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## Monetary Policy in a Balance-of-Payments-Constrained Economy: Fiscal Dominance, External Vulnerability, and the Case for Caution in Pakistan[1]

**Naved Hamid[2] and Murtaza Syed[3]**

## Abstract

*Following a severe macroeconomic crisis in the fiscal year 2023, Pakistan has achieved notable stabilization, with inflation falling to historic lows and external buffers rebuilding. This has intensified the debate over the State Bank of Pakistan's maintenance of a strongly positive real interest rate amidst modest economic growth. This paper argues that the current tight monetary stance is justified, given Pakistan's history of boom-bust cycles driven by fiscal dominance and a consumption-led, import-intensive growth model. Pakistan's growth is fundamentally constrained by its balance of payments, with a sustainable rate now estimated below four percent. Using recent data and historical patterns, we demonstrate that premature monetary loosening risks reigniting external pressures and exchange rate instability, thereby undermining the hard-won price stability. The primary conclusion is that monetary policy must prioritize price and financial stability over growth support until structural reforms significantly enhance productivity and export competitiveness.*

## Introduction

The Pakistani economy has undergone significant stabilization since the fiscal year (FY) 2023, one of its most challenging years, which featured negative growth

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[2] Professor and Director, Centre for Research in Economics and Business (CREB), Lahore School of Economics.

[3] Head of Ecosystem, Economics Department, Asian Infrastructure Investment Bank.

and inflation exceeding 29 percent. Headline inflation had decelerated to approximately 5 percent by FY 2025, while growth recovered modestly to 2.7 percent.

This successful stabilization, while creditable, presents a new policy dilemma. Despite halving its policy rate since April 2024 to 11 percent, the State Bank of Pakistan (SBP) maintains a large positive real interest rate. This stance has drawn criticism from various quarters, which question its necessity amid low inflation and suboptimal growth.[4]

This is not the first time Pakistan has restored stability after a crisis. Similar episodes occurred in 2001–2002, 2008–2010, 2013–2014, and 2019–2020. However, a persistent pattern is the transience of these stable periods, which are frequently followed by a new crisis. The central challenge for policymakers, therefore, is twofold. First, they must ensure that the current stability is durable. Second, they must lay the groundwork for sustainable, long-term growth that generates sufficient employment for Pakistan's rapidly expanding labor force and significantly reduces poverty.

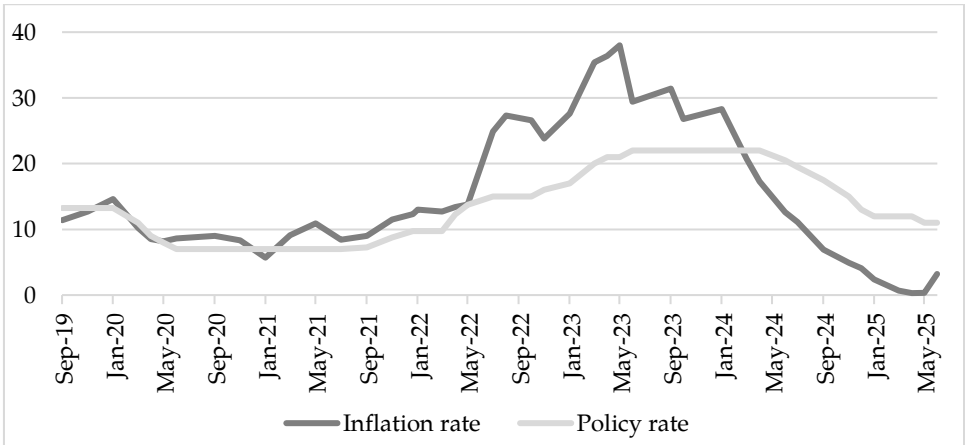
This paper contends that monetary policy's role in this context is to safeguard macroeconomic stability. The task of engineering the structural transformations necessary for sustainable growth falls to other policy domains, notably industrial, trade, and tax policy.

## The Current Conjuncture: Stabilization Amidst Persistent Vulnerabilities

The Pakistani economy exhibits a classic stabilization profile following a severe balance-of-payments (BOP) crisis. Headline inflation, which peaked at 38 percent in May 2023, had decelerated sharply to 3.2 percent by June 2025 (Figure 1). This disinflation was the direct result of a concerted macroeconomic adjustment package anchored by a tight monetary stance and fiscal consolidation under an International Monetary Fund (IMF) extended fund facility. The nominal anchor has held firm, with the exchange rate stabilizing at approximately PKR 280/USD since February 2023; a period of unprecedented stability in recent years (Figure 2).

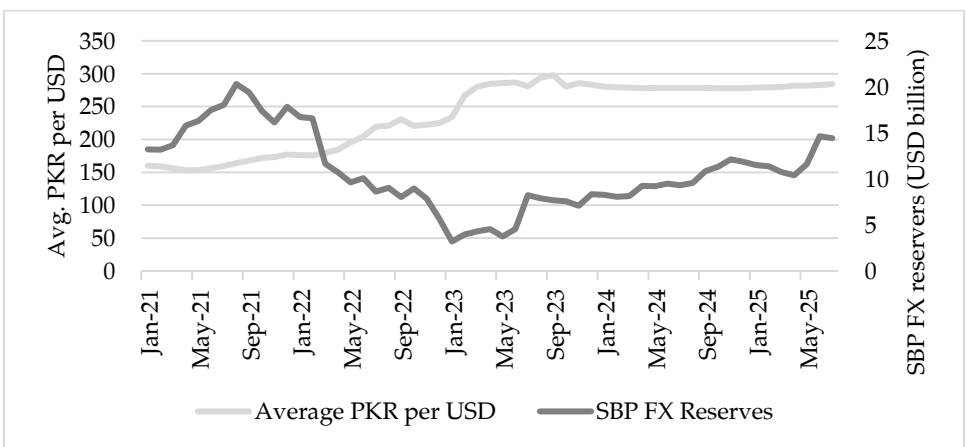
[4] See Hamid and Syed (2024) for a discussion of the relative merits of this criticism.

**Figure 1: Inflation rate and policy rate**




Source: Monetary policy report and inflation snapshot (new base: 2015–2016), SBP.

**Figure 2: Exchange rate and SBP foreign exchange (FX) reserves**



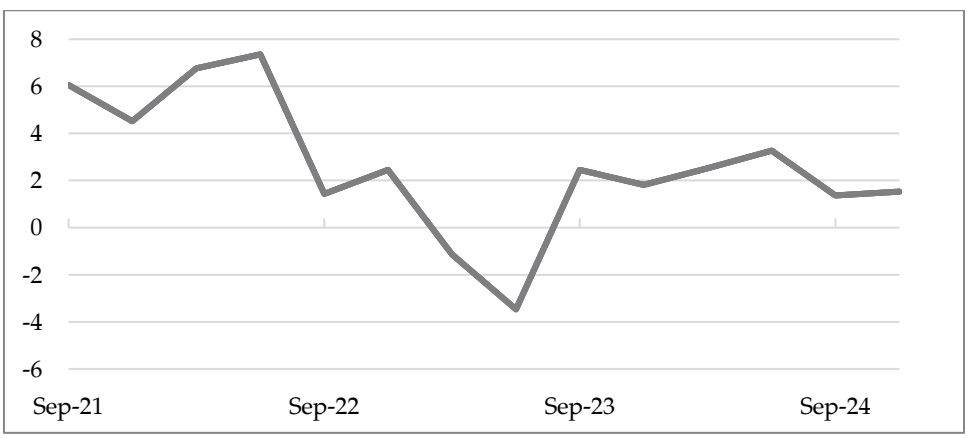

Source: Gold and FX reserves of Pakistan (SBP); International financial statistics database (IMF).
FX = foreign exchange, SBP = State Bank of Pakistan.

This stability has facilitated the rebuilding of external buffers. The SBP's FX reserves increased from a critically low USD 4.5 billion in June 2023 to USD 14.5 billion in June 2025. This accumulation was supported by the SBP's net purchases of over USD 8 billion from the interbank market between June 2024 and June 2025 (SBP, n.d.), a policy aimed explicitly at rebuilding resilience rather than resisting depreciation. The improved macroeconomic environment is also reflected in key vulnerability metrics: the ratio of total external debt and liabilities to gross

domestic product (GDP) fell from 43.1 percent to 33.4 percent between June 2023 and June 2025 (SBP, 2025a), and five-year credit default swap spreads retreated to pre-crisis levels, signaling restored market confidence. The successful completion of the first review of the IMF extended fund facility in May 2025 and the negotiation of a USD 1.4 billion resilience and sustainability facility further underscore this positive reassessment by international financial institutions.

However, this hard-won stability masks persistent and deep-seated vulnerabilities. The economic recovery remains fragile and insufficiently broad-based. Quarterly GDP growth, while positive, fluctuated around a modest two-percent trend in FY 2024 and FY 2025 (Figure 3). This growth rate is only marginally higher than the population growth rate of approximately two percent, implying near-stagnant per-capita income. The social consequences are severe; Wieser and Meyer (2025) estimate that the poverty rate rose to over 25 percent in FY 2024, while the IMF (2025) reports that unemployment increased from 6.2 percent in 2022 to 8 percent in 2025. An economy growing at two to three percent cannot generate the millions of jobs required annually for its expanding labor force, let alone make meaningful progress in poverty reduction.

**Figure 3: Quarterly growth rate of GDP (percentage)**



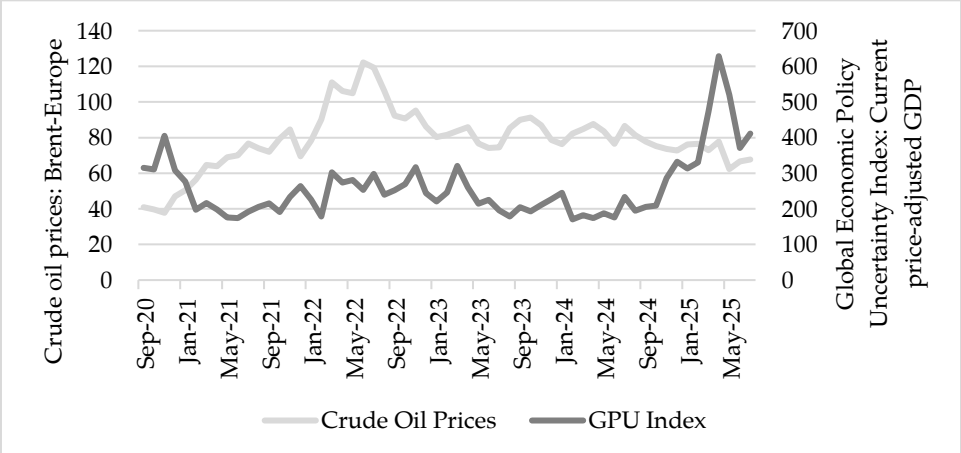

Source: Economic data: Quarterly GDP of Pakistan, SBP.

It must be emphasized that the current stabilization is also precariously dependent on a favorable, yet volatile, external environment. The decline in global energy prices provided significant relief to the import bill and current account. However, as depicted in Figure 4, this period of low prices coincides with a peak in global economic policy uncertainty, driven by a shift toward mercantilist US

trade policy, the ongoing war in Ukraine, and conflict in the Middle East. This uncertainty suppresses global energy demand, creating a temporary benefit for oil-importing countries like Pakistan. A normalization of geopolitical tensions or a rebound in global growth could swiftly reverse this advantage, putting renewed pressure on the BOP. Consequently, the SBP's current monetary stance must be viewed not just through the lens of current low inflation, but as a necessary buffer against highly probable future external shocks.

Nevertheless, there is criticism from some quarters about the pace of policy rate cuts during this stabilization episode. Despite the 1,100-basis point reduction in the policy rate between May 2023 and June 2025, the even larger fall of over 3,500 basis points in the inflation rate has meant that there is a large positive gap between it and inflation. A frequently asked question is why the SBP is maintaining such a high (almost eight percent in June 2025) real interest rate as measured against current inflation. It is argued that a developing country like Pakistan cannot afford to have such a high real interest rate, particularly when inflation and growth are both relatively low. The next two sections address this point of view.

**Figure 4: Crude oil prices and the Global Economic Policy Uncertainty Index: Current price-adjusted GDP**




Source: US Energy Information Administration. (2025). *Crude oil prices: Brent - Europe (DCOILBRENTEU).* https://fred.stlouisfed.org/series/DCOILBRENTEU; Baker, S. R., Bloom, N., & Davis, S. J. (2025). *Global economic policy uncertainty index: Current price adjusted GDP (GEPUCURRENT).* https://fred.stlouisfed.org/series/GEPUCURRENT
GDP = gross domestic product.

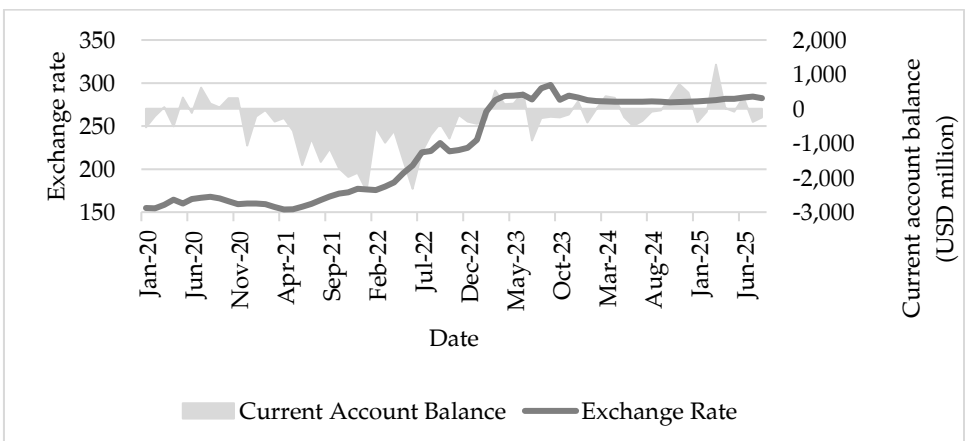
## Lessons from Recent Macroeconomic Management

The turbulent period of 2020–2023 offers three critical lessons for the formulation of monetary and exchange rate policy in an economy with Pakistan's structural characteristics.

### First, delaying necessary exchange rate adjustments through managed floating creates conditions for disorderly corrections.

The move to a market-determined exchange rate in 2019 was a step toward greater external sector flexibility. However, in practice, the SBP has maintained a tendency to 'lean against the wind,' aimed at smoothing depreciation to prevent market panic, which can prove counterproductive in the face of widening external imbalances. Figure 5 plots a three-month moving average of the current account balance against the nominal exchange rate. It reveals that as the current account deficit ballooned from November 2020, peaking in January 2022, the rupee depreciated by a mere ten percent over 14 months. This resistance contributed to immense pent-up devaluation pressure. The inevitable adjustment was consequently sharp and destabilizing, with the currency depreciating an additional 20 percent in the subsequent six months, and again, after exchange rate stability for a few months, the currency depreciated by another 20 percent between December 2022 and April 2023. This volatile, stop-go pattern of exchange rate management is more damaging than a smoother and timely adjustment, as it fuels market panic and erodes policy credibility.

**Figure 5: Current account balance and exchange rate**

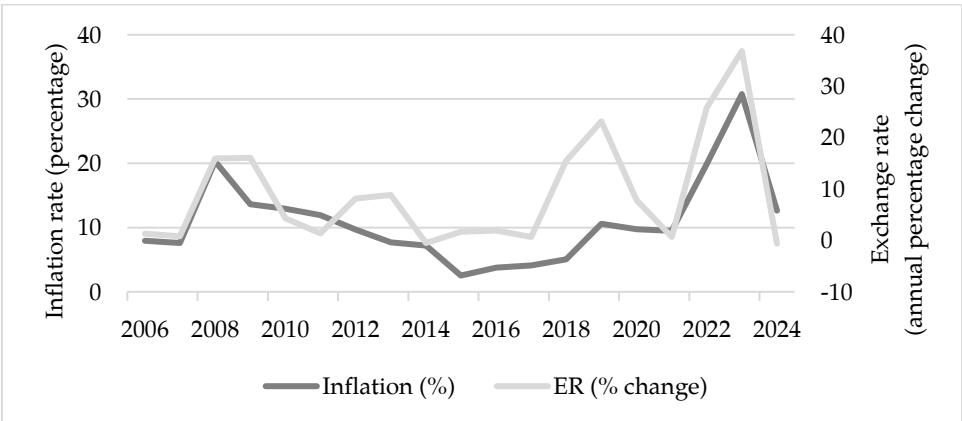



Source: Monthly summary of BOP per BPM6, SBP, and International financial statistics database, IMF.

**Second, the exchange rate is a primary determinant of inflation in a highly import-dependent economy, creating a direct channel from external stability to price stability.**

The high pass-through from depreciation to domestic prices is a well-documented phenomenon in Pakistan. Figure 6 demonstrates a strong co-movement between exchange rate changes and inflation for most of the sample period. The notable exception is the period of 2020–2021, when a tightening of macroeconomic policies and the massive negative demand shock from the subsequent COVID-19 pandemic helped suppress the inflationary impact of the preceding large depreciation.

**Figure 6: Inflation rate and exchange rate changes (2006–2025)**




Source: International financial statistics database, IMF.

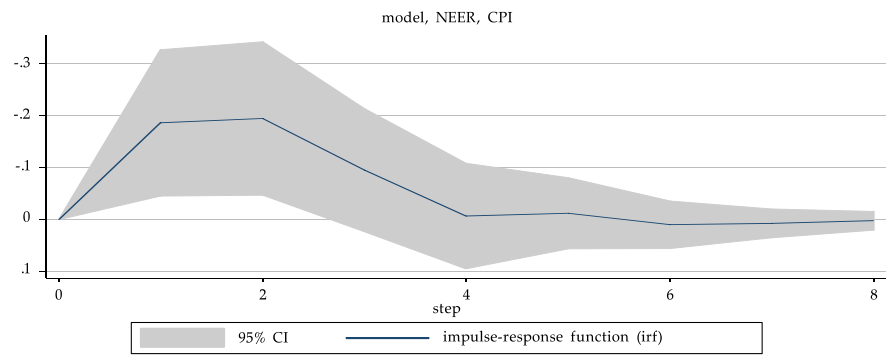
The close link between exchange rate fluctuations and inflation is also confirmed by an empirical investigation of the exchange rate pass-through in Pakistan, which shows it ranged between 50 percent and 80 percent in recent years. It also shows that the pass-through is quick, with most of the impact occurring in the first three months. Moreover, the impact is much greater when there is sustained, substantial exchange rate depreciation, such as in the periods of August 2021–August 2022 and November 2022–May 2023. In these periods, the depreciation of the rupee accounted for almost 50 percent and 80 percent of the increase in inflation, respectively (Box 1). In comparison, other variables capturing demand growth, international commodity prices, and domestic macroeconomic policies exhibit a smaller influence on inflation, with their effects stabilizing after approximately three to four months.

**Box 1: Estimating exchange rate pass-through to inflation in Pakistan**

We employ a vector autoregressive model to investigate the determinants of inflation in Pakistan in recent years, with a specific focus on exchange rate pass-through. The model is estimated using monthly data from July 2019 to April 2025, spanning the period since the move to a flexible and market-determined exchange rate regime. The dependent variable is the month-on-month percentage change in the consumer price index (CPI). The explanatory variables are also expressed as month-on-month growth rates to deal with non-stationarity. These include the nominal effective exchange rate (NEER), the large-scale manufacturing (LSM) index as a proxy for the strength of domestic economic activity, global oil prices to capture external price shocks, broad money supply (M2) to reflect domestic monetary conditions, and the primary balance as a percent of GDP to capture the stance of fiscal policy.

Our empirical results indicate that the NEER is a statistically significant determinant of inflation at the one-percent significance level. The impulse response function (IRF) shown in Exhibit A quantifies this relationship. A 1 percent depreciation in the NEER induces an immediate CPI increase of 0.2 percentage points in the first month, a further 0.2 percentage points in the second month, and another 0.1 percentage points in the third month before returning to steady state in the fourth month. The cumulative effect over this period is a 0.5 percentage point rise in inflation. The pass-through effect is temporary, dissipating over time. However, during periods of sustained exchange rate depreciation, the effect will be more persistent as it accumulates over time.

**Exhibit A. IRF: Impulse (NEER), response (CPI)**




CI = Confidence Interval, CPI = consumer price index, NEER = nominal effective exchange rate.

The forecast error variance decomposition (FEVD) in Exhibit B provides further insight into the dynamics of this transmission—shocks to the exchange rate account for none of the forecast error variance in CPI at the initial horizon. However, their explanatory power rises sharply to approximately 68 percent by the second month and then slowly dissipates over the next eight months. This pattern confirms that the exchange rate pass-through materializes with a lag of one to two months and plateaus thereafter. The FEVD analysis shows that other variables, including the LSM index, oil prices, M2, and the fiscal balance, also exhibit a lagged but smaller influence on CPI, with their effects stabilizing after approximately three to four months.

**Exhibit B: FEVD of explanatory variables**

| T (months) | NEER | LSM index | Oil prices | M2 | Primary balance |
|---|---|---|---|---|---|
| 0 | 0 | 0 | 0 | 0 | 0 |
| 1 | 0 | 0 | 0 | 0 | 0 |
| 2 | 0.681 | 0.021 | 0.014 | 0.016 | 0.028 |
| 3 | 0.123 | 0.024 | 0.013 | 0.030 | 0.030 |
| 4 | 0.135 | 0.024 | 0.013 | 0.030 | 0.030 |
| 5 | 0.135 | 0.024 | 0.017 | 0.030 | 0.030 |
| 6 | 0.135 | 0.024 | 0.017 | 0.031 | 0.030 |
| 7 | 0.136 | 0.024 | 0.017 | 0.031 | 0.030 |
| 8 | 0.136 | 0.024 | 0.017 | 0.031 | 0.030 |

LSM = large-scale manufacturing, M2 = money supply, NEER = nominal effective exchange rate.

The economic significance of this pass-through is substantial, especially during periods of sustained exchange rate depreciation. The model suggests that the depreciation of the NEER alone was responsible for around four-fifths of the surge in inflation between November 2022 and May 2023, and slightly below half of the earlier increase between August 2021 and August 2022. These results demonstrate that disorderly movements in the exchange rate have a significant bearing on inflation developments in Pakistan, such that price stability is closely intertwined with external stability during such episodes.

The pass-through coefficient is high due to the economy's reliance on imported energy, intermediate goods, and food items. This evidence underscores that, for the SBP, managing inflation is inextricably linked to avoiding extreme exchange rate depreciation. This does not mean avoiding depreciation driven by fundamentals like inflation and the trade deficit, which we noted only leads to a more disorderly correction in the future. Instead, it means allowing the exchange

rate to act as a buffer as imports rise and ensuring that monetary conditions are not contributing to an overheating of the economy. A monetary policy that is too loose risks triggering external imbalances and currency depreciation, which would quickly feed through to consumer prices, undermining the central bank's primary mandate. At the same time, fiscal policy must be prudent, and domestic economic policy and political uncertainty must be kept in check to ensure that the exchange rate does not come under undue pressure and price stability is achieved.

**Third, inadequate FX reserves leave the economy acutely vulnerable to capital flight and disorderly currency depreciation, even under formal capital controls.**

The exchange rate is extremely sensitive to the strength of the external position as well as macroeconomic and political uncertainty. An empirical investigation of the determinants of FX rate instability showed that the external position, proxied by FX reserves (in months of import cover) or the current account deficit, is the most important determinant, followed by the inflation differential relative to Pakistan's trading partners and economic policy uncertainty (Box 2). Therefore, maintaining external buffers and a stable domestic environment is paramount to exchange rate stability. The results suggest that the significant nominal effective depreciation of the rupee during FY 2022 can be mainly traced to the halving of FX reserves, together with the tripling of both domestic policy uncertainty and the inflation differential.

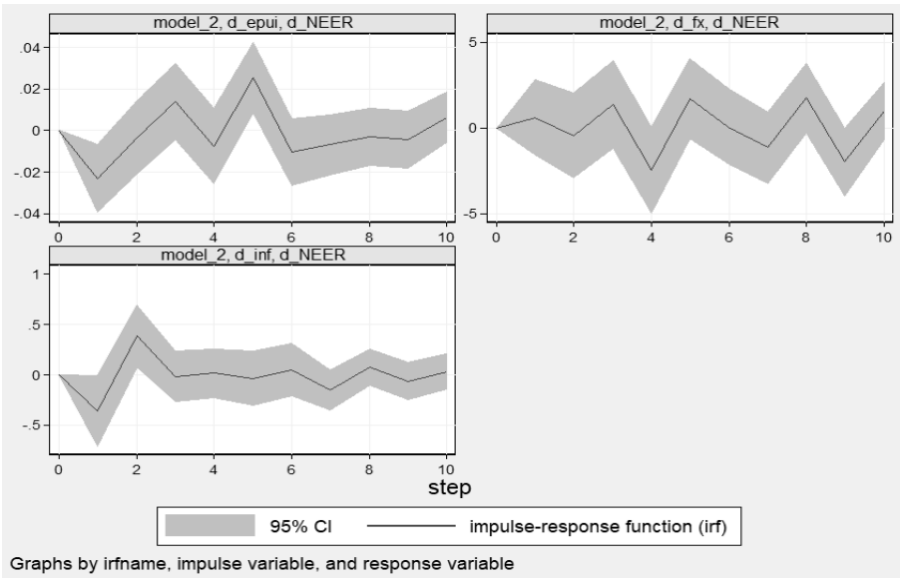
**Box 2: Investigating the determinants of the exchange rate in Pakistan**

We examine the drivers of Pakistan's exchange rate using a differenced vector autoregressive model. The model is estimated using monthly data from January 2020 to December 2024 to capture the period since the move to a flexible and market-determined exchange rate regime. The dependent variable is the NEER expressed as the first difference of month-on-month growth rates. The explanatory variables are also specified in first differenced month-on-month growth rates to address non-stationarity since a unit root was found in the growth rate data.

The explanatory variables are FX reserves measured in months of import cover (FX) as a proxy for the strength of the external position; the inflation differential between Pakistan and its trading partners (INF), capturing the fundamental effects of purchasing power parity; and the SBP's Economic Policy Uncertainty (EPU) Index as a measure of domestic uncertainty.

Granger causality tests establish that the inflation differential, FX reserves, and economic policy uncertainty are statistically significant determinants of the NEER at the five-percent level. The IRFs in Exhibit A illustrate the dynamic effects. A one-percent decline in the growth of the FX reserves position triggers an immediate 1.2 percentage point amplification in the current month's exchange rate depreciation, which moderates to 0.2–0.3 points in subsequent months before stabilizing. A similar shock to the growth in the inflation differential causes an acceleration of depreciation of approximately 0.36 percentage points in the first month, with the effect fading after the third month. Shocks to the growth in policy uncertainty (EPU) result in a comparatively smaller but persistent acceleration in depreciation of 0.01–0.02 percentage points. These findings indicate that external shocks, relative price pressures, and policy uncertainty exert a strong and persistent influence on the exchange rate.

**Exhibit A: IRFs**




CI = Confidence Interval, NEER = nominal effective exchange rate.

The FEVD in the table in Exhibit B corroborates these results over a longer horizon. After ten months, shocks to foreign reserves explain approximately ten percent of the forecast error variance in the NEER, while the inflation differential and policy uncertainty account for about seven percent and six percent, respectively.

**Exhibit B: FEVD of explanatory variables**

| t (months) | FX reserves | Inflation differential | EPU Index |
|---|---|---|---|
| 0 | 0 | 0 | 0 |
| 1 | 0 | 0 | 0 |
| 2 | 0.030 | 0.055 | 0.028 |
| 3 | 0.029 | 0.072 | 0.027 |
| 4 | 0.030 | 0.074 | 0.027 |
| 5 | 0.075 | 0.064 | 0.027 |
| 6 | 0.078 | 0.062 | 0.054 |
| 7 | 0.080 | 0.063 | 0.060 |
| 8 | 0.080 | 0.065 | 0.060 |
| 9 | 0.090 | 0.066 | 0.059 |
| 10 | 0.100 | 0.067 | 0.061 |

EPU = Economic Policy Uncertainty (Index), FX = foreign exchange.

The economic relevance of these determinants is especially pronounced during periods of major instability. For instance, a 16 percent depreciation in the NEER in FY 2022 can be mainly attributed to the halving of FX reserves during this period and the more than tripling of both domestic policy uncertainty and the inflation differential relative to trading partners. These results underscore that exchange rate stability in Pakistan rests predominantly on the maintenance of strong external buffers, inflation alignment with trading partners, and the fostering of a credible policy environment. This emphasizes the critical need for sound macroeconomic management and political stability to anchor the exchange rate and prevent disorderly movements that can feed into inflation (Box 1).

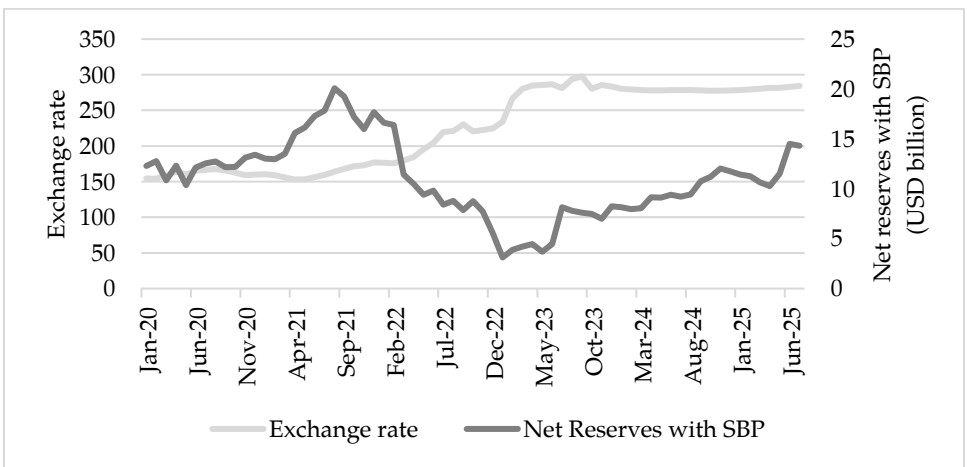
The exchange rate's sensitivity to macroeconomic and political uncertainty may seem surprising since Pakistan maintains de jure capital account restrictions. However, in practice, de facto convertibility has existed in Pakistan since economic reforms by the Sharif government in 1991, which were subsequently codified in the Protection of Economic Reforms Act, 1992 (Haque, 2011). This act gave all Pakistani citizens the 'freedom to bring, hold, sell, and take out foreign currency.' They have been allowed to open foreign currency accounts in commercial banks since early 1991. In addition, residents can purchase foreign currencies from money changers and deposit them in their foreign currency accounts. In 2002, the SBP issued regulations for the establishment of exchange companies, so licensed exchange companies replaced informal money changers. This created a multi-tiered FX market in Pakistan: the official interbank market, the licensed kerb market, and an informal grey market (Khalid, 2014; Salman & Ali, 2023).

The SBP tries to ensure that the interbank market and kerb market rates are closely aligned because a large gap between the two can result in the diversion of current account flows from the interbank market, particularly remittances, to the kerb market. In normal times, the current account balance determines the rates in the interbank and kerb markets. However, during periods of stress, when FX reserves are low and economic uncertainty is high, a different dynamic emerges. Increased capital account outflows through the informal market, driven by a flight to safety, have a dominant influence on the kerb and grey market rates.

This dual dynamic is illustrated in Figure 7. The decline in the SBP's gross reserves from August 2021 onward was accompanied by a gradual depreciation. However, this depreciation process accelerated dramatically in early 2023, driven

by a confluence of low reserves, a deadlock in IMF negotiations, and intense political uncertainty.[5] In this environment, the demand for safe-haven foreign assets surged. Capital flight manifested not through the official channel but through the informal economy, widening the premium in the grey market. In turn, this created a powerful incentive to divert remittances from formal banking channels to informal ones, i.e., through *hundi/hawala* networks. That the diversion of inflows from formal to informal channels can be substantial is evidenced by the USD 4 billion (over one percent of GDP) drop in official remittances in FY 2023 (Figure 8). The resulting depreciation fueled a self-reinforcing cycle: households and firms, observing the rupee's falling value, sought to dollarize their assets, further exacerbating pressure on the currency. This speculative bubble was only broken when the rupee was stabilized by an administrative crackdown on exchange companies and illegal FX operators and the imposition of informal rationing in the interbank market.[6] While helping to arrest panic and disorderly exchange rate conditions, these measures had substantial harmful side effects on the economy in terms of market distortion and the loss of investor confidence.

**Figure 7: Exchange rate and gross reserves with the SBP**

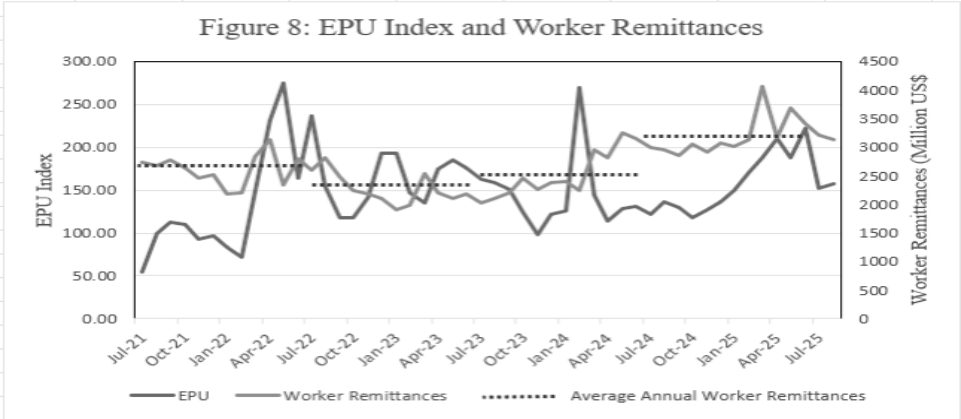



Source: Gold and FX reserves of Pakistan, SBP and International financial statistics database, IMF.

[5] See Syed and Hamid (2023) for a more detailed discussion of the 2022–2023 crisis.

[6] Tens of millions of dollars poured back into Pakistan's interbank and open markets after the military was called in and raids on black market operators took place (Shahid & Ali, 2023).

**Figure 8: EPU Index and worker remittances**




Source: Country-wise workers' remittances and EPU Index database, SBP.
EPU = Economic Policy Uncertainty (Index)

This episode delivers a clear lesson: monetary policy cannot afford to be stimulative when FX reserves are precariously low. A conservative, high real interest rate stance is essential to moderate import demand, attract portfolio flows, and, most critically, maintain confidence to prevent capital flight through informal channels. The SBP's current policy of maintaining a positive real interest rate, while criticized for its growth impact, is a rational response to the imperative of rebuilding and sustaining external stability, which is the foundation for lasting price stability.

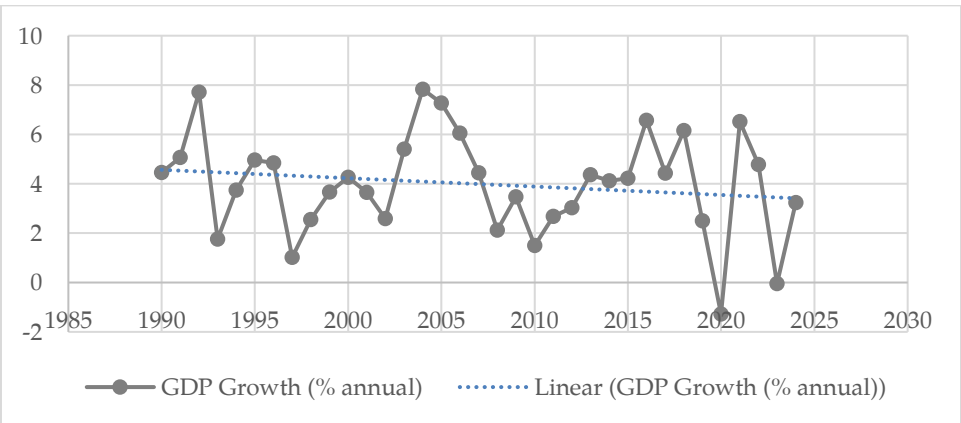
## The Structural Context: A Balance-of-Payments-Constrained Growth Model

Pakistan's contemporary growth dilemma is not a cyclical anomaly but the culmination of a long-term structural trajectory characterized by a consumption-led, import-intensive, and externally financed growth model.

A historical perspective reveals that since the economic liberalization of the 1990s, growth has been predominantly driven by surges in government spending and private consumption rather than by productive investment or export competitiveness. This pattern has been sustained by periodic inflows of geopolitical rents, which alleviated external constraints without addressing underlying inefficiencies. During the 2000s, substantial aid and assistance flows from the US, linked to the war in Afghanistan, financed large current account

deficits. In the following decade, investment from China under the China-Pakistan Economic Corridor played a similar role. This reliance on external financing has created a form of 'resource curse,' discouraging the difficult structural reforms necessary to foster a competitive, export-oriented manufacturing sector and to mobilize domestic savings. As a result, Pakistan has experienced uneven growth and a gradual decline in its average growth rate (Figure 9). This dependence on external financing has also left the economy increasingly vulnerable to shifts in global financial conditions and changing geopolitical priorities, undermining the prospects for long-term, sustainable development. The economic situation in the last few years has become even more difficult because, in addition to the drying up of access to external resources on easy terms, political developments inside the country have made it more difficult for the government to undertake much-needed structural reforms in tax, industrial, and tariff policies.

**Figure 9: GDP growth (annual percentage)**



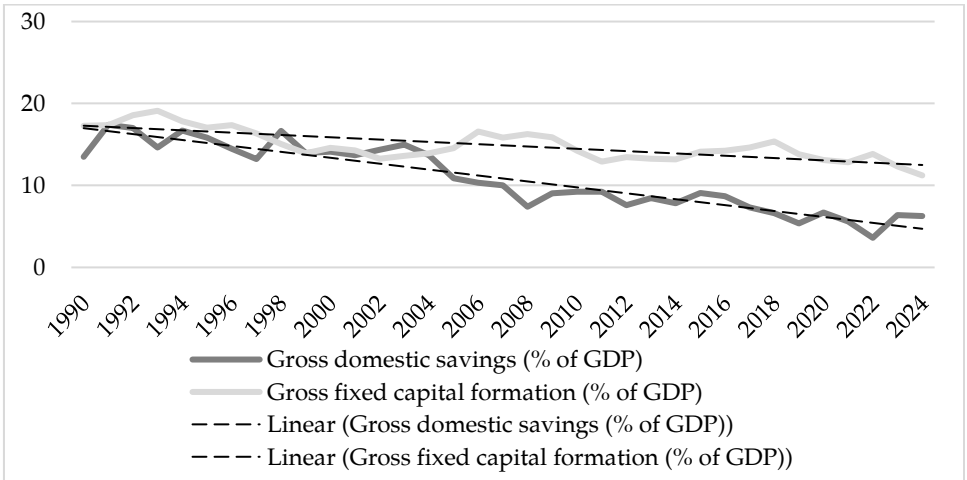

Source: World Development Indicators, World Bank.
GDP = gross domestic product.

The fundamental symptom of this malaise is a persistently low and declining investment-to-GDP ratio, which has fallen from an average of over 20 percent in the 1990s to around 15 percent in recent years (Figure 10). This decline is driven by a dual failure on both the demand and supply sides of capital formation.

On the demand side, private investment is severely discouraged by a toxic combination of recurrent macroeconomic crises and a deeply distorted investment climate. A primary source of distortion is the tax system, which places a disproportionately heavy burden on the easy-to-tax formal sectors (notably LSM)

while effectively exempting large segments of the economy, such as wholesale and retail trade, real estate, and agriculture. This raises the cost of doing business in the formal industrial sector and creates a perverse incentive for capital to flow into speculative, non-tradable activities rather than productive, export-oriented industries. The pressure to meet escalating revenue targets under successive IMF programs has exacerbated this problem, further increasing the effective tax rate on the already compliant sectors.

**Figure 10: Investment and savings (percentage of GDP)**



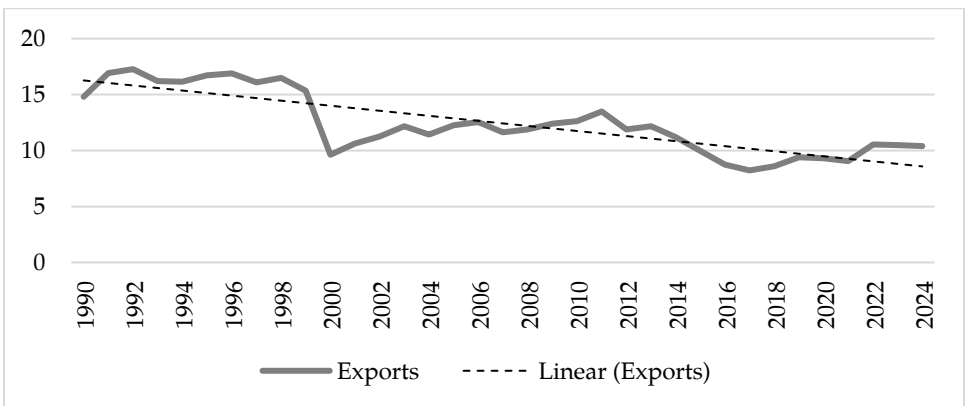

Source: World Development Indicators, World Bank.
GDP = gross domestic product.

On the supply side, rigid government spending and the chronically narrow tax base (which results in persistently low tax-to-GDP ratios) severely constrain the government's capacity for public investment in critical infrastructure, human capital, and technology. Moreover, large fiscal deficits financed by government borrowing from the financial sector crowd out lending to the private sector. At the same time, past policies designed to reduce the cost of government borrowing and please the politically important group of 'traders and retailers,' e.g., negative real interest rates and an overvalued exchange rate, stimulated import-intensive consumption and discouraged financial savings. Consequently, Pakistan's national savings rate is among the lowest of peer countries and has declined faster than the investment rate. The gap between low domestic savings and inadequate investment has been filled by external borrowing, creating a vicious cycle of debt and dependency.

A critical consequence of this growth model has been a sustained loss of international competitiveness. A substantial body of literature (Hussain, 2008; Ahmad, 2009; Hamid & Mir, 2017) documents the persistent overvaluation of Pakistan's real effective exchange rate. This overvaluation has been exacerbated by a 'Dutch disease' effect stemming from large and growing remittance inflows. A recent IMF study (Carare et al., 2025) confirms a positive correlation between remittances and overvaluation in flexible exchange rate regimes as these inflows increase domestic consumption and drive up the price of non-tradables. Coupled with low investment, this overvaluation has stifled the tradable sectors. The SBP (2025b) reports that labor productivity growth remains anemic and total factor productivity growth has been volatile and on a downward trajectory, indicating that economic activity is becoming less efficient over time.

The most telling indicator of this structural decline is the relentless fall in the share of exports in GDP, which dropped from an average of 16.5 percent in the 1990s to 11.6 percent in the 2000s, and to just 9.4 percent in the last decade (Figure 11). An economy that is failing to integrate into global markets at a comparable rate to its peers is, by definition, losing its competitive edge.

**Figure 11: Exports (percentage of GDP)**




Source: World Development Indicators, World Bank.

This confluence of factors (low investment, a distorted incentive structure, and declining productivity) has cemented Pakistan's status as a BOP-constrained economy (Felipe et al., 2010; Rosbach & Aleksanyan, 2019; Raza, 2021). The long-run growth rate in such an economy is determined by the growth of exports relative to the income elasticity of demand for imports. Pakistan's growth has

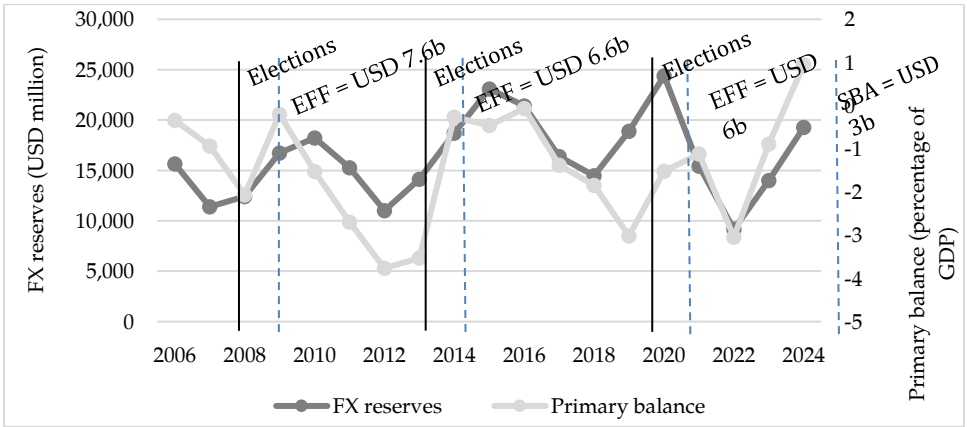
consistently hit a 'BOP wall,' where any growth acceleration above a certain threshold rapidly inflates the import bill, leading to a deficit on the BOP. Instead of allowing the exchange rate to depreciate to act as a moderating influence on the current account deficit, international reserves are used to resist rupee adjustment until they are close to depletion. Ultimately, it becomes clear that this policy is no longer sustainable, and the country is forced to adopt contractionary policies. Crucially, this BOP-consistent growth rate itself has declined over time, from estimates of around five percent in the 2000s to less than four percent today (ibid). This decline is a direct result of the factors outlined above: falling export competitiveness (reducing export growth) and an entrenched consumption pattern (maintaining a high income elasticity of imports).

This dynamic is institutionalized in a persistent political business cycle (Figure 12). The pattern is recurrent: fiscal policy turns expansionary, stimulating consumption-led growth that exceeds the BOP-consistent rate in the run-up to general elections. This leads to overheating, a widening current account deficit, and a depletion of reserves, culminating in a crisis.

The (usually new) government is then compelled to seek an IMF-supported stabilization program, which enforces fiscal austerity and tight monetary policy, leading to a growth slowdown. Once stability is restored and the IMF program ends (usually three to four years later), the approach of the next election triggers a renewed fiscal expansion, and the cycle repeats.

The problem is that with each cycle, the underlying sustainable growth rate appears to be ratcheting downward, as structural weaknesses are left unaddressed and public debt accumulates. The historical advantages of geopolitical rents are no longer sufficient to sustain a reasonable growth rate. Without profound structural reforms to enhance competitiveness, boost domestic savings, and redirect investment into tradable sectors, Pakistan faces a future of low-quality, low-growth equilibrium, unable to generate the employment required for its burgeoning youth population.

**Figure 12: Pakistan's FX reserves, primary balance, and IMF programs**




Source: Gold and FX reserves of Pakistan, SBP and public finances in modern history database (February 2025), IMF.
EFF = extended fund facility, FX = foreign exchange, GDP = gross domestic product, SBA = stand-by arrangement.

## Conclusion

The current economic environment (low inflation and modest growth) might conventionally justify aggressive monetary easing. However, such a move would be premature and risky for Pakistan. The economy is only beginning to recover from a deep crisis. External buffers, while improving, remain vulnerable, and global uncertainty is elevated.

The SBP's primary mandate of price stability is inextricably linked to financial stability through the exchange rate channel. At the same time, Pakistan's growth is fiscally driven and BOP-constrained. Until structural reforms in taxation, industrial policy, and public administration succeed in boosting productivity, savings, and exports, the sustainable non-inflationary growth rate will remain below four percent. Monetary policy must, therefore, act as a stabilizing anchor, tightening when growth threatens to exceed this BOP-consistent rate to prevent a recurrence of exchange rate and inflation crises.

While current policymakers demonstrate an understanding of these imperatives, the critical test will come after the IMF program concludes and the country approaches the 2029 general election. The ability to resist the historical pattern of fiscal loosening will determine whether the current stabilization can be transformed into lasting prosperity.

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