

Comments on “Proper Use of Fiscal Reserves”

A submission to the LegCo Panel on Financial Affairs

by

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Since most governments in the world have accumulated debts rather than fiscal reserves, information and discussion on what constitutes “optimal” or “adequate” fiscal reserves in other economies do not seem to exist. Thus, Hong Kong must make its choices without the benefits of international experience.

I welcome the opportunity of commenting on the subject matter and would like to share my views with the Panel on Financial Affairs. While in the following paragraphs, I shall emphasize public investment in building and strengthening Hong Kong’s capability to compete in the global market, I should point out that it is equally important to invest in the environment to make the SAR a better place to live for Hong Kong citizens, foreign investors, and expatriate workers. While in the long run the most important factor that helps the less skilled and under-educated workers is a prosperous economy, I do think that the government should spend enough to help the underprivileged throughout a long transition period for the spirit of community and social stability.

1. Hong Kong’s fiscal reserves, in absolute amount and as a fraction of its GDP, are huge by international standard. A moderate reduction of the reserves for good reasons in all likelihood will not trigger adverse reactions by local and international investors. When part of the reserves is used to create new and sustainable economic capabilities or to enhance existing competitive positions, monetary assets are transformed into real assets, not unlike any typical non-financial investment. Furthermore, if such investment effectively raises Hong Kong’s overall productivity, then the SAR’s total wealth will have risen despite a reduction in the government’s fiscal reserves.

2. The formula announced by the Financial Secretary in the 1998/99 Budget Speech is debatable. I agree that there is a need to maintain liquidity to deal with seasonal imbalances between government revenue and expenditure. I also agree that there is a need to build up fiscal reserves to weather economic fluctuations and unexpected adversities. However, I do not believe there is any need to maintain fiscal reserves for the purpose of backing up Hong Kong's money supply as defined by M1 given the existence of a very sizable Exchange Fund. There is no indeed scientific formula. But based on Hong Kong's own experience, I think it would be adequate for the SAR to maintain fiscal reserves at a level between 12 to 15 months of government expenditure to address the first two needs mentioned above.
3. If the formula proposed in the 1998/99 Budget Speech were to be applied to previous years, then Hong Kong's fiscal reserves would have been grossly inadequate, with the exception of 1997/98, the year the Land Fund became part of the SAR's fiscal reserves. Apparently, that was not the view of the Hong Kong government prior to the establishment of the SAR; it was also not the case that before 1997 international investors were concerned about the inadequacy of Hong Kong's fiscal reserves.
4. There is a view that the Asian financial crisis of 1997/98 has rendered the fiscal situation prior to 1998 irrelevant. I do not agree with this view because I regard 1997/98 as an aberration rather than as a normal fiscal year. The fiscal bonanza in that year was primarily a result of (a) a high land premium reflecting optimism then in the SAR's property market, (b) an active stock market, and (c) a one-off transfer of the Land Fund.
5. I reject the view that additional fiscal reserves should be kept in preparation of future speculative attacks on the Hong Kong dollar. An objective analysis of the attacks during the Asian financial crisis reveals that the attacks had little to do with the size of Hong Kong's foreign reserves or fiscal reserves. Instead they were largely caused by operational and institutional loopholes of Hong Kong's currency board system. More specifically, prior to the Hong Kong

Monetary Authority's introduction of new measures in September 1998, the HKMA's mechanical and predictable interest rate response enticed speculators with almost guaranteed profits. In addition, before reform was undertaken in the aftermath of the government stock market intervention, rules governing the futures market appeared to have favored speculation.

6. Regarding the fiscal situation of 1997/98 as an aberration and the earlier period as a useful benchmark, I believe there is room to use part of the existing reserves to invest in Hong Kong's economic foundation. Some advocates for maintaining or even increasing the size of the fiscal reserves argue that extra fiscal reserves are now required for the purpose of generating an investment income to make up for a shortfall in tax revenue, but this argument is wrong. Fiscal reserves are usually invested conservatively because the government is generally more concerned about preserving capital than seeking high returns. More fundamentally, with the exception of investment that generates social benefits in excess of private returns, it would be more productive for the private sector to make investment and for the government to finance its recurrent expenditures with taxes on income generated by the private sector. If Hong Kong's tax system fails to generate adequate general revenue, a rational solution should be a tax reform, not further accumulation of reserves for the purpose of generating government revenue from investment income.
7. A general lack of human capital and technological sophistication in Hong Kong combined with handsome profits derived from China-related trade and investment was probably responsible for a lack of appreciation for the importance of knowledge and technology. However, China's modernization and the foreign multinational enterprises' growing familiarity with the Chinese markets will inevitably erode the advantages enjoyed by Hong Kong as the former's intermediary. The Asian financial crisis has not changed this worrisome trend, but only served to wake Hong Kong up to the reality that its old tricks are no longer sufficient in the future. Unless it succeeds in upgrading knowledge, skills and technology, its economic prosperity will be at risk.

Without any doubt, Hong Kong's economic future lies in the creation and application of new knowledge, new skills and advanced technologies to manufacturing and services. This is not a surprising conclusion because technological progress based on either domestic inventions or imported technologies is the primary reason for sustained per capita economic growth in the developed economies.

8. In Hong Kong less skilled and under-educated workers simply cannot achieve Hong Kong's living standard by competing directly in the world market. Their best chance to make a decent living is to provide non-tradable goods and services (e.g., restaurant, retailing, and personal services) for those who compete successfully in the world market, including those that do so by making use of Hong Kong's location advantages (such as transportation and tourism). Given the skill mix of Hong Kong's population and immigrants, for many years to come Hong Kong will have relatively too few workers who can compete directly in the world market, and relatively too many who must be shielded from international competition by producing non-tradable goods and locally consumed services. To address this expected imbalance between these two segments of the labor market, the government should seriously consider using part of the excess fiscal reserves to invest in human capital development (via formal education, training and retraining) and in the physical and institutional infrastructures that are essential to a thriving knowledge-based, technology intensive economy.
9. While an aspiration for a knowledge-based, technology intensive economy has been quite clearly articulated, it is less clear what measures will be taken by the government and the private sector to achieve the objective. Despite all of the talks, not much has been accomplished in creating new competitive advantages. Indeed, substantial private investment in areas that are deemed to be important to building a knowledge-based, technology-intensive economy has yet to take place. From the experience of economies that are regarded as major players in knowledge-based and technology-intensive industries, it is quite clear that governments of the latecomer economies almost always took an active part in establishing industries that were regarded as strategic to their

development. They realized that in order to have a chance of success, they needed an integrated strategy and a set of cohesive policy measures that all aimed to foster the strategic industries. Hopefully, the new government agency InvestHK will help to attract important foreign investment to the SAR.

10. Knowledge-based and technology-intensive industries are characterized by both knowledge spillovers (e.g., spillovers of knowledge through movement of workers across firms or leakage of proprietary information) and agglomeration benefits (i.e., the presence of complementary and ancillary products make related activities more attractive to locate around the former). The first characteristic may call for government assistance (in advanced countries such as the US and the UK government assistance often takes the form of government procurement), and the second characteristic implies that government coordination may be essential. Regions with a head start in these industries enjoy what are called “first-mover advantages.” In contrast, latecomers may fail either due to a lack of government assistance or a lack of coordination, or both.

11. The issue of inter-firm spillovers can be addressed to some extent with appropriate contracts between firms and their employees plus legal protection of intellectual property. However, left to themselves, firms are less able to solve the industry-wide coordination problem. In the absence of coordination, the situation may be as follows. Investor A will not invest because complementary or ancillary investment by investors B,C, D, etc has not occurred; B will not invest because investment by A, C, D, etc has not occurred; and so on. In contrast, if for some reasons the investors believe that others will make the investment, then everyone will invest, quickly establishing a new industry. That both of these two outcomes are possible is what economists call “multiple equilibria.” If multiple equilibria are present due to significant “external economies” or “agglomeration economies,” then government actions and policies may have a crucial role in deciding which equilibrium will be the actual outcome. For instance, if the government is able to signal its commitment to a new industry, say by taking a minority equity share in some catalyst projects, then the other complementary and ancillary

projects may follow the catalyst projects without further prompting by the government. In a sense, the initial push by the government may be crucial in tipping the scale in favor of a more desirable equilibrium.

12. When promoting knowledge-based, technology-intensive industries for which complementary investment is essential, coordination measures that aim to achieve a better market outcome may be necessary. Only advanced economies that enjoy the benefits of first-mover advantages can afford to do nothing, but even these countries regularly provide indirect assistance to their commercial high tech products indirectly via defense procurement programs. The latecomer economies must understand what barriers they face in their endeavor to upgrade their technology and skills, and try to overcome these barriers with an effective strategy.
13. There is another coordination problem that may become a hurdle to Hong Kong's effort to develop a knowledge-based, technology intensive economy. Technology intensive firms may not be willing to come to Hong Kong if they worry about inadequate supply of appropriate manpower, but without these firms the limited manpower will either choose to go elsewhere to seek relevant employment (not every scientist and engineer can start his/her own business and the lack of agglomeration benefits will work against them) or are forced to get jobs that do not fit their background. That is to say, there may be a chicken and egg problem. Thus, besides an effort aiming to provide manpower that is suitable for a knowledge-based, technology intensive economy, the government should also have concrete measures to attract knowledge-based, technology intensive firms to Hong Kong.
14. I would like to call your attention to an editorial of the *Hong Kong Economic Journal* on 30 March 2001. It proposed investing tens of billion dollars per year (from fiscal reserves/budgetary surpluses) in the next ten years to build a foundation for our knowledge-based economy. It also suggested four main foundation areas, namely, (a) education and human resources; (b) physical environment, including urban development and cleaning up pollution; (c) cultural environment, including arts and sports; and (d) technology, including

information technology, bio-technology, and Chinese medicine. I like the scope of this editorial because it covered four key areas that Hong Kong should invest in (but I defer judgment on the choice of appropriate technologies to qualified experts). I also like its time horizon because transforming Hong Kong into a knowledge-based, technology intensive economy not only will require a great deal of financial and human resources, but also will take a long time.

15. As important as the scope of public investment, the government should learn from other economies how to design policy packages that will reinforce one another in fostering a knowledge-based, technology-intensive economy. How to integrate existing and future policy measures into a cohesive strategy will be a challenge to policy making, but without a cohesive and reinforcing policies the transition to a knowledge-based, technology-intensive economy may prove illusive.
16. It should be warned that public investment in Hong Kong's economic foundation is like any other investment in that the realized outcomes may sometimes not as expected. Thus, even with an integrated strategy to promote the transformation of Hong Kong's economy, errors, mishaps and disappointments are bound to occur along the way. Launching an ambitious plan to build Hong Kong's economic future requires the use of a substantial amount of Hong Kong's fiscal reserves, and is therefore politically risky. The citizens of the SAR should understand that Hong Kong has little choice but to embrace transformation. They should show understanding when some policy measures fail to work as expected and require adjustment and fine-tuning. If errors made by policymakers are too harshly criticized, then a safe personal strategy for high level officials would be doing little other than safeguarding the fiscal reserves.