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Panel on Financial Affairs

Updated Background Brief
on the Use of the Accumulated Surplus of the Exchange Fund

Purpose

This paper summarizes the major views on the use of the accumulated surplus of the Exchange Fund (EF) and related issues expressed by Members at meetings of the Legislative Council (LegCo) and meetings of the Panel on Financial Affairs (FA Panel) from the 2000-01 session to the current session.

Establishment and management of the Exchange Fund

2. The EF was established by the Currency Ordinance of 1935 (later renamed the Exchange Fund Ordinance (EFO) (Cap. 66)). The EFO provides that EF shall be used primarily for such purposes as the Financial Secretary (FS) thinks fit affecting the exchange value of the currency of Hong Kong and for other purposes incidental thereto. The functions of EF were extended with the enactment of the Exchange Fund (Amendment) Ordinance 1992 by introducing a secondary and subsidiary role of maintaining the stability and the integrity of the monetary and financial systems, with a view to maintaining Hong Kong as an international financial centre. The relevant provisions of EFO (section 3(1) and (1A)) are set out in **Appendix I**.

3. The EF is managed by the Hong Kong Monetary Authority (HKMA) under the powers delegated by FS. The Exchange Fund Advisory Committee (EFAC) advises FS on the investment policies and strategies for EF. The investment objectives of EF are:

(a) to preserve capital;

(b) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid short-term US dollar-denominated securities;

(c) to ensure sufficient liquidity for the purpose of maintaining monetary and financial stability; and

(d) subject to (a) to (c) above, to achieve an investment return that will preserve the long-term purchasing power of the assets.

4. The assets of EF are grouped under two portfolios, the Backing Portfolio and the Investment Portfolio, to facilitate management and investment of the assets. The Backing Portfolio holds highly liquid short-term US dollar-denominated securities and provides full backing for the monetary base of Hong Kong. The balance of EF's assets that constitutes the Investment Portfolio is primarily invested in the Organization for Economic Co-operation and Development bond and equity markets to preserve the value and long-term purchasing power of these assets.

Fiscal reserves placed in the Exchange Fund

5. In 1976, the Government began to transfer its fiscal reserves to EF. This arrangement was introduced to avoid fiscal reserves having to bear exchange risks arising from investments in foreign currency assets and to centralize the management of the Government's financial assets. Through the transfer of the fiscal reserves[1], the bulk of the Government's financial assets are, therefore, placed with EF. On 1 November 1998, the assets of the Land Fund amounting to about $211.4 billion were merged into EF and managed as part of the Investment Portfolio of EF.

6. As at 31 October 2006, the total assets of EF amounted to HK$1,162.7 billion. The placement by the fiscal reserves amounted to HK$291.8 billion.

<u>Purposes and level of fiscal reserves</u>

7. In the light of the Asian financial crisis in 1997 and 1998, the then FS in the 1998 Budget Speech defined three purposes for which it is necessary for the Administration to hold substantial public funds in reserve, as follows:

(a) <u>To meet operating requirement</u>
This is for the Administration to have money on hand to meet its day-to-day cash flow needs and to cover the several months in the financial year when expenditure exceeds revenue;

(b) <u>To meet contingency requirement</u>

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[1] The 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, the Innovation and Technology Fund, and the Lotteries Fund.

This is to offset the effects of any downswing in the economic cycle, or to cope with the consequences of unforeseen events in the world or the region that would have serious implications for public finance; and

(c) To meet monetary requirement
This is to underpin the exchange rate stability.

8. The then FS also set the guideline on the level of fiscal reserves to be kept. He considered that an amount equal to 12 months of government expenditure (with a margin of plus or minus three months) should be kept for meeting operating and contingency requirements. As regards the monetary side, he considered it not easy to define the appropriate level of fiscal reserves for monetary purposes, except that experience had shown that the higher the fiscal reserves, the greater the public confidence. He stated that the Government would adopt the Hong Kong Dollar money supply under the M1 definition as the benchmark (with a range of plus or minus 25% of M1).

9. In the 2002 Budget Speech, the then FS pointed out that in the wake of Asian financial crisis, HKMA had implemented a series of measures to reinforce the stability of the Hong Kong Dollar exchange rate, and that the accumulated surplus of EF had reached $300 billion. These developments had greatly enhanced EF's ability to maintain exchange rate stability. The then FS said that he saw no further need to link the level of fiscal reserves to money supply, and that it should be sufficient to have fiscal reserves equivalent to around 12 months of government expenditure to meet operating and contingency requirements. He also pointed out that although it was no longer necessary to link the level of fiscal reserves to money supply, the Government's fiscal reserves would continue to be placed with EF, thereby providing even more resources for EF to maintain the stability of the Hong Kong Dollar and Hong Kong's monetary system.

Income sharing arrangement with the Exchange Fund

10. Before 1 April 1998, fiscal reserves were placed with EF as Hong Kong dollar deposits to minimise market risk. Since the Government's reserves had grown over the years, it was decided that the fiscal reserves placed with EF should be more actively managed to achieve a higher long-term real rate of return. The then FS announced in the 1998 Budget Speech that with effect from 1 April 1998, the return of the fiscal reserves placed with EF would be linked to that achieved by the entire EF. Under the arrangement agreed between the Government and HKMA, the annual rate of return achieved by the entire EF is calculated by reference to the value of EF's investment portfolio at 31 December each year, i.e. EF's accounting year end. This rate of return is used to calculate the investment income payable by EF to the Government in respect of the fiscal reserves placed with EF. The investment income is paid to the Government in March, which constitutes government revenue upon receipt. This is reflected under the item "Treasury's share" in **Appendix II**.

11. However, the income sharing arrangement mentioned above does not apply to the balances of the Loan Fund and the Capital Investment Fund, because the resolutions approved by LegCo for the setting up of these two Funds require the balances in these two Funds to be invested in interest bearing securities. The balances in these two funds therefore continue to receive interest income at market-based interest rates from EF. The interest is paid to the Government on maturity of the individual deposits and constitutes government revenue upon receipt. This is reflected under the item "Interest paid to the Treasury at market-based interest rates" in **Appendix II**.

Accumulated surplus of the Exchange Fund

12. After deducting interest and expenses and the Treasury's share from the investment income, the surplus for each year will be accrued in EF as the accumulated surplus. In accounting terms, the accumulated surplus of EF represents the amount in which the assets of EF exceed its liabilities, i.e. profits of EF. As at 31 October 2006, the accumulated surplus of EF stood at HK$493.0 billion. The accumulated surplus of EF for the past ten years is set out in **Appendix II**.

Mechanism for transfer of fund from the Exchange Fund to the general revenue

13. Section 8 of EFO provides a mechanism for transfer of funds from EF to the general revenue or to such other fund or funds of the Government as may be authorized by the Chief Executive (CE) in Council. The provisions of section 8 are set out in **Appendix I**. The mechanism involves the following key elements:

(a) FS is satisfied that such transfer is not likely to affect adversely his ability to fulfil any purpose for which EF is required to be or may be used under section 3(1) or (1A) of EFO;

(b) The transfer would not reduce the assets of EF to a level less than 105% of the total obligations of EF for the time being outstanding; and

(c) The transfer could be only made after FS has consulted EFAC and with the prior approval of the CE in Council.

14. On item (b) above, the Administration[2] has pointed out that the presumption that the Government may transfer to the general revenue from EF any assets in

[2] Written reply from the then Secretary for Financial Services to a Member's written question for the Council meeting on 8 March 2000.

excess of 105% of the EF's liabilities is incorrect. The 105% threshold is merely the absolute statutory minimum that EF must maintain to meet its liabilities in the unlikely event that a transfer is contemplated. Even then, any such transfer could only proceed after consultation with EFAC and with the approval of the CE in Council.

Members' major views on the use of EF

15. During budget debates and motion debates at LegCo meetings and briefings by FS and the Chief Executive of HKMA (CE/HKMA) at FA Panel meetings, Members urged the Administration to review how the accumulated surplus of EF should be used and the need of revising the current income sharing arrangement with EF. The major views expressed by Members from the 2000-01 session to the current session are summarized as follows:

(a) The current level of EF is well above the level required to provide full backing for the current Monetary Base. The need of the fiscal reserves for meeting the monetary purpose has already been met. It is high time for the Administration to review how the accumulated surplus of EF should be used. Given that EF is public moneys, consideration should be given to using it for the interests of the people in Hong Kong, such as by transferring part of the accumulated surplus of EF to finance public programmes;

(b) In connection with item (a) above, the Government should consider transferring a fixed rate or fixed sum from the accumulated surplus of EF to the general revenue;

(c) There should be flexibility for transferring money from the accumulated surplus of EF to the general revenue to allow the implementation of new initiatives for improving the livelihood of the general public, to stimulate the economy, to provide economic relief to the general public during times of economic downturn, to address the problem of poverty, to introduce tax concessions for the needy classes, and to avoid implementing cuts in public expenditure;

(d) A higher rate of return should be provided to the fiscal reserves placed in EF to increase government revenue so as to address the fiscal deficit problem; and

(e) As the investment income of EF is subject to volatility and uncertainties in the global financial markets, there may be fluctuation in the share of investment income for the fiscal reserves, thus creating difficulty for the Government to project the annual investment return for the fiscal reserves. The Government should consider alternative arrangements, such as adopting a five-year average rate of investment return; setting a fixed amount of return; or setting a reasonable rate of return which would be subject to periodic review etc., for the fiscal reserves in sharing the annual investment return to EF so as to provide the Government with a more stable revenue source.

16. A summary of Members' major views expressed at FA Panel meetings since January 2001 and the Administration's responses is in **Appendix III**.

Financial Secretary's views on the use of EF

17. The views of FS previously expressed on the use of EF are summarized as follows:

(a) FS[3] did not consider it necessary or desirable to contemplate making any transfer from EF to the general revenue, which anyway still had a very substantial surplus accumulated over the years. It was important that any proposals on or requests for government spending, whether or not for infrastructural projects, should be subject to the discipline of fiscal prudence (including that laid down in the Basic Law) and the usual budgetary criteria;

(b) FS[4] emphasized the importance of maintaining fiscal prudence in the management of public finances which meant achieving fiscal balance over the medium term, avoiding recurrent operating deficits in the Government account, and maintaining adequate fiscal reserves. Recurrent operating deficits and unhealthy fiscal reserves position would undermine international confidence and lower the credit rating for Hong Kong. This would also raise borrowing costs for businesses and adversely affect economic growth. FS also advised Members that he was aware of public concern about the appropriateness of the guidelines for determining the level of fiscal reserves which was set out in the 1998 Budget Speech. The Government kept the guidelines under review and he welcomed views from Members and the public on the subject;

(c) FS[5] stressed the need for the Government to adopt a prudent approach in setting the appropriate level of EF to be maintained and to boost the financial position of EF for the purposes of maintaining the stability of Hong Kong dollar and the monetary and financial systems in Hong Kong. He considered it not prudent at that point in time to utilize the

3 Written reply from the then Secretary for Financial Services to a Member's written question for the Council meeting on 8 March 2000.
4 Reply of FS in response to Members' questions at the FA Panel meeting on 4 June 2001.
5 Reply of FS in response to Members' questions at the FA Panel meeting on 2 February 2004.

accumulated surplus of EF for meeting Government operating deficits. Despite that the promising investment performance of EF in 2003 had boosted the financial position of the Fund, the investment outlook for 2004 remained uncertain and was expected to be difficult. It was unlikely that EF could achieve the good returns seen in 2003. Moreover, deploying the accumulated surplus of EF to meet Government operating deficits would not tackle the budget deficit problem at root;

(d) On some Panel members' suggestion that part of the accumulated surplus of EF be transferred to the general revenue in accordance with section 8 of EFO, FS[6] did not intend to invoke section 8, and the Government's position remained unchanged;

(e) FS[7] said that he noted the suggestion that part of the investment income of EF should be transferred to the Government's revenue account to ease the fiscal deficit. He pointed out that given the unpredictability of the international monetary environment, Hong Kong must maintain adequate levels of foreign reserves to ensure the stability of Hong Kong dollar and preserve both local and overseas confidence in the currency. Moreover, the investment income of EF was volatile and unpredictable and was therefore not a stable source of income. For example, the investment income for 2004 was only about half of that for 2003. FS therefore considered it unnecessary to contemplate making the transfer arrangements at present;

(f) FS[8] said that transferring the accumulated surplus of EF to the general revenue would reduce the asset base available for protecting Hong Kong against external speculative attacks. Despite the gradual recovery of Hong Kong's economy, it was still faced with risks and uncertainties in the global financial environment (for example, significant increase in the number of hedge funds and pressure arising from the expectation that the renminbi would be appreciated etc.). As a small but open economy, Hong Kong had to be well prepared to safeguard against potential financial risks. The Government would keep the income sharing arrangement with EF under review from time to time;

(g) FS[9]pointed out that in passing the motion at the Council meeting on 1 June 2005, while Members were of the view that more investment income of EF and part of the accumulated surplus of EF should be

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6 The reply dated 23 March 2005 from the Administrative Assistant to FS to the Clerk to the FA Panel.

7 Remarks made by FS in concluding the Second Reading debate of the Appropriation Bill 2005 on 27 April 2005.

8 FS's response to Members' views and suggestions at the motion debate on "Investment income of the Exchange Fund" on 1 June 2005.

9 Reply of FS in response to Members' questions at the FA Panel meeting on 6 June 2005.

transferred to the general revenue, there was no consensus among Members as to how the transferred income should be used;

(h) FS[10] stressed that while the investment return on fiscal reserves placed with EF had been a source of income for the Government, the investment return of EF was volatile and unpredictable. Hence, the transferred arrangements suggested by Members at the motion debate (such as setting a fixed rate of return; allocating a fixed amount to the Government; or setting a reasonable rate of return which would be subject to periodic review etc.) might not in practice achieve a stable return on the fiscal reserves in EF;

(i) Given the primary objective of EF to maintain currency stability, FS[11] pointed out that an adequate level of foreign reserves must be maintained to preserve local and overseas confidence in the Hong Kong dollar. EF's ability to meet its objective would be reviewed from time to time taking into account the changing international monetary environment and the latest developments of the financial markets with a view to striking a proper balance between returning part of the wealth to the people of Hong Kong and maintaining currency stability. FS had examined with CE/HKMA from time to time feasible options for achieving a more stable return on the fiscal reserves in EF. It was highlighted that any change to the existing sharing arrangement would be a significant policy change which should not be resorted to lightly in the near future in order not to pre-empt the policy decision of the next term (i.e. 2007-2012) of Government; and.

(j) FS[12]stressed that in considering methods for calculating the investment income for the fiscal reserves, one important principle was to avoid using the accumulated surplus of EF lightly. Otherwise, the asset base available for EF to withstand external attacks would be undermined. The Government would keep the income sharing arrangement with EF under review and explain to the community if there were changes to the sharing arrangement.

Council Business Division 1
Legislative Council Secretariat
18 December 2006

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10 Same as Note 9 above.
11 Reply of FS in response to Members' questions at the FA Panel meeting on 6 November 2006.
12 Written reply from FS to a Member's oral question for the Council meeting on 22 November 2006.

Appendix I

Sections 3(1), 3(1A) and 8 of the Exchange Fund Ordinance (Cap. 66)

Section	Provisions
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.

Accumulated surplus of the Exchange Fund
(Position as at 30 September 2006)

(in billions of Hong Kong dollars)	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006 up to Q3
Investment income/(loss)	25.4	35.6	93.8	103.8	45.1	7.4	47.0	89.7	56.7	37.8	67.8
Other income	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1
Interest and expenses											
(a) Interest paid to the Treasury at market-based interest rates[Δ]	(7.8)	(10.9)	(4.4)	(0.5)	(0.9)	(0.6)	(0.2)	(0.1)	(0)	(0.1)	(0)
(b) Other interest and expenses	(5.1)	(7.5)	(11.6)	(9.5)	(10.1)	(9.9)	(6.8)	(5.5)	(4.8)	(7.5)	(7.8)
Net investment income/(loss)	12.7	17.4	78.0	94.0	34.3	(2.9)	40.2	84.3	52.1	30.4	60.1
Treasury's share°	0.0	0.0	(26.0)	(45.4)	(18.1)	(1.6)	(15.6)	(25.7)	(14.5)	(10.1)	(19.0)
Revaluation gain/(loss) on premises affecting accumulated surplus	-	-	-	-	-	-	-	(0.9)	0.9	0.0	0.0
Adjustment to accumulated surplus effect of implementation of HKAS 39[@]	-	-	-	-	-	-	-	-	-	(0.6)	0.0
Increase/(decrease) in accumulated surplus	12.7	17.4	52.0	48.6	16.2	(4.5)	24.6	57.7	38.5	19.7	41.1
Total accumulated surplus	***172.9***	***190.2***	***242.3***	***290.9***	***307.1***	***302.6***	***327.2***	***384.9***	***423.4***	***443.1***	***484.2***

Source: Information provided by the Hong Kong Monetary Authority (HKMA) in HKMA Annual Report 2005 and for the meetings of the LegCo Panel on Financial Affairs on 2 February 2004, 17 February, 6 May 2005 and 6 November 2006, as well as reply dated 24 May 2005 from the Administrative Assistant to Financial Secretary (AA/FS).

Δ **According to AA/FS's reply dated 24 May 2005, interest paid to the Treasury has dropped significantly from 1998 onward because of the implementation of the current income sharing arrangement with the Exchange Fund since 1 April 1998 as well as the fall in interest rates over this period. The interest expense incurred for the period after 1 April 1998 was for the Loan Fund and the Capital Investment Fund only.**

° **The "Treasury's share" reflects only the Treasury's income for the fiscal reserves placed with the Exchange Fund under the current income sharing arrangement with the Exchange Fund and does not include the interest paid at market-based interest rates to the Loan Fund and the Capital Investment Fund, which is shown under “"Interest and expenses - Interest paid to the Treasury at market-based interest rates".**

@ **The effect of changing from using mid-price to using bid-price for valuing securities held, and using ask-price for valuing securities issued upon adoption of the new Hong Kong accounting standards in 2005**

Appendix III

Panel on Financial Affairs

Summary of Members' major views on the use of the accumulated surplus of the Exchange Fund

Date of meeting	Members' major views	Administration's responses
11 Jan 2001	Given the huge size of the Exchange Fund (EF) amounting to HK$1,020.8 billion at the end of 2000, Mr James TIEN opined that the Hong Kong Monetary Authority (HKMA) should consider increasing the share of the fiscal reserves in the investment income of EF so as to cover possible deficits in the 2000-01 budget.	Chief Executive of HKMA (CE/HKMA) explained that the primary purpose of EF was to safeguard the exchange value of the Hong Kong dollar and to maintain the stability and integrity of Hong Kong's monetary and financial systems. The Financial Secretary (FS) was responsible for the use of EF in achieving the above purposes. On the appropriate size of EF to be maintained, CE/HKMA said that in theory, it would be sufficient for EF to maintain the foreign currency assets at a level adequate for backing the monetary base of HK$215.4 billion. But given the risks and vulnerabilities in the regional economy and the global financial market, it would be advisable to maintain EF at a higher level for defending the Hong Kong dollar.
3 May 2001	Noting that the level of EF had reached over HK$1,000 billion with an accumulated surplus of over HK$300 billion, Mr SIN Chung-kai considered that the monetary purpose of EF to maintain the stability of the Hong Kong dollar should have been fully met. He asked whether the accumulated surplus of EF could be used to fund government programmes.	CE/HKMA said that in terms of foreign currency reserves ranking, Hong Kong's EF was the third largest in the world. In terms of reserves on a per capita basis, Hong Kong was ranked as the second highest in the world i.e. after Singapore. He shared members' view that EF was public money and should be invested for the interest of Hong Kong's long-term development. On the monetary purpose of EF, CE/HKMA said that in order to provide full backing for the

Date of meeting	Members' major views	Administration's responses
		current monetary base of HK$220 billion, it was necessary for Hong Kong to maintain the level of foreign reserves at US$28 billion, i.e. the theoretical minimum. However, HKMA had utilized about US$38 billion to defend the Hong Kong dollar against the attacks on the currency in 1998. The amount was over three times of the then theoretical minimum of US$12 billion. While it was difficult to derive a scientific formula for determining the appropriate level of foreign reserves, given that Hong Kong was a small economy with an entirely open market, it would be prudent to maintain a level of foreign reserves well above the theoretical minimum to meet possible vulnerabilities and associated risks.
7 May 2001	Members generally were of the view that as Hong Kong had accumulated huge fiscal reserves of over HK$440 billion, there was considerable room for the Government to earmark more public funds for programmes to improve the livelihood of the general public and to stimulate the economy. However, members noted that in his 1998-99 Budget Speech, FS had defined three purposes for which the fiscal reserves were needed, namely to meet operating, contingency and monetary requirements. The guidelines adopted by the Government in determining the appropriate level of fiscal reserves was the total of 12 months' government expenditure and the Hong Kong	Secretary for the Treasury (S for Tsy) said that the fiscal reserves had been used to finance budget deficits. For instance, the deficit of HK$23.2 billion in 1998-99 and the estimated deficit of $7.8 billion in 2000-01 were financed by drawing down the reserves. Moreover, the investment income of the reserves gained each year was used to fund government expenditure. S for Tsy emphasized the importance of maintaining fiscal prudence in the management of public finances through maintaining adequate fiscal reserves. She cautioned that an unhealthy fiscal position would undermine international confidence and lower the credit rating of Hong Kong. This would raise borrowing costs for

Date of meeting	Members' major views	Administration's responses
	dollar money supply under the M1 definition, allowing a margin of plus or minus 25%. The Administration had explained in the Special Finance Committee meetings held in March 2001 that in order to maintain fiscal prudence in the management of public finances, the Government had to maintain the fiscal reserves at a level within the guidelines. Ms Emily LAU said that there had been no public consultation on the 1998 guidelines on the fiscal reserves and that some reputable academics and experts had commented that the guidelines were inappropriate. She considered that it was high time for the Government to review the guidelines. Ms LAU urged the Government to make reference to the practice of the US Government to undertake regular review on the level of fiscal reserves. She referred to the comments of the US Congress which recognized the importance of using fiscal reserves for the betterment of the economy, and as a means to enhance economic efficiency and to improve the livelihood of the general public.	business and affect economic growth adversely. In respect of the 1998 guidelines, S for Tsy said that while she was not aware of any criticisms from economists or strong objection within the community when the guidelines were announced, the said guidelines were subject to ongoing reviews. However, any guidelines for determining the level of fiscal reserves should not be subject to frequent changes which might adversely affect the credibility of Government's fiscal policy. Bearing in mind changes in the economy since the said guidelines were adopted in 1998 and the views expressed by the public recently, the Government would conduct a review. It would keep an open mind and welcome any views on the subject. On Ms LAU's suggestion for the Government to make reference to the US practices in maintaining its fiscal reserves, S for Tsy said that due to differences in the nature and size of the two economies, it would be inappropriate to make a direct comparison of the fiscal policies of Hong Kong and the US.
	Mr TSANG Yok-shing questioned the rationale for the 1998 guidelines. Noting that there was a big increase in the fiscal reserves in 1997-98 as a result of the transfer of HK$197.1 billion from the Hong Kong Special Administrative Region Government Land Fund to	Regarding actions which the Government would take when the upper limit of the fiscal reserves level was reached, S for Tsy said that a range of measures could be considered to enable the public to reap the benefits of economic prosperity. These included introducing tax concessions,

Date of meeting	Members' major views	Administration's responses
	the reserves on 1 July 1997, he was of the view that the 1998 guidelines were to rationalize the retention of this vast amount of public money under the fiscal reserves. He further asked what actions the Government would take when the upper or lower limit of the fiscal reserves level was reached.	reducing fees and charges, etc. However, the Government expected that the problem of operating deficits would continue in the next few years. Therefore, it was unlikely that the upper limit would be reached. On the other hand, it was still unclear whether the problem of operating deficits was cyclical or structural in nature. The Government's Task Force on Review of Public Finances would continue to examine the matter.
	Mr LEE Cheuk-yan considered that as the current level of EF had reached HK$1,000 billion, which was well above the level required to provide full backing for the current monetary base of HK$220 billion to maintain the stability of the Hong Kong dollar, the need of the fiscal reserves for meeting this monetary purpose had already been met. Members considered that EF was also public money and should be used for the interests of the people of Hong Kong. Mr James TIEN suggested that the accumulated surplus of EF which amounted to over HK$300 billion should be used to finance public programmes. Members considered that there should be flexibility for transferring money from EF to the general revenue. Mr Albert HO specifically asked whether there were provisions under the Exchange Fund Ordinance (EFO) (Cap. 66) to cater for this purpose.	S for Tsy said that EF and the fiscal reserves were invested together by the Hong Kong Monetary Authority, but they were two separate entities. With effect from April 1998, the fiscal reserves placed with EF enjoyed the same rate of investment return achieved by the entire EF in a year. The decision to place the fiscal reserves with EF for investment purpose rested entirely with the Government. S for Tsy further explained that the use of EF was governed by EFO which stipulated FS as the controller of the Fund. The annual investment income of EF and the accumulated surpluses were not treated as recurrent income of the Government.
4 June 2001	Mr LEE Cheuk-yan considered that the best way to stimulate the	FS emphasized the importance of maintaining fiscal prudence in the

Date of meeting	Members' major views	Administration's responses
	economy was to increase Government spending. In view of the two constraints imposed by the Basic Law which required the Government to keep its expenditure within the limits of revenue and to keep the budget commensurate with the growth rate of GDP, Mr LEE asked whether the Government would consider using the abundant fiscal reserves to fund new initiatives in order to improve the livelihood of the general public. His views were shared by Mr SIN Chung-kai and Mr David CHU. They were of the view that increased Government spending would provide immediate relief to people and would be beneficial to economic recovery.	management of public finances which meant achieving fiscal balance over the medium term, avoiding recurrent operating deficits in the Government account, and maintaining adequate fiscal reserves. Recurrent operating deficits and unhealthy fiscal reserves position would undermine international confidence and lower the credit rating for Hong Kong. This would also raise borrowing costs for businesses and adversely affect economic growth. Nevertheless, FS shared Members' view that there would be room for the Government to spend more on non-recurrent services to address the immediate needs of the community, such as to create more employment opportunities and to upgrade human capital. He welcomed any views in this respect. FS also advised Members that he was aware of public concern about the appropriateness of the guidelines for determining the level of fiscal reserves which was set out in the 1998 Budget Speech. The Government kept the guidelines under review and he welcomed views from Members and the public on the subject.
4 Feb 2002	On the subject of fiscal reserves, Ms Emily LAU said that while she appreciated the need to maintain adequate reserves to ensure currency stability and hence the overall stability of the local financial system, the Government's reserves should be properly utilized to provide economic relief to the general	In response, CE/HKMA said that it was highly difficult, if not impossible, to determine at what respective levels EF surplus and the fiscal reserves could be regarded as adequate to ensure financial stability. Theoretically, under our currency board system, the basic requirement was to maintain an

Date of meeting	Members' major views	Administration's responses
	public. She observed that apart from the fiscal reserves of some $380 billion, there was also an accumulated surplus of about HK$300 billion in EF. Given these large sums of reserves/surplus, she considered that there should be room to manoeuvre and spend some of the reserves/surplus to benefit the community at this difficult time. She sought CE/HKMA's view on what levels of fiscal reserves and accumulated surplus of the Exchange Fund could be considered as adequate for maintaining the stability of the local financial system.	amount of foreign reserves to provide full backing for the monetary base. But the 1997-98 Asian financial crisis had revealed that a much higher level of foreign reserve than the theoretical minimum of 100% backing for the monetary base might need to be mobilized at times to protect the Link and stabilise the financial market. CE/HKMA pointed out with the influence of globalization, financial markets were subject to swift changes and the overall situation was getting more vulnerable. After the Asian financial crisis in 1997-98, many economies in the region had introduced stringent capital control measures to protect their financial and economic systems. Hong Kong, however, could not put in place any such measures amounting to exchange controls. Therefore, the local financial markets were subject to greater risks posed by external factors than other Asian economies. Hence, there was the on-going possibility that a much higher level of funds in excess of the theoretical minimum level of foreign reserves had to be called upon to deal with contingencies when they arose. CE/HKMA said that in a nutshell, he considered that the greater amount of funds in EF available for disposal, the greater the protection could be afforded to the Link and the stability of Hong Kong's financial system.

Date of meeting	Members' major views	Administration's responses
	Ms Emily LAU queried the basis for CE/HKMA's view that the accumulated surplus of EF should also be used to safeguard currency stability, and that it was always better to maintain as much accumulated surplus as possible in the Exchange Fund. In this regard, she queried whether there were any objective and scientific factors to support CE/HKMA's view.	In response, CE/HKMA advised that it was not possible to devise a scientific basis for determining the "adequate" level of funds for disposal in EF, given the high volatility of the global as well as local financial markets. This was evident in the 1997-98 Asian financial crisis. He was particularly worried that currency stability could be undermined if the accumulated surplus of EF was drawn down for economic relief measures. He also remarked that the state of public finance in Hong Kong and the ability of the Government/HKMA in maintaining robust reserves had considerable impact on market confidence in the stability of the local currency.
6 May 2002	Mr SIN Chung-kai recalled that during HKMA's last briefing in February 2002, some members had requested HKMA or the Administration to consider alternative arrangements for the fiscal reserves placed with EF in sharing the annual investment return to EF in order to reduce the volatility in the annual return to the fiscal reserves. He enquired about the progress of discussion on this matter.	CE/HKMA said that a number of alternative arrangements were available for calculation of annual return to the fiscal reserves, such as reverting to the "deposit" arrangement, or using a three-year moving average of the rate of investment return. He had given his views on the matter to FS. CE/HKMA stressed that the final decision was with FS and not HKMA.
4 Nov 2002	Mr Albert HO enquired whether HKMA would consider transferring part of EF accumulated surplus to the fiscal reserves so as to bolster the Government's financial position and help alleviate the problem of fiscal deficits.	On the relationship between the fiscal reserves and EF, CE/HKMA explained that they were distinct from each other. Whilst the Government placed its fiscal reserves in EF and received returns annually, EF's accumulated surplus was the profits accumulated from investment of EF over the past

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		years since the establishment of the Fund. Such surplus had formed part of EF for backing the Hong Kong dollar and the Linked Exchange Rate system. As regards the proper use of EF's accumulated surplus, CE/HKMA advised that the Fund had more than sufficient foreign exchange assets to back the monetary base. However, in defending the Hong Kong dollar against currency attacks in 1998, the Government had to deploy substantial amounts of funds in EF. This indicated the need to maintain a level of reserves in excess of the size of the monetary base. As such, HKMA would be concerned with using EF's accumulated surplus to address the fiscal deficit problem. Nonetheless, CE/HKMA stressed that the control of EF rested entirely with FS. According to section 8 of the EFO, FS, with approval of the Chief Executive in Council, could transfer funds from EF to the general revenue of the Government after satisfying certain conditions, such as having regard to the purposes of EF and the possible impacts on the stability of the monetary and financial system, as stipulated in section 3 of EFO. CE/HKMA added that he would offer his views to FS in this respect if such a decision were made to use section 8 of EFO.
	Sharing the views of Mr Albert HO, Ms Emily LAU opined that for the benefit of members, HKMA should provide a paper explaining the mechanism	CE/HKMA reiterated that the control of EF rested with FS. He would consult FS before providing the paper to the Panel.

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	for effecting the transfer of funds from EF, the factors to be considered during the process, and the possible implications involved.	(Note: The information paper was circulated to members vide LC Paper No. CB(1)410/02-03 on 29 November 2002.)
5 May 2003	Noting CE/HKMA's comment that it was appropriate to use fiscal reserves for relieving the impact of SARS on the economy, Ms Emily LAU sought his views on the public call for revising the revenue proposals in the 2003-04 Budget to help revive the economy.	In reply, CE/HKMA stressed that the use of fiscal reserves for relieving the economy and tackling the deficit problem were two separate issues. While he considered it reasonable to use the fiscal reserves in a one-off manner for relieving the economy from shock caused by unusual circumstances like the SARS crisis, there should not be delay in tackling the problem of structural deficit. As it was important for the Government to demonstrate to the international community its ability and determination in resolving the deficit problem, any delay in implementing the proposed measures would be undesirable. On whether the revenue proposals in the 2003-04 Budget should be revised, CE/HKMA said that he was not in a position to give comment as the matter was outside the purview of HKMA.
2 Feb 2004	Members noted that EF had gained a sizable net investment income of $83.4 billion in 2003, with $25.7 billion as fiscal reserves' share and $57.7 billion added to the accumulated surplus of EF. As at end of December 2003, the accumulated surplus of EF amounted to $384.9 billion. Mr LEE Cheuk-yan considered that it was high time to review how the accumulated surplus of EF should be used. In his view,	In response, CE/HKMA said that as the accumulated surplus of EF belonged to the people of Hong Kong, it was justified to use it for their benefit. In this connection, CE/HKMA pointed out that as provided for in EFO, EF was under the control of FS and such control should be exercised in consultation with the Exchange Fund Advisory Committee (EFAC). EFO also provided that apart from using EF for its

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	the sum of money should be used for the benefit of the general public. He therefore urged the Administration to consider using the accumulated surplus of EF for 2003 to address the budget deficit problem and to relieve the financial hardship of the general public. Ms Emily LAU shared Mr LEE Cheuk-yan's view and requested the Administration to consider how the accumulated surplus of EF could be used for the benefit of the general public.	primary purpose, FS might, with a view to maintaining Hong Kong as an international financial centre, use EF as he thought fit to maintain the stability and the integrity of the monetary and financial systems of Hong Kong. Moreover, FS might, after consulting EFAC and in accordance with section 8 of EFO, transfer from EF to the General Revenue any sum or part of any sum where he was satisfied that such transfer was not likely to affect adversely his ability to fulfil any purpose for which EF was required to be or might be used under EFO. Responding to Mr LEE Cheuk-yan's enquiry, CE/HKMA said that while it was difficult to determine the appropriate level of EF to be maintained, currency crises in the past had indicated that a sizable EF was vital for Hong Kong to withstand currency attacks and external shocks. From the point of view of the Monetary Authority, it was appropriate to adopt a prudent approach in maintaining the level of EF. Responding to Ms Emily LAU's enquiry, CE/HKMA explained that the fiscal reserves placed with EF were absorbed under the item of "Placements by other HKSAR government funds" in Chart 52. He also pointed out that before 1998, the fiscal reserves placed with EF received fixed interest returns. It was agreed in 1998 that from then on the fiscal reserves placed with EF

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		would receive the same variable rate of investment returns as other parts of the Fund.
	Noting that EF was under the control of FS, Mr LEE Cheuk-yan urged FS to consider utilizing the $57 billion surplus of EF for 2003 to address the budget deficit problem and to relieve the financial hardship of the general public. He was of the view that the strong financial position of EF (total assets of EF was over $1,000 billion as at 31 December 2003) was sufficient for maintaining the stability of Hong Kong dollar. Ms Emily LAU pointed out that there had been increasing public concern about the adverse impacts of the reduction in public expenditure on the public, in particular on the less privileged class. Ms LAU concurred that Mr LEE's proposal was a viable means to address the problem of budget deficit.	In response, FS advised that with a view to enhancing transparency of the financial performance and position of the Government and promote greater awareness of public finance in the community, the Administration had started publishing accrual-based accounts in this financial year. The accrual accounts for 2002-03 published in January 2004 had included the accounts of EF with details of the fiscal reserves and investment returns. The assets in EF were recognized as assets of the Government, which were owned by Hong Kong people. FS stressed the need for the Government to adopt a prudent approach in setting the appropriate level of EF to be maintained and to boost the financial position of EF for the purposes of maintaining the stability of Hong Kong dollar and the monetary and financial systems in Hong Kong. He considered it not prudent at this point in time to utilize the accumulated surplus of EF for meeting Government operating deficits. Despite that the promising investment performance of EF in 2003 had boosted the financial position of the Fund, the investment outlook for 2004 remained uncertain and was expected to be difficult. It was unlikely that EF could achieve the good returns seen in 2003. Moreover, deploying the accumulated surplus of EF to

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		meet Government operating deficits would not tackle the budget deficit problem at root.
1 Nov 2004	Mr SIN Chung-kai expressed the Democratic Party's view that given the increase in the level of EF since 1998, the share of investment return for the fiscal reserves placed with EF should be increased. He also suggested that the Administration should consider deploying part of EF's net investment income gained for a year to meet Government expenditure.	On the suggestion of using part of EF's net investment income for meeting Government expenditure, CE/HKMA advised that as provided under EFO, EF was under the control of FS. EFO also provided that apart from using EF for its primary purpose, FS might, with a view to maintaining Hong Kong as an international financial centre, use EF as he thought fit to maintain the stability and the integrity of the monetary and financial systems of Hong Kong. Moreover, FS might, after consulting EFAC and in accordance with section 8 of EFO, transfer from EF to the General Revenue any sum or part of any sum where he was satisfied that such transfer was not likely to affect adversely his ability to fulfil any purpose for which EF was required to be or might be used under EFO. As regards the appropriate level of EF to be maintained, CE/HKMA stressed that given the volatility in the global financial market and that Hong Kong was a small and externally oriented economy, a sizable EF was vital for Hong Kong to withstand currency attacks and external shocks. In his view as the MA, it was necessary to adopt a prudent approach in maintaining the level of EF.
17 Feb 2005	Mr CHAN Kam-lam also expressed concern that the	CE/HKMA appreciated the merits of providing a stable revenue

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	investment income of EF was subject to volatility and uncertainties in the global financial markets. As a result, there might be fluctuation in the share of investment income for the fiscal reserves placed with EF, thus creating difficulty for the Government to project the annual investment return for the fiscal reserves. In order to reduce volatility in the investment return for the fiscal reserves and to provide a more stable revenue source for the Government, Mr CHAN considered that the Administration should consider adopting a five-year average rate of investment return of EF as the rate of return for the fiscal reserves placed with EF.	source for the Government and agreed to convey the suggestion to FS.
	Miss Mandy TAM enquired whether the Administration would consider changing the existing arrangement under which the fiscal reserves shared the same rate of investment return achieved by the entire EF in a year.	In response, CE/HKMA advised that the existing arrangement was introduced in 1998. Over the years, the arrangement had on average generated greater return for the fiscal reserves. It might be inappropriate to revise the rate of return for the fiscal reserves upward as this would result in the investment return of EF subsidizing that of the fiscal reserves.
	Noting that the accumulated surplus of EF amounted to $423.4 billion at the end of 2004, Ms Emily LAU considered that it was high time for the Administration to consider deploying part of the accumulated surplus to meet Government expenditure and to finance new initiatives, such as the programmes for combating	In response, CE/HKMA explained that fiscal reserves were placed with EF for investment purpose. On the balance sheet of EF, the fiscal reserves were regarded as liability of EF, while the accumulated surplus was regarded as fund equity of EF. He stressed that the assets in EF were recognized as assets of the Government, which were owned

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	poverty. Mr LEE Cheuk-yan shared her view. Whilst appreciating that maintaining a strong financial position of EF would facilitate the work of HKMA in maintaining monetary stability in Hong Kong, Mr LEE was of the view that part of the accumulated surplus of EF should be transferred to the General Revenue for meeting Government expenditure and for the benefit of the public. He was also concerned about the appropriate level of EF to be maintained. Mr LEE Cheuk-yan suggested that the Panel should consider inviting FS to discuss with members on how the accumulated surplus of EF should and would be used. Ms Emily LAU supported Mr LEE's suggestion. The Chairman said that he would convey the suggestion to FS.	by people of Hong Kong. In his view, it was justified to use these assets for the benefit of the public. CE/HKMA however reiterated that the use of EF was governed by EFO. Apart from the primary purposes of EF, FS might, after consulting EFAC and with the prior approval of the Chief Executive in Council, transfer from EF to the General Revenue any sum or part of any sum where he was satisfied that such transfer was not likely to affect adversely his ability to fulfil any purpose for which EF was required to be or might be used under EFO. As regards the appropriate level of EF to be maintained, CE/HKMA stressed that it would be extremely difficult, if not impossible, to devise a scientific formula for determining such level. Given the volatility in the global financial market and that Hong Kong was a small and externally oriented economy, a sizable EF was vital for Hong Kong to withstand currency attacks and external shocks. As the Monetary Authority, CE/HKMA considered it necessary to adopt a prudent approach in maintaining the level of EF.
6 June 2005	Ms Emily LAU and Mr LEE Cheuk-yan referred to the motion on investment income of the EF passed at the LegCo meeting on 1 June 2005 urging the Administration to review the existing methodology for sharing EF's investment income and	FS advised that according to Article 113 of the Basic Law, EF should be managed and controlled by the Government primarily for regulating the exchange value of the Hong Kong dollar. The EFO also stipulated this as the primary purpose of EF. Moreover, EF

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	allocate more investment income to the Government. They expressed disappointment that despite Members' consensus on the subject, FS had not taken on board Members' views.	might also be used by FS to maintain the stability and the integrity of the monetary and financial systems of Hong Kong with a view to maintaining it as an international financial centre. FS recapped the existing mechanism for sharing EF's investment income whereby the annual rate of return of fiscal reserves placed with EF was linked to the rate achieved by the entire EF. On the motion passed at the LegCo meeting on 1 June 2005, FS pointed out that while Members were of the view that more investment income of EF and part of the accumulated surplus of EF should be transferred to the general revenue, there was no consensus among Members as to how the transferred income should be used. FS stressed that while the investment return on fiscal reserves placed with EF had been a source of income for the Government, the investment return of EF was volatile and unpredictable. Hence, the transferred arrangements suggested by Members at the motion debate (such as setting a fixed rate of return; allocating a fixed amount to the Government; or setting a reasonable rate of return which would be subject to periodic review etc.) might not in practice achieve a stable return on the fiscal reserves in EF.

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	Ms Emily LAU and Mr LEE Cheuk-yan considered that while Members had different suggestions on the use of the accumulated surplus of EF, it was clear that there was a consensus among Members that part of the accumulated surplus should be transferred to the general revenue. Ms LAU and Mr LEE urged FS to respect Members' consensus and seriously consider Members' views before deciding on the way forward. Ms LAU suggested that FS should discuss the subject with the new Chief Executive.	FS assured Members that the Administration would constantly review the arrangements of sharing EF's investment income with due regard to the needs for maintaining the resources of EF for safeguarding the stability of the Hong Kong dollar and for ensuring a reasonable and stable investment return for the fiscal reserves. He stressed that the Administration would continue to maintain the fiscal discipline in managing public finance as enshrined in Article 107 of the Basic Law.
6 Feb 2006	Mr CHAN Kam-lam was concerned whether CE/HKMA had explored with FS possible means to improve the existing sharing arrangement for determining the Treasury's share of the investment income of EF	CE/HKMA responded that under the existing sharing arrangement, the Treasury's share of the investment income of EF fluctuated from year to year and might not always meet the Treasury's projected return. Nevertheless, having regard to the difference in the investment strategy of EF from other investment funds, assessment of its investment return should not be made only on the basis of whether the target set by the Treasury was met.
4 May 2006	Mr CHAN Kam-lam said that consideration should be given to changing the arrangement of sharing of investment income with the Treasury, e.g. by using an average of the actual returns over the last five years. Miss TAM Heung-man expressed support for the option of charging an annual fixed fee on EF as the Treasury's share of return. Mr SIN Chung-kai asked whether HKMA had explored with the	CE/HKMA advised that while the existing arrangement might generate different levels of income for the Treasury because of volatilities in different years, the arrangement before 1998-99, which was based on a fixed rate of interest, might ensure a more stable income for the Treasury. Nevertheless, there were pros and cons in both the existing and past arrangements (i.e. higher return or more stability). CE/HKMA

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	Administration the alternatives for sharing the investment income with the Treasury in order to ensure more stable investment income for transfer to the General Revenue.	opined that charging an annual fixed fee on EF might be a feasible option as it could relieve the pressure for achieving the estimated return, hence reducing the reputation risk of HKMA where the estimated return could not be achieved. In working out the annual fee to be charged on EF, the principles of objectivity and reasonableness should be observed. The decision on any change to the existing arrangement would ultimately vest with FS as the Controller of EF. He had discussed the merits of different options with FS.
6 Nov 2006	As the accumulated surplus of EF and the placement by the fiscal reserves to EF amounted to nearly $800 billion, Ms Emily LAU raised concern about the mechanism for transfer of income from EF into the general revenue as well as what constituted an "appropriate" level of reserves.	CE/HKMA advised that the mechanism for transfer of EF to the general revenue or other funds had been specified under section 8 of EFO. CE/HKMA said that he had held discussion with FS on the subject of the appropriate level of foreign reserves. FS advised that as the Controller of EF, he was responsible for ensuring that the statutory objectives of EF would be achieved. Given the primary objective of EF to maintain currency stability, an adequate level of foreign reserves must be maintained to preserve local and overseas confidence in the Hong Kong dollar. EF's ability to meet its objective would be reviewed from time to time taking into account the changing international monetary environment and the latest developments of the financial markets.

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	Miss TAM Heung-man was of the view that the existing arrangement for sharing the investment income of EF with the Treasury should be improved with a view to providing a higher return on the placement by fiscal reserves.	CE/HKMA referred members to the past sharing arrangement which was based on the payment of a fixed rate of interest to the fiscal reserves. However, it had been changed into the existing arrangement since 1998-99.
	The Chairman opined that to secure more stable government revenue, FS should explore with CE/HKMA possible changes to the existing arrangement of sharing of investment income of EF with the Government. One option might be to fix an annual fee as the Government's share. The Chairman recalled that this and other suggestions had been put forward to FS for consideration some time ago but no progress had been announced so far.	FS pointed out that despite the volatility of the financial markets in the last three years since he had taken office, there had not been significant variations in the Government's share of EF's investment income (which was $14.7 billion, $10.4 billion and a forecast of $18.2 billion in 2004-05, 2005-06 and 2006-07 respectively). He had examined with CE/HKMA from time to time feasible options for achieving a more stable return from the fiscal reserves placed with EF, such as investing part of EF in higher return financial instruments without undermining the objective of safeguarding currency stability; or setting a fixed amount of annual return for the Government. In this connection, FS highlighted that any change to the existing sharing arrangement would be a significant policy change which should not be resorted to lightly in order not to pre-empt the policy decision of the next term of Government.
	Given that Hong Kong did not have to bear expenses in areas like national defence and was by and large free from devastating natural disasters, Mr James TIEN was of the view that	FS said that contrary to common perception, national defence did not take up a very substantial portion of government expenditure. For example, the expenditure of the United States

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	transferring part of the accumulated surplus of EF to the general revenue would provide the Government with the necessary financial resources to cope with future economic downturns. Such an arrangement would also remove any imminent need on the part of the Government to broaden the tax base for the purpose of seeking sustainable revenue.	in this area only amounted to about 4% of its GDP. The Government was committed to keeping public expenditure within an appropriate percentage of Hong Kong's GDP. At present, the public expenditure was equivalent to about 17.7% of GDP, which was within fiscal targets.

Council Business Division 1
Legislative Council Secretariat
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