**Progress Report on the Motion on
"Investment Income of the Exchange Fund"
at the Legislative Council Meeting on 1 June 2005**

Purpose

This paper informs members of the views of the Administration on the motion and the progress of the follow-up actions taken.

Background

2. At the Legislative Council meeting on 1 June 2005, the following motion on "Investment Income of the Exchange Fund" moved by the Hon SIN Chung-kai, as amended by the Hon CHAN Kam-lam, was carried :

> "That this Council urges the Government to review the existing methodology for sharing the Exchange Fund's investment income between the Government and the Hong Kong Monetary Authority, allocate more investment income of the Exchange Fund to the Government, and ensure that there is stable government revenue from the investment income; in determining the level of the Exchange Fund's investment income to be allocated to the Government, the principle of keeping expenditure within the limits of revenues in drawing up the budget, striving to achieve a fiscal balance, avoiding deficits and keeping the budget commensurate with the growth rate of the gross domestic product must be strictly followed."

Views of the Administration

3. The views of the Administration on the above motion are summarised as follows –

(a) The Exchange Fund Ordinance (EFO) (Cap. 66) states that the Exchange Fund (EF) shall be used primarily for affecting, either directly or indirectly, the exchange value of the Hong Kong dollar and also for ensuring the stability and the integrity of the monetary and financial systems of Hong Kong with a view to maintaining Hong

Kong as an international financial centre. Article 113 of the Basic Law (BL) also states that EF is primarily for regulating the exchange value of the Hong Kong dollar.

(b) The Government has since 1976 deposited its fiscal reserves with the EF. The major purpose of this arrangement was to boost the financial position of EF for regulating the exchange value of the Hong Kong dollar. At that time, the fiscal reserves were deposited with EF at a fixed rate of return.

(c) In 1998, we decided to link the return of the fiscal reserves placed with EF to that achieved by the entire EF. The reason for the decision was that while the fixed rate of return arrangement applied before 1998 could minimise market risk, the rates of return often lagged behind the inflation rates prevailing at that time. In the past seven years, although the investment returns of EF have fluctuated along side with market performance, the overall returns in respect of the fiscal reserves are considered reasonable.

(d) The transfer of funds from EF to the general revenue to meet government expenditure requirements can only be made with reference to Section 8 of EFO, which provides a mechanism for "transfer from the Fund". Under this section, the Financial Secretary has to satisfy himself that such transfer is not likely to affect adversely his ability to fulfill any purpose for which EF is required to be or may be used; besides, the transfer can only be made after consulting the Exchange Fund Advisory Committee and with the prior approval of the Chief Executive in Council.

(e) Transferring the accumulated surplus of EF to the general revenue would reduce the asset base available for protecting Hong Kong against external speculative attacks. Making such transfer may affect the Government's ability to maintain monetary and financial stability. Despite the gradual recovery of Hong Kong's economy, we are still faced with risks and uncertainties in the global financial environment. As a small but open economy, Hong Kong has to be well prepared to safeguard against potential financial risks.

(f) The fiscal principles of the Government as laid down in Article 107 of BL are keeping the expenditure within the limits of revenues in drawing up its budget, striving to achieve a fiscal balance, avoiding deficits and keeping the budget commensurate with the growth rate of its gross domestic product. We will give due consideration to the social and economic development needs and the aspirations of the community, and allocate adequate resources for providing services and investing in our future.

The Way Forward

4. The Administration will keep the income sharing arrangement with EF under review from time to time. We will preserve the ability of EF to maintain the stability of the Hong Kong dollar and the monetary and financial systems in Hong Kong, and ensure that the fiscal reserves will secure a steady and reasonable rate of return. We will continue to adhere strictly to the fiscal disciplines as laid down in Article 107 of BL and make the best use of public resources for investing and building a better future for Hong Kong.

Financial Secretary's Office
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