For discussion on 7 May 2001

LEGISLATIVE COUNCIL PANEL ON FINANCIAL AFFAIRS

Proper Use of Fiscal Reserves

Purpose

Members have asked for background information on five aspects concerning the use of the fiscal reserves. This note provides such background information.

2. A general background note on the fiscal reserves is at Annex.

Five Specific Aspects of Information on the Fiscal Reserves

The formula for determining the appropriate level of the fiscal reserves since 1998

3. In the 1998-99 Budget Speech, the Financial Secretary announced a set of guidelines on the level of fiscal reserves the Government should maintain. He defined three purposes for which the fiscal reserves are needed, namely to meet operating, contingency and monetary requirements.

4. The **operating** requirement provides money on hand to meet day to day cash flow needs and to cover the several months in the financial year when expenditure exceeds revenue. An amount equivalent to three months of Government expenditure is considered adequate. The **contingency** requirement is to meet Government's financial requirements when its revenues decline during a downswing in the economic cycle, or to cope with the consequences of unforeseen events in the world or the region that would have serious implications for public finance. An amount equal to nine months' expenditure, allowing a margin of plus or minus three months' expenditure, is considered sufficient. The **monetary** requirement underpins our exchange rate stability. An amount equal to the Hong Kong Dollar money supply under the M1 definition, allowing a margin of plus or minus 25%, is necessary.

5. In other words, under the guidelines, the level of fiscal reserves should be the sum of 12 months' government expenditure and Hong Kong Dollar money supply under the M1 definition, with a margin of plus or minus 25%. It means that the fiscal reserves are considered to be at an appropriate level if they stay between the limits of 15 months' government expenditure plus 125% of Hong Kong Dollar money supply under the M1 definition (i.e. the upper limit) and 9 months' government expenditure plus 75% of Hong Kong Dollar money supply under the M1 definition (i.e. the lower limit).

How the current formula compares with the bases adopted previously for setting the level of fiscal reserves

6. Previously, we did not have any guidelines as precise as the ones announced in the 1998-99 Budget, on the level of fiscal reserves to be maintained by the Government. Before then various Financial Secretaries had from time to time emphasized the importance of maintaining adequate reserves to provide a cushion to cover possible fluctuations in cash flow and future uncertainties in order to maintain fiscal stability, but had not laid down any specific guidelines.

7. In any case, the situation prior to 1983 was not relevant as Hong Kong did not operate a currency board system then. As evidenced by the turmoil that Hong Kong went through during the Asian financial crisis in 1997 and 1998, the situation prior to 1998 was also not particularly relevant.

How the rate of return is assessed to calculate the investment income payable by the Exchange Fund to the Government in respect of the fiscal reserves placed with the Fund.

8. Each year the Exchange Fund conducts a valuation of its investment portfolio as at 31 December, the accounting year end of the Fund, to ascertain the annual rate of investment return achieved by it. This rate of investment return is used to calculate the investment income payable by the Exchange Fund to the Government in respect of the fiscal

reserves placed with the Exchange Fund.

9. The projection of investment income from the fiscal reserves in the annual Estimates is made on the basis of a combination of assumptions, including the asset structure of the investment portfolio of the fiscal reserves, dividend from shares, change in the value of local equities, interest income from bonds and interest on bank deposits, etc. We also make reference to the past rates of return achieved.

The circumstances under which the fiscal reserves could be used

10. The fiscal reserves are used to finance fiscal deficits. For example in 1998-1999, the deficit of $23.2 billion was financed by drawing down the reserves. The estimated deficit of $7.8 billion in 2000-01 would also be financed by drawing down the fiscal reserves. The $3 billion deficit budgetted for the current fiscal year 2001-02 will be financed by drawing down the fiscal reserves.

11. The fiscal reserves are also used as a source of income. The investment income of the reserves each year is used to fund government expenditure. For fiscal year 2000-01 the investment income amounted to $23.2 billion which funded about 10% of that year’s total government spending. For fiscal year 2001-02, we forecast an investment income of $35.6 billion, which will fund about 14% of that year’s estimated total government spending.

Practices of overseas jurisdictions in maintaining their fiscal reserves

12. Published information on practices of overseas jurisdictions in maintaining their fiscal reserves is scant and is at most in general terms. According to data published by the OECD, we understand most of its member countries have accumulated fiscal deficits rather than accumulated fiscal reserves.

13. According to published information, we understand Singapore maintains strong reserves to see itself through times of crises and secure investor confidence in the country's future. In addition, the country's absolute level of reserves is kept in step with the growth of its population and increase in its standard of living. The country also closely follows the convention of achieving a balanced budget over the term of the government in order not to draw on "past reserves", i.e. reserves not accumulated by the government during a current term of office. In January this year, the country also made a constitutional amendment to protect (i.e. not draw on) at least 50 per cent of the net investment income earned from past reserves. Previously, the investment income used to accrue fully to current reserves and was all spendable. No published information is available on the level of the country's fiscal reserves. The only information is on the official foreign reserves. At the end of 2000, they amounted to about 88% of the country's GDP in 2000.

14. For countries relying on exhaustible resources (e.g. oil and gas) for their revenue such as Norway, Chile, Venezuela, and Kuwait, the

primary concern is stabilisation, namely how to adjust government spending and smooth out the domestic economy from the sharp and unpredictable variations in the price of their resources and revenue. Each country develops its own arrangements suited to itself. The most common practice is to set up stabilisation funds to build up the reserves through accumulating budget surpluses, or through setting aside a percentage of the government revenue each year, or through accumulating the annual investment income in the stabilisation funds. The Governments of these countries draw on the stabilisation funds to pay for government spending when there is a shortfall in government revenue due to a decline in the price of their resources or quantum of the resources sold. According to an observation of the IMF, in most cases, stabilisation funds have contributed to enhancing the effectiveness of fiscal policy by making budget expenditure less driven by revenue availability, but it is clear that a stabilisation fund cannot be a substitute for sound fiscal management.

Finance Bureau

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