FACT SHEET

Management of the Exchange Fund and fiscal reserves

(as at 19 March 2010)

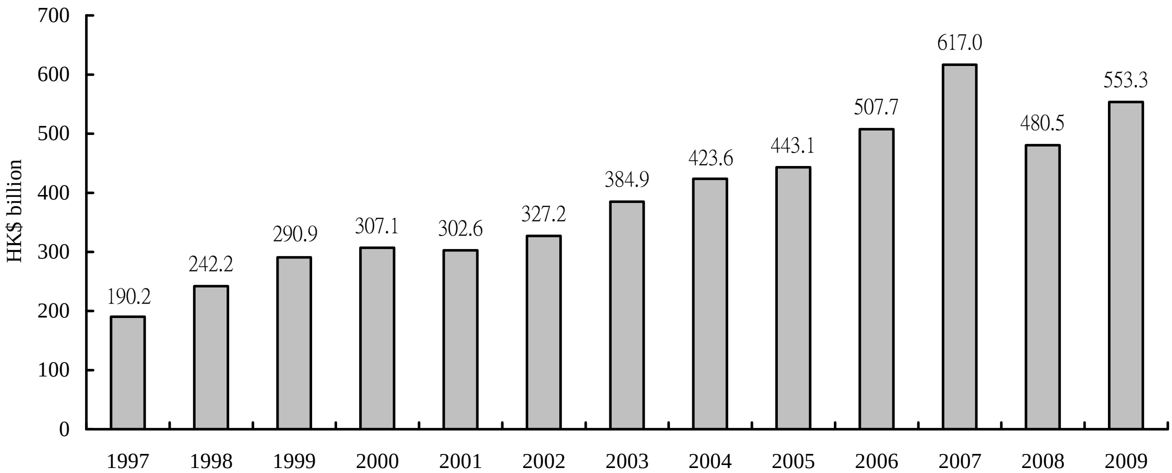
1. Establishment of the Exchange Fund

1.1 The Exchange Fund (EF) was established in 1935 by the *Currency Ordinance* (later renamed the *Exchange Fund Ordinance (Cap. 66)*) to back the issue of banknotes in Hong Kong. In 1976, the role of EF was expanded to cover the assets of the Coinage Security Fund (containing funds received against the issue of coins), as well as the bulk of the fiscal reserves of the Government's General Revenue Account. The fiscal reserves placed with EF are not permanently appropriated for the use of EF. They have to be repaid to the General Revenue Account when they are required to meet the obligations of the General Revenue[1]. On 1 November 1998, the assets of the Land Fund were merged into EF and managed as part of the Investment Portfolio of EF.

2. Accumulated surplus of the Exchange Fund

2.1 The accumulated surplus of EF, which is the total net profit earned by the Fund since its establishment in 1935, represents the equity of EF. Chart 1 shows the accumulated surplus of EF since 1997. It is noted that the accumulated surplus of EF has generally been on an upward trend, reaching a record high of HK$617 billion at end-2007 before moderating to HK$480.5 billion at end-2008 and HK$553.3 billion at end-2009.

Chart 1 – Accumulated surplus of the Exchange Fund



Source: Hong Kong Monetary Authority.

1 See Hong Kong Monetary Authority (2009).

3. Statutory functions of the Exchange Fund

3.1 The primary statutory function of EF, as defined in Section 3(1) of the *Exchange Fund Ordinance*, is to affect, either directly or indirectly, the exchange value of the currency of Hong Kong. Article 113 of the *Basic Law* also states that EF is primarily for regulating the exchange value of the Hong Kong dollar.

3.2 The statutory function of EF was extended in 1992 with the enactment of Section 3(1A) of the *Exchange Fund Ordinance* to provide for EF to assume a secondary and subsidiary role of maintaining the stability and the integrity of the monetary and financial systems, with a view to maintaining Hong Kong as an international financial centre[2].

4. Management of the Exchange Fund

4.1 Under the *Exchange Fund Ordinance*, the Financial Secretary (FS) is the controller of EF. He exercises his control in consultation with the Exchange Fund Advisory Committee (EFAC), of which he is the ex-officio chairman. Other EFAC members are appointed in a personal capacity by FS under the delegated authority of the Chief Executive of the Hong Kong Special Administrative Region (Chief Executive). EFAC advises FS on the investment policies and strategies for EF and on projects, such as the development of financial infrastructure, charged to the Fund.

4.2 Under the delegated authority of FS, the Hong Kong Monetary Authority is responsible to FS for the management of EF under the investment objectives endorsed by EFAC.

5. Mechanism for the transfer of funds from the Exchange Fund to the General Revenue

5.1 Section 8 of the *Exchange Fund Ordinance* provides a mechanism for the transfer of funds from EF to the General Revenue or to other such fund or funds of the Government as may be authorized by the Chief Executive-in-Council. The mechanism involves the following key elements:

(a) FS is satisfied that such transfer is not likely to affect adversely his ability to fulfil any purpose for which EF is required to be or may be used under section 3(1) or 3(1A) of the *Exchange Fund Ordinance* (see paragraphs 3.1 and 3.2 above);

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2 See Hong Kong Monetary Authority (2007).

(b) the transfer would not reduce the assets of EF to a level less than 105% of the total obligations of EF for the time being outstanding; and

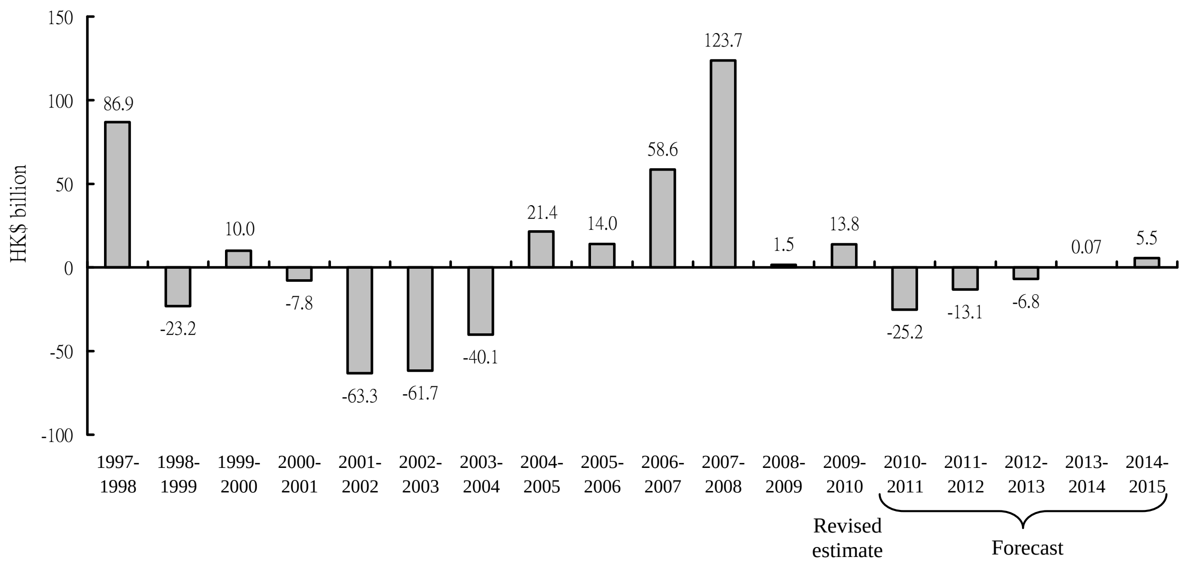
(c) the transfer could only be made after FS has consulted EFAC and with the prior approval of the Chief Executive-in-Council.

6. Fiscal reserves placed with the Exchange Fund

6.1 The principles of the fiscal policy are set out in the *Basic Law*. The Government maintains that in drawing up the budget, it has to follow the principles set out in Article 107 of the *Basic Law*: keeping expenditure within the limits of revenues, striving to achieve a fiscal balance, avoiding deficits and keeping the budget commensurate with the growth rate of GDP.

6.2 Chart 2 shows the fiscal positions of the Government since 1997-1998.

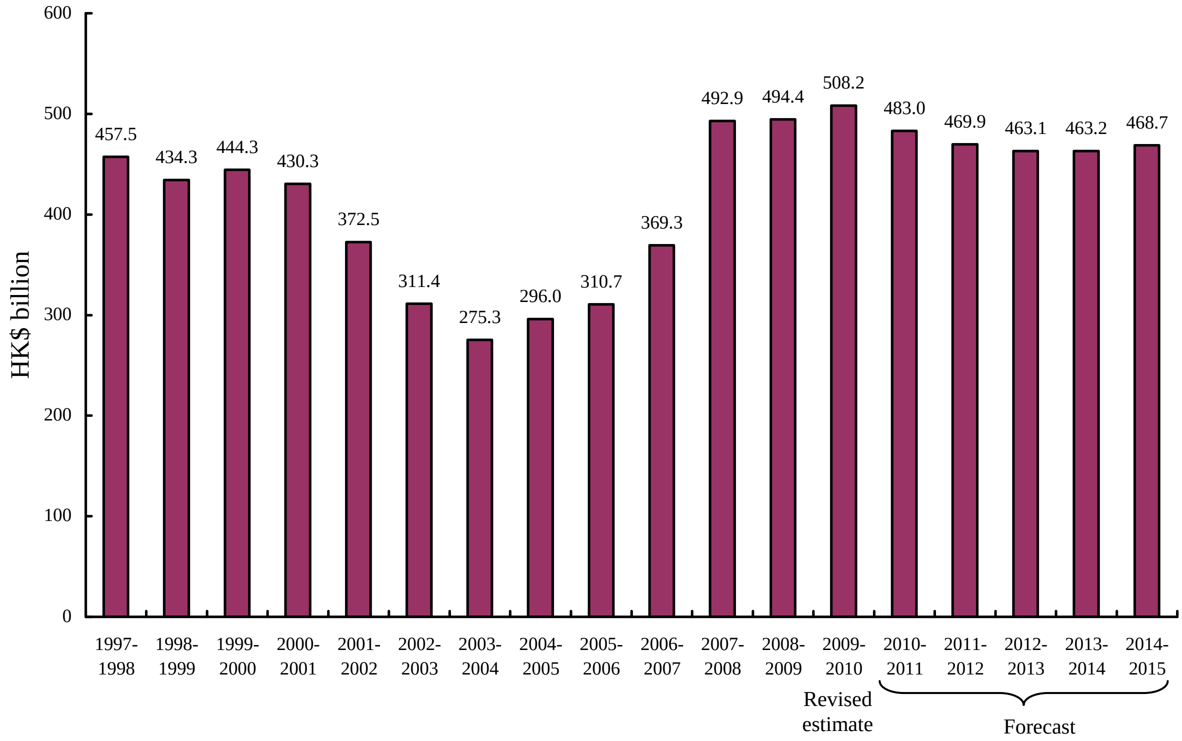
Chart 2 – Budget surplus/deficit



Sources: *Hong Kong Annual Digest of Statistics* and *2010-2011 Budget*.

6.3 As a substantial component of the liabilities of EF, the fiscal reserves are accumulated from budget surpluses run over the years. Standing at an estimated HK$508.2 billion by the end of March 2010, the fiscal reserves are placed with EF for two reasons[3]. The first is the centralization in the investment management of public funds. The second reason is the need to enhance the resources available to EF in achieving the purposes for which the Fund is established[4]. Chart 3 shows the fiscal reserves balances accumulated by the Government since 1997-1998.

Chart 3 – Fiscal reserves balances



Sources: *Hong Kong Annual Digest of Statistics* and *2010-2011 Budget*.

<u>Purposes and appropriate level of fiscal reserves</u>

6.4 In the light of the Asian financial crisis, the then FS in his 1998-1999 Budget identified the following three purposes for which it was necessary for the Government to hold substantial public funds in reserves:

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3 From 1 April 2007, the Treasury will collect a fee on the fiscal reserves placed with EF based on a fixed rate for the year determined every January. The rate is the average investment return of EF's investment portfolio for the past six years or the average annual yield of three-year EF Notes for the previous year, whichever is the higher.

4 See Hong Kong Monetary Authority (2001).

(a) the operating requirement to meet the cash flow requirement of the operation of the Government. An amount equivalent to three months of government expenditure was considered adequate;

(b) the contingency requirement to reserve funds for the Government's unexpected and urgent uses. An amount equivalent to nine months of government expenditure, allowing a margin of plus or minus three months of government expenditure, was considered sufficient; and

(c) the monetary requirement to maintain the stability in the exchange rate of the Hong Kong dollar. An amount equal to the Hong Kong money supply under the M1 definition, allowing a margin of plus or minus 25%, was necessary.

6.5 According to the Government, the level of fiscal reserves was considered appropriate if it stayed between the limits of 15 months of government expenditure plus 125% of Hong Kong Dollar money supply under the M1 definition (i.e. the upper limit) and nine months of government expenditure plus 75% of Hong Kong Dollar money supply under the M1 definition (i.e. the lower limit).

6.6 In the 2002-2003 Budget, the then FS revised the target level of fiscal reserves in view of the stability of the Hong Kong Dollar exchange rate and the accumulated surplus of EF at the time. Under the new guideline, the Government would no longer link the level of fiscal reserves to money supply. Instead, it would only maintain fiscal reserves at a level equivalent to around 12 months of government expenditure to meet operating and contingency requirements. FS reiterated this guideline on the level of fiscal reserves in the subsequent 2003-2004, 2004-2005, 2005-2006, 2006-2007 and 2007-2008 Budgets[5]. Table 1 summarizes the guidelines on the level of fiscal reserves announced in 1998 and 2002 respectively.

5 In the 2008-2009 Budget, the budgetary criterion for the Medium Range Forecast was changed as follows: "the Government aims to maintain adequate fiscal reserves in the long run". Since then, the same criterion has been applied to the subsequent Budgets of 2009-2010 and 2010-2011. In the briefing to the Legislative Council on the 2010-2011 Budget, the FS stated that there was no need to follow the practice of prescribing a target level of fiscal reserves. He claimed that from past experience, the more fiscal reserves, the stronger would be the defending ability of Hong Kong. See 明報 (2010).

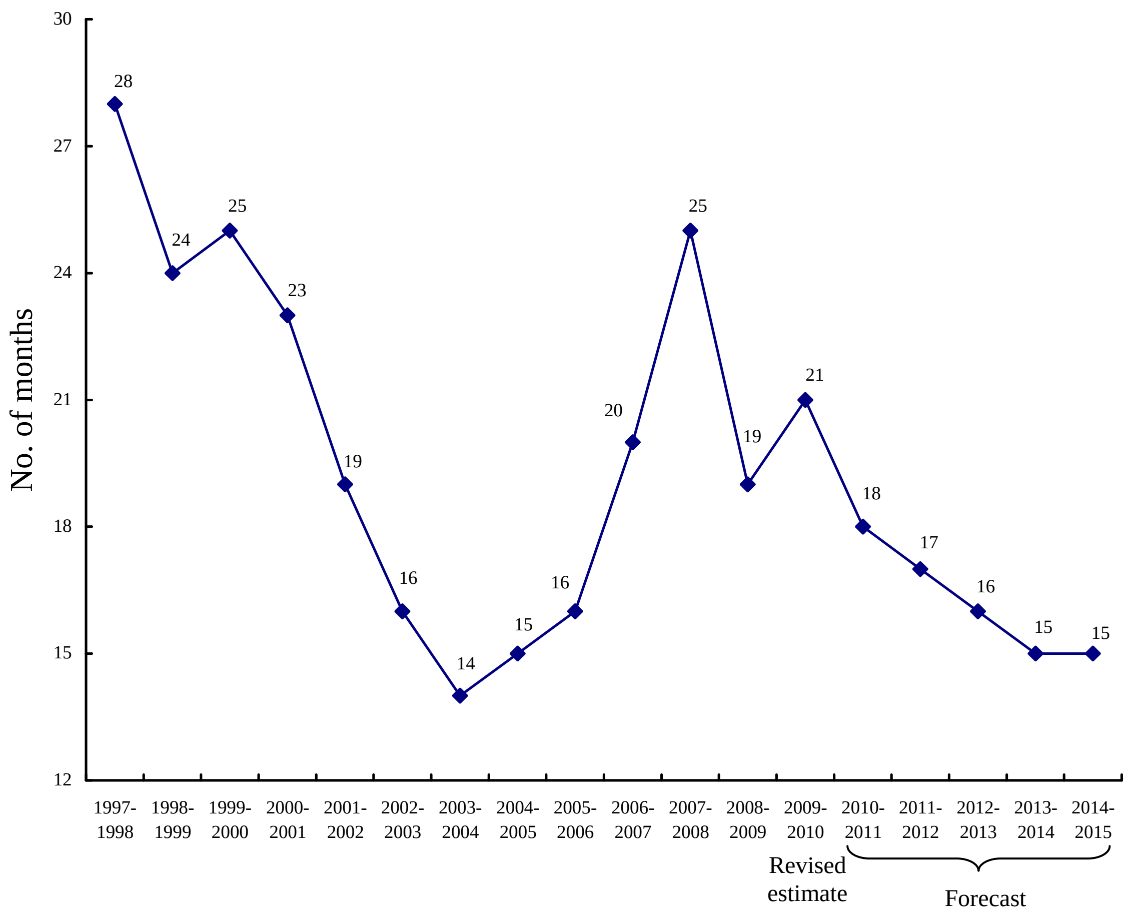
Table 1 – Guidelines on the level of fiscal reserves in Hong Kong

	1998	2002
Operating requirement	3 months of government expenditure	12 months of government expenditure
Contingency requirement	9 months ± 3 months of government expenditure	
Monetary requirement	M1 ± 25%	–

Sources: *1998-1999* and *2002-2003 Budgets.*

6.7 As shown in Chart 4, the Government has maintained the fiscal reserves at an amount more than 15 months of government expenditure between 1998-1999 and 2001-2002, and more than 12 months of government expenditure since 2002-2003. The actual government expenditure varies in those fiscal years covered in the chart, and primarily includes the operating and capital expenditure incurred during the fiscal year concerned.

Chart 4 – Fiscal reserves as number of months of government expenditure



Sources: *Hong Kong Annual Digest of Statistics* and *2010-2011 Budget*.

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