Hot Money – The Giant Killer
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Over the years, persistent low investment rate is a worrying sign for Pakistan, and it has become challenging to compete with the emerging and developing economies, which are growing with much faster pace, making it an uphill task for the country. Structural weaknesses, legal and constitutional constraints, increasing tax compliance, policy uncertainty and unpredictability are major barriers to attract sizeable traditional capital inflows in the country.

In addition to debt trap, Pakistan has also stuck in low-investment-low-saving vicious cycle leading to crowding-out of private sector which has limited the growth potential of the country. With respect to the regional economies, investment rate in Pakistan is deteriorating both in absolute terms and as percentage of the GDP which has negatively affected productive sectors of the economy including human capital, infrastructure, energy, industrial sector, transport, agriculture etc.

To increase the foreign exchange reserves and to finance the fiscal deficits, emerging economies lure foreign investors to invest their 'Hot Money' into the country to build up foreign exchange reserves. We will discuss in detail the 'Hot Money' implications in this report.

1. WHAT IS HOT MONEY:

Hot money refers to a flow of funds moving from one country to another seeking short-term profit on interest rate differentials and/or expected changes in exchange rates

In the wake of short-term gains, overseas investors' search new jurisdictions where interest rates differentials are higher or economic fundamentals are strong. One of distinguishing features of hot money is that it is invested for shorter periods of time and is very elastic to interest rate variations. This feature makes the recipient country's economy very much volatile.

2. PAST EXPERIENCES:

In early 1970's, Pakistan introduced foreign currency accounts (FCAs) by providing reliable and saving instruments to overseas worker's working abroad to attract capital flows to finance growing deficits. This scheme turned costly as accounts protected against the exchange risk, banks were given by SBP 'cushion' forward cover on their foreign exchange liabilities against the foreign currency deposits.

During early 1990's, Pakistan opened up its economy, adopted liberal and market-oriented policies, and accelerated private sector by offering incentive packages eying capital flows. As a result of certain legal interventions to pamper tax evaders, FCAs turned tax heaven for overseas investors to park wealth which increased country's external debt and added cost to the economy.

Proponents of trade liberalization regime believes financial capital markets and flexible exchange rates attract free capital inflows from one country to another to exploit short term gains which make economies more vulnerable. On account of globalization phenomenon, numerous international portfolio funds started targeting Pakistani Stock market and kept pouring hot money for their short-term gains.

To accompany the essential requirement of opening capital account during first half of 2000 era/decade, liberalization process continued and resulted into more transparency and supervision, making the foreign exchange companies to encourage formal channel of inward remittances instead of hawala *and hundi*. With the liberalizing foreign banks operations, market determined exchange rate and financial reforms, country managed to attract $8 billion private foreign investment in 2007. Such foreign capital inflows fueled the speculations in stock market and real estate, which made them vulnerable leading to deterioration in country's competitiveness. Given the fact that Pakistan economy's exposure to global economy is not as big as that of emerging economies but in past, it nevertheless remained highly vulnerable and regularly felt the 'heat' out of the external shocks emanating in international oil prices that threw Pakistan into regular balance of payment crisis.

No serious legislation in foreign investments policies was pursued by the country to attract capital flows in human resource, advanced technology, infrastructure, industry or business environment.

In past, country raised loans at floating rates with short term investment horizon from foreign commercial banks or multilateral agencies to build foreign exchange reserves. Such past practices to capitalize hot money poses serious challenges for the debt sustainability and weaken external account of the country.

3. OTHER COUNTRIES EXPERIENCE:

3.1. East Asian Crisis 1997

Asian financial crisis (1997-98) started from Thai baht in July 1997 followed by unprecedented financial crisis in Asian economies and later in the whole world, which revealed premature financial liberalization in the absence of established regulatory functions and inadequate policy responses/measures which triggered panic in the region.

On July 2, 1997, Thailand devalued its currency against US dollar which couldn't absorb the speculative attacks on account of low reserves and weak external account which eventually depleted Thailand's official foreign exchange reserves, leading to beginning of financial crisis in East Asia.

Interest differential between Thailand and foreign money markets were one of the key reasons in Asian financial crisis besides other factors including absence of financial risk management, large current account deficit, uncontrolled capital flows, elevated interests' rates and rigid exchange rate.

Minimum Lending Rate (Thailand)	LIBOR	Interests Rate Differential
13.75%	5.38%	8.37%

Prime lending rate in Thailand (Minimum Lending Rate or MLR 13.75%) had always remained higher than that of LIBOR (5.38%) or Federal Funds Rate (5.25%) during 1996. The interest rate differential between MLR and LIBOR were 8.37%, which provided big incentives to commercial banks/financial institutions in Thailand to borrow cheap hot money from foreign markets and remit back into Thailand which eventually exceeded banks' lending growth and exposed systematic risks.

Bangkok International Banking Facility (BIBF) allowed licensed banks to raise foreign capital in foreign currency from abroad and lend it to residents or non-residents and had no restriction on foreign borrowing by private sector on the inflow side. In addition to that several other incentives were also offered such as reduction in corporate tax rate from 30% to 10% and exemption on sales tax and duties in order to increase foreign exposure in Thai economy. At one-point, massive BIBF lending crossed to over 2 trillion baht first time ever which exposed financial mismanagement of the central bank.

BIBF financed their domestic long-term loans through overseas financing and ballooned balance of payment and external account risks. Hence, Thailand's short-term debt which recorded at $66 billion (80% of total external debt of $82 billion) put country into balance of payment crisis and spread panic in the market. The strategy to attract free capital movement in a fixed exchange rate regime made things more difficult for the country.

Within short span of time, Thai baht devalued from 25.34 to 48.80 per dollar as outflows under BIBF were recorded at negative 128 billion baht. Overall outflows of Hot money increased by 10 times since 1997 through first quarter of 1999 amounted to 390 billion baht as against the 335 billion baht inflows during 1992 to 1996.

In order to absorb panic attacks, Malaysia, Philippines, and Indonesia also devalued their currencies in the face of market pressures. Plummeting of Indonesian markets and Rupiah, political instability and civil unrest further aggravated economic meltdown and investors' confidence. Japan's economic woes compounded regional trouble; massive speculative attacks were recorded in financial sector of Malaysia, Taiwan,

Philippines, Singapore and China. Hong Kong had also faced several large speculative attacks on its currency peg to the dollar, which triggered massive sell off in equities across the globe while spillover effects were also seen in Latin America and Eastern Europe.

Prior to Asian crisis, four Asian countries (Indonesia, Korea, Philippines and Thailand) accumulated $87 billion net inflows constituting major chunk of the hot money. While the cumulative net outflows of over $100 billion were recorded during the Asian crisis of 1997.

3.2. Egypt

Central Bank of Egypt in November 2016, following the IMF prescription, raised interest rate, liberalized exchange rate and devalued the currency. Thereafter, free floating exchange and high interest rates occasioned massive hot money inflow in Egyptian economy. Generally, in Egypt yields have remained higher than the Occident.

Following the IMF program, Egypt raised interest rate by 700 bps from 12.25% to 19.25% thus brought hot money and foreign direct investment in the economy. Overseas investors bought short-term maturity paper, T-bills and bonds and hot money worth $16 billion in addition to foreign direct investments which stood at around $8 billion. Out of $16 billion inflows, $5.49 billion were invested in only bond market. Overall, financial account balance was recorded at $24 billion during 2017-18 enabling Egypt's foreign exchange gross reserves reached at $36 billion, this strengthened exchange rate and impacted positively over country's balance of payments in short term.

(US $ million)	2016-17	2017-18	2018-19	Absolute Change over 2016-17
Portfolio Inflows	15,985	(2,829)	3,137	(12,848)
Bond	5,492	2,101	2,050	(3,442)

Source: Egypt Central Bank

However, despite overseas investor's hot money injection in Egypt, country could not manage to attract much foreign direct investment which was the concern for policy makers. As a result, with the decline in discount rate by 200 bps from 19.25% to 17.25%, total outflows of over $16 billion hot money evaporated in 2018-19 within a short span of time that put country into current account deficit and large fiscal deficit and if the trend persists, Egypt will soon be bankrupt.

3.3. Turkey

During 1980's, in the wake of balance of payment crisis, macroeconomic instability and high foreign debt and deteriorating reserves in Turkey, foreign financial liberalization policies were introduced and abolished restrictions on the foreign capital movement. After IMF-supported stabilization program was adopted in April 1994, Turkish policymakers were desperate to attract hot money to finance deficits by increasing domestic interest rate in economy and accelerate capital markets. Hence foreign capital inflows before 1994 crisis in turkey were recorded at $12 billion but after the 1994 crisis $4.2 billion capital outflows were recorded. Similarly, after the global crisis of 2008, capital flow to Turkey again increased to around $53 billion in March 2011 comprising of $23 billion portfolio inflows, $21 billion other investments and $9 billion FDI.

4. HOT MONEY IN PAKISTAN

Portfolio inflows are easy to trade and less sustainable which includes stocks, bonds, debt securities etc. Predominately, short term nature of such type of investment instruments usually associates short-term interests which bring greed, volatility and uncertainty in the financial markets.

Given speculative nature of short-term investments, sudden and fast outflows have historically triggered financial and economic crisis. Hot money comes in and goes out of a country with sudden shift in market sentiment; this is also known as "carry trade".

In world of 'zero interest rate' regime, Pakistan has offered higher interest rate in recent past which has stimulated substantial inflows of Hot Money or Carry Trade from cheaper sources. Likewise, during Musharraf regime shortly after 9/11 Pakistan's economy received overwhelming inflows of billions of dollars through gateways of foreign aid, economic assistances from US, WB and IMF, overseas Pakistani remittances and hidden off-shore wealth from tax heavens and consequently injected large amount of liquidity in the banking system.

The massive hot money injection accelerated economic activities. However, such injections also became problematic which appreciated asset prices in the country, encouraged speculation in equity & real estate markets, fueled consumerism and initiated boom-bust cycle triggering crisis in the economy.

Weighted avg. 6 Month T-bill	6-Month LIBOR	Interest Rate Differential	Rupee appreciation Vs. US Dollar	Net return
13.29%	1.88%	11.41%	5.31%	16.72%

At the moment, interests rate differential between two jurisdictions (Pakistan vs. World) stands at 11.62% being offered to the overseas investors to attract hot money for reserves accumulations of the country. Interest rate differential is the difference between the six months LIBOR rate (1.88%) and the corresponding six months Pakistani T-bill (13.5%), spread reached to 11.62%. This is in addition to around 5.31% return on account of Rupee appreciation against US dollar since June 2019 taking commutative return to 16.72% which in nowhere in the world.

LIBOR stands for London Interbank Offered Rate which is the accepted benchmark rate that major global banks charge each other for short-term loans.

State Bank and Government of Pakistan are betting on a risky strategy to attract hot money through T-bills and PIBs to boost reserves by keeping interests' rates on higher side, offering tax concessions and simplifying tax regime for non-resident companies investing in the local debt market. According to State Bank, overseas investors have so far invested $1.161 billion in T-bills and $3.19 million in PIBs in debt markets in a short span of four months.

Cumulative Net inflows in T-bills, PIBs and Equity markets				
July 19 to 5th Dec 2019				
(Thousand US$)	**Equity**	**T-Bills**	**PIBs**	**TOTAL**
Net inflows	(17,331)	1,161,947	3,190	1,147,806

Source: SBP

Out of speculative hot money funds 'SCRA' (Special Convertible Rupee Account) inflows are largely driven by overseas investors from US, UK and UAE have invested 98% hot money funds in Pakistan since FY20 to 5th Dec 2019.

On one hand, hot money injections in local debt market have boosted the foreign exchange reserves of State Bank from $7.827 billion (July 2019) to $8.682 billion (Nov 2019). On the other, move to lure foreign buyers into the country's debt market could expose economy to external shocks and economic repercussions as in Asian Crisis 1997.

Since 'loyalties' of hot money funds are short-lived, as soon as country reduces its interest rates/yields or an economic fundamental weakens, investors with "hot money" would withdraw their funds and switch to another jurisdictions with higher rates which will bring additional pressure on foreign exchange reserves and put Rupee under pressure.

Given the historical practices, country's central bank maintain their policy rates on higher side to keep inflows of hot money intact which increased government's domestic debt burden leading to accumulated public debt and left little fiscal space for the country to invest in human capital, infrastructure and development.

The degree of temporariness of hot money has increased in recent years and this phenomenon of potential reversibility of large capital outflows may trigger repercussions for macroeconomic stability in short term. Large

supplies of foreign exchange entering into local economy also increase money supply which can generate demand pressures, push inflation, multiply economic woes and reduces competitiveness of the country.

It is said that the PKR to Dollar parity was artificially kept lower by the Finance Ministry in previous regime. It is learnt that dollars used to be bought from Foreign Exchange Companies and were injected into open market to keep the exchange rate lower. Policy rates were also kept lower which stimulated the borrowing and investments in new projects which in turn boosted the economic activity resulting in the GDP growth.

Present government is also doing same by inviting hot money to attract foreign exchange. Foreign hot money investors have been guaranteed that PKR/USD parity will not exceed Rs. 155 so that they will not be exposed to any exchange loss at the time of redemption and conversion into USD of their PKR denominated investments. For example, investments in T-Bills at 13.5% will earn them a risk free return of 13.5% (net of taxes as per treaties, tax deduction rate is 15% and 10% as per tax treaties with UK and UAE, respectively). This high interest rate should be brought down to around 7% and to safeguard the out flow of hot money, the exchange rate should also be brought down to PKR 140-145. In this way the investors' rate of return would be intact (or could even be more) as part of profit on debt foregone would be offset against exchange gain from PKR appreciation.

Reduction in interest rates coupled with lower exchange rates would highly be beneficial for the economy as on one hand import bill will reduce, while on other, lower interest rate means easy access to capital, lower costs of doing business, more investments in active rather than passive projects, lower unemployment rates, more economic activity and higher GDP growth.

5. BOTTOM LINE

1. The degree of temporariness of hot money has increased in recent years in the wake of globalization, technological assistance and tough competition to get short term gain and this phenomenon of potential reversibility of large capital outflows may trigger repercussions for macroeconomic stability in short term.
2. Such speculative hot money funds can make Pakistan's financial markets more vulnerable and volatile to any external shock in near future in the wake of high oil prices, elevated fiscal deficits, and high interest rates and on heightened inflation risks.
3. Hot money comes in with increase in interest rate and goes out quickly from the country with the drop-in interest rates, yields and change in economic fundamentals.
4. Hot money funds can trigger bubbles in asset prices in local economy leading to surge in money supply resulting into inflation and reduces competitiveness of the country.
5. Before withdrawal of hot money funds, Pakistan must diversify its sources of foreign currency funds as sudden outflows could deplete reserves and may further weaken the Rupee.
6. On account of past experiences and historical evidences, betting on risky strategy to earn risky foreign capital flows may work in the short run but can have adverse effects in the long run.
7. In the wake of short-term gains, overseas investors' search new jurisdictions where interest rate differentials are higher or economic fundamentals are strengthened; emerging economies lock inflows of hot money to finance deficits in desperation. Hence, substantial capital inflows make recipient country more volatile and vulnerable to future external shocks.
8. Overseas Pakistani's also play a vital role while contributing to foreign exchange reserves of the country. These remitters may also be incentivized to remit their savings to Pakistan through specialized investment schemes instead of Pakistan Remittance Initiative ("PRI"). Banks should not be paid bank charges under PRI, instead the remitters should be offered discounted exchange rates or cash backs for using banking channels for remittances.