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Why foreigners want our bonds

During the first quarter of this fiscal year, Pakistan has attracted about $322 million foreign investment in its debt securities i.e. treasury bills and bonds.

A sharp increase in the yields of treasury bills and Pakistan investment bonds or PIBs, subsequent to rapid monetary tightening, has apparently made them attractive.

But as we all know, it is not just the net interest rate that lures foreign investment into debt instruments of a country. A number of factors, including the perceived economic and market risks, also play a key role. When foreign investment starts coming in, it can be taken as a sign that the foreign investors' perception is changing. This also explains, at least in part, why foreign investment starts trickling with some time lag. Perceptions do not change overnight.

Moreover, low economic and market risks alone do not embolden foreign investors to pour funds into the debt market. They also factor in the political and security environment of that country before investing.

That is why we notice that even though our treasury bills and bonds had become attractive in terms of yields in the last fiscal year, actual foreign investment began coming in only with the beginning of 2019-20.

The government's overreliance on international investment to accumulate forex reserves is unwise

Arif Habib, an eminent business tycoon, gives credit to the governor of the State Bank of Pakistan (SBP), Dr Reza Baqir, who "has been making a case for attracting foreign investors to our government bond market".

Commenting on a sizable inflow of foreign investment into our treasury bills and bonds, he says that having the rupee slightly below its REER or real effective exchange rate level can help attract more of such investment in the future. He told Dawn that the rationalisation of the withholding tax regime would also help in an obvious reference to the changes announced in the 2019-20 budget regarding the taxation on income from profit on debt.

The SBP gradually raised its policy rate to 12.25 per cent in the last fiscal year from 6.5pc in the preceding year as the rupee lost 31.7pc of its value to the dollar and inflation shot up. As a consequence, yields on treasury bills and bonds moved to new heights.

The central bank did raise its policy rate by another percentage point in July this year to ward off underlying inflationary pressures and avoid a possible hit on the rupee. It, however, left the key policy rate unchanged in September as some improvement in the external account helped the rupee regain part of its lost ground and central bankers were convinced that inflation was not as much demand-induced as they initially thought and independent economists insisted that it was rather cost-push in nature.

The 6.75-percentage-point rise in the central bank's policy rate — from 6.5pc to 13.25pc — resulted in an unprecedented yearly increase in treasury bills and bonds. At the end of September, the cut-off yields on six-month treasury bills and three-year PIBs gradually rose to 13.55pc and 12.95pc, respectively, from 6.85pc and 7.50pc in June last year.

Between June 2018 and September 2019, six-month Libor that serves as benchmark for international investors worldwide remained range-bound between 2.35pc and 2.4pc. The interest rate on three-year US bonds fell from 2.65pc to 1.58pc.

That essentially explains why foreign investors feel attracted to our treasury bills and bonds even after discounting for the inflation rate. Even after adjusting for 11.4pc inflation in Pakistan in September, 13.55pc net interest on our six-month treasury bills comes to 2.15pc.

On the contrary if six-month September Libor of 2.35pc is adjusted against 1.7pc inflation in the United States in that month, the net interest rate shrinks to just 0.65pc. And inflation-adjusted yield on three-year US bonds, in fact, turns slightly negative with a nominal yield of 1.58pc inflation at 1.7pc.

Pakistan's treasury bills and bonds are expected to continue offering high returns for quite some time in the future as chances for a reversal of the current tight monetary regime are dim. Inflation may not decelerate anytime soon, not to the levels where the central bank can opt for a lax monetary policy.

The reason is underlying inflationary pressures i.e. continuing fiscal adjustments and removal of subsidies on energy and agricultural input sectors. This means that returns on government debt instruments will remain high in the near future. That will hopefully help in attracting foreign investment in treasury bills and bonds thereby helping the country expand its shallow base of foreign exchange reserves. (The central bank's foreign exchange reserves stand around $7.81bn, enough to cover imports of nine weeks).

But the overreliance on foreign investment for the build-up of foreign exchange reserves is unwise. A change in the foreign investors' perception or reversal of tight monetary policy or prolonged stability of the exchange rates can bring such investment to a halt. More prudent management of foreign exchange reserves requires that we focus on job-creating inflows of foreign direct investment or FDI.

During the first quarter of this fiscal year, FDI inflows totalled $542.1m, down 3.1pc from $559.4m a year ago, statistics released by the central bank show. Analysts say Pakistan's recent ascent to the 108th position from 136th on the Ease of Doing Business Index 2020 can help the country receive more FDI in the near future.