The importance of fiscal prudence under the Linked Exchange Rate System in Hong Kong SAR

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Abstract

The Hong Kong SAR has consistently pursued a prudent fiscal policy. Substantial fiscal reserves have insulated government funding from the volatility of financial market conditions, and have buffered the economy against shocks, particularly in the absence of a discretionary monetary policy. Sound fiscal management has also reinforced the credibility of the Linked Exchange Rate system.

Keywords: Foreign exchange reserves, peg, deficit, fiscal policy

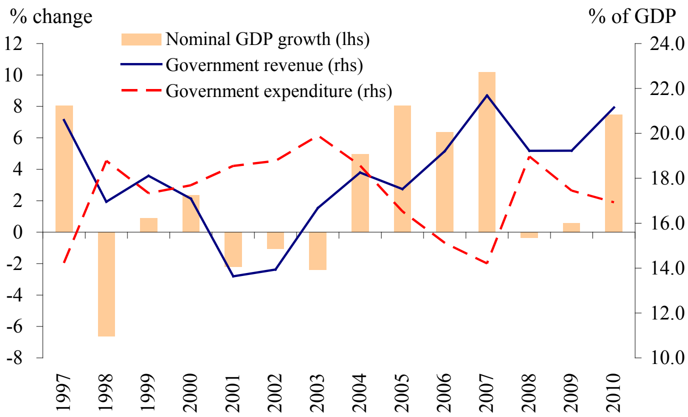
JEL classification: E52, F31, H62

Fiscal position of the Hong Kong government

***Hong Kong has an impressive track record of fiscal prudence*.** The government has made significant efforts over the years to observe the provisions in the Basic Law[1] that call for a balanced budget over the medium term and require the pace of spending increases to be commensurate with the GDP growth rate. A case in point is the experience during the early 2000s, when the government undertook a series of major fiscal reforms (mainly in the form of spending cuts) in response to a decline in revenues associated with a protracted economic downturn. With the bursting of US dotcom bubble and the subsequent SARS epidemic exacerbating the painful adjustment in the aftermath of the 1997–98 Asian financial crisis, Hong Kong suffered a long period of deflation and anaemic real growth, with nominal GDP not returning to the 1997 peak level until 2005. However, the government's reform efforts helped to keep the fiscal deficits at a relatively low level, and eventually to restore the budget balance to surplus in 2005 (Chart 1). Even during the 2008–09 global financial crisis, the government continued to register a small surplus, thanks to a tight control on expenditure. For the current 2011/12 fiscal year, the budget projects a small deficit, driven mainly by one-off relief measures.[2]

Chart 1

Hong Kong's fiscal performance and nominal GDP growth



***The sustained fiscal discipline has yielded a sizeable accumulation of fiscal reserves*.** Unlike most fiscal authorities internationally, the Hong Kong government is a net creditor, with more financial resources at its disposal than the liabilities it owes to the public. Outstanding general government gross debt to finance fiscal operations totalled only about HK$11 billion (or 0.6% of GDP),[3] while the pool of fiscal reserves stood at HK$595 billion (or one third of GDP) as of March 2011. The reserves are large enough to cover about 24 months of government expenditure. Given the considerable fiscal headroom, along with

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1 The Basic Law serves as the constitutional document of post-colonial Hong Kong SAR.

2 It now seems likely, however, that the government will record a surplus in 2011/12, partly due to higher-than-expected revenue collections.

3 This debt was issued in 2004 and 2005, complementing the drawdown from the fiscal reserves. The government also issues bonds under the Government Bond Programme to promote development of the local bond market. Proceeds from this programme are credited to a separately managed bond fund and are not used for fiscal operations. As at the end of October 2011, outstanding bonds under the programme amounted to HK$43 billion (or 2.4% of GDP).

Hong Kong's other favourable economic and institutional fundamentals, the government's creditworthiness has been strongly endorsed by the rating agencies, with long-term credit ratings of AAA from Standard and Poor's and Aa1 from Moody's.

The need for strong fiscal reserves to cope with shocks

Having adequate fiscal scope for cushioning economic downturns is particularly important for economies with a fixed exchange rate regime and perfect cross-border capital mobility, such as Hong Kong. Under a fixed exchange rate regime and with an open financial account, the monetary authorities cannot pursue an independent monetary policy, thus leaving fiscal policy, possibly supplemented by other policy tools including macroprudential measures, as the key levers for managing economic cycles and mitigating the impact of shocks on the economy. The availability of a sizeable pool of fiscal reserves provides the government with sufficient financial resources to implement a countercyclical expansionary fiscal policy during economic downturns, without having to worry about potentially volatile funding conditions in the government debt market. The unfolding European sovereign debt crisis has clearly demonstrated how heavy reliance on debt can expose governments to swings in market sentiment.[4]

The experience in the years following the Asian financial crisis underscores the role of strong fiscal reserves in supporting Hong Kong's economic stability. Due to falling income in the private sector and sluggish asset markets amid a series of adverse shocks including the Asian financial crisis, the bursting of the US dotcom bubble and the SARS epidemic, government revenue dropped by more than 35% in nominal terms between FY1997/98 and FY2002/03. The marked revenue loss contributed to consecutive years of budget deficits, from FY1998/99 to FY2003/04 (with the brief exception of FY1999/2000). While reforms were undertaken to shore up the fiscal position, the needed fiscal adjustment would have been much larger – and hence the fiscal support for the economy much weaker – if not for the option to deploy the existing fiscal reserves to finance public spending. A total of HK$182 billion, or 40% of the fiscal reserves, was drawn down during the period, which represented about 15% of Hong Kong's annual GDP at the time.

In addition, the fiscal reserves can contribute to maintaining financial stability in Hong Kong at times of heightened market stress, as the 2008–09 global financial crisis illustrates. As in the economic downturn during the early 2000s, the available fiscal headroom enabled the government to effect significant relief measures – which totalled about 6.3% of annual GDP from 2008/9 to 2010/11 – to bolster the economy against the fallout from the global financial crisis. As importantly, at the depth of the crisis when concerns about bank soundness arose, to maintain confidence the government adopted full deposit guarantees and standby measures to backstop banks' recapitalisation needs. The credibility of these policy actions was underpinned by the strong financial backing of the Exchange Fund, of which the fiscal reserves constitute a major part.[5] In other words, the fiscal reserves substantially augment the government's resources in supporting the financial sector as needed during times of extraordinary distress.

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[4] In addition, for a small economy whose currency is not a major reserve currency, for example Hong Kong, the local debt market tends to be less liquid and could experience particularly acute sell-off pressures in times of global stress when investors' demand for liquid assets surges. In Hong Kong, yields on Exchange Fund bills rose sharply vis-à-vis their US counterparts during the 2008–09 crisis.

[5] The fiscal reserves account for about one quarter of the Exchange Fund assets.

The importance of building up strong fiscal reserves in Hong Kong also reflects volatile government revenue and future ageing-related fiscal pressures.

- The fluctuations in Hong Kong's government revenue are among the most extreme in the world (Porter (2007)).[6] This is partly due to the openness of the economy and its susceptibility to external shocks, but it also reflects a revenue regime that has a narrow tax base and relies heavily on non-tax income. Taxes are based either on earnings (not on more stable consumption spending) or dependent on asset market activities (where stamp duties apply). Also, the volatile non-tax asset income (comprising the proceeds from land sales and investment income in Hong Kong) accounts for around 20% of government revenue, one of the highest levels in Asia. The large fluctuation in fiscal receipts amplifies the importance of maintaining strong fiscal reserves to support steady government spending.
- The government has large potential contingent liabilities associated with the future ageing of the population**.** In the case of Hong Kong, the expected rise in health care spending due to ageing will put pressure on public finances as health care services are largely government-funded.[7] The availability of fiscal reserves could ensure a smooth transition for any necessary structural reforms in the revenue regime.

The role of fiscal reserves in fortifying the Linked Exchange Rate system

The government's fiscal discipline has been a cornerstone of long-term monetary stability in Hong Kong. As the government holds a substantial amount of net financial assets, there are few concerns that the Hong Kong Monetary Authority would ever be forced into monetising government debt, thus undermining the currency board arrangement. Separately, under the fixed exchange rate, any overheating pressures in the economy would have to be absorbed solely by domestic price adjustment, thus likely resulting in high inflation. However, the government's prudent approach to spending reduces the risk that the economy will face overly strong demand pressures, thereby helping to support a low level of inflation in Hong Kong. The Argentina debt crisis in the late 1990s that led to the collapse of the country's exchange rate peg is a notable example of the importance of fiscal discipline in ensuring the feasibility of a currency board system (see, eg, IMF (2003)).[8]

***The absence of government borrowing would also help alleviate the likely interest rate adjustment in crisis scenarios*.** In the event of a crisis, money markets typically come under pressure, causing interbank interest rates to surge. Heavy government borrowing compounds the liquidity pressures and pushes interest rates even higher, thus exacerbating the economic downturn and associated asset market correction. The ensuing downturn in confidence intensifies adverse sentiments towards the local currency. If, on the other hand, the government has no borrowing requirement, the Hong Kong dollar will experience that much less downward pressure during a crisis.

More importantly, the fiscal reserves boost the financial resources available to defend the Linked Exchange Rate system*.* The fiscal reserves placed with the HKMA, which constitute about one quarter of the total Exchange Fund, expand the resources that can be called upon to defend the Hong Kong dollar against speculative attack or a sudden reversal

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6 N Porter, "Guarding against fiscal risks in Hong Kong SAR", IMF Working Paper, no 07/150, 2007.

7 There are estimates that fiscal reserves totalling up to 30% of GDP may be needed by 2030 to anticipate the ageing-related budget pressures in Hong Kong (Porter (2007)).

8 "Lessons from the crisis in Argentina", International Monetary Fund (IMF), October 2003, pp 8–11.

in capital flows. In August 1998, to counteract market manipulations and defend the Linked Exchange Rate system, in addition to dispensing the foreign reserves to meet the Hong Kong dollar sell-off pressures, the government and the HKMA drew on the Exchange Fund in an unprecedented operation in the stock and futures markets that involved stock purchases totalling HK$118 billion. The support of the fiscal reserves alleviated the constraints on the possible scale of the operation, thus improving the odds that the Hong Kong dollar could be effectively defended. While the technical refinements undertaken over the years have greatly improved the robustness of the currency board arrangement,[9] the additional financial resources conferred by the fiscal reserves would certainly still be useful in extreme circumstances to support our exchange rate regime.

9 These refinements include the formal establishment of two-sided convertibility undertakings and convertibility zone, and the introduction of a discount window.