11 May 2004

By Post & Fax (2869-6794)

Mr. Anthony Chu
Clerk to Subcommittee on Proposed Resolution Under
Section 3(1) of the Loans Ordinance
(by way of issuance of Government bonds)
Legislative Council Secretariat
3/F Citibank Tower
3 Garden Road
Central
Hong Kong

Dear Mr Chu,

Subcommittee on proposed issuance of government bonds

Thank you for your letter to David Marshall of 6th May 2004, inviting views on the government's plans borrow for financial works projects and the issuance of government bonds. On behalf of the Fitch Ratings Sovereign Group I would like to offer the views set out in the two paragraphs below.

The planned issuance of government bonds announced in the 2004/05 Budget follows an unprecedented deterioration in Hong Kong's public finances over the last few years. But despite sustained fiscal deficits the government maintains fiscal reserves of around 22% of GDP, leaving it with a stronger financial balance sheet position than many other governments and the capacity, in principle, to finance deficits for several years to come without recourse to market borrowing. Nevertheless, the decision to borrow offers a number of potential benefits including increasing the options available for deficit financing and enhanced bond market depth and liquidity, although the latter could be somewhat limited by a one-off bond issue. Greater flexibility in financing could be of value in the face of inherent uncertainty about the timing of asset sales. Market borrowing would also allow the government to slow the pace of drawdown of the fiscal reserves from the Exchange Fund. This diminishes the prospect of the Exchange Fund – which only holds around HKD90bn in local currency assets – having to sell foreign currency assets to meet the withdrawal of government deposits, a transaction that, while having no implications for monetary stability, would reduce the size of official foreign currency reserves relative to the monetary base.

However it will be important to ensure that market borrowing does not contribute to any easing in pressure on the government to resolve the deficit problem. While the government favours earmarking bond receipts for its capital spending priorities, Fitch notes that any funds raised will be fungible and emphasises the importance of reducing the overall government spending to GDP ratio back towards historical norms of 16% to 17% from over 20% in 2003/04. Tax reform will also be crucial to broaden the revenue base and reduce its vulnerability to asset market developments. In its assessment of the health of the government's financial balance sheet, Fitch will concentrate primarily on net fiscal reserves – i.e. fiscal reserves minus the stock of debt outstanding.

I hope this will be of use to the subcommittee. Feel free to contact me in the event of any questions about these comments.

Yours sincerely,

Brian Coulton
Senior Director
Asia Sovereign Ratings