The Pakistan Situation

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Is this the real life? Is this just fantasy?

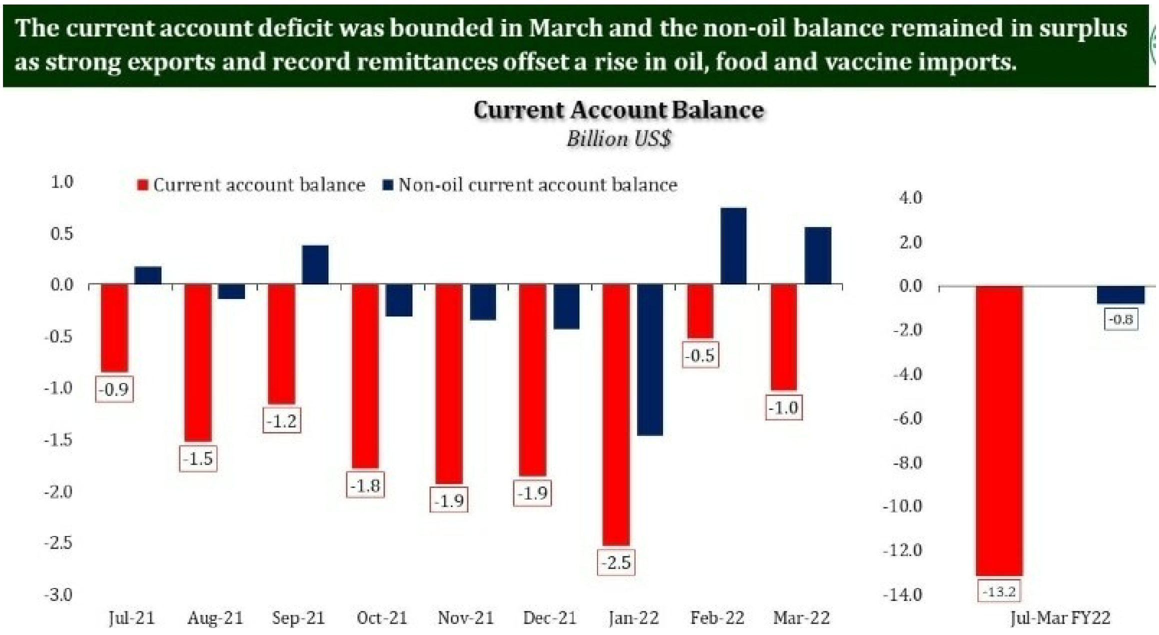
You are probably judging me on the sloppy caption, but trust me it is there for a good reason. And I like the song, but I digress. Remember the 1993 cult classic, Groundhog Day? Don't worry, the cult status of the film is not relevant to the article. In the film, the protagonist re-lives the same day for 33 years. He goes to sleep, and wakes up to the same events happening to him. That is what Pakistan's economy looks like from the outside. Every three years, there is an organic or propped up regime change, followed by a very high current account deficit and a near default situation. Notice how I use the word *near*, because as amazing as it might sound, Pakistan has never defaulted on it's sovereign debt obligations. Anyway, the near default situation is followed by the Prime Minister going on a tour of friendly countries asking for dollar deposits and concessions. In the past 64 years (yes, almost immediately after it's independence), Pakistan has gone to the IMF for extended fund facility some 22 times. The current crisis would have ordinarily been written down as a re-enactment of the aforementioned scenario, but it is different.

How is This Crisis Different?

You know what they say, everything is different until it isn't. This crisis might turn out OK for our neighbors after all but right now, it has all the makings of a protracted struggle. First, nations *friendly* to Pakistan have apparently gotten a hang of Pakistan's infatuation with the aforementioned movie, and are now making their deposits contingent on an IMF Programme. With demand back to pre-pandemic levels, the international commodities markets are on a roll. And for a heavily imports driven economy, this can spell doom. This leads us to the first fundamental flaw in Pakistan's economy:

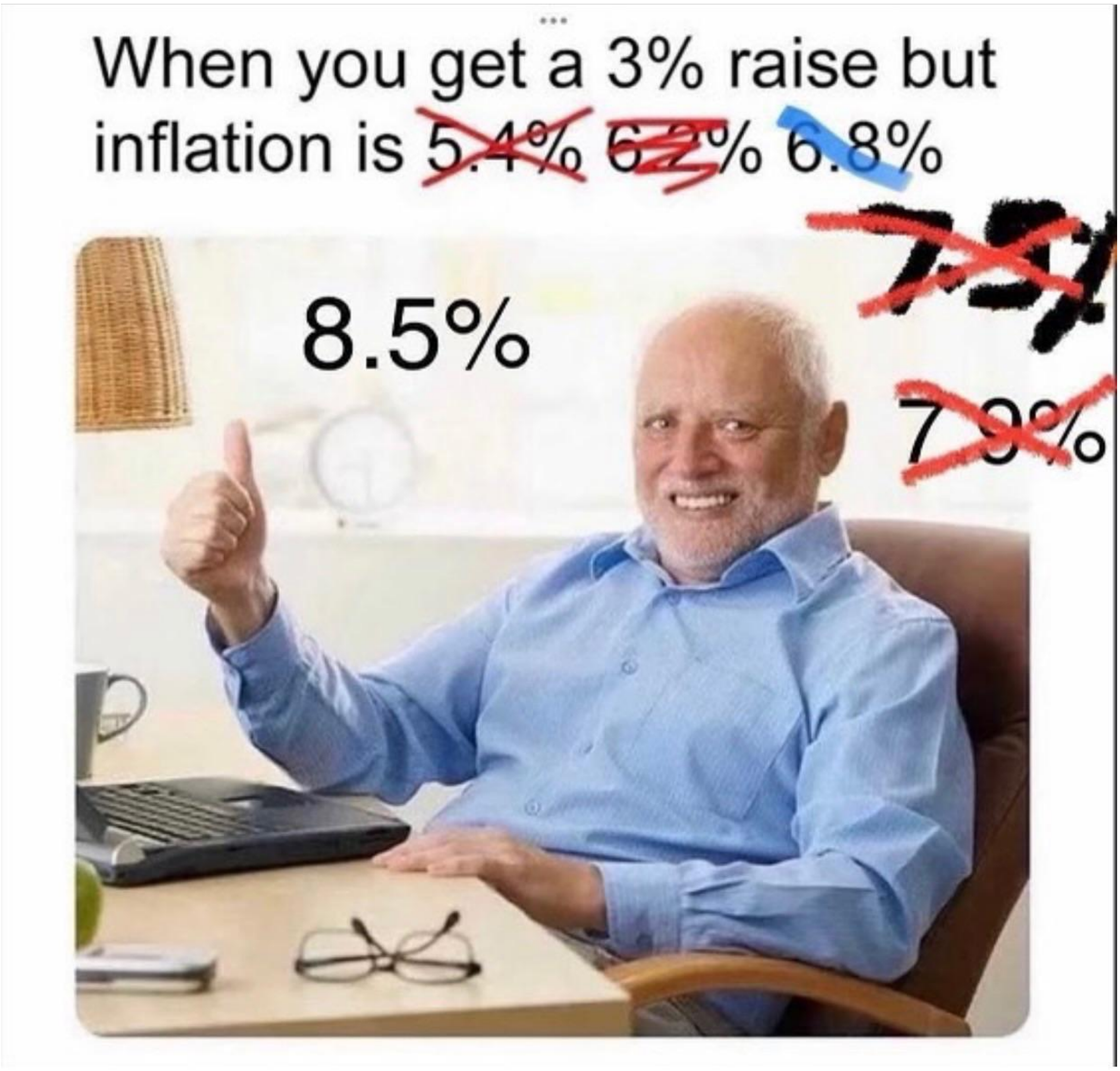
1. **Over dependence on Imports:**

   Pakistan imports everything, from pulses to fuel to cars. And while such an arrangement might work for a country like Japan, for a primarily agrarian economy like Pakistan's, this can spell doom. Commodity prices are, like most other things, cyclical. A commodity supercycle, when prices are consistently high, puts a lot of strain on countries that do not have many high value exports. Let's face it, good quality mangoes (Pakistan's premier export) can fetch only so much foreign exchange.



Note: Non-oil current account balance is arrived at using petroleum related export and import transactions through the banking channel.
Source: SBP

2. **Sustained Inflation**



Cost Push Inflation takes place when demand remains steady, but the cost of producing goods goes up. After the pandemic started waning, demand has shown a strong uptick but supply chain disruptions across the world have made supplying goods difficult. Pakistan is no different, and this coupled with the very unfavourable PKR/USD exchange rate has driven inflation. The latest figures peg the number at 21%. It would be natural to think that the Central Bank (State Bank of Pakistan) will take measures to stem inflation. The thing with cost push inflation, however, is that once started, it is very difficult to control. The statebank has taken drastic measures like a 125bps increase in the policy rate.

i. **A Digression: Policy Rate vs Inflation**: Policy rate is the interest rate at which the Central Bank lends. It directly influences the interest rate at which credit is available. Suppose a country has high inflation (say something worth a 100 rupees today will be worth 150 rupees next quarter) and a low policy rate, then you can essentially borrow 100 rupees, buy goods and sell them for 150 rupees next quarter, making a tidy profit after repaying your loan. Needless to say, it reinforces inflation.

3. **So, will Pakistan Default?**

   With Sri Lanka recently defaulting on all its foreign debt obligations the idea of Pakistan defaulting on its foreign debt obligations might seem plausible, but there is near zero probability of it actually defaulting because of the following reasons:

   a. Pakistan has never been in default on its sovereign debt, except for a technical default in the late 90s that occurred due to sanctions that were imposed on a country following nuclear tests.
   b. A sovereign default occurs when a sovereign nation is not able to pay back its creditors, whether the interest or principal amount as per its commitment.
   c. Pakistan's foreign debt obligations make up about **17% percent** of total external debt. 63% of Pakistan's debt is denominated in PKR, and a country can, in principle always print as much of its currency as it needs. Of course the repurcussions may be harsh, but that's life.

d. 37% of Pakistan's total debt is denoted in foreign currencies, primarily in USD. The breakup of external debt is as follows:
i. 57% is due to multilateral institutions like IMF, World Bank. Mulilateral organisations rarely call on a default. Their priority is to negotiate with the borrowing country to work out a restructuring plan.
ii. 24% is due to friendly countries, like China and UAE.
iii. 17% is due to private investors through instruments like Eurobonds and commercial debt. Private investors may call on default, but the amount owed to them is less than one percent of the GDP, so it is unlikely that the government will default on them.

Conclusion

I knew my years of doomscrolling on Pakistani twitter won't be in vain. This blog helped me legitimize the time I wasted on Pakistonomy and Profit to some extent. It was fun. Also, watch Groundhog day.