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When Borders Move Markets: Decoding the Rupee

107.9	277.47	$17.09 bn	11.5%
REER Index, Jul-2026 (8-yr high)	PKR/US$ Interbank	SBP FX reserves, 21st Aug 2026	SBP policy rate

- **REER at an 8-year high:** Pakistan's Real Effective Exchange Rate climbed to 107.92 in July 2026, its highest reading since 2018 and well above its 10-year average of ~102.4, suggesting the rupee is relatively strong in inflation-adjusted terms — a signal that bears watching for export competitiveness.
- **Nominal rupee has been broadly stable:** the PKR/US$ interbank rate has held in a narrow ~PKR 277–282 band for most of FY26, a marked contrast to the sharp depreciation cycles of 2022–2023.
- **Geopolitics was the year's dominant swing factor:** the Iran-related Middle East conflict that began in February 2026 pushed Brent crude to a high near US$126/barrel, prompted SBP's first policy rate hike in over two and a half years (+100bps to 11.5%), and briefly triggered capital outflows and wider sovereign spreads.
- **External buffers improved but remain remittance-dependent:** SBP reserves rose to roughly US$18.5bn by end-FY26 before easing to US$17.09 bn on 21st August 2026 on external payments; record workers' remittances of US$41.6bn (+8.6% YoY) did the heavy lifting, while goods exports lagged.
- **The 12-month picture is one of managed stability with two-sided risk:** continued IMF program compliance, Eurobond market access, and remittance strength argue for a broadly stable-to-mildly-depreciating rupee, while any escalation in Middle East tensions, sustained oil-price spikes, or fiscal slippage represent the key downside risks.

Currency Appreciation & Depreciation — What Actually Drives It

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A currency “appreciates” when it buys more of another currency than before, and “depreciates” when it buys less. For a floating or managed-float currency like the Pakistani rupee, the exchange rate is ultimately a price — set where the supply of and demand for foreign currency meet. Four broad forces move that price, and geopolitical events typically work through one or more of them simultaneously.

1. Trade & current account flows

A country that exports more than it imports, or receives large remittance inflows, generates a steady supply of foreign currency that supports its own currency. Pakistan's FY26 current account was helped substantially by record remittances (US$41.6bn) even as the goods trade deficit widened — meaning the rupee's stability was purchased mainly through diaspora inflows rather than export competitiveness.

2. Interest rate differentials & capital flows

Higher domestic interest rates, relative to trading partners, tend to attract portfolio capital seeking yield, supporting the currency; rate cuts or narrowing differentials can do the opposite. SBP's 100bps hike to 11.5% in mid-2026 — explicitly justified by geopolitical-driven inflation risk — illustrates monetary policy being used partly as a currency and inflation stabilization tool.

3. Inflation differentials

Purchasing Power Parity theory holds that currencies of high-inflation countries should depreciate in nominal terms against those of low-inflation countries over time, to keep real purchasing power aligned. This is precisely what REER measures.

4. Risk sentiment, safe-haven demand & geopolitical shocks

Geopolitical shocks move currencies through several channels at once: they alter commodity prices (Pakistan is a large energy importer, so an oil-price spike directly worsens the trade balance), they change global risk appetite (capital tends to flee emerging and frontier markets toward the US dollar during crises, a “flight to safety” that itself strengthens the dollar broadly), and they can disrupt shipping, remittance corridors, and investor confidence in a specific country. The Iran-related conflict that began in February 2026 delivered a textbook example: oil spiked, the current account came under fresh strain, sovereign bond spreads widened temporarily, and the central bank responded by tightening policy.

Investor takeaway

No single indicator explains currency moves in isolation. A useful mental model is to separate the nominal exchange rate from the real, inflation and trade-weighted exchange rate (REER) — the latter tells you whether currency moves reflect genuine competitiveness shifts or are simply offsetting inflation differentials.

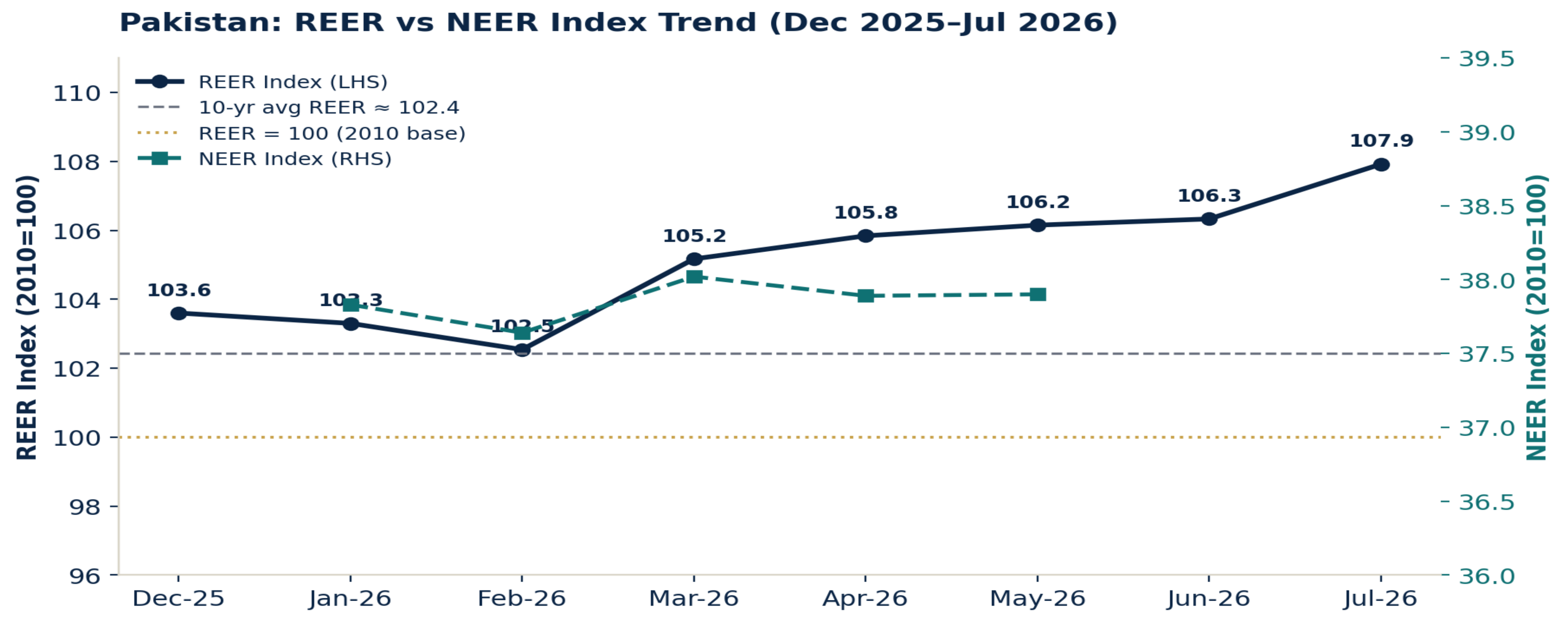
REER & NEER: The SBP's Competitiveness Scorecard

The State Bank of Pakistan publishes two related indices every month, both benchmarked to 2010 = 100:

- **NEER (Nominal Effective Exchange Rate):** a trade-weighted average of the rupee's nominal exchange rate against the currencies of Pakistan's major trading partners. It captures pure currency movement, without adjusting for inflation.

- **REER (Real Effective Exchange Rate):** the NEER adjusted for relative inflation between Pakistan and its trading partners. A REER reading above 100 means Pakistani goods have become relatively more expensive than the 2010 base period once inflation differentials are accounted for — imports become cheaper, exports become less price-competitive. A reading below 100 implies the opposite.

Importantly, SBP itself cautions that 100 should not be read as an “equilibrium” or “fair value” level — movement away from 100 reflects change relative to the 2010 average, not a formal misalignment estimate. That said, the REER's trend and its position relative to its own 10-year average are widely used by analysts as a competitiveness gauge.



Source: SBP, Figure 1: REER climbed 7.5 points between February and July 2026 — a 7% real appreciation in five months — even as the nominal rupee stayed broadly flat, implying the move was driven mainly by Pakistan's inflation running hotter than its trading partners'.

What the current reading is telling investors……

At 107.92 in July 2026, Pakistan's REER sits at its highest level since 2018 and roughly 5.4 points above its 10-year average. Two interpretations coexist among market commentators, and this presents both rather than picking a side:

- **The “overvaluation caution” view:** REER is above its long-term average, which historically has preceded periods of real exchange-rate correction and has coincided with pressure on export competitiveness.
- **The “fundamentals-supported” view:** argue that the appreciation reflects genuine dollar oversupply — strong remittances, a current account close to balance, and rebuilding reserves — rather than an artificial or unsustainable peg, and that REER strength driven by inflation differentials is a different phenomenon from the pre-2022 overvaluation that preceded a disorderly devaluation.

Both views agree on the underlying mechanics: Pakistan's inflation has been running above key trading-partner inflation for several months of 2026, which is arithmetically sufficient to push REER higher even with a nominal exchange rate that has barely moved.

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