Progress Report on the Motion on
"Increasing the Government's share in the
Investment income of the Exchange Fund"
At the Legislative Council on 20 December 2006

Purpose

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

Background

2. At the Legislative Council meeting on 20 December 2006, the following motion on "Increasing the Government's share in the investment income of the Exchange Fund" moved by Hon. Howard Young, as amended by Hon Chan Kam-lam, was carried:

> "That this Council urges the Government to revise the existing agreement between the Government and the Hong Kong Monetary Authority on the methodology for sharing the investment income of the Exchange Fund, so as to 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 additional investment income of the Exchange Fund 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 and actions taken by the Administration

3. 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 (HKD), 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 also states that the EF is primarily for regulating the exchange value of HKD.

4. Since 1976, the Government has deposited its fiscal reserves with the EF, initially earning a fixed rate of return, mainly to strengthen the EF's financial position for regulating the exchange value of HKD. To allow the fiscal reserves' return to catch up with inflation, it was linked to the return of the entire EF in 1998.

5. The investment income of the fiscal reserves is an important source of revenue for the Government, yet it is extremely volatile. It represented between 0.5% and 18% of government revenue over the past decade. Meanwhile, the Administration has noted calls from the community for higher returns from the fiscal reserves. After careful consideration and with a view to increasing the Government's investment income and enhancing the stability and predictability of this source of income, the Financial Secretary has decided to revise the income-sharing arrangement between the fiscal reserves and the EF, subject to the principle that the EF's ability to defend our currency and stabilise our monetary and financial systems should not be undermined.

6. Effective from 1 April, the return on the fiscal reserves will be calculated on the basis of the average rate of return of the EF's investment portfolio over the past six years. Under the new arrangement, the rate of return on the fiscal reserves for 2007 will be 7%. There will also be the guarantee of a minimum return so as to ensure that the annual investment return in any year will not be lower than the average yield of three-year Exchange Fund Notes for the previous year. This new arrangement would make the investment income more predictable for the Government in preparing its budgets without affecting the EF’s ability to fulfil its statutory purposes of ensuring monetary and financial stability.

7. The Government will adhere to the prudent fiscal principles as laid down in Article 107 of the Basic Law, that is, keeping 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.

Financial Secretary’s Office
6 March 2007