

The Exchange Fund in 2001

The Exchange Fund recorded a positive investment income of HK\$7 billion in 2001, a year that has been especially difficult for the world's financial markets.

The unaudited preliminary figures for the Exchange Fund's performance in 2001 show that we have at least managed not to lose any money in the investment of the Exchange Fund in the year. This does not seem, on the face of it, to be an impressive performance. We all want attractive returns on our investments, year after year. But it is a fact that the prices of financial assets do go up and down, and with globalisation they do so with increasing volatility. And it has been a year marked with very unusual and unpredictable events, including the burst of the IT bubble and the tragic events of September 11th. All those involved in fund management will agree that the investment environment in 2001 was a particularly difficult one. This is evidenced by the fact that the great majority of investment funds worldwide have posted significant losses. The performance in the investment management of the Exchange Fund is, therefore, very much an exception, and to that extent, notwithstanding not being able to make a significant return, our investment team has done quite well in the circumstances. Indeed, the benchmark return – the return that we would have achieved had we tracked closely the allocation of investment assets in accordance with the benchmark set by the Exchange Fund

Advisory Committee – was an increase of 0.4%. To be able to do 0.3 percentage point better than the benchmark is an indication of good performance, involving judicious, tactical deviations from the benchmark allocation.

The tactical deviation we deployed was to hold more bonds and less equity than the percentages specified in the benchmark allocation of 80% and 20% respectively, to the full extent allowable under the investment guidelines determined by the Exchange Fund Advisory Committee. And so, when the global equity markets adjusted sharply downward, we were hurt, relatively speaking, less than we otherwise might have been. Further, by being overweight in bonds, we benefited more than we otherwise would have from the successive cuts in US interest rates. We also held more assets in US dollars and less in other currencies than the benchmark allocation, also of 80% and 20% respectively, and almost to the extent allowable, enabling us to be hurt less by the weakness of the euro and the yen than we might have been. But the interest income and the investment gains in bonds, at a hefty HK\$50.4 billion, were merely adequate to cover the currency and equity losses of HK\$13.1 billion and HK\$30.3 billion (net of dividends) respectively. In the event, there was only a small investment income of HK\$7 billion recorded for the year.

The investment income for 2001 could have been bigger, in fact, if we did not have to sell a significant amount of US dollar bonds during the year to raise

Hong Kong dollars for meeting withdrawals of fiscal reserves by the Treasury, as the budget deficit widened. There was a net withdrawal of HK\$36.6 billion of fiscal reserves deposited with the Exchange Fund in 2001, and the bulk of this took place in the “dry” revenue months, which coincided with the period before bond prices rose sharply. The withdrawals were also responsible for the decline in the overall size of the Exchange Fund falling from over one trillion at the end of 2000 to below one trillion at the end of 2001. It is important for those who monitor these numbers to be aware of this, and not to attribute the fall (or indeed a rise resulting from fiscal reserves increasing) erroneously to our investment performance.

A further point to note is that we do have interest and other expenses. For example, we have about HK\$118.2 billion of borrowed money in the form of Exchange Fund paper issued, on which market interest is paid. There are good monetary and market development reasons for issuing the paper and incurring the costs thereon. The paper provides the important cushion to absorb the pressure of volatile capital flows exerted from time to time on our domestic interest rates. Through providing benchmark references to longer-term interest rates (up to ten years) it is also an essential element of Hong Kong’s bond market. It is a fact, nevertheless, that the small investment income in 2001 was not enough to pay for these interest expenses. As a result, they had to come out of the Accumulated Surplus of the Exchange Fund, resulting in it falling from HK\$307.1 billion at the end of 2000 to HK\$302.7 billion at the end of 2001.

But at HK\$302.7 billion the figure still compares very favourably with the corresponding figure of, say, seven years ago of HK\$125.8 billion. I hope the community finds these preliminary numbers on the Exchange Fund satisfactory.

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