Linked to Win

September 14, 2011

Pershing Square Capital Management, L.P.

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Structure of the Presentation

I. The Context

II. The History

III. The Current State of Play

IV. Our Prediction of What is Likely to Happen

V. The Investment Opportunity

VI. Why Now?

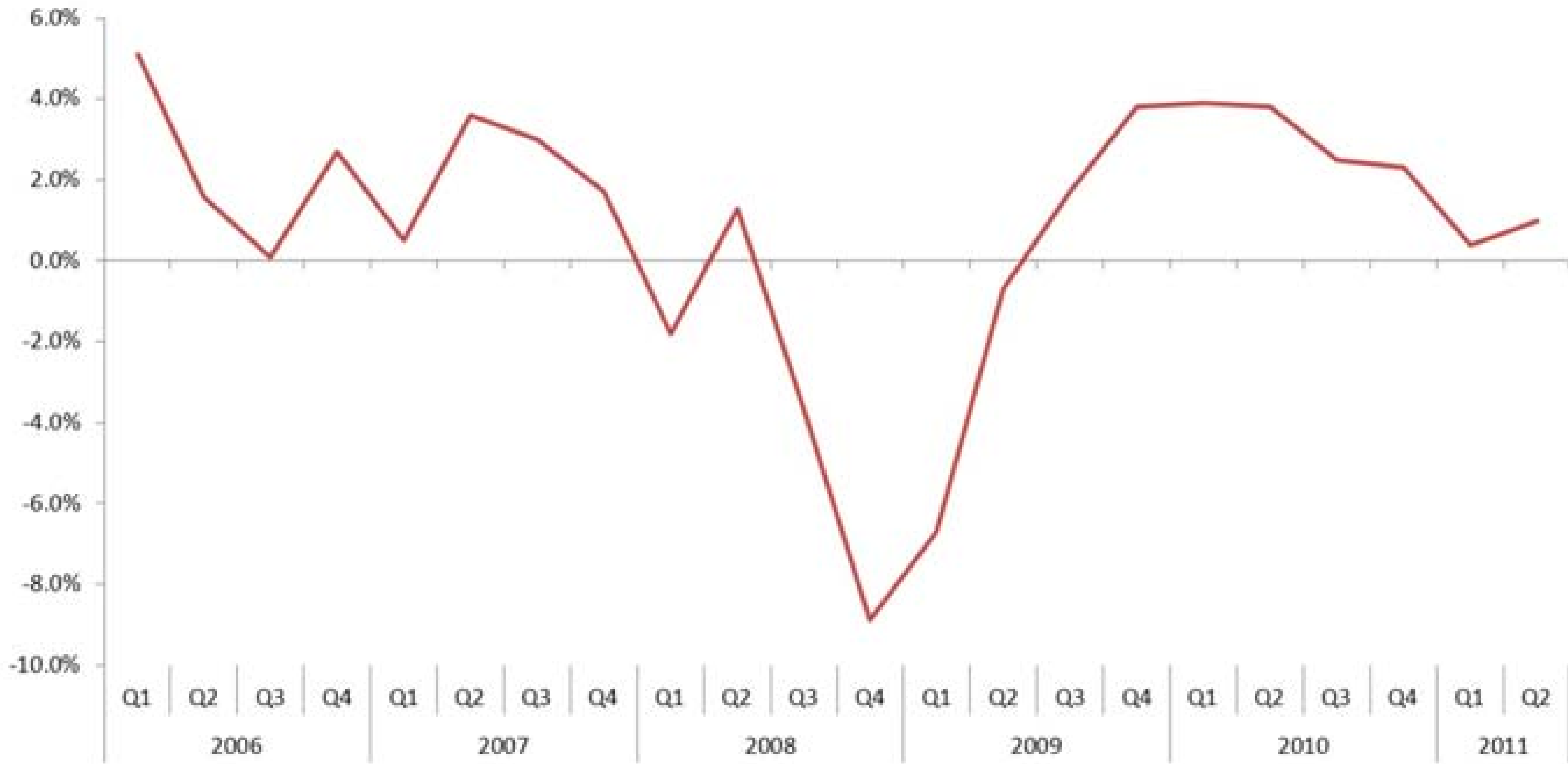
I. The Context

The US Economy Today

GDP Growth – U.S.

U.S. economic growth remains sluggish

Real GDP Growth (%QoQ – Annualized, Seasonally Adj.)

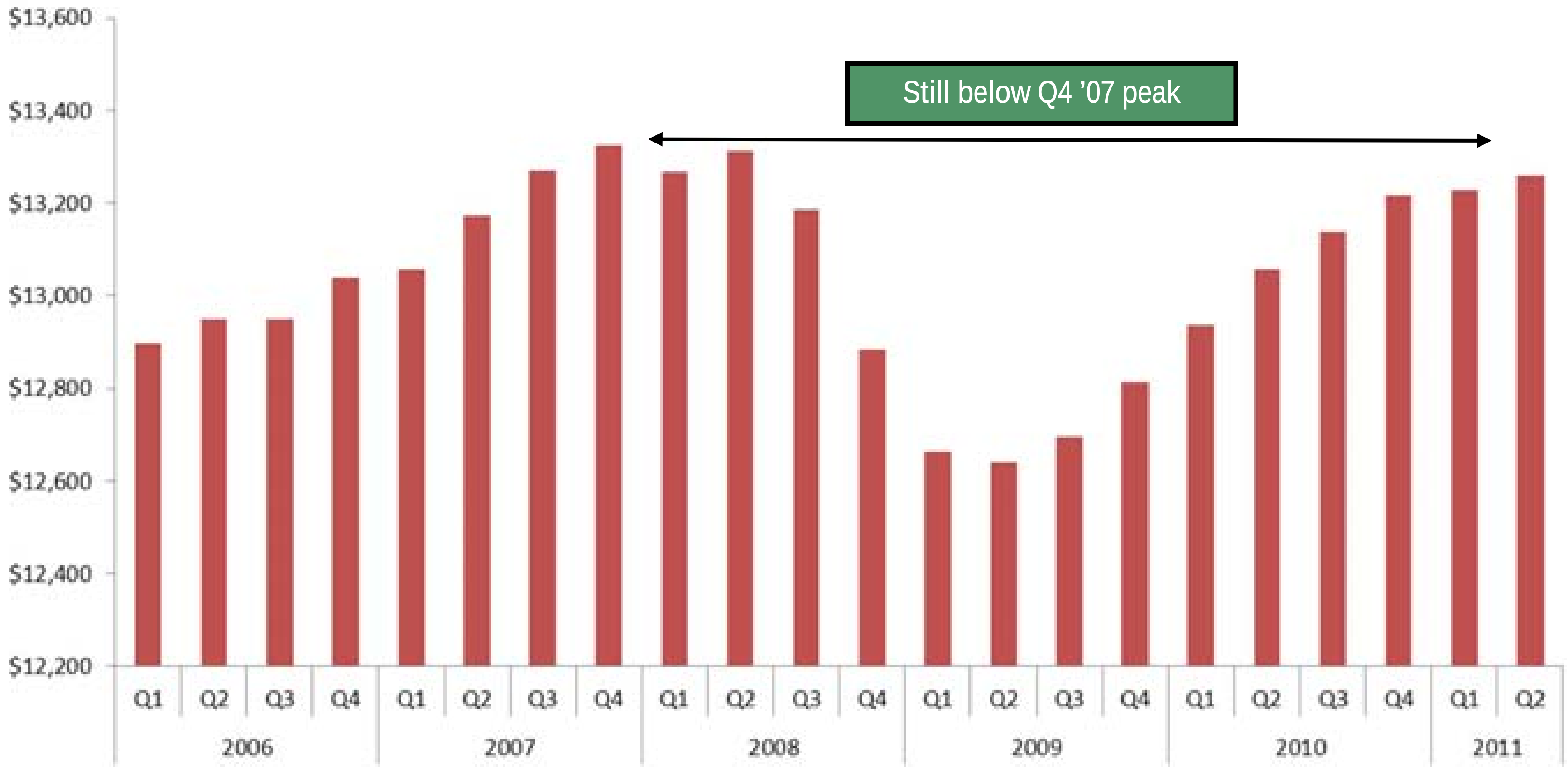


Source: Bloomberg.

GDP – U.S.

U.S. GDP is still below the Q4 ’07 peak

Annualized Real GDP (Billion USD, 2005 Dollars)

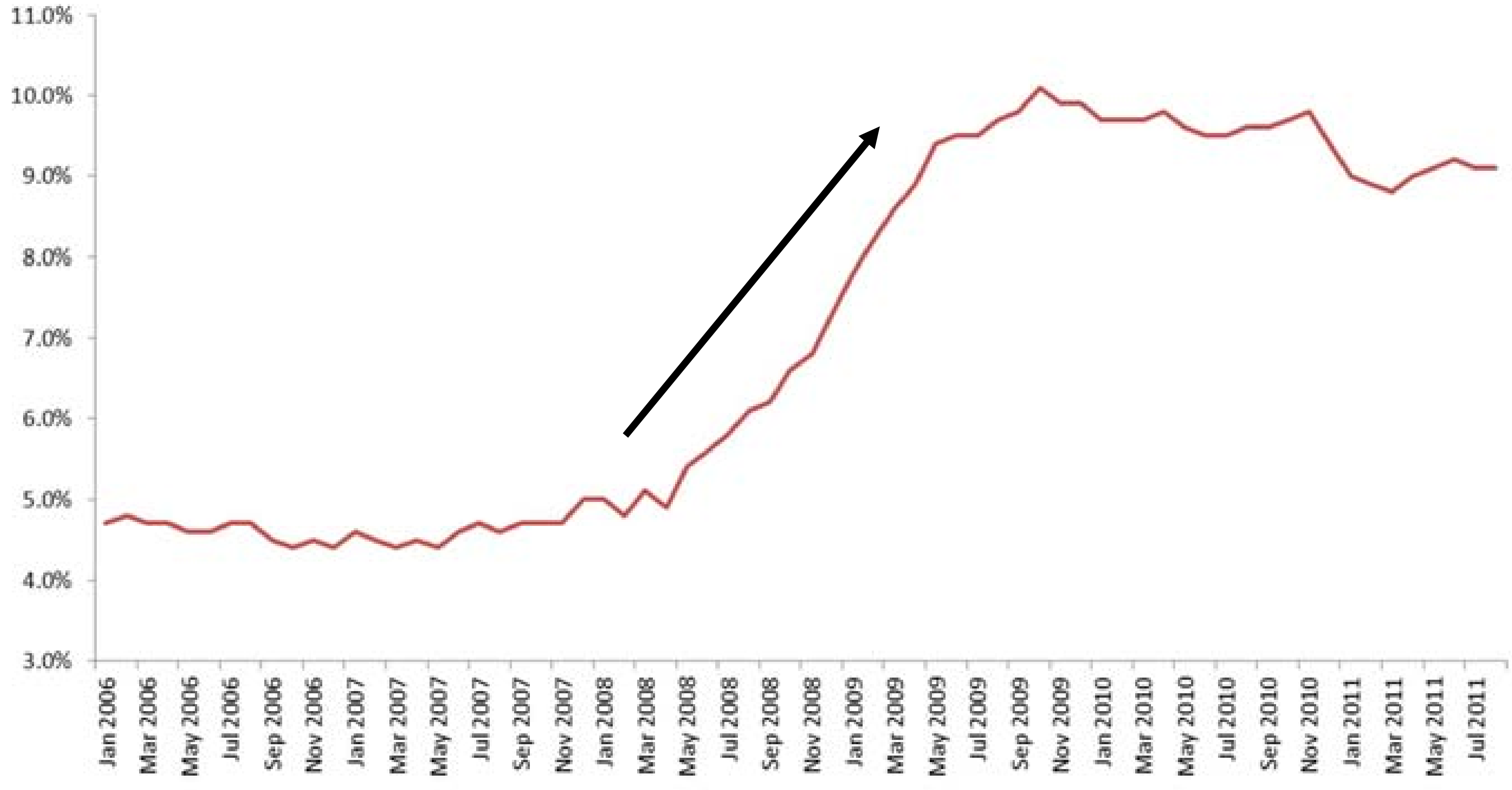


Source: Bloomberg.

Unemployment – U.S.

Unemployment in the U.S. remains stubbornly high at over 9%

Unemployment Rate (%)

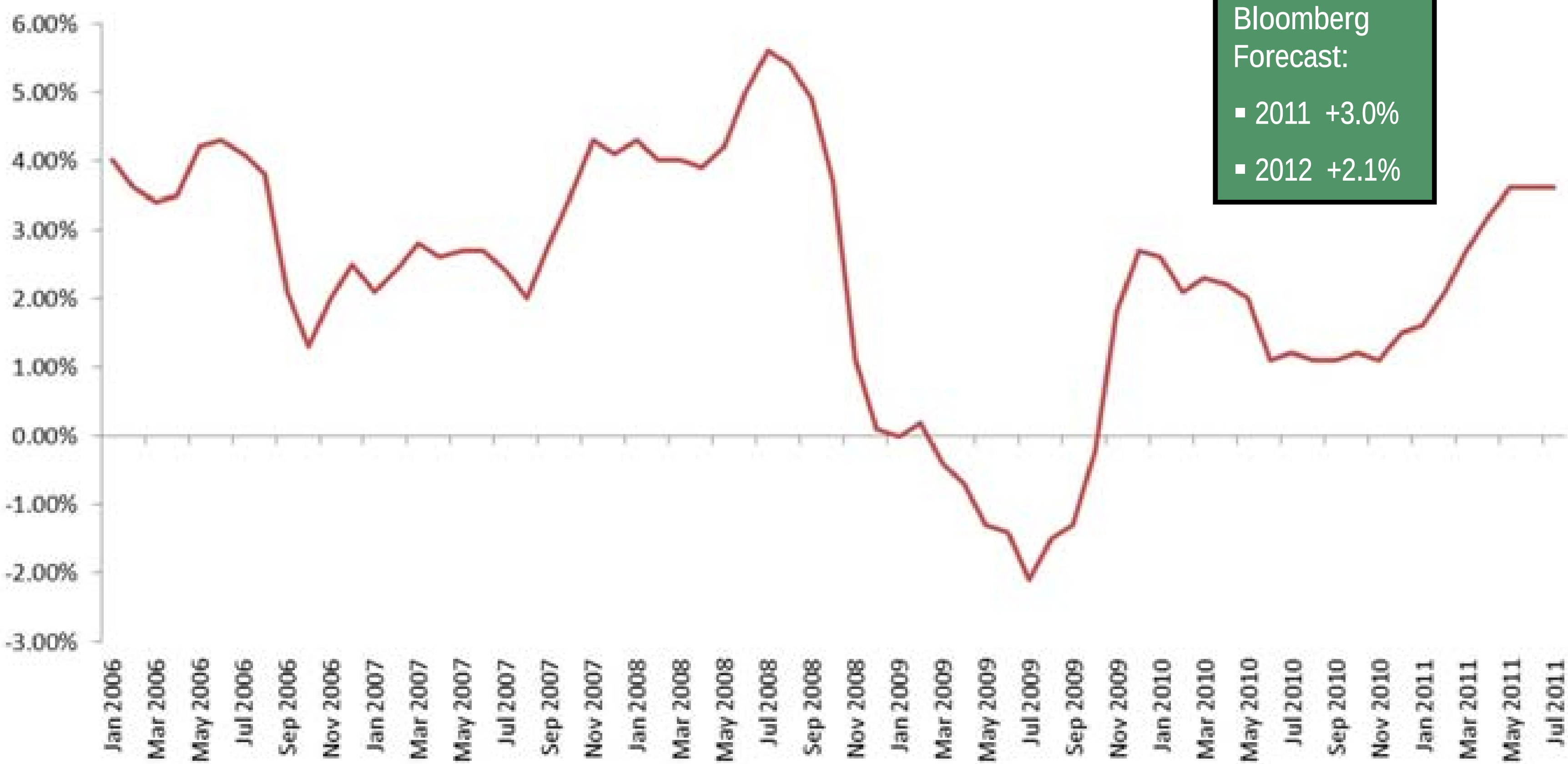


Source: Bloomberg.

Inflation – U.S.

Inflation has picked up, but seems to have leveled off and is forecast to decrease

Consumer Price Index Growth (YoY)



Median Bloomberg Forecast:

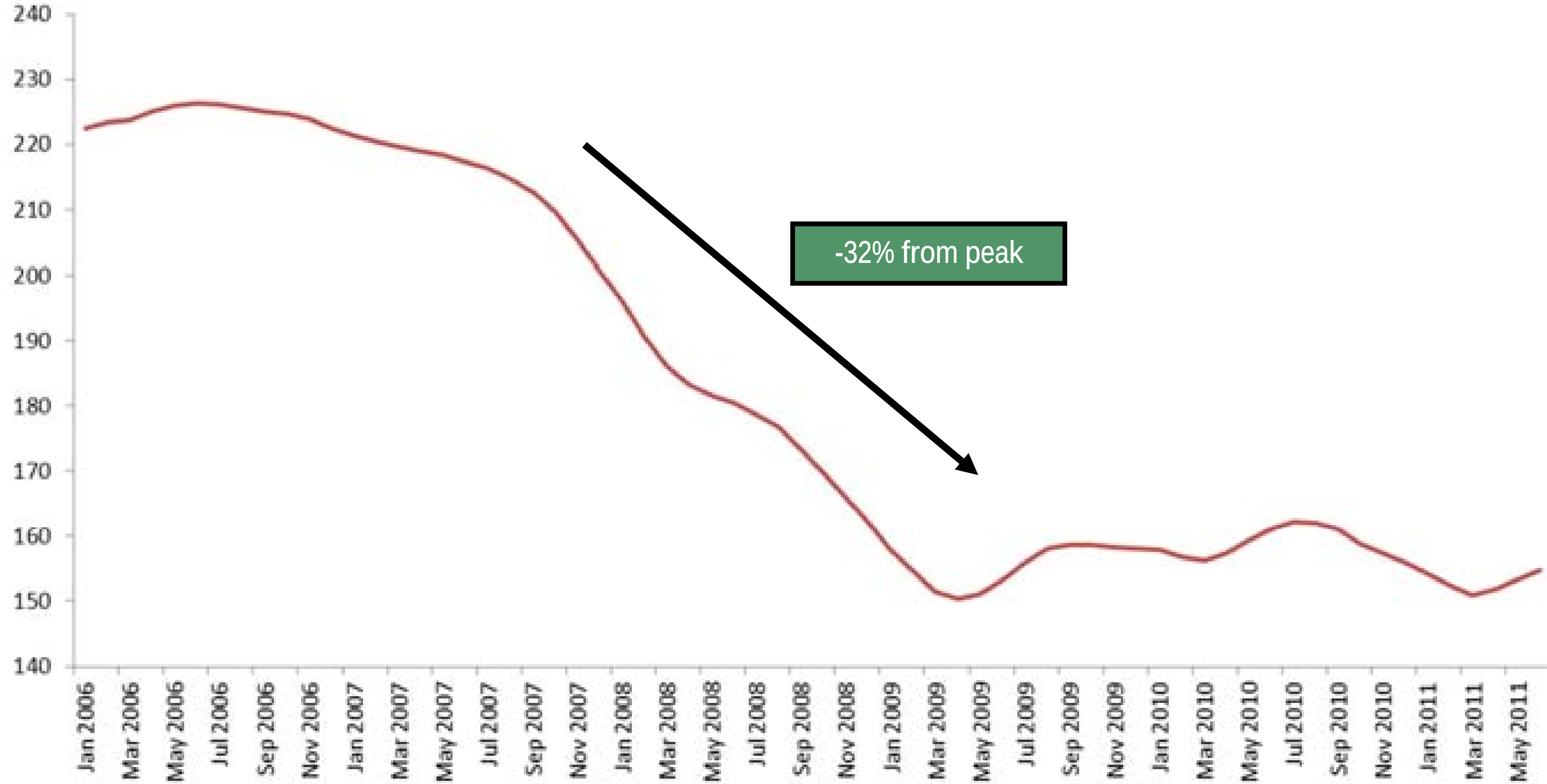
- 2011 +3.0%
- 2012 +2.1%

Source: Bloomberg.

Home Prices – U.S.

U.S. Home Prices are down 32% from peak and have not recovered

Home Price Index (Case Shiller Home Price 10-City Index)



Source: Bloomberg.

U.S. Monetary Policy Today

To combat persistent weakness in the U.S. economy, the Federal Reserve has reduced short-term rates to zero and enacted two rounds of quantitative easing

Economic Weakness → Accommodative Monetary Policy

Real GDP (YoY%)	+1.5%
Unemployment	9.1%
Home Prices (YoY%)	-3.8%
CPI (YoY%)	3.6%

- **Near 0% Short-Term Interest Rates through mid-2013**
- **Multiple Rounds of Quantitative Easing**

Source: Based on the latest available Bloomberg data.

U.S. Monetary Policy Will Remain Extremely Accommodative:

"The committee currently anticipates that economic conditions – including low rates of resource utilization and a subdued outlook for inflation over the medium run – are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013"

- Federal Reserve statement, August 2011

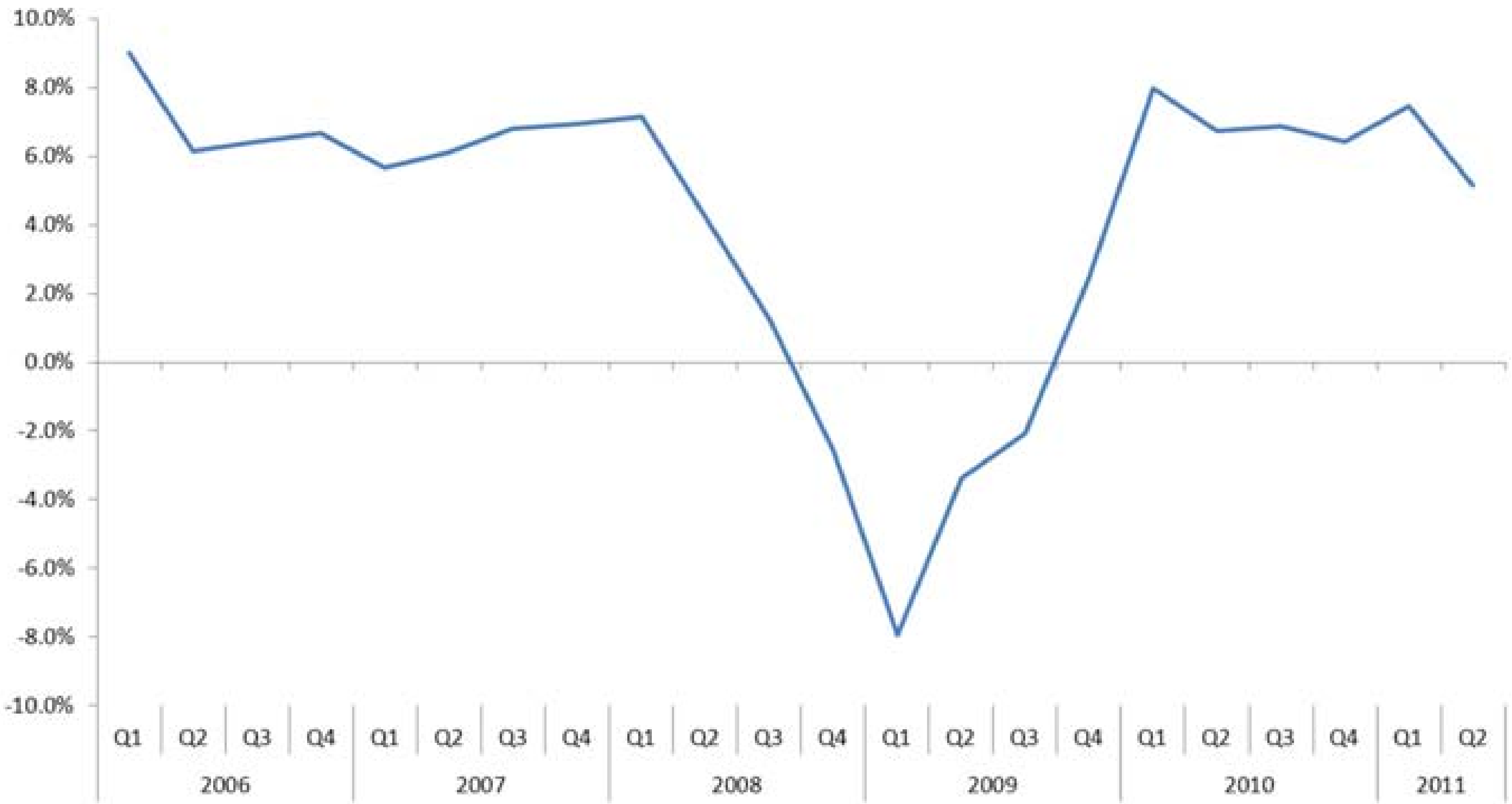
Source: Press, Release August 9, 2011 – Board of Governors of the Federal Reserve System (http://www.federalreserve.gov/newsevents/press/monetary/20110809a.htm).

Compare with Economy X

GDP Growth – Economy X

Economy X has recovered strongly from the global recession

Real GDP Growth (YoY)

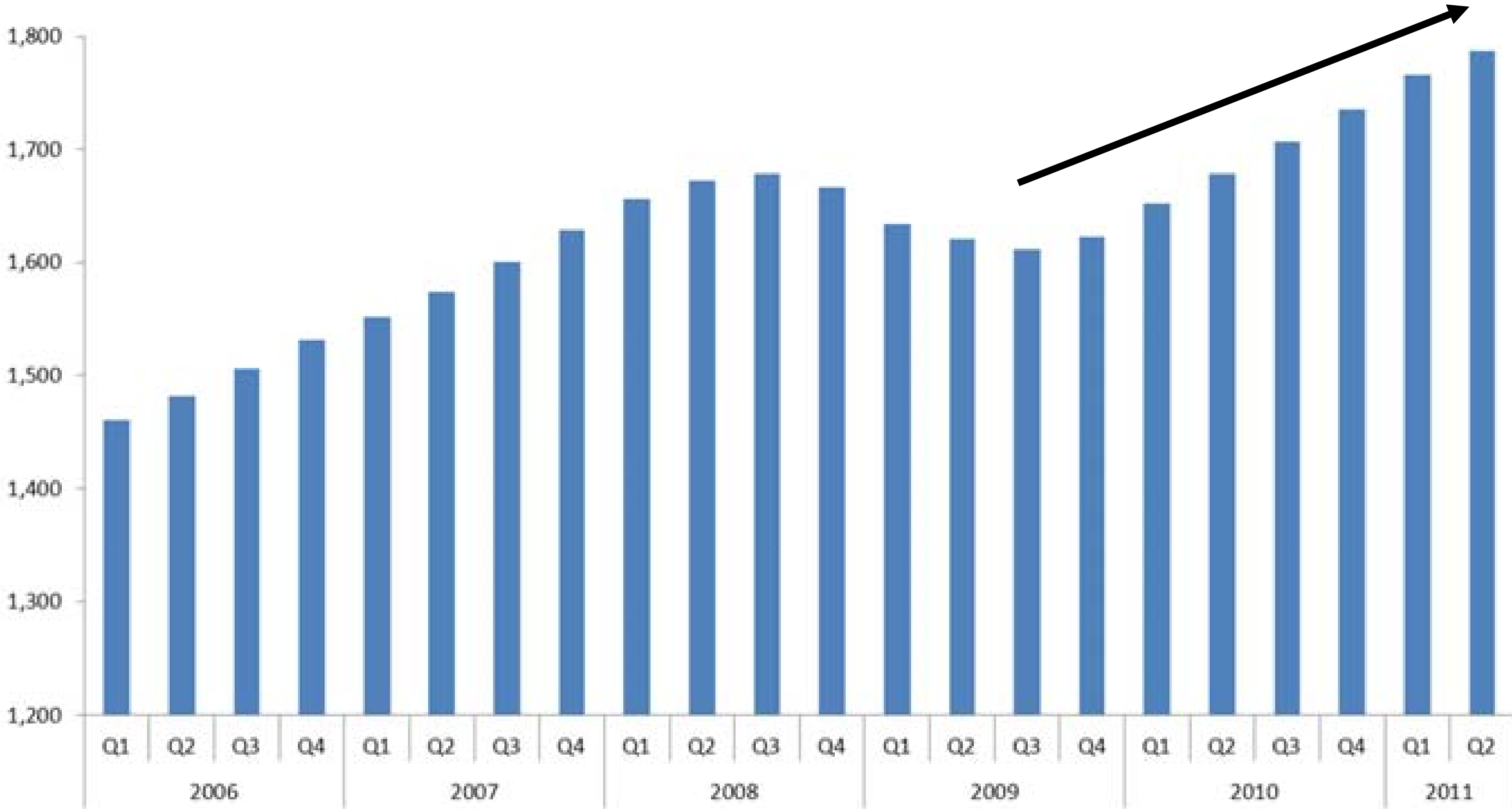


Source: Bloomberg.

GDP – Economy X

Economy X GDP is well above its peak

LTM Real GDP (Billion Local Currency)

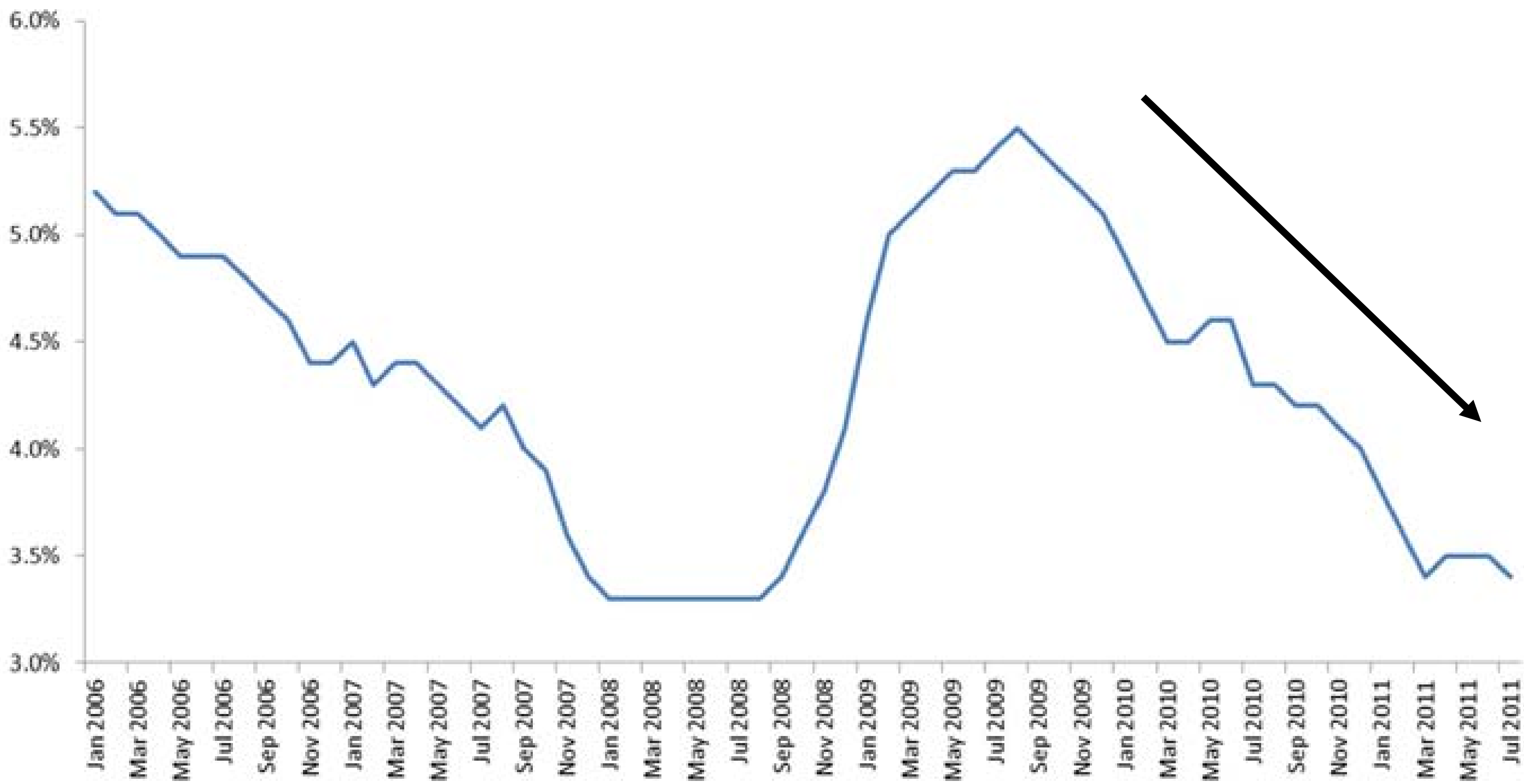


Source: Based on Bloomberg data (Cumulative Last 4Q's).

Unemployment – Economy X

Unemployment is 3.4% and back to pre-recession lows

Unemployment Rate (%)

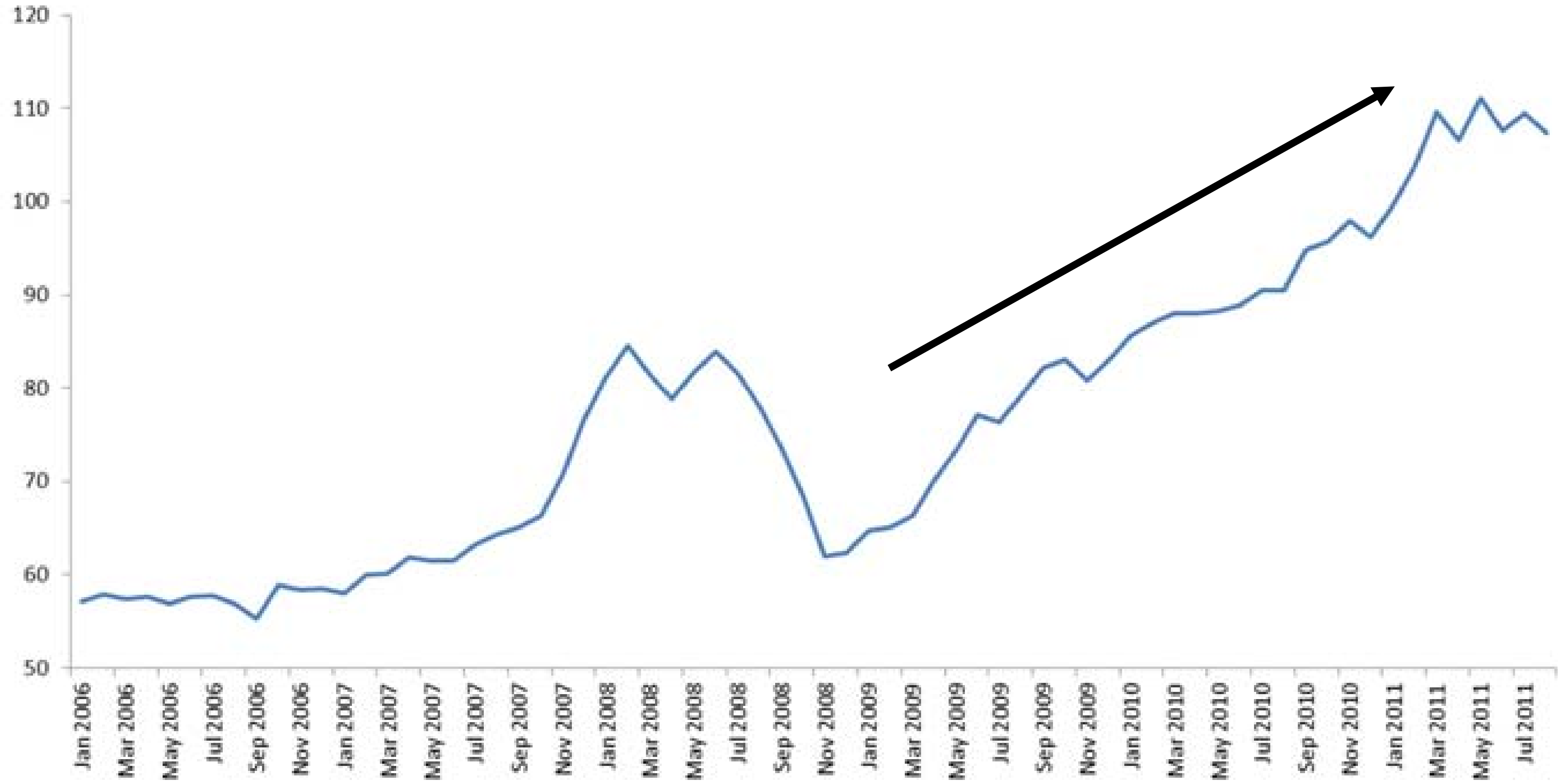


Source: Bloomberg.

Home Prices – Economy X

Since January 2006, home prices are up ~90%

Home Price Index

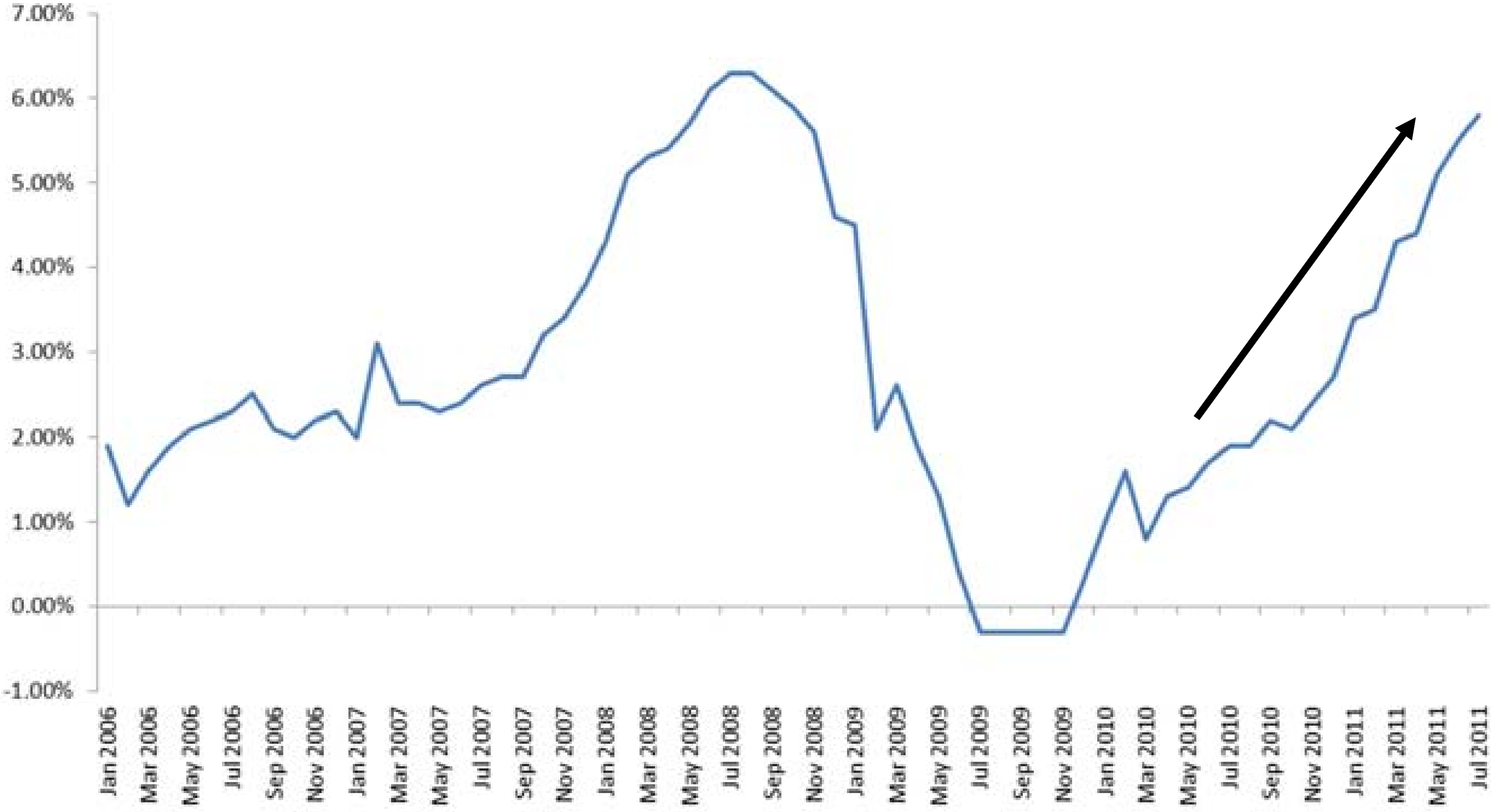


Source: "Centaline Property Centa-City Leading HK Index" - Bloomberg.

Inflation – Economy X

Inflation is accelerating and is now nearly 6%

Underlying Consumer Price Index Growth (YoY)



Source: "Monthly Report on the Consumer Price Index" - Census and Statistics Department, Hong Kong SAR Government. (http://www.censtatd.gov.hk/products_and_services/products/publications/statistical_report/prices_household_expenditure/index_cd_B1060001_dt_detail.jsp).

Economy X's Monetary Policy Mirrors the US's

Despite surging growth and inflation, Economy X's monetary policy mirrors that of the United States with a near-zero interest-rate policy and large amounts of money printing

	Economy X	U.S.
Real GDP (YoY%)	+5.1%	+1.5%
Unemployment %	3.4%	9.1%
Home Prices (YoY%)	+18.5%	-3.8%
CPI (YoY%)	+5.8%	+3.6%

Source: Based on the latest available Bloomberg data.
Press Release, August 22, 2011 – Census and Statistics Department, Hong Kong SAR Government (http://www.censtatd.gov.hk/press_release/press_releases_on_statistics/index.jsp?sID=2798&sSUBID=19062&displayMode=D).

Who is Economy X?

Why would Economy X have the same monetary policy as the United States?

Economy X = Hong Kong

Why Does Hong Kong share U.S. monetary policy?

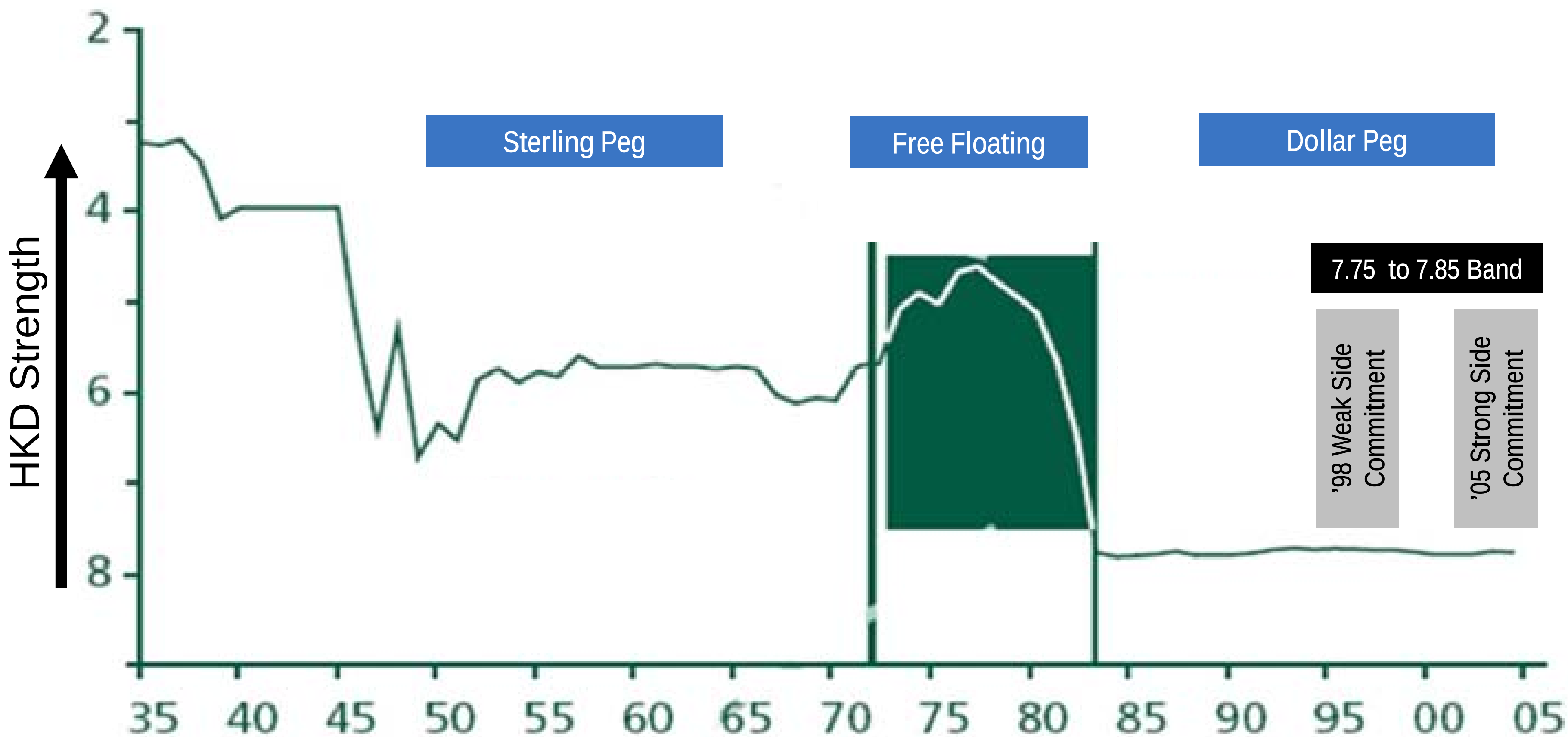
The Hong Kong Dollar's (HKD) peg to the U.S. Dollar (USD) <u>forces Hong Kong to import the U.S.'s ultra-accommodative monetary policy</u>, despite its much stronger economy

II. The History

The Hong Kong Dollar Over Time

Hong Kong has implemented several different currency regimes, demonstrating a pattern of change and adaptation during times of stress

HKD/USD (inverted)



Source: "Hong Kong's Linked Exchange Rate System" – Hong Kong Monetary Authority, p.34 (http://www.info.gov.hk/hkma/eng/public/hkmalin/index.htm).

Sterling Link Adopted (1935)

- **By 1935, facing a dramatic rise in the price of silver and a shrinking money supply, Hong Kong abandoned silver as backing for its currency**

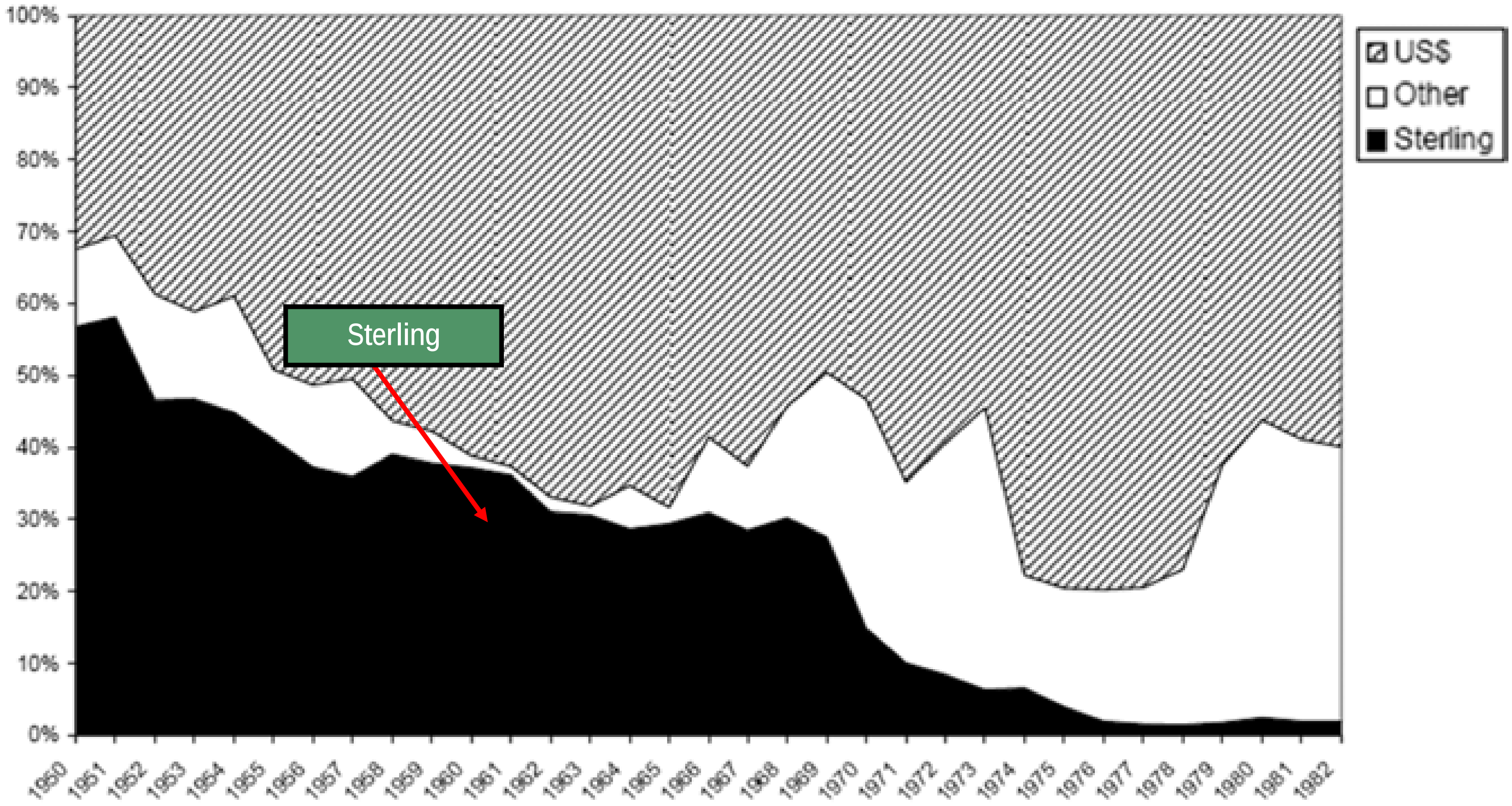
- **HK replaced the silver link with a Sterling-based currency board**

- **At the time, HK was a British colony and Sterling was a major reserve currency**

The Sterling Peg (1935-1972)

Sterling's role as an international reserve currency was displaced by the USD after WWII

Denomination of Foreign Currency Reserves 1950-1982

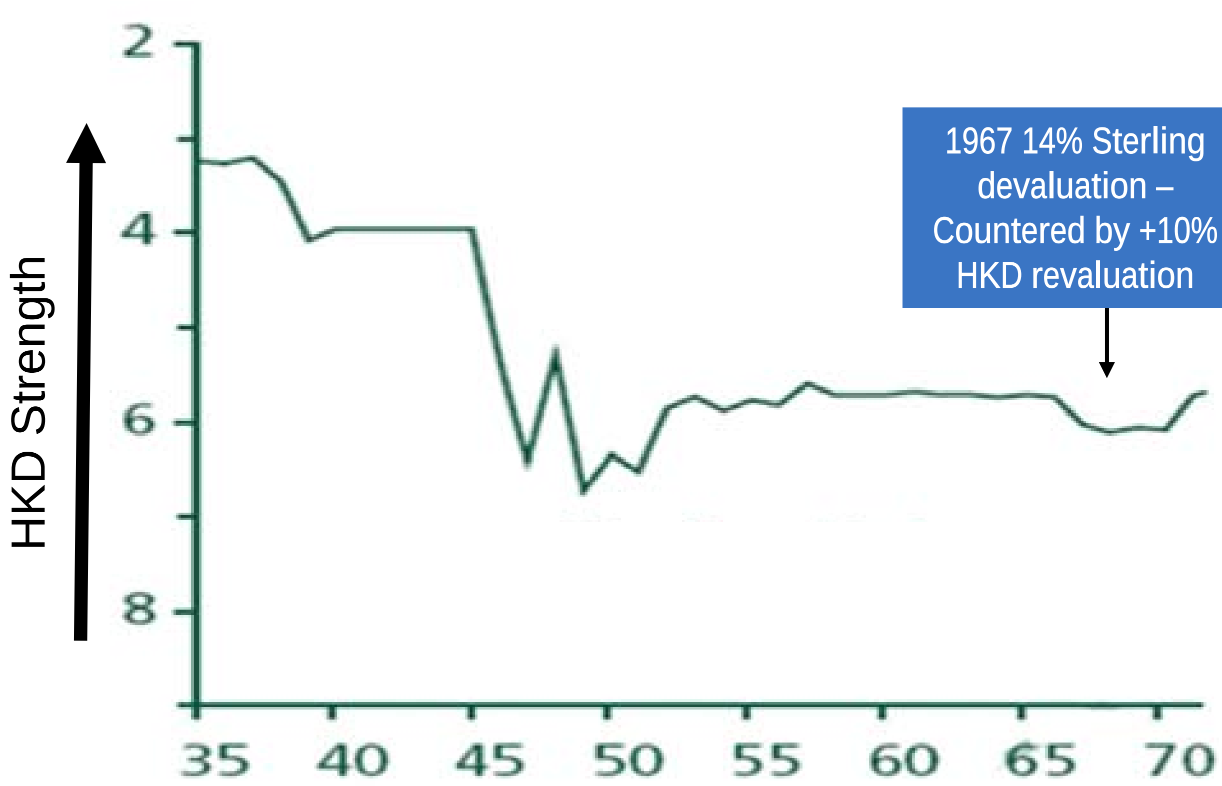


Source: "The Decline of Sterling: Managing the Retreat of an International Currency, 1945-1992" - Catherine R. Schenk, p.23.

Sterling Link Abandoned (1972)

In 1949 and in 1967, Sterling was devalued. Shortly after the 1967 devaluation, <u>the HKD was revalued by 10%</u> against Sterling to preserve its purchasing power

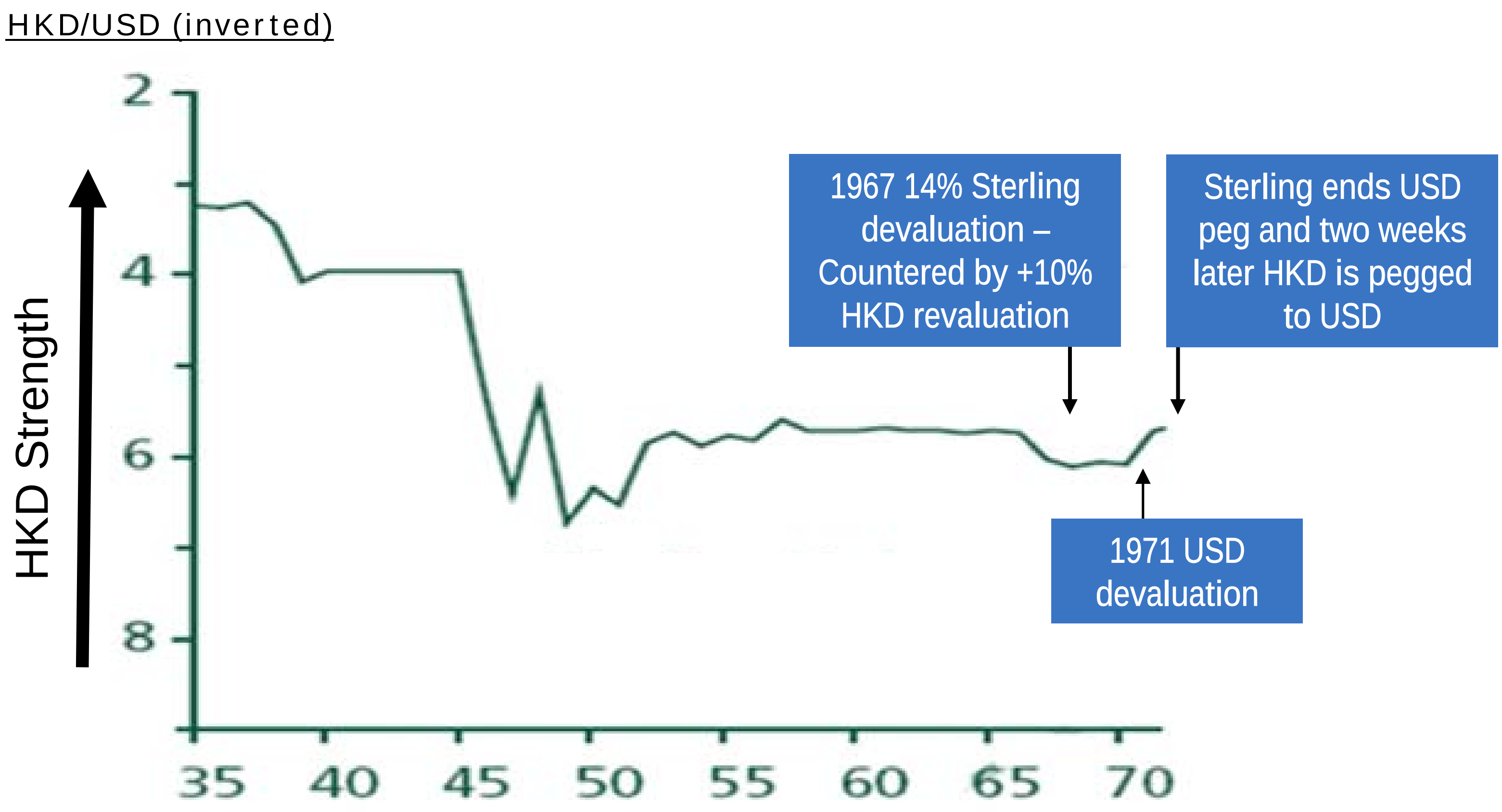
<u>HKD/USD (inverted)</u>



Source: "Hong Kong's Linked Exchange Rate System" - Hong Kong Monetary Authority, p.34 (http://www.info.gov.hk/hkma/eng/public/hkmalin/index.htm).

Sterling Link Abandoned (1972)

In 1971, Nixon gave up the gold standard and devalued the USD. In 1972, Sterling broke its USD peg. Two weeks later HK announced a USD link



Source: "Hong Kong's Linked Exchange Rate System" - Hong Kong Monetary Authority, p.34 (http://www.info.gov.hk/hkma/eng/public/hkmalin/index.htm).

First Dollar Link (1972-1974)

- **In February 1973, with the US struggling with inflation and Vietnam war debt, USD was devalued against gold by 10%**

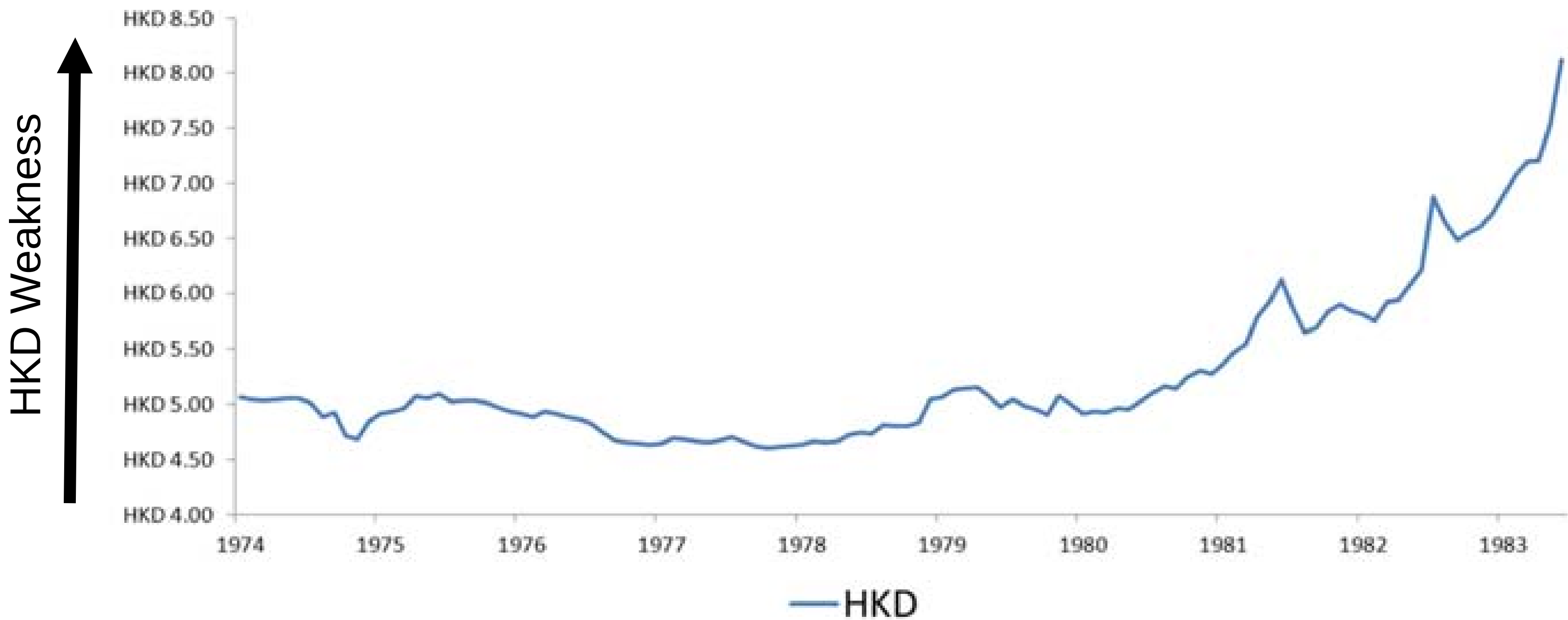
- **HK responded to this USD devaluation and adjusted its currency to maintain HKD's price relative to gold, implying a <u>10% revaluation against USD</u>**

- **Finally, in November 1974, without a reliable anchor, HK discarded the USD link and floated its currency**

The Float (1974-1983)

Until 1982, the Float worked reasonably well despite HK's lacking a formal central bank. The commercial banks were made responsible for managing the system, leaving the HKD vulnerable to a crisis

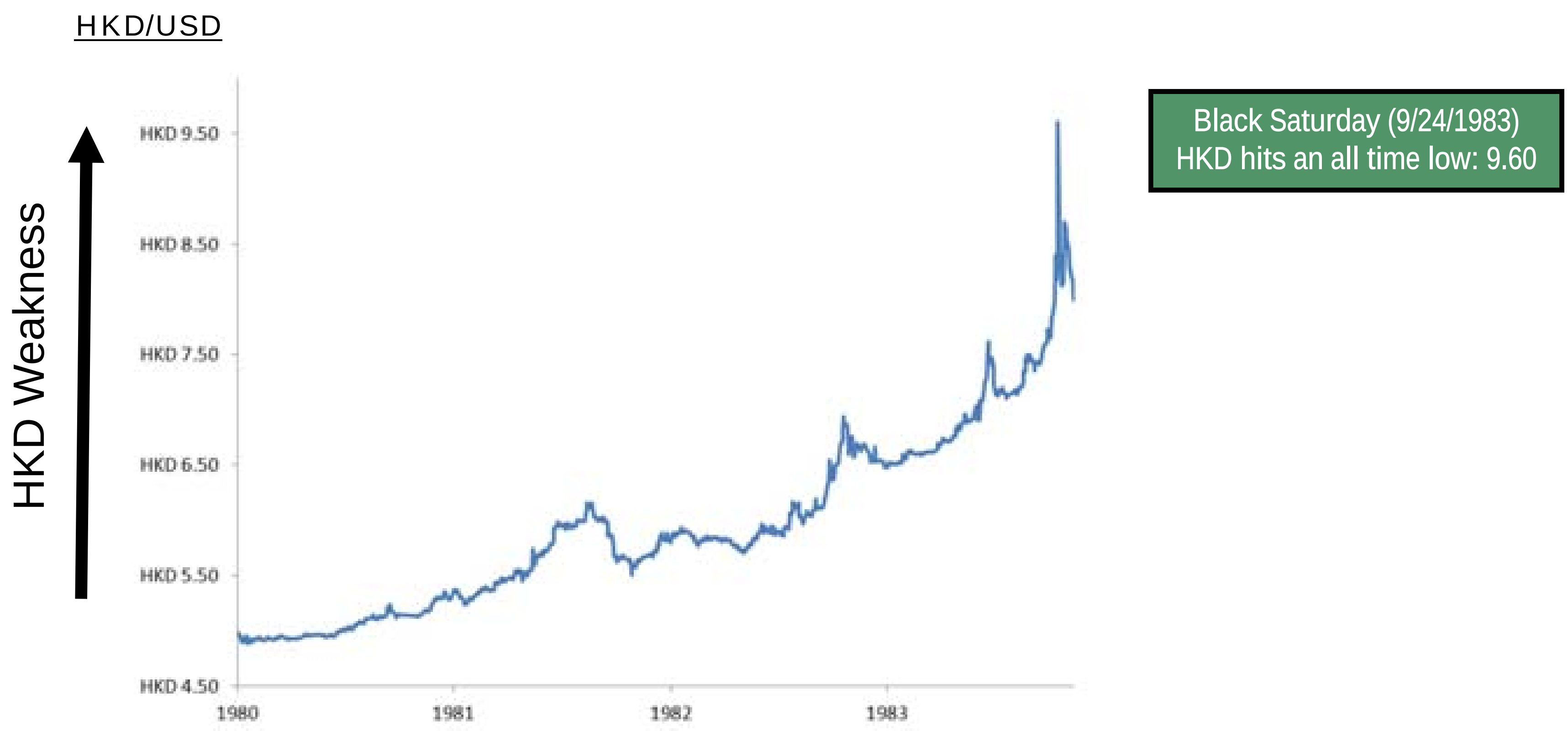
HKD/USD



Source: Bloomberg.

The Float Ends in Crisis (1983)

In September 1983, negotiations over the UK's agreement to transfer control of HK to the Mainland sparked a crisis of confidence in the HKD, leading to bank runs and food shortages. A rapid decline in the HKD ensued



Source: Bloomberg.

The Float Ends in Crisis (1983) Cont.

Panic Overwhelms the Streets

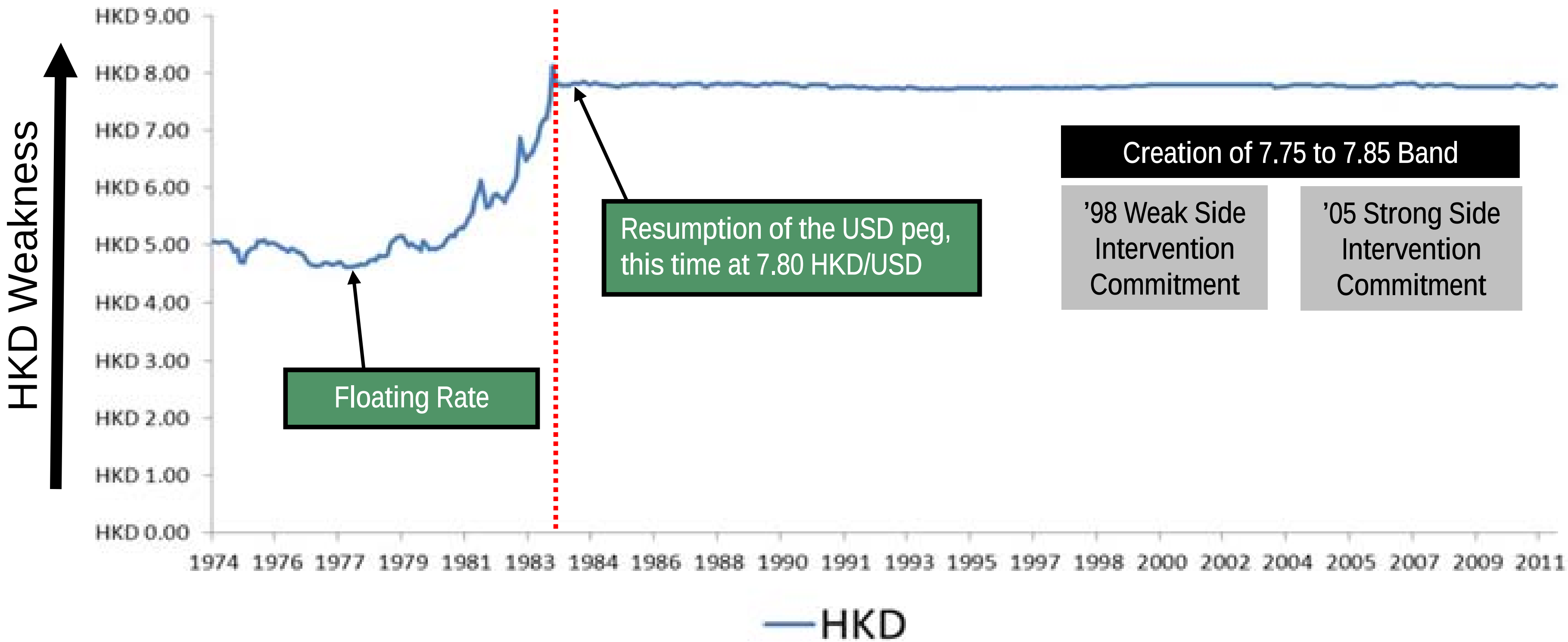
Fear Grips Hong Kong

Source: "Hong Kong SAR's Monetary and Rate Challenges" - Catherine Schenk, p149-50.

The Dollar Link (1983 – Present)

To stem the panic, authorities adopted a currency board and a USD peg. While the initial workings of the currency board were basic, the strength of the USD and the simplicity of the currency board made it credible

HKD/USD



Source: Bloomberg.

Why Did HK Choose the USD as an Anchor in 1983?

- **US monetary policy established tremendous credibility in the Volcker era**
- **There was no other viable anchor – Precious metals had been discredited and Sterling was a secondary currency**
- **The US was a major HK trading partner**
- **The USD was commonly used in international trade and finance**

"The crucial factor is that there should be confidence that the anchor currency will be managed responsibly by its central bank."

- Tony Latter, Former HKMA Deputy Chief Executive and co-architect of the peg

Source: "Hong Kong's Money: The History, Logic and Operation of the Currency Peg" - Tony Latter, p.56.

How do we know what the HK government was thinking when the peg was introduced in 1983?

This publically available HK government policy memo details the HK government's thinking at the time:

STABILISATION OF THE EXCHANGE RATE

Introduction

This memorandum describes a scheme to stabilise the exchange rate of the Hong Kong dollar, and seeks Members' advice as to whether it should be implemented immediately.

We will get back to this memo later in the presentation…

Source: "Stabilization of the Exchange Rate" (http://www.sktsang.com/ArchiveI/1983.pdf).

HK Has Been Responsive to Change

- **Event: Silver appreciation (1935)**
  - Response: Sterling Peg
- **Event: Sterling devaluation (1967, 1972)**
  - Response: Revaluation; Switch to USD Peg
- **Event: USD devaluation (1973, 1974)**
  - Response: Revaluation; HKD Float
- **Event: HKD Crisis (1983)**
  - Response: USD Peg

III. The Current State of Play

Hong Kong

<u>Population</u>: 7.1mm

<u>GDP by Sector</u>: Finance 26%, Trade 27%, Public Administration 18%, Transportation 9%

<u>Economic Freedom</u>: Ranked #1 for 17 consecutive years by the Heritage Foundation

<u>History</u>:

•British colonial rule (1842-1997)

•Reversion to Chinese sovereignty (1997)

•“One Country, Two Systems” (1997-2047)

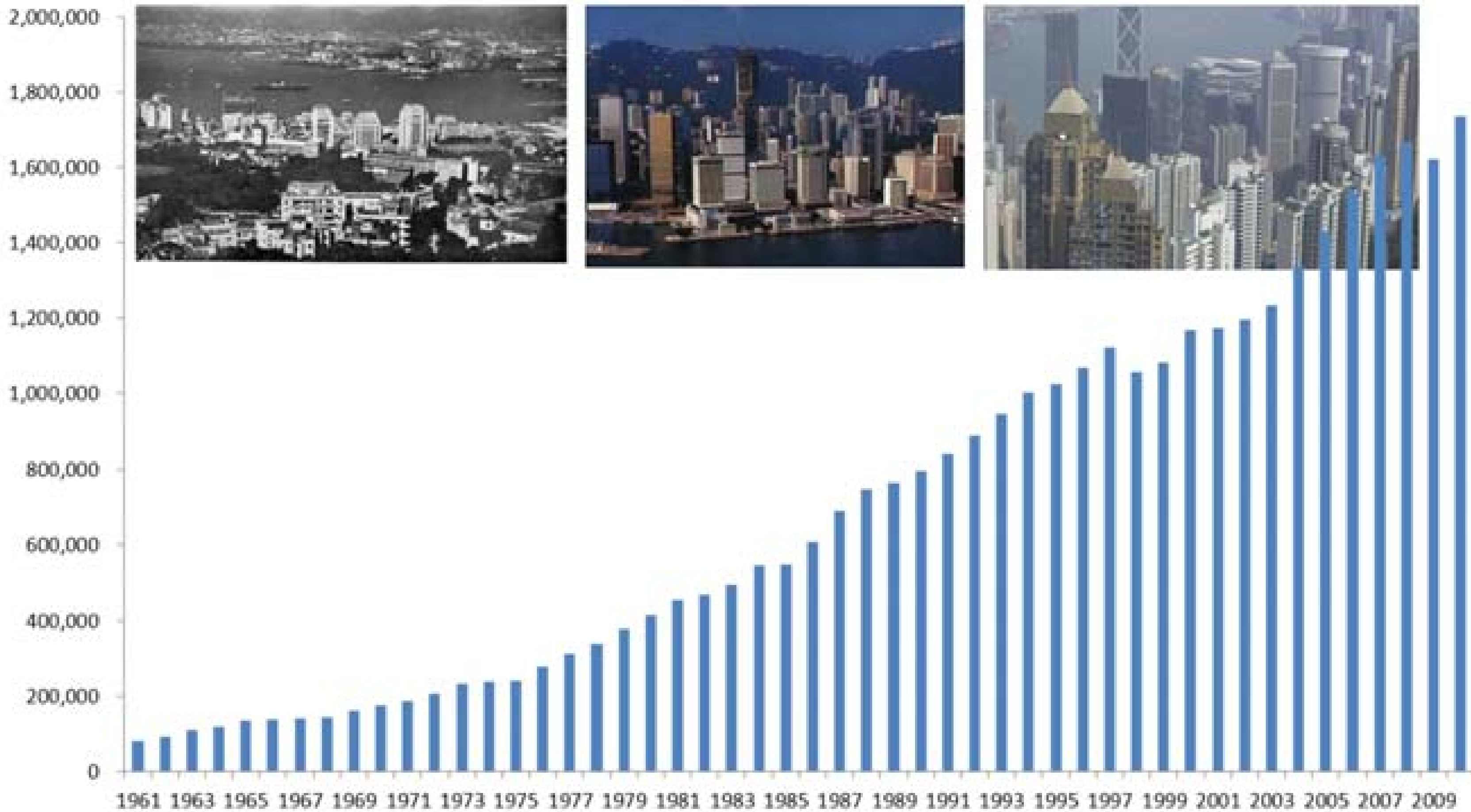
•Harmonization with the Mainland (2047 - Onward)

Source: “Hong Kong Yearbook 2010” - Information Service Department, Hong Kong SAR Government, p.49 (http://www.yearbook.gov.hk/2010/en/index.html).
Picture - (http://www.expatify.com/hong-kong/navigating-the-residential-neighborhoods-of-hong-kong.html).

The Hong Kong Economic Miracle

Hong Kong's real GDP has grown 21x over the last 50 years. This success is a product of its unique location and successful economic policy

Real GDP ($HKD mm, 2005 dollars)



Source: "National Income and Balance of Payments" - Census and Statistics Department, Hong Kong SAR Government, Table 32.

HK's Currency Regime is Tremendously Flexible

- **The Basic Law, HK's constitution, allows for a broad range of currency regimes**
- **Consequently, unlike many currency boards, the HKD system can be <u>quickly and easily amended</u>**
- **Any change would be made through an administrative process involving the Financial Secretary, the Chief Executive, and the Monetary Authority (HKMA), with likely consultation with Mainland authorities**

The Linked Exchange Rate System (LERS)

The LERS

- **Since 1983, the LERS has kept the HKD pegged to the USD at a rate of ~7.80 HKD/USD**
- **The HKMA has established a 7.75 to 7.85 HKD/USD trading band for the currency**
- **The price of the HKD is kept within the trading band through a series of arbitrage and automatic intervention mechanisms**

How the LERS System Works

Strong Side Defense: 7.75 HKD/USD

Capital Inflow

↓

Market Participants Buy HKD

↓

Upward Pressure On Exchange Rate

↓

Currency Board Sells HKD at 7.75

↓

Monetary Base Expands

↓

Interest Rates Fall

↓

Downward Pressure On Exchange Rate Back Towards 7.80 HKD/USD

Weak Side Defense: 7.85 HKD/USD

Capital Outflow

↓

Market Participants Sell HKD

↓

Downward Pressure On Exchange Rate

↓

Currency Board Buys HKD at 7.85

↓

Monetary Base Contracts

↓

Interest Rates Rise

↓

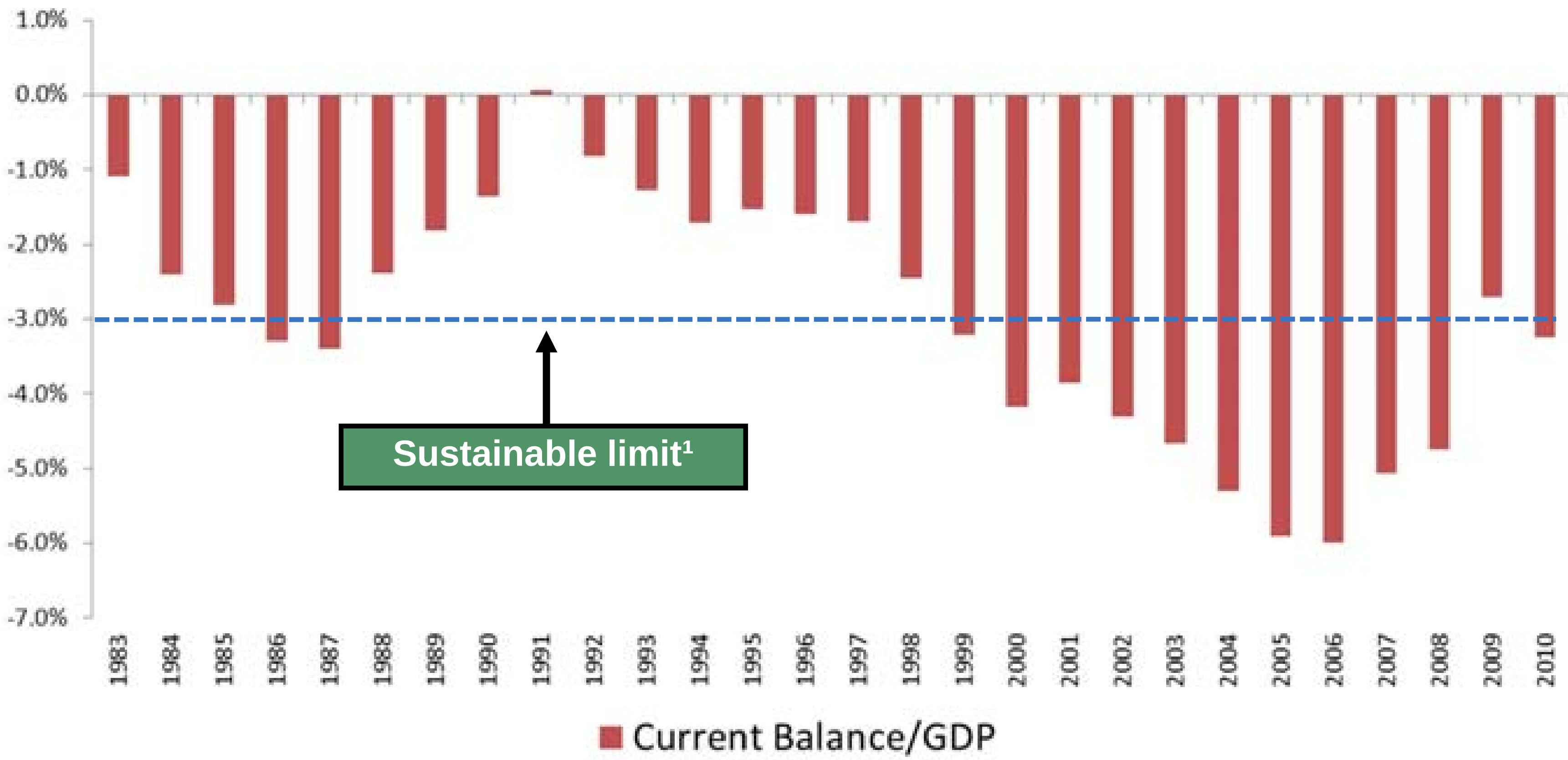
Upward Pressure On Exchange Rate Back Towards 7.80 HKD/USD

A Lot Has Changed Since 1983...

America's Trade Deficit

America's trade deficit has grown enormously since 1983. Funding such deficits requires large corresponding capital inflows

Trade Deficit as of GDP (%)



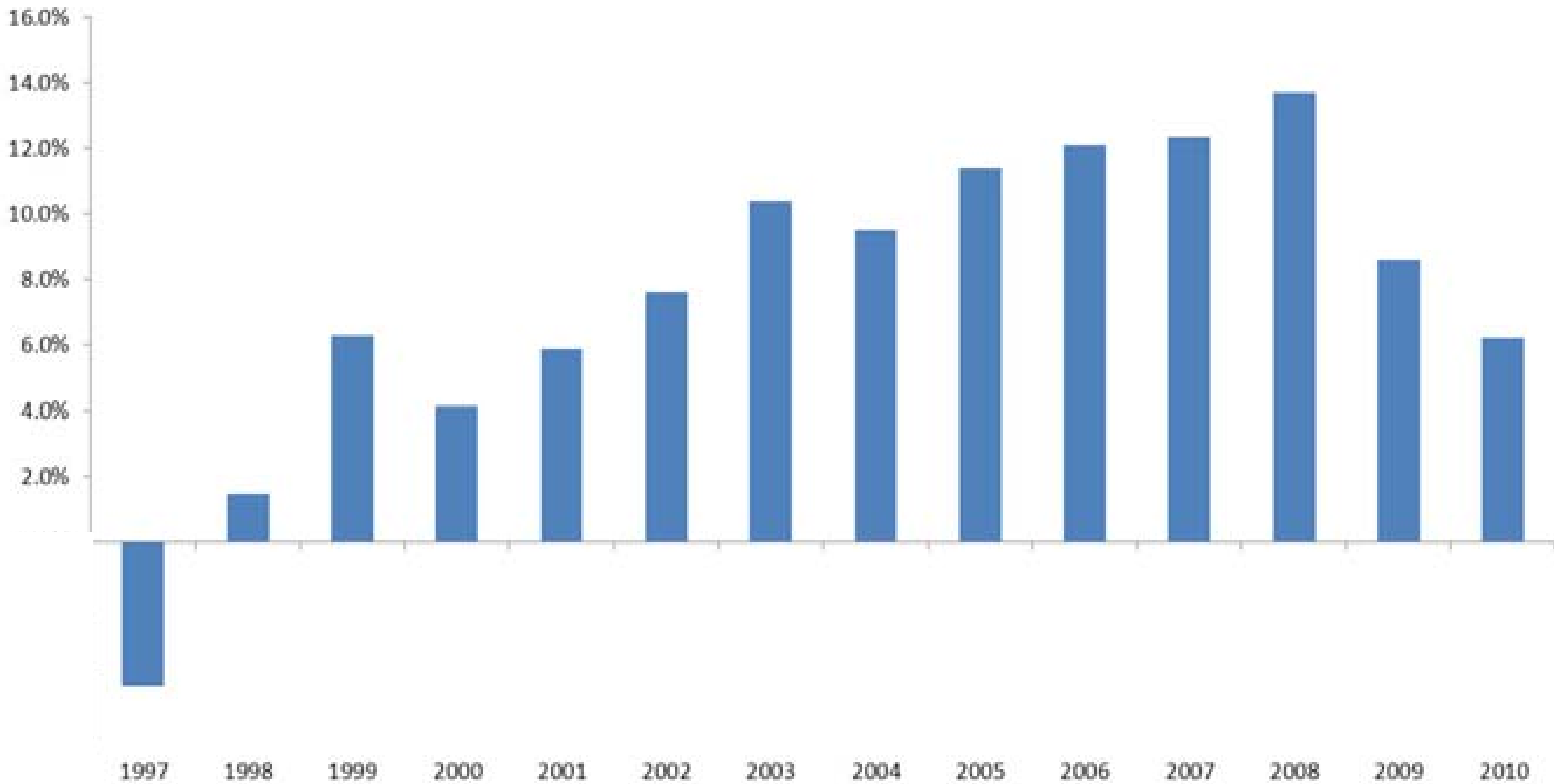
Source: Bloomberg.

[1] "Estimates of Fundamental Equilibrium Exchange Rates" - Peterson Institute for International Economics, p.3.

Hong Kong's Trade Surplus

Hong Kong's large trade surplus reflects its position as a global trading and financial services center, as well as the relative cheapness of its currency

Trade Surplus/ Deficit(% of GDP)

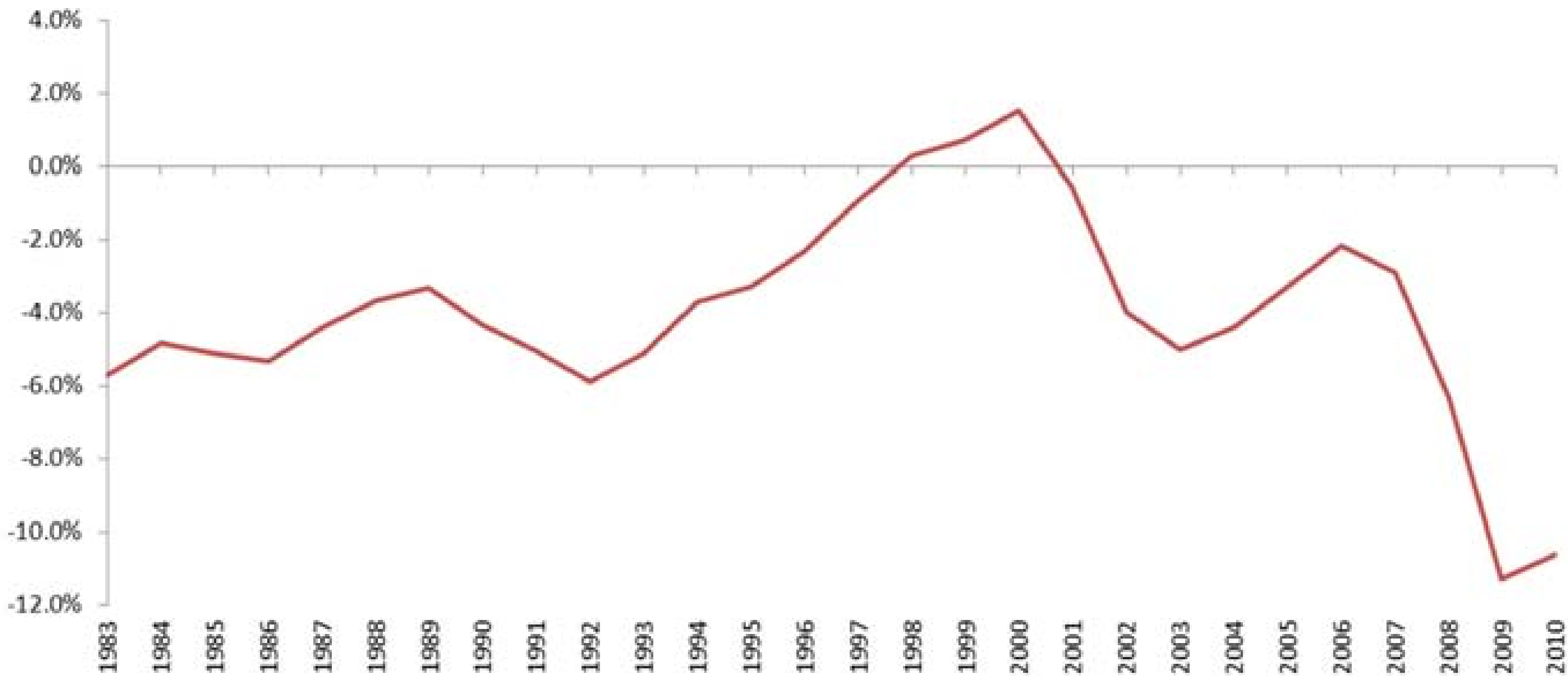


Source: "National Income and Balance of Payments" - Census and Statistics Department, Hong Kong SAR Government, Table 42.

America’s Debt Crisis

The U.S. has suffered from decades of chronic deficits

Deficit/GDP (%)

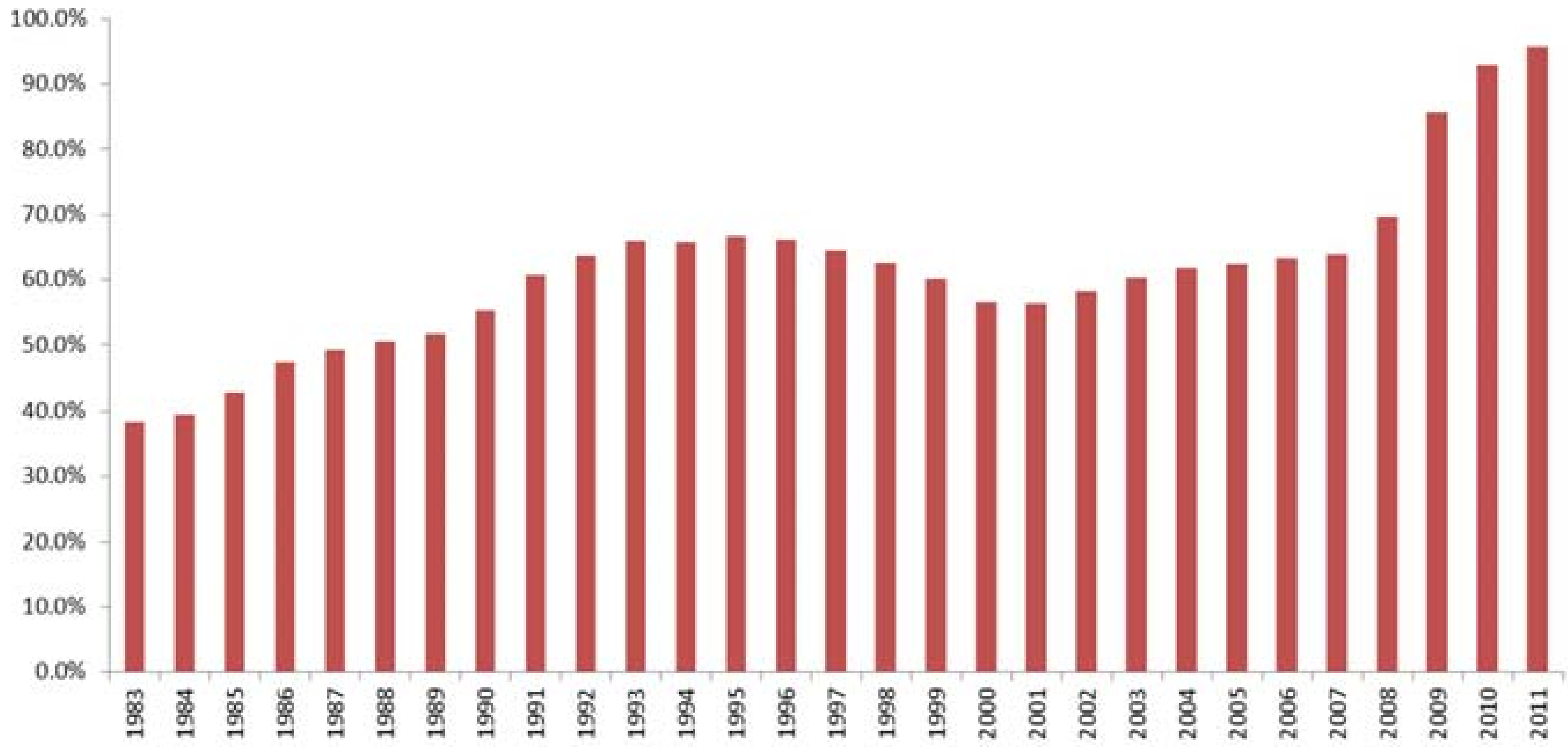


Source: Bloomberg.

America’s Debt Crisis – The US is No Longer AAA

America’s fiscal position has worsened considerably since 1983. S&P recently downgraded the U.S., citing poor leadership from Washington in solving the U.S.’s serious budget problems

Debt/GDP (%)

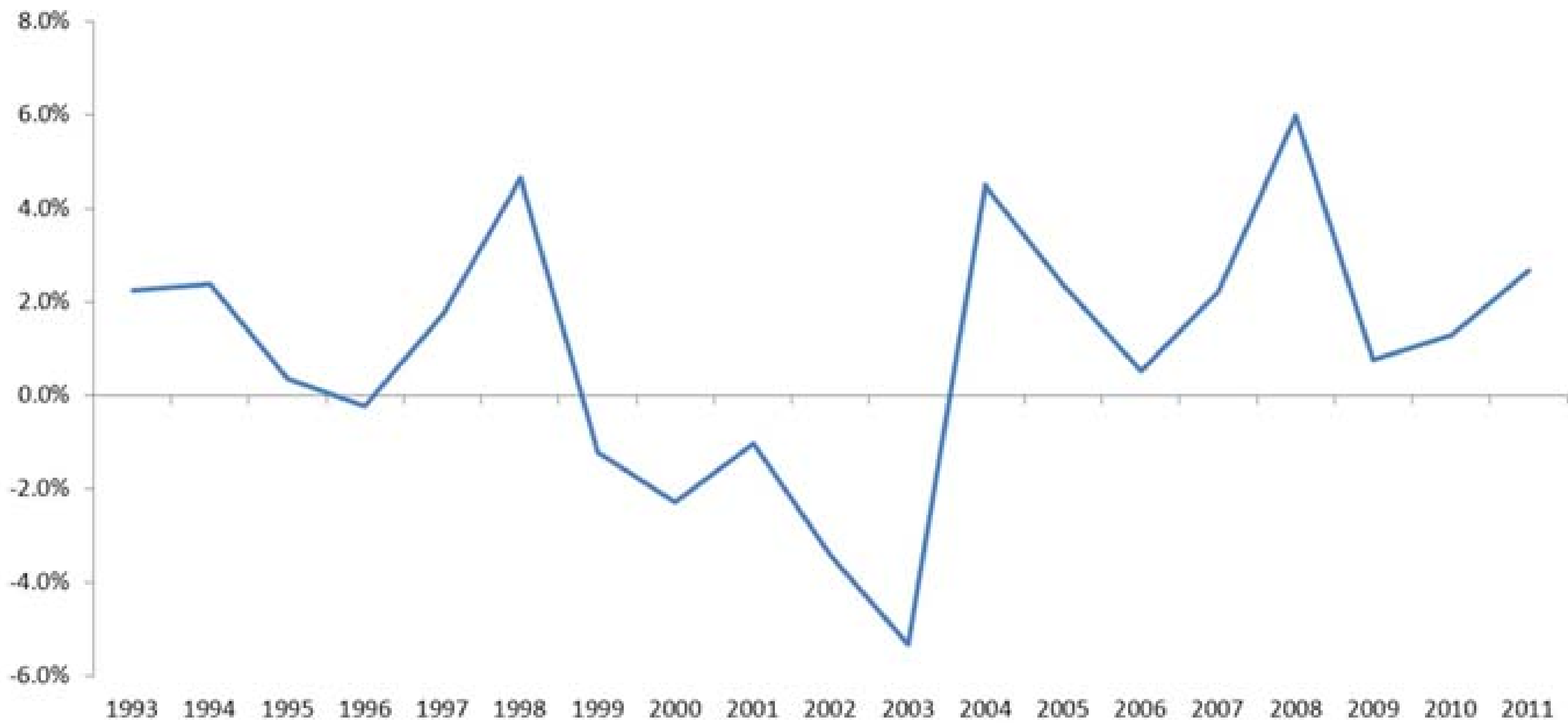


Source: Bloomberg.
Treasury Direct (http://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo4.htm).

Hong Kong's Fiscal Health is Solid

Hong Kong has a history of budget surpluses

HK Surplus (% of GDP)

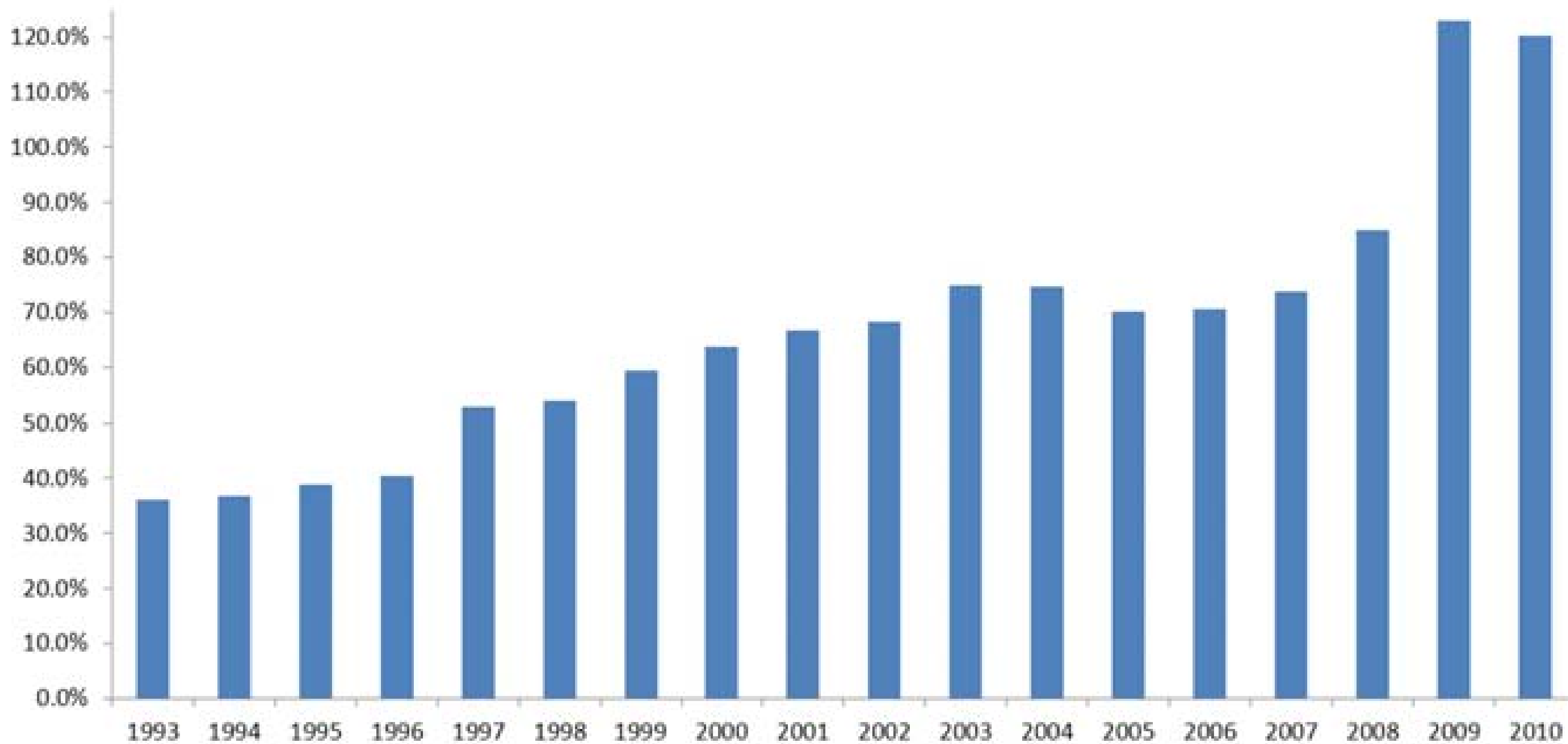


Source: Surplus - "Public Account, Money and Finance" - Census and Statistics Department, Hong Kong SAR Government, Table 192.
Nominal GDP - "National Income and Balance of Payments" - Census and Statistics Department, Hong Kong SAR Government, Table 32.

HK's Fiscal Health is Strong – 2010 S&P AAA Upgrade

HK has built a USD $77bn foreign currency fiscal reserve, or $294bn (~126% of trailing GDP) including the funds backing the currency board and other assets

Foreign Currency Assets (% of GDP)

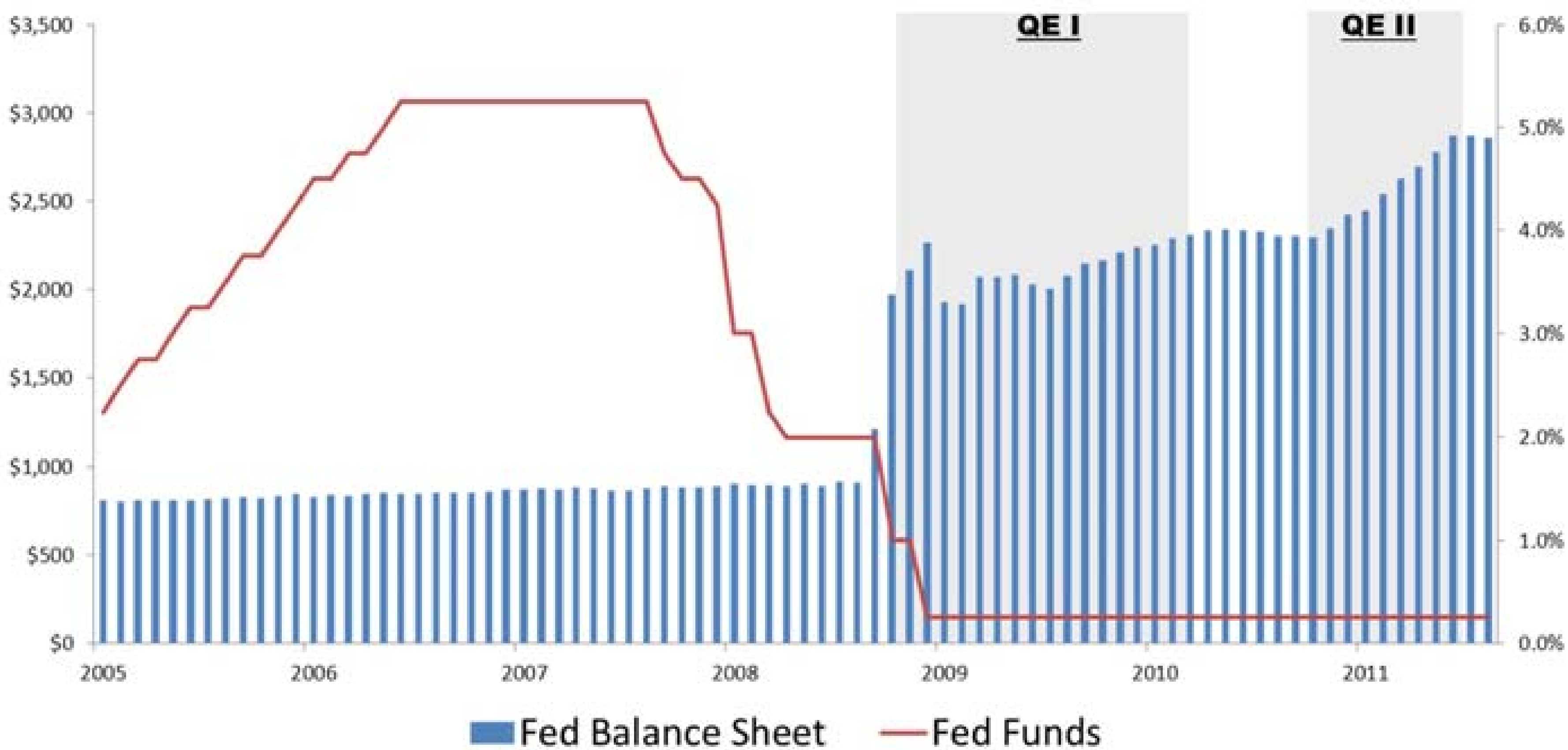


Source: Foreign Currency Assets - Bloomberg (Adjusted for HKD).
Nominal GDP - "National Income and Balance of Payments" - Census and Statistics Department, Hong Kong SAR Government, Table 32.

Evolving American Monetary Policy

Since the recent financial crisis, the Federal Reserve has struggled to stimulate the US economy, resorting to massive quantitative easing and promises of extended ultra-low interest rates

Fed Balance Sheet (Billion) | Fed Funds (%)



Source: Bloomberg.

Persistent US Dollar Weakness

Accommodative monetary policy, a weak economy and large fiscal and trade deficits have driven the USD lower and the HKD with it

Trade-Weighted Nominal USD Index

Source: "Nominal Major Currency Index" - Board of Governors of the Federal Reserve System (http://www.federalreserve.gov/releases/h10/summary/default.htm).

“The success of a currency board arrangement, and its acceptability to local people and businesses, depend to a considerable extent on the anchor currency being reasonably stable.”

- Tony Latter, Former HKMA deputy chief executive and co-architect of the peg

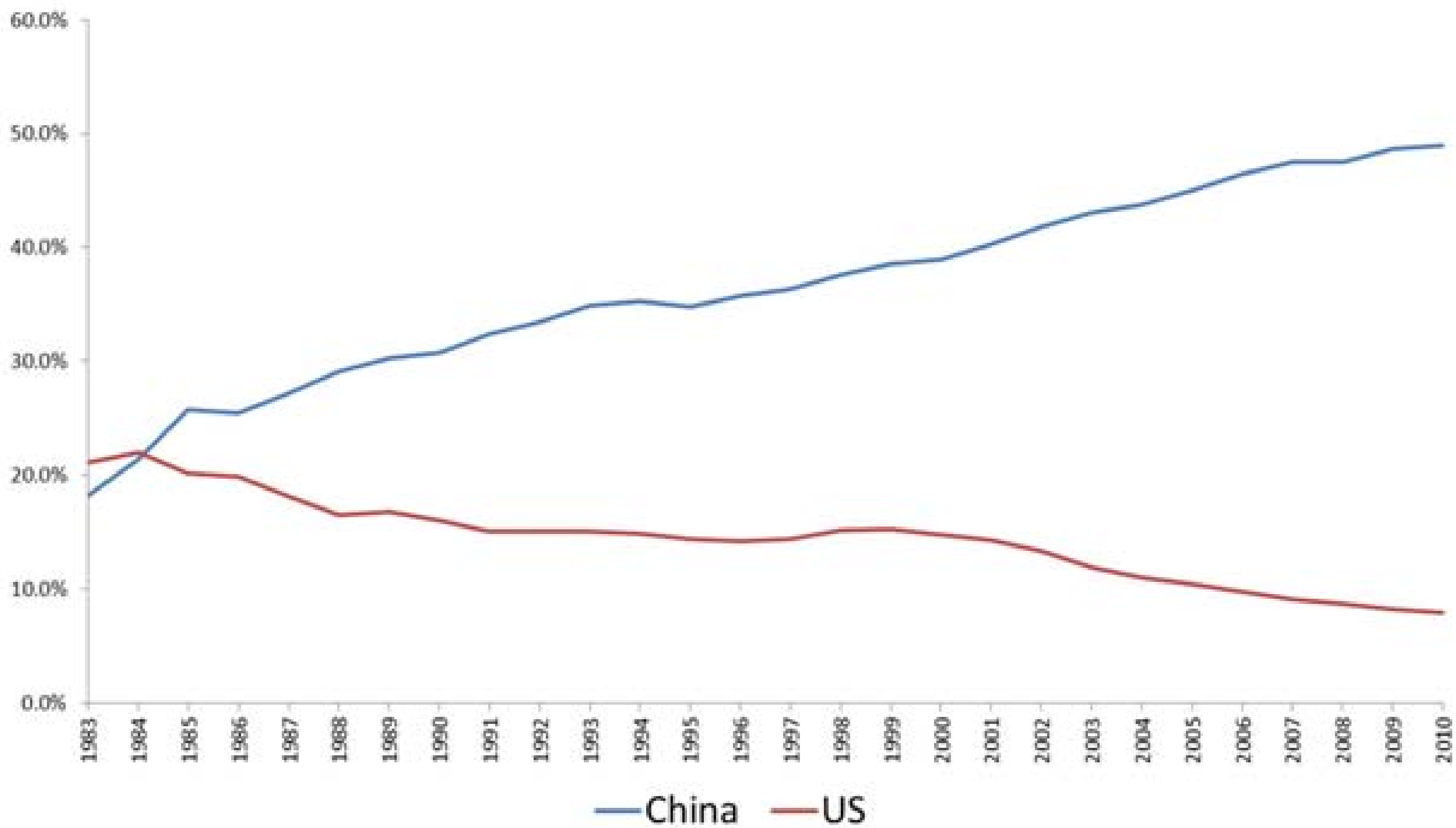
Source: “Hands On, Hands Off?: The Nature and Process of Economic Policy in Hong Kong” - Tony Latter, p.75.

Links with China are growing

Trade Links with China are Growing

Hong Kong's trade with America has fallen as a percentage of total trade, while trade with China is booming

% of Hong Kong's Total Trade



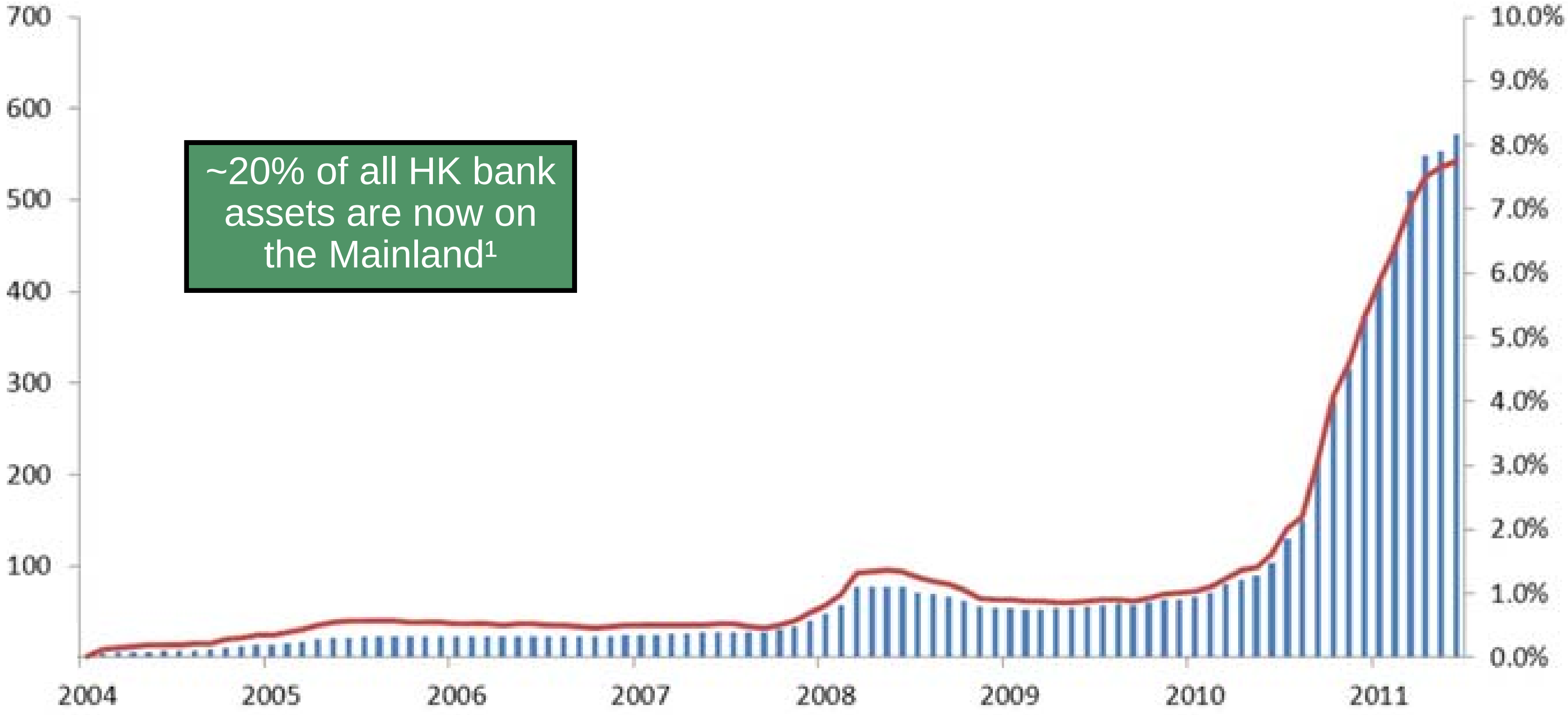
Source: "External Trade" - Census and Statistics Department, Hong Kong SAR Government, Table 60.

Monetary Links with Beijing are Growing

China's increasing liberalization of the RMB market, especially via expanded usage in trade settlement, has led to a rapid increase in RMB deposits in Hong Kong, further deepening HK's economic ties with the Mainland

RMB Deposits (Billion in RMB)

RMB Deposits (as % of Total HKD Deposits)



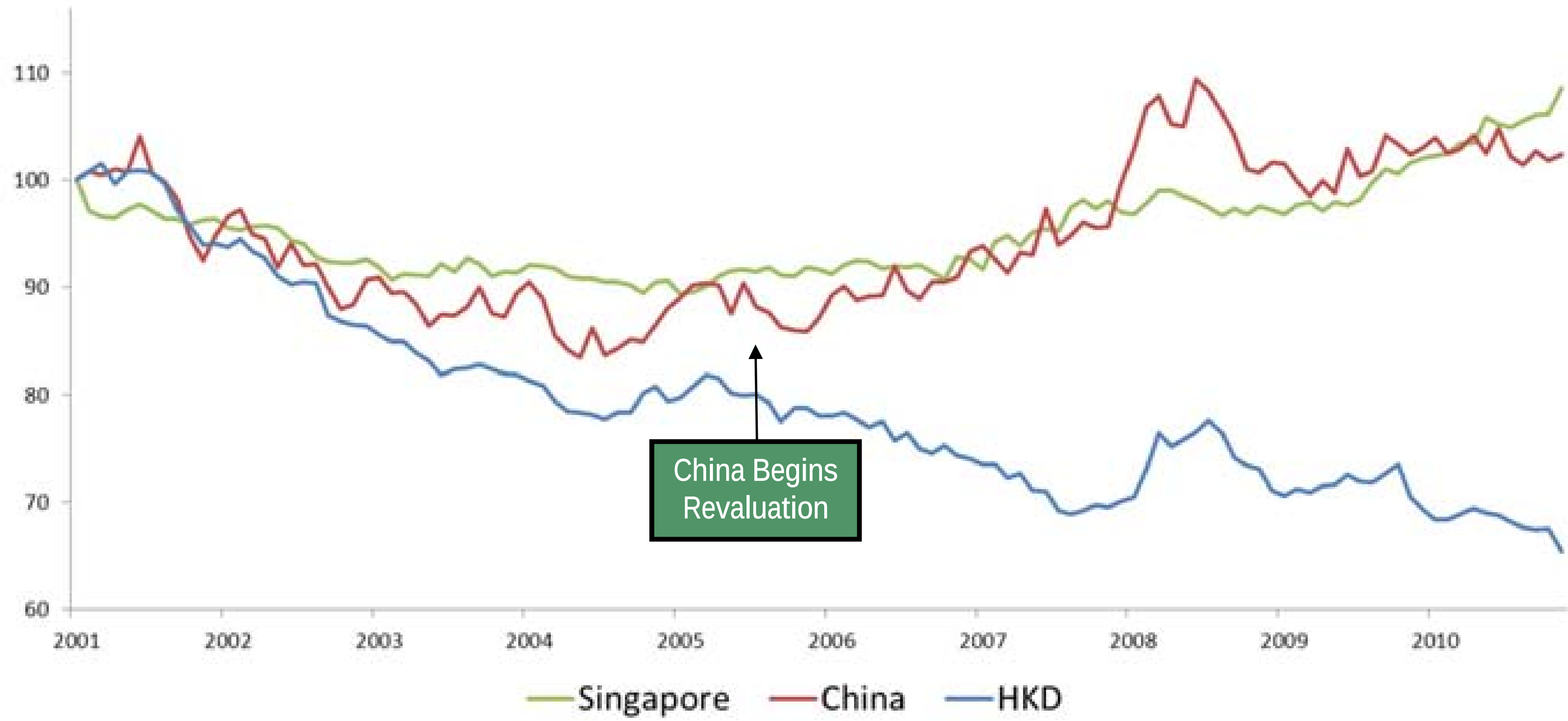
Source: Bloomberg.
[1]RBS, June 22, 2011

The USD Peg Has Materially Reduced the Market Value of the HKD

HKD – Trade-Weighted Value

Dragged down by a weak USD, the HKD has lost ~35% of its value on a real (inflation-adjusted) trade-weighted basis over the last ten years

Real Effective Exchange Rate (Trade Weighted)

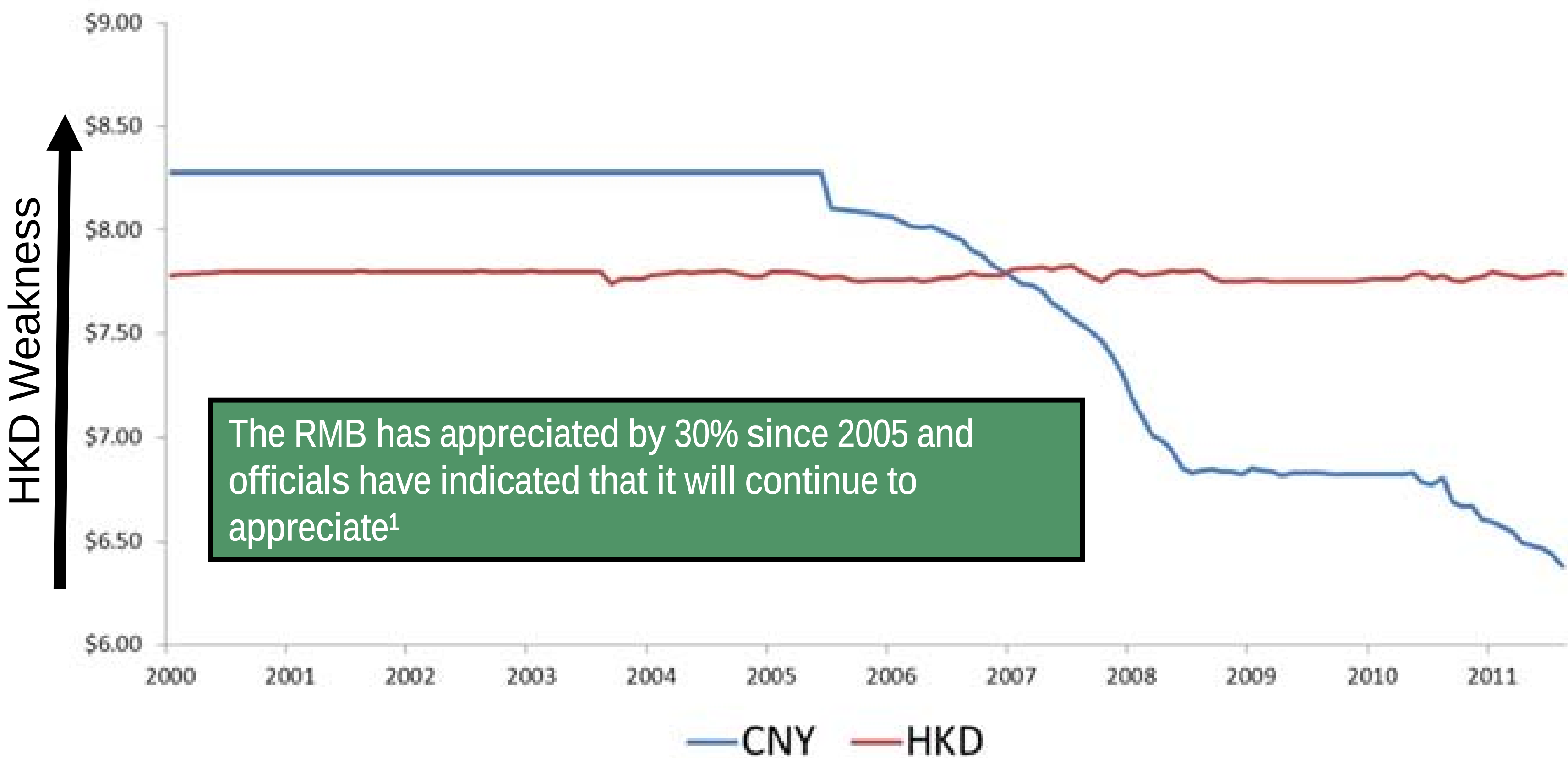


Source: "BIS Real Effective Exchange Rates" - Bank of International Settlements, Broad Index (http://www.bis.org/statistics/eer/index.htm).

Yuan Strengthening Pressures HKD Lower

HKD's trade-weighted value will continue to fall as China, HK's largest trading partner, steadily strengthens its own undervalued currency. The Yuan's strengthening recently accelerated after the July U.S. credit downgrade

Yuan and HKD/USD



Source: Bloomberg.

[1] "China will stick to gradual appreciation of Yuan: Wen" - Economic Times (http://articles.economictimes.indiatimes.com/2011-03-15/news/28691614_1_wen-jiabao-growth-rate-exchange-rate).

Valuation Summary

Economist models and changes in trade-weighted real exchange rates indicate that the HKD is materially undervalued relative to a basket of its trading partners

Model	% Undervalued (Multi-Lateral)
Decline in Real Trade-Weighted Value - Last 10yrs	54%
Goldman Sachs DEER Model	26%
Barclays PPP Model	33%
Undervaluation	**26% - 54%**

% Undervalued:

% Undervalued = (7.80/Fair Value) -1

Source: "Economic Research: GS DEER" - Goldman Sachs, Q2 2011 Trade Weighted Misalignment.
"Currency valuation from a macro perspective" - Barclays Capital, June 14, 2011, p.3.
"Estimates of Fundamental Equilibrium Exchange" – Peterson Institute for International Economics, Real Effective Exchange Rate, May 2011.

A Lot Has Changed Since 1983...

	1983	Peg Rationale
Hong Kong Economy	Manufacturing-Based	✓ Undervalued currency increased demand for HK goods
Primary Trade Partner	U.S.	✓ Alignment of currency and major trade partner
Foreign Currency Reserves	Low	✓ Set initial peg to below fair value to avoid risk of devaluation
U.S. Interest Rates	High (~10%)	✓ Linked HK rates to credible monetary policy
U.S. Credit Rating U.S. Debt / GDP U.S. Trade Deficit	AAA 38% (5.7%)	✓ USD is a stable anchor currency

Source: Bloomberg.

A Lot Has Changed Since 1983... (Cont.)

	Today	Peg Implications
Hong Kong Economy	Services-Based / Real Estate Oriented	X Low interest rates have amplified effect on banks / property developers
Primary Trade Partner	China	X Misalignment of currency and major trading partner
Foreign Currency Reserves	High	X Hong Kong can afford to price its currency to fair value
U.S. Interest Rates	Low (~0%)	X Low interest rates create bubbles and fuel inflation
U.S. Credit Rating U.S. Debt / GDP U.S. Trade Deficit	Downgraded 96% (10.6%)	X USD is a less stable anchor currency

Source: Bloomberg.

At the time the peg was introduced, the HK government recognized the risks of tying HK's monetary policy to that of the US

"[D]omestic interest rates and domestic inflation will be substantially influenced by the behavior of the economy to whose currency it is tied (the USA in this case). It was, in essence, the potential effect of such ties upon the Hong Kong economy which led to the abandonment of the sterling link in 1972 and then the US dollar link in 1974."

- Hong Kong government policy memo, 1983

But in the midst of crisis, the government had no other choice

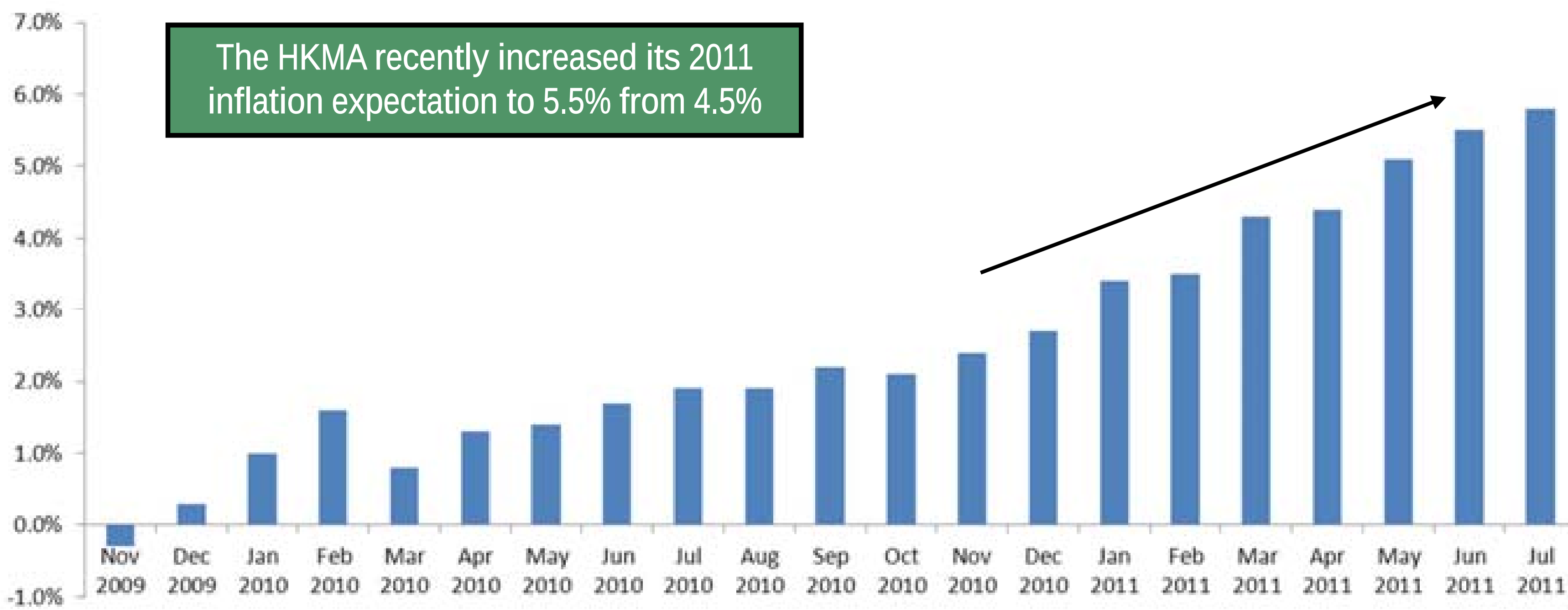
Source: "Stabilization of the Exchange Rate" (http://www.sktsang.com/ArchiveI/1983.pdf).

Impact of the Peg on HK

Inflation – A growing concern

Consumer price inflation in Hong Kong is accelerating

Underlying Inflation (% YoY)

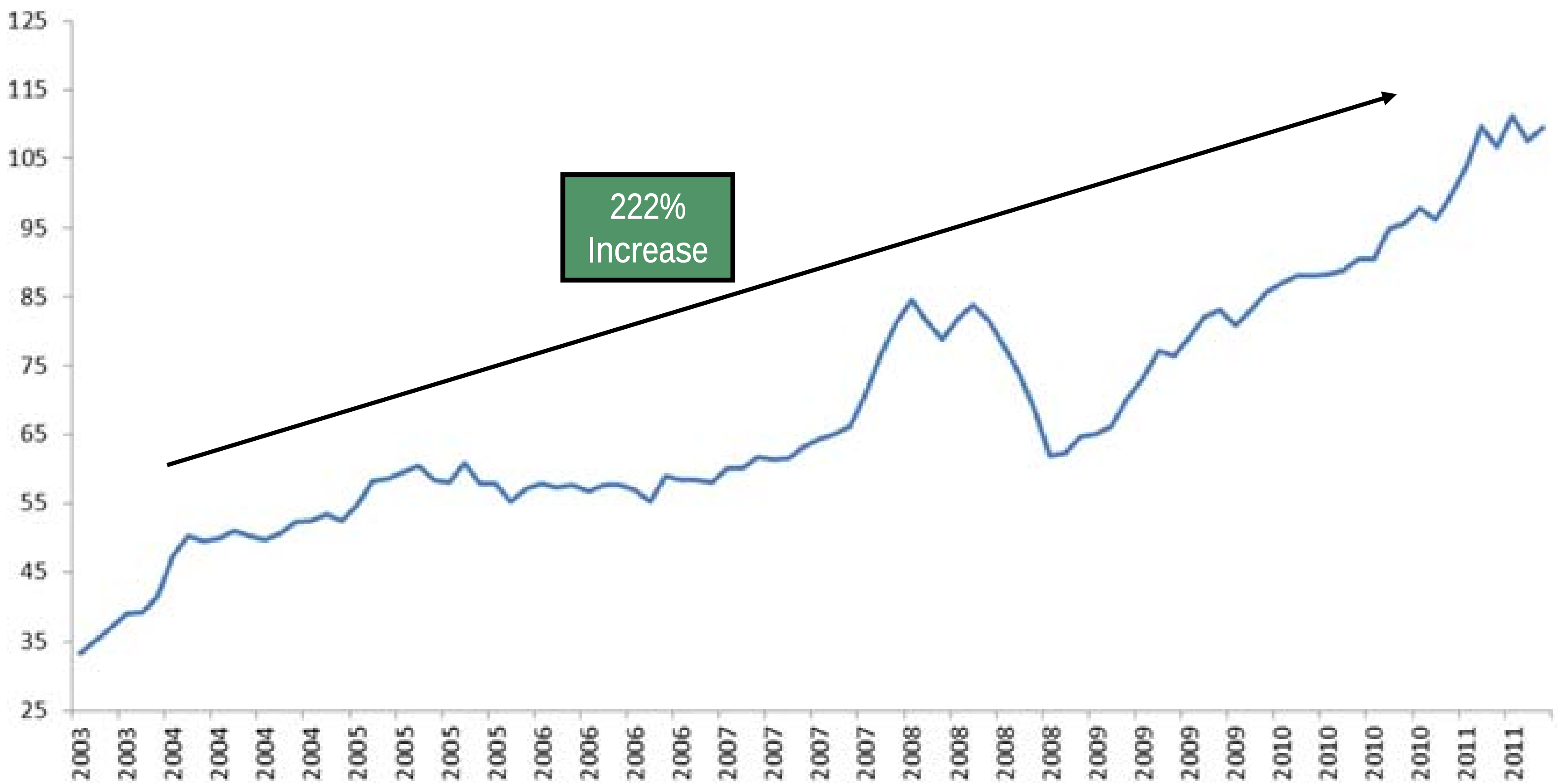


Source: "Monthly Report on the Consumer Price Index" - Census and Statistics Department, Hong Kong SAR Government.

Asset Bubbles Building - Residential Real Estate

Prices in Hong Kong's residential real estate market are soaring

HK Residential Price Index (Centaline Property Centa-City Leading Hong Kong Index)

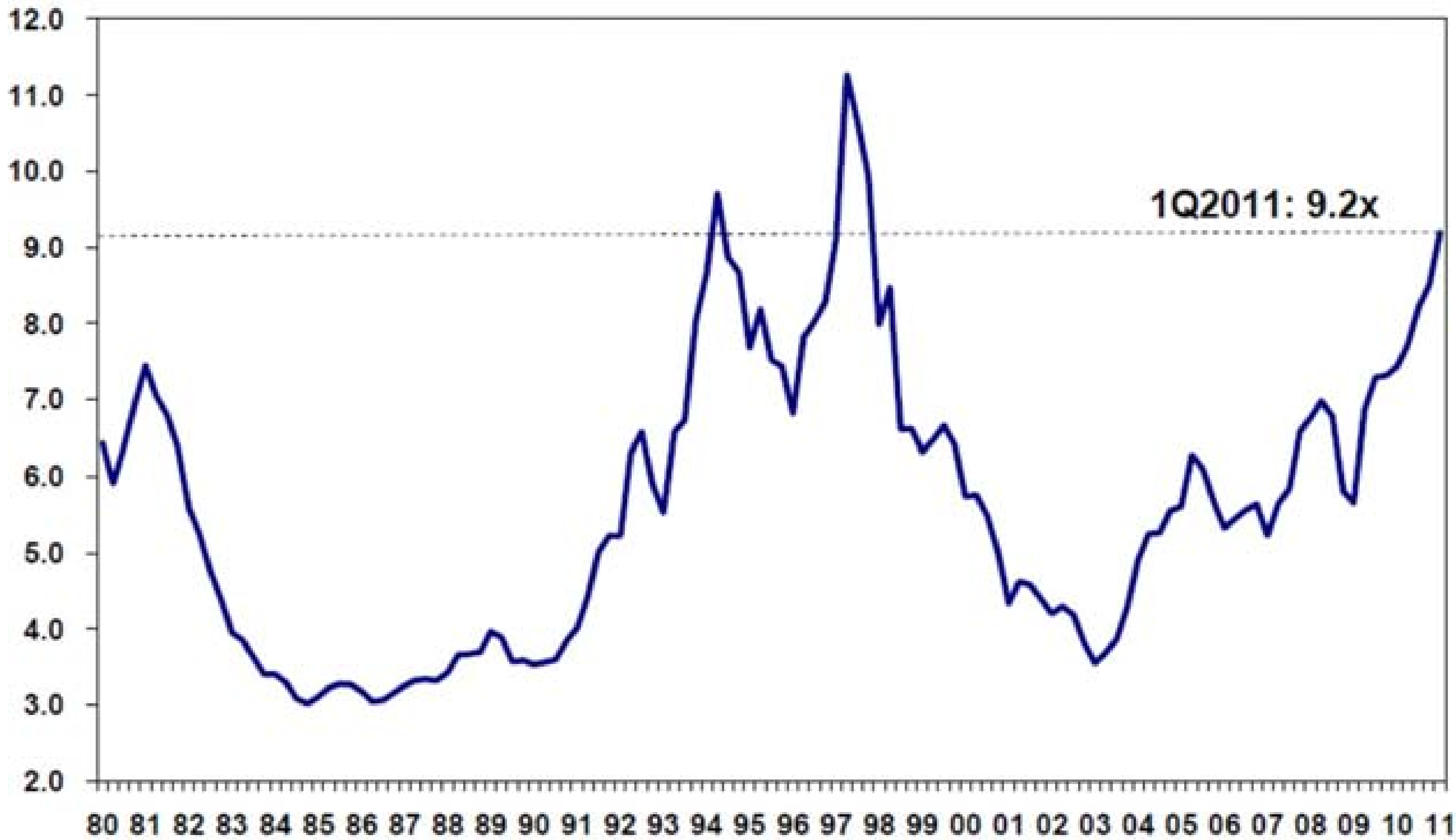


Source: Bloomberg.

Asset Bubbles Building - Residential Real Estate

Residential valuations are approaching Pre-Asian Financial Crisis levels

HK Residential Price to Income Ratio

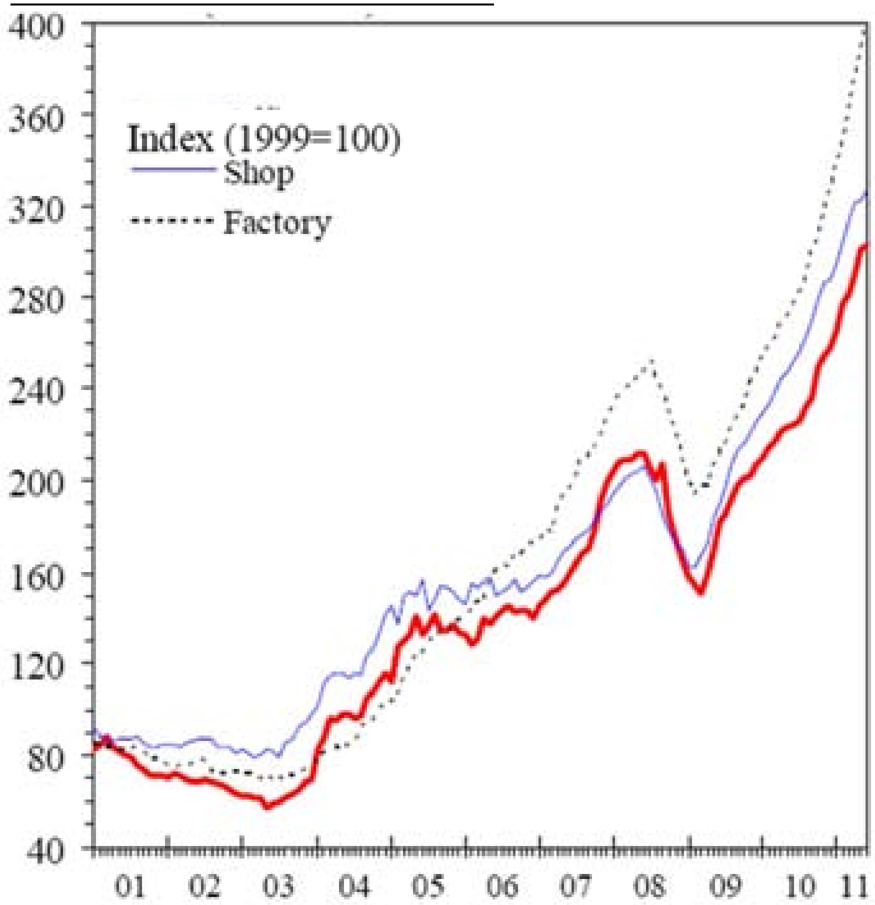


Source: "Hong Kong Property" - Citi, May 2011, p.51.

Asset Bubbles Building - Commercial Real Estate

Prices in Hong Kong's commercial real estate market are increasing rapidly

HK Commercial Price Index



- **Class A office market stats:**
  - Vacancy Rate: ~2%
  - Rent (% yoy): ~+18%
  - Cap Rates: ~3%

Source: "Half-Yearly Monetary and Financial Stability Report - March 2011" - Hong Kong Economy, HK Commercial Price Index , p. 38 (http://www.hkeconomy.gov.hk/en/reports/index.htm).
[1] CBRE Data – Prepared for Pershing Square.

How the USD Link Contributes to Inflation

How Does the Peg Cause Inflation

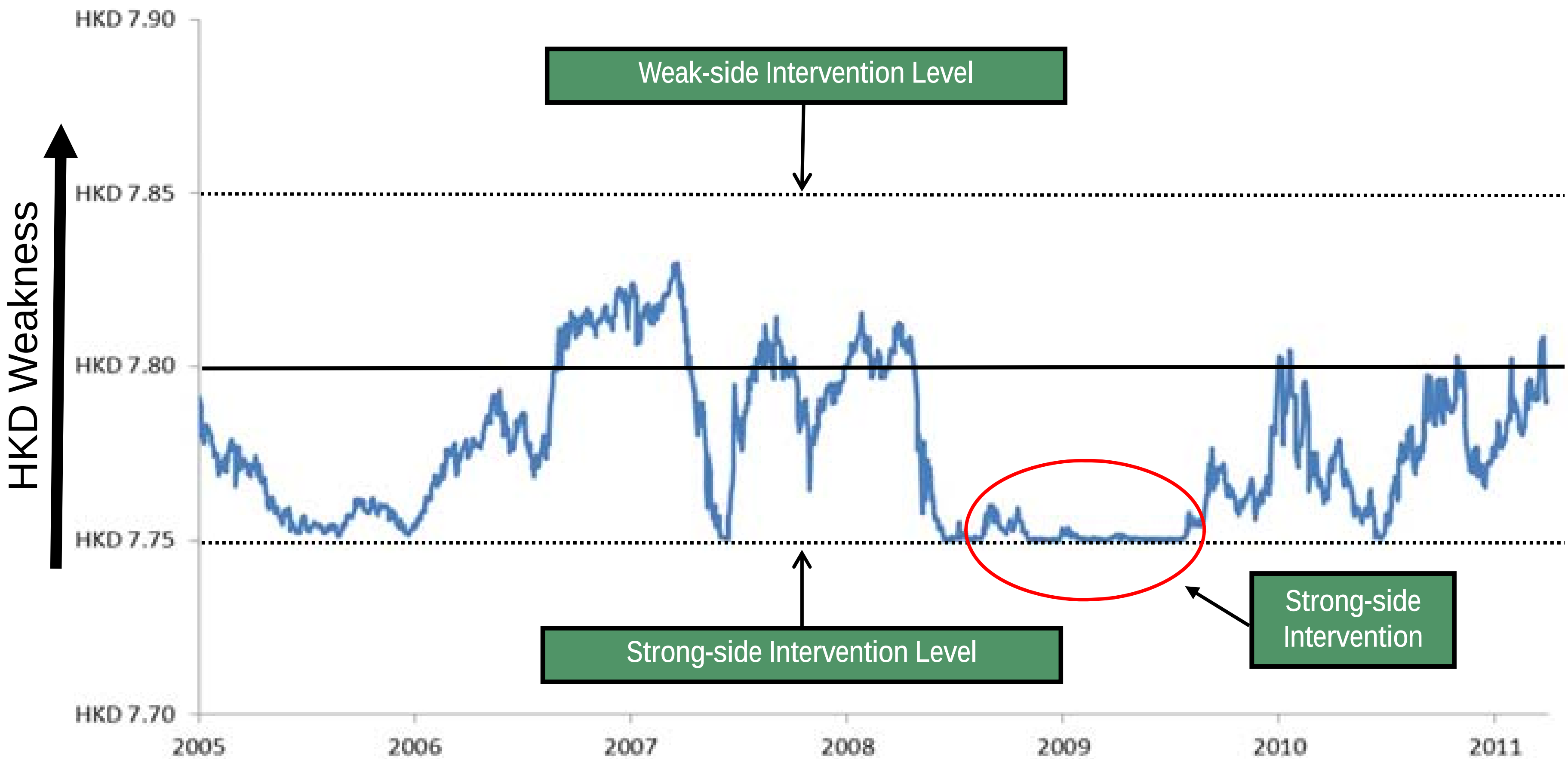
- **The USD peg and the vastly divergent US and HK economies impact the HK economy through various channels**
  - Rapid Expansion of the Monetary Base
  - Imported Low Short-Term Rates
  - Diminished Purchasing Power

Rapid Expansion of the Monetary Base

The Monetary Costs of Intervention

In 2008 and 2009, attracted by its safe-haven status and undervaluation, investors flooded into HKD, pushing the rate to 7.75 and forcing the HKMA to print money to defend the strong side of the band

HKD/USD

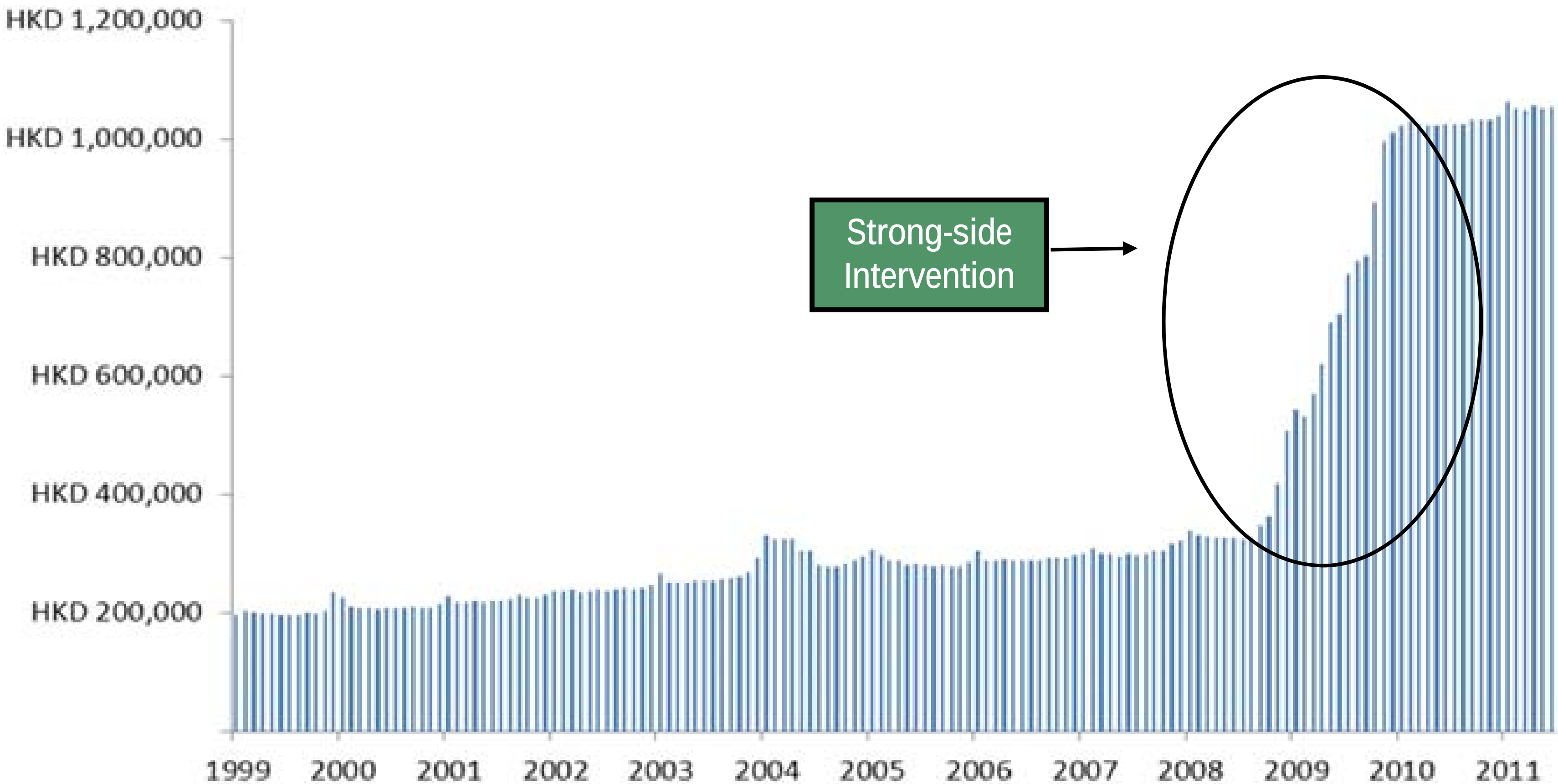


Source: Bloomberg.

The Monetary Costs of Intervention (Cont.)

As a result of strong side intervention, HK's Monetary Base increased HKD $671bn or ~200% over two years. HK has effectively no control over the size of its Monetary Base

Monetary Base (HKD million)

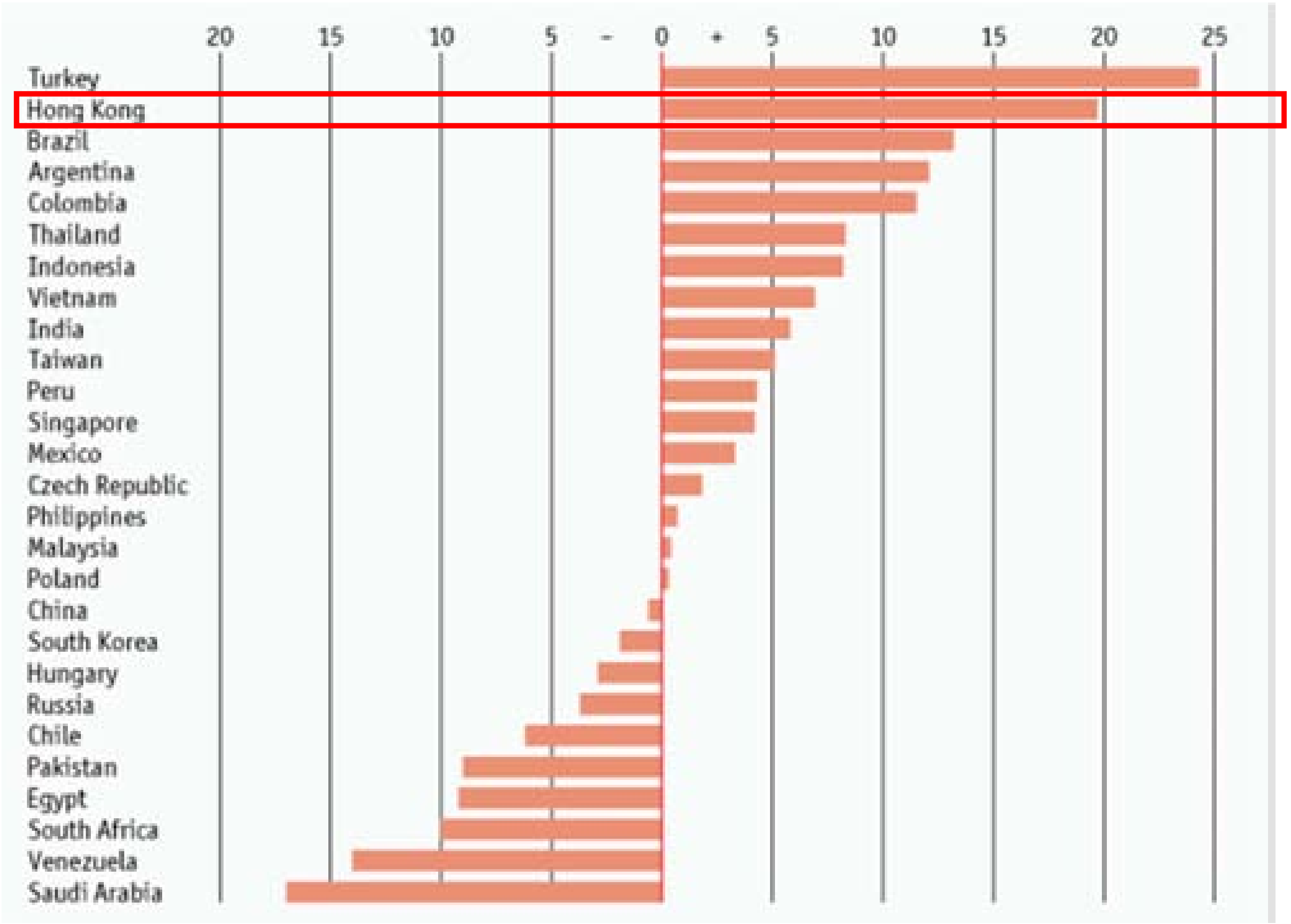


Source: "Monthly Statistical Bulletin - Table 1.1" - Hong Kong Monetary Authority, September 5, 2011 (http://www.info.gov.hk/hkma/eng/statistics/msb/index.htm).

Rapid Credit Growth

Growth in base money supply has contributed to HK having one of the fastest rates of credit growth in the world

Private Credit Growth less Nominal GDP Growth – 12 Months



Same figure for the US: -3%

Source: "Overheating Emerging Markets: Temperature Gauge" - The Economist (http://www.economist.com/blogs/dailychart/2011/06/overheating-emerging-markets-0).

The Strong Side Defense Risks Further Money Printing

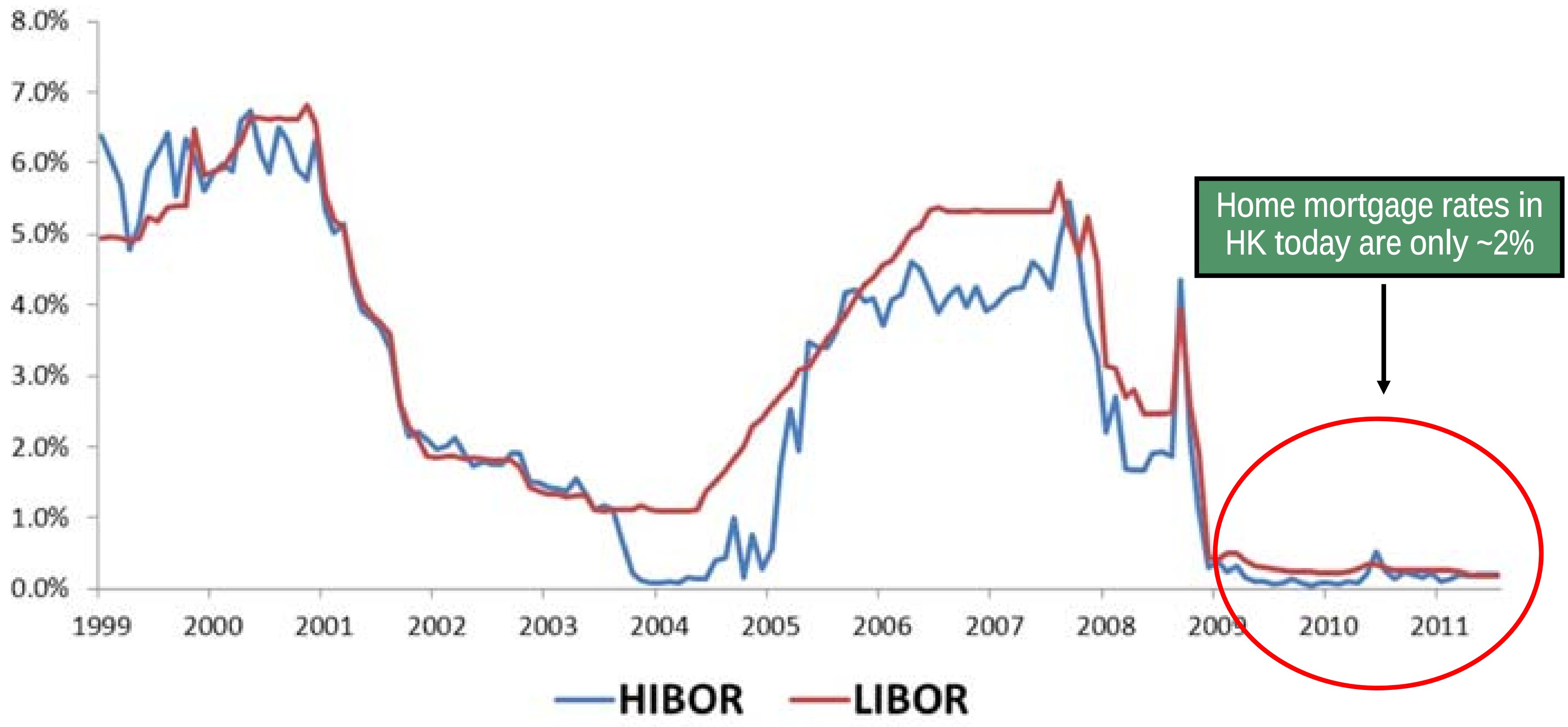
- **The HKD's widely recognized undervaluation increases the likelihood that the HKMA will need to print more money to keep the HKD within the band**
- **With short-term interest rates already near zero, rates can't fall any further to discourage investors from holding the HKD**

Imported Low Short-Term Interest Rates

Tied to U.S. Short-Term Interest Rates

Arbitrageurs take advantage of the peg and keep Hong Kong short-term rates (HIBOR) in line with LIBOR, irrespective of the suitability of such rates for Hong Kong

1-Month HIBOR and LIBOR Rates

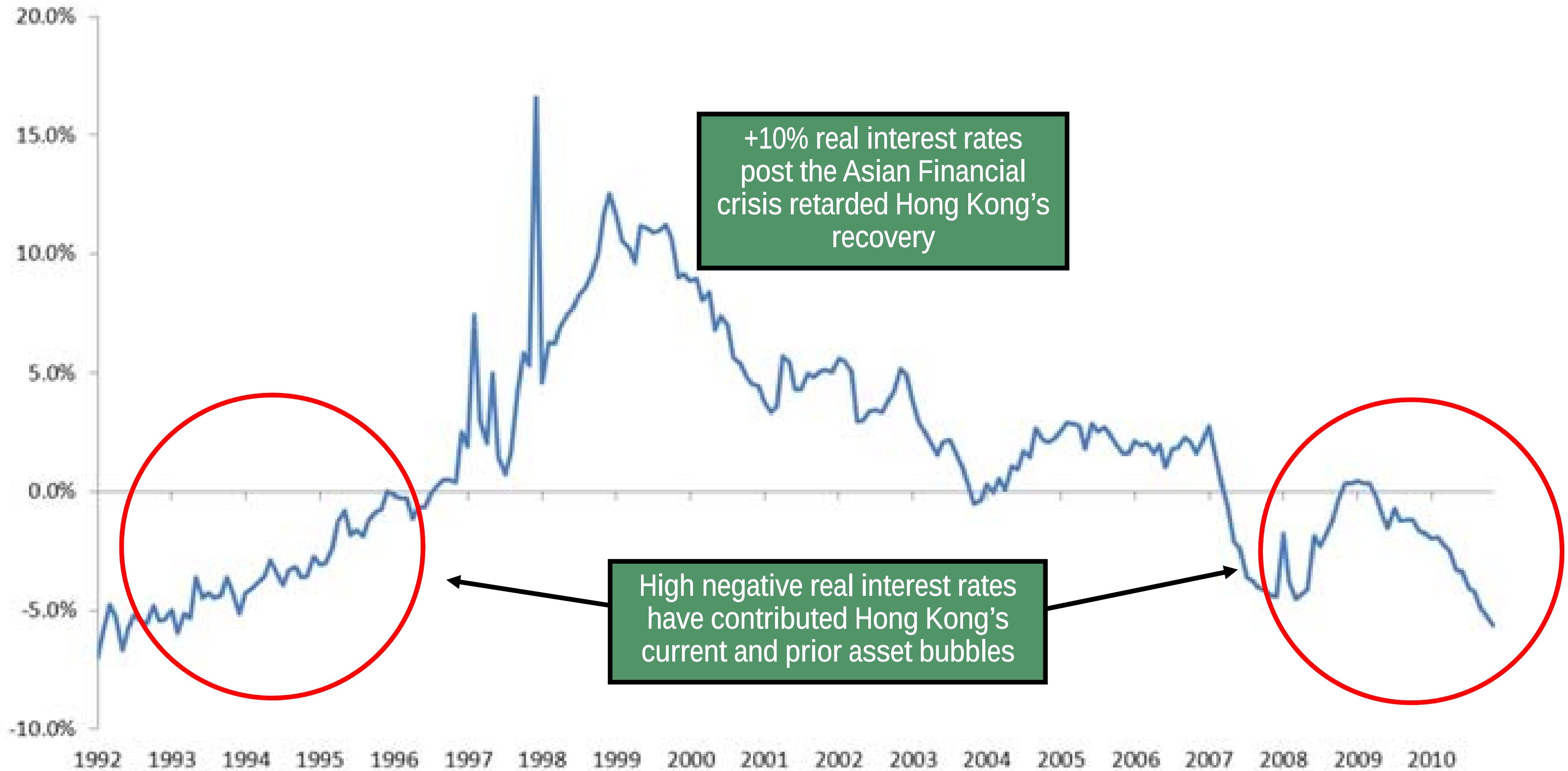


Source: Bloomberg.

High Negative Real Interest Rates Today

Interest-rate parity with the US means Hong Kong suffers frequently from inappropriately high and low real interest rates

Real Interest Rates (1-Month HIBOR less Underlying CPI)

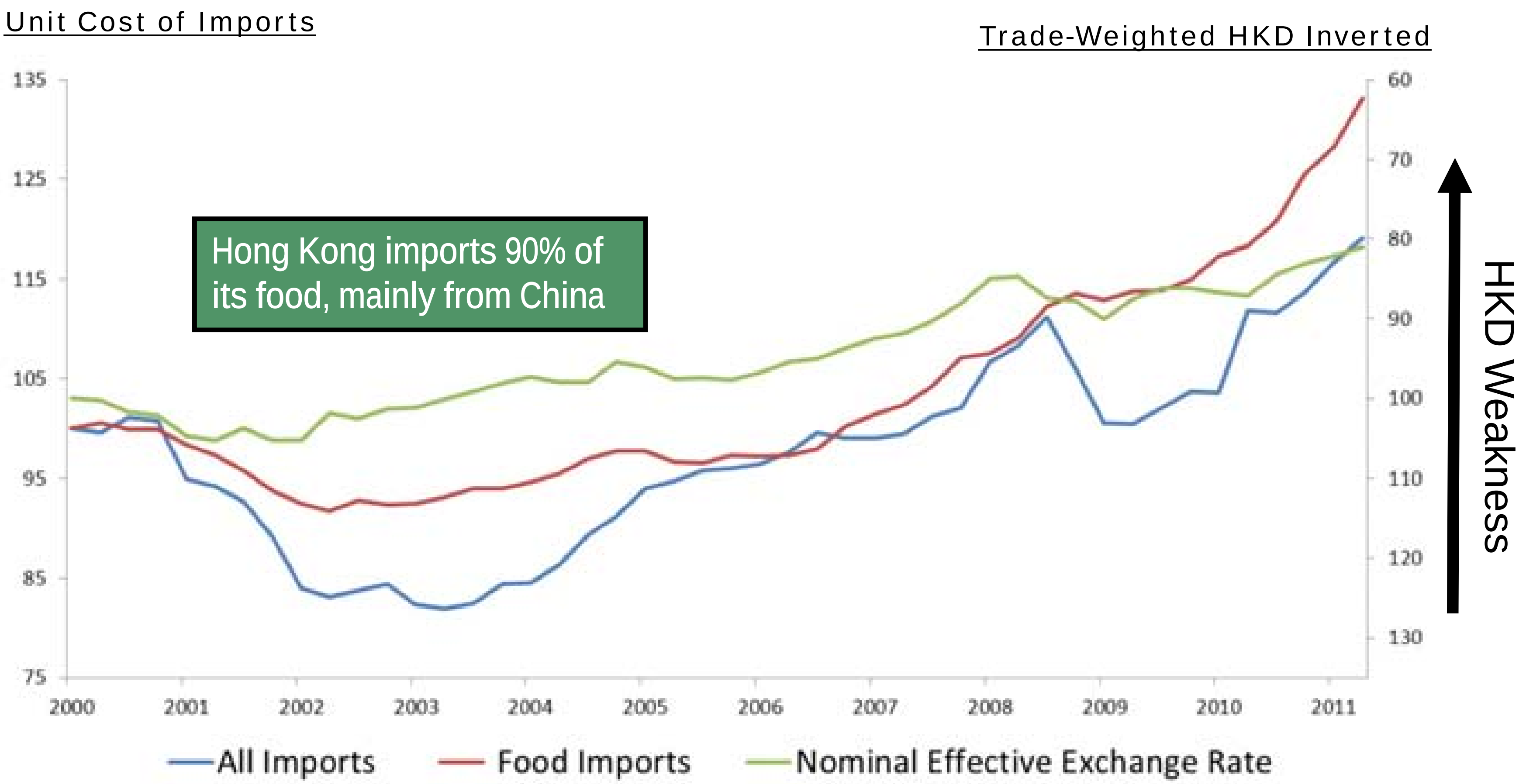


Source: Bloomberg.
"Monthly Report on the Consumer Price Index" - Census and Statistics Department, Hong Kong SAR Government, Underlying Inflation.

Diminished Purchasing Power

Rising Cost of Imports

Unable to revalue higher, Hong Kong's weak currency has led to a large increase in the cost of imports, particularly in the critical food sector

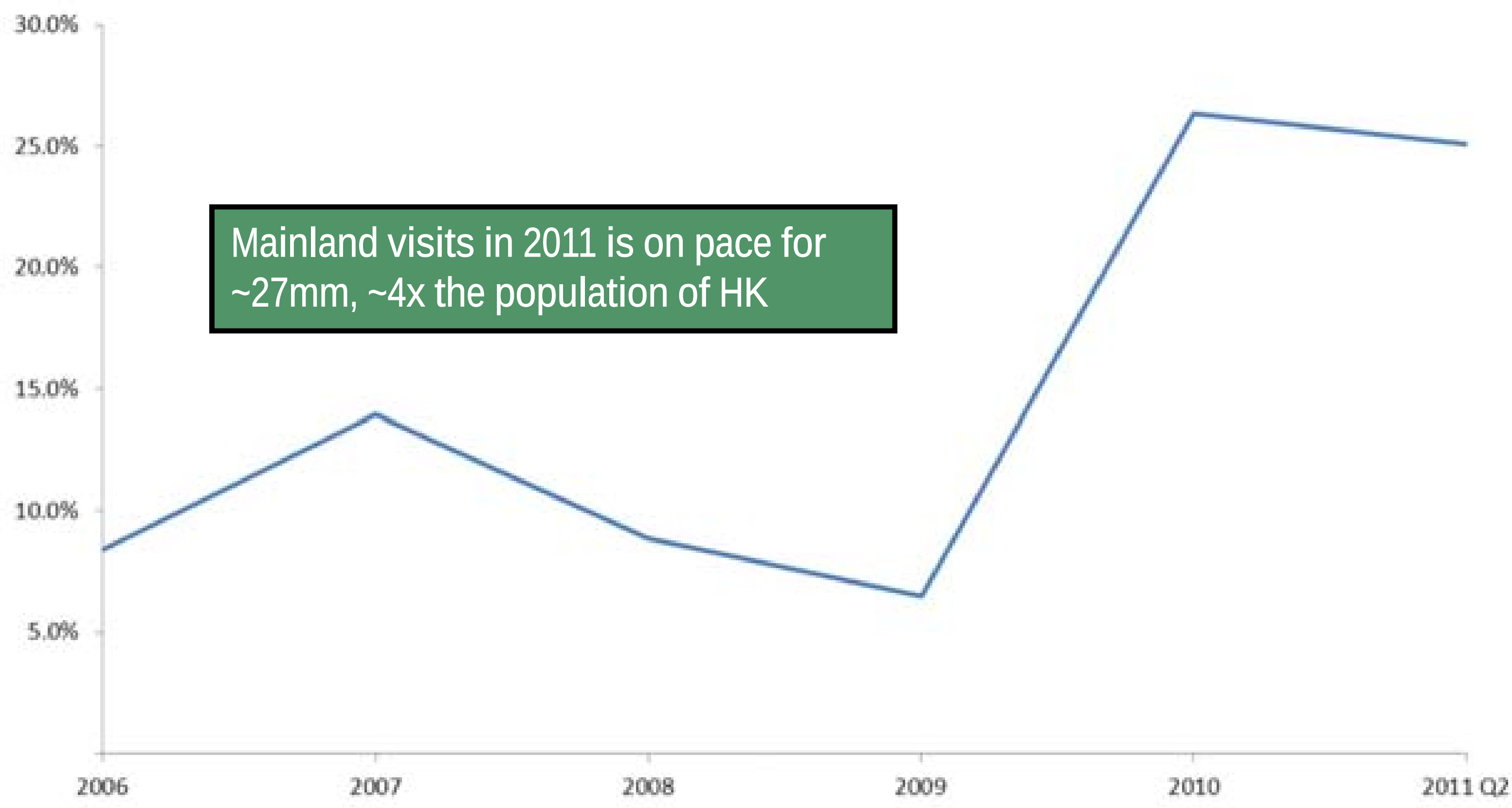


Source: "Nominal Effective Exchange Rate" – Bloomberg.
"External Trade " - Census and Statistics Department, Hong Kong SAR Government, Table 76.

Mainland Tourists Flocking to HK

Partly attracted to HK by the cheap HKD, visitors from the Mainland are flocking to HK, pressuring local prices upward

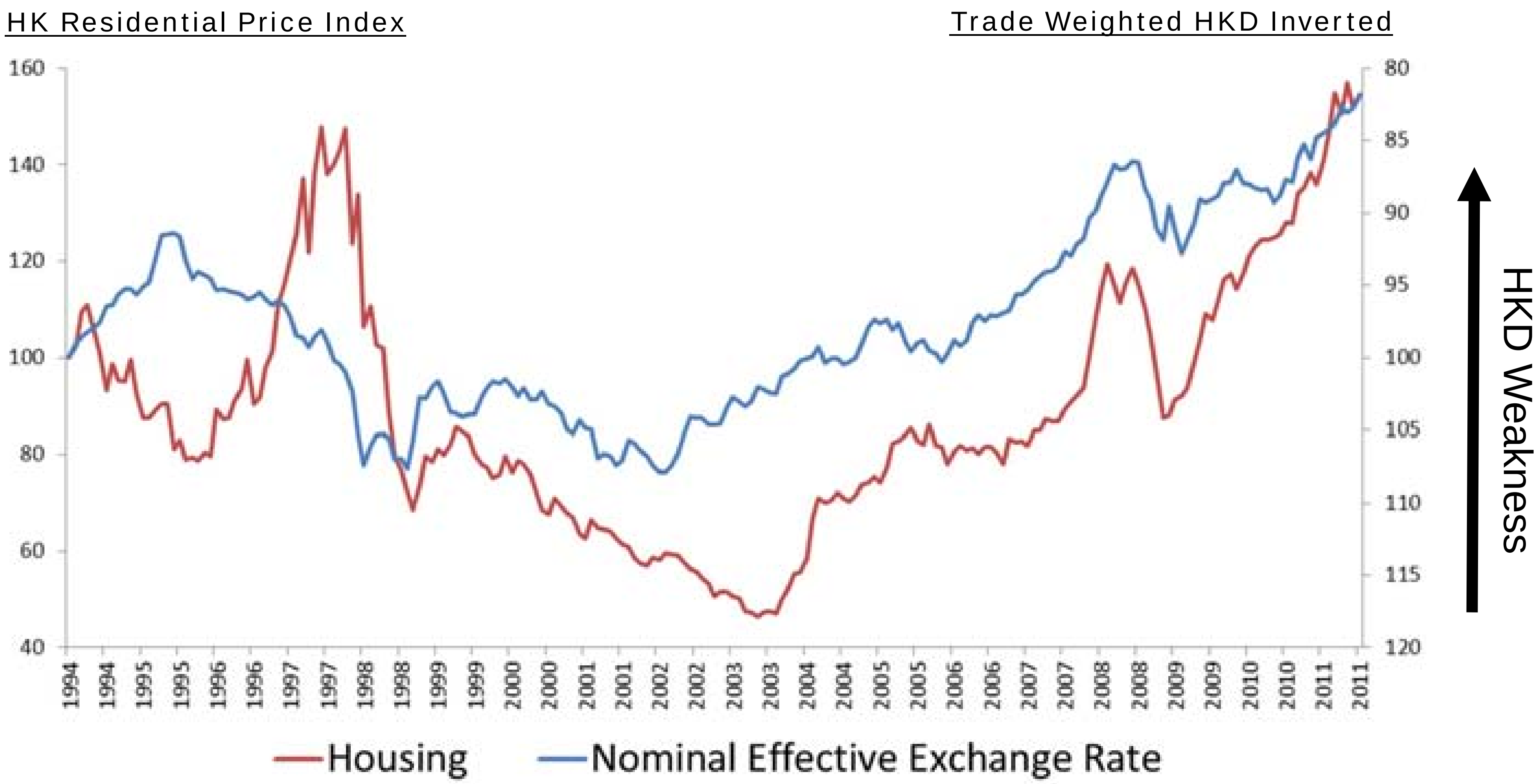
Mainland visitors (% YoY)



Source: "Half - Yearly Economic Report" - Hong Kong SAR Government, p.111 (http://www.hkeconomy.gov.hk/en/pdf/er_11q2.pdf).

Home Price Inflation Rises with HKD Undervaluation

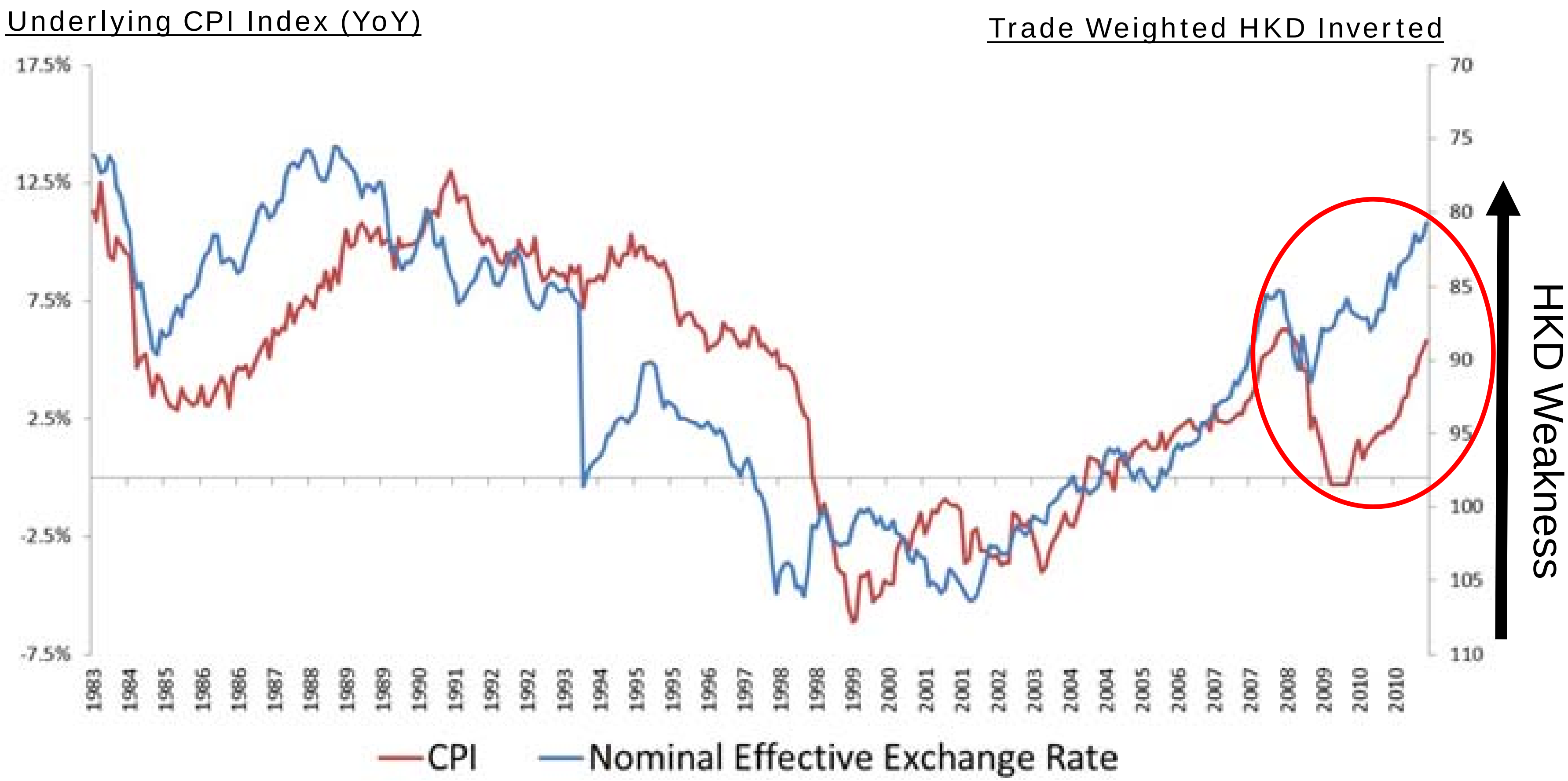
Mainland Chinese home buyers are taking advantage of an undervalued HKD. 30% to 40% of luxury new home sales are to Mainland buyers



Source: Bloomberg.

Consumer Price Inflation Rises with HKD Undervaluation

There is a direct correlation between weak HKD and HK inflation



Source: Bloomberg.
"Monthly Report on the Consumer Price Index" - Census and Statistics Department, Hong Kong SAR Government, Underlying Inflation .

HK's Inflation Problem Will Likely Get Worse

- **Near zero US short-term interest rates for two years or more**
- **Despite high inflation, the HKD is still undervalued by ~30%**
- **HKD's undervaluation will only worsen as the RMB appreciates**
- **Broad money supply (M2) has not yet grown to reflect the full impact of the massive 2008/2009 Monetary Base expansion**
- **Undervaluation increases the risk that the HKMA will need to print more HKD to keep the currency within the band**
- **The HKMA estimates that HK has no spare resource capacity to absorb further demand growth[1]**

Source: [1] "Half - Yearly Monetary and Financial Stability Report" - Hong Kong Monetary Authority, March 2010, p.33.

Significant Risk of Overheating

The Economist ranks HK near the top of its list of emerging-markets at risk of overheating

Emerging-Market Overheating Index

Countries were measured across six different economic indicators of overheating

- Inflation
- GDP Growth
- Employment
- Credit
- Interest
- Current Account

Source: "Overheating Emerging Markets: Temperature Gauge" - The Economist (http://www.economist.com/blogs/dailychart/2011/06/overheating-emerging-markets-0).

Growing Social Risks

Social Consequences of Inflation

The Middle Class, "Sandwich Class"

- **Priced out of first time home ownership but too well-off to be comfortable in public housing**

The Elderly

- **Value of their savings is eroded by inflation**
- **Low interest rates reduce fixed income investment returns**

The Poor

- **Do not have the savings to absorb price shocks**

The Rich

- **While some rich get richer speculating on real estate with low-cost credit, their global purchasing power deteriorates**

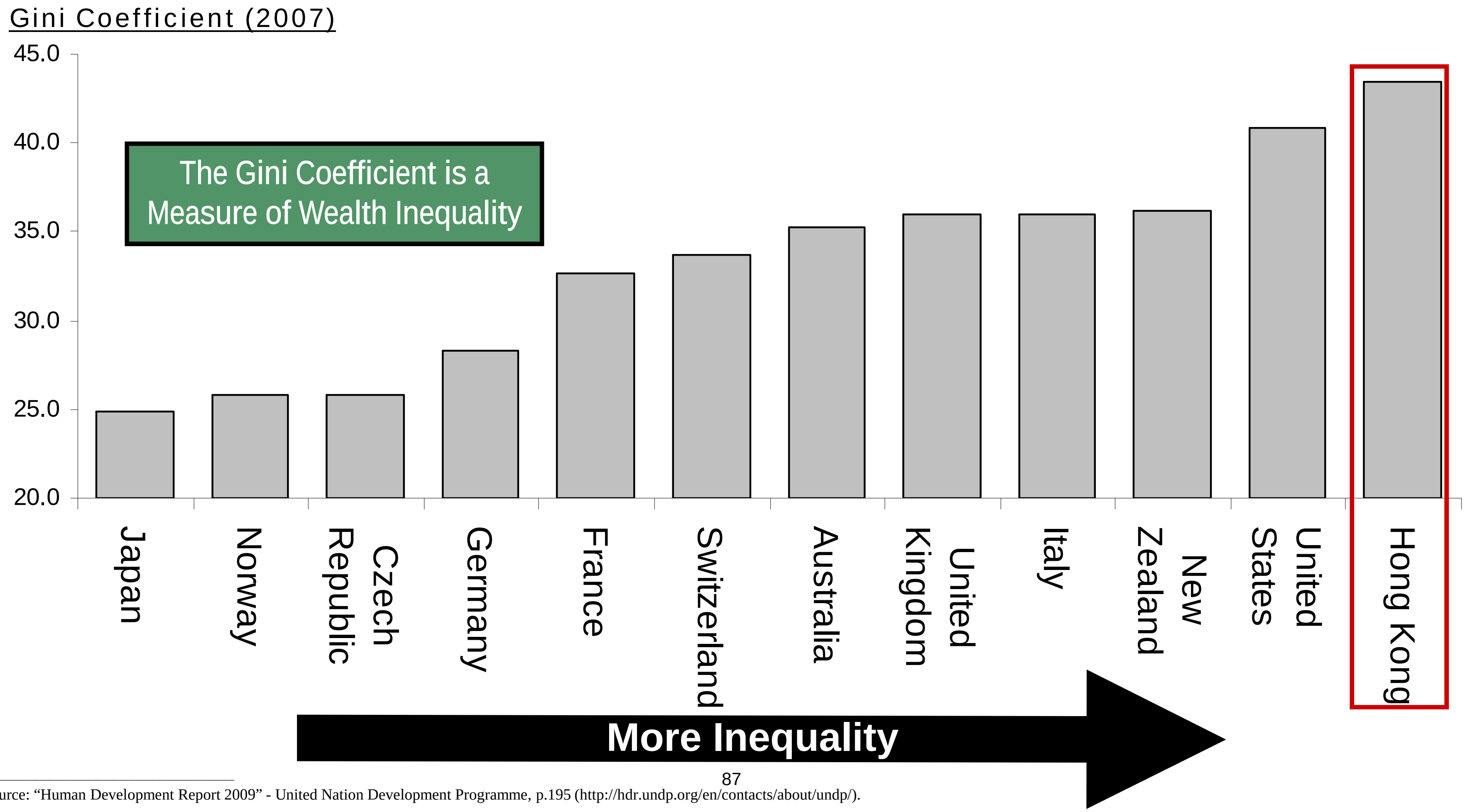
Hong Kong's Wealth Gap

Hong Kong's rich-poor gap is Asia's widest according to UN data

Source: Pictures - Zoe Li, William McCallum, Christopher DeWolf (http://jmsc.hku.hk/hkstories/content/view/659/8786/) and (http://www.lcscapes.com/HK-VerticalHousing/LC-HK_VerticalHousing.html).

Beijing Has Taken Notice of HK's Inequality

In 2009, Chinese Premier Wen Jiabao called on the Chief Executive of Hong Kong to address "deep rooted contradictions in Hong Kong" in reference to Hong Kong's persistent and troubling wealth gap.

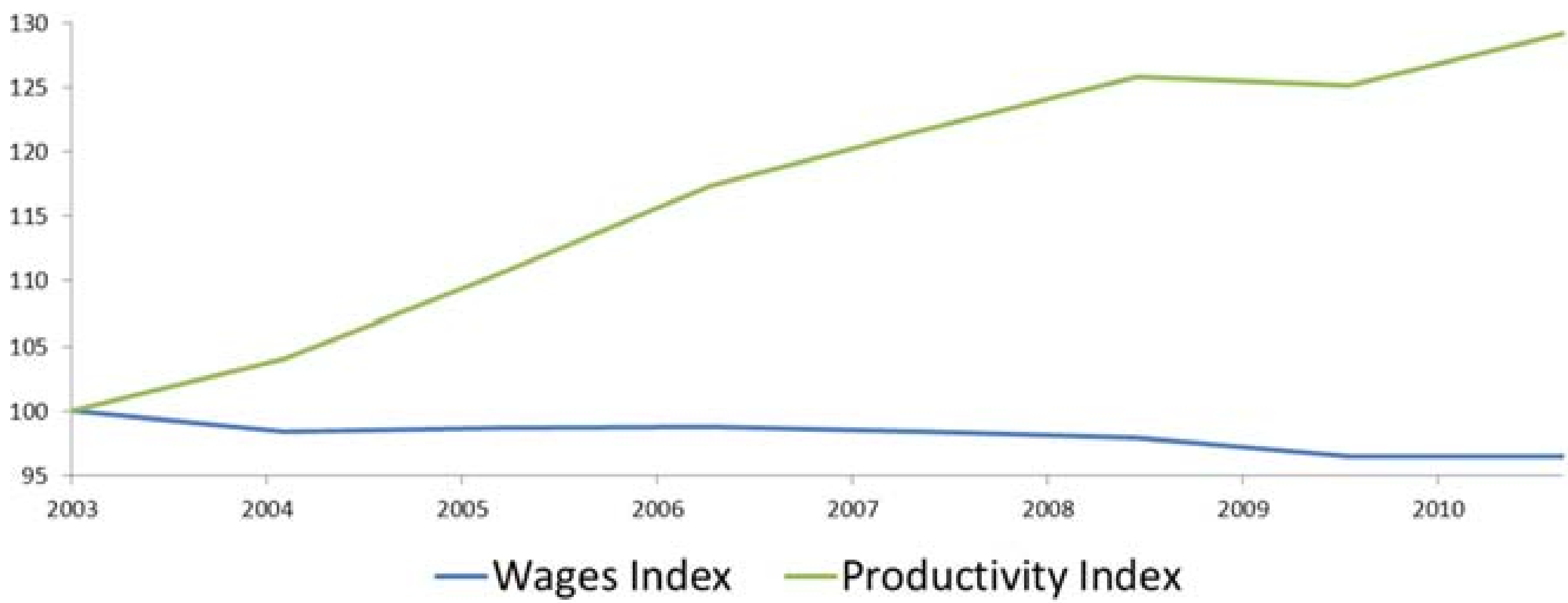


Source: "Human Development Report 2009" - United Nation Development Programme, p.195 (http://hdr.undp.org/en/contacts/about/undp/).

Flat Real Wages

Gains from economic growth have not been evenly spread. Average wages have been flat for many years despite very low unemployment and strong productivity growth

Real Wages in Hong Kong – Indexed to 2003 = 100

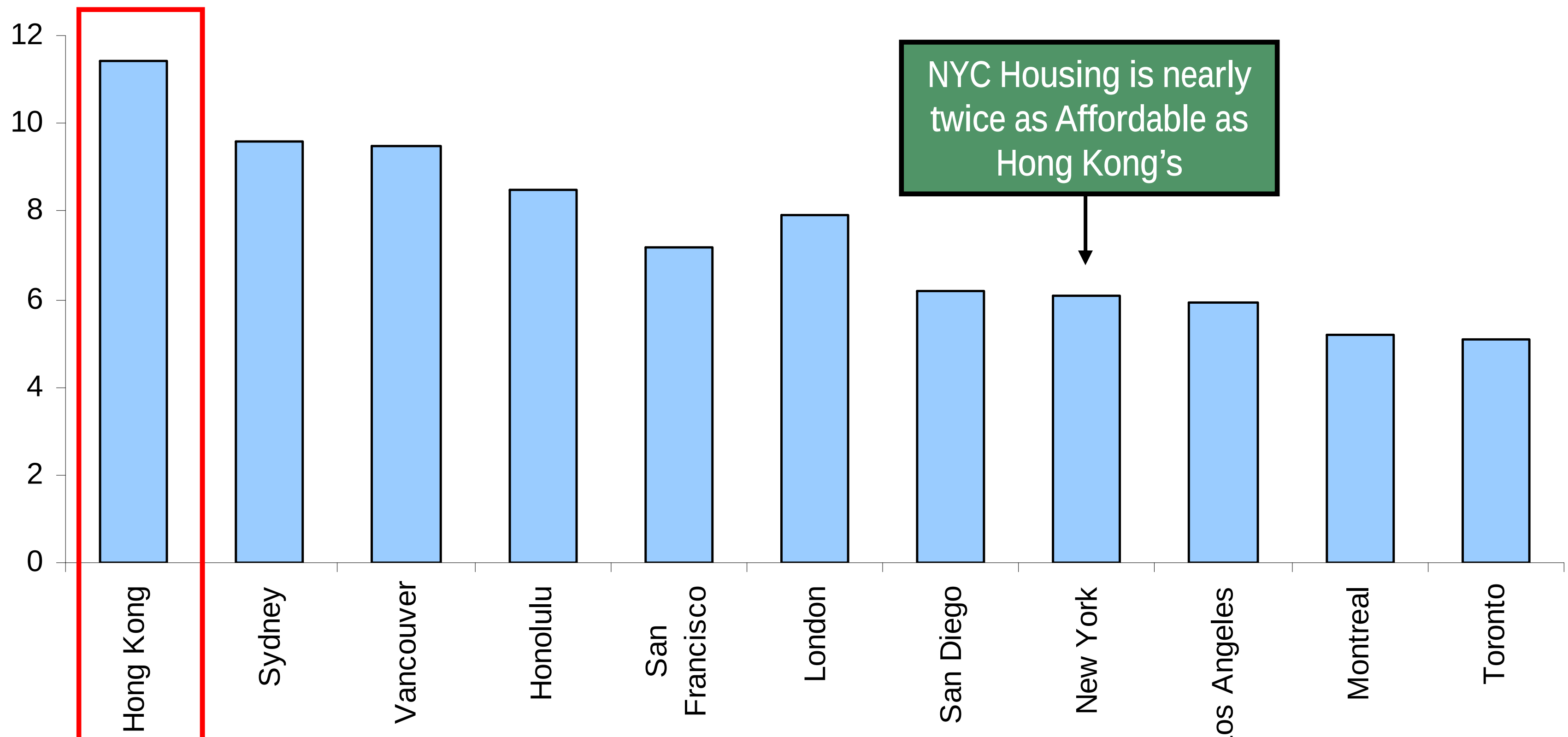


Source: "Real Wages" - Bloomberg.
"Census and Statistics Department" Hong Kong SAR Government, Productivity Index, table 103.

Housing Affordability is Squeezing the Middle Class

HK is one of the least affordable places in the world. With the home ownership rate at only ~53%, home price appreciation only benefits a small percentage of the population

Housing Affordability Index – (Median Home Price/Median Annual Household Income)



Source: "7th Annual Demographic International Housing Affordability Survey: 2011" - Performance Urban Planning, p.10.

Apartment Rents Are Among the Highest in the World

In 2010, Hong Kong was the third most expensive market for two bedroom rental apartments, up from ninth place in 2009

World's 20 most expensive locations to rent a two bedroom apartment

Rank 2010	Location	Country	Rank 2009
1	Tokyo	Japan	1
2	Moscow	Russia	4
3	Hong Kong	Hong Kong	9
4	London	United Kingdom	5
5	Singapore	Singapore	6
6	Caracas	Venezuela	2
7	Abu Dhabi	UAE	3
8	Bogota	Colombia	8
9	San Francisco	USA	13
10	Geneva	Switzerland	14
11	Paris	France	7
12	Istanbul	Turkey	11
13	Sydney	Australia	23
14	Amsterdam	Netherlands	10
15	Seoul	Korea Republic	22
16	Doha	Qatar	16
17	New York NY	USA	19
18	Dubai	UAE	12
19	Stockholm	Sweden	24
20	Zurich	Switzerland	20

Luxury rents in Hong Kong are up 23% YoY

Source: "15% Rental Increase Makes Singapore 5th Most Expensive Locations Globally" - ECA International (http://www.eca-international.com/news/press_releases/show_press_release?ArticleID=7309).

A high-level Beijing official has expressed concern that the housing situation may become politically destabilizing:

"Housing is of course a social and an economic issue. However, if dealt with inappropriately, it will also become a political issue."

-Wang Guangya
Director of Hong Kong and Macau Affairs Office of the State Council of the People's Republic of China

Source: "Wang Guangya Talking About Housing Market When Visiting HK: Housing Issues May Become a Political Issue if Inappropriately Deal With" – June 15, 2011 (translation).

Social Unrest – Pressure for Change

"Inflation, particularly in the price of food and housing; lack of democracy; public austerity followed by handouts, followed by howling protests, followed—some hope—by a change in government" –The Economist, May 2011

Tens of thousands of people are not satisfied with the level of political freedom in Hong Kong on July 1st, 2010

10,000 people protested against inflation (prices of food and housing) in March 2011

Several organizations protested against the dominance of property developers and high prices in May 2011

Source: Picture - BBC (http://www.bbc.co.uk/news/10480116).
Picture - The Economist (http://www.economist.com/blogs/banyan/2011/03/protests_hong_kong).
Picture - Macau Daily Times (http://www.macaudailytimes.com.mo/china/25180-residents-protest-high-property-prices.html).

More…Social Unrest

This year, 218,000 people, the most since the massive 2003 civil liberty protests, marched in Hong Kong's annual July 1st rally

"They aren't happy with the fact that they do not see an improvement in living standards, despite the good economic statistics."
– Bloomberg July 1st , 2011

Source: Pictures - Seattle Pi (http://www.seattlepi.com/news/article/Marchers-vent-anger-on-Hong-Kong-prices-policies-1448544.php).

Unpopular Government

Despite a surging economy and 3.4% unemployment, the Chief Executive of Hong Kong has a lower approval rating than President Obama

Source: Bloomberg.
University of Hong Kong (http://hkupop.hku.hk/english/popexpress/ce2005/vote/poll/datatables.html).
Gallup (http://www.gallup.com/poll/149114/obama-close-race-against-romney-perry-bachmann-paul.aspx).

The Call for Change is Growing Louder

Major business publications, prominent investors, local politicians, and economists have all recently questioned the suitability of the peg

Recent Headlines

"Hong Kong Faces Heat on Dollar Peg" – Financial Times, November 2010

"Hong Kong Should End Peg to U.S. Dollar, Deutsche Bank Says" – Bloomberg, November 2010

"The Peg will be History" – The Standard, January 2010

Source: Picture - Hong Kong Business (http://hongkongbusiness.hk/).

Diverse Voices are Calling for Change

Investor

"A link to a basket of currencies or 'no link at all' is 'more desirable'"[1]
– Marc Faber – March 2011

Politician

"Continuous appreciation of the Renminbi means diminishing purchasing power of the Hong Kong dollar…The problem cannot be tackled unless we abolish the linked rate in Hong Kong."[2]
– The Honourable Chan Kin-Por, Legislative Council Member & Chief Executive of Munich Re Hong Kong – January 2011

Economist

"I think it's a case of a frog boiling in water…It could happen sooner than people think given the rapid rise in circulation of the currency [RMB]"[3] **– Peter Redward, Barclays Economist – October 2010**

Analyst

"The merits of reform are high and the cost of the relevant option is low."[4] **– James Grant – May 2011**

Source: [1]"It's time to end the HK$ peg" - Hong Kong Business, March 10, 2011.
[2] Legislative Council Transcript of January 6, 2011 meeting.
[3]"Hong Kong May have to revalue in 2 years, Barclays says" - Bloomberg Businessweek, October 26, 2010.
[4] Grant's Interest Rate Observer, May 2011.

Fiscal and Regulatory Measures Have Been Inadequate

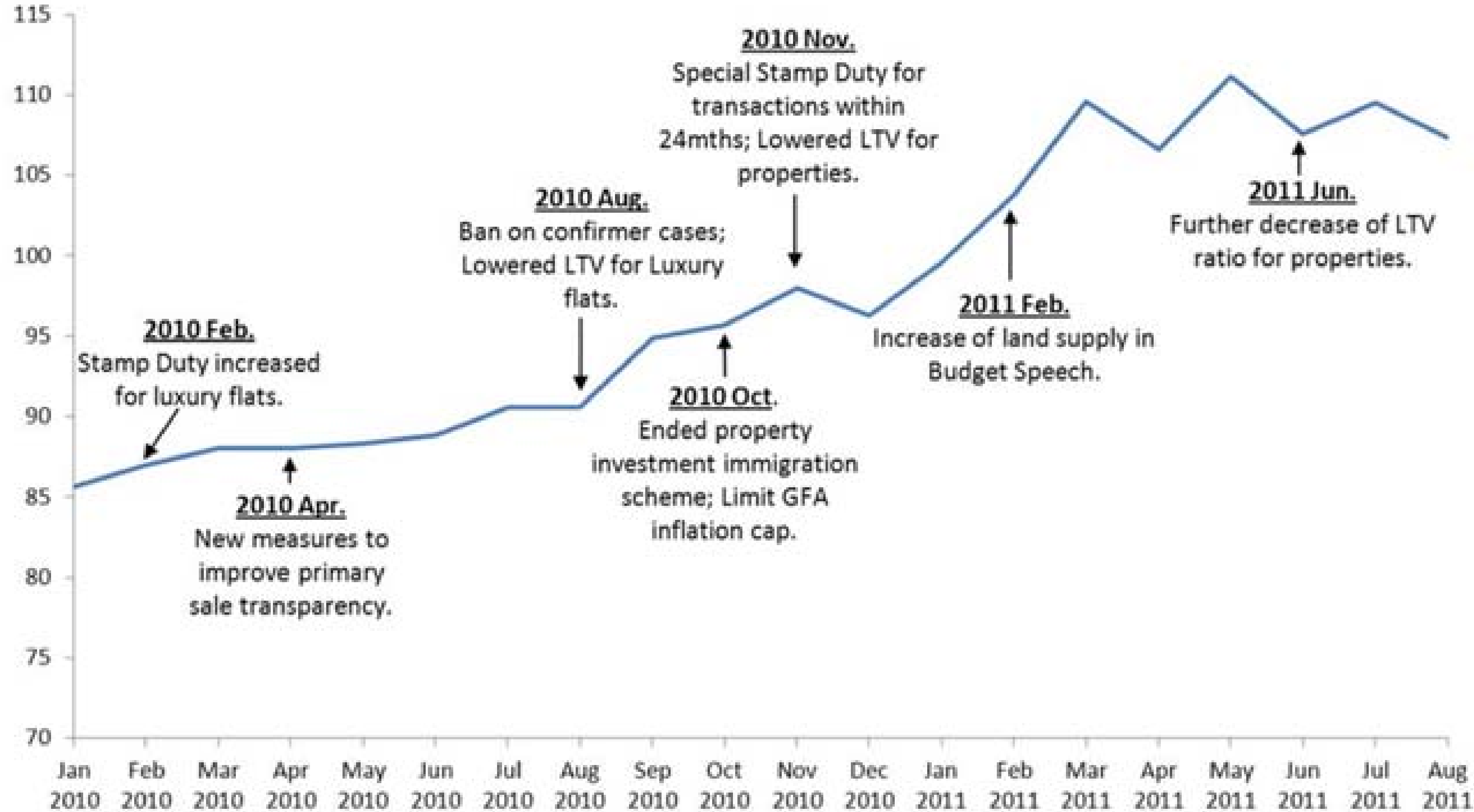
HK has implemented a series of unsuccessful "macro-prudential" reforms to deal with its inflation and wealth gap problems. These efforts do not address the underlying cause of the problems and in some cases are actually inflationary (e.g. cash handouts)

- **Housing – Efforts have failed to reduce prices meaningfully**
  - LTV caps on new mortgages
  - Transaction tax on homes sold soon after purchase
  - Home Supply – Increased land sales
- **Introduction of a Minimum Wage**
- **Rent Relief**
- **Utility Subsidy**
- **Cash Handouts**

Real Estate Market Intervention is Not Working

For example, the prevalence of cash buyers has reduced the impact of mortgage LTV caps

HK Residential Price Index



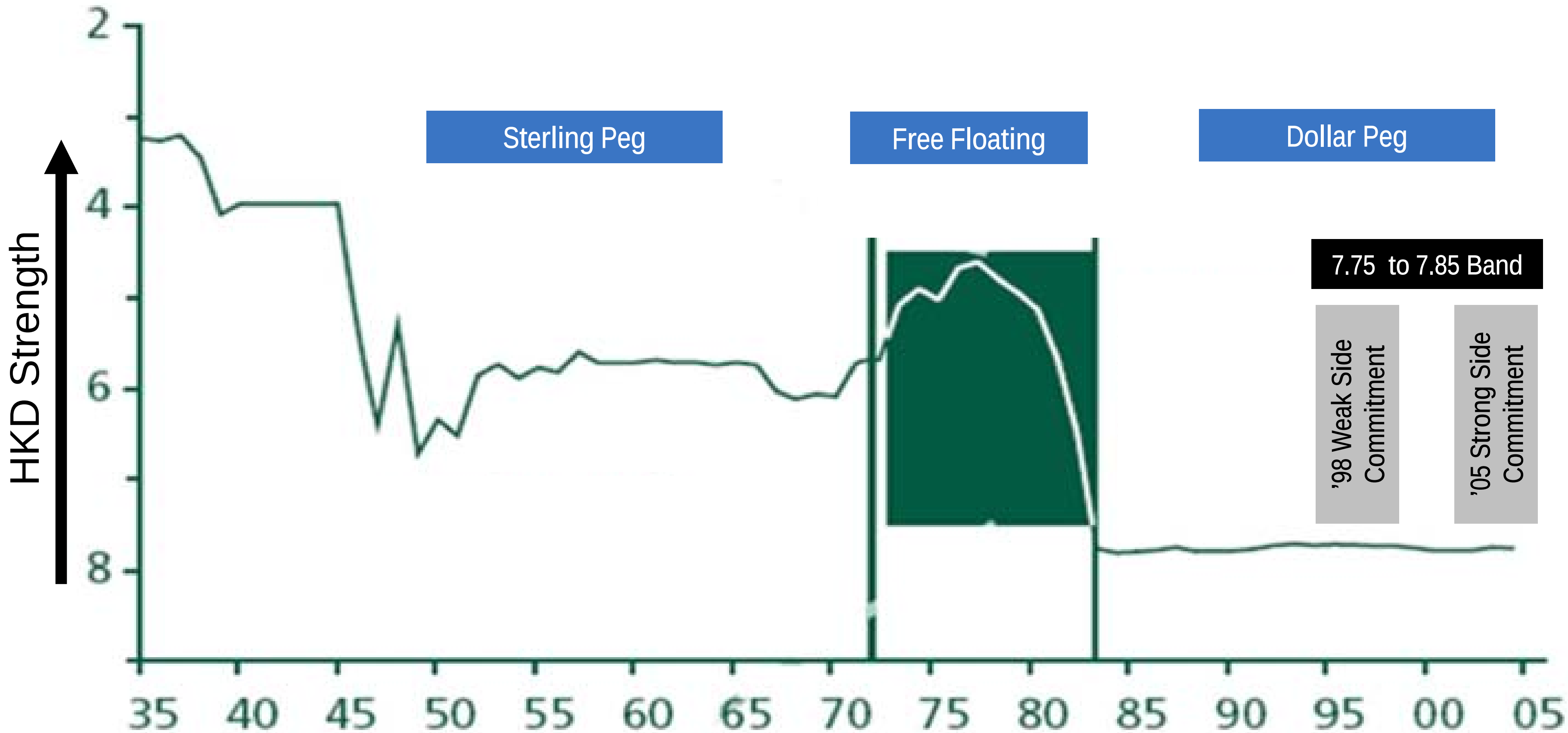
Source: Bloomberg.
"Hong Kong Property" – Morgan Stanley, September 2, 2011, p.19.
"Asian Economics Analyst" – Goldman Sachs, June 23, 2011, p.4.

IV. Our Prediction of What is Likely to Happen

Reminder

The history demonstrates that Hong Kong has modified its exchange rate system to address major economic changes

HKD/USD (inverted)



Source: "Hong Kong's Linked Exchange Rate System" – Hong Kong Monetary Authority, p.34 (http://www.info.gov.hk/hkma/eng/public/hkmalin/index.htm).

The only effective way to mitigate inflation and a potential real estate bubble is to allow the HKD to appreciate

There are Four Principal Revaluation Alternatives

1. **Allow the HKD to float**

2. **Repeg the HKD to a trade-weighted basket**

3. **Repeg the HKD to the RMB**

4. **Keep the USD peg, but revalue to an appropriate exchange rate**

Alternative One – Float

Pros:

- Full monetary independence
- The exchange rate would absorb economic shocks

Cons:

- Large trade flows make it difficult for the monetary authority to manage money supply
- A floating exchange rate could be volatile
- HK had a bad experience when it allowed its currency to float between 1974 and 1983

Alternative Two – Peg to a Trade-Weighted Basket

Pros:

- Monetary policy would more closely match that of its trading partners
- Reduces HK's real exchange rate volatility
- Singapore has successfully used this approach

Cons:

- A basket is less transparent and more complicated than the Peg
- The average interest rates of HK's trade partners is low today, which would mean continued low HK rates
- A basket introduces more discretion as trade weights can be adjusted and are subjective, increasing the risk of politicizing monetary policy

Alt. Three – A Direct or Basket RMB Link is Inevitable

- **HK's deepening economic ties with the Mainland make a direct or basket RMB link the widely understood best long-term solution to solving the pressures of the USD link**

- **While the HKMA has said that it does not support an RMB link now, it has laid out preconditions, which we believe will likely be met in the coming years**

- **The biggest impediment to an RMB peg today is the lack of capital account convertibility of the RMB**

But we believe full capital account convertibility is inevitable and coming soon…

The RMB is rapidly internationalizing in the current account and full convertibility is possible by 2015:

"I should say it is quite possible for China to realise yuan convertibility by 2015."

– Li Daokui, People's Bank of China (PBOC) Monetary Policy Committee, September 2011

Source: "Yuan Will Be Fully Convertible by 2015, Chinese Officials Tell EU Chamber" – Bloomberg, September 8, 2011 (http://www.bloomberg.com/news/2011-09-08/yuan-to-be-fully-convertible-by-2015-eu-chamber.html).
"China Yuan Likely Convertible by 2015" – Thompson Reuters – September 9, 2011.

The extremely divergent economic characteristics of HK and the US make the status quo unsustainable, destructive, and a distortion to the HK economy

The HKD will likely be pegged to the RMB or to an RMB-led basket within the coming years. All that is needed is an interim solution…

We believe the HK government will repeg the HKD at a stronger exchange rate to the USD while leaving the LERS intact

Contemporaneous with this revaluation, we believe the HKMA may indicate that the HKD will eventually be pegged to the RMB or to an RMB-led basket when the RMB is fully convertible

Why Does This Make Sense?

- The current LERS is simple, transparent, and credible so a continuation of the current system makes sense
- A revaluation can be achieved quickly
- Only an interim solution is needed because the RMB will be convertible in coming years
- No other interim change will be necessary

How much should the HKD be allowed to appreciate?

Considerations

- **The exchange rate should be adjusted sufficiently to quell speculation about further appreciation**
- **But not so much that the currency would become overvalued**
- **A wider trading band could be introduced to provide greater flexibility in a volatile world**

We Believe a 30% Revaluation to 6:1 is Likely

- **Would bring HKD back in line with fair value**
- **It would be sizeable enough to convince the market that this is a one-time event**
- **A revaluation is consistent with HK's handling of prior Sterling and USD devaluations in the 1960s and 1970s**
- **Hong Kong would retain the simplicity and credibility of the USD peg and maintain the current currency board apparatus**
- **It would reinforce the HKMA's and government's credibility as responsible stewards of Hong Kong's economy**

Revaluation: How are Stakeholders Affected?

- **Citizens:**
  - The purchasing power of savings would instantly rise
  - The cost of food imports (~30% of the poorest half's spending)[1] would drop immediately
  - Real estate appreciation would moderate and rents should stabilize over time
- **The Banks:**
  - HKMA data show that banks would not suffer large FX or loan losses on a revaluation[2]
- **The HKMA:**
  - Has sufficient foreign reserves to ensure that the Monetary Base is covered
- **Mainland China:**
  - A revaluation could be seen as evidence that HK is addressing its social divide and political tensions

Source: [1] "Half-yearly Hong Kong Economic Report 2011" – Hong Kong SAR Government, p. 97.
[2] "Foreign Currency Position" and "Asset Quality of Retail Banks" – Hong Kong Monetary Authority (http://www.info.gov.hk/hkma/eng/statistics/msb/index.htm).

V. Investment Opportunity

Three Ways to Make Money

- **Buy HKD Outright**
- **Buy HKD with USD Leverage**
- **Buy HKD Call Options**

Buy HKD Outright

- **The HKMA’s commitment to support HKD at 7.85 HKD/USD limits the downside to owning HKD to ~1%, making the HKD effectively a one-way bet**

- **The HKMA’s 7.85 HKD/USD defense is credible:**
  - The HKD is materially undervalued
  - HK has substantial international reserves, at ~2.2x the Monetary Base
  - The HKMA’s successful defense of the HKD during the Asian Financial Crisis makes its credibility unquestioned

Purchase HKD with USD Leverage

Similar short-term interest rates and the HKMA's pledge to support HKD at 7.85, means investors can cheaply and safely purchase HKD on USD leverage

Leverage: (Notional/Equity)	12-Month %Total Return (from 7.80): 7.85 (Weak Side)	6.24 (25% Reval)	5.78 (35% Reval)
4.0x	-3%	100%	140%
6.0x	-5%	149%	209%
8.0x	-6%	199%	279%
10.0x	-8%	249%	349%
12.0x	-9%	298%	418%
14.0x	-11%	348%	488%
16.0x	-12%	398%	558%
18.0x	-14%	447%	627%
20.0x	-16%	497%	697%

12 Month Financing Cost (Fixed)	
HIBOR	0.67%
LIBOR	0.82%
Carry	-0.15%

Reflects the cost of financing for a bank. Institutional and individual investors will pay a higher rate (~35bps more)

HKD Call Options

HKD call options are extremely cheap

Option Terms			
Notional	$ 1,000,000,000	$ 1,000,000,000	$ 1,000,000,000
Strike (HKD/USD rate)	7.80	7.50	7.00
Premium (% of notional)	0.83%	0.57%	0.27%
Premium Dollars (USD)	**$ 8,300,000**	**$ 5,650,000**	**$ 2,700,000**

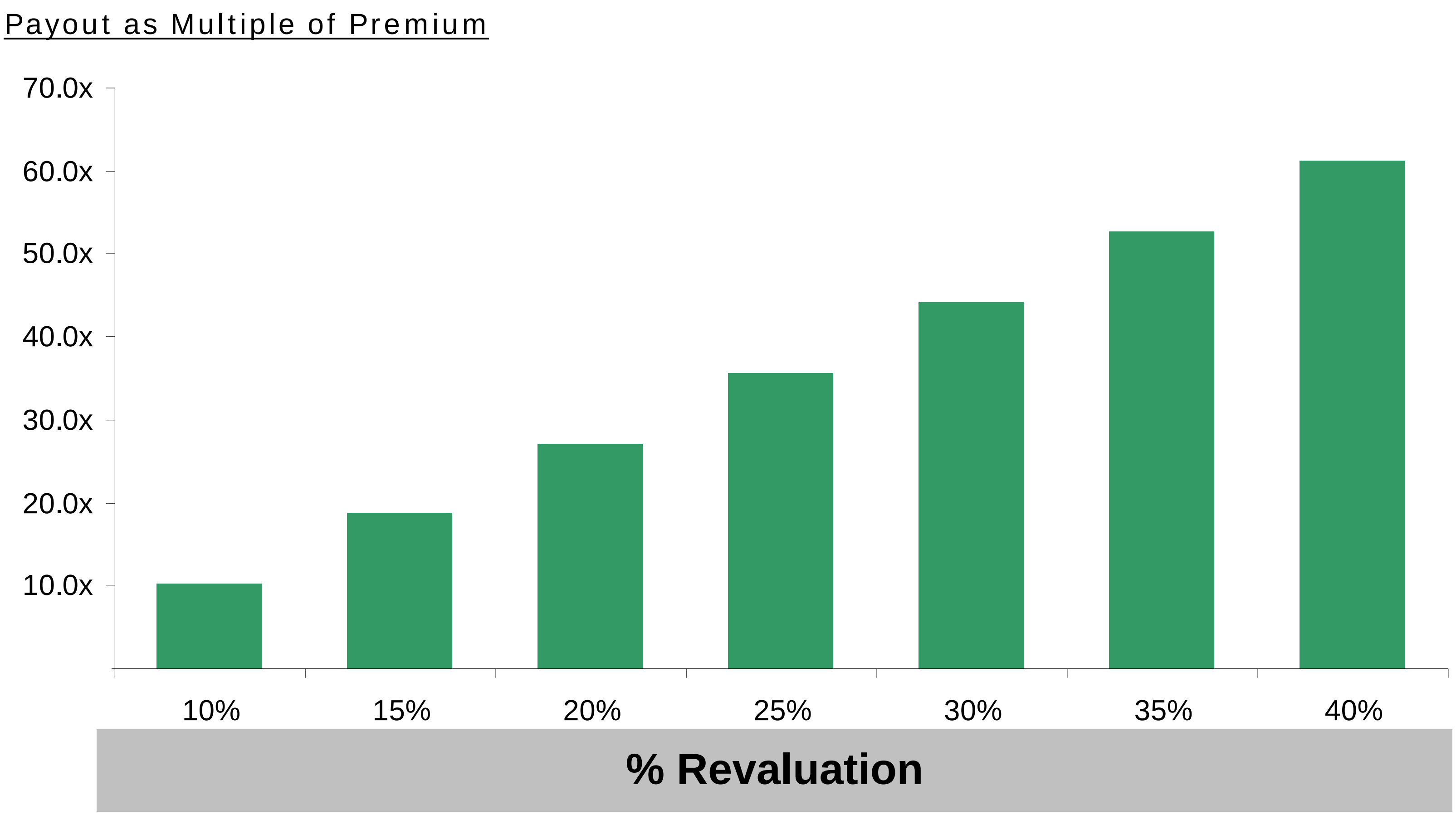
Payouts at Exercise (Revaluation to 6.00, +30%)			
USD Received	$ 1,300,000,000	$ 1,250,000,000	$ 1,166,666,667
USD Spent (notional)	1,000,000,000	1,000,000,000	1,000,000,000
Payoff	**$ 300,000,000**	**$ 250,000,000**	**$ 166,666,667**
Payoff/Premium	**36x**	**44x**	**62x**

USD received = value of HKD purchased at strike price converted back at spot (6.00)

Source: Indicative broker quote September 8, 2011.

HKD Call Options are Cheap

The HKD options market implies that the probability of a revaluation is extremely remote. We think a ~30% revaluation is likely, giving investors a ~44x payout on one-year 7.50 strike options



The Market is Mispricing this Option

- **Because of the peg, HKD/USD volatility is very low**

- **We believe HKD call options should be priced based on expected value rather than volatility**

Expected Value = (Probability of Reval) X (Expected Amount of Reval)

- **We think a revaluation is more likely than not, but <u>the market price implies extremely low probabilities</u>**

One Year, 7.50 Strike		
Expected HKD Stregthening	**Payoff**	**Implied Probability of Revaluation**
15%	18.7x	5.3%
20%	27.2x	3.7%
25%	35.7x	2.8%
30%	44.2x	2.3%
35%	52.8x	1.9%
40%	61.3x	1.6%

A revaluation will likely be in this range

Market implied probabilities are very low

The HKD is a cheap hedge against a weakening USD:

A falling USD puts more pressure on HK authorities to act

VI. Why Now?

Why Now? – Benefits Outweigh the Cost

- **The benefits of acting now**
  - Consumer inflation could get materially worse
  - It's not too late to prevent a real estate bubble
  - Social unrest is building
  - The fiscal and economic divergence with the US will continue
  - Revaluation is inevitable when the RMB peg is established
- **The costs of acting today are low**
  - The credibility of the HKMA would be enhanced
  - The HKMA has reserves to support a large revaluation
  - HKMA data show the banks' FX exposure is minimal and their real estate loans are well performing[1]
  - HK's lack of an export manufacturing sector reduces the economic risk of a stronger currency

Source: [1] "Foreign Currency Position" and "Mortgage Survey Results"– Hong Kong Monetary Authority (http://www.info.gov.hk/hkma/eng/statistics/msb/index.htm).

Why Now? – 2012 Election

The March 2012 HK Chief Executive election increases the chances of a near-term revaluation

- **Change tends to happen around political transitions:**
  - Outgoing politicians are often less risk averse
  - Incoming politicians are often most bold when they first take office
- **A revaluation may well materially increase the new Chief Executive's approval ratings**
- **It would enhance HK's citizens' perception of China's beneficence**

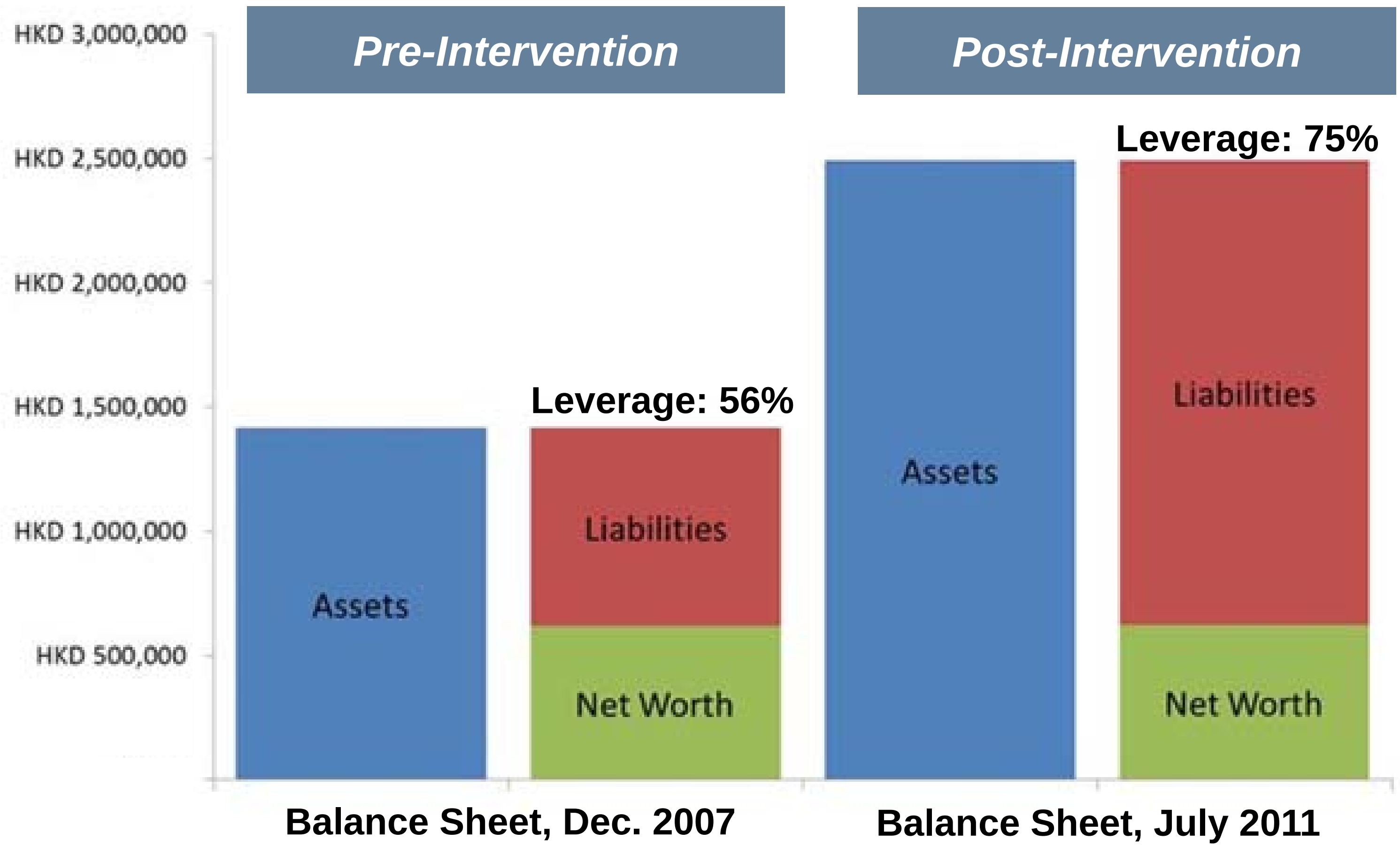
Source: [1] "Previewing the Political Year Ahead: Article 23" – Suzanne Pepper (http://chinaelectionsblog.net/hkfocus/?p=168).

Revaluing Now Mitigates the Financial Risk to the HKMA

- **The conventional wisdom is that central banks (CBs) can defend the strong side of their currency without limit by simply printing an unlimited amount of money**
- **The reality is different:**
  - The CB loses money on a revaluation, because a revaluation reduces the value of foreign assets on their balance sheet
  - Printing money expands and leverages the CB’s balance sheet, making it more costly to revalue
  - Printing money is highly inflationary
- **Because the Basic Law requires the HKMA to back its Monetary Base 100% with international reserves, printing money could severely limit the HKMA’s future revaluation options**

Revaluing Now Mitigates Financial Risk to the HKMA

The HKMA's 2008/2009 intervention, in response to over HKD $600bn of money flows, greatly increased the size and leverage of its balance sheet



Source: "Monthly Statistical Bulletin – Table 8.2" – Hong Kong Monetary Authority, July 2011 (http://www.info.gov.hk/hkma/eng/statistics/msb/index.htm).

We believe it would be imprudent for Hong Kong to print more money

The principal argument against a revaluation is that it might harm the HKMA's credibility. We believe this is false for two reasons:

1) Reducing inflation and the risk of asset bubbles in HK enhances HK's status as a stable, economically successful, AAA rated region

2) Allowing the HKD to appreciate only increases the credibility of the HKD as a store of value

Some observers have suggested a revaluation would be inconsistent with the HKMA's public statements

However, an upward revaluation was explicitly contemplated in 1983 when the LERS was introduced:

"It will be acceptable to indicate eventual possible appreciation in the event of confidence returning to such a degree as to produce unduly rapid monetary expansion, but such an indication must carry complete conviction that the rate would only ever be adjusted in that direction."

- Internal Hong Kong government policy memo, 1983

Source: "Stabilization of the Exchange Rate" (http://www.sktsang.com/ArchiveI/1983.pdf).

A peg depends on confidence and credibility. Any hint of devaluation would compromise the integrity of the link:

“Any statement which can be interpreted as hinting at the possibility of depreciating the announced rate would sabotage the scheme from the onset.”

- Hong Kong government policy memo, 1983

Source: “Stabilization of the Exchange Rate” (http://www.sktsang.com/ArchiveI/1983.pdf).

As such, anytime observers have questioned the link, the HKMA has issued a prompt statement to quell speculation

"The Hong Kong dollar peg has been working well since its adoption in 1983. It's the foundation for the stability of the currency and financial system in Hong Kong so we have no intention to make any change"

– Norman Chan, HKMA Chief – August 2011

Sources: "Linked Exchange Rate System" – Hong Kong Monetary Authority, August 2011 (http://www.info.gov.hk/hkma/eng/insight/20110815e.htm).

In 2002, facing SARS, deflation, and budget deficits the then Financial Secretary strongly defended the peg publically:

"We have no plans to change the peg. One of the reasons the peg remains and people are confident about the Hong Kong dollar is that it has not changed in the last 19 years"

– Antony Leung, Financial Secretary (2001-2003) – Nov. 2002

But in private the story was very different…

Source: "Financial Secretary Transcript" - Press Release, November 23, 2002 (http://www.info.gov.hk/gia/general/200211/23/1123063.htm).

Behind the scenes…

“The chief executive, Joseph Yam, and I did seriously evaluate the various options including unpegging”

– Antony Leung, Financial Secretary (2001-2003)

Interview – “Hong Kong’s Peg Admission May Hurt its Future Defense” Bloomberg, June 2007

Sources: “Hong Kong's Peg Admission May Hurt Its Future Defense” – Bloomberg, June 8, 2007 (http://www.bloomberg.com/apps/news?pid=newsarchive&sid=akb5SpAzhFKg&refer=asia).

We also know from a document WikiLeaks released August 30th, 2011 that in 2006 a float was seriously considered by members of an important HK government commission:

"Numerous commission [HK's Commission on Strategic Development – One of the HK government's most prominent] members who, in Fung's words, 'have the ear of senior officials' are arguing that the HKD-USD peg should be floated shortly after the Chinese RMB surpasses the HKD in value."

Internal US Treasury Memo, "Hong Kong Dollar Peg's Future Under Consideration by Government Advisory Body" – April 2006

Sources: Wikileaks, August 30, 2011 (http://wikileaks.org/cable/2006/04/06HONGKONG1383.html).

A prominent member of the HKMA committee responsible for advising on the peg suggests a revaluation could happen when the market least expects:

"[T]he HKMA might choose a hot and boring Friday afternoon in mid-summer, when most fund managers and top government officials had gone vacationing, and announce the floating of the Hong Kong dollar."

-Shu-ki Tsang
Academic Economist and HKMA Advisory Board Member, Currency Board Sub-Committee

Source: "Commitment to Exit Strategies from a CBA" – Hong Kong Baptist University (http://sktsang.computancy.com/attrachment/Tsang20000506.pdf).

We have every reason to believe HK decision makers will approach the HKD peg question with the same diligence and rationality they have used in the past

Economic and Monetary Policy Making in HK

- Since its inception in 1993, the HKMA has built a reputation as one of the most credible monetary authorities in the world
- The HKMA is known for its intelligence, transparency, and prudent oversight of the economy and banking system
- Most importantly, the HKMA and other important decision makers in Hong Kong have a track record of behaving in an economically rational manner

Repegging is easy and quick to execute:

Unlike some other currency regimes, HK’s peg can be modified through a purely administrative process. No legislative action is required

In Sum:

A highly undervalued currency

+

A highly undervalued option

= An extraordinary investment opportunity

Q & A

STABILISATION OF THE EXCHANGE RATE

Introduction

This memorandum describes a scheme to stabilise the exchange rate of the Hong Kong dollar, and seeks Members' advice as to whether it should be implemented immediately.

Background

2 Since 1974 the Hong Kong dollar has been a freely floating currency. Although the Exchange Fund has always possessed the capability of intervention in the foreign exchange market, such intervention has generally been limited to seeking to smooth out short-term fluctuations, acknowledging the experience of governments and central banks across the free world that intervention cannot resist more fundamental pressures. In brief, massive expenditure of foreign currency reserves is futile. A particular difficulty in Hong Kong has been the limited effectiveness of other policy instruments available to influence the domestic money supply in support of any intervention in the foreign exchange market.

3 Over the last nine years the floating exchange rate regime has served Hong Kong well. Its merit has been in assisting the automatic adjustment process towards the achievement of full employment and outstanding economic growth, but it has been accompanied by high rates of inflation at times - particularly recently - and by uncontrolled growth of the money supply.

4 During the past 12 months the exchange rate has become increasingly affected by political uncertainties and loss of confidence as opposed to current economic factors. The latter are excellent. Currency depreciation has nevertheless shown signs recently of feeding on itself, which has led to consternation and indeed a degree of panic amongst the public. The Government has been unable to control the slide, despite both substantial intervention by the Exchange Fund in the foreign exchange market and upward pressure on interest rates. The Administration has consequently explored the possibility of introducing fundamental structural changes to the exchange rate system, given that the free float, however successful in the past, may no longer be appropriate to Hong Kong's unique present circumstances. Great caution is clearly essential. We do not wish to leap from the frying pan into the fire.

Proposal

5 The central element in the scheme which is now proposed is that Certificates of Indebtedness, which are issued by the Exchange Fund to the note-issuing banks to be held as cover for their note issues, should henceforth be issued and redeemed against foreign currency (US dollars) at a fixed rate. At present they are issued against Hong Kong dollars, which normally subject to timing were used to purchase foreign exchange.

6 This proposal is neither novel nor untried. There are precedents here and further afield. For instance, an analogous arrangement existed in Hong Kong from 1935 to 1972, whereby Certificates of Indebtedness were issued and redeemed against sterling, but of course the environment in which the system then operated - sterling area and associated exchange controls, a predominance of fixed exchange rates around the world, and no political overhang in Hong Kong - was very different.

How the scheme would work

7 Although the price of Certificates of Indebtedness against US dollars would be the only formal, announced, fixed rate, the processes of competition and arbitrage within the monetary system should bring the market exchange rate to within a small range of the announced rate. The scheme maintains by arbitrage the exchange rate fixed in the first instance. Since a bank, or through a bank a bank customer, can always obtain foreign currency (say at US1 per HK$8), then any excess sales of HK dollars on the foreign exchange market driving it below $8 say to $8.25, will, subject to transactions costs, induce the bank, or its customer, to buy Hong Kong dollars at 8.25 and pay for them in US dollars obtained by redeeming notes with the Exchange Fund at $8. Pure arbitrage will ensure that the rate must remain linked so long as the public has the wherewithal (in notes or foreign currency). to trade with the Exchange Fund. The public, of course, can renew its note holding by shifting from bank deposits to notes, so long as convertibility remains. If, then, the public wants to move into, say, US dollars at the fixed rate, what prevents it continually changing more Hong Kong dollar deposts into Hong Kong dollar notes and thence into US dollars? The answer to that is that the shift out of HK dollar deposits into notes (whether Hong Kong or US) puts pressure on the available liquid reserve

base of the banks. Initially they may be able to draw on surplus available liquid foreign currency assets, but if the drain continues they have to react more forcefully. Their reaction will take the form either of bringing in to Hong Kong additional foreign currency, if the return and risk prospects merit it, and/or raising interest rates on Hong Kong dollar deposits and loans to stem the drain.

8 If the new arrangement attracts total confidence and credibility - i.e. in the belief that it will endure - there will no longer be any incentive for people to rush out of Hong Kong dollars in the short-term, even though political worries if continued would occasion a steady outflow of capital over a number of years. In other words, confidence in the currency, but not necessarily in the future nor hence in Hong Kong assets, would have been restored, and the introduction of the scheme would not impose any intolerable strains.

9 In practice, however, there will probably be some initial scepticism and miscomprehension, however deftly the all-important presentation is handled. To the extent that people perceive the arrangement as a chance to get out of Hong Kong dollars quickly at a relatively generous rate, pressures could develop.

10 Essentially the scheme transfers the pressure of a run out of the local currency away from the exchange rate onto the banking system and thus to borrowers. The level of local currency interest rates has to rise to a point where the continuing outflow into foreign currencies by residents is matched by an offsetting inflow by banks and other speculators. If the banks will not increase their exposure in Hong Kong, and the public's desire to diversify into foreign currency is very strong, then interest rates would have to rise sharply. Without any such scheme, however, in such circumstances the exchange rate would be falling sharply, and that would also lead to domestic interest rates rising markedly, though perhaps not so quickly. It is essential to realise that the extent to which domestic Hong Kong interest rates may rise will depend on confidence in the scheme itself. If bankers, businessmen, foreigners, etc., were really confident that a linked rate against, say, the dollar would be maintained for, say, six months, then they would bring in extra US dollar funds until the Hong Kong dollar six month interest rate was brought into line with the US

dollar six months rate ruling in Hong Kong. Currently the local Hong Kong dollar interest rates are above comparable US dollar rates, so that were confidence in the success of the scheme to be instilled then Hong Kong dollar rates would fall, not rise. Some proponents of the scheme believe that this is what would happen.

11 Public reaction might not, however, be limited to switching deposits. There could conceivably be a surge in demand for either HK dollars or US dollar banknotes. Steps will be taken to ensure supplies of Hong Kong dollar and of US dollar notes if the scheme proceeds, but such a demand could conceivably lead to pressure on banks' liquidity if it was more than shortlived. Meanwhile, if there was any sort of rush to the banks, either to draw notes or switch deposits between currencies, there might be another bout of rumour and panic directed against some local banks. In such circumstances the major banks will no doubt be willing to recycle additional funds coming to them, but the Exchange Fund will also need to provide liquidity to individual banks on a last-resort basis. The Financial Secretary will also stand ready temporarily to relax the statutory liquidity requirement for particular banks or bank groups.

12 While steps can be taken to provide relief in particular cases, the process of adjustment to the new scheme and the establishment of confidence in it will be frustrated if the Government were to act indiscriminately so as to avert the possible initial interest rate consequences.

<u>The rate and the currency</u>

13 Although the equilibrium exchange rate calculated purely by reference to current economic forces may be in the region of $7.00 or better, it is crucial for the success of the scheme that the chosen rate be credible to the market and to the public. A fair discount for the political bankground is therefore in order, but some improvement on the present market rate (8.41/46 at the time of writing) is both desirable and feasible, and will squeeze at least a few bears.

14 A rate of $8.00 is therefore presently suggested. The possibility of having a small spread between issue and redemption rates for Cs of I is being considered. The Financial Secretary will report.

15 The Financial Secretary will give Members at the meeting the Administration's final views on the appropriate rate. It will depend on the latest exchange rates.

16 The recommendation of a US dollar criterion follows from the fact that the US dollar is established as the main benchmark currency in both the markets and in the eyes of the public - as evidenced by the panic of 23/24 September - as the main refuge currency. The days of the Hong Kong dollar's sterling peg appear to be long forgotten and a return might provide ground for political speculation and misunderstanding.

17 By linking Certificates of Indebtedness to another currency Hong Kong would be tying itself, once things have settled down, to an arrangement by which domestic interest rates and domestic inflation will be substantially influenced by the behaviour of the economy to whose currency it is tied (the USA in this case). It was, in essence, the potential effect of such ties upon the Hong Kong economy which led to the abandonment of the sterling link in 1972 and then the US dollar link in 1974. One cannot be sure that similar pressures will not develop later under the present proposal, but at this juncture in Hong Kong's history the balance of advantage seems to be firmly in favour of accepting such pressures on the economy as a link to the US currency might bring, as against accepting the consequences of a continuing floating rate, the bounds of which appear to be virtually unlimited. While the fall of the Hong Kong dollar exchange rate mainly results from lack of political confidence, there will be no confidence without a relatively stable dollar. It is a classical chicken and egg situation.

18 A case can be made for fixing on a trade-weighted basis. This would be both complicated, since the rate against any individual currency would need to be continually adjusted, and unnecessarily refined given the scale of the Hong Kong dollar's recent slide against virtually every major currency. We must seek presentational simplicity. It is also absolutely critical that the rate be regarded as fixed indefinitely. Any statement which can be interpreted as hinting at the possibility of depreciating the announced rate would sabotage the scheme from the outset. It will be acceptable to indicate eventual possible appreciation in the event of confidence returning to such a degree as to produce unduly rapid monetary expansion, but such an indication must carry complete conviction that the rate would only ever be adjusted in that direction.

Consultation

19 Detailed discussions, both as to the advisability of this scheme and on the mechanics of its implementation,

have been held with the two note-issuing banks. Both are aware of the benefits which the scheme would bring if successful, and the problems that would loom it it was badly received. They believe that the Government has anyway worked itself into the position of having to do something and they have told the Administration that this scheme appears to be the best, if not only, immediate option. They have undertaken to co-operate fully should a decision be taken to proceed. Their approach has as always been responsible and helpful.

20 Selected academics and others have been consulted, displaying as might be expected some polarisation of views between extremes of enthusiasm and scepticism.

21 Senior and able monetary experts from the Bank of England and UK Treasury visited Hong Kong last week to study the proposal. Their conclusion was that the scheme was technically feasible and in many respects desirable. They underlined the risks involved, should the presentation fail to carry conviction. The decision is of course one for the Hong Kong Government, but they left us in no doubt what they would do if in our shoes. The Governor will mention his discussions with the Chancellor.

Legislation

22 Section 4(1) of the Exchange Fund Ordinance (chapter 66) states that the note-issuing banks should pay the face value of Certificates of Indebtedness to the Exchange Fund. The value of the Certificate is expressed on it in Hong Kong dollars. This might suggest that legislative amendment is required in order to operate the scheme, but in earlier years sterling was used without any such amendment. Since the note-issuing banks have agreed to co-operate in foreign currency payments, there does not appear to be any immediate need for legislation.

Costs

23 As outlined earlier, the thrust of the scheme is to shift the burden of adjustment to crises in confidence away from the exchange rate and onto the banks and hence borrowers. The scheme should not, in principle, involve any intervention by the Exchange Fund in the foreign exchange market, although there may be reason, at any rate in the initial phase, to intervene in order to ease the transition.. The formal commitment of the Exchange Fund will be limited to redeeming any amount of the note issue as the fixed rate. The note issue currently stands at HK$14½ billion (less than US$2 bn at a rate of $8.00). In the very worst circumstances this sum is at risk. The Fund's foreign currency holdings are very greatly in excess of this.

Timing

24 If the decision is taken to proceed, it is envisaged that the new arrangements would be announced by the Financial Secretary on the evening of Thursday 13 October. The following day is a bank holiday in Hong Kong. The Chairman of the Hong Kong Association of Banks has been consulted and considers that banks should be able to cope with opening as usual on Saturday. When this paper is discussed there may be reason for modification of this plan.

Presentation and public reaction

25 A recurrent theme in this memorandum has been the importance of the presentation of the scheme to the public. The Financial Secretary proposes to deliver a carefully prepared statement, followed by a press conference on Thursday evening. Briefing for banks will be prepared by both the Monetary Affairs Branch and the note-issuing banks with a view to obtaining their fullest and properly informed co-operation.

26 In order to avoid any complaints by (or against) the note-issuing banks to the effect that the scheme was unduly costly (or beneficial) to them, they will arrange that all other banks draw or surrender notes to them on exactly the same payment basis as they are subject to for Certificates of Indebtedness - i.e. against US dollars at the fixed rate. It is necessary to emphasise that the rate at which banks deal in foreign exchange with customers or in the inter-bank market will continue to be set by the forces of competition, and that, although the rate should settle close to the C of I rate, the public must not expect to find the rate fixed at precisely that level.

27 The initial public reception to a measure designed to stabilise the exchange rate is expected to be favourable. The success of the scheme depends, however, upon later financial reactions which cannot be predicted. If interest rates were to rise, even if only temporarily, certain sectors - particularly property companies and home buyers - would be hurt and could be expected to react accordingly.

Conclusion

28 The proposed scheme appears to be the only practical method of stabilising the exchange rate at this time. Its introduction would shift the burden of confidence crises onto banks and borrowers and thence asset prices, instead of onto the exchange rate and thence consumer prices. Inflation would be controlled.

The interest rate route could in the worst circumstances be painful, but would not possess the sort of apparent self-feeding instability that the exchange rate has exhibited on some recent occasions. In terms of longer-term economic consideration, the scheme would spell the end of the exchange rate as a dimension of adjustment, but would introduce another in-built automatic mechanism whereby the Hong Kong dollar money supply and interest rates would tend to adjust in a stabilising manner to balance of payments pressures, whether resulting from domestic or external developments. The benefits in terms of lower inflation rates might have to be paid for by lower growth rates. Risks are involved, but they seem far less than the risks of maintaining the status quo. In any case there is arguably a political need for action.

Interest Withholding Tax

29 The Administration considers that the impact of the scheme, and the degree of confidence it attracts, will be substantially enhanced if the interest tax on Hong Kong dollar deposits is simultaneously removed.

30 Examination of the further implications for revenue from profits tax and possible ways of preventing any erosion have not yet been completed. Indeed they have just started. It is therefore proposed that interest tax on Hong Kong dollar deposits with financial institutions should simply be exempted from tax with effect from Monday 17 October, prior to any more fundamental legislative changes which may be introduced in the budget next spring. The Financial Secretary will speak on how immediate legislation can be implemented.

31 The loss of revenue for the remainder of this financial year is estimated at $250 million. There are more severe implications qua profits tax for the future. Application has been made to the Secretary for State under Section 8 of the Exchange Fund Ordinance for this sum to be transferred to general revenue account from the Exchange Fund; such a move is considered to be especially justified in view of the fact that the zero-rating of interest tax would be introduced as part of the package specifically directed at stabilising the exchange rate. It is also essential to maintain confidence in budgetary control and discipline of the deficit.

Advice sought

32 Members are asked to advise whether the proposal with effect from 15 October to issue and redeem Certificates of Indebtedness only against US dollars at a fixed rate sould be implemented, and whether such a step should be accompanied by the zero-rating of interest tax.

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(The Secretary for Monetary Affairs, Mr. D.W.A. Blye, the Deputy Secretary for Monetary Affairs, Mr. A Latter and the Deputy Secretary (Economic Services), Dr. A McLean will attend before the Council for the discussion of this item.)