HONG KONG MONETARY AUTHORITY
香港金融管理局

By fax (2869 6794) and post

4 February 2005

Miss Salumi Chan
Clerk to Panel on Financial Affairs
Legislative Council Secretariat
3rd floor, Citibank Tower
3 Garden Road
Hong Kong

Dear Miss Chan,

Panel on Financial Affairs Meeting on 17 February 2005
Return rate of the Exchange Fund

Thank you for your letter on 7 January. The information requested by members is provided below.

(a) a target return rate for the Exchange Fund

The objectives of the Exchange Fund are:

1. to preserve capital;
2. to ensure that the entire Monetary Base at all times will be fully backed by highly liquid short-term US dollar denominated securities:
3. to ensure sufficient liquidity for the purpose of maintaining monetary and financial stability; and
4. subject to 1 – 3 above, to achieve an investment return that will preserve the long-term purchasing power of the assets.

The assets of the Exchange Fund are invested according to a long-term strategic investment benchmark designed to achieve the above investment objectives. As market conditions and returns vary from period to period, there is no set numerical return target.

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(b) the actual return rates of the Exchange Fund in recent years

The table attached provides the annual investment return for the Exchange Fund from 1994 to 2004. As the table indicates, the annualised return for the period of 6.6% compares favourably with the annualized domestic inflation rate of 1.3% in Hong Kong.

(c) A comparison of item (b) above with those reflecting the performance of relevant bodies in other jurisdictions, such as United States and United Kingdom

Central banks invest assets according to different investment objectives and levels of risk tolerance.

The primary objective of Hong Kong's foreign currency reserves is to safeguard the exchange value of the Hong Kong dollar against the US dollar. Therefore, a large share of the assets are invested in high credit quality US dollar denominated bonds. Some central banks manage the reserves as hedges against external liabilities, other central banks may manage their reserves against a trade-weighted basket of currencies.

Central banks also adopt different methodologies in valuating their reserves. Some central banks do not require liquidity from their reserves and the assets are therefore marked at historical cost. Others, such as Hong Kong's Exchange Fund, are marked-to-market daily to reflect the most current market value of the assets. The investment performances computed using different methodologies are therefore not comparable.

Furthermore, most central banks (including the US and the UK) do not disclose the rate of return on their investment of the reserves. The reasons for not doing so have not been disclosed but it is understood that one principal justification is to safeguard central bank independence from political interference either for or against the use of reserves, and on its management. Incidentally, the Hong Kong Monetary Authority is one of the most transparent among central banks.

The above paragraphs explain why it would be inappropriate to compare the investment performance of the Exchange Fund with that of other central banks

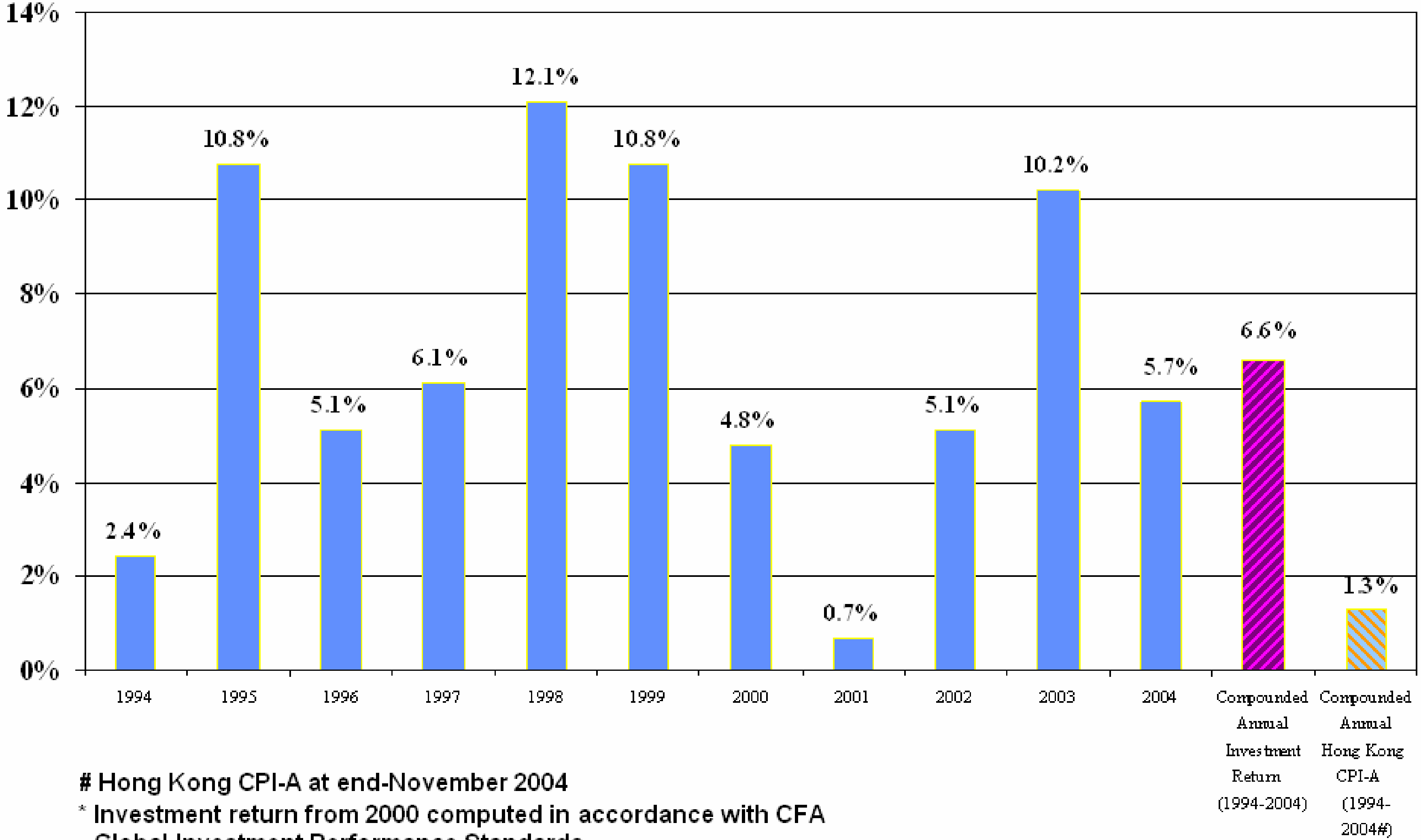
Yours sincerely,

(Fiona Chan)
for Chief Executive
Hong Kong Monetary Authority

Encl.

Table

Investment Return* of the Exchange Fund



Hong Kong CPI-A at end-November 2004

* Investment return from 2000 computed in accordance with CFA Global Investment Performance Standards