

Reserves Management

Hong Kong's official reserves, held in the Exchange Fund, serve 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. Hong Kong's foreign currency assets stood at US\$89.6 billion at the end of 1998, making them the fourth largest in the world. Prudent management by the HKMA during a year of considerable volatility resulted in a high profitability for the Exchange Fund investments in 1998. The accumulated surplus of the Exchange Fund grew by 27.5%. This is the highest growth rate for the accumulated surplus of the Exchange Fund since the establishment of the HKMA in 1993.

Objectives

At \$694.3 bn, or \$102,020 for every person in Hong Kong, the official reserves of Hong Kong represent a very significant store of value for the people of Hong Kong. These official reserves include foreign currency assets amounting to US\$89.6 bn at the end of 1998, which placed the Hong Kong SAR Government's foreign currency reserves as the fourth largest in the world, after Japan, the Mainland of China and Taiwan.

The purpose of the Exchange Fund is to safeguard the exchange value of the currency of Hong Kong and to maintain the stability and integrity of the monetary and financial systems. The crucial lessons from the excessive volatility that rocked the financial markets in 1998 highlight the importance of prudent management of the Fund and the critical role of risk management in the investment process. In managing

the official reserves, the HKMA has taken every care to ensure that the returns are achieved with low risk, minimum volatility and in accordance with an investment process which is in line with international best practices.

A new asset allocation strategy

At the beginning of 1999, the Exchange Fund adopted a new long-term asset allocation strategy. This asset allocation strategy, known commonly as an investment benchmark, is presented in Table 12 below:

Table 12 New investment benchmark of the Exchange Fund

	New investment benchmark	Previous investment benchmark
Bonds	80%	90%
Equities	20% (Hong Kong: 5%)	10% (Hong Kong: 0%)
Currencies	80% US\$-bloc	70% US\$-bloc
	15% European-bloc	20% European-bloc
	5% Yen	10% Yen

The investment benchmark, which directs the long-term strategic investment of the Exchange Fund, is derived from the investment objectives of the Exchange Fund. In April 1998, a new arrangement was adopted to determine the return on the fiscal reserves placed with the Exchange Fund. These fiscal reserves now enjoy a return achieved by the Exchange Fund as a whole. In November 1998, the assets of the Land Fund were merged into the Exchange Fund. In view of these developments, a review of the investment objectives and long-term asset allocation strategy of the Exchange Fund was both necessary and timely.

The new investment benchmark of the Exchange Fund is an optimal mix of assets designed to meet the following investment objectives:

1. to preserve capital;
2. to ensure that the entire monetary base will be at all times fully backed by highly liquid short-term US dollar denominated securities;
3. to ensure sufficient liquidity for the purpose of maintaining monetary and financial stability; and
4. subject to (1) – (3) above, to achieve an investment return that will preserve the long-term purchasing power of the assets.

The Exchange Fund

The Exchange Fund was established in 1935. Since its inception, the fund has held the backing to the note issues of Hong Kong. In 1976, the backing for coins issued and the bulk of the foreign currency assets held in the government's General Revenue Account were also transferred to the Exchange Fund.

In the past, to minimise risk, fiscal reserves were placed as deposits with the Exchange Fund in return for market interest rates. However, as the official reserves have grown dramatically over the years, it was decided that these fiscal reserves should be more actively managed to achieve a higher long-term real rate of return. Therefore, effective from 1 April 1998, the fiscal reserves previously placed as Hong Kong dollar deposits with the Exchange Fund became actively managed and the return of these official reserves was linked to the performance of the overall Exchange Fund. Under this arrangement, the Financial Secretary may also declare a special dividend from the Exchange Fund if necessary to maintain the real value of that portion of the fiscal reserves which is kept for the purpose of enhancing monetary stability. In order to preserve the long-term purchasing power of the assets of the Exchange Fund, the new investment benchmark includes a 20% allocation to equities, of which 5% will be allocated to the Hong Kong equity market.

In early September, the monetary base was re-defined to include Exchange Fund Bills and Notes in addition to Certificates of Indebtedness, coins in circulation and the aggregate clearing balance maintained by banks with the HKMA. It was also decided to increase the transparency of the operation of the currency board arrangements by designating certain asset and liability items in the Exchange Fund balance sheets as those relating to the currency board operations. This led to the establishment of a Backing Portfolio to hold short-term, highly liquid US dollar denominated securities to fully back the monetary base. Accordingly, the portfolio composition of the

Exchange Fund was re-organised into a Backing Portfolio and an Investment Portfolio.

Merger of the assets of the Land Fund into the Exchange Fund

The Hong Kong SAR Government Land Fund Trust was established on 13 August 1986 to facilitate the management of the Hong Kong SAR's share of revenue obtained from land sales during the period from the entry into force of the Joint Declaration, on 27 May 1985, until China's resumption of the exercise of sovereignty on 1 July 1997.

Upon the establishment of the Special Administrative Region on 1 July 1997, the assets of the Land Fund Trust were vested in the Hong Kong SAR Government. The Chief Executive of the Hong Kong SAR appointed the Financial Secretary as the public officer to receive, hold and manage the fund, as part of the Hong Kong SAR Government reserves. Subsequently, the Land Fund was established by resolution made and passed by the Provisional Legislative Council under section 29 of the Public Finance Ordinance. Between 1 July 1997 and 31 October 1998, under the direction of the Financial Secretary, the fund was managed by the HKMA as a portfolio separate from the Exchange Fund. Effective 1 November 1998, the assets of the Land Fund were merged into the Exchange Fund and managed as part of the Investment Portfolio of the Exchange Fund. In addition to meeting the objectives of minimising risks while maximising investment returns, the merger serves to achieve administrative efficiency and economies of scale by allowing effective deployment of resources within the HKMA as a whole.

Following the merger, the Land Fund remains a separate government fund to be managed in exactly the same way as other fiscal reserves which are placed with the Exchange Fund. This will enable the Land Fund to achieve a more optimal and stable investment return under profit sharing arrangements similar to those for the fiscal reserves placed with the Exchange Fund. Furthermore, the Land Fund will continue to be administered in accordance with the Resolution of the Provisional Legislative Council in July 1997. The alignment exercise will not pre-empt consideration of the long term use of the Land Fund, and any proposal in this regard is subject to approval by the Legislative Council in accordance with the Resolution establishing the Land Fund.

The acquisition of Hong Kong Equities and Exchange Fund Investment Limited

As a result of the Government's operations in the stock market in August 1998, the Exchange Fund acquired a substantial portfolio of Hong Kong equities. Exchange Fund Investment Limited (EFIL) was established on 14 October 1998 to manage the Hong Kong equity portfolio purchased in August together with the Hong Kong equities transferred from the Land Fund. EFIL has been charged with the responsibility of recommending and executing a disposal programme during which these Hong Kong equities will be returned to private sector hands in an orderly manner without disrupting the market. EFIL is appointing a panel of advisors to assist in this endeavour.

With the adoption of the new investment benchmark of the Exchange Fund, which includes a 5%

allocation to the Hong Kong equity market, the HKMA has also asked EFIL to manage, through external managers, the Hong Kong equities to be held as a long-term investment portfolio. This investment portfolio will be managed basically as an index-linked portfolio. Half of this long-term investment portfolio will be managed as a passive portfolio replicating the Hang Seng Index whereas the remaining half will be allowed some moderate deviations from the Hang Seng Index. The investment activities of the external managers will be subject to guidelines that will prevent them from taking excessive risks or adopting aggressive trading strategies that may destabilise the market.

The Board of EFIL is chaired by the Hon. T.L. Yang, and the majority of the directors of EFIL are drawn from distinguished members of the community, including members of the Legislative Council. EFIL is incorporated under the Companies Ordinance and is registered as an Investment Adviser under the Securities Ordinance. EFIL is therefore subject to full regulation by the Securities and Futures Commission. EFIL has also been designated as a public body under the Prevention of Bribery Ordinance (PBO) by the Chief Executive in Council, which means that the directors and staff of the company will become public servants for the purpose of the PBO. This ensures that EFIL staff and directors will comply with the high standard of conduct required of public servants.

The investment process

The investment of the Exchange Fund is directed by the long-term asset allocation strategy, which is defined as the allocation of investments to bonds and

equities by country as well as the overall currency composition of the fund. The Exchange Fund is permitted to invest in 19 bond markets, ten equity markets and 18 currency markets.

The strategic investment direction is set by the Exchange Fund Advisory Committee and the day-to-day management of the Exchange Fund is conducted by the Reserves Management Department of the HKMA. In carrying out its responsibilities, the Reserves Management Department operates under authority delegated from the Financial Secretary and within investment guidelines approved by the Exchange Fund Advisory Committee.

Using fundamental analyses of economies and assessments of market developments and trends, the investment professionals determine the allocations to asset classes by countries and the appropriate timing for entry into and exit from markets. To generate returns above market returns, these professionals also engage in the selection of specific securities within each market. The HKMA has concluded a thorough review of the investment process and related technological and risk management support to ensure that the risks incurred will be carefully monitored and managed to generate steady, consistent returns with minimal additional volatility.

Use of external managers

The Exchange Fund employs over 30 external managers located in nine major financial centres to invest about 20% of its total assets. The purpose of engaging the services of external managers is to benefit from their expertise, skills and geographical

coverage in selected markets. Within the Reserves Management Department are divisions dedicated to monitoring the investment activities undertaken by the external managers for compliance and to analysing their investment performance in order to determine the value-added provided by these external managers. The assets managed by external managers are vested in specially chosen custodians.

Risk management and compliance

The risk management and compliance division at the Exchange Fund is crucial to the risk control function. The division is responsible for measuring performance and risks arising from the investment process. In addition to evaluations of returns against benchmark and performance attribution analysis, the portfolios are also tested for risk using the latest tools in the market. Value-at-risk and scenario stress testing are used to quantify the market risks inherent in the portfolios under normal as well as extreme adverse market conditions. The risk management division also ensures the creditworthiness of counterparties, custodians and external managers through regular credit reviews and with reference to ratings by internationally accepted independent rating agencies.

Increased transparency

Consistent with the HKMA's commitment of moving towards greater transparency in disclosure, the Financial Secretary has decided to publish on a monthly basis, from 1999, an abridged balance sheet of the Fund and a set of Currency Board Accounts. The first set of monthly figures as at the end of January 1999 was released in February.

A concurrent move in 1999 to increase transparency is the implementation of the International Monetary Fund's Special Data Dissemination Standards (SDDS) in monthly announcements of Hong Kong's International Reserves, that is, official foreign currency reserves and Analytical Accounts of the Central Bank, which are specifically prescribed balance sheet data. Under the SDDS, International Reserves and Analytical Accounts of the Central Bank must be published within one week and two weeks, respectively, of the end of the reference month. The purpose of the SDDS is to guide members of the IMF that have, or that might seek, access to international capital markets in the provision of their economic and financial data to the public. To show its discipline in complying with the SDDS, the HKMA published on 1 February 1999 the Advance Data Release Calendar for the year of 1999.

Performance

The financial markets in 1998

In 1998, global financial markets were marked by extreme volatility as the effects from Asia's turmoil rippled through other emerging markets, culminating in the Long Term Capital Management episode and the unexpected 75 basis points interest rate reduction by the US authorities. Meanwhile, the US economy entered its eighth year of strong growth and its equity market surged ahead, undeterred by the events plaguing other economies. The performances of major bond, equity and currency markets are set out in Table 13.

Table 13 1998 Market returns

Currencies	Against DEM	Against Yen
Depreciation of US\$	-6.8%	-13.0%
Bond markets*	Hedged	Unhedged
	8.4%	11.8%
Equity markets	In US\$	In local currency
S&P 500 Index	28.6%	28.6%
Nikkei 225 Index	3.6%	-8.5%
Hang Seng Index	-2.7%	-2.7%

*Merrill Lynch Global Government Bond Index, 1-5 years.

Table 14 Investment return of the Exchange Fund

	Return on average net assets	Return on average investible assets	Domestic inflation rate
1998	34.6%	14.9%	-1.4%
1997	10.1%	6.7%	4.8%
1993-1998 cumulative	130.2%	64.1%	n/a
1993-1998 annualised	14.9%	8.6%	5.7%

The Exchange Fund's performance in 1998

The investment strategy of the Exchange Fund steered a steady course through the excessive volatility in the financial markets. The primary objectives of capital preservation, liquidity and steady, low volatility returns were strictly observed. The Fund benefited from a favourable interest rate environment and from its defensive currency positioning. The Fund also enjoyed the bonus of positive returns from the Hong Kong equity portfolio acquired from the Government's stock market operations in August.

In 1998, the accumulated surplus of the Exchange Fund grew by 41.1% before payment of interest to the fiscal reserves, and by 27.5% after payment of

\$26 bn interest to the fiscal reserves representing their share of the overall investment income of the Exchange Fund. Even when the gains of \$35 bn from the Hong Kong equity portfolio are excluded, the accumulated surplus still grew by a healthy 22.6%. The rates of return on the Exchange Fund's average net assets and average investible assets for the year 1998, and for the six years from 1993 to 1998, are provided in Table 14. These returns compare favourably with the domestic inflation rate for the same period. The currency mix of the Fund's assets as at 31 December 1998 is provided in Table 15.



Chief Executive Joseph Yam and Executive Director Amy Yip brief the media on the performance of the Exchange Fund in 1998.

Table 15 Currency mix of the Exchange Fund's assets (as at 31 December 1998) – Including forward transactions

	HK\$bn	%
US Dollar	569.5	61.8
HK Dollar	220.3	23.9
European currencies	103.7	11.3
Yen	23.9	2.6
Others	4.0	0.4
Total	921.4	100.0

The Land Fund's performance in 1998

Unlike the Exchange Fund, which is predominantly invested in OECD bond and equity markets, the investment benchmark of the Land Fund allocates some exposure to the Asian equity markets.

Precautionary measures were taken in 1997 to reduce holdings in Asian markets, and the balance of the exposure was further reduced in 1998. Throughout the year, the Land Fund maintained a defensive investment strategy by reducing its allocation to equities and reinvesting the proceeds in bonds. For the first ten months of 1998, the Land Fund achieved a return on its assets of 7.7%, which represented a slight underperformance of 0.4% against the investment benchmark. This was mainly attributable to the defensive investment strategy adopted to ensure capital preservation in light of the volatile equity and currency markets in 1998.

A comparison of the Land Fund's return against the investment benchmark for the ten months to October 1998 is at Table 16. The currency mix of the Land Fund as at 31 October 1998, when its assets were merged into the Exchange Fund, is provided in Table 17.

Table 16 Comparisons of the Land Fund's returns against benchmark

	Rate of return on average net assets	Rate of return on average investible assets	Rate of return on investment benchmark
1 Jan 98 to 31 Oct 98	7.7%	7.7%	8.2%

Table 17 Currency mix of the Land Fund's net assets (as at 31 October 1998) – Including forward transactions

	HK\$bn	%
US Dollar	135.2	64.0
HK Dollar	62.4	29.5
European currencies	12.5	5.9
Yen	–	0.0
Others	1.3	0.6
Total	211.4	100.0

The Exchange Fund

- Report of the Director of Audit to the Financial Secretary
- Exchange Fund Income and Expenditure Account
- Exchange Fund Balance Sheet
- Notes on the Accounts

Report of the Director of Audit to the Financial Secretary

I have audited the statement of the accounts on pages 84 to 99 which has been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective responsibilities of the Monetary Authority and the Director of Audit

The directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance (Cap. 66) requires the Monetary Authority to sign the statement of the accounts. In preparing the statement of the accounts, the Monetary Authority has to select appropriate accounting policies and to apply them consistently.

It is my responsibility to form an independent opinion, based on my audit, on that statement of the accounts and to report my opinion to you.

Basis of opinion

I certify that I have audited the statement of the accounts referred to above in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance and the Audit Commission auditing standards. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the statement of the accounts. It also includes an assessment of the significant estimates and judgements made by the Monetary Authority in the preparation of the statement of the accounts, and of whether the accounting policies are appropriate to the Exchange Fund's and the Group's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance as to whether the statement of the accounts is free from material misstatement. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the statement of the accounts. I believe that my audit provides a reasonable basis for my opinion.

Opinion

In my opinion the statement of the accounts gives a true and fair view, in all material respects, of the state of affairs of the Exchange Fund and of the Group as at 31 December 1998 and of their surplus for the year then ended and has been properly prepared in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance.

Audit Commission
Hong Kong
26 March 1999

Dominic Y T Chan
Director of Audit

Exchange Fund – Income and Expenditure Account

for the year ended 31 December 1998

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		1998	1997	1998	1997
INCOME					
Investment income	3	94,218	35,555	93,795	35,532
Licence fees	3	170	174	170	174
Others	3	173	235	19	56
TOTAL INCOME		94,561	35,964	93,984	35,762
EXPENDITURE					
Note and coin expenses	4	672	457	672	457
Operating expenses	4	937	745	799	661
Interest	4	40,699	17,280	40,494	17,280
TOTAL EXPENDITURE		42,308	18,482	41,965	18,398
SURPLUS BEFORE SHARE OF PROFIT / (LOSS) OF ASSOCIATED COMPANY					
		52,253	17,482	52,019	17,364
Share of profit / (loss) of associated company		9	(14)	-	-
SURPLUS BEFORE TAXATION					
		52,262	17,468	52,019	17,364
Taxation : subsidiaries		40	13	-	-
SURPLUS AFTER TAXATION BEFORE MINORITY INTERESTS					
		52,222	17,455	52,019	17,364
Minority interests		48	16	-	-
SURPLUS FOR THE YEAR					
		52,174	17,439	52,019	17,364
STATEMENT OF ACCUMULATED SURPLUS					
Accumulated surplus brought forward		190,136	172,697	190,226	172,862
Surplus for the year		52,174	17,439	52,019	17,364
ACCUMULATED SURPLUS CARRIED FORWARD					
		242,310	190,136	242,245	190,226

The notes on pages 86 to 99 form part of these accounts.

Exchange Fund – Balance Sheet

as at 31 December 1998

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		1998	1997	1998	1997
ASSETS					
Cash and short-term funds	5	133,334	99,880	133,325	99,875
Fixed deposits		52,439	74,999	52,194	74,584
Certificates of deposit		27,832	69,387	27,832	69,387
Investments	6	676,963	374,588	677,569	374,588
Mortgage loans		11,376	650	–	–
Fixed assets	7	293	290	217	214
Other assets	8	19,165	16,896	21,138	18,025
TOTAL ASSETS	9	921,402	636,690	912,275	636,673
LIABILITIES					
Certificates of Indebtedness	10	86,465	87,015	86,465	87,015
Coins in circulation		5,778	5,399	5,778	5,399
Balance of the banking system	11	2,527	296	2,527	296
Exchange Fund Bills and Notes	12	98,334	89,338	98,334	89,338
Placements by other government funds	13	424,562	237,629	424,562	237,629
Placements by other institutions	14	21,401	21,062	17,219	21,062
Other liabilities	15	39,902	5,740	35,145	5,708
TOTAL LIABILITIES		678,969	446,479	670,030	446,447
NET ASSETS		242,433	190,211	242,245	190,226
REPRESENTING					
ACCUMULATED SURPLUS		242,310	190,136	242,245	190,226
MINORITY INTERESTS		123	75	–	–
TOTAL		242,433	190,211	242,245	190,226

Joseph Yam

Monetary Authority

25 March 1999

The notes on pages 86 to 99 form part of these accounts.

Notes on the Accounts

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated)

1. General

The Monetary Authority, under delegated authority from the Financial Secretary as Controller of the Exchange Fund, manages the Exchange Fund in accordance with the provisions of the Exchange Fund Ordinance.

2. Principal accounting policies

(a) Group accounts

The consolidated accounts for the year ended 31 December 1998 comprise the accounts of the Exchange Fund (the Fund) and its subsidiary companies (the Group).

A cash flow statement is not included as such a statement is not meaningful having regard to the nature of activities of the Group.

All significant transactions and balances between the Fund and its subsidiary companies have been eliminated on consolidation.

(b) Financial assets and liabilities

Financial assets and liabilities which are traded in an active market are valued in the accounts at market value at the balance sheet date. Fixed deposits, certificates of deposit, placements by other government funds for which interest is payable at predetermined fixed rates, placements by other statutory bodies and other borrowings are valued according to a price matrix of discounted cash flows using year end interest rates for discounting. The consequential change in value of the asset or liability is reflected in the carrying value of the relevant asset or liability in the Balance Sheet except in the case of placements by other government funds for which interest is payable at predetermined fixed rates, which are stated in the Balance Sheet at the principal amounts payable at the balance sheet date with the revaluation differences included in other liabilities. Placements by other government funds for which interest is payable at rates determined by reference to the investment income of the Fund are stated at the principal amounts payable at the balance sheet date. Mortgage loans are stated at their principal value less provisions for bad and doubtful loans.

Revaluation gains and losses are included in the Income and Expenditure Account.

(c) Investments in subsidiary and associated companies

Investments in subsidiary and associated companies are stated in the Fund's Balance Sheet at cost less any provisions for permanent diminution in value as determined by management. In the Group's Balance Sheet, the investment in the associated company is stated at the Group's share of its net assets. The Group's Income and Expenditure Account includes the Group's share of the results of the associated company for the year.

(d) Investment in the Bank for International Settlements

Investment in unlisted shares of the Bank for International Settlements is stated at cost.

Notes on the Accounts (Cont.)**(e) Foreign currency translation**

Assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at the rates of exchange ruling at the balance sheet date. Exchange gains and losses on foreign currency assets and liabilities are included in the Income and Expenditure Account.

Certificates of Indebtedness which are denominated in Hong Kong dollars but are issued and redeemed in US dollars at the linked exchange rate of US\$1=HK\$7.80 are stated in the accounts at their Hong Kong dollar face value. At the balance sheet date the difference between their Hong Kong dollar face value and the market value of the US dollars required for their redemption is included in other assets.

Foreign currency income and expenditure are translated into Hong Kong dollars at the exchange rates prevailing at the transaction dates.

(f) Off-balance sheet financial instruments

Forward foreign exchange contracts, interest rate swap contracts and stock index futures contracts are marked to market on the balance sheet date with the resultant revaluation gains and losses being included in the Income and Expenditure Account. Exchange gains and losses arising from forward foreign exchange contracts are included in the Income and Expenditure Account. Interest income and expenses arising from interest rate swap contracts and gains and losses on the sale and maturity of stock index futures contracts are included in the Income and Expenditure Account.

(g) Fixed assets

Fixed assets, including land and building, plant and machinery, furniture, fixtures and equipment, motor vehicles, personal computers and capitalised systems development costs, are stated at cost less accumulated depreciation and are depreciated on a straight line basis over their respective estimated useful lives of between 3 and 50 years.

(h) Goodwill

Purchased goodwill which represents the excess of purchase consideration over the fair value of the separable net assets acquired is immediately eliminated against surplus in the year of acquisition.

Notes on the Accounts (Cont.)

(i) Revenue recognition

Interest income is recognised on an accrual basis and dividend income is recognised when the share price goes ex-dividend.

(j) Borrowing costs

Interest costs are recognised on an accrual basis. Discounts and premiums relating to borrowings are amortised.

3. Income**(a) Investment income**

	Group		Fund	
	1998	1997	1998	1997
Interest income	34,044	27,224	33,603	27,201
Dividend income from listed investments	1,770	488	1,770	488
Net exchange gains (losses)	7,412	(5,455)	7,412	(5,455)
Net investment and revaluation gains	50,992	13,298	51,010	13,298
Total	94,218	35,555	93,795	35,532

(b) **Licence fees** are fees receivable from Authorised Institutions under the Banking Ordinance.

(c) **Others** include income from sale of withdrawn coins, Central Moneymarkets Unit fees and other operating income.

Notes on the Accounts (Cont.)

4. Expenditure

(a) **Note and coin expenses** represent reimbursements to the note-issuing banks in respect of note issue expenses, and expenses incurred directly by the Exchange Fund in issuing coins.

(b) **Operating expenses**

	Group		Fund	
	1998	1997	1998	1997
Staff costs	454	376	389	342
Premises and equipment expenses	115	96	104	91
Depreciation charges	64	52	49	42
Provisions for bad and doubtful loans	17	–	–	–
Other operating expenses	287	221	257	186
Total	937	745	799	661

The numbers of senior staff (Executive Directors and above) of the Hong Kong Monetary Authority (“HKMA”) whose emoluments fell within the following bands were:

HK\$	1998	1997
1,000,000 or below	2	–
2,500,001 to 3,000,000	–	1
3,000,001 to 3,500,000	4	3
3,500,001 to 4,000,000	1	2
4,000,001 to 4,500,000	1	–
4,500,001 to 5,000,000	1	1
5,000,001 to 5,500,000	1	–
5,500,001 to 6,000,000	–	2
6,000,001 to 6,500,000	1	–
8,000,001 to 8,500,000	–	1
8,500,001 to 9,000,000	1	–
	12	10

(c) **Interest** comprises the interest cost of, and amortisation of discounts and premiums on, Exchange Fund Bills and Notes, and interest payable on notes issued by The Hong Kong Mortgage Corporation Limited and placements by other government funds and other institutions.

With effect from 1 April 1998, the basis of interest payable on certain placements by other government funds was amended from predetermined fixed rates to rates determined by reference to the investment income of the Fund.

Notes on the Accounts (Cont.)

5. Cash and short-term funds

	Group		Fund	
	1998	1997	1998	1997
Cash and money at call and short notice	12,268	4,964	12,259	4,959
Treasury bills and commercial papers	120,733	90,725	120,733	90,725
Others	333	4,191	333	4,191
Total	133,334	99,880	133,325	99,875

6. Investments

	Group		Fund	
	1998	1997	1998	1997
Debt securities	476,275	342,313	476,881	342,313
Equities				
Listed in Hong Kong	161,426	–	161,426	–
Listed outside Hong Kong	39,097	32,124	39,097	32,124
Unlisted	16	–	16	–
Gold	149	151	149	151
Total	676,963	374,588	677,569	374,588

7. Fixed assets

	Group		Fund	
	1998	1997	1998	1997
Costs				
As at beginning of the year	354	243	263	173
Additions	70	111	55	90
Disposals	(3)	–	(3)	–
As at end of the year	421	354	315	263
Accumulated depreciation				
As at beginning of the year	64	12	49	7
Charge for the year	64	52	49	42
As at end of the year	128	64	98	49
Net book value as at end of the year	293	290	217	214

Notes on the Accounts (Cont.)

8. Other assets

		Group		Fund	
		1998	1997	1998	1997
Investments in subsidiary companies	(a)	–	–	2,145	1,140
Investment in associated company	(b)	31	18	43	39
Investment in the Bank for International Settlements	(c)	300	300	300	300
Thailand financing package	(d)	5,872	4,649	5,872	4,649
Loan to the International Monetary Fund	(e)	342	–	342	–
Staff housing loans	(f)	291	159	291	159
Others	(g)	12,329	11,770	12,145	11,738
Total		19,165	16,896	21,138	18,025

(a) Investments in subsidiary companies

Name of company	Place of incorporation	Principal activities	Issued equity capital (HK\$ million)	Exchange Fund's interest in equity capital
Hong Kong Note Printing Limited	Hong Kong	Notes printing	255	55%
The Hong Kong Mortgage Corporation Limited	Hong Kong	Mortgage securitisation	2,000	100%
Exchange Fund Investment Limited	Hong Kong	Investment management	5	100%

Exchange Fund Investment Limited was incorporated on 14 October 1998 to manage the Hong Kong equity investments held by the Exchange Fund.

Notes on the Accounts (Cont.)

(b) Investment in associated company

Name of company	Place of incorporation	Principal activities	Issued equity capital	Exchange Fund's interest in equity capital
Hong Kong Interbank Clearing Limited	Hong Kong	Interbank clearing	HK\$10,000	50%

The breakdown of the investment is:

	Group		Fund	
	1998	1997	1998	1997
Shares at cost (HK\$5,000)	-	-	-	-
Loans	43	39	43	39
Accumulated deficit	(12)	(21)	-	-
Total	31	18	43	39

(c) **Investment in the Bank for International Settlements comprises 3,000 unlisted shares with a nominal value of 2,500 Swiss gold francs each (25% paid).**

(d) **Thailand financing package**

On 21 September 1997, the HKMA participated in a financing package organised for Thailand by the International Monetary Fund ("IMF"). The financing package is in the form of a Currency Swap Agreement ("the Agreement") between the Bank of Thailand ("BOT") and a number of Asian central banks and multinational institutions, including the HKMA and the IMF. Under the Agreement, the HKMA, on behalf of the Exchange Fund, entered into swap transactions to exchange US dollars for Thai Baht up to a maximum of US\$1 billion for a maximum period of 5 years. At the end of the agreed period for each swap transaction, the exchange of currencies will be reversed and the US dollars to be received by the HKMA will be equivalent to the original principal swapped plus interest at market rate. The transaction is accounted for as a US dollar loan to reflect its economic substance. As at 31 December 1998, the outstanding principal and accrued interest due from BOT under the Agreement amounted to US\$758 million (1997 US\$600 million) and US\$7 million (1997 US\$6 million) respectively.

Notes on the Accounts (Cont.)

(e) Loan to the International Monetary Fund

On 27 January 1997, the HKMA participated in the New Arrangements to Borrow ("NAB"), a standby credit facility to the IMF for coping with instability in the international monetary system. In respect of this, the HKMA undertakes to lend foreign currencies up to HK\$3,709 million equivalent to the IMF, in the form of a term loan of five year maturity bearing prevailing market interest rates. As at 31 December 1998, the outstanding principal and accrued interest due from the IMF under the NAB amounted to HK\$342 million (1997 - nil) and HK\$1 million (1997 - nil) respectively.

(f) Staff housing loans amounted to HK\$290.7 million as at 31 December 1998 (1997 - HK\$159.1 million). The portion of the loans repayable within one year amounted to HK\$8.7 million (1997 - HK\$4.1 million).

(g) Others include interest receivable, prepaid expenses and the difference between the Hong Kong dollar face value of the Certificates of Indebtedness and the market value of the US dollars required for their redemption.

9. Total assets

	Group		Fund	
	1998	1997	1998	1997
Foreign currency assets	701,239	588,475	701,239	588,475
Hong Kong dollar assets	220,163	48,215	211,036	48,198
Total	921,402	636,690	912,275	636,673

The Exchange Fund holds Hong Kong dollar and foreign currency assets. A large proportion of the Fund's foreign currency assets is held in US dollars. Apart from the US dollar assets, the Fund also holds assets denominated in fully convertible foreign currencies.

Notes on the Accounts (Cont.)

9. Total assets (Cont.)

As at 31 December 1998, total foreign currency assets and forward foreign exchange transactions of the Exchange Fund are as follows:

	Group		Fund	
	1998	1997	1998	1997
Exchange Fund foreign currency assets excluding forward transactions	701,239	588,475	701,239	588,475
Net forward transactions	(127)	1,892	(127)	1,892
Total	701,112	590,367	701,112	590,367
US\$ million equivalent	90,498	76,191	90,498	76,191

The Exchange Fund's assets are held in deposit, trustee and safe-keeping accounts with banks, central banks and custodial organisations situated in Hong Kong and other major financial centres.

Starting from 1 October 1998, specific US dollar assets of the Exchange Fund have been designated to back the monetary base, which comprises Certificates of Indebtedness, coins in circulation, the balance of the banking system and Exchange Fund Bills and Notes. While specific assets of the Exchange Fund have been earmarked for backing the monetary base, all Exchange Fund assets have continued to be available for the purpose of supporting the Hong Kong dollar exchange rate under the linked exchange rate system.

As at 31 December 1998, the position of the Currency Board Account is as follows:

Monetary base		
Certificates of Indebtedness	86,465	
Coins in circulation	5,778	
Exchange Fund Bills and Notes	98,334	
Interest payable on Exchange Fund Notes	620	
Balance of the banking system	2,527	
Net accounts (receivable)/payable	(6)	
Total	193,718	(b)
Backing assets		
Investment in designated US dollar assets	207,394	
Interest receivable on investments	2,290	
Total	209,684	(a)
Backing ratio [(a) / (b)] x 100%	108.24%	

Notes on the Accounts (Cont.)

10. Certificates of indebtedness

As backing for the bank note issues, each note-issuing bank is required to hold a non-interest bearing Certificate of Indebtedness issued by the Financial Secretary. Payments for the issuance and redemption of notes against these Certificates are made in US dollars at a fixed rate of US\$1 = HK\$7.80.

11. Balance of banking system

Under the interbank payment system based on Real Time Gross Settlement principles, all licensed banks maintain a Hong Kong dollar clearing account with the HKMA for the account of the Exchange Fund. The aggregate balance in these accounts represents the total level of liquidity in the interbank market. Under the Convertibility Undertaking which came into effect from 7 September 1998, the HKMA undertakes to convert Hong Kong dollars in the clearing accounts maintained by licensed banks with the HKMA into US dollars at the fixed exchange rate of HK\$7.75 to US\$1. The HKMA further announced on 26 November 1998 a scheme to move the exchange rate under the Convertibility Undertaking from HK\$7.75 to HK\$7.80 over a 500-day period starting from 1 April 1999.

12. Exchange fund bills and notes

Exchange Fund Bills are issued by the Exchange Fund for maturities not exceeding one year. Exchange Fund Notes are issued by the Exchange Fund with 2-year, 3-year, 5-year, 7-year and 10-year maturities. In the table below, Exchange Fund Notes are categorised according to their remaining term to maturity.

	Group		Fund	
	1998	1997	1998	1997
Exchange Fund Bills	63,165	65,825	63,165	65,825
Exchange Fund Notes				
Maturing within 1 year	6,050	4,065	6,050	4,065
Maturing after 1 year but within 5 years	19,208	13,370	19,208	13,370
Maturing after 5 years	9,911	6,078	9,911	6,078
Total	98,334	89,338	98,334	89,338

Notes on the Accounts (Cont.)

13. Placements by other government funds

These represent placements by other government funds with the Exchange Fund. Until 31 March 1998, all placements by other government funds bore interest at predetermined fixed rates. With effect from 1 April 1998, the basis of interest payable on certain placements by other government funds was amended from predetermined fixed rates to rates determined by reference to the investment income of the Fund. The breakdown of placements by other government funds is:

	Group		Fund	
	1998	1997	1998	1997
Placements with interest payable at predetermined fixed rates				
General Revenue Account	2,030	167,498	2,030	167,498
Capital Investment Fund	5,112	4,956	5,112	4,956
Loan Fund	510	3,418	510	3,418
Capital Works Reserve Fund	1,015	52,809	1,015	52,809
Civil Service Pension Reserve Fund	–	8,910	–	8,910
Disaster Relief Fund	–	38	–	38
	8,667	237,629	8,667	237,629
Placements with interest payable at rates determined by reference to the investment income of the Fund				
General Revenue Account	159,020	–	159,020	–
Land Fund	211,383	–	211,383	–
Capital Works Reserve Fund	36,397	–	36,397	–
Civil Service Pension Reserve Fund	9,079	–	9,079	–
Disaster Relief Fund	16	–	16	–
	415,895	–	415,895	–
Total	424,562	237,629	424,562	237,629

Notes on the Accounts (Cont.)

14. Placements by other institutions

	Group		Fund	
	1998	1997	1998	1997
Placements by other statutory bodies	4,647	8,028	4,647	8,028
Placements by licensed banks under the Liquidity Adjustment Facility	–	7,885	–	7,885
Others	16,754	5,149	12,572	5,149
Total	21,401	21,062	17,219	21,062

15. Other liabilities

Other liabilities include interest payable on Exchange Fund Notes, notes issued by The Hong Kong Mortgage Corporation Limited and placements by other government funds, other accrued expenses and the revaluation differences of placements by other government funds for which interest is payable at predetermined fixed rates.

16. Staff retirement scheme

The HKMA operates a defined contribution scheme, under which contributions applicable each year are charged to the Income and Expenditure Account. Contributions to this staff retirement scheme amounted to HK\$19.8 million in 1998 (1997 - HK\$18.2 million). The assets of the staff retirement scheme are held separate from the Exchange Fund.

Notes on the Accounts (Cont.)

17. Capital commitments

Capital expenditure authorised but not provided for in these accounts amounted to:

	Group		Fund	
	1998	1997	1998	1997
Contracted	5	10	4	1
Not contracted	135	104	114	104
Total	140	114	118	105

18. Off-balance sheet items

	Group		Fund	
	1998	1997	1998	1997
Forward foreign exchange contracts				
Outstanding contract amount	34,792	109,109	34,792	109,109
Gross replacement costs	242	2,304	242	2,304
Interest rate swap contracts				
Notional principals	37,741	38,350	33,600	38,350
Gross replacement costs	1,796	2	1,635	2
Stock index futures contracts				
Notional principals	25,303	78	25,303	78
Gross replacement costs	2	-	2	-

Notes on the Accounts (Cont.)**19. Contingent liabilities**

At 31 December 1998, the Group had the following contingent liabilities:

- (a) The Fund has a contingent liability, amounting to 5.6 million Swiss gold francs or HK\$116.9 million equivalent as at 31 December 1998 (1997 - 5.6 million Swiss gold francs or HK\$118.3 million equivalent), in respect of the uncalled portion of its 3,000 shares held in the Bank for International Settlements.
- (b) Under the Forward Commitment Facility, The Hong Kong Mortgage Corporation Limited, a subsidiary company, has committed to purchase from an approved seller of residential mortgage loans an agreed amount of eligible floating rate mortgages at a specified price within a specified period of up to 12 months. The pricing of the mortgages is based on two pricing approaches: standalone approach and bundle approach. As at 31 December 1998, the outstanding commitment amount to purchase floating rate mortgages was HK\$8,526 million (1997 - nil).
- (c) Under the Fixed Adjustable Rate Mortgage Programme Agreement, The Hong Kong Mortgage Corporation Limited, a subsidiary company, has committed to purchase agreed amounts of eligible loans from eight banks within a specified period. As at 31 December 1998, the outstanding commitment amount to purchase such loans was HK\$3,112 million (1997 - nil).

The Land Fund

- Report of the Director of Audit to the Financial Secretary
- Land Fund Income and Expenditure Account
- Land Fund Balance Sheet
- Notes on the Accounts

Report of the Director of Audit to the Financial Secretary

I have audited the financial statements on pages 102 to 107 which have been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective responsibilities of the Monetary Authority and the Director of Audit

The Monetary Authority is responsible for the preparation of the financial statements in accordance with generally accepted accounting principles. In preparing the financial statements, the Monetary Authority has to select appropriate accounting policies and to apply them consistently.

It is my responsibility to form an independent opinion, based on my audit, on those statements and to report my opinion to you.

Basis of opinion

I have audited the financial statements referred to above in accordance with the provision of section 8(1) of the Audit Ordinance (Cap. 122) and the Audit Commission auditing standards. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Monetary Authority in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Land Fund's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance as to whether the financial statements are free from material misstatement. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the financial statements. I believe that my audit provides a reasonable basis for my opinion.

Opinion

In my opinion the financial statements give a true and fair view, in all material respects, of the state of affairs of the Land Fund as at 31 October 1998 and of its surplus for the period from 1 January 1998 to 31 October 1998.

Audit Commission
Hong Kong
26 February 1999

Dominic Y T Chan
Director of Audit

Land Fund – Income and Expenditure Account			
for the period from 1 January 1998 to 31 October 1998			
(Expressed in millions of Hong Kong dollars)	Note	For 10 months ended 31 October 1998	For 6 months ended 31 December 1997
INCOME			
Investment income / (loss)	3	15,877	(1,357)
TOTAL INCOME / (LOSS)		15,877	(1,357)
EXPENDITURE			
Operating expenses	4	132	77
TOTAL EXPENDITURE		132	77
SURPLUS / (DEFICIT) FOR THE PERIOD		15,745	(1,434)
STATEMENT OF ACCUMULATED SURPLUS / (DEFICIT)			
Accumulated deficit brought forward		(1,434)	-
Surplus / (deficit) for the period		15,745	(1,434)
ACCUMULATED SURPLUS / (DEFICIT) CARRIED FORWARD		14,311	(1,434)

The notes on pages 104 to 107 form part of these accounts.

Land Fund – Balance Sheet

as at 31 October 1998

(Expressed in millions of Hong Kong dollars)

	Note	31 October 1998	31 December 1997
ASSETS			
Cash and short-term funds	5	38,436	18,738
Fixed deposits		41,689	47,967
Certificates of deposit		9,381	5,929
Debt securities		90,245	75,879
Equities	6	30,530	44,068
Fixed assets	8	4	2
Other assets	9	4,781	3,450
TOTAL ASSETS		215,066	196,033
LIABILITIES			
Creditors and accruals	10	3,683	395
TOTAL LIABILITIES		3,683	395
NET ASSETS	11	211,383	195,638
REPRESENTING			
FUND BALANCE			
Balance at 1 July 1997		197,072	197,072
Accumulated surplus / (deficit)		14,311	(1,434)
TOTAL		211,383	195,638

Joseph Yam
 Monetary Authority
 26 February 1999

The notes on pages 104 to 107 form part of these accounts.

Notes on the Accounts

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated)

1. General

The Land Fund was established on 1 July 1997 by a Resolution passed by the Provisional Legislative Council under section 29(1) of the Public Finance Ordinance (Cap. 2) in July 1997. During the period from July 1997 to October 1998, the assets of the Land Fund were managed by the Hong Kong Monetary Authority (“HKMA”) under the direction of the Financial Secretary as a separate portfolio.

On 17 November 1998, the Hong Kong Special Administrative Region Government announced that the assets of the Land Fund would be merged into the Exchange Fund. The reference date for the merger is 31 October 1998. The value of the net assets of the Land Fund as at 31 October 1998 would be placed with the Exchange Fund for the account of the Land Fund.

The Land Fund would continue to be administered in accordance with the Resolution establishing the Land Fund and would remain a separate government fund after the merger.

2. Principal accounting policies

(a) Financial assets and liabilities

Financial assets and liabilities which are traded in an active market are valued in the accounts at market value at the balance sheet date. Fixed deposits, certificates of deposit and other borrowings are valued according to a price matrix of discounted cash flows using year end interest rates for discounting. Unlisted shares are stated at cost less any provisions for permanent diminution in value as determined by management. Revaluation gains and losses are included in the Income and Expenditure Account.

(b) Foreign currency translation

Assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at the rates of exchange ruling at the balance sheet date. Exchange gains and losses on foreign currency assets and liabilities are included in the Income and Expenditure Account. Foreign currency income and expenditure are translated into Hong Kong dollars at the exchange rates prevailing at the transaction dates.

(c) Off-balance sheet financial instruments

Forward foreign exchange contracts are valued at the forward rates for the balance of the contracts at the balance sheet date. Exchange gains and losses arising from these contracts are included in the Income and Expenditure Account.

Stock index futures contracts are marked to market on the balance sheet date with the resultant revaluation gains and losses being included in the Income and Expenditure Account.

(d) Fixed assets

Fixed assets, including furniture, fixtures, office equipment, computers and motor vehicles, are stated at cost less accumulated depreciation and are depreciated on a straight line basis over their respective estimated useful lives.

(e) Revenue recognition

Interest income is recognised on an accrual basis and dividend income is recognised when the share price goes ex-dividend.

Notes on the Accounts (Cont.)

(f) Borrowing costs

Interest costs are recognised on an accrual basis.

3. Investment income/(loss)	For 10 months ended 31 October 1998	For 6 months ended 31 December 1997
Interest income	8,663	4,339
Dividend income	797	455
Net exchange gains/(losses)	372	(946)
Net investment and revaluation gains/(losses)	6,044	(5,206)
Other income	1	1
Total	15,877	(1,357)

4. Operating expenses	For 10 months ended 31 October 1998	For 6 months ended 31 December 1997
Staff costs	50	30
Premises and equipment expenses	9	6
Depreciation charges	1	1
Other operating expenses	72	40
Total	132	77

5. Cash and short-term funds	31 October 1998	31 December 1997
Cash and money at call and short notice	1,236	578
Treasury bills and commercial papers	37,200	18,160
Total	38,436	18,738

6. Equities	31 October 1998	31 December 1997
Listed shares	30,514	44,052
Unlisted shares	16	16
Total	30,530	44,068

7. Assets pledged

Treasury bills of HK\$ 91 million and debt securities of HK\$ 168 million were pledged to a broker as margin for stock index future contracts.

Notes on the Accounts (Cont.)

8. Fixed assets

Costs	
At 1 January 1998	3
Additions	3
Disposals	-
At 31 October 1998	6
Accumulated depreciation	
At 1 January 1998	1
Charge for the period	1
Written back on disposal	-
At 31 October 1998	2
Net book value	
At 31 October 1998	4
At 31 December 1997	2

9. Other assets

	31 October 1998	31 December 1997
Dividend and interest receivables	2,587	2,453
Outstanding settlement on sale of securities	1,879	145
Unrealised gains on forward foreign exchange contracts	310	848
Others	5	4
Total	4,781	3,450

10. Creditors and accruals

	31 October 1998	31 December 1997
Outstanding settlement on purchase of securities	2,638	343
Bank advances and overdrafts	228	17
Unrealised losses on forward foreign exchange contracts	711	18
Margin call payable	75	-
Others	31	17
Total	3,683	395

11. Net assets

	31 October 1998	31 December 1997
Foreign currency assets	148,989	136,316
Hong Kong dollar assets	62,394	59,322
Total	211,383	195,638

Notes on the Accounts (Cont.)

The Land Fund holds Hong Kong dollar and foreign currency assets. A large proportion of the Fund's foreign currency assets is held in US dollars. Apart from the US dollar assets, the Fund also holds assets denominated in other fully convertible foreign currencies.

As at 31 October 1998, total foreign currency assets and forward foreign exchange transactions of the Land Fund are as follows:

	31 October 1998	31 December 1997
Foreign currency assets excluding forward transactions	149,382	135,475
Net forward transactions	(393)	841
Total	148,989	136,316
US\$ million equivalent	19,234	17,590

The Land Fund's assets are held in deposit, trustee and safe-keeping accounts with banks, central banks and custodial organisations situated in Hong Kong and other major financial centres.

12. Capital commitments

Capital expenditure authorised but not provided for in these accounts amounted to :

	31 October 1998	31 December 1997
Contracted	4	-
Not contracted	31	-
Total	35	-

13. Off-balance sheet items

	31 October 1998	31 December 1997
Forward foreign exchange contracts		
Outstanding contract amount	41,050	35,351
Gross replacement costs	310	848
Stock index futures contracts		
Notional principals	4,134	-
Gross replacement costs	-	-