

立法會
Legislative Council

LC Paper No. CB(1)2306/07-08
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by the Administration)

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Panel on Financial Affairs

Minutes of meeting
held on Tuesday, 10 June 2008 at 2:00 pm
in the Chamber of the Legislative Council Building

Members present : Hon CHAN Kam-lam, SBS, JP (Chairman)
Hon Ronny TONG Ka-wah, SC (Deputy Chairman)
Hon James TIEN Pei-chun, GBS, JP
Hon Albert HO Chun-yan
Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP
Dr Hon David LI Kwok-po, GBM, GBS, JP
Hon Bernard CHAN, GBS, JP
Hon SIN Chung-kai, SBS, JP
Hon Emily LAU Wai-hing, JP
Hon Abraham SHEK Lai-him, SBS, JP
Hon Jeffrey LAM Kin-fung, SBS, JP
Hon Andrew LEUNG Kwan-yuen, SBS, JP
Hon CHIM Pui-chung
Hon TAM Heung-man

Members attending: Hon LEE Cheuk-yan
Hon Fred LI Wah-ming, JP
Hon CHAN Yuen-han, SBS, JP
Hon LEE Wing-tat

Members absent : Hon James TO Kun-sun
Hon WONG Ting-kwong, BBS

**Public officers
attending**

: Agenda Item IV

Financial Services and the Treasury Bureau

Ms Alice CHEUNG

Principal Assistant Secretary for Financial Services and
the Treasury (Financial Services)

Mr Paul CHEUNG

Assistant Secretary for Financial Services
and the Treasury (Financial Services)

Agenda Item V

Mr John C TSANG, JP

Financial Secretary

Prof K C CHAN, SBS, JP

Secretary for Financial Services and the Treasury

Mr K C KWOK, BBS, JP

Government Economist

Mr Eddie YUE Wai-man, JP

Deputy Chief Executive

Hong Kong Monetary Authority

Mr Freely K CHENG

Administrative Assistant to Financial Secretary

**Attendance by
invitation**

: Agenda Item IV

Securities and Futures Commission

Mr Keith LUI

Executive Director, Supervision of Markets

Mr Rico LEUNG

Director, Supervision of Markets

Hong Kong Exchanges and Clearing Limited

Mr Gerald GRIENER

Chief Operating Officer

Mr Eric YIP
Head, Cash Market Department

Clerk in attendance: Miss Polly YEUNG
Chief Council Secretary (1)5

Staff in attendance: Ms Annette LAM
Senior Council Secretary (1)3

Ms Rosalind MA
Senior Council Secretary (1)8

Ms Sharon CHAN
Legislative Assistant (1)8

Action

I. Confirmation of minutes of meeting and matters arising

(LC Paper No. CB(1)1774/07-08 — Minutes of meeting on 5 May 2008)

The minutes of the meeting held on 5 May 2008 were confirmed.

II. Information papers issued since the last meeting

(LC Paper No. CB(1)1737/07-08 — Mandatory Provident Fund Schemes
Statistical Digest — March 2008)

2. Members noted that the above paper had been issued for the Panel's information.

III. Date of next meeting and items for discussion

(LC Paper No. CB(1)1771/07-08(01) — List of outstanding items for
discussion

LC Paper No. CB(1)1771/07-08(02) — List of follow-up actions)

Special meeting on 30 June 2008

3. The Chairman reminded members that a special meeting was scheduled for 30 June 2008 at 2:30 pm for the Panel to receive views of deputations on the proposal

to increase employees' control over Mandatory Provident Fund investment. The Chairman suggested and members agreed that the item on "Report on write-off of a judgement debt" be included on the agenda of the special meeting. Members noted that this item had originally been scheduled for discussion at the meeting today but deferred to allow time for discussion of an additional agenda item.

Regular meeting in July 2008

4. Members agreed to discuss the following items at the meeting to be held on 7 July 2008 at 10:45 am:

- (a) Regulation of sale of structured investment or derivative products;
and
- (b) Consultancy study on the feasibility of establishing insurance policyholders' protection funds in Hong Kong.

5. The Chairman referred to the letter dated 6 June 2008 from the office of Dr David LI tabled at the meeting, proposing to brief the Panel on the Fortis Bank Merger Bill (the Bill) at the meeting on 7 July 2008. Noting that the proposed Member's Bill was planned to be introduced into the Legislative Council in the 2008-2009 legislative session, the Chairman sought members' view on whether the proposed briefing should be arranged at the meeting in July 2008, or at a future meeting in the next session. Mr Ronny TONG opined that there was no time-critical need for holding the briefing in July 2008. Moreover, Mr TONG remarked that it might be more desirable to arrange the briefing in the new term so that the Bill would be studied by new Members and there would be time for Members to invite and consider views from the banking industry. Dr David LI said that while the Fortis Bank had indicated its wish to brief the Panel on the Bill as soon as practicable, he appreciated that it might be more cost-effective to conduct the briefing in the new legislative session. After consideration, members agreed that the briefing on the Bill should be arranged in the 2008-2009 session.

IV. Implementation of the Closing Auction Session by the Hong Kong Exchanges and Clearing Limited

(LC Paper No. CB(1)1771/07-08(03) — List of issues to be addressed prepared by the Legislative Council Secretariat

LC Paper No. CB(1)1771/07-08(04) — Hong Kong Exchanges and Clearing Limited's paper on the matters raised by the Panel in relation to the closing auction session

Briefing by the Hong Kong Exchanges and Clearing Limited

6. At the invitation of the Chairman, the Chief Operating Officer of the Hong Kong Exchanges and Clearing Limited (COO/HKEx) briefed members on the background leading to the implementation of the Closing Auction Session, the trading activities on 30 May 2008, follow-up action taken to investigate any market misconduct and plans to improve the operation of the Closing Auction Session. The following salient points were highlighted in the presentation:

- (a) Following broad market and public consultation in 2007, the Closing Auction Session (an end-of-day closing trading session for all securities for a single price auction after completion of the continuous trading session) was launched on 26 May 2008 after successful completion of extensive system tests plus a series of mandatory market rehearsals.
- (b) The design of the closing mechanism was based on market consensus and the long-standing Pre-opening session which had been well received by market participants since its introduction in 2002.
- (c) High volatility in share prices and substantial turnover for certain stocks on 30 May 2008 coincided with the MSCI Barra index rebalancing. Of the 167 stocks affected by the index rebalancing exercise, 21 stocks recorded more than 5 % fluctuation between the closing prices and the last traded prices, while the remaining 146 stocks did not experience any major volatility during the Closing Auction Session. Most of the 21 stocks in question experienced price volatility throughout the Continuous Trading Session as well as during the Closing Auction Session on 30 May 2008. Some of these 21 stocks had also recorded price fluctuations and increased transaction volumes before 30 May 2008. The volatility in those 21 stocks was in fact similar to the daily volatility of the top 20 gainers and losers among HKEx listed stocks.
- (d) HKEx would conduct a thorough review of the Closing Auction Session and seek feedbacks from all segments of the market, as well as consider suggestions to further enhance the closing auction mechanism. HKEx in conjunction with the Securities and Futures Commission (SFC) would continue to review the trading activities on 30 May 2008 to see if there was any indication of market misconduct.

Discussion

Review of trading activities on 30 May 2008

7. Mr CHIM Pui-chung referred to the sharp price movements and the sudden increase in turnover and trading volume for certain stocks during the 10-minute trading extension from 4:00 pm to 4:10 pm on 30 May 2008, and sought the SFC's views on whether there might have been market manipulation by large brokers. Noting that some small market participants had to face prosecution or other forms of court action for certain malpractice or suspected market manipulation, Mr CHIM considered that the unusually high volatility and sharp price movements during the Closing Auction Session on 30 May 2008, where HK\$14 billion worth of shares were transacted and 21 stocks recorded price rise of more than 5 %, should similarly be investigated by the SFC. He opined that to treat the unusual price fluctuations on 30 May 2008 lightly would undermine SFC's hard-earned credibility as a market regulator.

8. The Executive Director, Supervision of Markets, SFC (ED(SM)/SFC) stressed that HKEx and SFC took a serious view of any market misconduct. Both HKEx and SFC had put in place market surveillance programmes to monitor trading activities and price movements. Any unusual market condition and suspected market manipulation would be investigated in accordance with relevant provisions in the Securities and Futures Ordinance (SFO)(Cap 571). He said that it was premature to conclude at the present stage whether the volatility on 30 May 2008 was related to market manipulation. Nevertheless, he stressed that actions were underway to review all relevant trading orders and transaction activities by each exchange participant during the Closing Auction Session on 30 May 2008. Where appropriate, regulatory action would be taken against non-compliance with the SFO and the Rules of the Stock Exchange of Hong Kong. ED(SM)/SFC highlighted that Hong Kong's reputation as an international financial centre was the result of the continuous effort of all market players. The closing auction mechanism was introduced to put Hong Kong on par with the arrangement adopted by leading world markets so as to maintain and enhance the overall competitiveness of Hong Kong's securities market.

9. The Chairman noted that the HKEx had conducted a comprehensive review on trading activities during the Closing Auction Session on 30 May 2008 and had referred the analysis to the SFC for consideration. He enquired when the SFC would conclude its examination. In response, ED(SM)/SFC advised that the SFC would thoroughly review HKEx's analysis in addition to conducting its own analysis on the market conditions on that day. Appropriate regulatory action would be taken where evidence so warranted. He assured members that SFC's findings would be announced as early as practicable.

10. ED(SM)/SFC further informed members that on 30 May 2008, there were two deletions from and two additions to the MSCI index constituents. However, their impact on the affected stock prices was minimal and there was no significant price fluctuations during the 10-minute extended trading. He said that the trading

volume during the Closing Auction Session on 30 May 2008 accounted for about 17% of the day's turnover and an average of about 3% to 4% for each day of the following two weeks. This pattern was broadly consistent with that of other Asian markets such as the Singapore Exchange, Korea Exchange and the Australian Securities Exchange, which recorded stock price fluctuations in the range of 17% to 20% on the date of MSCI index rebalancing and a range of 5% to 8% on the other trading days. He pointed out that it took time for brokers and the investing public to familiarize with the newly introduced Closing Auction Session. COO/HKEX supplemented that the Closing Auction Session on 30 May 2008 appeared to have operated normally and market fluctuation around the time of an MSCI Barra rebalancing was not unusual.

11. Mr CHIM Pui-chung did not subscribe to the explanation. He maintained that the significant increase in transaction volume, which accounted for 17% of the day's turnover, and the unusual fluctuation of some 18% between the closing prices and the last traded prices of certain stocks on that day were clear signs of market manipulation. He urged the SFC to expedite its investigation into the matter, and sought the Administration's views in this respect.

12. The Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) (PAS/FS) responded that the Administration was equally concerned about the market conditions on 30 May 2008 which had attracted much public attention. Noting that a comprehensive review and analysis of the trading activities during the Closing Auction Session on 30 May 2008 had been conducted, she said that the HKEx and the SFC would work closely to review the incident and would finalize and announce the findings as soon as practicable.

Implementation of the Closing Auction Session

13. Ms TAM-Heung-man noted that stock markets adopted different closing auction mechanisms. She enquired about the criteria adopted for devising the current Closing Auction Session, and whether reference had been made to the arrangements adopted by major overseas markets.

14. In this regard, COO/HKEX referred members to the comparison of closing trading sessions among major overseas stocks markets set out in Appendix 1 to the Consultation Paper on the Introduction of a Closing Auction Session. He advised that in devising the current Closing Auction Session, reference had been made to the practice adopted by various Asian, Western, and European markets. Local market participants had also been consulted on the options of a fixed-time approach or a random-closing approach. The majority of responses received indicated a preference for a Closing Auction Session that was easy for market participants to understand and use. There was a general consensus and broad market support for adopting a trading mechanism similar to that used in the pre-opening session as the latter had been operating smoothly and was well received by market participants since its introduction in 2002. The HKEx had therefore proposed to adopt the trading

mechanism that was already in use in the pre-opening session and would introduce further enhancement in the light of operational experience.

15. Ms TAM Heung-man expressed concern about possible abuse by large brokers amidst market volatilities during the Closing Auction Session to the detriment of small investors. She enquired about the measures, if any, that the HKEx and the SFC would put in place to safeguard the interests of small investors and to improve the trading arrangements during the Closing Auction Session.

16. The Chairman noted that HKEx, in two circulars issued on 19 May 2008 and on 4 June 2008, had reminded exchange participants to pay special attention to the significance of the MSCI index rebalancing and the restructuring of the Hang Seng Index constituents respectively. In addition, during a briefing session organized by the Hong Kong Stockbrokers Association on 22 May 2008, HKEx had reminded the attendees that the MSCI index rebalancing might give rise to market volatility. In anticipation that market volatility would arise from index rebalancing, the Chairman enquired about the measures and remedial actions that the SFC and HKEx would take to reduce future volatilities in the newly introduced extended closing session. In response, COO/HKEx reiterated that the HKEx would conduct a thorough review of the Closing Auction session and consider various suggestions made by market participants for improvement, including the random closing model, with a view to enhancing the closing auction mechanism.

17. The Chairman noted that the SFC was in the course of considering the proposed amendments to the Rules of the Exchange in relation to allowing short selling at the Pre-opening and Closing Auction Sessions submitted by HKEx in August 2007. He enquired when the SFC would arrive at a decision on the matter. Noting that the market had diverse views on short selling, the Chairman considered that a prudent and timely decision would remove uncertainty and enhance market confidence. In this connection, ED(SM)/SFC said that while short selling during the Closing Auction Session might have the effect of containing the sharp increase in stock prices on 30 May 2008 thereby facilitating smooth market operation, there were always pros and cons to every arrangement. He pointed out that short selling could be used as a means to push down stock prices under some circumstances. He added that SFC was currently examining the merit or otherwise of allowing short selling at the Pre-opening and Closing Auction Sessions and an announcement would be made in due course.

18. Mr CHIM Pui-chung held the view that the current closing auction mechanism was susceptible to market manipulation by large brokers. He called for an expeditious review of the Closing Auction Session and sought the Administration's stance on this matter.

19. In response, PAS/FS recapped that the HKEx and the SFC had already undertaken to conduct a review of the Closing Auction Session. Given that the closing auction mechanism was an internationally proven practice and was similar to the pre-opening session which had been operating well, she said that it was important

for the HKEx and the SFC to ascertain as soon as practicable whether the high volatility and turnover on 30 May 2008 were an isolated incident, or whether they were indicative of flaws in the closing mechanism that needed improvement. She called on the HKEx and SFC to take into consideration the views and suggestions from all market segments as well as from investors and LegCo Members in order to further enhance the closing auction mechanism. On the regulation of the stock market, PAS/FS said that under the existing regulatory regime, HKEx was responsible for overseeing the operation of the stock exchange and ensuring that trading activities were conducted in an orderly manner. The SFC was the regulator of Hong Kong's securities and futures sector and one of its major functions was to monitor the conduct of licensed intermediaries. She assured members that while the Administration would not normally intervene into market activities, it would continue to monitor market developments with a view to ensuring that the existing regulatory framework underpinned by SFC and HKEx would work effectively and command investors' confidence.

Investor education

20. In response to Mr CHIM Pui-chung's enquiry on measures, if any, to strengthen small investors' right to know and to participate in the Closing Auction Session, ED(SM)/SFC said that as exchange participants, market users and the general public might not be very familiar with the newly introduced Closing Auction Session, the HKEx and the SFC would conduct continuous market education to enhance their understanding of the new mechanism and the possible impact of the Closing Auction Session. To ensure transparency, the equilibrium prices and trading volumes throughout the Closing Auction Session were continuously updated and disseminated to the market. COO/HKEx supplemented that a series of seminars had been conducted since April 2008 and were attended by more than 500 representatives from over 200 exchange participants. In addition, HKEx had issued circulars, press releases and newspaper articles, and organized media interviews to publicize the implementation and the main features of the Closing Auction Session.

21. In this connection, Ms TAM Heung-man sought more detailed information on the education and publicity programmes to enhance the investing public's understanding of the Closing Auction Session. She called on the Administration to step up investor education and to apprise the investors of the high investment risks involved in the trading of structured investment and derivative products.

22. In response, COO/HKEx confirmed that ongoing and new education programmes would be launched to enhance understanding about the closing auction mechanism. The public was advised not to trade in the products which they did not understand. However, it might not be feasible to have direct contact with individual members of the investing public. Education efforts was focused on providing the necessary information to brokers and exchange participants who in turn would advise their clients accordingly. Moreover, a special page on the Closing Auction Session had been added to HKEx's website so that exchange participants, market

users and the investing public could review related news releases, circulars, technical documents and other relevant information.

Concluding remarks

23. Summing up, the Chairman called on the SFC to expedite its review of the trading activities on 30 May 2008, and urged the SFC and the HKEx to further improve the closing auction mechanism in the light of the review findings in order to ensure smooth market operation and enhance investors' confidence. He also requested the Administration/SFC/HKEx to provide a written response to the submission from Mr David WEBB proposing a random closing time.

(Post-meeting note: The written response provided by the HKEx had been circulated to members vide LC Paper No.CB(1)2097/07-08 on 2 July 2008.)

V. Briefing by the Financial Secretary and other officials on Hong Kong's latest overall economic situation

(LC Paper No. CB(1)1569/07-08 — First Quarter Economic Report 2008 and the press release

LC Paper No. CB(1)1771/07-08(06) — List of inflation-related issues to which the Administration's response is sought (prepared by the Legislative Council Secretariat)

LC Paper No. CB(1)1771/07-08(07) — Administration's paper on recent situation and near-term outlook for the Hong Kong economy

LC Paper No. CB(1)1773/07-08 — Background brief on inflation-related issues prepared by the Legislative Council Secretariat

LC Paper No. CB(1)1852/07-08(01) — Powerpoint presentation material provided by the Administration (tabled at the meeting and soft copy issued to members on 11 June 2008)

LC Paper No. CB(1)1853/07-08(01) — Speaking note of Mr John C TSANG, JP, Financial Secretary)

Briefing by the Financial Secretary

24. At the invitation of the Chairman, the Financial Secretary (FS) and the Government Economist (GE) briefed members on the latest developments in Hong

Kong's economy with regard to external trade, domestic demand, labour market, and consumer prices. Members were also updated on the economic forecasts and inflation outlook for 2008 as a whole. The salient points highlighted in the presentation were as follows:

- (a) Hong Kong's economy continued to expand strongly in the first quarter of 2008 despite growing adversities in the external environment characterized by uncertainties arising from deteriorating subprime problem and a weakening economy in the United States (US), turbulence in global financial market, the surge in global food and fuel prices. With real Gross Domestic Product (GDP) growing by 7.1%, the economy had shown above-trend growth for 18 quarters, underpinned by upbeat consumer and business confidence, strong domestic demand and exports of goods and services.
- (b) Domestic demand maintained its key role in driving the overall economic growth. Private consumption expenditure rose markedly by 7.9% in real terms, bolstered by the firm labour market conditions and rising income.
- (c) Exports of goods and services remained strong. Total exports of goods grew by 8.3% in real terms in the first quarter, supported by the robust performance of the Mainland and other emerging economies. Exports of services also remained strong in the first quarter, registering a 10.8% growth in real terms.
- (d) The labour market stayed firm in the first quarter of 2008, with the seasonally adjusted unemployment rate remaining stable at 3.4%, while underemployment rate fell further to a ten-year low of 1.9%. Labour earnings and wages were on the rise.
- (e) While the external environment would remain uncertain and challenging, the economic outlook for 2008 remained positive, riding on the growth momentum in the emerging and developing economies, including the Mainland economy, as well as firm consumer and investor confidence and low interest rates.
- (f) Given the uncertainties hanging over the external environment and dimmer global economic prospects, the GDP forecast of 4 to 5% as announced in the Budget in February 2008 was kept unchanged. However, with the strong GDP growth in the first quarter, and barring any abrupt external shocks, it was likely that GDP growth in 2008 would be close to the upper end of the forecast range.
- (g) Consumer price inflation (CPI) picked up further in the first quarter of 2008, mostly due to the surge in food prices (an inflation rate of 17.4% for foodstuffs, i.e. food excluding meals bought away from home)

amidst the global food inflation. The sustained above-trend economic growth also added to the inflationary pressure. Headline Composite CPI (CCPI) averaged at 4.6% in the first quarter. After netting out the one-off effects of the rates concession this year and the public housing rental waiver last year, underlying CCPI in the first quarter stood at 4.9%.

- (h) The inflation outlook for the remainder of 2008 was uncertain and would hinge on the movements of global food and crude oil prices. High food and energy prices, rising wages and rentals, as well as the volatility of the exchange rates were likely to continue to exert inflationary pressure. In view of the high degree of uncertainties in the external environment, the forecast rate of increase in the CCPI for 2008 was maintained at 4.5%. The corresponding forecast headline inflation rate was also kept unchanged at 3.4%. The risks to these forecasts were on the upside.
- (i) Supported by further growth in jobs and labour earnings, household income continued to increase generally over the past few months. The number of economically active households (i.e. with at least one economically active household member) continued to decline. Nevertheless, the number of low-income households with monthly income below \$4,000 increased by 6.1% over a year earlier mainly due to a significant increase in the number of retired elderly households and a decline in the average household size.
- (j) The Government was committed to assisting various sectors of the community, notably the disadvantaged and low-income groups, to cope with inflation. The Administration had announced 20-plus measures in the 2008-2009 Budget to help alleviate the impact of soaring inflation. Action would be taken to secure a stable supply of food for Hong Kong, to ensure effective market competition at the import and retail levels, to ensure the provision of adequate land supply to meet market demand, and to enhance the overall economic and labour productivity. The Administration had taken the lead to freeze water charges for 2008-2009 and 2009-2010 and would appeal to the operators of public utilities and public transport to take into account their corporate social responsibility when applying for tariff or fare adjustment. To relieve the difficulties faced by the transportation industry and motorists, the Administration would review the fuel duties for Euro V diesel with a view to further lowering or waiving the duty.

25. Members noted that the Administration' response to the list of inflation-related issues raised by the Panel in the Clerk's letter dated 6 May 2008 was set out in Annex B to the Administration's Paper No. CB(1)1771/07-08(07).

Discussion

Economic and inflation outlook for 2008

26. Referring to the uncertain external environment amidst a weakening US economy and more stringent measures in the Mainland to regulate its economy, Miss TAM Heung-man expressed concern about the possible slowdown of the Hong Kong economy in the second half of 2008. She enquired about the measures that the Administration would implement in the event of an economic slowdown in Hong Kong and the possible economic recession of major trading partners.

27. In response, GE said that the US economy was likely to remain weak. Similar to US, a number of European countries were experiencing a downturn in the property market. Consumer sentiment and investment confidence were dampened as a result. Economic activities in Japan and the growth momentum in emerging and developing economies also showed signs of deceleration. Here in Hong Kong, despite strong GDP growth (7.1%) in the first quarter of 2008, the GDP forecast at 4 to 5% for the whole year had factored in the possible economic slowdown in the second half of 2008. GE advised that apart from the surge in global food and energy prices in the external market, the recent pick-up in inflation in Hong Kong was a consequence of brisk economic expansion, driven mainly by strong local consumption and the sustained above-trend economic expansion, thus resulting in increases in wages and rentals. As such, a slight slow-down in economic growth and development could help to reduce inflationary pressure and was not all bad for Hong Kong.

28. On promoting economic development, Mr Abraham SHEK appreciated the Administration's decision to allow contractors to adjust prices under works contracts with contractual periods exceeding 21 months, as this arrangement could ease inflationary pressure on the construction industry. In consideration that sustained economic growth and increase in labour productivity were the key factors for Hong Kong's quick recovery from past financial turmoils, Mr SHEK urged the Administration to put in place measures to attract investments, such as by streamlining and expediting the procedures for modification of land leases. This would encourage more investment in development projects and lead to the creation of more employment opportunities in the construction sector now badly hit by unemployment. FS noted Mr SHEK's view and undertook to conduct a review on the procedures for modification of land leases in due course.

29. As the inflation rate of foodstuffs in the first quarter of 2008 shot up to 17.4% and that of the food prices worldwide was high at 38.6%, Mr LEE Cheuk-yan doubted the accuracy of the Administration's inflation forecast for 2008 and considered the forecast at 4.5% for 2008 too conservative. In response, GE pointed out that while prices of foodstuffs rose sharply by 17.4%, those for durable goods fell by 3.5% and the overall inflation rate for the first quarter of 2008 stood at 4.6%. He advised that the inflation outlook was rather uncertain as global food, crude oil and commodity prices, as well as exchange rates would likely remain volatile. Given the high degree of uncertainties in the external environment, the forecast rate of increase

in the underlying Composite CPI for 2008 was maintained at 4.5%. GE stressed that the Administration would closely monitor the inflationary trend and review the inflation forecast as more economic data became available in the coming few months.

30. Mr Abraham SHEK enquired about the reasons for the inflation rate of transport in the first quarter of 2008 which stood at 1.3%. He was also concerned that the successive fare adjustment applications by public transport operators, if approved, would further push up the overall inflation. In response, GE explained that the rise in transport cost was mainly due to the increases in fuel price and cross-boundary transport fares. However, GE added that the rise in transport cost was unlikely to exert much upward pressure on the overall inflation rate as transport expenses accounted for less than 10% of average household spending.

Coping with inflationary pressure

31. Miss CHAN Yuen-han was of the view that the relief measures announced in the 2008-2009 Budget could not adequately address the livelihood problems arising from soaring inflation, in particular the recent sharp increase in food prices as evidenced by the 17.4% inflation rate of foodstuffs in the first quarter of 2008. She said that despite the Administration's claim that the unemployment rate (3.4%) stayed at a 10-year low and that labour earnings and wages had increased across-the-board, wages in real terms for a number of economic sectors including the retail trade, restaurant and transport sectors had in fact recorded either a drop or only a slight increase. For example, the hourly rate for cleaning workers and security guards were as low as \$21.90 and \$24.30 respectively. Referring to the recent spate of industrial actions in overseas countries and the recent protests staged by workers in the transportation industry, Miss CHAN said that public discontent in the face of inflationary pressure was mounting. She enquired whether new measures, in addition to on-going initiatives and those announced in the 2008-2009 Budget, would be put in place to help ease inflationary pressure on the grassroot population. She called for early implementation of further measures, such as food and beverage vouchers and a cross-district transport support scheme etc, as soon as practicable, instead of waiting till the next Policy Address and Budget to announce new relief measures.

32. While welcoming the relief measures already announced by the Administration, Miss TAM Heung-man doubted whether the measures could effectively increase people's purchasing power. She urged the Administration to consider giving out additional financial assistance such as providing low-income earners with a living allowance.

33. Given that the inflation rate of foodstuffs, which usually accounted for a large share of the expenditure of lower-income households, had escalated to 17.4% in the first quarter of 2008, Mr James TIEN said that Members of the Liberal Party agreed that appropriate relief measures should be introduced during this critical period to provide timely assistance to the grassroot population. Ms Emily LAU cautioned that

the continued rise in food prices and cost of living would lead to social instability. She urged the Administration to introduce expeditiously more concrete measures to help the needy in maintaining a reasonable standard of living.

34. Noting members' views, FS responded that the Administration was also gravely concerned about the impact of inflation, in particular the hardship faced by lower-income families due to the recent surge in food prices, as food expenses might account for as much as 35% of the expenditure of lower-income households. A series of relief measures had been announced in the 2008-2009 Budget to ease the inflationary pressure on the community. FS highlighted that when devising the relief measures as announced in the 2008-2009 Budget, he had taken into account the forecast rise of inflation. He believed that the implementation of the some 20 measures in the second half of 2008, such as one additional monthly payment of Comprehensive Social Security Assistance (CSSA) at the standard rate, one additional month of allowance for recipients of Disability Allowance, one-off grant of \$3,000 to Old Age Allowance recipients, the rates waiver, one-month rental waiver for lower income tenants of public housing rental units and the electricity charge subsidy etc, would help ease the pressure of rising prices and increase people's purchasing power. FS further advised that the sustained growth in labour productivity would help cushion the upward pressure on consumer prices. In addition, the Administration would continue to promote long-term economic development, reinforce pillar industries, generate more employment opportunities for lower skilled workers, explore more business opportunities for small and medium enterprises, enhance the overall productivity of the labour force through investment in education, training and retraining, as well as enlarge the productive capacity of the economy through investment in infrastructure projects. FS stressed that the Administration would continue to monitor closely the inflationary trend and its impact on the community, especially population at the grassroot level. Where necessary, the Administration would consider introducing additional measures to help the community cope with rising inflation.

35. Mr Albert HO requested the Administration to consider shortening to three months the current six-monthly review of the standard rate of CSSA payment. In response, FS advised that the CSSA standard rate had been increased twice by 2.8% and 4.4% in February and June 2008 respectively. Nevertheless, the Administration would consider the feasibility of reviewing the CSSA payment rates ahead of the normal schedule.

36. While welcoming the proposed one-off injection of \$6,000 into the accounts of eligible members of Mandatory Provident Fund (MPF) Scheme and MPF exempted Occupational Retirement schemes, Mr LEE Cheuk-yan called on the Administration to allow fund withdrawal prior to the age of 65 so that low-income groups could make use of the money to cope with the rising cost of living. In this regard, FS pointed out that the objective of the \$6,000 MPF injection was to boost the retirement savings of the workforce. It was not meant to be a tool to increase people's purchasing power, which might in turn aggravate the current inflation. Referring to the proposed profits tax rate reduction which would benefit large

consortia, Mr LEE Cheuk-yan disagreed that the modest one-off sum of \$6,000, if made available to eligible persons for immediate withdrawal, would intensify inflation.

Measures to assist small and medium enterprises and the middle class

37. Mr Andrew LEUNG Kwan-yuen highlighted the difficulties faced by small and medium enterprises (SMEs), which included the intensifying global financial turmoil, a possible recession in major trading partners, increased operating costs due to the rise in unit labour cost, wages and rental, high energy prices, exchange rate factors and more stringent regulatory requirements in the Mainland. Given that under the Linked Exchange Rate (LER) System, Hong Kong was unable to pursue a discretionary monetary policy to reduce inflationary pressure, Mr LEUNG enquired about the relief measures that the Administration would adopt to assist SMEs which currently made up about 95% of the enterprises in Hong Kong.

38. Notwithstanding that Hong Kong recorded a GDP growth of 7.1% in the first quarter of 2008 amidst dimmer global economic prospects, Mr Jeffrey LAM anticipated that the external environment would remain uncertain and challenging. He raised concern about the inflationary pressure on SMEs due to the rise in operating costs. Sharing similar concern, Ms Emily LAU urged the Administration to provide timely assistance to SMEs to help ease their operating difficulties.

39. FS responded that the Administration was keenly aware of the hardship faced by SMEs. He acknowledged that slower expansion in economic activities was anticipated for the remainder of 2008 despite a GDP growth of 7.1% in which export of goods grew by 8.3%, investment spending expanded by 8.9%, and private consumption expenditure rose by 7.9% in real terms in the first quarter of 2008. He highlighted that efforts had been made to tap new business opportunities for SMEs by developing overseas markets, in particular emerging markets. Assistance had also been rendered to SMEs to facilitate their business transformation, and to enhance their adoption of information and communications technology. Referring to the tax reduction measures announced in the 2008-2009 Budget, FS said that the lowering of the corporate profits tax rate, the one-off tax reduction of 75% on profits tax, and the waiver of business registration fee for 2008-2009 could help ease the cost burden on SMEs.

40. In addition to the tax reduction measures benefiting the middle class, Mr James TIEN called on the Administration to consider waiving the levy on foreign domestic helpers (\$400 per month payable by the employer for each foreign domestic helper hired by him). FS took note of the suggestion for further consideration and recapped that the levy collected had been used to finance the operation of the Employees Retraining Scheme for training and retraining the local workforce in the face of Hong Kong's economic transformation.

Income disparity

41. Mr Ronny TONG expressed concern about the impact of the hike in food prices and transport cost on the livelihood of lower-income groups, as well as the widening income disparity between those on the upper and lower ends of the skills spectrum. He noted that despite above-trend economic growth for 18 quarters in a row, the number of low-income earners/households were on the rise, thereby widening the wealth gap. Mr TONG held the view that in addition to ad-hoc one-off measures, the Administration should formulate a clear policy and introduce longer-term measures to effectively address the needs of the grassroot population and narrow the wealth gap. Mr LEE Cheuk-yan expressed similar concern about the continued rise in the number of low-income households, vis a vis the increase in earnings of higher-skilled workers, which had the effect of widening the disparity between the rich and the poor.

42. FS noted that while the growth in earnings of low-skilled workers had picked up recently, the increase had lagged behind that of higher-skilled workers and inflation. He nevertheless pointed out that the strong labour market with nominal pay rises across-the-board had on the whole benefited workers at different skill levels. FS reiterated that the relief measures announced in the 2008-2009 Budget would help ease the inflation burden on the community, especially the disadvantaged and low-income groups. FS further said that in the longer-term, the most effective way to cope with inflation was to facilitate economic growth through increasing labour productivity and creating employment opportunities. Initiatives in this direction included plans on mega infrastructure projects to create employment, upgrading the skills and productivity of the labour force through education and training, and ensuring the provision of adequate land supply to meet the demands for long-term economic development.

43. Mr Ronny TONG remained unconvinced. He maintained that the Administration should formulate long-term measures with the appropriate focus to assist lower-income earners during this critical period of soaring inflation and to narrow the wealth gap.

44. Ms Emily LAU referred to the number and breakdown of low-income households set out in Table 2 of Annex A to the Administration's Paper No. CB(1)1771/07-08(07) and expressed serious concern about the continued rise in the number of households with income below \$4,000 by 10 700 (or 6.1%) over a year earlier to 187 300 in the first quarter of 2008. Given the substantial fiscal surplus recorded for 2007-2008, she urged the Administration to introduce as early as possible more relief measures to help the disadvantaged sectors.

45. On the rise in the number of low-income families over the past 10 years, GE explained that this was mainly due to an aging population, a significant increase in the number of retired elderly households, and a decline in the average household size. There had been an increase in two types of low-income households, namely elderly households (with all members aged 60 or above) and economically inactive

households (with all members being economically inactive). GE remarked that although the regular monthly income of these households was below \$4,000, the household members might have savings or other assets, or some might be financially supported by their children/family members. On the other hand, the number of economically active low-income households (with at least one economically active household member) continued to decline, mainly due to sustained improvements in the labour market which had enabled some working household members to move up the income ladder. As such, by promoting economic growth to create more job opportunities and through education, training and retraining, upward social mobility was possible and cross-generation poverty would eventually be reduced. GE said that to assist disadvantaged groups, a multi-pronged approach was required under which measures in areas such as social security, medical and health, public housing as well as community support networks should be introduced. In this connection, the Task Force on Poverty (Task Force) headed by the Secretary for Labour and Welfare had been examining measures targeted to address the needs of low-income households and the disadvantaged. At the Panel's request, the Administration undertook to provide supplementary information on the work progress of the Task Force.

46. Ms Emily LAU expressed her view that since relief measures to assist the needy actually straddled a wide range of policy areas, the relevant work should be steered by FS, instead of being undertaken by a single bureau secretary.

(Post-meeting note: The information provided by the Administration had been circulated to members vide LC Paper No.CB(1)2109/07-08(01) issued on 3 July 2008)

Rising prices of key commodities

47. Noting the continued surge in fuel prices, Mr Jeffrey LAM and Ms Emily LAU enquired whether the Administration would consider reviewing the various fuel duties with a view to further lowering or waiving them to relieve the difficulties faced by the transportation industry and motorists. In this connection, Mr James TIEN urged the Administration to consider waiving the duty on diesel and to reduce the duty on petrol by half.

48. Referring to the hardship faced by the transportation industry in the face of rising fuel prices, the Chairman called on the Administration to seriously consider waiving the duty on diesel to ease the burden on operators/drivers of public light buses, vans, lorries and taxis, and to resume the supply of ultra-low sulphur diesel to provide users with more choices. Noting that the price of crude oil had increased twofold from around US\$60 a barrel to US\$130 a barrel, the Chairman urged that the duty on petrol be reduced by half to relieve the inflationary pressure on motorists and middle-income households, given that car ownership nowadays was more of a transport need than a luxury.

49. In response, FS said that the Administration shared grave concern about the impact of high fuel prices on the business sector, transportation industry and motorists. He advised that the duty on low-sulphur diesel had been reduced from \$2.89 to \$1.11 per litre. The current concessionary duty on Euro V diesel at \$0.56 per litre constituted only about 5% of the retail price which was among the lowest in the region. On fuel duties, FS advised that the Administration would review the concessionary duty rate on diesel, taking into account revenue and environmental protection considerations, as well as the financial implications on the transportation industry. As regards lowering the duty on petrol, he said that the matter would have to be thoroughly examined having regard to the impact on the Government's fiscal position, the environment, and the transport industry. FS further advised that from the perspective of supply and demand, the most effective way to reduce price was to decrease the demand for the commodity. This could be achieved by encouraging people to make more use of public transport. He further clarified that ultra-low sulphur diesel was currently available in the market, though Euro V diesel, due to its concessionary duty rate, was the main market supply.

50. In response to the Chairman's request to address the transportation industry's concern about the technical and emission problems of diesel-fuelled public light buses and buses, as well as the current use and extending the use of liquefied petroleum gas to vehicles other than taxis and public light buses, the Administration undertook to provide the requisite information as far as practicable.

(Post-meeting note: The information provided by the Administration had been circulated to members for information vide LC Paper No. CB(1)2125/07-08(01) on 8 July 2008.)

51. While supporting a waiver of duty on fuel, Mr LEE Cheuk-yan was concerned that the benefit of a waiver might ultimately be offset by the increase in fuel prices. He called on the Administration to consider waiving the licence fees for public light buses, vans, taxis and lorries. Noting Mr LEE's suggestion, FS cautioned that whether taxpayers' money should be deployed to pay for licence fees levied on the users-pay principle would require more careful examination.

52. Noting the sharp rise in the price index of residential property since the trough in 2003 and the climb in rental since the relaxation of rent control in 2003, Mr Albert HO considered that domestic factors such as high land price, rising private housing rental, and the increase in the price of residential property were some of the key factors giving rise to inflationary pressure. He remarked that the rental assistance for CSSA recipients could not catch up with the rental increase for low-rental units or cubicles. Mr HO enquired about the measures, if any, that the Administration would introduce to assist the lower economic strata of the community to cope with inflation.

53. GE responded that with the continued economic upturn, the demand for residential and commercial premises had increased. This exerted upward pressure on both property prices and rental. Regarding assistance to the needy, he recapped that in addition to regular reviews of the standard rate of CSSA payment for

lower-income groups and the one-off rent waiver and rates waiver announced in the 2008-2009 Budget, the Administration would, as a long-term measure, ensure adequate land supply through the existing Application List System to meet market demand and to ease the upward pressure on property prices and rentals. He nevertheless pointed out that property prices were also influenced by interest rate movements and the prevailing investment sentiment.

Related monetary and banking issues

54. Given the peg of the Hong Kong dollar to the US dollar, Mr LEE Cheuk-yan remarked that the Government was quite powerless in regulating interest rates and was unable to pursue a discretionary monetary policy to reduce inflationary pressure. He asked whether the Administration would review the LER system and consider adopting a more flexible exchange rate regime.

55. In response, FS advised that rising inflation was a global phenomenon. Compared with other economies adopting more flexible exchange rate regimes, the current inflation rate in Hong Kong was not particularly high. He said that the objective of Hong Kong's existing monetary policy was to maintain exchange rate stability, rather than to manage inflation. The effectiveness of LER system should be judged on its ability to deliver monetary and financial stability through economic cycles and turmoils. FS added that the weakening of the Hong Kong dollar in tandem with the US dollar was not a key factor for the recent rise in inflation. In fact, a weak Hong Kong dollar had increased the competitiveness of Hong Kong's exports. He reaffirmed the Government's policy stance to uphold the existing LER system as it had provided Hong Kong with a firm monetary anchor and had served Hong Kong well since 1983.

56. Mr James TIEN noted that there were pros and cons in adopting the LER. While Hong Kong was unable to pursue a discretionary monetary policy to reduce inflationary pressure, he noted that the weakening of the Hong Kong dollar along with the US dollar had helped to boost the development of tourism and the exports trade.

57. Referring to the financial crisis during the 1990s which led to the collapse of some banks in Hong Kong, Mr SIN Chung-kai enquired about the measures taken/ to be taken by the Hong Kong Monetary Authority (HKMA) to safeguard the stability of the local banking sector, and whether small depositors would be covered by the Depositors Protection Scheme (DPS) in the event of the collapse of local banks/financial institutions which were adversely affected by the financial difficulties of overseas banking /financial institutions.

58. In reply, the Deputy Chief Executive, HKMA (DCE/HKMA) advised that although individual banks might suffer from their investment in asset-backed securities, the fall-out of the US sub-prime crisis had not caused any systemic problem in the local banking sector as local banks' investment in sub-prime related financial products was generally low. He assured members that the HKMA had and

would continue to closely monitor local banks' asset quality, review their risk management systems and where necessary, to apprise them of the need to stay vigilant of market risks. On small depositors' protection, DCE/HKMA confirmed that they would be covered by the DPS in accordance with relevant provisions in the governing legislation in the event of the collapse of local financial institutions/banks.

VI. Any other business

59. There being no other business, the meeting ended at 4:27 pm.

Council Business Division 1
Legislative Council Secretariat
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