Information Note for
Legislative Council Panel on Financial Affairs

Accumulated Surplus of the Exchange Fund

<u>Introduction</u>

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.

<u>Statutory provisions</u>

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.

Hong Kong Monetary Authority
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