LCQ3: Making good use of assets of Exchange Fund

Following is a question by the Hon Chung Kwok-pan and a reply by the Secretary for Financial Services and the Treasury, Mr Christopher Hui, in the Legislative Council today (May 5):

Question:

As at December 31 last year, the total value of the assets of the Exchange Fund (EF) stood at about $4,500.7 billion and the accumulated surplus reached $852.4 billion. In this connection, will the Government inform this Council:

(1) whether it has forecasted the level at which the total value of the EF assets needs to be kept in each of the coming five years for it to be sufficient for maintaining Hong Kong's monetary and financial stability;

(2) as it is expected that fiscal deficits will be recorded in the coming few years, whether the Government will review the method for calculating the return that can be obtained from the fiscal reserves placed with EF and the mechanism for transferring funds from EF to the General Revenue Account, with a view to improving the Government's financial position; if so, of the details; if not, the reasons for that; and

(3) as the Coronavirus Disease 2019 epidemic has dealt a heavy blow to Hong Kong's economy and people's livelihood, whether the Government will consider deploying the accumulated surplus of EF for implementing measures to relieve people's hardship, facilitate employment and stimulate the economy?

Reply:

President,

Upon consultation with the Hong Kong Monetary Authority, the Government's reply to the various parts of the question raised by Hon Chung Kwok-pan is as follows:

(1) and (3) The major uses of the Exchange Fund (EF) are stipulated in both the Basic Law and the Exchange Fund Ordinance (Cap. 66) (the Ordinance). According to Article 113 of the Basic Law, the EF is primarily used for regulating the exchange value of the Hong Kong dollar. It is also stipulated in the Ordinance that the EF is used primarily for the purpose of affecting either directly or indirectly the exchange value of the Hong Kong dollar. It also has a secondary purpose of maintaining the stability of Hong Kong's monetary and financial systems with a view to maintaining Hong Kong as an international financial centre.

As at end-March 2021, the total assets of the EF stood at about HK$4,500 billion. The accumulated surplus of the EF, however, only amounted to about HK$830 billion, after taking into account its liabilities.

The global economy and the financial market are volatile and unpredictable. Being a small and open economy, Hong Kong needs to be well-prepared for tackling different kinds of potential financial risks. Therefore, we must have a considerably sizable EF with a high level of liquidity to maintain monetary and financial stability, maintain the confidence of the market and the public in the EF and the financial system, and combat shocks to or attacks on the financial market effectively, thereby safeguarding the stability of the financial system. In fact, the EF has served the key role in providing a buttress for safeguarding Hong Kong's monetary and financial stability in face of external shocks or unexpected blows in the past decades.

Though it is stipulated in the Ordinance that the Financial Secretary may make transfers from the EF under certain conditions, the assets of the EF are important in supporting our Linked Exchange Rate and stabilising the Hong Kong dollar exchange rate. Taking it lightly to use the EF to meet government expenditure will severely undermine its ability to perform its main function, which is to safeguard Hong Kong's monetary and financial stability. This will also send a wrong message to the market that the Hong Kong Special Administrative Region Government is no longer observing strict fiscal discipline and hence undermine people's confidence in the Linked Exchange Rate System.

The fiscal reserves of the Government are the fruits of the economic development of Hong Kong and the hard work of our people over the years. This makes the Government financially capable of meeting challenges by adopting measures to support the economy and relieve people's burden amid the prevailing economic downturn. At end-March 2021, the consolidated balance of the fiscal reserves stood at more than $920 billion, equivalent to about 14 months of government expenditure. In order to provide relief from the impact of the economic downturn and the pandemic to the public and various businesses, counter-cyclical measures totalling over $120 billion have been announced in this year's Budget. It is hoped that these measures could strengthen the support to the economic development and hence benefit the overall economy as much as possible.

In light of the above, the EF and the fiscal reserves have different uses and serve different purposes. We consider there is no need to change the established operating mechanism of the EF, any change of which might seriously affect the monetary and financial stability in Hong Kong.

(2) The Government has placed its fiscal reserves with the Investment Portfolio of the EF in order to earn a return. Under the existing arrangements, the investment return of the fiscal reserves is calculated based on the average annual rate of return of the EF's Investment Portfolio for the past six years. There is also a guaranteed minimum return to ensure capital preservation and that the investment return in any year will not be

lower than the average annual yield of three-year Government Bond for the previous year. The investment return of the Government's fiscal reserves is transferred to the General Revenue Account or various funds depending on the sources of funding. The existing investment arrangements enable the Government's fiscal reserves to yield a more stable return and achieve capital preservation. The Government will continue to monitor the investment situation and review the relevant arrangements as necessary.

Under the said existing arrangements, as the EF pays investment return to the Government based on the average annual rate of return of its Investment Portfolio for the past six years, the EF would need to make use of its accumulated surplus to pay investment return to the Government in case the EF has a loss or insufficient investment income in any financial year, leading to a shrinkage of the accumulated surplus of the EF. This has happened before in 2015 and 2018. Therefore, the decision to alter the arrangements for payment between the EF and the Government should not be made lightly in order to ensure prudent risk management in respect of investments of the EF.

Apart from the placements with the EF's Investment Portfolio, the Government established the Future Fund (FF) in 2016, which is a notional savings account held within the fiscal reserves for securing higher returns through long-term investments for a period of 10 years. The annual composite rates of return of the FF for the period from 2016 to 2020 were 4.5 per cent, 9.6 per cent, 6.1 per cent, 8.7 per cent and 12.3 per cent respectively.

The investment return of the FF forms an integral part of public financial resources, and has accumulated to more than $100 billion. The Financial Secretary has therefore decided to reflect the cumulative investment return of the FF in the Operating Account on a progressive basis starting from 2021-22, with $25 billion brought back in the first year.

Moreover, the Government has decided to use part of the FF to set up the Hong Kong Growth Portfolio for direct investments in projects with a "Hong Kong nexus", and preparation for implementation is under way.

I am now ready to answer questions from Members.

Thank you, President.