

By fax: 2840 0569

CB1/PL/FA
2869 9244
2869 6794

2 March 2005

Ms Shirley YUEN
Administrative Assistant to Financial Secretary
Financial Secretary's Office
12/F, West Wing
Central Government Offices
Lower Albert Road
Hong Kong

Dear Shirley,

Panel on Financial Affairs

Use of the accumulated surplus of the Exchange Fund

On behalf of Hon Bernard CHAN, Chairman of the Panel, I write to invite the Financial Secretary (FS) to discuss with the Panel on the above subject.

When the Panel was briefed on the work of the Hong Kong Monetary Authority (HKMA) at its meeting on 17 February 2005, members noted that the accumulated surplus of the Exchange Fund reached \$423.4 billion at the end of 2004. Given that the Exchange Fund is under the control of FS, some members suggested that FS be invited to discuss with the Panel on how the accumulated surplus of the Exchange Fund should and would be used. In this connection, they suggested that part of the accumulated surplus be transferred to the general revenue for the benefit of the public.

As the Administration is aware, questions on the above subject have been raised by members at previous meetings in various contexts, e.g. when the Panel was briefed on the work of HKMA, or when the Panel discussed the management of fiscal reserves. In response to a member's request raised at the Panel meeting on 4 November 2002, HKMA provided an information paper on the "Accumulated Surplus of the Exchange Fund" after the meeting (LC Paper No. CB(1)410/02-03 attached). Given that the subject has only been briefly touched upon at previous meetings but has not been thoroughly discussed by the Panel, the Chairman would like to invite FS to discuss the subject with the Panel.

Our suggested timing is the Panel meeting on Friday, 6 May 2005. The meeting is scheduled to start at 10:45 am but the starting time may be advanced if necessary. At that meeting, the Chief Executive of HKMA (CE/HKMA) will brief the Panel on the work of HKMA, including the performance of the Exchange Fund. A separate agenda item may be added for FS (and CE/HKMA) to discuss with the Panel on the use of the accumulated surplus of the Exchange Fund.

I should be grateful if you would convey the Chairman's invitation to FS and let me have your written reply (in both Chinese and English) **by 17 March 2005**. Please forward the soft copy of the written reply to Ms May LEUNG at mleung@legco.gov.hk.

Yours sincerely,

(Miss Salumi CHAN)
Clerk to Panel

Encl.

c.c. Hon Bernard CHAN, JP
Chairman of LegCo Panel on Financial Affairs

Hon LEE Cheuk-yan

Hon Emily LAU Wai-hing, JP

Mr Joseph YAM, GBS, JP
Chief Executive, Hong Kong Monetary Authority
(Fax: 2878 8190)

Mr Frederick MA Si-hang, JP
Secretary for Financial Services and the Treasury
(Fax: 2147 3873)

Mr Clement CHAN, AS/FSTB
(Fax: 2527 0790)

Miss Fiona CHAN
Senior Manager, Hong Kong Monetary Authority
(Fax: 2509 9159)

**Information Note for
Legislative Council Panel on Financial Affairs**

Accumulated Surplus of the Exchange Fund

Introduction

1. In a letter dated 7 November 2002, the Clerk to Panel conveyed the request from a Member of the Panel that the Hong Kong Monetary Authority (HKMA) provide the Panel with an information paper setting out the following details:

- (a) the mechanism under which the accumulated surplus of the Exchange Fund can be used to meet operating and contingency requirements of the Government which are also the purposes of the fiscal reserves;
- (b) the factors to be considered in the process; and
- (c) the possible implications of such a move.

Statutory provisions

2. Before providing the requested information on the three items, it will be helpful first to note the content of three relevant sections in the Exchange Fund Ordinance, namely sections 3(1), 3(1A) and 8. They are reproduced below for convenience.

3(1) There shall be established a fund to be called "the Exchange Fund" which shall be under the control of the Financial Secretary and shall be used primarily for such purposes as the Financial Secretary thinks fit affecting, either directly or indirectly the exchange value of the currency of Hong Kong and for other purposes incidental thereto. The control of the Financial Secretary shall be exercised in consultation with an Exchange Fund Advisory Committee of which the Financial Secretary shall be ex officio chairman and of which the other members shall be appointed by the Chief Executive.

3(1A) in addition to using the Fund for its primary purpose, the Financial Secretary may, with a view to maintaining Hong Kong as an international financial centre, use the Fund as he thinks fit to maintain the stability and the integrity of the monetary and financial systems of Hong Kong.

- 8 *Where the Financial Secretary is satisfied that such transfer is not likely to affect adversely his ability to fulfill any purpose for which the Exchange Fund is required to be or may be used under section 3(1) or (1A), he may, after consulting the Exchange Fund Advisory Committee, and with the prior approval of the Chief Executive in Council, transfer from the Fund to the general revenue or to such other fund or funds of the Government as may be authorized by the Chief Executive in Council any sum or part of any sum in excess of the amount required to maintain the assets of the Fund at 105% of the total obligations of the Fund for the time being outstanding and may for the purpose of any such transfer realize any of the assets of the Fund.*

Mechanism for transfer from the accumulated surplus to the general revenue

3. In accounting terms, the accumulated surplus of the Exchange Fund represents the amount in which the assets of the Exchange Fund exceed its liabilities. At the end of October 2002, the total assets of the Exchange Fund, on the basis of accounts that have not yet been audited, amounted to HK\$943 billion and liabilities amounted to HK\$626 billion, so that the accumulated surplus of the Exchange Fund was HK\$317 billion.

4. Regardless of the size of this accumulated surplus, it is not possible to use any assets of the Exchange Fund “to meet operating and contingency requirements of the Government”, because this purpose does not fall within those specified in sections 3(1) and 3(1A) of the Ordinance.

5. However, section 8 of the Ordinance allows “the transfer from the Fund to the general revenue or to such other fund or funds of the Government as may be authorized by the Chief Executive in Council any sum or part of any sum...” under certain conditions. Assuming that these conditions are met and the transfer of a certain sum is made to, say, the general revenue, the use to be put to that sum so transferred is a matter for the Government.

6. The mechanism for making such a transfer is specified in section 8 of the Ordinance. It involves:

- (1) the Financial Secretary’s satisfying himself “that such a transfer is not likely to affect adversely his ability to fulfill any purpose for which the Exchange Fund is required to be or may be used under section 3(1) or (1A)”;
- (2) the Financial Secretary’s consulting the Exchange Fund Advisory Committee;
- (3) the approval of the Chief Executive in Council;

- (4) the authorisation by the Chief Executive in Council of the Government fund for receiving the transfer; and
- (5) satisfying the requirement that the transfer would not reduce the assets of the Exchange Fund to a level less than “105% of the total obligations of the Fund for the time being outstanding”.

Factors to be considered

7. There are two factors to be considered when contemplating a transfer under section 8 of the Exchange Fund Ordinance. The first is the statutory minimum 105% cover for the total obligations of the Fund at the time of the transfer. The second is, crucially, the likelihood of such a transfer affecting adversely the ability of the Financial Secretary “to fulfill any purpose for which the Exchange Fund is required to be or may be used under section 3(1) or (1A)” of the Ordinance. The latter is a view to be taken entirely by the Financial Secretary in consultation with the Exchange Fund Advisory Committee.

8. Specifically, the Financial Secretary has to satisfy himself that his ability to affect “either directly or indirectly the exchange value of the currency of Hong Kong and for other purposes incidental thereto” will not be adversely affected. He also has to satisfy himself that his ability “to maintain the stability and the integrity of the monetary and financial systems of Hong Kong” will not be adversely affected.

Possible implications

9. It is very difficult to give an authoritative assessment on the possible implications of making a section 8 transfer. These depend very much on a number of factors, e.g. the amount to be transferred, the reason or reasons for making the transfer, the prevailing macroeconomic conditions, the vulnerability of Hong Kong to sizeable speculative attacks, public confidence in and market perception on the ability of the Government to maintain monetary and financial stability after the transfer.