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Betting on hot money

The foreign portfolio investment (FPI) in short-term government debt in recent months has spawned a controversy and debate on the potential benefits and risks of such flows.

Popularly known as hot money, global capital inflows were recently a target of criticism by Princeton economist Atif Mian. In a long thread posted on Twitter, he essentially cautioned the State Bank of Pakistan (SBP) against the accumulation of short-term, risky (external) borrowing, stressing the need for re-profiling it to long-term debt as "Pakistan's debt (already) has the lowest maturity among its peers".

Dr Mian went on to point out that the "unregulated capital inflow can build dangerous external liabilities that whiplash the economy and severely constrain the central bank (as) East Asia learned it the hard way in 1998, (and) Mexico before that etc".

In the same thread, he made another important point: with little confidence that Pakistan will be insulated from external whiplashes (because of its habit of relying on the accumulation of external borrowings for short-term economic boost, which has repeatedly led it into IMF progra-mmes), long-term investment does not happen.

Foreign portfolio investment has strengthened the value of the rupee and built the SBP's foreign exchange reserves

According to the latest SBP data, FPI flows into short-term treasury bills stood at $2.6bn while those into longer maturity Pakistan investment bonds (PIBs) were just $35.8 million, helping the government finance its budget. Another $558m found its way into equities. FPI inflows, according to financial analysts, have significantly helped strengthen the value of the rupee and build the SBP's foreign currency reserves.

Few will dispute his advice to discourage short-term debt and portfolio inflows and encourage long-term capital formation by attracting foreign direct investment (FDI) with proper valuation protocol and technology transfer.

But what other choices does the government or the central bank have at this early stage of economic stabilisation to finance the budget and build foreign exchange reserves? Not many. Growth in exports remains anaemic, remittances are unlikely to increase quickly and FDI is not flowing into Pakistan because of the same reasons that Dr Mian listed in Twitter thread. On top of that, the authorities are unable to meet the tax collection target owing to numerous reasons, slowing economy being one of them.

Ahmed Jamal Pirzada, a Bristol University economist, argues that the accumulation of FPI is actually a reflection of the fiscal problem. If the government gives up on raising revenues via FPI, how and where will it get money to finance its expenditure, with tax receipts already falling short of the target?

Indeed, trade-offs aren't easy. Increasing taxes at a time when the government is already struggling with the revised target is not possible. Another way is to cut development spending. Lastly, if the government borrows more from banks, it will crowd out the private sector and the borrowing from the SBP will produce more inflation.

"Which of these (options) is better than FPIs in the current scenario?" Mr Pirzada asks and goes on to suggest that the medium-term solution lies in reforming state-owned enterprises (SOEs), simplifying tax laws and policy and expanding the tax base. The unfortunate part is that not much 'appears' to be happening towards this end."

Unless the country sorts out the fiscal mess, the problem/risk will keep appearing in one form or another — in the form of FPI, more arbitrary taxes or a liquidity crunch in the banking system, he says. He is spot on because any movement in any of these directions will further dampen growth, which is already projected to slow down to 2.4pc this year.

There's no doubt that the "easy come, easy go" hot money flows pose new challenges to the economy and the central bank. Nonetheless, these global short-term capital flows, in spite of a higher cost they entail, did rescue the SBP and the cash-starved treasury running out of fiscal and monetary space at a time when other options could prove to be dearer and riskier.

The SBP may still have some space left to attract short-term external liabilities, but this cannot go on forever. Pakistan's bonds, in spite of an upgrade of its negative economic outlook to stable by Moody's and Fitch, still fall in the junk category. Even a small event on the fiscal side can make hot money flee at the expense of the external-account stability.

We have seen this in the recent past as imprudent fiscal and monetary policies pursued by the previous government landed us in this mess and led to adjustments that are proving extremely painful for people as well as industry.

A sound fiscal and external-sector management demands a faster increase in the country's external debt maturity and exports as well as measures to attract longer-term, stable FDI to ward off the future boom-and-bust cycles.

In an email response to a couple of questions from this correspondent, Boban Markovic, an economist for the Middle East, North Africa, Afghanistan and Pakistan region at the Institute of International Finance (IIF), says a tighter monetary policy and the sharp depreciation of the rupee have reduced Pakistan's external vulnerability. "Achieved results in economic stabilisation have to be maintained by prudent policies, even after the IMF programme ends. This is an ongoing process given Pakistan's structural deficiencies."

Beyond the near term, he expects economic activity to pick up gradually. "It is important for Pakistan to continue improving the business environment in order to attract FDI into high value-added sectors and to stimulate exports… a lot more needs to be done to create the business environment conducive to export-oriented economic growth.