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Alpha Capital REN # REP - 004
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Inflation Risk Real or Just a Fear?

Pakistan is at a pivotal moment in determining the direction of its exchange rate. While the rupee has long been associated with inflationary spikes whenever devalued, the present macroeconomic context signals a limited inflationary transmission from PKR depreciation. Since domestic food prices have already adjusted by 26.5% beyond global benchmark, the scope for additional inflationary pressure from depreciation remains limited. In this environment, a carefully managed depreciation of the rupee could support export competitiveness, attract higher remittance inflows, and strengthen the external account, offering a strategic opportunity to devalue the currency without immediately destabilizing prices.

Key Data (Oct-25)

Policy Rate (%)	11%
NCPI (% YoY)	6.2%
CA Balance 4MFY26 (USD mn)	-733
FX Reserves (USD bn)	14.5
Exchange rate	281.1
Import cover (months)	2.5

Source: PBS, SBP, Akseer Research

Muted food shock risk

Domestic food inflation is already running well above the global index nearly 26.5% higher with a weight of 34.6% in the overall CPI basket. This elevated base reduces the risk of a sharp surge in prices from currency depreciation. In addition, food prices in Pakistan have historically been downward sticky, implying that they do not decline quickly even when global prices ease. In this context, external inflationary forces, such as PKR depreciation or an uptick in world food prices, are likely to have a limited pass-through effect on local food costs. Going forward, the World Bank is projecting a further decline in the global food price index by 6.1% in 2025 and 0.3% in 2026. As a result, the existing gap may widen further in Pakistan’s favor, providing additional cushion for the economy to absorb potential international price shocks or PKR depreciation without triggering significant domestic inflation.

Global vs. Local Food Price Index

	Oct-25
Global Food Index	359
Pakistan Food Index	454
Local vs. Global Food Index Gap	26.5%

Source: WB, PBS, Akseer Research

Limited NFNE risk

Although the Non-Food Non-Energy (NFNE) index is 5.5% below the global average, its weight-adjusted impact on CPI inflation is 3.1%. Historical trends suggest that it took nearly a decade for Pakistan’s NFNE index to converge with the global index, thereby suggesting that divergences can linger for a longer period, further diluting the risk of a sharp adjustment in the NFNE gap.

Global vs. Local NFNE Index

	Oct-25
Global NFNE Index	111
Pakistan NFNE Index	105
Local vs. Global NFNE Index Gap	-5.5%

Source: WB, PBS, Akseer Research

Global commodity outlook

Stable oil, wheat, and edible oil prices, along with World Bank forecasts of declining global commodity prices in 2025-2026, reduce the risk of external price shocks feeding into domestic inflation. According to the World Bank, global commodity prices are expected to fall by about 7% in both 2025 and 2026. So, unlike previous cycles where rupee depreciation coincided with global commodity upswings, the current environment is marked by stabilizing international prices.

World Bank Expectation of Price Indices

Price Indices	2025	2026
WB Food Index	-6.1%	-0.3%
WB Energy Index	-12%	-10%
WB Commodity Index	-7%	-7%

Source: WB, PBS, Akseer Research

Macro stability

Improved reserves, easing policy rates, and a narrowing current account deficit provide a relatively stable backdrop for exchange rate adjustment, unlike previous periods of volatility where external buffers were weak and monetary tightening constrained growth.

Pakistan faces the dilemma again!

Until recently, the Pakistani rupee has been closely managed with its every move watched, measured and often feared. Devaluing the PKR historically meant a rise in inflation, making the government hesitant to loosen its grip. However, after almost two years of currency stability, Pakistan now finds itself at a critical crossroads. One path involves maintaining the current exchange rate and the other, perhaps a more strategic option, is a controlled devaluation of the rupee.

While many people assume that devaluation would spark steep inflation, what if this time around, the circumstances are a bit different? A carefully managed depreciation of the PKR may not ignite the kind of inflationary pressure it once did. Why? Because Pakistan's food inflation index is already above global benchmark index. Even if global inflation rises, it may not necessarily translate into fresh domestic price pressures to the same quantum. Meanwhile, the NFNE component of the Consumer Price Index (CPI) currently lies below that of global level and it would take some time to gradually catch up to the global index level.

Background

For decades, the prevailing belief in Pakistan's economic policy circles has been that frequent rupee devaluation is the primary driver of inflation. The reasoning is straightforward: when the currency loses value, imported goods and raw materials become more expensive and these higher costs are then passed on to consumers. Given Pakistan's high dependence on imports for fuel, energy, machinery, edible oil, and even basic food staples, this transmission mechanism has historically been both powerful and immediate.

Historical data underscores this relationship. Each major episode of devaluation, whether in the late 1990s, the global financial crisis of 2008, or the adjustment period of 2018-19 was followed by sharp spikes in consumer prices. As a result, currency depreciation became synonymous with surging inflation in the public and policymaker mindset.

Globally, many emerging economies have faced a similar challenge, but in Pakistan the inflationary response has been more pronounced. In countries like Vietnam and Bangladesh, for instance, stronger domestic supply chains and export bases have helped absorb the shock of weakening currencies. According to the IMF, the pass- through of currency depreciation to inflation in Vietnam and other ASEAN countries are low around 1.7%, twelve months after a 10% change in the exchange rate. On the contrary, a study by the Pakistan Institute of Development Economics (PIDE) estimated that a 10% PKR devaluation leads to a 3.4% increase in consumer prices in the short run.

Table 01: Pass through effect of currency depreciation to inflation in the short run

Short run (12M) pass-through effect of currency depreciation on inflation		
Country	**Currency depreciation**	**Short run effect on inflation**
Pakistan	10%	3.4%
Other ASEAN countries	10%	1.7%

Source: PIDE, Akseer Research

This is followed by the full impact of depreciation, reflected in a 0.99 correlation between PKR devaluation and inflation over the past 17 years. Pakistan, therefore, has remained more vulnerable to imported inflation due to its narrow export basket and dependence on global commodity cycles.

Table 02: Correlation between Inflation & PKR depreciation in different time periods

Correlation between inflation & PKR depreciation in different time periods	
Period	**Correlation**
2008-2025	**0.99**
2008-2011	0.86
2011-2018	0.90
2018-2025	0.98

Source: PBS, SBP, Akseer Research

Inflation dynamics and its linkages

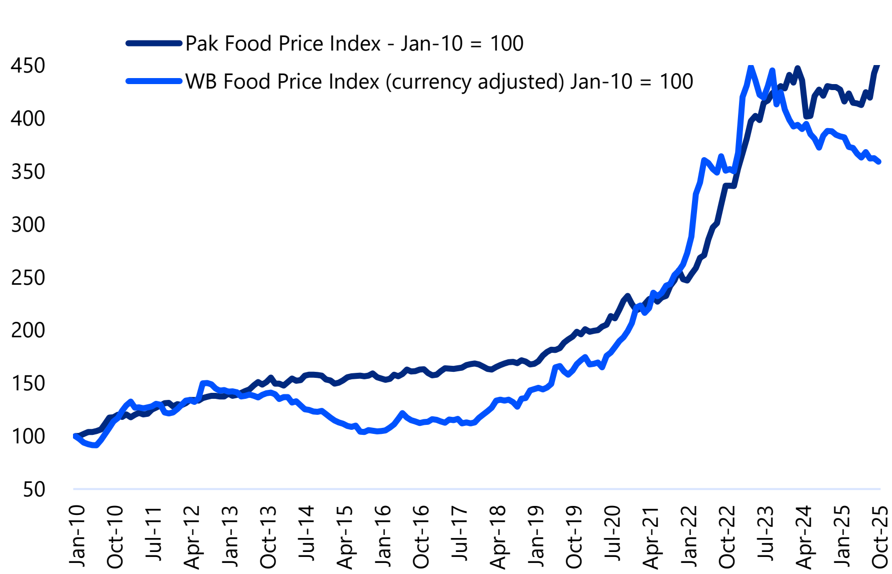
Inflation risk from food basket

Food prices have been a significant driver of inflation in Pakistan due to their dominant weight of 34.6% in the CPI basket. Currently, the Pakistan Food Price Index stands way above global food price index. The gap between the two stands at around 26.5% which, when adjusted for its weight in the CPI, translates into a potential buffer of 9.2% on overall inflation. Owing to downward price rigidity in Pakistan, adjustments in the domestic food price index are further likely to be delayed.

Moreover, as per the World Bank forecasts, food prices are expected to recede by 6.1% in 2025 and another 0.3% in 2026. Consequently, the divergence between the domestic and global index is expected to widen going forward. Given that international food prices will experience a drop, the likelihood of a sharp inflationary spike in the near term remains low.

Nonetheless, even in the event of a global food price surge driven by geopolitical developments or adverse global weather patterns, Pakistan's food prices may not exhibit a commensurate response, as international prices would largely be converging toward the already elevated domestic levels.

Figure 01: Comparison of Pakistan Food Price Index & Global Food Price Index



Source: PBS, WB, Akseer Research

Graphical insight: From Jan-10 to Oct-25, domestic and global food inflation indices reveal recurring phases of convergence. Initial convergence in 2010–2013 was followed by a prolonged divergence, with domestic food inflation persistently outpacing global levels until 2021. This gap largely reflects price dynamics in Pakistan where downward stickiness was evident between 2014-2021. Once prices increased, they proved resistant to decline even as global prices continued their downward slope.

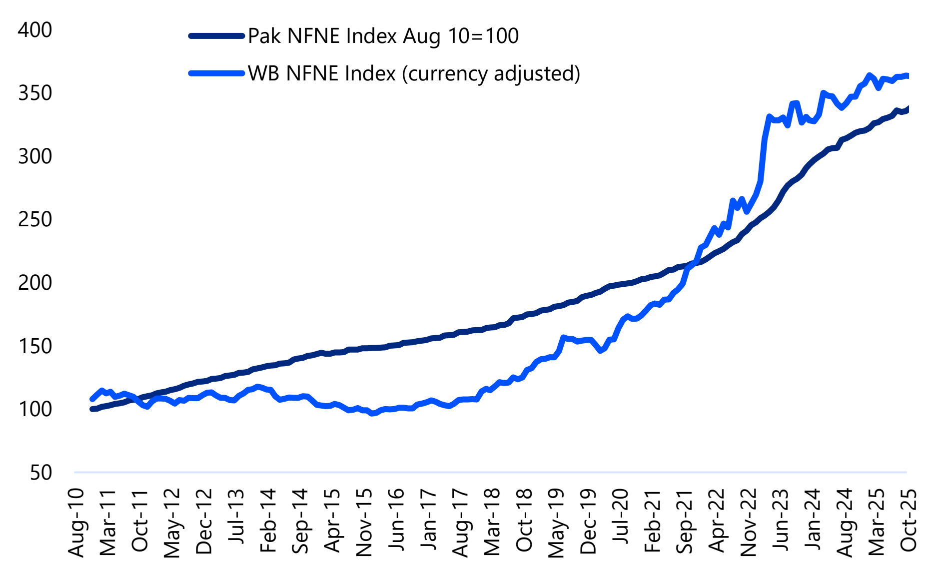
The sharp narrowing of this gap in 2021, followed by renewed intersections in 2022–23, signaled a temporary realignment. However, domestic prices have since remained elevated above the global index, creating a persistent gap. So, historical patterns suggest that due to the factor of price stickiness in Pakistan, the situation will remain similar in the current scenario as well. Going forward, Pakistan's food inflation may rise at a slower pace than the global benchmark, reinforcing the view that external shocks will have limited inflationary impact in the medium term.

Pakistan's NFNE inflation: below global levels, lower vulnerability

The NFNE component, which carries the heaviest weight of 55% in Pakistan's CPI, currently lies below the global index by about 5.5%. The present differential implies that even if local NFNE prices were to fully converge with global levels, the maximum impact on headline inflation would be around 3.1%.

However, historical evidence shows that such convergence is typically slow. In the last cycle, it took nearly a decade for domestic and global NFNE indices to intersect. This suggests that short-term inflationary risks from this channel remain muted, with any upward adjustment likely to unfold gradually.

Figure 02: Comparison of Pakistan NFNE index & Global NFNE index



Source: WB, PBS, Akseer Research

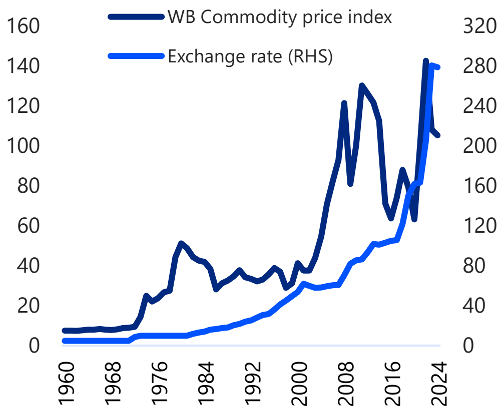
Graphical insight: Between 2010 and 2025, Pakistan's NFNE inflation intersected with the global index only twice, in 2011 and 2021, underscoring the rarity and lagged nature of convergence. Historically, Pakistan's NFNE has stayed above global levels, but since late 2022 the trend reversed with a consistent rise in global NFNE inflation. Given that the last two intersections were a decade apart, the current divergence is likely to persist, limiting the pass-through of external shocks.

International commodity prices

International commodity prices see sharp corrections following significant spikes during major economic events. Unlike earlier cycles, when rupee depreciation amplified inflationary pressures by coinciding with global commodity upswing, the current scenario presents a more stable dynamic.

According to the World Bank, global commodity prices are expected to decline by about 7% in 2025 and 2026. In nominal terms, prices will still remain above their pre-pandemic levels. However, when adjusted for inflation, they are expected to drop for the first time below the average seen between 2015 and 2019. This would signal the end of a surge, driven by the global economic rebound after the COVID-19 pandemic and the commodity price shocks following the conflict between Russia and Ukraine.

Figure 03: Impact of WB Commodity Price Index on Exchange rate

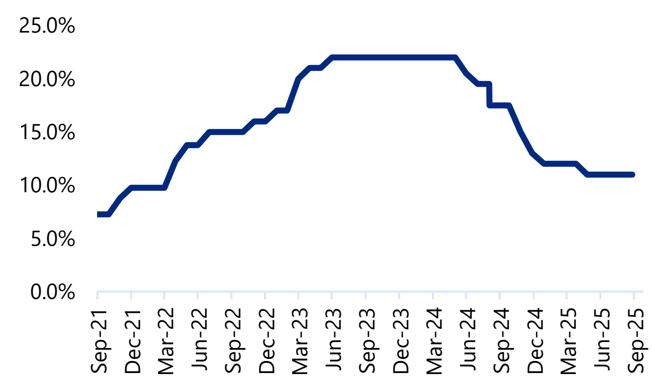


Source: WB, SBP, Akseer Research

Favorable macroeconomic stage

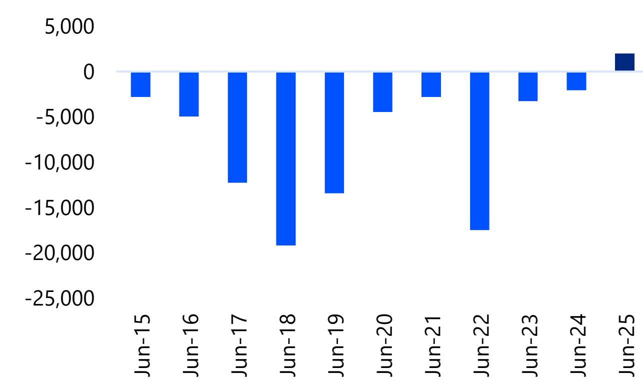
The macroeconomic backdrop is considerably more stable than in previous episodes of PKR devaluation. Foreign exchange reserves are standing at USD 14.5bn, which are sufficient to cover 2.6 months of imports and are projected by the State Bank of Pakistan (SBP) to rise to USD 17.8bn by Jun-26. At the same time, the policy rate has eased from its peak, while the current account deficit has narrowed. This relative stability suggests that any potential devaluation of the PKR would take place in a more controlled environment rather than under crisis conditions.

Figure 04: Downward adjustments in Policy Rate



Source: SBP

Figure 05: Current Account surplus after several years (USD mn)



Source: SBP

Benefits of controlled PKR devaluation

Boost to export competitiveness

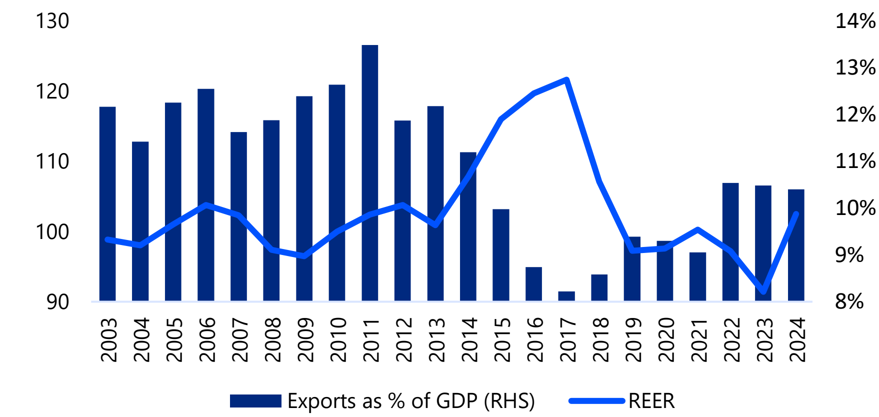
A moderate, well-managed devaluation at around 4-5% could enhance the global price competitiveness of Pakistani goods abroad. Since a large share of Pakistan's exports are priced in foreign currency, a weaker rupee effectively reduces their cost in global markets, making them more attractive to foreign buyers. Pakistan's trade history shows a clear link between the Real Effective Exchange Rate (REER) levels and export performance. Periods when the REER stayed near or below 100 generally coincided with higher exports as a percentage of GDP.

Graphical insight: The graph illustrates the close inverse relationship between the REER and exports as a percentage of GDP.

For example, between 2003 and 2011, the REER hovered close to 100 and exports rose steadily, peaking around 13–14% of GDP. However, from 2013-2017, the REER rose above 100, peaking at nearly 120 in 2017. This period of an overvalued PKR aligned with a sharp decline in exports as a share of GDP, falling from around 13% to about 8%.

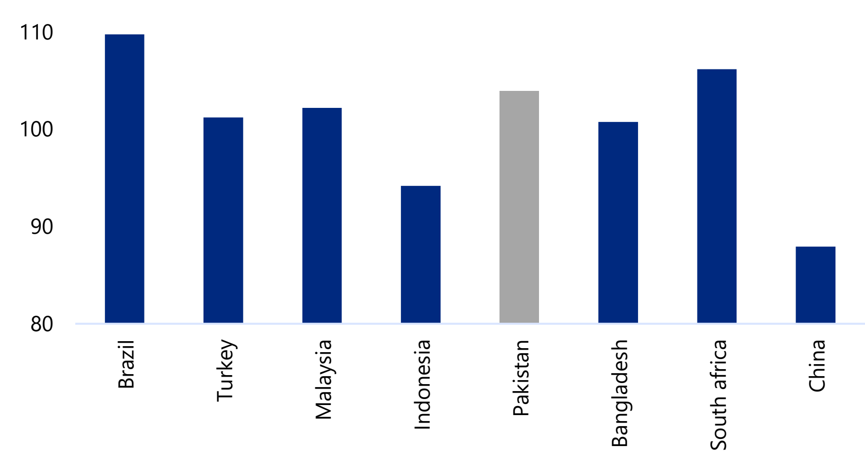
The 2017-2019 period saw a sharp drop in the REER due to PKR devaluation, which helped stabilize and slightly recover exports after some years of decline. From 2019 to 2022, the REER stabilized near 97-100, and exports showed modest improvement.

Figure 06: Lower REER leads to stronger Exports



Source: SBP, Akseer Research

Figure 07: Comparison of Pakistan's REER with major Export Competitors



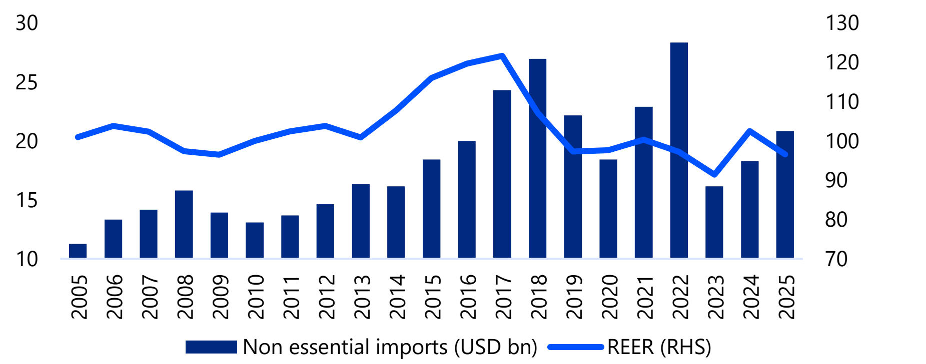
Source: SBP, WB, Akseer Research

Non-essential imports and REER

The relationship between Pakistan's REER and non-essential imports provides strong evidence that currency movement directly shapes consumer behavior. When the REER declines signaling rupee depreciation, non-essential imports contract as the higher cost of foreign goods discourages discretionary demand. Unlike total imports, this measure excludes essential items such as food, petroleum, textile group and agricultural essentials, offering a clearer picture of how discretionary consumer demand responds to exchange rate movements.

The trend is evident in the sharp rise of non-essential imports during 2014-2017, when the REER appreciated strongly and the subsequent decline in imports after 2018 as the rupee weakened. The only major deviation appears in 2022, which can be considered an outlier due to the extraordinary spike in global commodity prices. This spike temporarily inflated import values despite a weaker REER, but the underlying relationship remains intact: a stronger rupee fuels discretionary import growth while a weaker rupee curtails it.

Figure 08: Lower REER controls non-essential Imports



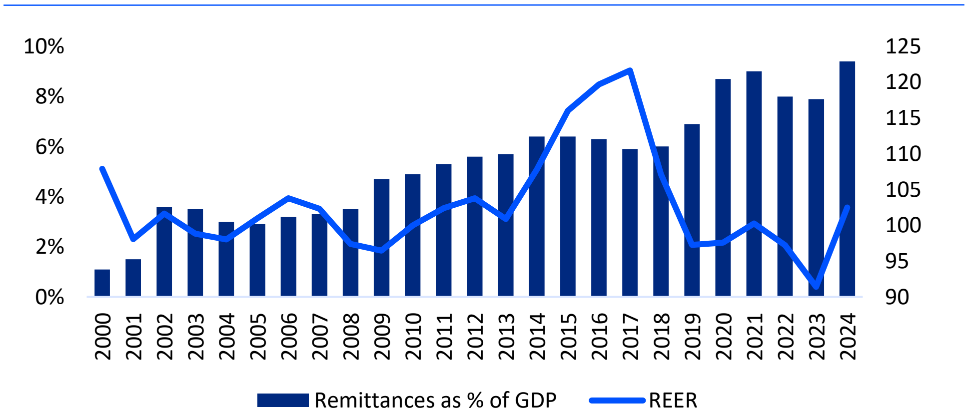
Source: PBS, Akseer Research

Increased remittance inflows

A higher REER means only essential or maintenance capital will flow, whereas the rest will become speculative, waiting for a devaluation before more funds are sent. Real estate and financial investments are usually the ones that transition into speculative nature.

Graphical insight: The data reveals inverse relationship between Pakistan's REER and workers' remittances as a share of GDP. Periods of REER appreciation, such as 2003–2006 and 2014–2017 coincided with slighter decline in remittance inflows. In contrast, a decline in the REER, particularly during 2000-2001, 2007-2009, and 2017-2021, was accompanied by a notable increase in remittances, reflecting the greater incentive for overseas Pakistanis to remit when the rupee weakened.

Figure 09: Remittances rise as REER falls



Source: SBP, Akseer Research

What is happening now?

Over the past 30 months, the PKR has remained broadly stable within the 278–285 range. The REER has also stabilized and has remained in a neutral zone, indicating that the currency is neither overvalued nor undervalued in terms of purchasing power.

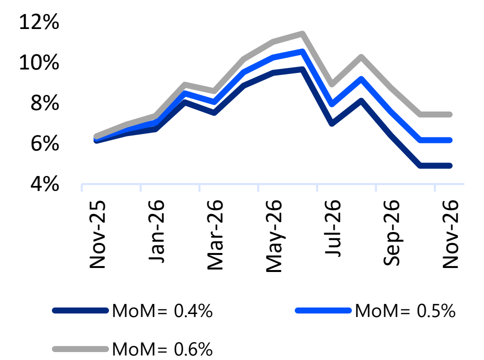
Looking ahead, we expect that a moderate PKR depreciation of around 4–5% may help maintain REER stability. However, imports as a share of GDP may edge up amid rising remittances and Pakistan's emphasis on export-led growth. However, we still anticipate the current account deficit to remain within 1% of GDP.

We expect inflation to be slightly elevated, breaching the upper band of the target range of 5-7% during the second half of FY26. The recent floods and supply chain disruptions have also exerted temporary upward pressure on food prices, which have contributed to the near-term inflationary persistence.

Moreover, an examination of Pakistan's long-term REER pattern shows that it has historically fluctuated within a band of 90 to 100, with nearly half (49%) of all observations over the past two decades falling inside this range. It is important to note that the period from 2013 to 2018, during which the REER stayed persistently above 100, cannot be ruled out because it reflects a phase of a heavily managed and controlled exchange rate regime. In the current policy environment, such currency control is neither feasible nor advisable.

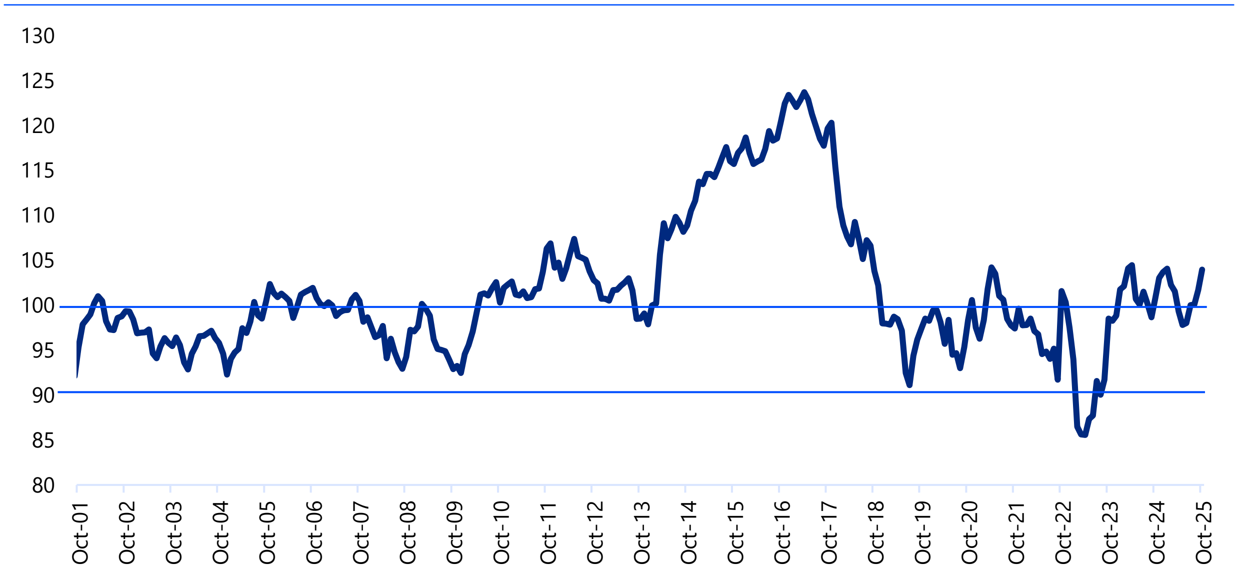
Against this backdrop, the latest REER reading of 103.95 stands above the long-term corridor, indicating a current overvaluation. This degree of overvaluation erodes export competitiveness and reduces the attractiveness of PKR denominated assets for foreign investors. Accordingly, a moderate depreciation of the PKR appears both consistent with historical REER dynamics and necessary to realign the currency with its long-term fair value range.

Figure 10: NCPI YoY sensitivity



Source: PBS, Akseer Research

Figure 11: Historical REER



Source: SBP, Akseer Research

Exchange rate dynamics, interest rates, and structural constraints

In most economies, the relationship between monetary policy and currency movement follows predictable patterns: interest rate cuts typically weaken the currency by stimulating demand and widening trade deficits, while rate hikes strengthen it by attracting capital inflows.

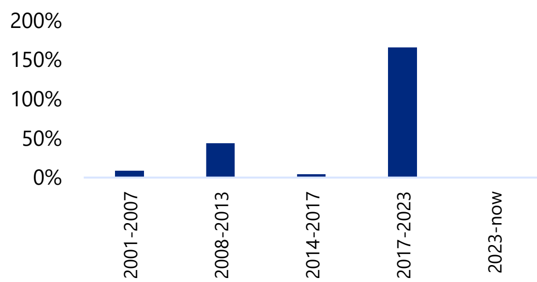
As opposed to wider global economies, Pakistan's interest rates tend to follow currency movements rather than the other way around. The primary reason for this anomaly lies in the lack of free capital movement, i.e., even when interest rates rise or fall, foreign investors cannot easily enter or exit Pakistan's bond market. Also, Pakistan's currency market remains largely managed, creating a disconnect between actual inflation and potential inflation that would emerge if the currency were allowed to depreciate freely. The stability persists only as long as Pakistan can fund dollar demand through external borrowing or inflows. Once these funding sources dry up, the disconnect ends swiftly, triggering PKR depreciation. This is precisely why the PKR has always depreciated in batches followed by prolonged periods of managed stability, as shown in Figure 12.

Table 3: PKR Depreciation & Stability in different periods

Period	Depreciated or stable currency
2001-2007	Stable
2008-2013	Depreciation
2014-2017	Stable
2017-2023	Depreciation
2024-present	Stable

Source: SBP, Akseer Research

Figure 12: Different periods of PKR Depreciation



Source: SBP, Akseer Research

Consequently, Pakistan's monetary policy tool of interest rates carries limited significance in the broader macroeconomic context. Credit-based consumer spending remains extremely small with household credit accounting for roughly PKR 836bn (as of Sep-25), less than 9% of total private sector lending of about PKR 9.7tn. This implies that rate adjustments have a muted impact on domestic demand, as the majority of consumption is financed through income rather than borrowing.

As a result, the burden of moderating demand in inflationary periods falls primarily on direct price shocks. Policymakers often resort to either raising indirect taxes (fiscal route), which reduces purchasing power by raising prices on goods and services or depreciating the PKR, thereby causing blanket inflation across all segments of the economy and moderating demand immediately.

Hot money flows and exchange rate sensitivity

An important dimension of our assessment is the behavior of short-term foreign portfolio flows (hot money). Our analysis shows that Pakistan's ability to attract such flows is sensitive to the valuation of the PKR.

To assess return attractiveness for foreign investors, we estimated Pakistan's implied 1-year sovereign risk premium (CDS) by subtracting the U.S. 1-year rate from Pakistan's closest-to-maturity international bonds. Since no exact 1-year bond exists, a proxy was constructed using an average of: i) 4-month maturity and ii) 2-year maturity Eurobonds.

Using this CDS estimate, the total cost of funds was derived for a foreign investor (U.S. 1-year rate + Pakistan CDS) and a differential was then obtained by subtracting this cost from Pakistan 12-month T-bill rate. This differential was then adjusted for REER overvaluation to compute real exchange rate adjusted returns.

The results exhibit a clear, valuation-driven pattern:

- When the REER is overvalued (e.g., Oct-25: REER ≈ 103.95), investors face a higher risk of devaluation burden, resulting in negative real returns (–1.44%) and limited incentive to deploy capital into PKR assets.

To evaluate whether real returns are attractive even if the SBP cuts rates after a depreciation, we conducted a scenario test. By lowering Pakistan's 12M T-bill rate from 11.31% to 10.31%, real returns were positive and meaningful.

Table 04: REER adjusted Real Return (Scenario Analysis)

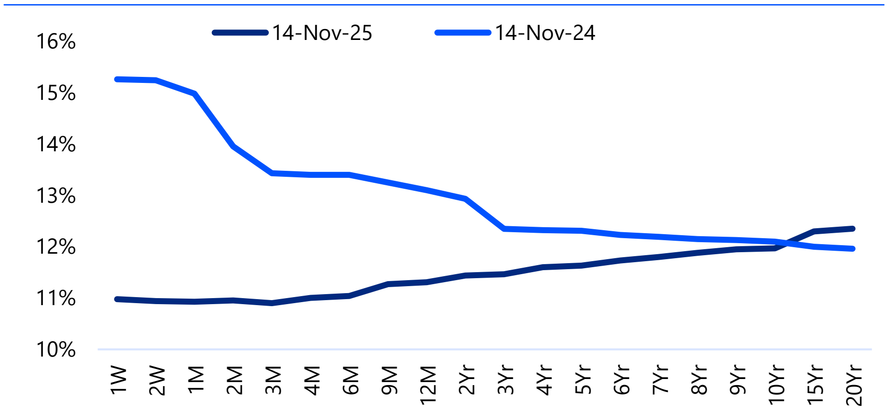
Hot Money flow & Return attractiveness	Oct-25	Nov-25*
US 1 year rate (%) **(a)**	3.71	3.71
Pakistan CDS (%) **(b)**	2.96	2.96
Total cost of funds (%) **(c=a+b)**	6.67	6.67
Pakistan 12M T-bill rate (%) **(d)**	11.31	10.31
PKR yield differential (%) **(e=d-c)**	4.64	3.64
REER **(f)**	103.95	99.0
Neutral REER benchmark **(g)**	98	98
REER overvaluation (%) **(h=f/g-1)**	6.07	1.0
Real return **(i=e-h)**	**-1.44**	**2.62**

Source: SBP, Akseer Research

Yield curve expectation

Compared to last year, the yield curve now signals a very different market expectation. In Nov-24, the curve was sharply downward sloping, reflecting the market's belief that policy rates would fall significantly over the course of 12 months, which it did. However, the latest curve (Nov-25) shows limited enthusiasm regarding sharp cuts in rates. Short-tenor yields remain stable around current policy rate, while the long-end slopes slightly upward, indicating that the market does not foresee meaningful rate-cuts even in the medium term. Instead, investors expect interest rates to stay broadly unchanged, with a mild upward tilt at longer maturities.

Figure 13: Yield curve shifts from steeply downward to slightly upward



Source: SBP, Akseer Research

Outlook

Looking ahead, Pakistan's monetary policy trajectory will remain closely anchored to exchange rate dynamics. Historically, the interest rate adjustments have generally followed, rather than influenced currency movements, and this structural characteristic is expected to persist. In our view, as long as the PKR does not depreciate, interest rates are unlikely to witness major downward adjustments.

In addition to this, core inflation is 7.5% and the real interest rate stands near 3.5%, indicating that the SBP retains a narrow cushion of roughly 100 basis points. Therefore, we expect interest rates to remain stable for the remainder of FY26, with minor downward adjustments of 100–150 bps possible in FY27.

Glossary

NCPI	National Consumer Price Index
WB	World Bank
IMF	International Monetary Fund
CPI	Consumer Price Index
NFNE	Non-Food Non-Energy
PKR	Pakistani Rupee
CPI	Consumer Price Index
PIDE	Pakistan Institute of Development Economics
SBP	State Bank of Pakistan
ASEAN	Association of Southeast Asian Nations
REER	Real Effective Exchange Rate
GDP	Gross Domestic Product
FY	Fiscal Year
CY	Calendar Year
Mn	Million
Bn	Billion
Tn	Trillion
YoY	Year on Year
MoM	Month on Month
USD	United States Dollar
CDS	Credit Default Swap
T-bill	Treasury Bill

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To arrive at our 12-months Price Target, the JV uses different valuation methods which include: 1). DCF methodology, 2). Relative valuation methodology, and 3). Asset-based valuation methodology.

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Rating	Expected Total Return
Buy	Greater than or equal to +15%
Hold	Between -5% and +15%
Sell	Less than or equal to -5%

Ratings are updated to account for any development impacting the economy/sector/company, changes in analysts' assumptions or a combination of these factors.

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