

The Adequacy of Hong Kong's Foreign Reserves

Experience suggests that Hong Kong needs considerably more in foreign reserves than the bare theoretical minimum to maintain currency stability.

I have recently been asked the question of how much in foreign reserves do we need to ensure that our monetary policy objective of exchange rate stability is comfortably achieved. This is not an easy question to answer. It is true that we have probably the most robust exchange rate system – by design and as a result of our continuous efforts to strengthen it ever since its establishment in October 1983. It is also true that our exchange rate system, characterised by currency board arrangements, only requires our monetary base, currently at about HK\$220 billion, to be fully backed by foreign reserves of US\$28 billion at the exchange rate of 7.80. It is, therefore, tempting to consider this theoretical minimum as all we need in foreign reserves to ensure exchange rate stability. Whoever takes this view is making a big mistake.

To understand why, let us go back to the international financial crisis of 1997/1998. The size of our monetary base at that time was smaller, at around HK\$95 billion, and the amount of foreign reserves needed to back it 100% amounted to about US\$12 billion. The crisis came, and there was the initial attack on our currency in October 1997. The robustness of our exchange rate system, as expected, automatically transferred the pressure on the exchange rate on to our interest rates, without the need to use foreign reserves in the Exchange Fund other than those dedicated for the purpose of backing the monetary base. Reflecting the severity of the currency attack, our overnight interest rate went up for a short while to over 200%, and interest rates for longer-term money also rose sharply. This caused a lot of pain, to the community and the speculators alike. The HKMA was blamed for squeezing interest rates and I was given a nickname. The system, by and large, worked in the manner for which it was originally designed. But the pain inflicted on the community, through the hikes in interest rates and the associated slides in asset prices, was considerable.

Then came the wicked month of August 1998, when we were hit by the tidal waves of international finance. The attack on the currency was many times more severe. Furthermore, the currency predators were well positioned to avoid the

likely interest rate pain, by pre-funding themselves, and to benefit from the expected sharp slide in asset prices by running huge short positions in stock futures. Thankfully they did not succeed. We put up a gallant fight and Hong Kong won. I am sure readers are familiar with the story and how it played out in the end. But it is important to recap, now that the question of how much in foreign reserves we need has been raised, what it took in terms of foreign reserves. First, we used the opportunity to sell foreign reserves for Hong Kong dollars, in anticipation of the draw down of fiscal reserves deposited with the Exchange Fund, as the public finances moved into a cyclical as well as a seasonal deficit. This relieved some of the pressure on the exchange rate and therefore obviated the need for a repeat of the very sharp interest rate hike of 1997. The amount of foreign reserves utilised in this manner was about US\$10 billion. Secondly, we sold large sums of foreign reserves for Hong Kong dollars for the purchase of Hong Kong stocks equivalent to US\$15 billion. Thirdly, we made the monetary base much bigger in order to reduce the sensitivity of interest rates to inflows and outflows of funds. This involved committing another US\$13 billion as additional backing.

Thus, what was at that time the theoretical minimum requirement of US\$12 billion in foreign reserves for the provision of 100% backing to the monetary base became a requirement to mobilise a much higher level of foreign reserves, amounting to a few times the minimum. It should also be noted that we were able to do so without causing a breakdown of confidence in monetary and financial management in Hong Kong on the part of the international financial community, including financial analysts and rating agencies. To a large extent, this was because we had significantly more foreign reserves in the Exchange Fund than the sums mobilised, and the Fund had no significant liabilities other than the fiscal reserves deposited there.

History may repeat itself. The risks of globalisation have not declined, and Hong Kong, as an entirely open market, remains vulnerable. Although over the years we have strengthened our system considerably, I still would rather that we have, in the Exchange Fund, foreign reserves amounting to multiples of the theoretical minimum needed to give 100% backing to our monetary base.

Joseph Yam

5 April 2001

Fiscal Reserves and the Exchange Fund

The Exchange Fund and the Government's Fiscal Reserves are managed and invested together. But they are two separate and distinct entities.

Last week, in concluding the debate on the budget, the Financial Secretary once again drew attention to the distinction between the fiscal reserves and the Exchange Fund. I hope what he said will provide a rational basis for whatever future discussion there may be on Hong Kong's reserves.

As the aspirations of our community increase along with economic progress, legislators and community leaders are understandably questioning the need for the Government to be holding on to such large reserves. This is particularly so when aberrations in the economy, for whatever reasons, are adversely affecting the well-being of the community, to such an extent that government relief of one kind or another, with significant financial implications, may seem justified. If these cannot be met through provisions in the annual budget, then naturally the very substantial reserves come to mind.

This is where confusion between the fiscal reserves and the Exchange Fund comes in. The fiscal reserves are accumulated from the budget surpluses run over the years. Currently standing at over HK\$430 billion, the fiscal reserves are deposited with the Exchange Fund. This is done for two main reasons. The first is the centralisation in the investment management of public funds. There are obviously significant benefits in terms of the economies of scale in doing so, including the management of risks and liquidity, and, within those constraints, the maximisation of return. The monetary implications arising from such activity also have to be considered. The second reason is the need to enhance the resources available to the Exchange Fund in achieving the purposes for which the Fund is established. Although the fiscal reserves represent money borrowed for the account of the Exchange Fund and will have to be repaid on demand, the corresponding assets, managed along with other assets of the Fund, can be used for such purposes.

Monetary considerations notwithstanding, if it is considered appropriate that some of the HK\$430 billion of fiscal reserves should be used to address the needs

of the community, then the necessary amounts can, at any time, be withdrawn from the Exchange Fund. The HKMA, having responsibility for the day-to-day management of the Exchange Fund, will have to come up with the money. We can sell some of the foreign currency assets in the Exchange Fund for the Hong Kong dollars needed for the purpose, in which case the amount of foreign reserves held in the Exchange Fund, and the size of the Fund itself, will fall. Alternatively, if there are Hong Kong dollar assets in the Exchange Fund that can be deployed, these could be used, again involving a fall in the size of the Exchange Fund. And if, for monetary or other reasons, both are considered not desirable or not cost-effective, we could borrow Hong Kong dollars in the market to fund the repayment. In this case, there would be a change in the composition of the liabilities of the Exchange Fund and no change in its assets.

But this is not the end of the discussion. Questions have been raised about whether there is a need for so much money in the Exchange Fund and about whether money in excess of the requirements needed to achieve the purposes of the Fund could be used to provide more immediate benefits to the community. Last week in this column I addressed the question of the adequacy of foreign reserves. Although I did not draw any specific quantitative conclusions, my view was clearly that we could ill afford to be complacent. Nevertheless, Section 8 of the Exchange Fund Ordinance does provide a mechanism for the Financial Secretary, after satisfying certain conditions, to transfer money from the Exchange Fund to the general revenue. One condition is that the Financial Secretary should be "satisfied that such transfer is not likely to affect adversely his ability to fulfil any purpose for which the Exchange Fund is required to be or may be used under Section 3(1) or (1A)". These sections deal with "the exchange value of the currency of Hong Kong", "the stability and the integrity of the monetary and financial systems of Hong Kong" and "maintaining Hong Kong as an international financial centre". I cannot speak for the Financial Secretary, but, having regard to the risks to Hong Kong arising from international financial developments, I think it would be difficult for the Financial Secretary to be so satisfied.

Joseph Yam
12 April 2001

Letterhead of Hong Kong Monetary Authority

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12 April 2001

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Dear Mrs Lam,

Permanent Accommodation for the HKMA

Thank you for your letter of 30 March 2001 requesting additional information on the proposed acquisition of permanent accommodation for the HKMA.

The current rental payable by the HKMA for its existing office premises is in the region of \$100 million per annum. The amount is however subject to review in about a year's time. At current market rental and assuming that the rental level does not increase any further, we expect the total rental payable would be about 25% - 30% higher.

The office area of the proposed office accommodation at Two International Finance Centre will be larger than HKMA's current accommodation. This is to cater for the possible long term requirements of either the HKMA or the international financial institutions which prefer to stay close to the HKMA. It is difficult to specify precisely such requirements in detail given their long term nature. However, certain international financial institutions have expressed an interest to expand in Hong Kong. There are also a number of areas in which the HKMA may be asked to play a more prominent role in future, e.g. consumer and payment system issues.

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Any initially unused space will be let out at market rent to suitable tenants to provide a reasonable return for the Exchange Fund. The cost of catering for such possible requirements is therefore very low. On the other hand, the costs of not catering for future needs, and subsequently suffering from a shortage of space, would be relatively high. We may be accused of inadequate forward planning if that occurs.

I also attach two articles published by us on our website regarding the "Adequacy of Foreign Reserves" and "the Fiscal Reserves and the Exchange Fund", in which Members may be interested. Please let me know if further information is required.

Yours sincerely,

(Eddie Yue)
for Chief Executive
Hong Kong Monetary Authority

Encl.

c.c. Hon Ambrose Lau Hon-chuen, JP