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PRE-MONETARY POLICY OUTLOOK

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PRE-MP OUTLOOK

Analyzing the Drivers of Pakistan's Monetary Policy

ICMA Research and Publications Department

What Do External Inflation Signals Reveal Through Petroleum Imports and the Exchange Rate?

Preamble

11 September 2026: The upcoming Monetary Policy Committee (MPC) meeting on 14 September 2026 comes at a time when Pakistan's inflation outlook has again become more challenging. The policy rate currently stands at 11.5 percent, while national CPI inflation increased to 11.1 percent year-on-year in August 2026, compared with 9.2 percent in July. Underlying price pressures also strengthened, with core inflation rising to 8.8 percent in urban areas and 8.5 percent in rural areas.

At its July 2026 meeting, the State Bank of Pakistan maintained the policy rate at 11.5 percent and assessed that the prevailing stance remained appropriate for guiding inflation toward the 5–7 percent medium-term target range. The MPC also highlighted global energy-price volatility, higher input costs and administered energy-price adjustments among the key risks to the inflation outlook.

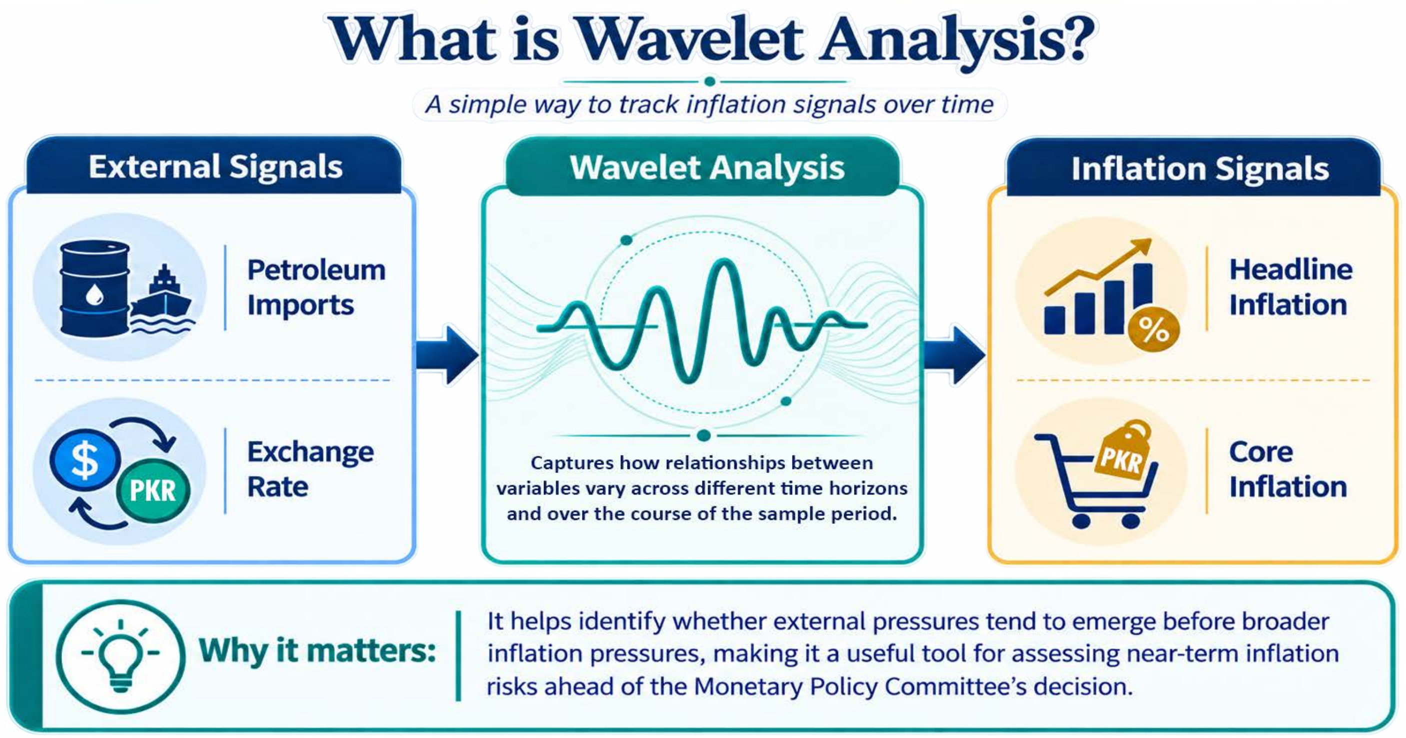
These developments make it important to look beyond the latest inflation number and identify pressures that may appear in prices with a delay. For Pakistan, two external channels deserve particular attention: petroleum imports and the exchange rate. Both affect the domestic cost structure well beyond the prices of directly imported goods and can therefore provide useful signals regarding the direction of future headline and underlying inflation.

External Inflation Pressures and Domestic Price Dynamics: Pakistan's Monetary Policy Outlook

Pakistan's exposure to imported energy creates a direct link between external developments and domestic prices. Changes in the petroleum import bill can reflect movements in international energy prices, import volumes and exchange-rate conditions. Once petroleum-related costs rise, their effect can move beyond fuel prices through higher transportation, freight, electricity-generation and production costs. Businesses facing persistently higher operating expenses may subsequently adjust the prices of other goods and services, extending an initially external shock into the wider inflation process.

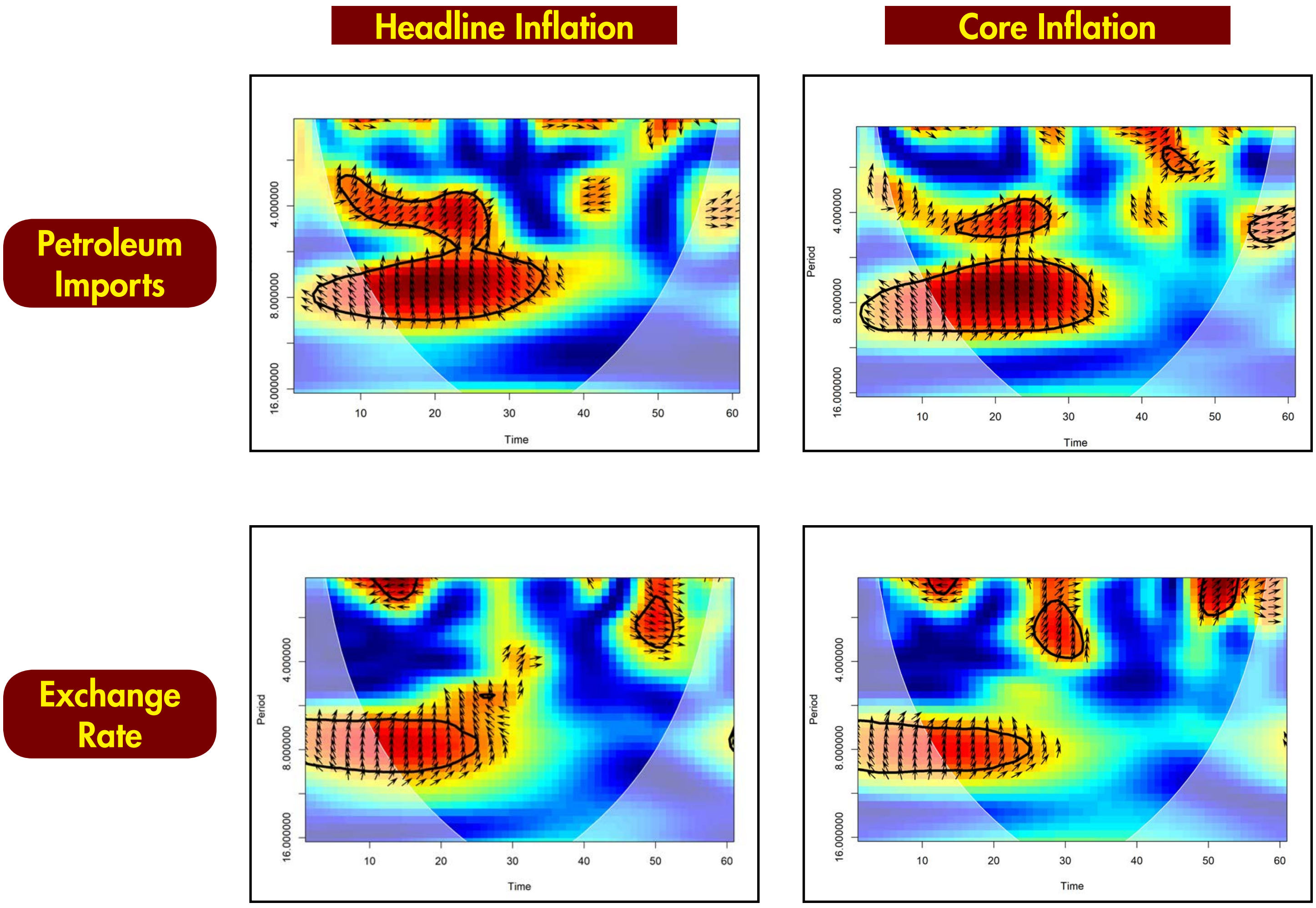
The exchange rate creates a second transmission channel. A weaker rupee raises the domestic-currency cost of dollar-denominated petroleum, intermediate inputs, machinery, chemicals and other imported products even if their international prices remain unchanged. The impact may not be immediate because firms can initially absorb higher costs, use existing inventories or adjust prices gradually. Exchange-rate movements can therefore precede changes in consumer inflation rather than appear at exactly the same time.

Ahead of the forthcoming MPC decision, ICMA examines the historical relationship of petroleum imports and the PKR/USD exchange rate with both headline and core inflation using monthly data and a Wavelet-based analytical approach. Unlike a conventional analysis that assumes the relationship between two variables remains unchanged throughout the sample, Wavelet Analysis captures how relationships between variables vary across different time horizons and over the course of the sample period.



Note: *Detailed Wavelet Transform Coherence (WTC) results and supporting technical analysis are available upon request.*

Results of Wavelet Transform Coherence (WTC)



Note: *Warmer colors indicate stronger Wavelet Transform Coherence. Black contours represent statistically significant coherence at the 5 percent level based on 1,000 Monte Carlo simulations. The Cone of Influence identifies areas susceptible to edge effects. Rightward arrows indicate in-phase movement, leftward arrows indicate anti-phase movement, upward arrows indicate that the first variable leads the second, and downward arrows indicate that the second variable leads the first. Phase arrows are displayed for coherence values above 0.6.*

Interpretation

Petroleum Imports and Headline Inflation

- ICMA's Wavelet assessment shows that petroleum import movements preceded headline inflation during significant periods, particularly at the 3 to 5 month and 6 to 9 month horizons during 2022 to 2023. This relationship reflects the transmission of petroleum related pressures through transportation, production and distribution costs. However, the result represents broader petroleum import pressure rather than a pure oil price effect.

Petroleum Imports and Core Inflation

- Petroleum import movements also preceded core inflation at the 3 to 4 month and 6 to 9 month horizons during 2022 to 2023, indicating possible second round transmission through production, transportation and distribution costs. A shorter petroleum leading relationship appeared in early 2025, but it should carry less weight than the broader earlier episode.

Exchange Rate and Headline Inflation

- Exchange rate movements preceded headline inflation mainly at the 6 to 8 month horizon during 2022 to 2023, reflecting gradual pass through through imported energy, raw materials and intermediate goods. However, the relationship reversed between approximately July 2025 and January 2026, when headline inflation preceded the exchange rate. The exchange rate therefore does not operate as a uniformly leading inflation signal.

Exchange Rate and Core Inflation

- Exchange rate movements preceded core inflation at the 6 to 8 month horizon during 2022 to 2023 and at the shorter 2 to 4 month horizon from August 2023 to February 2024. A further exchange rate leading episode appeared during the second half of 2025, but its short duration and proximity to the sample boundary require cautious interpretation.

Combined External Pressures

- Petroleum import and exchange rate pressures should be monitored together because higher international petroleum costs and rupee depreciation can simultaneously increase the domestic cost of energy. However, the WTC analysis examines these relationships separately. Their combined effect should therefore be treated as a policy consideration rather than a direct empirical finding.

Temporary and Persistent Inflation

- The key policy concern is whether external pressures remain concentrated in headline inflation or also become associated with core inflation. A significant leading relationship with core inflation may indicate transmission into production costs and wider price setting behaviour. With headline and core inflation rising in August, monitoring this distinction is particularly important ahead of the September MPC meeting.

Relevance of WTC Findings to Pakistan's 2026 Inflation Outlook

Overall, the WTC findings remain relevant to Pakistan's inflation dynamics in 2026. The recent rise in headline inflation, alongside higher petroleum and energy-related costs, is consistent with the petroleum-related inflation channel identified in the analysis. In contrast, the exchange rate has remained relatively stable, suggesting that exchange-rate pressures are not playing the consistent role in inflation as observed during the 2022–23 episode. The 2026 experience therefore reinforces the central finding that petroleum-import and exchange-rate pressures influence inflation differently across economic conditions and should be monitored according to their prevailing strength and direction.

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Policy Recommendations

1. Adopt a Wait-and-See Approach

The WTC results show that petroleum-import and exchange-rate pressures influence inflation during particular periods and horizons, rather than through a permanent relationship. SBP should therefore maintain a cautious wait-and-see stance in the near term. If inflation, exchange-rate and external cost pressures continue to stabilize, the policy rate may be reduced gradually, with a medium-term objective of moving toward a single-digit level.

2. Condition Future Rate Cuts

The WTC results show that petroleum-import and exchange-rate pressures can precede core inflation during significant episodes, indicating the potential for external pressures to extend into underlying inflation. The next phase of monetary easing should therefore not be triggered by a single favourable headline-inflation reading. SBP should look for sustained moderation in both urban and rural core inflation over successive readings, accompanied by exchange-rate stability and an absence of renewed petroleum-related cost pressures. Linking future rate cuts to improvement across these indicators would reduce the risk of easing while external cost pressures are still becoming associated with underlying inflation.

3. Distinguish Temporary and Persistent Inflation

The WTC results show that external pressures can be associated with both headline and core inflation, highlighting the importance of distinguishing direct price effects from broader underlying inflation pressures. Monetary-policy communication should therefore explicitly distinguish between a temporary direct increase in fuel or administered energy prices and evidence that the shock is spreading into non-energy goods, services and core inflation. This distinction would clarify why a short-lived headline spike may be tolerated while persistent underlying pass-through may require a tighter stance.

4. Publish External-Risk Scenarios

The WTC results identify petroleum imports and the exchange rate as important inflation signals, while showing that their strength and timing vary across different periods and horizons. Alongside its baseline inflation forecast, SBP should therefore periodically indicate how the forecast would change under plausible combinations of higher petroleum prices and rupee depreciation. Scenario ranges would be sufficient and would help markets understand how external shocks could alter the inflation and policy outlook.

5. Manage Exchange-Rate Volatility

The WTC results show that exchange-rate movements preceded headline and core inflation during significant periods, although the exchange rate did not operate as a uniformly leading inflation signal across the sample. The objective should therefore not be to defend a particular rupee level. However, maintaining adequate foreign-exchange buffers and managing disorderly market conditions remain important. Exchange-rate developments should be assessed jointly with inflation expectations, petroleum-import pressures and the composition of inflation.