INFLATION AND SOVEREIGN DEBT in Pakistan

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The risk of sovereign default is a recurrent feature of Pakistan's economic situation because the country's external debt and liabilities exceed USD 126 billion. This is the equivalent of over two thirds of Pakistan's GDP, and as a result, over 40% of government revenues are consumed by debt servicing costs. Many analyses of this situation, including those from lenders such as the IMF, highlight the various, complex and overlapping reasons for Pakistan's failure to overcome the crippling indebtedness that continually weakens the economy and impedes progress in areas such as education, healthcare and infrastructure. In this essay, I draw attention to the concept of monetary power and argue that this is a valuable tool for understanding Pakistan's issues around sovereign debt, particularly how these are closely connected to events in the 1970s, especially when the Bretton Woods system was undone.

Asymmetries in monetary power explain how global economic instability is worse for some countries than for others. This is perhaps best reflected in the unevenness of inflationary pressures which are structurally determined by monetary power. Every country has a different level of monetary power, which is determined by the interaction between two components: the degree of monetary sovereignty it possesses, and the place occupied by its currency in the global hierarchy of money.

Monetary sovereignty refers to a country's ability to control its own currency and monetary policy without external interference. Like many other countries of the Global South that were colonised or have experienced significant political instability, Pakistan's monetary sovereignty has been undermined by 'original sin'. This is the idea that certain countries struggle to issue debt denominated in their own currency. Because they are unable to borrow in their own currency, they must instead issue debt in a foreign currency, typically a major international currency like the US dollar or the Euro. Original sin can thus be seen as an outcome of a currency hierarchy. In the international financial system, the dominance of some currencies creates an uneven playing field; some countries can borrow in their own currency, but others cannot. For countries that are lower in the currency hierarchy, this arrangement is challenging. Not only is it difficult to access international capital markets, but economic shocks can be more devastating; this is the case in Pakistan currently.

The US dollar's apex position — at the top of the currency hierarchy — is a relatively recent development. The idea of a dominant currency in international trade and finance dates to the 19th century when the British pound sterling was the dominant currency in global trade and investment. But after World War II, the US dollar emerged as the dominant currency. This was a result of the new international monetary system established at the Bretton Woods conference. Under the Bretton Woods system, the US dollar was fixed to gold at a rate of USD 35 per ounce, and other currencies were pegged to the US dollar. In the decades that followed, the US dollar continued to play a dominant role in the global economy, and other currencies like the Japanese yen and the Euro emerged as key players in international trade and finance.

This system was disbanded in 1971 when President Nixon announced that the United States dollar would not be backed by gold anymore. This was a reasonable decision. The Bretton Woods system had been pivotal to the uplift of the post World War II global economy and had generated immense prosperity for the United States. But as a result, in the 1970s there was strong demand for USD which the Federal Reserve had been responding to by printing money. As a result, there were four times as many dollars in circulation as there was gold in reserves.

The Nixon Shock was not the only key monetary policy event of the 1970s, particularly for countries in the Global South. In 1973, displeased with US support of Israel, the Arab-led cartel known as the Organization of Petroleum Exporting Countries (or OPEC) quadrupled the price of crude oil. The national revenues of oil producers immediately surged and this excess money was placed in global commercial banks eager to lend it further. This resulted in a cascade of new loans to countries in the Global South. Often, these were disbursed with limited scrutiny and monitoring. These decisions exposed many countries to exchange rate risk and impeded them from pursuing independent monetary policies. The monetary power of these countries was limited further later in the same decade when interest rates rose and made debt servicing more expensive, particularly when the IMF demanded structural reforms in exchange for necessary financial assistance.

In Pakistan over the 1970s imports greatly outpaced exports and created dependence on external lenders. Balance of payments issues were somewhat mitigated by large increases in worker remittances from the Gulf states experiencing an oil book. Remittances increased from USD 136 million in 1972 to USD 1,744 million in 1980. Even today, these flows continue to partially plug the gap between imports and exports.

The failure of Pakistani policymakers to grow exports and rectify the trade balance has complex political reasons. But this should not detract from the reality that Pakistan is one of many economies still troubled by the events of the 1970s that removed monetary power in the Global South. These issues were revisited by economists and scholars of currency in the 1990s and 2000s, particularly as financial crises originating in East Asia, and the United States respectively, revealed the disadvantages faced by subordinate currencies. Many of these disadvantages are exacerbated because of the phenomenon known as financialisation. The influence of financial markets on economic policy has increased drastically over the last few decades and the asymmetrical capacities of countries to manage their own currencies — and hence financial markets — has been especially detrimental for countries like Pakistan.

This is easily illustrated through the recurrent issue of surging prices in Pakistan. High inflation has reduced purchasing power – and aside from reducing overall living standards it has also pushed millions of marginalised and vulnerable groups into deep poverty. For the Pakistani economy inflation is particularly devastating because it carries no advantages. In many OECD countries, for example, recent inflationary pressures — driven by supply shocks because of the war in Ukraine — can reduce the real value of domestic public debt, but in Pakistan's case any such benefit is heavily offset by an increase in external debt servicing, because inflation puts downward pressure on the Pakistani rupee, and external public debt is primarily in foreign currency.

Policymakers are of course well aware of these problems which have structural causes. This is reflected in initiatives such as the issuance of local currency karakoram bonds, in a project led by the Asian Development Bank. These bonds, issued in late 2020, offered an alternative to dollar borrowing. They raised USD 11.4 million, which is a tiny fraction of Pakistan's outstanding external debt which exceeds USD 126 billion. A related strategy, regularly endorsed by international financial institutions, is deep and liquid domestic capital markets to enhance investment and debt transparency. This approach has worked in some large emerging economies such as Brazil, India and South Africa, which currently have almost no foreign-currency public debts. For Pakistan, such plans are not feasible until tax revenues increase enough to give the government the fiscal space to sustainably meet interest obligations. Domestic debt can, relative to external debt, preserve foreign currency, but the payment of interest on government debt still involves a transfer of wealth from taxpayers to bondholders. It is nevertheless a desirable strategy given its potential for reclaiming monetary power.

Monetary power, reflected in debt sustainability, will remain elusive for Pakistan unless policymakers can decrease the trade gap and increase tax revenues. But this should not obscure the actuality of contemporary crises which have deep roots with political underpinnings. This is especially important given a rapidly growing awareness of how emergency situations — the debt crisis and climate crisis — overlap. The case for reforming the global debt architecture should be based not only on the perils of the present and the future, but with a clear view to a more just distribution of monetary power across nations.

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