests rather than over sovereignty — in the few days leading up to the start of the second phase. Governor Sir Edward Youde, a member of the British delegation headed by Ambassador Sir Percy Cradock, walked into a diplomatic minefield when replying to a question during a July 7 press conference on whom he would be representing at the negotiations.

Youde said categorically: "I am the governor of Hongkong. . . . Indeed I represent the people of Hongkong. Who else would I represent?" Youde had just returned with members of his policymaking Executive Council from London where he discussed Hongkong's future with British Prime Minister Margaret Thatcher and Foreign Office representatives. It was the first time he had defined so decisively his role to a seemingly leaderless community.

Youde, an experienced diplomat, had clearly contradicted Peking's earlier statements that he could represent only the British. China regards Hongkong as part of its territory, whose people are compatriots — thus part of the same family whose interests are a domestic issue and no concern of Britain. A Chinese Foreign Ministry response the next day said: "Mr Youde

will take part in the talks as a member of the British Government delegation. Therefore he can only represent the British Government in the talks."

After thus correcting Youde, the Chinese Foreign Ministry went on to refuse a visa for a last-minute addition to Youde's team from Hongkong — Director of Information Services Peter Tsao, who was to have joined political adviser Robin McLaren and chief government interpreter Y. P. Cheng as the governor's personal press officer.

The Tsao incident had all the ingredients of a classic diplomatic gaffe: in May, he had told a British newspaper that if a solution over Hongkong's future was not reached, he himself would emigrate. Next came the government's announce-

ment, the *Economic Journal*, pointed out, lay in miscalculating China's likely reaction to Tsao's presence in Peking during the talks, given that Youde had already tripped up on the question of whom he represented. The *New Evening Post's* scathing response clearly showed that Peking did not share the Hongkong Government's concern that a press aide should manage more than 40 local reporters covering the talks.

Youde obviously needed some help: press photographs and TV screens once again showed the small-statured governor almost overwhelmed by a stockade of waving microphones, entangled in a television cable and being pursued relentlessly by Hongkong reporters whenever he appeared in Peking. A con-



ment, immediately after Youde's press conference and before securing Peking's assent, that Tsao would be going.

The pro-Peking Hongkong newspaper the *New Evening Post* retorted the following day: "We shall know in a couple of days whether Peter Tsao will really accompany the governor north . . . One is at a loss just how he could have been requisitioned for [Youde's] personal service. As is known to all, the talks are a matter between China and Britain and there can be no interference by third parties . . . Details of the talks will naturally not be disclosed. Even if there is any news to be made public, this would be a matter for the representatives of China and Britain."

The Hongkong Government's mistake, as one independent Chinese daily in the

voy of cars carrying reporters shadowed Youde's limousine when it emerged from the British Embassy and headed for the first session of the new talks, which were held in a guest house in Peking's old legation quarter.

Analysts added that China, already unhappy with Britain's commitment that the solution must be acceptable to the people of Hongkong as well as to the two governments, probably saw Tsao's presence as an attempt by Youde to secure a position for Hongkong at the talks via the back door. It is not clear how Peking would have responded had London, and not Hongkong, submitted Tsao's name, thus observing protocol.

Arguably, Peking's decision to deny Tsao a visa may be no more than a heavy-handed reminder that China — not Britain and certainly not Hongkong — has the

upper hand in steering the talks. But the fallout from Youde's remark served as a reminder that, despite a "better understanding of each other's position" after nine months of "useful exchanges," a great deal of ground remains to be covered, though both sides have said that Youde's remark will not affect the negotiations.

It is increasingly evident that — as the REVIEW first reported (July 7) — the issue of sovereignty has been defused and circumvented. This lies in London's acknowledgement that, even if it sticks to the 19th century treaties under which Britain acquired Hongkong, the British would have no legal basis to remain in the New Territories after the lease on that portion of the colony expires in 1997 — and that there is no practical way they can hang on to the Kowloon peninsula and Hongkong Island itself once they are bereft of their hinterland. In return, informed sources say, China has indicated that it will not press for any change in Hongkong's status until 1997. (Thus its spokesmen are sticking to the still-comforting formula that China will reassume its sovereignty over Hongkong when the time is "right," or "ripe" or "opportune.")

The talks are therefore about how the British will work to facilitate the 1997 change of status and the guarantees and assurances they can extract from Peking to satisfy their desire to safeguard the interests of the people of Hongkong and thus achieve an eventual "honourable withdrawal."

**B**ritain's commitment to find a solution acceptable to the people of Hongkong is a problem in itself, since the government is unlikely to hold a referendum to assess the acceptability of any solution (Peking would never assent to this). There is also no elected institution that can claim to speak on behalf of the public. How London will be able to keep its pledge remains to be seen.

But what in fact do the people of Hongkong want? There is a clear answer to that: the majority, as opinion polls have indicated, prefers the status quo. Youde told Thatcher and Foreign Office ministers that the people "attached great importance to their lifestyle, to their freedom to come and go... and do their own thing, and they are looking for continuity." Continuity of what, he did not say.

If Youde's assessment is correct, then Hongkong people are hoping for a solution that will provide the best of both worlds — Chinese sovereignty and a British buffer (of undetermined form) to protect their style of life and high standard of living from interference by China. Thereafter, opinions are divided. The younger generation, particularly university students, want a more democratic form of administration, but this sends shudders down the collective spine of the business establishment.

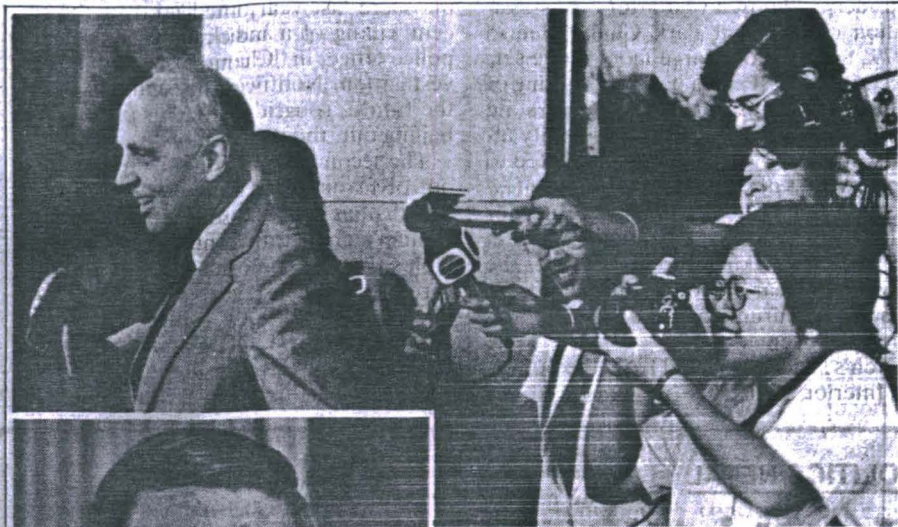
The students are already very keen on China's proposed gangren zhiqiang (self-administration by Hongkong people) plan. Even government officials grudgingly admit that the gangren formula is a masterful stroke in China's campaign for the hearts and minds of Hongkong people, particularly the younger generation. However, influential wealthy local Chinese and many middle-class professionals, who have a pathological fear of politics, particularly socialism, and who have vested interests in maintaining the existing elitist system of administration, think those who support the gangren plan are "dangerously naive."

A new variation of the self-administration plan has also recently emerged — put forward by a newly appointed member of

ond phase of talks constituted progress. As far as foreign investors are concerned, one analyst said: "Nothing has changed. What our clients want is reassurance that a solution, which has to ensure an administration independent of Peking, will work. Every aspect of Hongkong's future government must be dealt with at the local, rather than the federal level."

Analysts expect the same level of leakage from the current talks on substantive issues as that which prevailed in the past nine months. "We will probably know, over the next three months, whether the chances of an administratively independent Hongkong are rising or falling," one said.

Observers were meanwhile currently cheered by news that the second phase of



Youde pursued by the press;  
Tsao: a classic gaffe.

the Chinese People's Political Consultative Conference standing committee, local industrialist Ann Tse-kai. Ann told the REVIEW: "The law is above individuals. Hongkong should be governed by Hongkong laws. With law, you have order, then stability, followed by prosperity."

Meanwhile, confidence which resurfaced in the Hongkong stockmarket between June 30 and July 8 is once again hanging in the balance. Analysts maintain that much of the HK\$1.85 billion (US\$260 million) traded that week (the Hang Seng Index soared more than 95 points) came from local Chinese who felt that the sec-

the talks was to concentrate on the nitty-gritty of a solution — details like who will appoint the governor and to whom he will answer — rather than on sovereignty. Reports from various people who have met Chinese elder statesman Deng Xiaoping recently confirm earlier accounts that Peking now feels that once the administrative arrangements for Hongkong are sorted out, the sovereignty issue will resolve itself.

On the first day of the talks, Chinese Foreign Ministry spokesman Qi Huaiyuan denied a report in a Hongkong news magazine that China had told Britain it would revise its constitution in order to guarantee that Hongkong would continue as a capitalist society with different status from the rest of China after the sovereignty issue was resolved. The spokesman reiterated Premier Zhao Ziyang's statement in his report to the National People's Congress last month that "China will at an opportune moment recover Chinese sovereignty over Hongkong and take appropriate measures to maintain its prosperity." In any event, the report was incorrect because China has already taken account of cases such as Hongkong's through the provision for special administrative regions. ■

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LIMDIS  
E.O. 12356: DECL: OADR  
TAGS: EINP, ECON, CH, HK  
SUBJECT: NEGOTIATIONS ON HONG KONG'S FUTURE; HKG COMMENTS  
REF: LONDON 17004

1. WE ARE ENCOURAGED BY AMEMBASSY LONDON'S OPTIMISTIC  
READING OF THE SECOND STAGE OF SINO-UK NEGOTIATIONS ON  
HONG KONG.

2. OFFICIALS HERE HAVE BEEN MUCH LESS FORTHCOMING. DEPUTY  
POLITICAL ADVISER MARGOLIS, WHO PARTICIPATED IN THE MOST  
RECENT ROUND, STATED THEY WERE ON A VERY SHORT LEASH ON  
THE SUBJECT. MARGOLIS ALSO PROJECTED A LESS OPTIMISTIC  
READING OF THE NEGOTIATIONS TO DATE. HE SAID THAT CHINA'S  
PUBLIC STATEMENTS ABOUT SOVEREIGNTY AND HOW HONG KONG WOULD  
BE RUN AFTER 1997 SEEMED TO HAVE FORCED IT INTO A RIGID  
POSITION IN THE TALKS. THE CHINESE WERE QUOTE OUT ON A  
LIMB END QUOTE AND CLIMBING BACK WOULD BE DIFFICULT FOR  
THEM.

3. MARGOLIS SAID ONE UK GOAL WAS TO MAKE A TRANSITION  
IN OR AROUND 1997 AS SMOOTH AS POSSIBLE, AND TO KEEP  
ACTUAL CHANGES IN ADMINISTRATION, ETC. TO A MINIMUM.  
IT SEEMED TO HIM THAT THE CHINESE HAD PUT THEMSELVES  
IN A POSITION WHICH WOULD MAKE DISRUPTIVE CHANGES HARD  
TO AVOID.

4. HE CLAIMED THAT THE PRC'S LACK OF UNDERSTANDING OF  
HONG KONG CONTINUES TO BE A MAJOR PROBLEM. HE CITED AS  
AN EXAMPLE THE APPARENTLY CONTINUING CHINESE BELIEF THAT  
THE UK GAINS SIGNIFICANT MATERIAL BENEFITS FROM THEIR  
ADMINISTRATION OF THE TERRITORY.

5. COMMENT: MARGOLIS MAY BE OVERREACTING TO THE CHINESE  
NEGOTIATING STYLE OF STARTING OUT HARD AND PERSISTING IN  
SUCH A COURSE ABSENT INTERVENTION BY HIGHER AUTHORITY.  
WE WOULD ALSO POINT OUT THAT THE CHINESE HAVE ON MORE THAN

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