

ON GOVERNMENT RESERVE

Proper Use of Fiscal Reserves
LegCo Panel on Financial Affairs

Meeting on

Tuesday, 3 July 2001 at 10:45 am
in the Chamber of the Legislative Council Building

Presentation Paper prepared by
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1. In this paper, I will focus on the fiscal reserves of Hong Kong Government. After analyzing the reserves I will focus on their relations with Government expenditure and GDP. Finally, I will try to analyze the optimum level of fiscal reserves.
2. In the Financial Secretary's 1998 Budget speech, he suggested that the Government should hold substantial public funds in reserve. He identified three specific categories of needs:
 - The operating requirement \Rightarrow Three months' worth of government expenditure. The purpose of this fund is for the administration to meet its day-to-day cash flow needs and to cover the several months in the financial year when expenditure exceeds revenue.
 - The contingency requirement \Rightarrow Nine months' worth of government expenditure \pm three months'. This can be used to help the economy to adjust quickly to new conditions.
 - The monetary requirement \Rightarrow M1 \pm 25%. The purpose of this balance is to maintain public confidence in the local economy, in particular to maintain exchange rate stability.
3. The first two reasons are justified; however it is difficult to understand the rationale behind the third one since Hong Kong operates a currency board system. Our M1 is fully backed by the Exchange Fund. Of course, it is always better to have more ammunition in case of crisis, and this could have been the Financial Secretary's intention.
4. The major reason for governments holding a large amount of reserves is crisis prevention. Following the Asian crisis, we can see that holding large reserves *per se* cannot prevent a crisis. Major determining factors include prudent macroeconomic policies, exchange rate regimes, financial sector soundness, and debit management. However, we do see that countries that had big reserves, on average, did better than those with small reserves.
5. Another reason for a country needing such a large reserve is to serve as a safety cushion in times of war, a trade embargo, or a bank crisis. This may apply more to countries like South Korea than to Hong Kong.
6. Large reserves are costly because they represent a lot of money sitting idle in the bank account; by holding large reserve balances we lose the opportunity to invest this money in the economy. In most developed economies, keeping a large amount

of reserves seems unjustified, especially since these economies can borrow on the world capital market when needed.

7. The next question is how best to judge the adequacy of a country's reserves. The rule of thumb is that reserves should be sufficient to pay for three or four months' worth of imports. Figure 1 shows the ratios of reserves-to-imports among some Asian economies. Most of these economies, except for China, show a higher ratio for 2000 than for preceding years. The improvement is significant for Korea and Thailand, countries that were among the worst affected economies during the Asian crisis. Hong Kong's ratio increased from 4.8 during 1996-2000 to 5.1 in 2000.

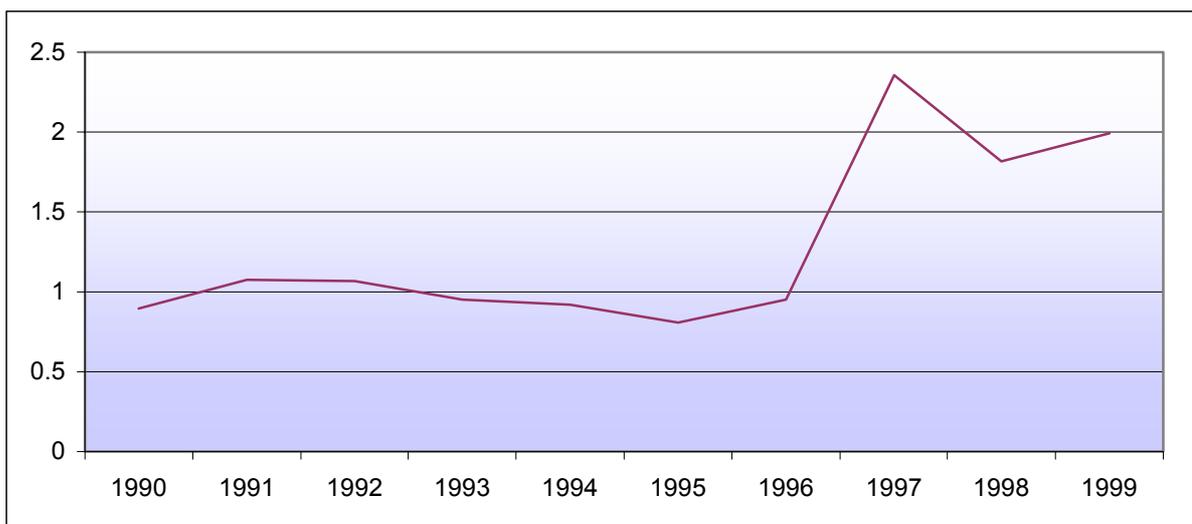
Table 1. Ratio of reserves to imports across countries

(in months)		
	1996-2000	2000
China	8.60	7.80
Korea	3.58	6.00
Thailand	5.80	6.70
Taiwan	8.60	8.60
Hong Kong	4.80	5.10
Japan	5.20	5.30
Singapore	6.50	6.50

Source: Standard & Poor's Sovereign Risk Indicators, 2000

8. Figure 1 shows the historical pattern of reserves in relation to Government expenditure. We can see that the ratio of reserves-to-expenditure in Hong Kong increased from 1 in the period from 1990-1996 to 2 in 2000. This implies that our fiscal reserves are sufficient to support Government expenditure for two years. Figure 2 shows the historical pattern of reserves in relation to GDP. This ratio of reserves-to-GDP increased from 15% in the period from 1990-1996 to 35% in 2000. The two ratios experienced a spike in 1997 because of the inclusion of the Land Fund in the fiscal reserves. Figures 3 and 4 show the patterns of the two ratios excluding the Land Fund. One remark that can be made is that the expenditure ratio remains at the same level of 1, and the GDP ratio varies between the range of 15% and 20% when the Land Fund figures are excluded.

Figure 1. Ratio of Reserves^a to Expenditure^b, 1990-1999

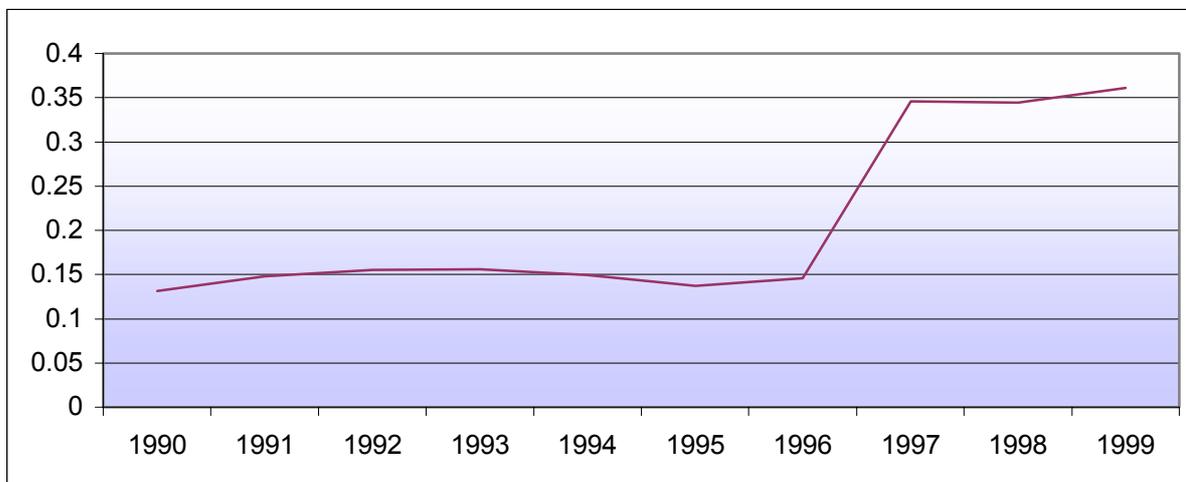


Source: Hong Kong Annual Digest of Statistics 1990-2000
 Finance Bureau, Government Secretariat
 Census and Statistics Department

^a Figures of reserves refer to fiscal year 1990/91, 1991/92 999/00

^b Figures of GDP refer to 1990, 1991, 1999

Figure 2. Ratio of Reserves^a and GDP^b, 1990-1999

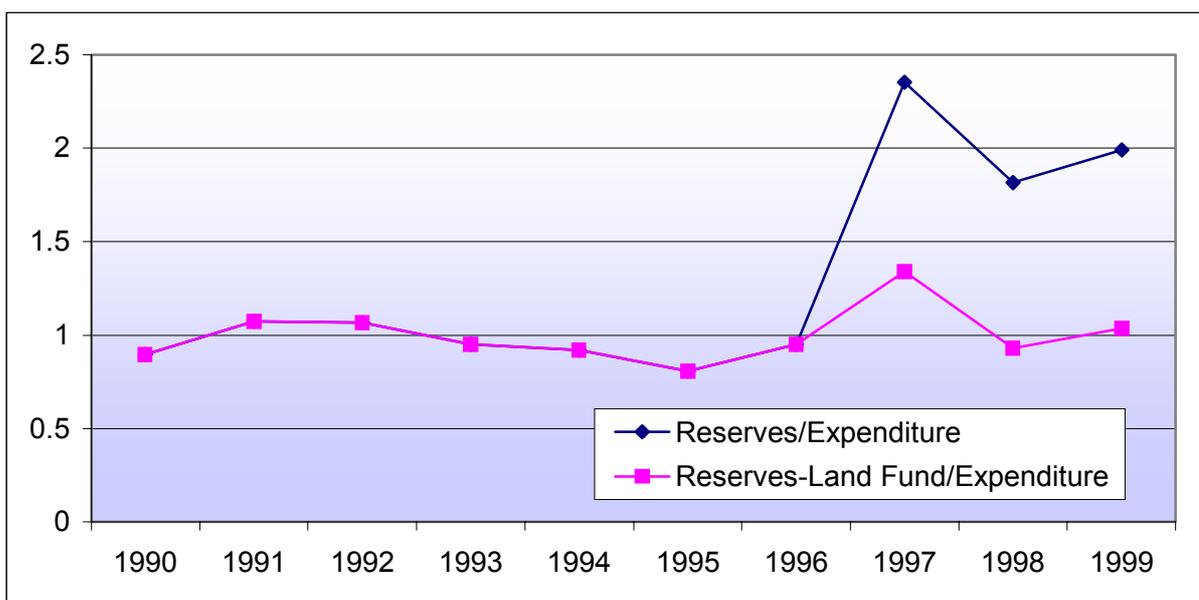


Source: Hong Kong Annual Digest of Statistics 1990-2000
 Finance Bureau, Government Secretariat
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^a Figures of reserves refer to fiscal year 1990/91, 1991/92 999/00

^b Figures of GDP refer to 1990, 1991, 1999

Figure 3. Ratio of Reserves^a less Land Fund^b to Government Expenditure^c, 1990-1999



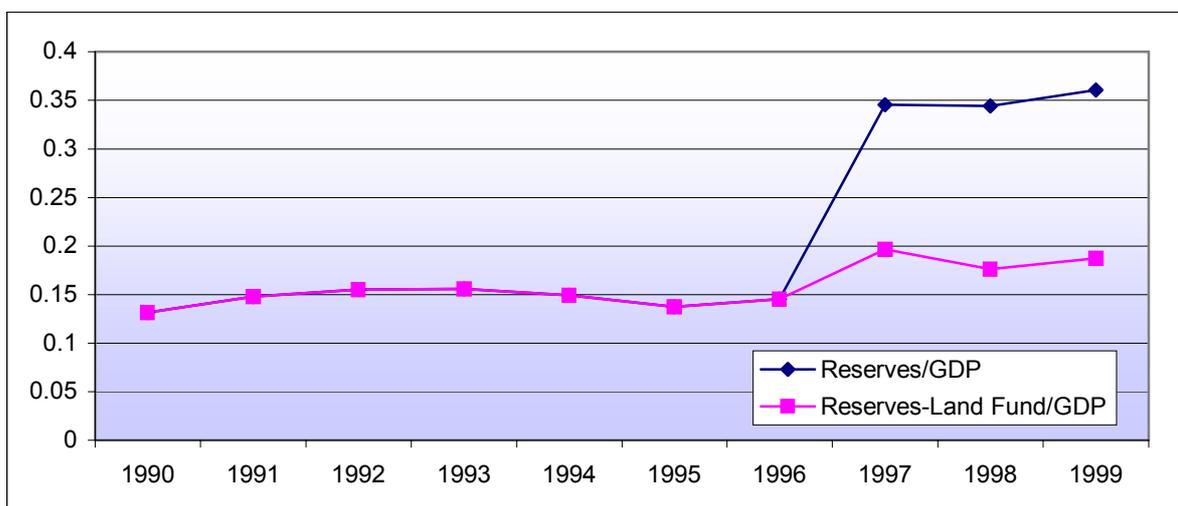
Source: Hong Kong Annual Digest of Statistics 1990-2000
 Finance Bureau, Government Secretariat
 Census and Statistics Department
 HKMA Annual reports, 1998-1999

^a Figures of reserves refer to fiscal year 1990/91, 1991/92, 1999/00

^b Figures of Land Fund refer to 1990, 1991, 1999

^c Figures of government expenditure refer to 1990, 1991, 1999

Figure 4. Ratio of Reserves^a less Land Fund^b to GDP^c, 1990-1999



Source: Hong Kong Annual Digest of Statistics 1990-2000
 Finance Bureau, Government Secretariat
 Census and Statistics Department
 HKMA Annual reports, 1998-1999

^a Figures of reserves refer to fiscal year 1990/91, 1991/92, 1999/00

^b Figures of Land Fund refer to 1990, 1991, 1999

^c Figures of GDP refer to 1990, 1991, 1999

9. I agree that reserves are important to maintain public confidence in Hong Kong. A sudden drop in reserves may attract adverse attention from the international investment community, particularly from credit rating agencies. However, holding an excessive amount of reserves may also indicate that the Hong Kong Government is too conservative in investing in our economy.
10. The ratio of reserves-to-GDP could be used as a benchmark in measuring the adequacy of the reserves. Lower and upper limits could be set to reflect short-term fluctuations in our economy. Excessive reserves could be invested in projects that will enhance Hong Kong's sustainable economic growth. These investments need not and should not be seen as being in direct competition with the private sector.
11. Investment projects should have a higher rate of return than that of the Exchange Fund. One major difficulty is to determine the rate of return of investment projects. For example, it is extremely difficult to quantify social projects in monetary terms.
 - Social safety net
 - Low monetary return
 - High social stability
 - Infrastructure projects (hardware and software)
 - High monetary return
 - Could attract more private (local + foreign) investments