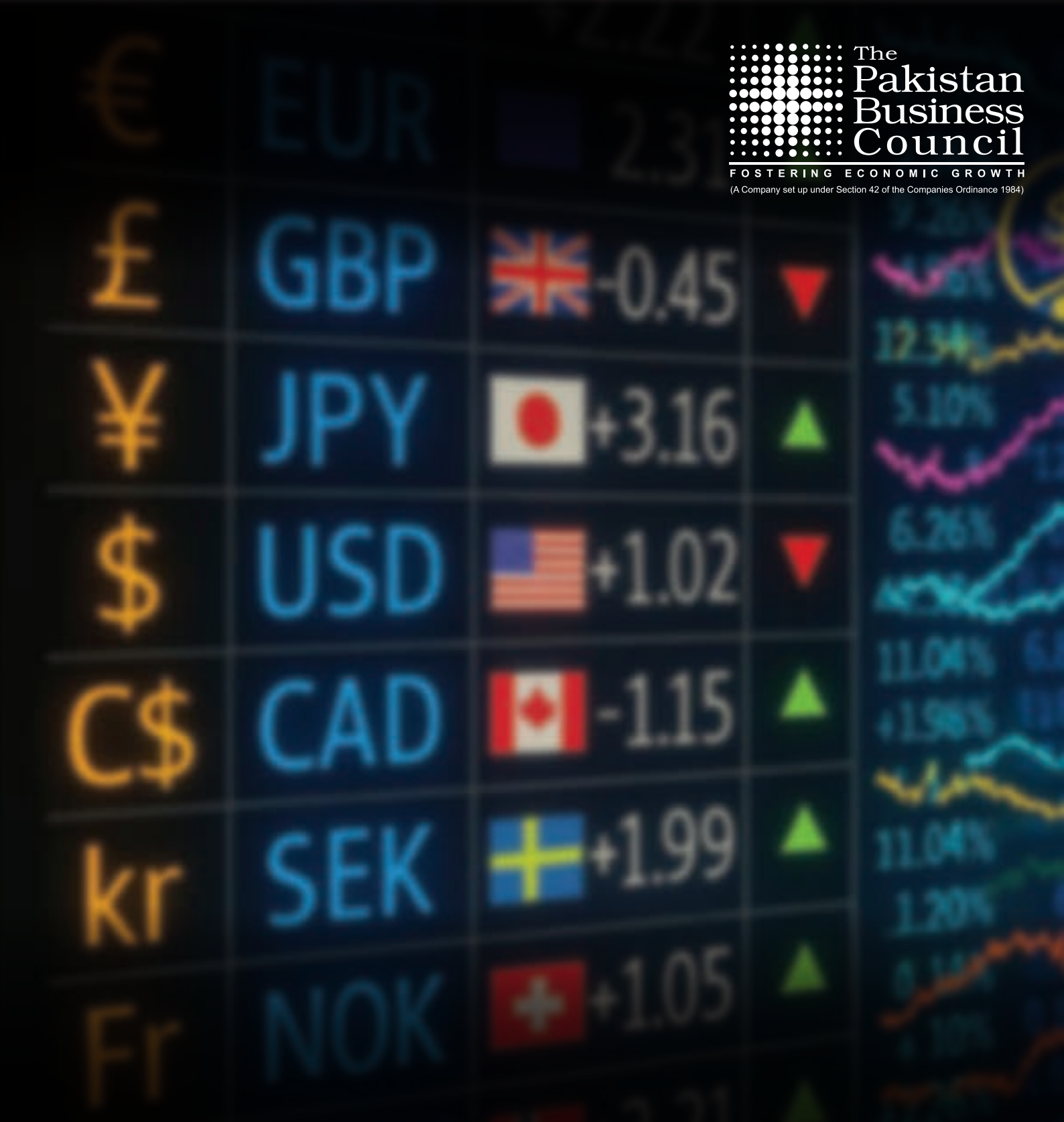

The Pakistan Business Council

FOSTERING ECONOMIC GROWTH

(A Company set up under Section 42 of the Companies Ordinance 1984)

REER DYNAMICS AND EXTERNAL COMPETITIVENESS OF PAKISTAN

A Layman's Guide to Understanding Real Effective Exchange Rate in Pakistan

April 2026

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April 2026

ACKNOWLEDGEMENTS

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For any queries or feedback regarding this report, please contact
samir@pbc.org.pk or **nida@pbc.org.pk**

THE PAKISTAN BUSINESS COUNCIL:

An Overview

The Pakistan Business Council (PBC) is a research-based business advocacy platform established in 2005. It is now supported by over 100 private sector local and multinational businesses with significant investment in, and long-term commitment to sustainable growth of the country. They come from 14 countries, have leading roles in 17 major sectors of the formal economy, generate 40% of annual exports, contribute a third of Pakistan's total tax revenues and employ three million. Their combined sales represent every 6th Rupee of Pakistan's GDP.

PBC's major objectives are to advocate policies that lead to creation of jobs, value-added exports and reduction in import reliance through improved competitiveness of manufacturing, services and the agriculture sectors. It also promotes formalization of the economy.

PBC's over-arching theme, "Make-in-Pakistan" consists of three pillars: "Grow More/Grow Better", "Make More/Make Better" and "Serve More/Serve Better." Its evidence-based advocacy is backed by over a hundred studies to date, through its full-time research team, supplemented by collaborative research with renowned industry experts and economists. Through its Centre of Excellence in Responsible Business (CERB), PBC works to build capacity and capability of businesses beyond its membership, to adopt high environmental, social and governance standards. PBC holds conferences, seminars and webinars to facilitate the flow of relevant information to all stakeholders in order to help create an informed view on the major issues faced by Pakistan. Through its presence in Islamabad and Karachi, it works closely with relevant government departments, ministries, regulators and institutions, as well as other stakeholders including professional bodies, to develop consensus on major issues impacting the economy.

PBC is a pan-sectoral, not-for-profit, Section 42 entity. It is not a trade body; therefore, it does not advocate for any specific business sector. Rather, its key advocacy thrust is on easing barriers that thwart competitiveness of businesses in Pakistan.

Further information on the PBC is available on: **www.pbc.org.pk.**

THE PBC'S FOUNDING OBJECTIVES

- To provide for the formation and exchange of views on any question connected with the conduct of business in and from Pakistan.

- To conduct, organize, set up, administer and manage campaigns, surveys, focus groups, workshops, seminars and fieldwork for carrying out research and raising awareness in regard to matters affecting businesses in Pakistan.

- To acquire, collect, compile, analyze, publish and provide statistics, data analysis and other information relating to businesses of any kind, nature or description and on opportunities for such businesses within and outside Pakistan.

- To promote and facilitate the integration of businesses in Pakistan into the World economy and to encourage in the development and growth of Pakistani multinationals.

- To interact with governments in the economic development of Pakistan and to facilitate, foster and further the economic, social and human resource development of Pakistan.

THE PBC MEMBER COMPANIES

THE PBC MEMBER COMPANIES

THE PBC AFFLIATES

engro energy terminal

engro fertilizers

engro polymer & chemicals

HINUCON (Private) Limited

HUBCO

IFL

ISL International Steels Limited
Shaping Tomorrow

LCI
LUCKY CORE INDUSTRIES

Lucky Electric Power Company

LMC Lucky Motor Corporation

MASTER
MASTER WIND ENERGY LTD.

PAKISTAN CABLES
TRUSTED NOT TO COMPROMISE

Tri-pack
Tri-Pack Films Limited

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ACRONYMS

EFF	Extended Fund Facility
ER	Exchange Rate
FY	Fiscal Year
IMF	International Monetary Fund
MPC	Monetary Policy Committee
MPS	Monetary Policy Statement
NEER	Nominal Effective Exchange Rate
NER	Nominal Exchange Rate
NIR	Net International Reserves
PKR	Pakistani Rupee
PKR/USD	Pakistani Rupee per US Dollar
REER	Real Effective Exchange Rate
RER	Real Exchange Rate
RPI	Relative Price Index
RSF	Resilience and Sustainability Facility
SBA	Stand-by Arrangement
SBP	State Bank of Pakistan
SDR	Special Drawing Rights
SOE	State-owned Enterprise
TT	Telegraphic Transfer
USD	United States Dollar

EXECUTIVE SUMMARY


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EXECUTIVE SUMMARY

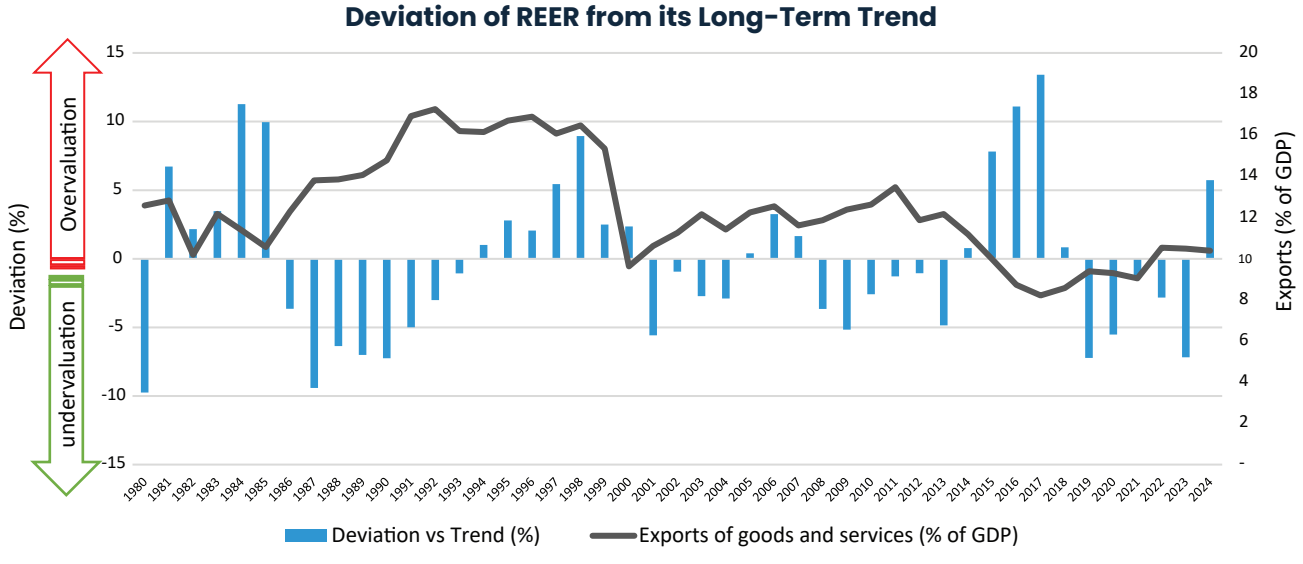
This report examines whether Pakistan's recent exchange-rate stability reflects a genuine improvement in external competitiveness or whether it is primarily supported by external inflows under the IMF program. Moving beyond the PKR-USD rate, the analysis adopts the Real Effective Exchange Rate (REER), which measures the rupee's value against a basket of trading-partner currencies adjusted for inflation. This provides a more accurate assessment of competitiveness by incorporating both exchange-rate movements and inflation differentials across countries.

A lower REER improves export competitiveness by making domestic goods cheaper in global markets, while a higher REER raises export prices and encourages imports. Pakistan's historical experience shows that sustained REER overvaluation is associated with weak export performance, whereas periods of correction or undervaluation coincide with relatively stronger export outcomes. This reinforces that nominal exchange-rate stability alone does not ensure competitiveness, what matters is maintaining a competitive real exchange rate over time.

Since 2014, Pakistan's REER has undergone three phases: sharp appreciation until 2017, correction during crisis years, and relative stability at an elevated level since 2024–25. By February 2026, the REER stood around 102, slightly above the long-term benchmark of 100, indicating mild overvaluation despite nominal exchange-rate stability. This divergence reflects persistently higher domestic inflation relative to trading partners rather than strength in the currency itself.

The report finds that recent exchange-rate stability is largely inflow-driven rather than trade-led. IMF disbursements, bilateral rollovers, strong remittances, and reserve accumulation have offset import demand and anchored expectations. However, expert input cautions that such stability particularly when supported by borrowing can mask underlying external vulnerabilities and contribute to a cycle where rising debt temporarily sustains the exchange rate but weakens long-term external sustainability.

Pakistan's export trajectory reinforces these concerns. Episodes of REER overvaluation particularly during 2015–17 were followed by declines in exports, highlighting that one-off nominal depreciation does not improve competitiveness unless supported by sustained real adjustment. Moreover, structural distortions, including high domestic production costs, energy pricing inefficiencies, and weak trade facilitation, continue to limit export responsiveness even when the exchange rate adjusts.



Source: The World Bank, World Development Indicators

The current IMF program has played a central role in stabilizing the external sector by providing predictable inflows, reserve buffers, and policy credibility. However, this stability remains conditional. As growth resumes and import demand rises, pressures on the REER are likely to re-emerge unless export performance strengthens and reliance on inflow-driven financing declines.

Within this framework, the State Bank of Pakistan operates a market-based exchange-rate system with managed-float characteristics, allowing market forces to determine direction while intervening to smooth volatility. Both the report and expert input emphasize that maintaining an artificially stable exchange rate, particularly through inflows, can delay necessary adjustment. A gradual, market-aligned depreciation path may be required to reflect underlying fundamentals and avoid abrupt, crisis-driven corrections.

At the same time, the report highlights that REER should not be viewed in isolation. Expert input underscores the importance of adopting a broader policy framework that incorporates external sustainability, debt dynamics, and foreign exchange obligations. Weak fiscal transparency particularly unrecorded liabilities from state-owned enterprises and government guarantees obscures the true external position and complicates exchange-rate assessment. Transitioning toward accrual-based fiscal accounting and strengthening data systems are therefore critical for improving policy credibility.

Pakistan continues to face a structural macroeconomic trade-off between inflation control, growth, and external competitiveness. Exchange-rate pass-through remains significant, particularly through energy imports, limiting the scope for sharp depreciation. However, keeping the currency too stable amid higher domestic inflation leads to real appreciation, eroding export competitiveness and increasing reliance on external financing.

The report concludes that Pakistan's current exchange-rate stability is program-backed rather than structurally driven. While it has reduced short-term volatility, the REER remains mildly overvalued due to inflation differentials and structural inefficiencies. Achieving durable external stability will require a shift away from debt-driven inflows toward export-led foreign exchange generation, alongside reforms in cost structures, trade facilitation, and fiscal transparency.

Maintaining exchange-rate flexibility, anchoring inflation, rationalizing domestic cost distortions, and strengthening institutional capacity are therefore essential to ensuring that exchange-rate stability translates into sustained external competitiveness over the medium term.

INTRODUCTION

1. INTRODUCTION

Discussions on whether the Pakistani rupee (PKR) is overvalued increase during periods of exchange-rate stability. However, assessing overvaluation requires looking beyond the simple PKR–USD exchange rate parameter and examining the rupee's value against a basket of trading-partner currencies, adjusted for inflation. **The Real Effective Exchange Rate (REER) is viewed as a better measure of a currency's competitiveness. Since 2014, in Pakistan's case, the REER passed through an upward phase, rising sharply until 2017, then correcting and moving in cycles. Adjusting for these adjustments, the REER in Pakistan's case remains above its long-term average, raising concerns that Pakistan's exports may have become more expensive & hence less competitive.**

At the same time, movements in the REER do not always reflect a loss of competitiveness. Economic fundamentals can drive changes in the real exchange rate and may not require policy action. **The key policy question is whether the REER is aligned with its equilibrium level or whether it is misaligned in a way that harms exports and growth.**

This issue is relevant to Pakistan's managed exchange-rate regime, in which the State Bank of Pakistan (SBP) intervenes to smooth or guide currency movements. Historical experience shows that REER misalignments, driven by inflation and exchange-rate management, have affected export competitiveness in the past. **For trade outcomes, what ultimately matters is the real - not the nominal - exchange-rate adjustment.**

1.1 Definitions

The exchange rate is viewed as a measure of a country's relative success in the external sector. There are different types of exchange rates used to gauge a country's competitiveness, stability, and strength in the global markets.

- **Nominal Exchange Rate (NER)** is the rate at which one currency is traded with another on a daily basis. It reflects nominal exchange rates without adjusting for inflation.

- **Real Exchange Rate (RER)** also shows the bilateral exchange rate parity, but it is adjusted for inflation and indicates the competitiveness of a country versus another country.

- **Nominal Effective Exchange Rate (NEER)** is the weighted average value of a country's currency relative to a basket of other major currencies, with weights reflecting the proportion of trade conducted with each trading partner. The only drawback is that it considers only nominal values, ignoring price differences across trading partners, which can distort the currency valuation analysis.

- **Real Effective Exchange Rate (REER)** is used to assess a country's trade competitiveness. It is an index constructed from a weighted average of a country's currency against a basket of trading partners'/competitors' currencies, adjusted for inflation.[1] [2]
  The REER index is also used to assess misalignment in the nominal exchange rate by adjusting for inflation differentials across trading partners.

[1] It takes into account inflation in home country and in trading partners plus the trade weights. So it truly captures the rupee is expensive or cheap in competitiveness terms.
[2] Bank for International Settlements. https://data.bis.org/topics/EER

1.2 Objective of the Study

The primary objective of this study is to simplify the concept of REER so that is moves out of the realm of economists and help businesses assess whether recent PKR stability reflects improved external competitiveness or is primarily driven by program-backed inflows and reserve accumulation. The study aims to evaluate the implications for REER alignment and export performance.

1.3 Structure of the Report

This report assesses whether the Pakistani rupee (PKR) is overvalued / undervalued / correctly valued and analyzes the role of the State Bank of Pakistan (SBP) in maintaining recent exchange-rate stability. The analysis examines the PKR not only against the US dollar but also relative to the currencies of Pakistan's major trading partners to assess REER competitiveness.

Using the Real Effective Exchange Rate (REER) framework, the report assesses export competitiveness, industrial profitability, and the risk of Dutch disease arising from real exchange-rate appreciation. It explains how Pakistan's REER is constructed and interpreted, highlights how the shift to a market-based exchange-rate system, in which the SBP intervenes to smooth or guide the currency movements, has supported competitiveness or otherwise, and notes the limitations of REER as an indicator.

The report then reviews Pakistan's historical REER trends, identifies periods of overvaluation and correction, and examines the role of capital flows, arbitrage, and carry trades in shaping trade competitiveness and financial markets. Finally, it discusses the key policy challenges faced by the SBP, like balancing inflation, growth, and exports; managing fiscal and external pressures; navigating IMF program constraints; and addressing measurement issues before presenting policy recommendations to support a stable and competitive exchange rate.

REER AND EXTERNAL COMPETITIVENESS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2. REER AND EXTERNAL COMPETITIVENESS

2.1 Background

The Real Effective Exchange Rate (REER) is a key measure of export competitiveness because it adjusts the exchange rate for inflation differences with trading partners and competitors. A lower/undervalued REER improves export profitability and supports growth by improving trade balances, while a higher/overvalued REER makes exports more expensive and weakens competitiveness. When the REER is high, imports become cheaper relative to locally produced goods, making it harder for domestic manufacturers of the same produced goods to compete, compressing profit margins, lowering capacity utilization, weakening investment and ultimately overall competitiveness.

For developing countries like Pakistan, a competitive REER (managed exchange rate) is important for supporting exports. It can have a direct impact on profit margins and market share, especially in price-sensitive sectors like textiles.

Historically, Pakistan has mostly operated with an overvalued REER rather than a competitive one. As the figure below shows, export performance tends to weaken during periods of REER overvaluation and improves when the REER corrects. **This pattern suggests that PKR appreciations hurt exports more than depreciations help them, highlighting the importance of maintaining a stable and competitive REER.**

From 1986 to 1996, sustained REER undervaluation coincided with a steady rise in exports, which peaked at 17.3% of GDP in 1992. Between 1997 and 2004, as the REER moved closer to equilibrium and occasional overvaluation emerged, exports remained flat and then declined to around 11-12% of GDP. During 2005-2011, despite relative nominal exchange-rate stability, exports failed to recover and remained well below their 1990s highs at a 16-18% of GDP. The sharp REER overvaluation during 2015–17 increased the relative price of Pakistani exports in international markets, contributing to weaker export performance and a decline in exports to around 8.2% of GDP.

Figure 1 Deviation of REER from its Long-Term Trend

Source: The World Bank, World Development Indicators

Recently, the PKR appreciated only slightly, but the REER increased mainly due to higher domestic inflation compared to major trading partners. **This means Pakistan's exports became more expensive even without a strong currency. While exchange-rate stability has been supported by improved external accounts and the IMF program, gradual depreciation is expected in the coming years. This healthy adjustment could help restore external competitiveness without causing market instability.**

Recent market commentary also suggests that further adjustment in the exchange rate may occur if the currency aligns more closely with REER indicators. According to market reports, ongoing consultations with the IMF indicate that such alignment could push the rupee toward a range of PKR 290-300 per USD from current levels near PKR 280. A weaker currency could improve export competitiveness, although it may also increase imported inflation pressures.

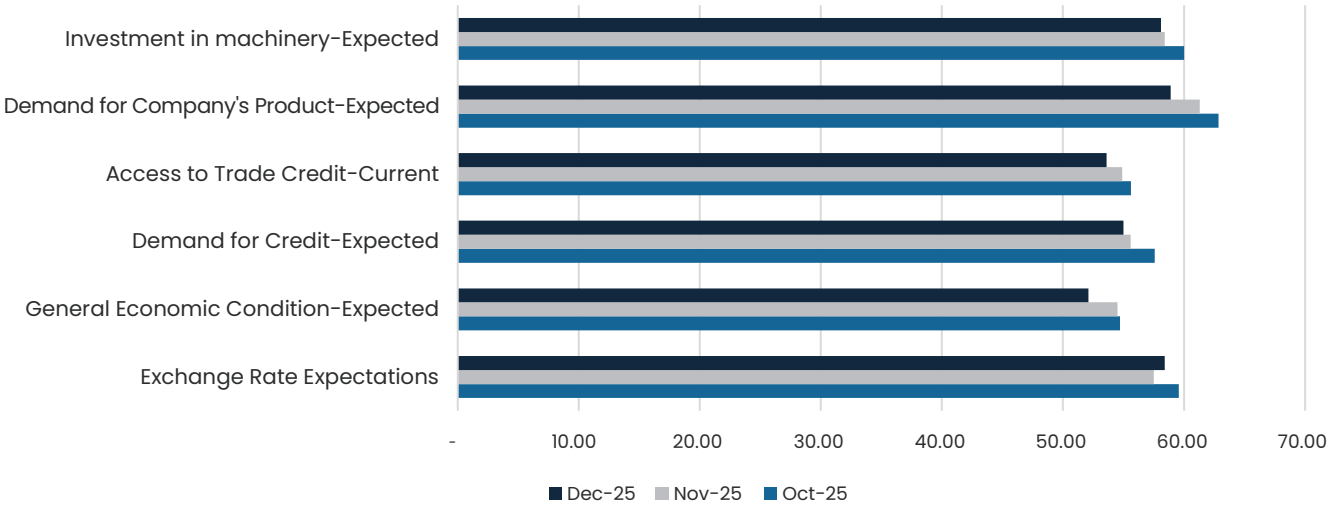
2.2 Industrial profitability

According to the Business Confidence Surveys (BCS) conducted by the State Bank of Pakistan (SBP), the firms expect the average exchange rate to increase over the next six months (implying a weaker rupee).[3] As reflected in a diffusion index reading of 58.4 for December 2025.[4]

The SBP survey is conducted to gauge industrialists' perspectives and expectations, taking into account the current economic environment. From an integrated policy perspective, exporters are more concerned with exchange-rate predictability than with keeping the currency artificially strong for optics. A sticky exchange rate is not sustainable and ultimately leads to abrupt depreciations.

A steady managed depreciation would allow industrialists to follow a gradual adjustment path and hedge risks which cannot be done with sudden depreciations. Keeping the REER below the benchmark 100 would potentially support an export-driven growth framework.

Figure 2 Business Confidence Survey – Diffusion Index



Source: State Bank of Pakistan

It is generally agreed that the government's vision to expand exports to $63 billion over four years could ease external pressures, reduce reliance on external financing, and create conditions for a more durable and credible exchange rate regime over the medium term.

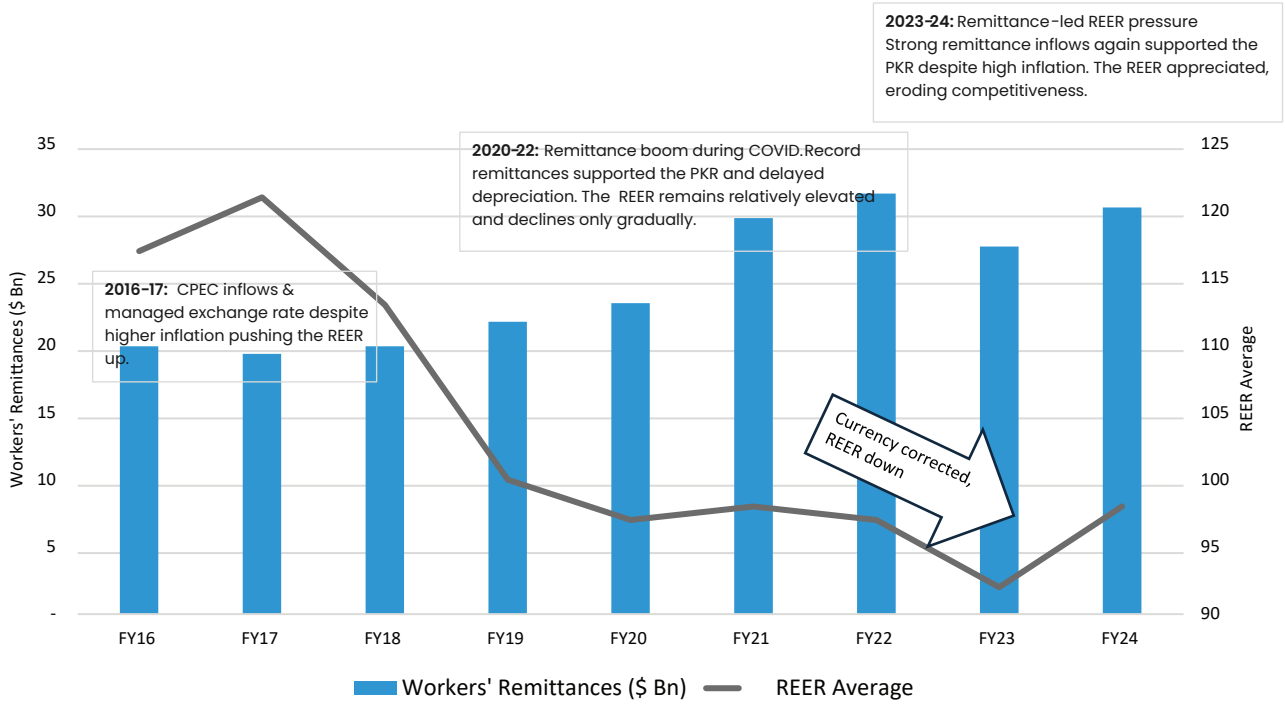
[3] These 500 firms are registered with the Securities and Exchange Commission of Pakistan (SECP).
[4] DI > 50 means more positive views from the business sector side.

2.3 Dutch Disease and REER Appreciation

The Dutch disease phenomenon refers to a situation in which large foreign-currency inflows cause the real exchange rate (REER) to appreciate, making a country's goods more expensive and less competitive globally. The concept originated in the Netherlands in the 1960s, when gas discoveries strengthened the currency and weakened manufacturing. **In Pakistan, Dutch disease is not driven by natural resources but by inflows such as remittances, external borrowings, IMF disbursements, and short-term capital flows. These inflows support the local currency (PKR) and push the REER higher, leading to a real overvaluation.**

As the REER rises, export-oriented and manufacturing sectors face pressure, while imports become cheaper and consumption increases. Resources gradually shift from tradable sectors toward non-tradable activities such as services and real estate. This increases dependence on remittances and borrowing instead of export-led growth. **When inflows slow or external financing tightens, the PKR comes under pressure, often resulting in sharp depreciation, higher inflation, and macroeconomic instability.**

Figure 3 Remittances, REER, and Dutch-Disease-Type Pressures in Pakistan



Source: State Bank of Pakistan

CONCEPTUAL FRAMEWORK

3. CONCEPTUAL FRAMEWORK

3.1 Computation and Construction of REER for Pakistan

Broadly, three core elements are required to construct a REER:

- Trade weights
- Price indices
- The number of trading partners and competitors

Trade Weighted Exchange Rates

Practically, calculating real exchange rates for each trading partner/competitor is not an easy task. Every trading partner brings its own currency, creating a whole portfolio of exchange rates to manage.[5]

This issue is resolved by calculating an index of bilateral exchange rates weighted by each trading partner's share in total foreign trade. This is denoted by $(Ei)^{wi}$.

Box 1: New weights (2016-18) and revised weights (2013-15)

SBP uses IMF-provided trade weights, which are periodically revised to reflect changes in Pakistan's trade partners. The weights and number of trading partners have been updated starting January 2016 and revised for the period from January 2013 to December 2015.

This update/revision, for Pakistan, led to a decrease in the number of countries in the basket of trading partners/competitors to 36 (from 37) for the 2016-2018 period and an increase to 38 (from 37) for the 2013-15 period.

Accordingly, NEER and REER series for Pakistan have been revised from January 2013 to December 2015 using revised weights 2013-15 and from January 2016-18 using the estimated weights for 2016-18. The SBP uses 2016-18 weights for January 2019 and onward until the IMF releases the updated weights. *See Annexure Table 1*.

Trade weights matter because they determine the influence of each partner's currency and price levels on the index.

Currently, the State Bank of Pakistan (SBP) employs trade weights for 36 major trading partners and competitors, representing bilateral trade volumes and third market competition.[6]

[5] real exchange rate is the rate at which goods are traded.
[6] In the updated list for 2016-2018, Ireland and Sri Lanka have been added whereas Afghanistan, Kuwait, Denmark and Egypt no longer count as a significant trading partner/competitor for Pakistan.

Figure 4 Trade Weights for Calculating Pakistan's REER

Country	Weight	Country	Weight	Country	Weight
China	32.15	Saudi Arabia	2.05	Brazil	0.91
United States	10.05	Indonesia	1.67	Vietnam	0.91
Germany	6.63	Netherlands	1.66	Poland	0.90
Japan	4.89	Turkey	1.47	Russian Federation	0.89
India	3.39	Taiwan	1.34	Mexico	0.88
Italy	3.11	Belgium	1.33	Sweden	0.78
United Kingdom	3.03	Singapore	1.30	Iran	0.63
France	2.68	Bangladesh	1.25	Austria	0.56
Thailand	2.31	Malaysia	1.19	Morocco	0.56
Korea	2.30	Canada	1.18	South Africa	0.55
Spain	2.24	Switzerland	0.99	Ireland	0.51
UAE	2.21	Australia	0.98	Sri Lanka	0.50

**Note: 32.14% not only reflects the bilateral trade volume between Pakistan and China but also the competition among the Pakistani and Chinese firms in the third market e.g., the US.*

Price indices

While calculating REER, the choice of price index is very important. The methodology used in Pakistan incorporates the Relative Price Index (RPI).[7] The RPI is the inflation differential between Pakistan and its major trading partners/competitors. It is derived as the ratio of the domestic price (Pakistan) to the trade-weighted foreign price level.[8] The Nominal Effective Exchange Rate (NEER) is a weighted average of bilateral nominal exchange rates between the PKR and the currencies of Pakistan's major trading partners and competitors, measured relative to a base currency. The weights reflect the significance of trading partners in Pakistan's total trade. It is computed as:

$$NEER = \pi_{i=1}^{N} \left(\frac{E_i}{E_i^{base}} \right)^{w_i}$$

where $\left(\frac{E_i}{E_i^{base}}\right)$ is the bilateral exchange rate index;
E_i exchange rate of Pakistan against currency '**i**';
E_i^{base} is the exchange rate for the base period; and
w_i is the weight of partner '**i**' in the trade basket
N is equal to the number of partner countries taken into consideration

[7] This incorporates the CPI index values. Other price indexes include WPI, GDP deflator, export/import unit values, and unit labor costs.
[8] RPI depends on exchange rate as it is a mix of local and foreign prices. To avoid double count of exchange rate movements in the REER formula, the price index should remain exogenous. This means the RPI should reflect equilibrium values, not short-term movements caused by exchange rate swings.

The Relative Price Index (RPI) captures the relative inflation difference between Pakistan and its major trading partners.

$$RPI = \frac{P_d}{\pi_{i=1}^{N}(P_i)^{w_i}}$$

where P_d is the index of domestic prices;
P_i reflects the price indices for partner countries;
w_i is the weight of partner 'i' in the trade basket; and
$\pi_{i=1}^{N}(P_i)^{w_i}$ is the weighted price index of all trading partners aggregated using trade weights.
RPI reading above 100 (RPI > 100) indicates that Pakistan's inflation is higher than that of its trading partners/competitors, eroding competitiveness.

The Real Effective Exchange rate (REER) shows nominal exchange rates adjusted for inflation differentials. It is the product of the NEER and the RPI:[9]

REER = NEER (*exchange rate effects*) * RPI (*inflation differential*)

3.2 Interpretation

To understand Pakistan's currency position, it is important to distinguish between REER appreciation and depreciation, and how they differ from currency overvaluation and undervaluation.

One clear distinction is that appreciation or depreciation describes how the exchange rate moves, while overvaluation or undervaluation describes whether the currency is priced too high or too low relative to its fundamentals.

When a currency strengthens, it can become overvalued. But even if the exchange rate stops rising, the currency can remain overvalued. Likewise, when a currency weakens, it can correct misalignment, but a currency can still be undervalued even if the exchange rate is no longer falling.

For clarity, the key points are summarized in the table below:

A Falling REER and Competitiveness	REER Appreciation and its Economic Implications
e.g. if ER increased from PKR 124/$ to PKR 280/$; Rupee lost its value by 126%	e.g., if ER declined from PKR280/$ to PKR 124/$; The rupee gained 55.7% in value.[10]
• Rupee Weakened; Dollar Strengthened • Rupee Depreciates; Dollar Appreciates PKR/USD exchange rate rises (indicating PKR depreciation)	• Rupee Strengthened; Dollar Weakened • Rupee Appreciates; Dollar Depreciates PKR/USD exchange rate falls (indicating PKR appreciation)
• Fall in the value of the rupee	• Rise in the value of the rupee
Domestic currency is depreciating against the basket of foreign currencies	Domestic currency appreciating against the basket of foreign currencies
NEER down, domestic goods are cheaper in foreign markets	NEER up, domestic goods are expensive in foreign markets
REER down, Real Depreciation	REER up, Real Appreciation
Inflation-adjusted REER depreciated in real terms, improving	Inflation-adjusted REER appreciated in real terms, eroding
export competitiveness	export competitiveness
Exports Cheaper, Imports Expensive = Competitive Gain	Exports Expensive, Imports Cheaper = Competitive Loss
Stronger external competitiveness	Weaker external competitiveness
May cause undervaluation of the currency	May cause undervaluation of the currency
Often a response to shocks or policy changes	Can be short-term or cyclical
Depreciation is a directional change, not necessarily healthy or unhealthy. It corrects misalignment.	It may be driven by IMF inflows, reserve buildup, or even higher remittances.

[9] Both NEER and RPI apply trade-based weights reflecting each partner's significance in overall trade, with adjustments for competition in third-country markets
[10] An appreciation is calculated using the new value as the base. Here 280/$ is the base.

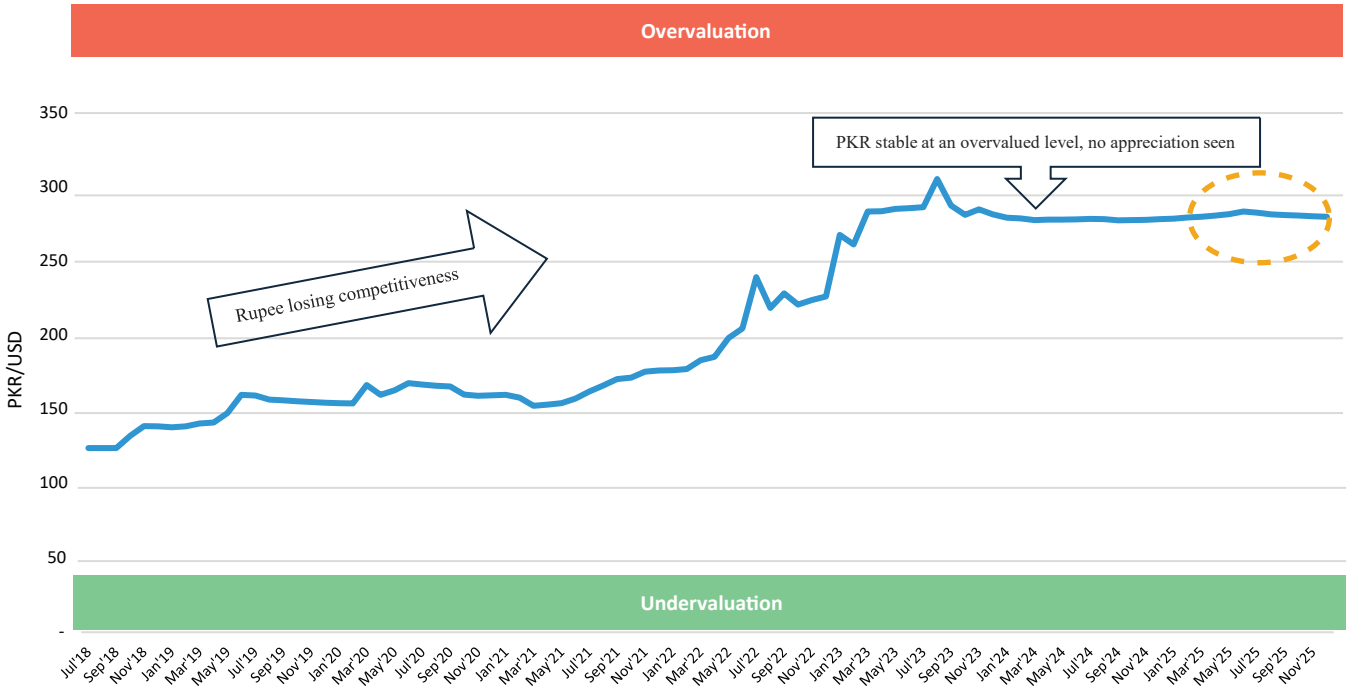
A Falling REER and Competitiveness	REER Appreciation and its Economic Implications
Even if the currency is undervalued, it is competitively aligned, even if it is no longer depreciating.	Even without further appreciation, the PKR becomes overvalued in real terms, hurting export competitiveness.
Real depreciations against the basket of trading partners and competitors' currencies.	Real appreciation against the basket of trading partners and competitors' currencies.

**Base year 2010 = 100 (set by the SBP as a reference point)*

3.2.1 Pakistan's Case: The move to a market-based exchange rate system has made the rupee competitive and will support exports[11]

In the PKR-USD bilateral exchange rate, an increase in the exchange rate indicates a depreciation of the PKR, as more rupees are required to purchase one US dollar.

Figure 5 Currency Trend: PKR vs USD



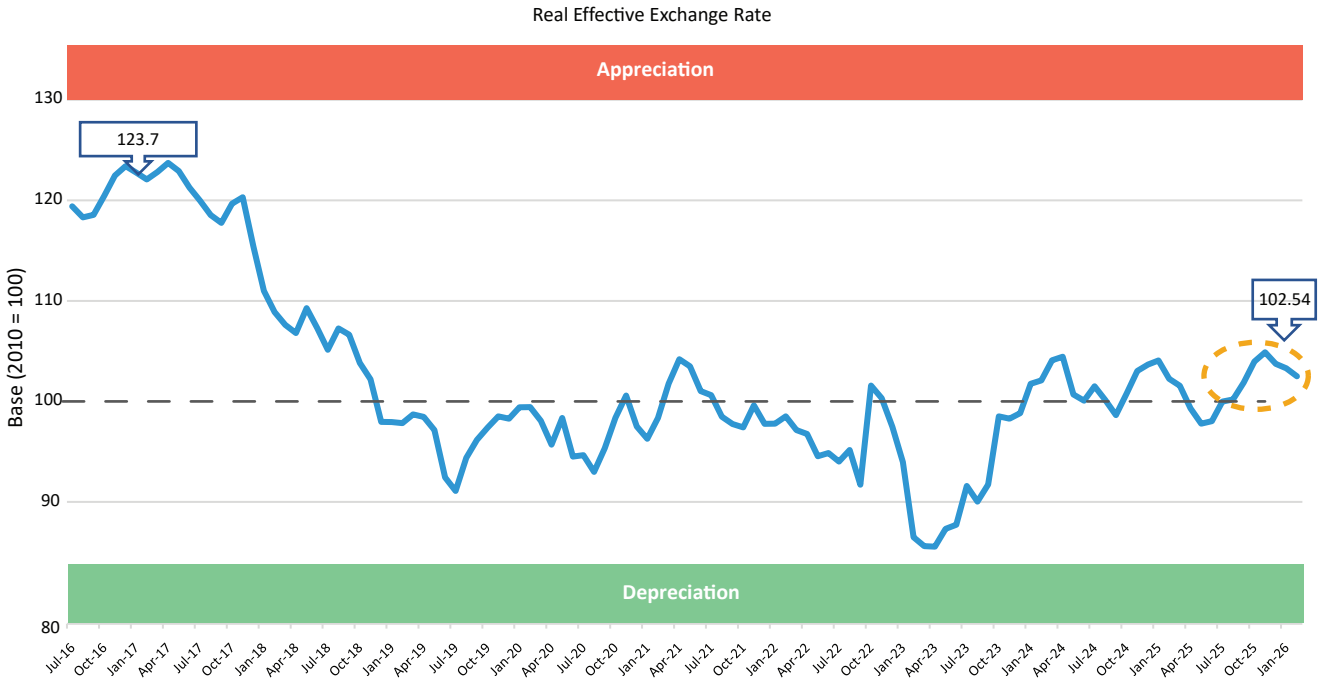
Source: Author's illustration based on the SBP's data

Since a REER index is calculated by defining the exchange rate in terms of domestic currency, a decrease in the REER index means real depreciation of the local currency against the basket of trading partners'/competitors' currencies and vice versa.

In recent years, the REER index has declined from a peak of 123.7 in April 2017 to 102.5 in February 2026, which indicates a real depreciation of 16.2% against the currencies of trading partners and competitors.

[11] https://www.pbc.org.pk/wp-content/uploads/Economic-Diplomacy-in-a-Challenged-Economy-Feb-2020.pdf

Figure 6 Appreciation and Depreciation in the Real Effective Exchange Rate



Source: State Bank of Pakistan

The bottom line is that the PKR has remained broadly stable last year, while the REER, after depreciating until March 2023, has been on an upward trend and is now stable at a mildly overvalued level. This appreciation is driven largely by Pakistan's higher inflation relative to its trading partners.

This means the REER can rise even when the currency itself is overvalued or nominally stable, simply because the inflation differential pushes the index upward, hurting export competitiveness. Although the REER is hovering close to the reference value of 100, this stability should not be mistaken for competitiveness.[12]

The key point is that the current REER stability in Pakistan's case is being supported by external inflows that offset import demand. As long as IMF disbursements, remittances, and the reserve buffer continue to balance these pressures, the REER will appear stable even though the underlying PKR–USD trend remains one of gradual depreciation.

On the downside, keeping the REER sustained around 103 carries the risk of eroding export competitiveness. As growth-led imports rise, a gradual adjustment in the exchange rate will likely become unavoidable.

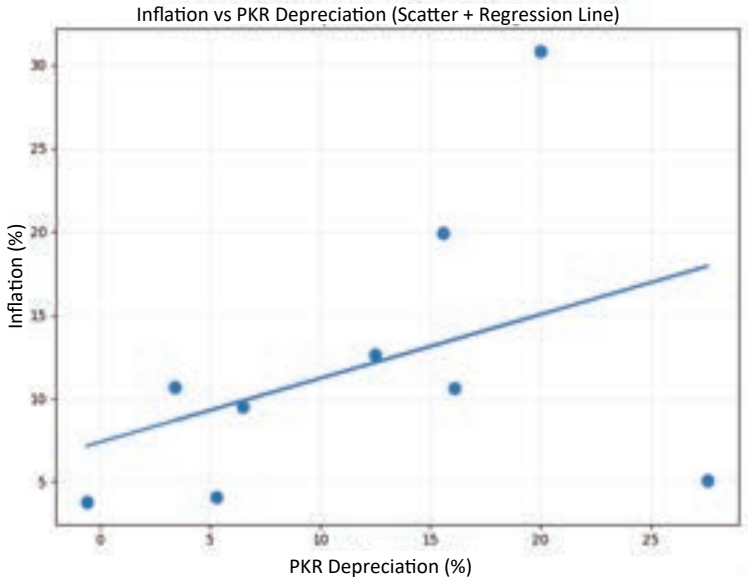
3.2.2 A Moderate Positive Correlation Between Inflation and Depreciation

The evidence indicates that inflation typically rises when the rupee depreciates. Data from the past decade shows a strong correlation between inflation and depreciation, with a correlation coefficient of about 0.72 from FY16 to FY25.

Pakistan is an import-dependent economy, and currency depreciation typically feeds into domestic prices through imported inflation. However, the pass-through is likely to be incomplete, particularly for food items. In Pakistan's Sensitive Price Index (SPI), food carries a disproportionately high weight (significant share of 51 essential items), and local food prices are already estimated to be around 26-27% higher than global food prices. This creates a built-in buffer, as further exchange-rate depreciation adds relatively less to food inflation at the margin, thereby limiting the immediate inflationary impact despite currency weakness.[13]

[12] See Section 3.4 "Limitations of REER as an Indicator" for clarification
[13] Local food index weightage is higher in quantum to global food index. The difference is about 26.5%.

Figure 7 Correlation matrix inflation and depreciation



3.3 Limitations of REER as an Indicator

Though the REER indicator helps gauge the country's trade competitiveness, it is often prone to two misconceptions in the context of exchange rate valuation:

1) Appreciation and depreciation are often mistaken for overvaluation and undervaluation, but they are not the same. REER movements simply show changes over time and do not determine whether the currency is overvalued or undervalued. The REER can go up or down regardless of the currency's true value.

2) Currently, the REER is indexed at the base year 2010 = 100.[14] This is just a benchmark point or a statistical reference. A REER value of 100 does not imply that the currency is fairly valued or in equilibrium; it just reflects the chosen base period. Similarly, a REER index of 95 (with the base year index set at 100) does not necessarily indicate that the currency is undervalued by 5% relative to the base year, as this interpretation is not robust and may break down when underlying conditions change. REER movements reflect real exchange-rate shifts rather than equilibrium misalignment.

Box 2: Understanding Overvaluation — Why the Concept Is Not Robust

A currency is typically labelled overvalued when its Real Effective Exchange Rate (REER) stays above its equilibrium level. However, determining this "equilibrium" is far from straightforward. Economists use multiple quantitative methods to estimate it—each with different objectives, assumptions, and conceptual frameworks. These methodologies range from reduced-form equations to partial-equilibrium and general equilibrium models, all producing different interpretations of the "right" exchange rate.

Because of this complexity, policymakers must choose the approach that best fits the economy's structure and then supplement it with qualitative realities that cannot be captured purely through data.

Ultimately, assessing whether the exchange rate is overvalued requires a medium-term sustainability lens, guided by the question: What exchange rate allows the external sector to remain sustainable, given the country's historical and structural characteristics? This involves evaluating a wide set of cross-country factors, including foreign exchange reserves, fiscal balances, credit demand, demographics, real interest rates, country risk, remittances, and global financial conditions.

(Adapted from the State Bank of Pakistan)

[14] REER is an index and it is free from any measuring unit. The State Bank of Pakistan (SBP) has set the base year. It is arbitrary. And can change over time. 100 was the average value of REER in 2010.

TRENDS IN REER AND MACROECONOMIC IMPLICATIONS

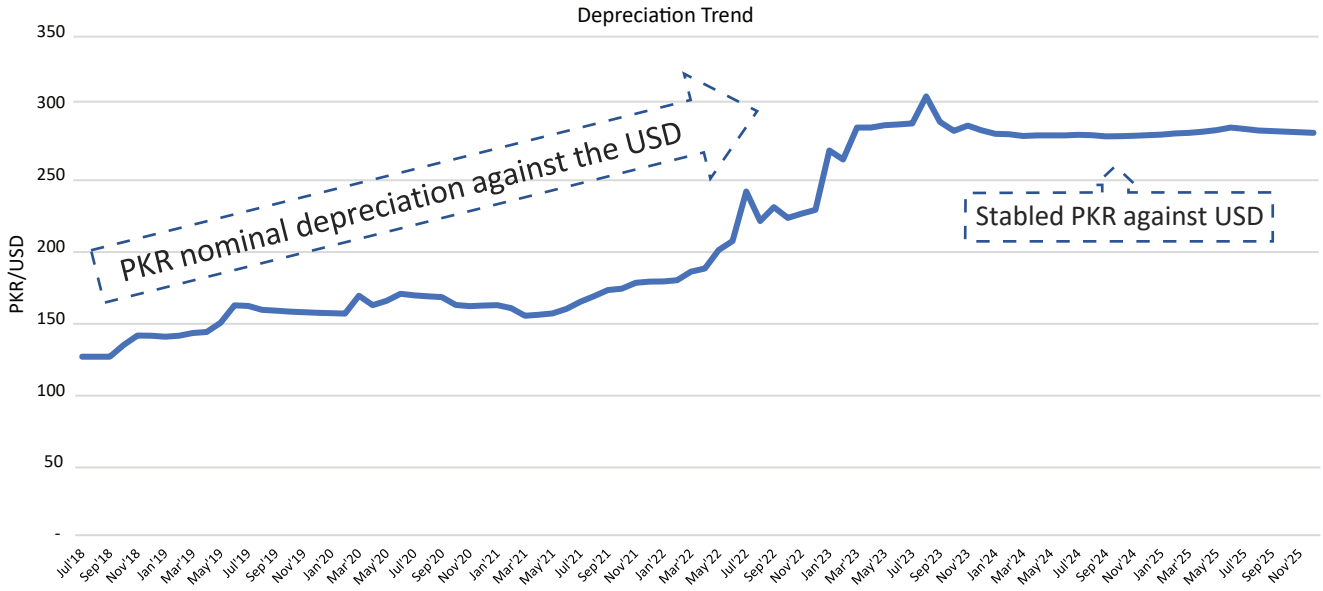

3M
6M
1A
2A
5A

4. TRENDS IN REER AND MACROECONOMIC IMPLICATIONS

4.1 HISTORICAL TRENDS

During calendar year 2025 (January-December), the rupee depreciated marginally by 0.42%, and by 1.8% in fiscal year 2024-25 (FY25). In contrast, in the current fiscal year to date, the rupee has appreciated by around 1%, indicating a moderate strengthening against the US dollar. Overall, this reflects stable foreign-exchange conditions rather than a sharp currency rally.[15]

Figure 8 PKR-USD Parity



Source: State Bank of Pakistan

Key triggers:

- **The stability is reinforced by improved external accounts and the resumption of an IMF program, which helped keep market expectations anchored and reduced volatility.**
- **Overall, the rupee remained broadly stable in 2025, but rising import demand from economic recovery and persistent imbalances in the fiscal and external accounts point to a gradual and orderly depreciation ahead.[16]**
- The rupee is projected to soften to PKR 282 (average in FY26e and further to PKR 292.3 in FY27, reflecting an annual depreciation of around 3.3% a level considered manageable given Pakistan's ongoing stabilization trajectory This gradual devaluation is expected to support external competitiveness without triggering disorderly market conditions.[17]
- Even if the rupee appears stable under a program, small gaps between foreign inflows and outflows can lead to a gradual slippage of the rupee rather than a sudden adjustment.[18]

Real Effective Exchange Rate (REER):

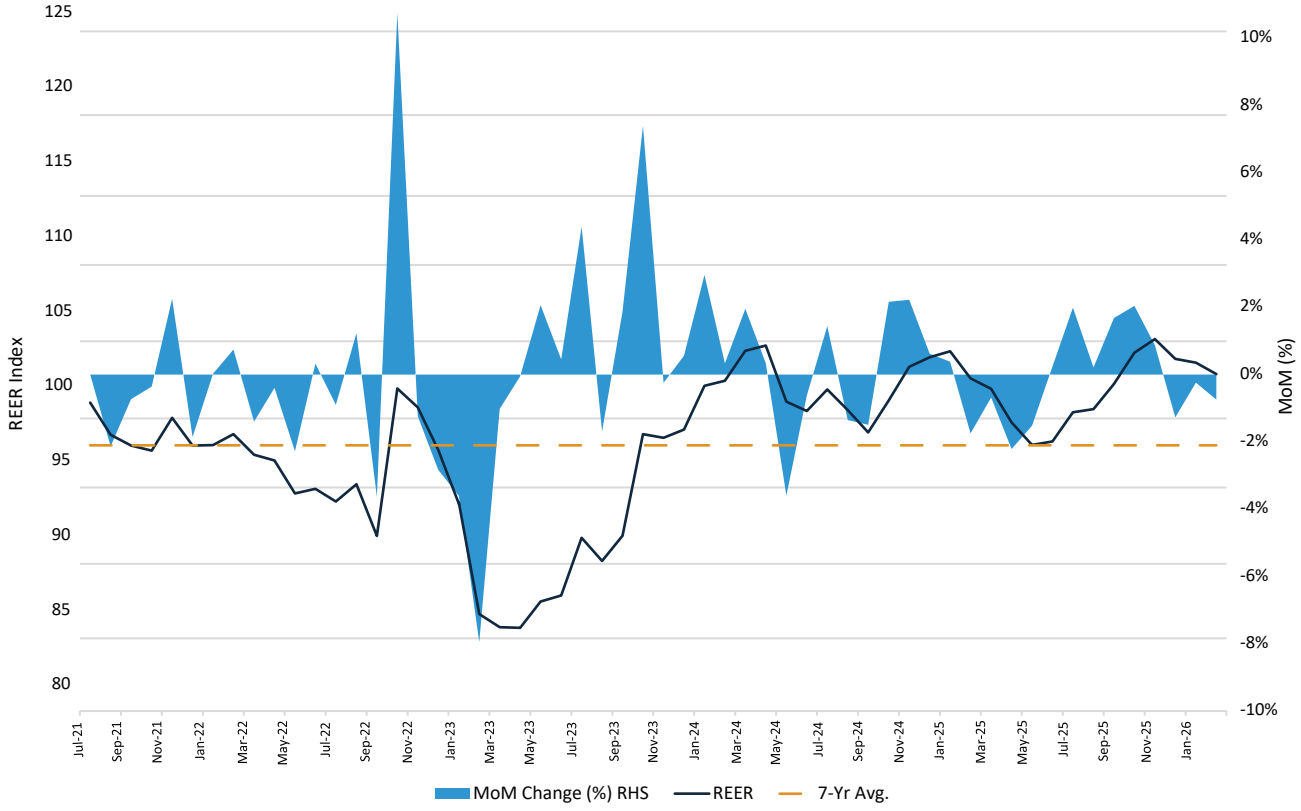
Pakistan's Real Effective Exchange Rate (REER) rose steadily through most of 2025, reaching an 86-month high of 104.9 in November. The index stayed above 100 for several months, indicating that the rupee strengthened in real terms compared to its long-term average. However, in February 2026, the REER declined by 0.7% month-on-month to 102.5, marking a modest correction after the recent rise.[19] Despite a marginal decline, the REER remains elevated, suggesting the rupee is still relatively strong, which can weigh on export competitiveness while making imports cheaper.

[15] The US dollar has weakened against several major currencies in recent periods, though its performance varies across currency pairs and market conditions.
[16] Higher demand for dollars puts downward pressure on the PKR.
[17] Arif Habib Limited. (2025). Pakistan Investment Strategy 2026: The Equity Edge Continues.
[18] Slippage refers to the difference between the expected price of a trade and the price at which the trade is executed, which would rise, potentially undermining the critical objective of building foreign exchange reserves to adequate levels.
[19] The current REER is still higher than the last 7-year average of 97.77.

Nominal Effective Exchange Rate (NEER):

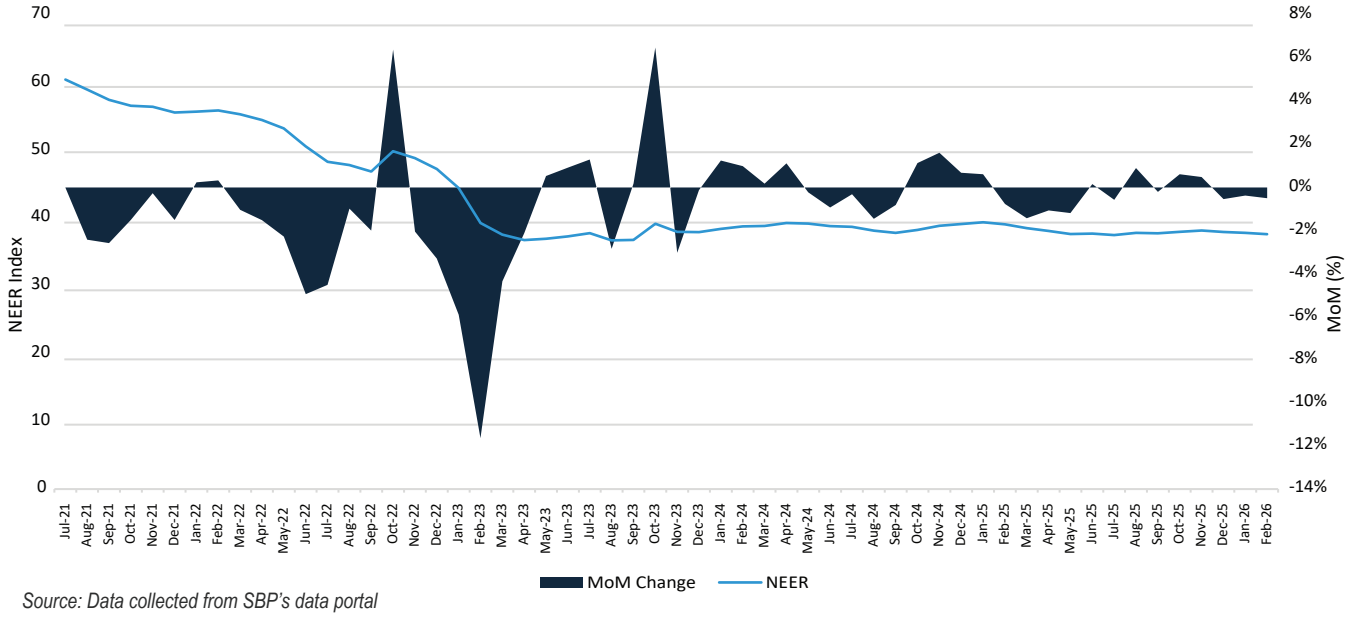
The Nominal Effective Exchange Rate (NEER) remained broadly stable during late 2025, with only limited month-to-month movement. NEER increased slightly in November but fell by 0.5% on a month-on-month basis in February 2026 to 37.64, indicating mild nominal weakening. **On a yearly basis, NEER continues to reflect underlying depreciation pressures. Overall, the data points to a stable exchange-rate environment, with small, gradual adjustments rather than sharp currency movements.**

Figure 9 Trends in the Real Effective Exchange Rate (REER)



Source: Data collected from SBP's data portal

Figure 10 Trends in Nominal Effective Exchange Rate (NEER)



Source: Data collected from SBP's data portal

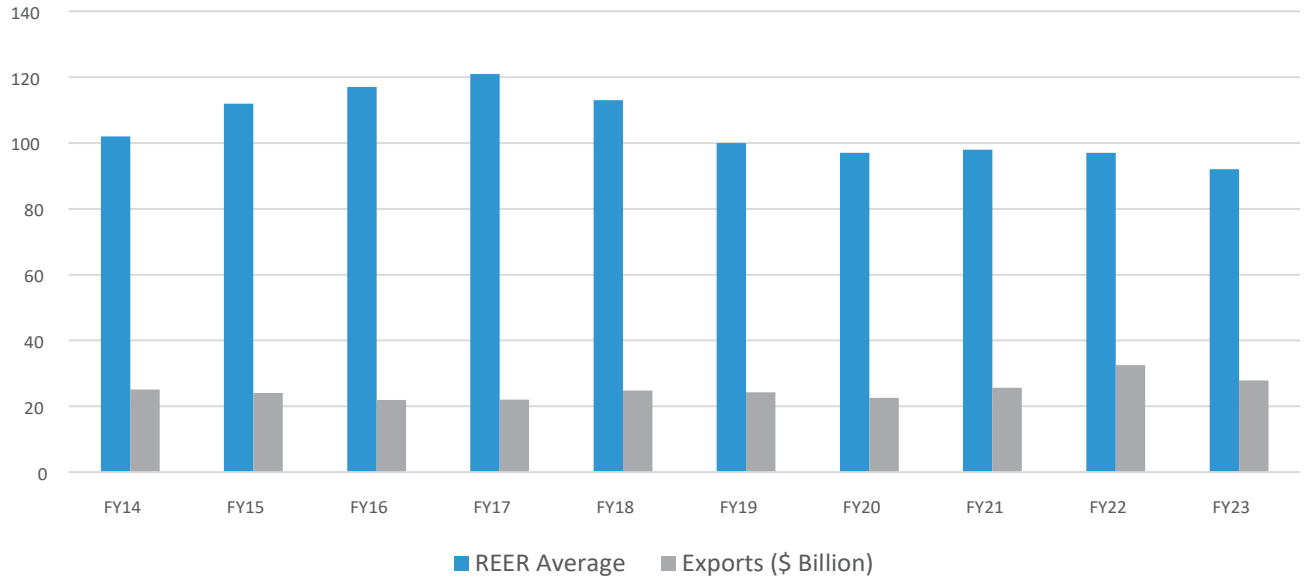
4.2 Periods of Overvaluation and Correction

Over decades, Pakistan did not maintain a steady, mildly undervalued currency. Instead, the PKR was frequently kept artificially strong through administrative controls. Once reserves became critically low, sharp devaluations followed, typically coinciding with IMF engagement. The IMF's Stand-By Arrangement (SBA) 2023 reflects this pattern, as exchange-rate adjustment occurred only after Pakistan reached the brink of default amid depleted reserves and delayed external financing.

This stop-go approach meant exchange-rate adjustments were sudden and crisis-driven rather than gradual and predictable. As a result, exporters were never provided with a stable and competitive exchange rate they could plan around, limiting the ability of devaluations to generate sustained export gains.

Against this backdrop, the rupee's fall from 100 to 300 between 2014 and 2023 does not mean that devaluation fails to support exports. Rather, it highlights that devaluation alone is not sufficient to boost exports unless the REER remains competitive and stable over time. Instead, it reflects poor exchange-rate management through the REER, with the rupee kept overvalued in real terms for long periods and corrected sharply only during crises. [20]

Figure 11 Exchange-Rate Devaluation and Export Outcomes



Source: State Bank of Pakistan

From a REER perspective, the rupee remained broadly stable in 2024–25, mainly due to strong external inflows. However, in real terms (REER), the currency remained quite strong. This stability did not lead to better export performance. As imports increase and past payments are cleared, keeping the rupee this strong (high REER) may become difficult, so a gradual adjustment may be needed to avoid misalignment.

In the past, REER overvaluation led to crisis-driven corrections. In 2024–25, REER is again high, so if the central bank doesn't adjust gradually, history might repeat itself.

[20] Exports respond to the REER not just to currency devaluations.

4.3 Currency Carry Trade, Arbitrage, and Trade Competitiveness

Sudden volatility arising from short-term financial flows can distort REER, making exports less competitive.

This results in arbitrage opportunities in the market.

A currency carry trade is a form of financial arbitrage that involves borrowing from a low-interest-rate currency (Country A: Policy rate 0%) and investing in a high-interest-rate currency (Country B: Policy rate 10% high return) to earn a return from the interest-rate differential.[21]

Such inflows are commonly referred to as 'hot money,' as they are short-term, yield-driven, and highly sensitive to exchange-rate expectations. This was especially important during the PTI period, when elevated domestic interest rates and temporary exchange-rate stability attracted sizable portfolio inflows, which later flowed back out.

A trader uses this investment strategy in an attempt to capture the difference between the rates, which can be substantial depending on the amount of leverage used.

Table 1 Carry-Trade Return Analysis for Pakistan

	6-month horizon	12-month horizon
Interest Rate	10.5% (annual); 5.25% for 6 months	10.5%
US Fed Rate	3.5 to 3.75% (annual); 1.75 to 1.88% for 6 months	3.5% to 3.75%
Interest Rate Differential	3.37% to 3.5%	6.75% to 7%
Spot PKR/USD	279.9	279.9
Forward PKR/USD	284.7	291
Implied PKR Depreciation	1.71%	3.97%
Net Carry-Trade Return	**1.66% to 1.79%**	**2.8% to 3.05%**

** Forward rates as of January 15, 2026, taken from the SBP*

Currency carry trade exploits interest-rate differentials and can attract short-term inflows into Pakistan, temporarily strengthening the PKR. This pushes the REER upward, eroding export competitiveness.

- In the 6-month horizon case, an investor would earn around 1.79% from an interest rate differential of 3.5%.
- If the PKR offers a strong interest-rate differential (exchange rate remains stable (PKR 279/284/291), foreign investors may increase short-term inflows to capture higher returns. However, expectations of depreciation can quickly reverse these positions, making carry-trade flows highly volatile.
- Short-term financial flows can cause sudden swings in the exchange rate, which distort the REER and hurt export competitiveness. While arbitrage-driven flows may temporarily enhance competitiveness, they tend to reverse rapidly amid depreciation concerns, generating exchange-rate volatility and weakening export stability.

[21] Arbitrage: Same asset. Same time. Different Price. Arbitrage opportunities are corrected so quickly by the market that they never last.

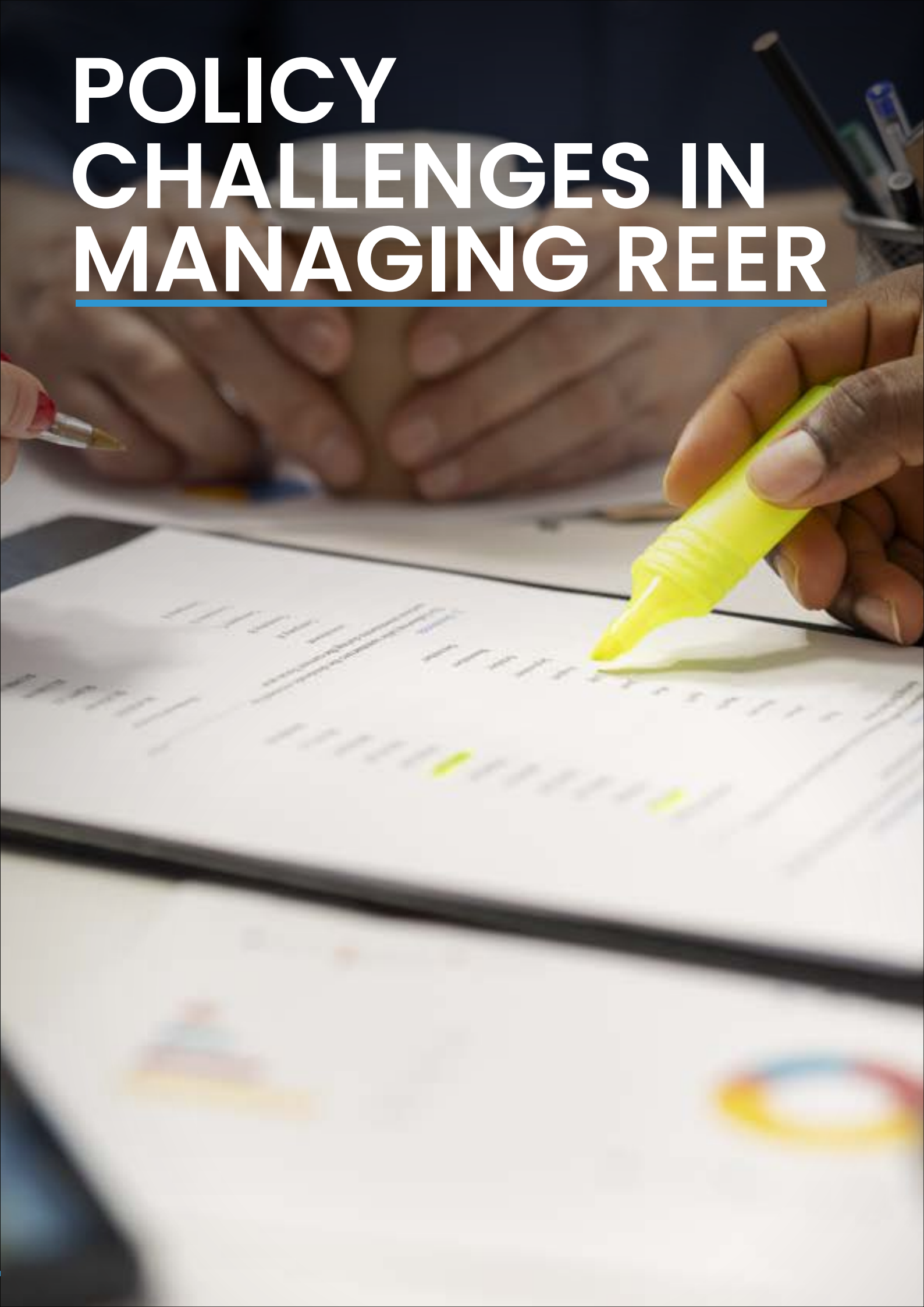
4.4 Impact on the Stock Market and Capital Flows

From a stock-market perspective, an overvalued REER discourages investment. When the REER is high, such as around 104, it signals that the PKR is overvalued, leading investors to expect future depreciation. Because investors factor this expected depreciation into their decisions, real returns can turn negative even when nominal returns appear attractive, reducing the incentive to invest in equities.

On the other hand, if the REER adjusts downward to a more sustainable level, around 98 or 99, it suggests that the rupee has already weakened enough. This reduces fears of further currency losses, improves real returns, and creates room for interest-rate easing. As a result, investor confidence improves, equity valuations become more attractive, and short-term speculative inflows (hot money) are more likely to return, supporting a rise in the PSX.

A key limitation of this analysis is that, while REER adjustment improves currency-adjusted equity returns and supports valuation re-rating, it does not fully explain the very high valuations observed at the PSX, which are also influenced by liquidity conditions, earnings dynamics, and short-term capital flows.

POLICY CHALLENGES IN MANAGING REER



5. POLICY CHALLENGES IN MANAGING REER

5.1 Trade-offs between Inflation, Exports, and Growth

Pakistan's macroeconomic policy framework involves a multidimensional tradeoff between inflation control, growth, export competitiveness, and external stability.

Pakistan's Achilles heel is its vicious boom-and-bust cycles. For several years, the country has functioned under an import-dependent framework. Higher growth leads to higher imports of essential raw materials, fuel, machinery and finished consumer goods, creating imbalances in the current account and renewed pressure on the exchange rate. This currency depreciation supports exports, but it raises imported inflation.

Changes in the exchange rate quickly affect domestic prices because the inflation basket is heavily weighted toward imported goods.[22] Although food carries a disproportionate weight in Pakistan's inflation basket (around 35%), exchange-rate pass-through is driven mainly by import-dependent items, particularly energy. Energy-related components, which account for 20 to 25% of CPI, are closely linked to imported fuels and adjust quickly to currency movements, explaining the fast transmission from exchange-rate changes to domestic prices.

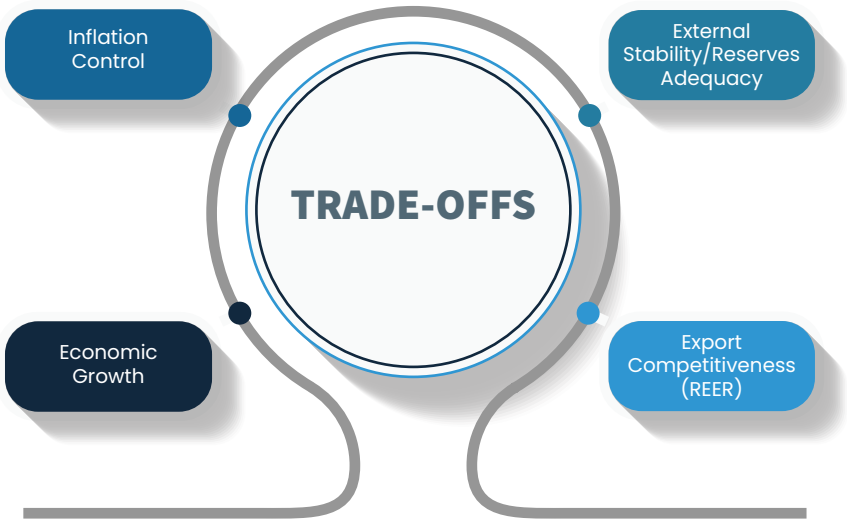
In this context, the SBP intervenes in the currency markets under a managed-float regime to prevent sharp PKR movements, while pursuing a contractionary monetary policy that indirectly supports nominal exchange-rate stability by containing inflation and import demand. **Conversely, maintaining stability in the nominal exchange rate when domestic inflation exceeds that of trading partners can result in REER appreciation, eroding export competitiveness and encouraging imports.**

In this framework, IMF program support plays a complementary role by reinforcing the SBP's stance and providing financing, reserve buffers, and credibility, and by setting rules e.g., Net International Reserves (NIR) floors, flexibility, FX market normalization. This anchors market expectations through predictable inflows and quantitative targets.

However, this program-backed stability is conditional. As growth resumes, rising import demand can reintroduce pressure on both the exchange rate and the REER, particularly if export gains fail to keep pace.

Moreover, while such stability helps contain inflation in the short run, persistently higher domestic inflation relative to trading partners can sustain REER appreciation, reinforcing competitiveness risks over time.

Figure 12 Trade-offs between Inflation, Exports, and Growth



[22] Food weightage 35%, energy-related components weightage 20-25%

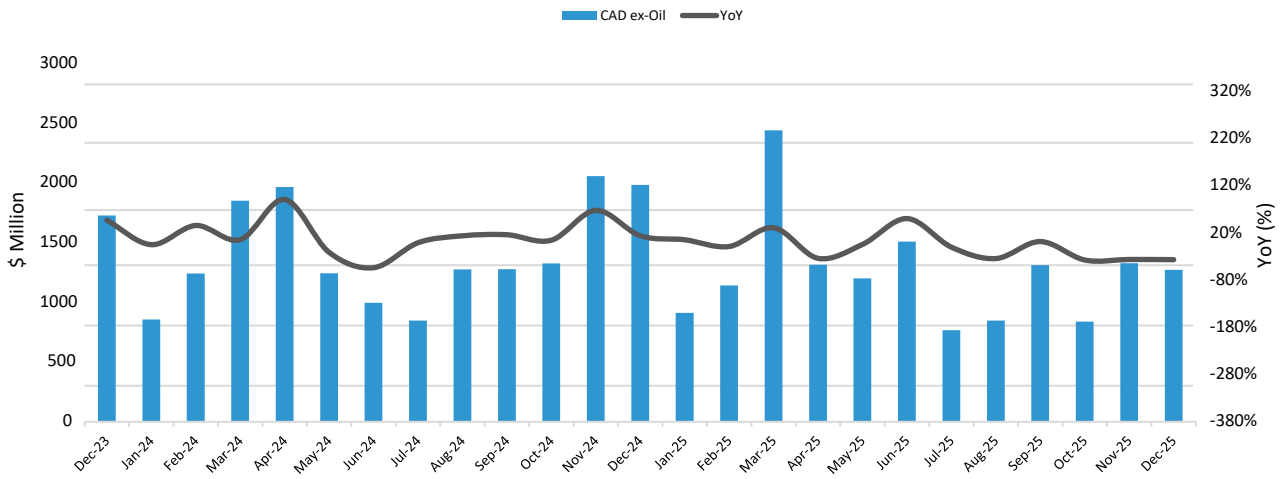
Against this backdrop, SBP prefers a gradual exchange-rate adjustment rather than defending an artificially strong currency. **Allowing limited flexibility in the PKR helps balance inflation control with competitiveness, reducing the risk of repeating past boom-and-bust cycles.** Over the medium term, easing these trade-offs will require structural reforms to raise exports and lower import dependence, rather than relying solely on exchange-rate stability.

5.2 Political Economy of Exchange-Rate Policy

Practical economic trade-offs, rather than pure market forces, increasingly drive Pakistan's exchange-rate policy. With the REER around 104, even a 3-4% rupee depreciation, combined with 2-3% dollar deposit returns, caps total gains on dollar holdings at roughly 6-7%, reducing incentives for dollarization and shifting investor preference toward domestic assets such as gold and equities.[23]

At the same time, oil prices have become a key policy tool given Pakistan's status as a net oil-importing economy. Lower oil prices support exchange-rate stability by easing inflation and the current account, allowing policymakers to manage the rupee and cut interest rates without immediate pressures on reserves.[24] However, with exports weak and imports rising, exchange-rate stability remains dependent on favorable external conditions, thus leaving the REER vulnerable if commodity prices or capital flows reverse.

Figure 13 Current Account Deficit Excluding Oil Imports



Source: Pakistan Bureau of Statistics

5.3 Fiscal Dominance, Hidden External Liabilities, and REER Pressures

Pakistan's exchange-rate stability is largely program-backed and inflow-driven rather than a reflection of a strong external position.[25] IMF conditionality, expected inflows, and rollover assurances have helped anchor expectations and stabilize the forex market. However, sizable unpaid external obligations, including dividend, royalty, and profit repatriation payments along with external debt servicing, continue to limit policy flexibility and constrain REER adjustments.[26]

Any current account surplus (incoming dollars) is therefore required to clear these dues rather than support currency appreciation (leaving no room for the rupee to strengthen). With the REER indicating slight overvaluation, the risk of gradual depreciation cannot be ruled out, particularly if inflows weaken or program discipline loosens.

[23] Topline Securities CEO Mohammed Sohail on assets to watch in 2026 | Kamran Khan | On My Radar [Nukta]. https://www.youtube.com/watch?v=KmJuc9tZXHI
[24] CPI does not measure imported energy inflation directly. It captures pass-through from LNG prices (gas tariffs), fuel prices (electricity tariffs), and petroleum imports (retail fuel prices).
[25] A strong external position is when a country can pay for imports and external debt comfortably or other trade fundamentals.
[26] Some unpaid external obligations have been cleared, but such payments continue to re-accumulate during periods of FX stress.

5.4 Capital Flows, IMF Conditionality, and FX Management

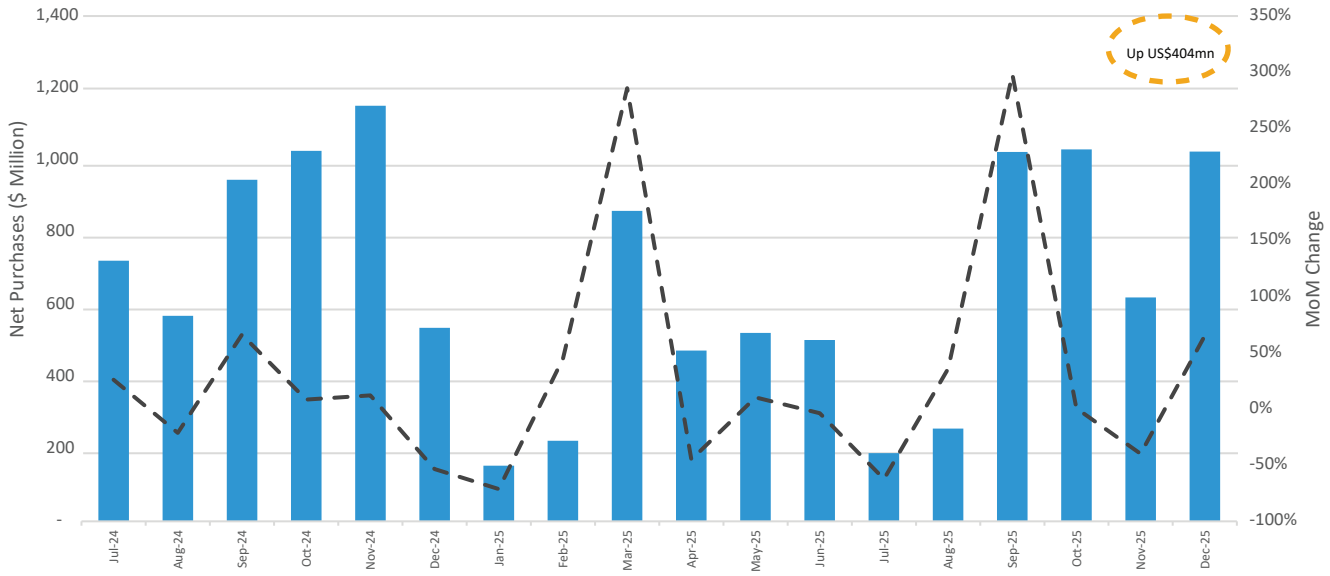
5.4.1 To what extent does SBP intervention shape the exchange rate?

Pakistan operates a hybrid exchange rate regime. Market forces determine the direction of the exchange rate (flexible/market-based), but at times, the SBP intervenes to anchor stability and mitigate excessive volatility caused by inflows and outflows.

The SBP is a net purchaser of dollars. As per the recent numbers, the SBP absorbed $1.02 billion of dollars in December 2025, reflecting a 65% month-on-month increase, bringing the cumulative figure to $4.14 billion during 1HFY26. The yearly trend suggests that the SBP's interventions were predominantly on the purchase side. These purchases were supplemented by multilateral and remittances inflows, which lifted SBP-held reserves to $16.35 billion as of March 13, 2026 (reaching their highest levels in almost 46 months).

In its recent Monetary Policy Committee (MPC) meeting, the State Bank of Pakistan (SBP) reiterated its medium-term objective of strengthening FX reserves. SBP expects reserves to surpass $18 billion by June 2026 and rise further in FY27, reaching the equivalent of more than three months of import cover and meeting the international benchmark for reserve adequacy.

Figure 14 SBP Net FX Intervention



Source: State Bank of Pakistan

In 2014, exchange-rate stability was maintained through active central bank intervention in the spot FX market, supported by large official inflows. As documented in the SBP Annual Report 2013-14, Pakistan received approximately $1.5 billion under the Pakistan Development Fund, alongside other external inflows including Eurobond issuance and multilateral financing.[27] These inflows increased the supply of foreign exchange, which would normally have led to PKR appreciation. To prevent this, the SBP absorbed excess dollars through spot-market purchases from the interbank market, adding to its reserve stock while limiting upward pressure on the currency. As a result, despite a strengthening external position and easing reserve pressures, the PKR remained broadly stable in nominal terms, even as the REER appreciated due to higher domestic inflation relative to trading partners.

[27] Pakistan Development Fund (PDF) refers to a special bilateral financial arrangement between Pakistan and Saudi Arabia, set up to support Pakistan's foreign-exchange reserves and development financing.

Table 2 Reserves Adequacy Indicators

Indicator	FY12	FY13	FY14
Import-based adequacy			
Total reserves / import of goods	4.5	3.3	4.1
SBP reserves / import of goods	3.2	1.8	2.6
SBP reserves / import of goods and services	2.7	1.5	2.2
Pre-determined short-term drains			
Maturing FX loans and deposits (1 yr)	4.3	0.9	1.5
Aggregate short position in forward (1 yr)	5.3	2.7	6
Net international reserves (billion USD)	-2.4	-	2.7
Short-term debt			
Total reserves / short-term debt	9.5	8.7	5.3
SBP reserves / short-term debt	6.7	4.7	3.4
Total reserves / short-term debt and CAD	2.4	2.9	2.5
SBP reserves / short-term debt and CAD	1.7	1.6	1.6

Source: SBP Annual Report 2013-14

In contrast to earlier episodes, the current scenario is different. Even though the SBP's interventions remain largely on the purchase side, reflecting surplus dollar liquidity from recent inflows. Following the elimination of the kerb–interbank premium after the crackdown on illicit FX channels, the market generated excess dollar supply, allowing the SBP to maintain a passive stance.

The SBP is absorbing excess dollars to rebuild reserves rather than artificially supporting the PKR through administered measures like dollar injections.

This distinction confirms that the current exchange rate parity is program-driven, but market-determined, rather than administratively controlled.[28] The exchange rate is fluctuating according to demand and supply forces within a program-backed environment, and it is not being artificially controlled by the SBP through administrative measures.

The SBP intervenes aggressively only in exceptional situations, such as when there is exchange-rate overshooting or panic selling of the currency. **The bottom line is, the SBP is rebuilding reserves from excessive appreciation arising from planned inflows, not manipulating the currency to avoid an overvalued PKR.**

While the SBP is a net purchaser of dollars (short-term liquidity supported by inflows), the current amount of external debt servicing, around $26 billion, exceeds the reserve buffer of $18 billion for FY26. Upcoming inflows are expected to be absorbed by scheduled repayments, making it difficult to keep reserves elevated. **This limits the SBP's ability to defend the PKR, making exchange-rate management necessarily cautious. However, SBP appears confident that expected inflows over the next six months will be sufficient to manage upcoming outflows.**

[28] upported by the IMF Extended Funded Facility worth $8 billion and the rollovers of around $8 billion in bilateral deposits from Saudi Arabia, the UAE and China.

Table 3 External Debt Servicing and Expected Inflows

in $ billion

Estimated FY26 Debt Servicing	26
SBP FX Reserves	18 (June-end 2026)
Planned External Inflows	19.9

Source: State Bank of Pakistan

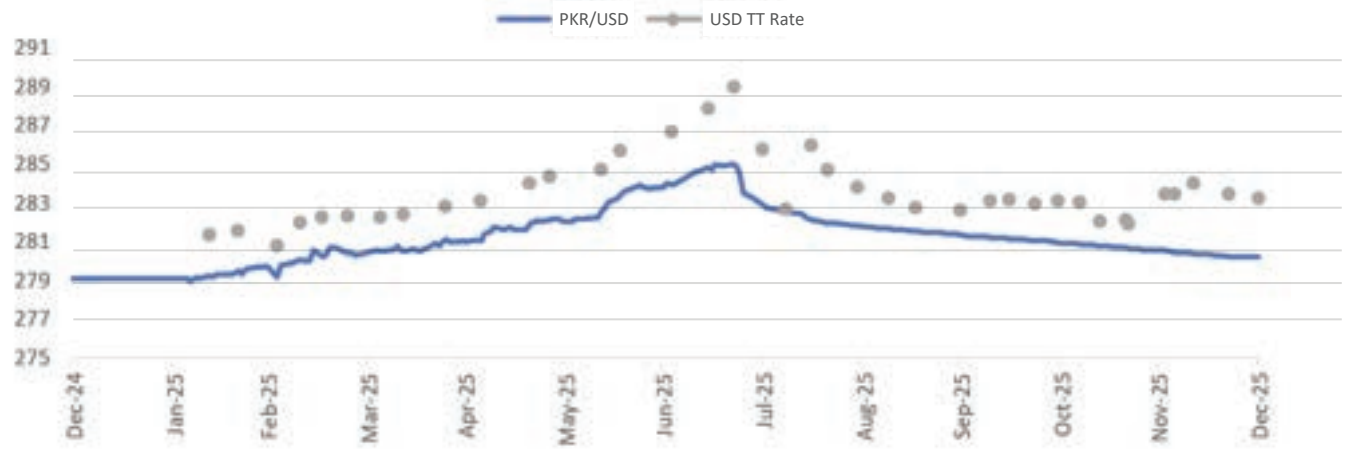
5.4.2 Kerb-interbank premium is also behind the PKR stability

Along with a series of external inflows such as the tranches worth $2.21 billion (SDR 1,674 million) under the IMF's Extended Fund facility (EFF) and Resilience and Sustainability Facility (RSF) programs, and bilateral deposit rollovers from friendly countries like Saudi Arabia, the UAE and China, an unexpectedly strong remittance surge has also played a crucial role in stabilizing the foreign exchange market during 2024 and 2025.

What explains the uptick in remittances?

- The shrinking spread between the interbank and the Telegraphic Transfer (TT) rate (formal channels).
- Crackdown on grey market/hawala hundi that narrowed the kerb premium (informal channels).[30]

Figure 15 US$ – PKR parity / US$ TT Rate



Source: State Bank of Pakistan

The rupee appreciated moderately by 0.13% month-on-month to PKR 280.16/US$ as of 31st December 2025, partly due to stronger remittance inflows as well as administrative measures (crackdown on hundi) to control the spread between the USD TT rate and the interbank rate.[31] [32] Cumulatively, remittances in the first five months of FY26 (5MFY26) increased by 9.3% year-on-year to $16.14 billion.

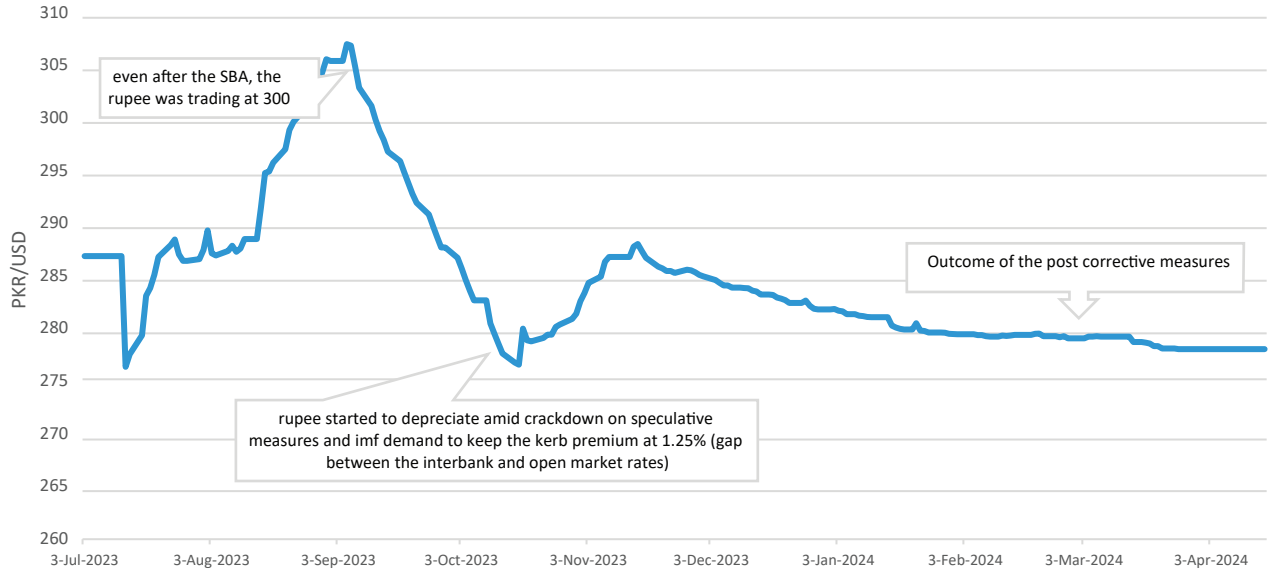
As flows shifted to formal channels, remittance inflows reached record highs in March 2025 and registered a 16% growth for the year. This supported FX liquidity as reserves built up through the banking system. The stabilization kerb premium, greater use of official channels, and an increase in overseas employment, particularly to Saudi Arabia (530,256) and the UAE (52,664) as of December 2025, further strengthened inflows. Therefore, the growing reliance on remittances to fund domestic demand is becoming significant, suggesting that with a stronger PKR supported by inflows, the REER is expected to appreciate moderately further.

[29] The TT–interbank spread shows the true cost of dollars in the banking system and acts as a barometer of FX liquidity, confidence, and market stress.
[30] The kerb premium is difference between the official exchange rate (official bank-to-bank) and the open market rate (exchange companies/cash market).
[31] USD Telegraphic Transfer Rate is the exchange rate applied for electronic transfers of USD, such as inward remittances, outward remittances, swift payments, and bank-to-bank foreign currency transfers.
[22] The administrative measures were taken by different government institutions along with the SBP and Ministry of Finance.

There is an indirect link between the kerb premium and the Real Effective exchange rate (REER). The shrinkage in kerb premium affects the nominal exchange rate. Since the nominal exchange rate is the key input to the REER formula, a stronger or stable interbank rate, especially when domestic inflation exceeds that of partner countries, can lead to REER appreciation.

As part of broader efforts to normalize the foreign exchange market, the SBP strengthened regulatory oversight of exchange companies. In January 2024, it introduced a regulation requiring biometric verification for all transactions exceeding $500. The measure aimed to curb informal dollar trading and improve traceability of FX flows amid pressures from weak exports, volatile remittances, and high import dependence.

Figure 16 Rupee Became Less Vulnerable to Domestic Risks



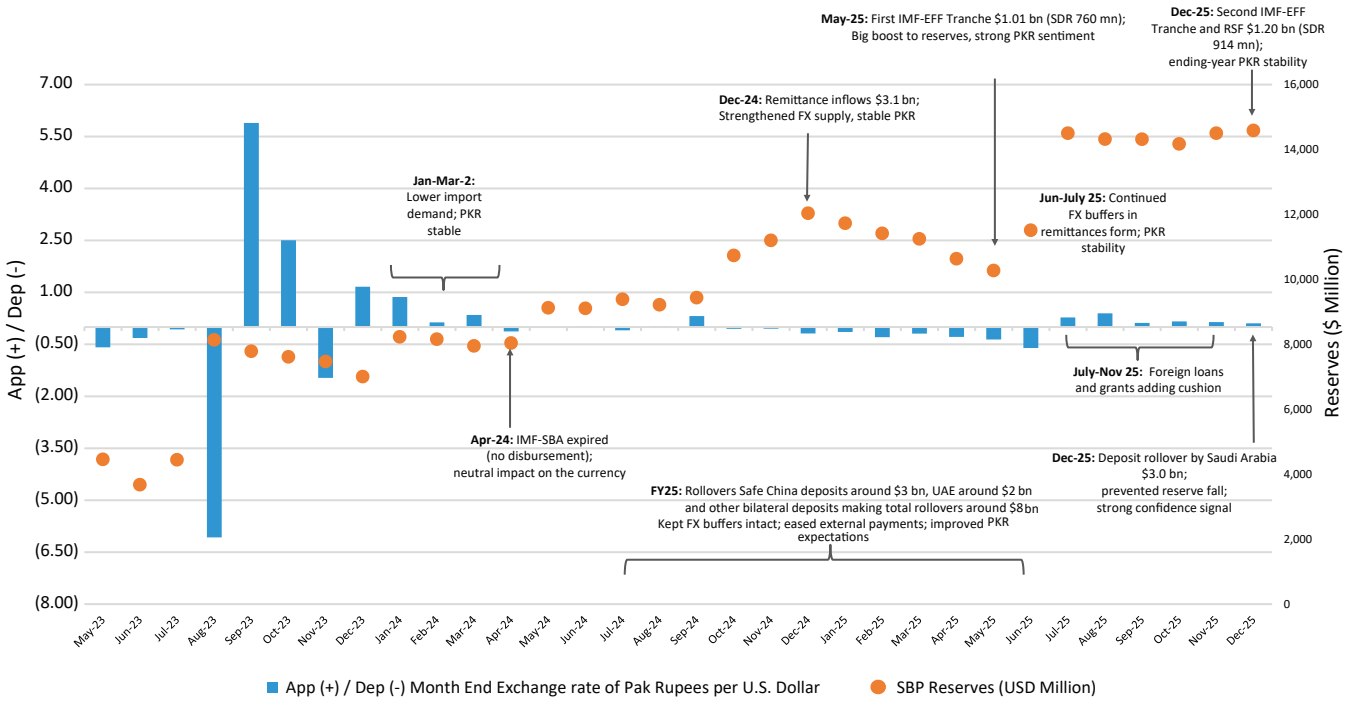
Source: Data taken from the SBP

5.4.3 IMF Program's Conditionality and Role of Capital Flows

The exchange-rate stability observed during 2024–25 reflects Pakistan's engagement under IMF-supported programs and the accompanying reserve accumulation strategy. This indicates how the IMF's conditionalities affect the exchange rate policy and shape the REER outcome.

Besides these fundamentals, the PKR/USD stability also stems from the SBP's REER-anchored exchange rate management framework, which does not target a specific nominal exchange rate but seeks to prevent excessive real misalignment by keeping enough foreign-exchange buffers.

Figure 17 Inflows via Tranches, Remittances, and Deposits, and PKR Fluctuation



Source: Currency and reserves data collected from the SBP

A clear illustration was observed across multiple episodes, reinforcing the interpretation that once an IMF tranche is credited into the SBP account, reserves rise, leading to currency stability. Focusing on last situation, when Pakistan received its first tranche under the Extended Fund Facility (EFF) amounting to approximately $1.01 billion (SDR 760 million), foreign-exchange reserves increased, and the currency remained stable.

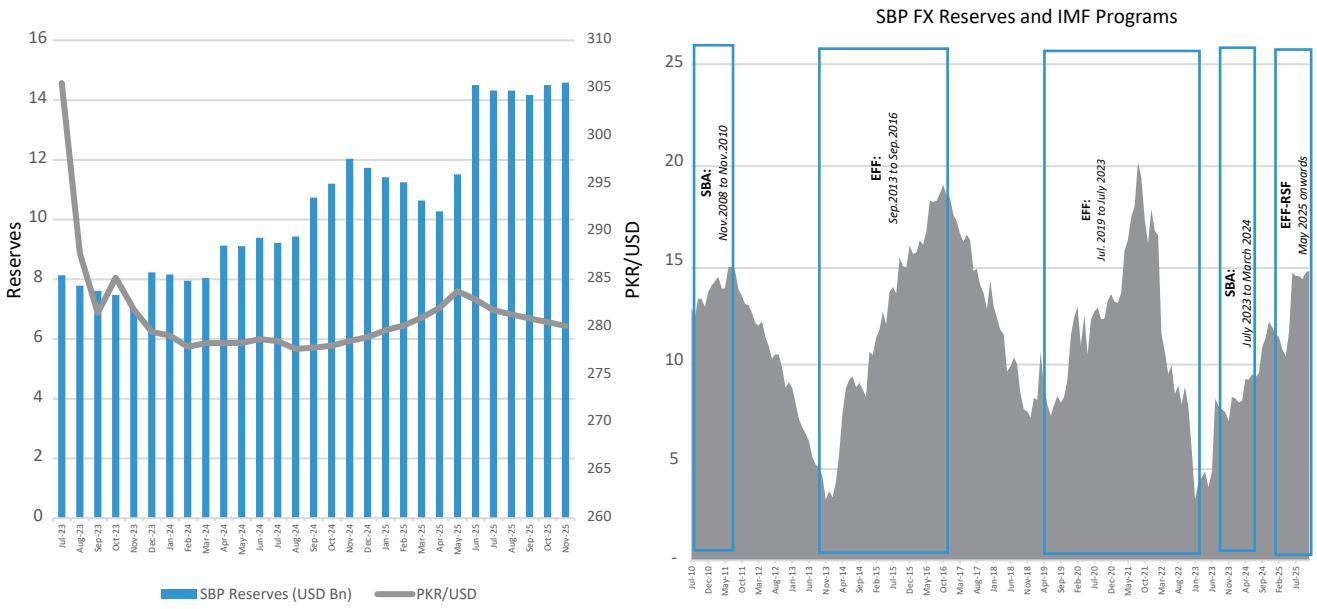
Market participants anticipated IMF Board approval and priced in the expected tranche within the exchange-rate mechanism even before it was credited to the SBP's account. As soon as the reserves arrived (as shown in the data for the week ending May 16, 2025), the interbank market was not surprised and reacted calmly. The investors had adjusted their positions beforehand, and the PKR didn't move much.

In addition to IMF disbursements, speculative pressures were also contained when reports of $3 billion and $1 billion rollovers from Saudi Arabia and the UAE, respectively, circulated in the market, easing external risk perceptions.

Market participants anticipated it as routine financing rather than a transitory shock, which helped anchor expectations and support currency stability.

This predictability proves that Pakistan is following a market-based exchange rate system with managed-float characteristics, supporting the narrative of program-driven stability.

Figure 18 PKR/USD Movements and SBP Foreign-Exchange Reserves during IMF-Supported Program Periods



The bottom line is that foreign-exchange market normalization and reserve accumulation driven by IMF inflows have eased balance-of-payments pressures, stabilized the currency, and boosted investor confidence. As a result, the REER has risen while the PKR has remained stable.

REER is edging higher, but it is broadly stable due to inflows and reserve accumulation rather than export fundamentals. However, risks remain if import-led growth outpaces export gains, reintroducing REER overvaluation pressures that may require gradual nominal depreciation by the SBP.

This aligns with the SBP's stance to some extent. The current problem is not the exchange rate itself, but whether the country has enough dollars to pay for imports. Even if the PKR looks stable, problems could recur if the import growth exceeds export gains, creating dollar shortages.

Currently, the SBP is managing the nominal exchange rate through a controlled adjustment mechanism, allowing for gradual exchange rate flexibility when required. As a result, the REER remains stable. Maintaining an artificially strong currency to prevent volatility could hurt exports and reintroduce boom-bust cycles.

Therefore, the stability in the exchange rate is program-backed rather than trade-driven, supporting the SBP's stance on exchange rate flexibility rather than defending an artificially strong currency that could erode competitiveness.

Under the IMF conditionality framework, Pakistan is required to maintain SBP's net international reserves above specified minimum floors at key review dates as part of the quantitative performance criteria. During its last MPS committee meeting, the SBP assured that the reserves would reach $18 billion by June 2026. This, to some extent, will provide a cushion to defend the rupee and stabilize it. It will also help rein in the imported inflation. This indirectly limits REER appreciation or volatility through contained inflation.

Exchange-rate surveillance in member countries is one of the IMF's core responsibilities. The crackdown on hawala and grey-market channels from September 2023 onward eliminated the kerb–interbank premium, limiting avenues for speculation and keeping the investors' response measured. This again led to FX market stabilization under the conditions set by the IMF.

Table 4 IMF Structural Conditionalities and Administrative Measures to Shape FX Dynamics

Structural Benchmarks	Rationale	Date	Status
Average premium between the interbank and open market rate will be no more than 1.25% during any consecutive 5-business-day period.	Maintain FX market functioning	Continuous	Met
Complete a comprehensive assessment of remittance costs and structural impediments to cross-border payments, complemented by an action plan	Maintain FX market functioning	end May 2026	Ongoing
Complete a thorough assessment of the bottlenecks for local currency bond market development and publish a strategic action plan to address areas of improvement	Reduce reliance on external financing & FX market pressures	end September 2026	Ongoing

Source: IMF first review under the EFF program (May 2025)

5.5 Measurement and targeting challenges

Measuring the REER is not straightforward and comes with several challenges. It is based on CPI inflation, trade weights, and a fixed base year, which do not reflect real-time changes in the economy, especially when administered prices move sharply.[33] Because REER is influenced by inflation differential, capital flows, and trade patterns, it cannot be targeted precisely. For this reason, the REER is viewed as an outcome of broader economic conditions rather than a policy target. In practice, the SBP focuses on avoiding sharp misalignments and reducing volatility, though communication gaps can sometimes confuse market expectations

[33] Prices of items such as electricity tariffs, gas prices, fuel prices, and some taxes and fees. Frequent changes in these prices can distort CPI-based measures like REER.

EXPERT INPUT AND POLICY RECOMMENDATIONS

6. EXPERT INPUT AND POLICY RECOMMENDATIONS

These recommendations, informed by expert input from a prominent Pakistani economist and a former Governor of the State Bank of Pakistan, emphasize that exchange-rate management must be complemented by stronger fiscal transparency, reduced reliance on debt-driven inflows, and structural reforms to improve export competitiveness.

Maintain a Market-Based Exchange Rate with Gradual Adjustment

- The report supports a managed-float regime, where market forces determine direction while the SBP smooths excessive volatility.
- Expert input suggests that exchange-rate stability supported by external inflows, including borrowing, may mask underlying pressures as debt accumulates.
- This creates a cycle where rising debt supports the exchange rate in the short term but weakens external sustainability over time.
- A gradual and market-aligned depreciation path should reflect underlying external conditions rather than prolonged inflow-driven support, which may otherwise delay necessary adjustment.
- Policy focus should shift toward export-led foreign exchange generation rather than reliance on debt accumulation.
- This approach reduces the risk of abrupt, crisis-driven adjustments observed in past cycles.

Strengthen Transparency of External Liabilities and Fiscal Risks

- The report acknowledges fiscal dominance; expert input deepens this by highlighting unrecorded liabilities from state-owned enterprises (SOEs) and government guarantees.
- A significant portion of public debt includes SOE obligations that are ultimately borne by the government, even if not fully reflected in official figures.
- Pakistan's cash-based accounting framework obscures the true external position, making it difficult to accurately record liabilities and foreign exchange obligations.
- Weak accounting systems across institutions further contribute to incomplete and unclear reporting of external debt.
- Recognizing and consolidating these liabilities is critical for realistic exchange-rate assessment, REER interpretation, and overall external sustainability analysis.

Adopt a Broader Framework Beyond REER for Policy Assessment

- While the report uses REER as a central analytical tool, expert input cautions against over-reliance on it as a standalone indicator of competitiveness.
- Structural distortions and restricted market conditions limit its ability to reflect the true equilibrium exchange rate.
- Policymaking should therefore incorporate broader indicators, including external sustainability, debt dynamics, and foreign exchange obligations.
- Structural reforms in energy pricing, taxation, logistics, and productivity are essential to support export growth and reduce reliance on inflow-driven stability.
- Maintaining exchange-rate flexibility and anchoring inflation are critical for achieving durable external stability over the medium term.

Rationalize Domestic Cost Structures to Support Exports

- The report emphasizes competitiveness, but experts highlight domestic distortions such as cross-subsidization.
- Higher tariffs on industry raise production costs, offsetting gains from exchange-rate adjustment.
- Reforming and revisiting subsidy structures, particularly for domestic consumers, can address cross-subsidization and high operational costs, thereby improving export competitiveness more sustainably than relying on currency depreciation alone.

Allow Exchange Rate Adjustment to Reflect Underlying Fundamentals

- Expert input suggests that a moderate exchange-rate adjustment (around 5–10%) may be required to better align the currency with underlying fundamentals.
- Current exchange-rate stability is partly supported by remittances and borrowing, which provide temporary support but do not address structural imbalances.
- Maintaining an overvalued exchange rate raises the cost of doing business and weakens export competitiveness.
- A gradual and well-communicated adjustment path will allow the economy to adapt over time, minimizing disruption while improving external balance.

Strengthen Trade Facilitation and Global Value Chain Integration

- The report calls for export diversification; expert input reinforces the need to integrate into global supply chains.
- Competitiveness depends on logistics, cost efficiency, and trade facilitation not just exchange-rate levels.
- Policy should enable firms to become part of international production networks.

Improve Data Transparency and Institutional Capacity

- The report discusses policy credibility; expert input identifies weak liability recording systems as a key gap.
- Ministries lack accurate data on external obligations, even relying on external agencies for verification.
- Strengthening data systems is essential for credible macroeconomic and exchange-rate policy.

Transition to Accrual-based Fiscal Accounting

- To complement fiscal reforms, expert input strongly recommends shifting from cash-based to accrual accounting.
- This will ensure liabilities (including guarantees) are recorded when incurred, not when paid.
- Improved accounting will enhance policy decisions related to debt sustainability and exchange-rate management.

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Annexure

Table 1: Pakistan's major trading partners/competitors and their respective weights

	Country	New Weights (2016-18)	Revised Weights (2013-15)	Previous Weights (2013-15)	Remarks
1	CHINA, P.R.: MAINLAND	32.148	29.217	29.122	
2	UNITED STATES	10.055	11.264	11.473	
3	GERMANY	6.631	6.629	6.379	
4	JAPAN	4.888	4.684	4.671	
5	INDIA	3.390	3.317	3.329	
6	ITALY	3.111	3.001	3.065	
7	UNITED KINGDOM	3.034	3.460	3.400	
8	FRANCE	2.675	2.745	2.723	
9	THAILAND	2.314	1.898	1.889	
10	KOREA, REP. OF	2.298	2.502	2.505	
11	SPAIN	2.236	2.054	2.239	
12	UNITED ARAB EMIRATES	2.214	1.682	2.103	
13	SAUDI ARABIA	2.054	2.494	2.456	
14	INDONESIA	1.673	1.358	1.361	
15	NETHERLANDS, THE	1.659	1.728	1.964	
16	TURKEY	1.472	1.590	1.479	
17	TAIWAN PROVINCE OF CHINA	1.336	1.459	1.455	
18	BELGIUM	1.325	1.225	1.468	
19	SINGAPORE	1.298	1.528	1.529	
20	BANGLADESH	1.245	1.319	1.314	
21	MALAYSIA	1.187	1.340	1.341	
22	CANADA	1.184	1.221	1.204	
23	SWITZERLAND	0.989	1.012	1.014	
24	AUSTRALIA	0.988	0.987	0.987	
25	BRAZIL	0.912	0.937	0.936	
26	VIETNAM	0.911	0.689	0.698	
27	POLAND, REP. OF	0.903	0.819	0.809	
28	RUSSIAN FEDERATION	0.895	0.907	0.908	
29	MEXICO	0.883	0.911	0.884	
30	SWEDEN	0.782	0.865	0.870	
31	IRAN, ISLAMIC REP. OF	0.627	0.734		NEWLY ADDED FROM 2013
32	AUSTRIA	0.561	0.524	0.520	
33	MOROCCO	0.560	0.582	0.577	
34	SOUTH AFRICA	0.551	0.708	0.675	
35	IRELAND	0.515	-	-	NEWLY ADDED FROM 2016
36	SRI LANKA	0.499	-	-	NEWLY ADDED FROM 2016
37	KUWAIT	-	0.565	0.563	REMOVED FROM 2016
38	AFGHANISTAN, ISLAMIC REP. OF	-	0.960	1.010	REMOVED FROM 2016
39	DENMARK	-	0.547	0.541	REMOVED FROM 2016
40	EGYPT, ARAB REP. OF	-	0.542	0.540	REMOVED FROM 2016

Source: International Monetary Fund

Table 2: NEER and REER indices IMF

Nominal / Real Effective Exchange Rate of Pakistan Rupees
(Base 2010=100)

	NEER	REER	NEER	REER
Month	Monthly Position		Percentage Change over last Month	
Feb-26	37.64	102.54	(0.50)	(0.74)
Jan-26	37.83	103.30	(0.39)	(0.24)
Dec-25	37.97	103.73	(0.54)	(1.09)
Nov-25	38.18	104.88	0.49	0.88
Oct-25	38.00	103.96	0.61	2.04
Sep-25	37.77	101.88	(0.21)	1.69
Aug-25	37.84	100.20	0.90	0.21
Jul-25	37.51	99.98	(0.57)	1.99
Jun-25	37.72	98.03	0.16	0.24
May-25	37.66	97.79	(1.19)	(1.52)
Apr-25	38.12	99.30	(1.06)	(2.21)
Mar-25	38.53	101.55	(1.43)	(0.68)
Feb-25	39.09	102.25	(0.77)	(1.74)
Jan-25	39.39	104.06	0.62	0.38
Dec-24	39.15	103.67	0.68	0.62
Nov-24	38.89	103.02	1.61	2.23
Oct-24	38.27	100.78	1.13	2.16
Sep-24	37.84	98.64	(0.82)	(1.49)
Aug-24	38.15	100.13	(1.46)	(1.35)
Jul-24	38.72	101.50	(0.31)	1.44
Jun-24	38.84	100.06	(0.93)	(0.62)
May-24	39.20	100.69	(0.23)	(3.60)
Apr-24	39.30	104.44	1.11	0.34
Mar-24	38.86	104.09	0.18	1.96
Feb-24	38.79	102.10	0.99	0.34
Jan-24	38.41	101.75	1.25	2.96
Dec-23	37.94	98.83	(0.12)	0.56
Nov-23	37.99	98.28	(3.03)	(0.24)
Oct-23	39.18	98.52	6.49	7.40
Sep-23	36.79	91.73	0.18	1.88
Aug-23	36.72	90.04	(2.85)	(1.69)
Jul-23	37.80	91.59	1.29	4.40

Source: State Bank of Pakistan

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