Investment Income on Fiscal Reserves Placed with the Exchange Fund

Introduction

1 At the meeting of the Legislative Council Panel on Financial Affairs held on 11 January, Members asked for information on the amount of the share of fiscal reserves in the investment income of the Exchange Fund over the past few years. This note provides Members with the relevant information.

Sharing Arrangements

2 Before 1 April 1998, the fiscal reserves were placed as deposits with the Exchange Fund and received market-based interest rates.

3 Since 1 April 1998, the return on the fiscal reserves placed with the Exchange Fund has been directly linked to that achieved by the Exchange Fund. This arrangement however does not apply to the balances of the Loan Fund and the Capital Investment Fund, which are required by the resolutions which establish these funds to be invested in interest bearing securities. The balances of these two funds therefore continue to receive interest income at market-based interest rates from the Exchange Fund. The interest is paid to the Government on maturity of the individual deposits and constitutes government revenue upon receipt.

4 The annual rate of return achieved by the entire Exchange Fund is calculated by reference to the value of the Exchange Fund's investment portfolio at 31 December of each year, i.e. the Fund's accounting year end. The investment income due to the Government is accrued in the form of "Interest Payable" from the Exchange Fund. It is ***paid*** to the Government in March, which constitutes Government Revenue upon receipt.

Share of Fiscal Reserves in the Investment Income of the Exchange Fund

5 The interest or investment income payable by the Exchange Fund to the Government on the fiscal reserves for 1995-2000 (in calendar year) is as follows:

	Interest income at market-based interest rates (in HKD million)	Share of investment income based on the Fund's return (in HKD million)	Total (in HKD million)
1995	7,433	N/A	7,433
1996	7,780	N/A	7,780
1997	10,855	N/A	10,855
1998	4,439	25,996 [*Note 1]	30,435
1999	484	45,407	45,891
2000	880	18,010 [*Note 2]	18,890

**Note 1: Except for the Capital Investment Fund and the Loan Fund, the new investment income sharing arrangements for the fiscal reserves placed with the Exchange Fund started on 1 April 1998.*

**Note 2: This is only a provisional figure, which is subject to confirmation.*

Refinement Introduced

6 There is a difference in the accounting year adopted by the Exchange Fund, which uses calendar year ending on 31 December, and the Government, which uses fiscal year ending on 31 March. The change in the value of the Fund's investment portfolio in the last quarter of each fiscal year (i.e. January to March) is therefore not reflected in the rate of return used to calculate the investment income to the Government for that fiscal year. In light of this, the Government has introduced a refinement to the arrangements in 2000. Under the refined arrangement, if the Fund's investment return in January and February is negative, it is required to pay the Government in March an amount equivalent to the investment income for the previous calendar year minus the loss incurred in January and February. Details of

the refinement are set out in a paper prepared by the Finance Bureau to the Finance Committee in March 2000, a copy of which is at Annex.

7. In accordance with the above-mentioned refinement, the actual amount of investment income for 1999 received by Government in March 2000 was $41,093 million which is after deducting Government's share of loss incurred in January and February 2000 of $4,314 million. This unpaid portion will be taken into account when the Finance Bureau calculates the investment income to be paid by the Exchange Fund to the Government in March 2001.

Hong Kong Monetary Authority
February 2001

Investment Income on Fiscal Reserves Placed with the Exchange Fund

Purpose

This note informs Members of how the Government estimates and accounts for the investment income on the fiscal reserves placed with the Exchange Fund.

Background

2. Government's fiscal reserves comprise the accumulated balances of the General Revenue Account, the Land Fund, the Capital Works Reserve Fund, the Capital Investment Fund, the Loan Fund, the Civil Service Pension Reserve Fund, the Disaster Relief Fund and the Innovation and Technology Fund. All the fiscal reserves are placed with the Exchange Fund.

Present Arrangement

3. Since 1 April 1998, the rate of return received on the fiscal reserves (except for the balances of the Loan Fund and the Capital Investment Fund [Note]) placed with the Exchange Fund is directly linked to the return achieved by the entire Fund. This arrangement was announced by the Financial Secretary in the

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[Note] The resolutions approved by LegCo for the setting up of the Capital Investment Fund and the Loan Fund require the balances in these Funds to be invested in interest bearing securities. These balances are thus placed with the Exchange Fund at the determined interest rates.

1998 Budget Speech. The annual rate of return achieved by the entire Exchange Fund is calculated by reference to the value of the Exchange Fund's investment portfolio at 31 December each year, i.e. the Fund's accounting year end. This rate of 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 Fund.

4. The investment income due to the Government is accrued in the form of "Interest Payable" from the Exchange Fund. It is ***paid*** to the Government in March. It constitutes Government revenue upon receipt, and it increases the balances of the General Revenue Account and the relevant Funds for the fiscal year ending 31 March.

5. The current arrangement works well except for one aspect which has arisen because of the different accounting year adopted by the Exchange Fund (ending on 31 December) and the Government (ending on 31 March). Because of this difference, the change in the value of the Exchange Fund's investment portfolio in the last quarter of each fiscal year (i.e. January to March) is ***not*** reflected in the rate of return used to calculate the investment income to the Government for that fiscal year. While this may be acceptable in a largely stable global and local financial market, it is not a satisfactory arrangement in an increasingly volatile environment when the value of the Exchange Fund's investment portfolio may vary somewhat significantly even within one quarter. Indeed, the Director of Accounting Services has advised, and the Director of Audit has agreed at the time the new arrangement was put in place in 1998, that in the event of a material diminution in the value of fiscal reserves placed with the Exchange Fund in the last quarter of a fiscal year because of a negative

investment return by the Fund, it is necessary to write down the value of the fiscal reserves in the Government accounts for that fiscal year.

Refinement Introduced

6. The theoretical solution to the above problem is for the Exchange Fund to calculate and pay the investment income to the Government on the basis of the value of the Exchange Fund's investment portfolio for the same 12-month period as that of the fiscal year. However, this is not practicable as the value of the Exchange Fund's investment portfolio for the month of March is not available until end-April; but the Government must receive the investment income from the Fund no later than 31 March in order for the receipts to be shown in that fiscal year's Government accounts.

7. The solution devised is to continue with the existing arrangement for calculating the investment income payable to the Government but, in the event of a negative investment performance by the Fund in the months of January and February, the Exchange Fund is required to pay the Government in March an amount equivalent to the investment income for the previous calendar year ***minus*** the loss incurred as a result of the negative performance in January and February. The unpaid investment income will accrue in the form of "Interest Payable" from the Exchange Fund to the Government and will be taken into account when calculating the investment return on fiscal reserves placed with the Fund for the subsequent fiscal year.

8. To illustrate, if the investment income on fiscal reserves placed with the Exchange Fund for calendar year 1999 was $40 billion and there was a negative investment performance of the Fund in January and February 2000 resulting in a loss of $5 billion of fiscal reserves, then under the new arrangement the Exchange Fund need only pay $35 billion to the Government in March 2000. The amount paid would be shown in the Government accounts for 1999-2000. The unpaid interest income (i.e. $5 billion in the illustration) would be accrued in the form of "Interest Payable" from the Exchange Fund to the Government and be taken into account when calculating the investment income payable to the Government for fiscal year 2000-01. If the investment performance for the months of January and February 2000 was not negative, no adjustment would be made and the Exchange Fund would pay the Government $40 billion in March 2000. This amount would be shown in the Government accounts for 1999-2000.

9. This approach is more prudent than the existing arrangement as it reduces the likelihood for the Director of Accounting Services to write down the value of the fiscal reserves at the end of a fiscal year. This is because any loss in value of fiscal reserves arising from negative investment performance by the Exchange Fund in January and February would be cushioned by the investment income achieved in the preceding calendar year. And the Director of Accounting Services would need to write down the value of the fiscal reserves in the Government accounts for any fiscal year only when there was a loss in March following a net loss in January and February or when the loss in March exceeded a net gain in January and February.

Arrangement from 1999-2000 Onwards

10. We have discussed the matter thoroughly with the Hong Kong Monetary Authority, Director of Accounting Services and Director of Audit. All parties agree to adopt the approach described in para. 7 from the current fiscal year (i.e. 1999-2000) onwards.

Reflection in the 1999-2000 Revised Revenue Estimates

11. The revised estimate of $44 billion of investment earnings on our total fiscal reserves in 1999-2000, as announced by the FS in the 2000 Budget, includes an estimated interest income of $43.3 billion from the Exchange Fund and $0.7 billion of other interest received, including that related to investments of the balances in the Loan Fund and Capital Investment Fund (which are placed with the Exchange Fund in deposits at pre-determined interest rates as explained in para. 3 above). The amount of $43.3 billion is our best estimate, taking into account the actual performance of the Exchange Fund up to end-December 1999 and our estimate of the likely performance of the Fund for the period January to mid-February when the 2000 Budget Speech was finalised.

12. The $43.3 billion and $0.7 billion figures are shown in the revised estimates of revenue for 1999-2000 as follows:

	Estimated Income from Exchange Fund **$'000**	**Estimate of Other Investment Income** **$'000**	**TOTAL** **$'000**
General Revenue Account (Head 7, Subhead 040)	15,401,752	262,374	15,664,126
Land Fund	22,749,856	-	22,749,856
Capital Works Reserve Fund	3,817,560	97,119	3,914,679
Civil Service Pension Reserve Fund	1,127,878	-	1,127,878
Disaster Relief Fund	3,600	-	3,600
Innovation and Technology Fund	242,206	232	242,438
Capital Investment Fund	-	58,554	58,554
Loan Fund	-	226,133	226,133
	43,342,852	644,412	43,987,264

Finance Bureau
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