

1. The administration's explanation that it has to adhere to the two budgetary principles enshrined in Article 107 of the Basic Law is not sufficient to justify the size of fiscal reserves. For the Basic Law merely prescribes the "balanced budget rule", but is silent on the question of fiscal reserve. Therefore, the size of the fiscal reserves needs to be justified by sound economic arguments. In my opinion, the case for a large fiscal reserve is very strong for the following reasons.
2. First, Hong Kong is an exceptionally open economy, the average ratio of its external trade to GDP being 226% in 1997-99. It is therefore particularly vulnerable to external shocks, be it economic, financial, or political. If any proof is needed, the Asian Financial Crisis (AFC), the effect of which is still being felt in Hong Kong, is the most dramatic example. A large fiscal reserve acts as a buffer against the more extreme adverse effects of an unanticipated crisis or contingency.
3. Second, under the present linked exchange rate regime, which is a variant of the Currency Board Arrangement (CBA), Hong Kong cannot conduct a meaningful monetary policy (e.g., changing the levels of interest rates) independently of the U.S. Federal Reserve. Fiscal policy however is not subject to this constraint. Thus, Hong Kong was able to pursue a moderately expansionary fiscal policy during 1998-2000, through tax cuts and reliefs, increased spending on infrastructure, training and social welfare etc. ameliorating somewhat the severe recession of 1998, and paving the way for the recovery of 1999-2000. But it was unable to cut interest rates in 1998 despite widespread complaints about high rates of both nominal and real interest. A large fiscal reserve therefore provides room for manoeuvre during the downward phase of the economic cycle.
4. This is not to suggest, however, that fiscal reserve can be freely used to stimulate the economy. Due to Hong Kong's exceptional openness and high propensity to import, a significant portion of the positive effect of public spending on income will be leaked externally through increased imports, in which case only foreign countries, and not Hong Kong, will benefit. This is another good economic reason why Hong Kong should use its fiscal reserve prudently.

5. Some people argue that Hong Kong's forex reserves, now standing at \$115.1 billion, is strong enough to protect Hong Kong against external shocks, implying that fiscal reserve can be freely used for spending. This is a dangerous argument which ignores recent reality and lessons of the AFC. The stability of the linked exchange rate by itself does not guarantee the absence of currency or financial crisis. It must be strengthened by fiscal soundness and probity. To give a very relevant example, Argentina also has a currency system based on the CBA. But because of its huge fiscal deficit, Argentina recently went through another devastating crisis that required an IMF bail-out amounting to US\$39.7 billion. Argentina's plight underlines the importance of keeping both a strong forex reserve and a fiscal reserve.
6. Any fiscal imprudence that results in a significant decrease in the size of Hong Kong's fiscal reserves will give wrong signals to both investors and speculators. Genuine foreign investors will be alarmed by Hong Kong's abandonment of its traditional fiscal prudence to pursue a profligate policy typical of a Third World country. Speculators, on the other hand, will find in this profligacy just the weakness they are looking for in order to mount another massive attack on Hong Kong's currency and financial system. In either case, confidence in Hong Kong will be greatly undermined. Ultimately, it is the ordinary people of Hong Kong who will suffer the most, as the AFC has clearly shown.
7. In view of the above sound economic reasons, I think that the Administration's proposed guideline of 12 months' government expenditure, plus Hong Kong dollar M1, as the appropriate size of the fiscal reserve, is quite reasonable and acceptable. However, I think that the range of plus or minus 25% gives too much leeway to government discretion. In my view, plus or minus 5% would be more appropriate. A simple rule can then follow: the upper limit of fiscal reserve should be 105% of the sum of 12 months' government expenditure and Hong Kong dollar M1. Any amount beyond this upper limit can be regarded as "freely disposable fiscal reserve". Similarly, the lower limit should be 95% of the sum of 12 months' government expenditure and Hong Kong dollar M1. Any shortfall should then be made up as soon as possible.
8. To give a numerical example, the Annex gives the forecast fiscal reserves for 2000-2001 as \$430.3 billion, equivalent to 23 months' government expenditure. Assuming that this estimate is accurate, then my proposed guideline suggests a

fiscal reserve figure of \$423.2 billion (12 months' government expenditure plus HK\$M1 as at the end of March 2001). Add another 5% margin, and the upper limit for the fiscal reserve is then \$444.4 billion. The actual fiscal reserve is well within this limit, implying that there is no "freely disposable fiscal reserve". On the other hand, it is well above the lower limit.

9. If there is a "freely disposable fiscal reserve" in future, how should it be spent? My priorities are as follows:
- (a) Job training or retraining for unemployed and under-employed;
 - (b) "Comprehensive Social Security Assistance";
 - (c) Education and High Technology;
 - (d) tax cut or relief.
10. To sum up, one important lesson from the AFC is that Hong Kong must keep at all times a strong forex reserve and a strong fiscal reserve. To achieve this, Hong Kong must pursue at all times prudent fiscal and macroeconomic policies. Clearly, if Hong Kong had not pursued such policies before the AFC, it would have suffered the same humiliation and misery that had befallen Thailand, Indonesia and South Korea.

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Note: My views on the Hong Kong economy are elaborated in fuller detail in two recent books of mine. The first, in Chinese, entitled 《亞洲金融危機與香港》, was published in 2000 by 香港三聯書店.

The other, in English, entitled *The Asian Financial Crisis and the Ordeal of Hong Kong*, will be published next month by Quorum Books, Greenwood Publishing Group, in USA.