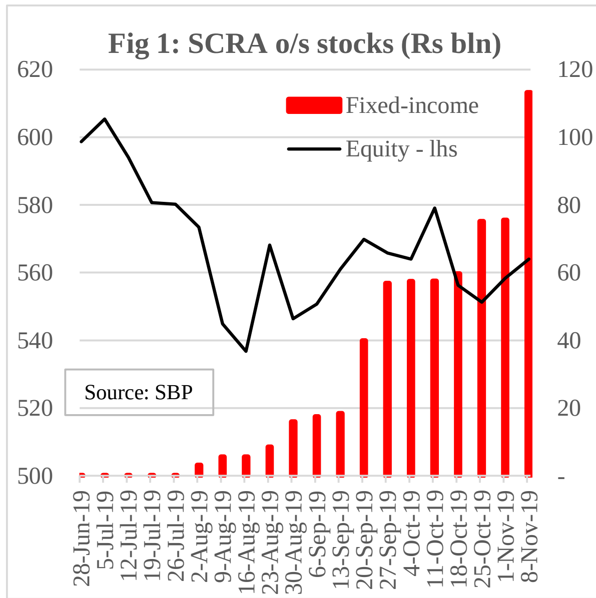
In Pakistan, hot money could be a very slippery slope

Mushtaq Khan, 19 November 2019

For over a month, we have been saying that SBP may opt for a token interest rate cut of 25-50 bps later this month, and then hold rates for the rest of the fiscal year. We have changed our mind, and now suggest no change. This is not because the SBP governor cautioned yesterday that cutting interest rates while inflation is high, is not appropriate, but for a more credible reason: as shown in **Figure 1**, foreign investment in government T-bills has been growing rapidly in recent weeks.[1] As shown, while the outstanding investment in Pakistani equities is much higher and more volatile (as it has been in play for decades), the rapid increase in *hot money* (foreign investment in fixed-income instruments) is staggering. For yield-hungry foreign investors, Pakistan's poor global image is being overshadowed by high domestic interest rates and an appreciating Rupee. The fear is that these inflows could become a torrent.



As discussed in out last paper (*The elusive Net International Reserves (NIR)*, 11 November 2019), foreign investment in government securities does not directly increase SBP's FX reserves, but since the $s must be invested in Rupee instruments, banks immediately sell the FX into the interbank market. Then it's up to SBP to use the dollars to either pay for imports, or to build its FX reserves, or both.

It is important to realize three things about these inflows: (1) hot money does not increase the country's external debt; (2) it provides *external financing* for Pakistan's fiscal deficit[2]; and (3) if SBP builds its FX reserves by purchasing hard currency from the interbank market, this will increase SBP's net international reserves (NIR) and not change the NIR targets. It is little wonder, therefore, that SBP's Governor has been so keen to promote such inflows.

Could this become problematic?

The source of Pakistan's macro stability can be traced to two factors: a stable (and appreciating) Rupee, and the fact that retail fuel prices have not increased much this fiscal year (PoL prices have only increased by 1.4% in five months). If dollar inflows increase given the herd-mentality of foreign investors, Pakistan's economy will gain in terms of easy deficit financing and an increase in SBP's NIR. This will make the EFF easier to navigate, and reinforce expectations that Pakistan's economy has truly stabilized.

[1] In the five months of this fiscal year, net inflows into government T-bills has been as follows: July $ 14.9 mln; August $ 71.3 mln; September $ 246.3 mln; October 108.3 mln; and in the first half of November, $ 345.1 mln. So while the total net inflows so far this year is $ 785.9 mln, 44% has been realized in the first half of November alone. This exponential increase is witnessed when fund managers jump on the bandwagon.

[2] By encouraging fresh external inflows, this money will also allow SBP to ease back on open market operations (OMOs) that have been injecting liquidity into the money market.

Concerns that hot money is fickle and could reverse at a turn on a dime, are true but perhaps exaggerated. With low and negative yields in the US and Europe, fund managers are desperate for yields and are willing to look at riskier assets. Egypt set the stage for such investments when it entered a similar EFF program in November 2016, but Egyptian interest rates have started to fall.[3] Furthermore, reputable fund managers in EM countries must diversify their portfolios, and Pakistan is becoming an attractive destination. If even a fraction of global carry trades were to enter Pakistan, the country could experience as much as $ 2-3 billion in a matter of months.

This would be greeted with howls of celebration, but this is where the problem starts. With a stable Rupee and rapidly increasing FX reserves, it would be too tempting for the authorities to embark on a growth phase, effectively ignoring the size of the twin deficits that drove the country to the IMF. The EFF program targets would be protected (NIR growth and ample external financing for the fiscal deficit), and the comfort on the currency should ease external sector concerns. This new source of financing has done little to solve the underlying problems in Pakistan's tradable sector, but it could do harm by ignoring it.

The resulting economic growth would not come from an increase in domestic investment (as interest rates could remain punishingly high), but from an increase in imports driven by consumption demand. As we have seen, imports have been driving Pakistan's economic growth for the past two decades.

To ensure that this stream of inflows is not interrupted, SBP is not likely to cut interest rates – even a token cut that does not *really* hurt their margins, could make potential investors think again. So to keep this momentum going, SBP will hold interest rates (even if this is severely criticized domestically) to make it easier to meet the IMF's program targets. Furthermore, if the external sector becomes comfortable (i.e. targets are met by large margins), imports could pick up and prematurely jumpstart the economy. This short-term fix worries us.

Why is the IMF encouraging this?

As discussed earlier, foreign investment in T-bills has several advantages that will help the IMF program. The bulk of financing that Pakistan requires would be arranged by ourselves (which explains why the IMF program was so small), and it would also allow the IMF to stand firm on its advice that SBP's exchange rate management is purely market driven. As discussed in earlier papers, the appreciation of the Rupee appears to be driven by market forces, aided by the hot money inflows.

Others, however, see a hidden agenda to keep Pakistan vulnerable and dependent on volatile inflows, and the IMF. We disagree with this conspiracy theory. What the IMF has always advocated is that policymaking must be sensitive to market forces, with the latter acting as a check on policymakers.[4] However, the IMF has encouraged the authorities to change the sources of dollar demand and supply in the interbank market. More specifically, by increasing the supply of dollars in the interbank market (which will open up an avenue of potential demand in the future), the IMF has facilitated a fundamental change in the FX market.

This should not be viewed negatively, as it creates another stakeholder in the FX market. Professional fund managers closely monitor their investments in EM countries, and if the country's economic management begins to deteriorate, they will pull their investments out. This creates a level of discipline that domestic financers (commercial banks) can never achieve as they are captive lenders to the

[3] Till quite recently, Egypt was the most attractive carry trade in what is called the Emerging Markets (EM).
[4] The whole point of debt management reforms in the early 1990s was to discourage government borrowing from the banking system, by making borrowing costs market determined – hence the auction of T-bills and PIBs.

government. Arguments have also been made that such foreign oversight is necessary to deepen local bond markets and push the authorities to adopt global best practices.

More importantly, it places greater responsibility on SBP to manage hot money inflows. This translates into how interest rates will be used, and how the central bank manages the Rupee. As things stand, SBP is likely to shy away from cutting interest rates and keep the Rupee stable to maintain the inflow of such foreign money. This poses an interesting question: if such inflows are too large (think herd instinct), how will the authorities contain the build-up of hot money?

They could either cut interest rates or intentionally weaken the Rupee, which could create uncertainty and be destabilizing. Looking at the other side, if foreign sentiments sour (say an exogenous factor turns investors against Pakistan), this could trigger pro-cyclical policies. For example, if foreign investors are increasingly concerned about Pakistan's twin deficits and threaten to withdraw their money, this could force SBP to either increase interest rates or stabilize the Rupee, or both. This policy response will be destabilizing, as it will only exacerbate the economic imbalances.

Will policymakers be able (willing) to manage hot money?

A growing stock of hot money will increase SBP's NIR, allow it to maintain a stable Rupee, and finance the fiscal deficit – it will also be used by the authorities to show the confidence that foreign investors have in Pakistan's economy.[5] If the inflows are large enough, it may also allow the authorities to run a larger current account deficit (in FY20) and still meet its EFF targets. This means Pakistan could grow its economy this year, and *still* stay on track with the IMF program. This is too tempting for policymakers to resist, especially if foreign investors discover a new-found love for high-yielding Pakistani T-bills.

Policymakers must be cautious about the type of economic growth this investment could generated. With high domestic interest rates and cheap imports, this could revive import-led growth and undermine the manufacturing sector. One must realize that the IMF's current account deficit is (at best) an indicative target – even if the current account deficit exceeds say $ 10-11 bln in FY20, as long as SBP's NIR targets are met, the IMF program will be on track and future tranches will be forthcoming.

The point is: it is hard to be disciplined when things are going well – we have seen this with 9/11. In our view, we are again at this stage. The larger the stock of hot money, the greater the risk that some part of it will want to exit, and this could put pressure on the Rupee and deplete SBP's reserves. How this is managed while SBP has quarterly NIR targets to meet, will create uncertainty.

As foreign investors pile into Pakistani T-bills, and SBP's NIR grows and the Rupee remains stable, domestic consumption is likely to increase. If importers take the Rupee's stability for granted, imports will rise and economic growth will increase. As we said, this may be too tempting to resist.

In an earlier paper (*Egypt, Turkey & Pakistan; Uncanny similarities & sobering lessons*, 17 August 2019), we cautioned policymakers against going down the hot money route, precisely because it is a short-term fix for structural dysfunction. It's easy to get started, especially when fund managers are desperately looking for yields. If the inflows increase too rapidly, this would signal a false sense of health in the economy, which policymakers would take credit for and achieve short-term growth. However, high interest rates would not solve Pakistan's fiscal problem nor would it help the real sector; furthermore, the

[5] This claim should be taken with a pinch of salt. Fund managers are looking at margins, and live by the risk-return trade-off. Higher returns will attract their money, not because they think Pakistan is the next Vietnam, but because the returns they could earn in Pakistan cannot be matched in other EM countries.

country would be exposed to the sentiments of foreign fund managers. If the economy deteriorates, this money will flow out (as quickly as it came in) and this would create an immediate BoP problem.

What to look out for

The IMF program is a good way to gauge whether Pakistan's economy is on the mend, but there are some glaring loopholes. The size of the current account deficit is not a hard target, which means Pakistan can exceed the $ 6.7 bln deficit target for FY20, as long as it is able to build SBP's FX reserves to finance the deficit and service its debts. Similarly, there is no hard limit on the size of the fiscal deficit but only on the primary deficit. From the IMF's perspective, this makes sense: as an institution, the IMF must ensure that Pakistan's external sector is sustainable (i.e. committed dollar payments are made on time), and since interest rates are used to "stabilize" the economy, it cannot put a limit on domestic debt servicing. In other words, while the IMF is concerned about the size of the twin deficits, it is more concerned that the authorities are able to finance the imbalances.[6]

In addition to the EFF targets, we should closely monitor the fiscal and current account deficits; the stock of foreign investment via SCRA (especially in T-bills); the collection of direct taxes; the losses posted by SOEs; and the size of the circular debt. It should be increasingly clear that the IMF is more a source of comfort for foreign investors than a source of confidence to domestic investors.

Unlike Egypt, Pakistan must not fall into the trap of catering to foreign investors at the expense of the domestic economy. In our August 2019 paper, we argued that Egypt's EFF that ended in mid-2019, has effectively bifurcated the economy, with the economic elite gaining at the expense of the average citizen. Despite this successful stabilization program, structural reforms have lagged behind and Egyptian policymakers are now struggling to calm public discontent.

Pakistan's policymakers must formulate a strategy to revive the real economy before they become hostages to the sentiment of fund managers. It boils down to the difference between thinking short-term and having a long-term vision. The EFF is short-term, which means we need more than the IMF program if Pakistan is ever going to achieve sustainable growth. The issue is whether the economic team is motivated to go beyond the IMF program, or risk an Egyptian replay several years down the line. Will Pakistan's policymaking horizon continue to remain short-term?

Most likely it will.

[6] The IMF's mandate is to ensure that global trade/capital flows are unhindered, while it is the country's responsibility to fix structural problems and set the stage for sustainable growth.

