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Macroeconomic Vulnerabilities and Exchange Rate Dynamics in Pakistan: Lessons from the COVID-19 Crisis

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Abstract
The COVID-19 pandemic has delivered a significant external shock to global economic systems, with developing economies experiencing the most pronounced effects. This study investigates the pandemic's impact on the exchange rate dynamics of Pakistan, utilizing a qualitative approach based on secondary data. Grounded in a conceptual framework that outlines indirect macroeconomic drivers—including foreign debt, interest rates, remittances, speculative activity, and trade disruptions—this research underscores how the pandemic intensified existing structural vulnerabilities. The findings indicate that the Pakistani rupee experienced considerable depreciation due to capital outflows, depletion of foreign reserves, and investor uncertainty, further exacerbated by contractionary monetary policies and weakened external inflows. Comparative evidence from other emerging markets contextualises Pakistan's challenges within global trends. The analysis concludes that relying on short-term capital and remittances without diversifying exports renders the exchange rate susceptible to ongoing instability during crises. This paper provides insights into the development of robust policy frameworks designed to enhance exchange rate resilience through structural reforms and improved monetary governance.

Keywords: Exchange Rate Volatility, COVID-19, Pakistan Economy, Remittances, Speculation, Qualitative Analysis, IMF, Macroeconomic Shocks.

1. Introduction

The COVID-19 pandemic, which emerged as a global health crisis in early 2020, rapidly evolved into a multifaceted economic shock with profound implications for exchange rate stability, particularly in developing economies such as Pakistan. Unlike the 2008 financial crisis, which originated in the financial sector, the COVID-19 crisis disrupted the real economy through global supply chain breakdowns, contractions in trade and investment, and heightened investor uncertainty (Gopinath, 2021). For Pakistan—a country historically reliant on external financing, remittances, and a narrow export base—these disruptions amplified pre-existing macroeconomic vulnerabilities, most notably affecting the exchange rate (Ahmed & Khan, 2022).

In the immediate aftermath of the pandemic, the Pakistani rupee experienced sharp depreciation, primarily driven by capital flight, dwindling foreign exchange reserves, and speculative pressures. By March 2020, the exchange rate breached historical highs against the US dollar, coinciding with a drastic fall in remittance inflows and a reduction in global demand for Pakistan's exports (State Bank of Pakistan [SBP], 2020). While global financial markets sought refuge in reserve currencies such as

the US dollar, Pakistan witnessed increased pressure on its current account due to high external debt servicing, reduced foreign direct investment (FDI), and declining tourism revenues.

As part of its crisis response, Pakistan re-entered negotiations with the International Monetary Fund (IMF), agreeing to a flexible exchange rate regime and adopting inflation-targeting measures. Although these policies were aimed at improving macroeconomic fundamentals, their timing during a pandemic-induced downturn resulted in unintended consequences—including sharp volatility in the exchange rate and heightened inflationary pressures (IMF, 2023; Rana & Mehmood, 2024). Moreover, repeated interest rate adjustments by the State Bank of Pakistan created short-term capital flow volatility, exposing the economy's dependence on "hot money" and the fragile nature of its monetary insulation.

This study aims to investigate the short- and long-term impacts of the COVID-19 pandemic on the exchange rate of Pakistan through a qualitative lens. It emphasizes the indirect economic channels—such as declining FDI, speculative currency demand, contraction in remittances, and structural weaknesses in the trade balance—that mediated the currency's depreciation. Furthermore, it situates Pakistan's exchange rate dynamics within a broader global context, comparing post-COVID monetary responses and exchange rate behavior across developed and developing economies.

In doing so, this research contributes to the limited but growing body of literature on pandemic-induced currency volatility in emerging markets, offering policy-relevant insights into how macroeconomic stability can be sustained in the face of global crises.

2. Research Question

1. What are the positive and negative impacts of the COVID-19 pandemic on Pakistan's exchange rate?

2. Through what indirect economic channels has COVID-19 affected exchange rate stability?

3. How has the pandemic exposed the structural fragility of the Pakistani rupee in global exchange markets??

3. Literature Review

3.1 Pandemics and Exchange Rate Volatility

Historically, global health crises have exerted indirect but significant pressure on currency markets through disruptions in trade, investment flows, and investor confidence. The COVID-19 pandemic reaffirmed these dynamics on a global scale. Countries with limited fiscal space, high external debt, and dependence on remittances—such as Pakistan—experienced disproportionately larger exchange rate depreciation (Bems et al., 2021).

South Africa's experience during the HIV/AIDS pandemic, for instance, demonstrated a strong correlation between public health uncertainty and currency depreciation due to capital outflows and risk aversion (Kauffman & Weerapana, 2006). Similar patterns were observed during COVID-19, where "bad news shocks" intensified speculation and worsened exchange rate instability (Ductor & Leiva-Leon, 2022). These effects are often magnified in economies with shallow foreign exchange markets and weak macroprudential buffers.

3.2 Lessons from the 1997 Asian and 2008 Global Financial Crises

The 1997 Asian financial crisis highlighted the risks of fixed or semi-pegged exchange rate regimes. Currencies across Southeast Asia—such as the Thai baht, Indonesian rupiah, and Malaysian ringgit—collapsed under the weight of overvaluation and speculative attacks, exacerbated by sudden reversals

of capital flows (Corsetti et al., 1999). Pakistan's more recent experience with COVID-19 mirrored these outcomes, especially under its shift to a flexible exchange rate regime in 2019 as part of IMF reforms.

3.3 HIV/AIDS Pandemic Sub - Saharan Africa (2003)

The AIDS pandemic is the world's greatest public health issue at the beginning of the 21st century. Although HIV / AIDS spreads in the developed world are tightly regulated, much of the developing world remains devastating. For example, there have been recent concerns about the spread of HIV / AIDS in China and India, the two most populous countries in the world. If these fears are true, long into this century the AIDS pandemic will continue to be a significant problem to public health. But AIDS is a much more pressing issue in sub-Saharan Africa. The pandemic has affected many sub-Saharan African nations, which are now the most vulnerable in the world. HIV / AIDS has a staggering prevalence and effects in these countries. According to UNAIDS, in 2003, 23.1 million people aged 15 to 49 in sub-Saharan Africa were infected with HIV / AIDS in the Joint United Nations Program on HIV / AIDS (UNAIDS). Their figures are rising annually by 3.1 million. About 2.2 million people die from AIDS each year and about 12.1 million orphaned babies. In Zimbabwe, approximately 24.67% of adults, 16.51% of Zambia's adults, 37.31% of Botswana's adults, and 21.51% of South African adults are HIV-infected (UNAIDS, 2004). In these countries HIV / AIDS is much more than a public health issue.

In South Africa, the AIDS pandemic probably had important exchange-rate impacts. As the result of this health issue, South African's production and exports reduced, income cut down in foreign investments and portfolio investment, along with, long-term market prospects in South Africa become more uncertain. It is therefore expected that there will be a long-term association between the currency exchange rate and other macroeconomic factors including GDP, investment, and net exports in South Africa, as well as the prevalence and spread of HIV/AIDS. Information of the propagation of the illness can have a big effect on financial markets since AIDS is now a macroeconomic concern rather than only a public health one. The value of the rand is negatively impacted by "bad" news regarding AIDS; for every extra bad news article, the rand depreciates by around 0.10 percentage points versus the dollar, according to daily statistics on the amount of AIDS-related news reports taken from the Cape Times. The results hold up well when additional macroeconomic factors that may impact the rand/dollar exchange rate are considered. In order to reduce some of the timing ambiguities, this study additionally considers different timing standards for the relationship between news and exchange rates. Additionally, data is aggregated to a weekly frequency. Additionally, the results tend to maintain at a weekly pace, with the rand depreciating by about 0.15 percentage points versus the dollar for every additional "poor" news item. Positive AIDS news is associated with greater thankfulness, according to their model, however this conclusion is not particularly strong. Given that HIV and AIDS are "incurable," the absence of a "healthy" news effect is not particularly startling.

3.4 Global Financial Crisis 2007 - 2008

The 2008 global financial crisis, in contrast, demonstrated how large-scale liquidity interventions in developed economies could trigger reserve currency appreciation, further weakening currencies in emerging markets (Ben Ltaifa, 2009). COVID-19 similarly caused a flight to safety—raising demand for the US dollar, yen, and Swiss franc—while depreciating risk-sensitive currencies in South Asia, including the Pakistani rupee. The currencies of many sub-Saharan African States have experienced significant depreciations since the onset of the global financial crisis, compared to other emerging and developed economies. The most important factor influencing the exchange-rate value was domestic, representing the propagation of the global economic crisis across trade, financial networks and the instability of the key foreign currency, the US dollar. This influence was in line with the degree and nature of trade and the global financial markets' exposure of every country. At that time, the complexity and scale of the effect were influenced by domestic policies. The breakdown of trade and financial flows created significant payment balance gaps, leading to rapid depreciation and

increased volatility in exchange rates, which began in mid-2008. The loss of exchange rates varied significantly according to the degree and nature of each country's exposure to foreign trade and financial markets. Both floating and regulated currencies face challenges with the current external climate. The costs of currency started leaning toward shift changes in regulated exchange rates contributed to broader exchange rates appreciation. It could threaten competitiveness and sustainability if the real effective exchange rates vary greatly from their equilibrium levels. Countries with floating currencies also faced heightened foreign exchange and market instability, and long-term investment also disrupted. For those countries which seek to enhance their integration into international capital markets, the prospect of continuing exchange volatility raises particular challenges. The deepening of domestic capital and foreign exchange markets would boost their ability over the long term to handle international financial volatility.

3.5 Effect of COVID–19 on Developed countries Exchange rates

3.5.1 US Dollar Exchange Rates

With over 2,400 deaths and over 140,000 confirmed illnesses, there are rising concerns that the US may soon emerge as an additional centre for the disease. The economic impact of the coronavirus on the economies of the US and the eurozone, as well as its influence on worldwide risk sentiment, has intensified as governments attempt to save lives and prevent the spread of the deadly virus. Throughout America, quarantine and social separation measures are being put into place; some places are completely under lockdown. People work from home, schools are closed, and the service sector—which makes up about 80% of the US economy—has stagnated. In several instances, non-essential manufacturing, restaurants, pubs, gyms, and tourism have temporarily shuttered. The government's actions to safeguard the American population against coronavirus are driving demand for products and services to fall. The United States is witnessing a dramatic drop in demand. Throughout the coronavirus pandemic, the value of the dollar has experienced damaged in a variety of ways. Firstly, the US dollar serves as the global reserve currency. This means that during periods characterized by financial stress, traders sell more volatile assets or what they believe are riskier currencies and purchase the US currency for its safe-haven qualities. Businesses are likewise storing cash for fear of harder times ahead. This raises the perceived worth of the US dollar. The Federal Reserve's vow of unlimited quantitative easing, along with the Senate's $2.2 trillion fiscal stimulus bill, helped to calm markets and decrease the dollar's value. Market investors feel that further stimulus may be approaching. This might further weaken the dollars' worth. However, it is important to note that the coronavirus outbreak in the United States is still spreading. The situation is projected to deteriorate before improving. If investors grow more concerned, or if a second wave of breakouts in China occurs after Wuhan, the initial epicenter, is released from lockdown, the dollar may rise again. Recently, this pandemic has been intensely hitting the U.S, and cases are rising drastically. as a result, the US Federal Reserve has cut interest rates to battle the pandemic, resulting in depreciation of the dollar.

3.5.2 Pound Sterling Exchange Rates

The British pound to Dollar rate of exchange (GBP / USD) shifted dramatically as the United States Federal Reserve unexpectedly cut interest rates to zero percent. The initially observed move was upside down, with Cable surging beyond 1.24 now that the interest rate gap between currencies has been eliminated. Regrettably for Sterling bulls, this was a short-lived surge, as the British Pound exchange rate swiftly erased the majority of its gains due to a drop-in risk appetite. There are no travel limitations on products, but it is a time-consuming trip in congested traffic.

When it is wrong for this "laissez-faire," GBP and SEK will prove to be the worst hiding place(s), since Sweden and Great Britain could, in such a case, be considered as 'pariahs.' Long EUR / GBP and long EUR / SEK are also good risk / recompense bets.

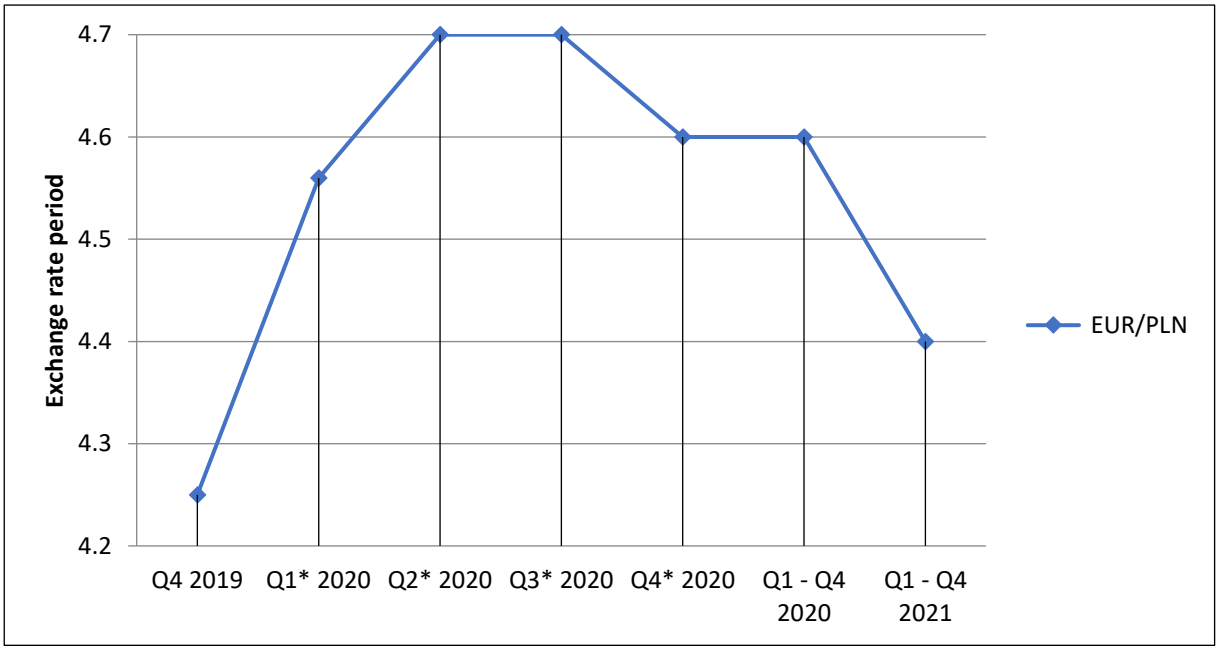
3.5.3 Euro (EUR) Exchange Rates

Unlike the Sterling Pound, euro prices rose, but the gains were scrapped as the stock market future dropped in EUR / USD. The dollar's higher referral to haven can be more easily seen now that the euro and the USD are so much closer to interest rates. Nevertheless, the euro is a long exchange far less costly than it was, so it can make a difference. Unfortunately, COVID-19 hits Europe quite hard, and it seems that the US is much less far away. Although travel bans and frontier closings are beginning to increase, the disparities in infection rates can be crucial to the development.

3.5.4 Euro to Dollar Impact

The EUR/USD exchange rate remained stable at $1.08 up until the very start of February. As the outbreak spread beyond China, the Euro-US Dollar exchange rate experienced a spike in volatility. The pair rose to US$ 1.1496 for 13 months before plummeting 860 points in just over two weeks to a low of US$ 1.0636 for nearly three months. EUR/USD has rebounded due to uncontrolled central bank financing and trades for more than $1.11. The pair's anxiety may not be resolved, while the pandemic in Europe and the United States continues.

3.6 The EUR / PLN exchange rate forecast for the 2019-2021 coronavirus outbreak (COVID-19) in Poland:



Source: Published by Adriana Sas, Apr 2, 2020

According to the current scenario, a deeper recession is expected to be triggered in Poland with the outbreak of coronavirus (COVID-19). The average EUR/PLN exchange rate is expected to increase from 4.25 in 2019 to 4.6 by the end of 2020. The zloty's weakening against foreign currencies is important. The exchange rate of the euro was therefore up by 3.5%, while the US dollar and the Swiss franc were up 6% against the Polish currency. Depreciation in the currency indicates that the currency of Poland has been affected by coronavirus.

3.7 The COVID-19 Pandemic and Pakistan's Exchange Rate

Unlike financial crises, the COVID-19 pandemic disrupted both demand and supply, severely affecting the informal economy, remittance flows, and export performance in Pakistan. Between March and June 2020, the rupee depreciated by over 7% against the dollar due to capital outflows, interest rate cuts, and speculative pressures (State Bank of Pakistan, 2020). While global oil price

declines helped moderate the current account deficit, the decline in foreign direct investment and a fall in export orders intensified exchange rate instability.

The pandemic exposed the fragility of Pakistan's external sector, particularly its reliance on short-term debt instruments (hot money), speculative foreign exchange activity, and remittance inflows. The IMF's emergency Rapid Financing Instrument (RFI) and subsequent disbursements temporarily stabilised reserves, but long-term exchange rate volatility persisted due to structural vulnerabilities (IMF, 2021; Fatima & Javed, 2023).

3.8 Indirect Drivers of Currency Depreciation During COVID-19

Empirical studies have confirmed that indirect channels—such as inflation expectations, capital flight, investor sentiment, and remittance volatility—have played a decisive role in exchange rate fluctuations during the pandemic (Iqbal & Shaheen, 2024). For example, the pandemic-induced fall in global remittances led to a depreciation of currencies in South Asia and North Africa (World Bank, 2022). Pakistan experienced a sharp 14% drop in remittances from key corridors (e.g., UAE and UK) during Q2 of 2020, which amplified currency pressure.

Moreover, inflation targeting policies—adopted as part of Pakistan's IMF program—struggled to contain cost-push inflation triggered by supply-side disruptions and currency depreciation, leading to policy dilemmas in managing interest rates and ER stability simultaneously (Ahmed & Khan, 2022). The pandemic has thus reignited debates around the limits of inflation targeting and flexible exchange rates in low-income, externally vulnerable economies.

3.9 Comparative Evidence from Other Developing Countries

Egypt, Turkey, and Nigeria provide comparative examples of pandemic-induced ER volatility in developing contexts. Egypt's pound faced pressure due to disruptions in tourism and a decline in Suez Canal revenues (Abdelaziz, 2022). Similarly, Turkey's lira depreciated by nearly 40% between 2020–2022 as the central bank engaged in unorthodox monetary easing despite inflationary pressures (Erdoğan & Yilmaz, 2023).

Pakistan's experience aligns with these trends but also highlights the risks of overreliance on debt-based inflows and insufficient foreign exchange buffers. Studies warn that unless structural reforms are enacted—such as export diversification, deepening the domestic capital market, and reducing dependency on remittances—emerging markets will remain vulnerable to exogenous shocks (Choudhary & Rehman, 2024).

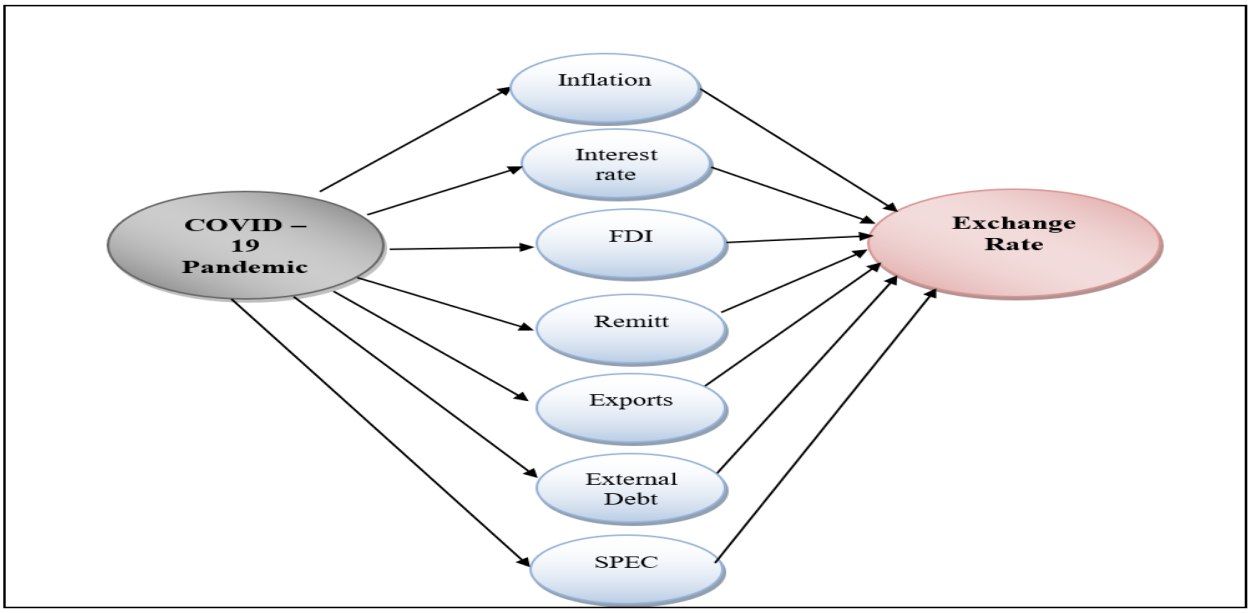
4. Methodology

This research employs a secondary methodology and adopts a qualitative approach. By investigating and studying the factors that significantly affects ER and how the COVID-19 pandemic indirectly affects these factors in accordance with economic theory.

4.1 Conceptual Framework

A framework is established for making a concrete analysis that describes a pattern of study. Ultimately, the study is based on this conceptual framework for assessing the indirect impact of the coronavirus outbreak on ER. We are developing a conceptual model which incorporates the key factors influencing ER. External debt, exports, inflation, interest rate, speculation (SPEC), remittances (Remit), and foreign direct investment (FDI) are factors.

The role of each variable was examined through descriptive analysis and case-based interpretation of Pakistan's exchange rate dynamics. This aligns with qualitative methods used in economic crisis research (Yin, 2018; Bhattacharya & Patel, 2023; UNCTAD, 2021).



5. Study Findings

5.1 Pakistan's External Economy Before and During COVID-19

In 2019, Pakistan was undergoing a challenging economic transition as it entered a new loan program with the International Monetary Fund (IMF). Under the IMF's directive, Pakistan moved from a managed exchange rate regime to a market-based system. This policy shift exposed the rupee to significant volatility, as the previous government had maintained an artificially overvalued exchange rate. To stabilize the exchange rate during this transition, the State Bank of Pakistan (SBP) secured large external loans to manage foreign exchange demand and supply.

For decades, Pakistan's economy has been characterized by high dependency on external debt and imports, both of which create persistent outflows of foreign currency. The shift to a floating exchange rate regime intensified these vulnerabilities. However, by late 2019, signs of recovery began to emerge. Pakistan climbed 28 rankings in the World Bank's Ease of Doing Business Index and was named one of the world's top ten reforming economies. The second phase of the China-Pakistan Free Trade Agreement (CPFTA), which came into effect in December 2019, further strengthened external sector prospects. Additionally, foreign direct investment (FDI), particularly from Chinese textile firms, began to rise, creating cautious optimism among stakeholders.

This period of relative stability helped reduce rupee overvaluation and decreased exchange rate volatility. Improvements in the balance of payments, including moderate gains in exports, remittances, and foreign reserves—partly driven by high policy interest rates—contributed to a short-lived stabilization in the external sector. However, these gains were abruptly disrupted by the onset of the COVID-19 pandemic in early 2020. Pakistan's fragile economy, still in the early stages of stabilization, lacked the resilience to absorb such an external shock, resulting in renewed exchange rate pressure. The impact of COVID – 19 on ER is shown in the fig 1.1. The figure clearly shows a hike in ER as well as high volatility too, that means drastic depreciation as this pandemic hits Pakistan.

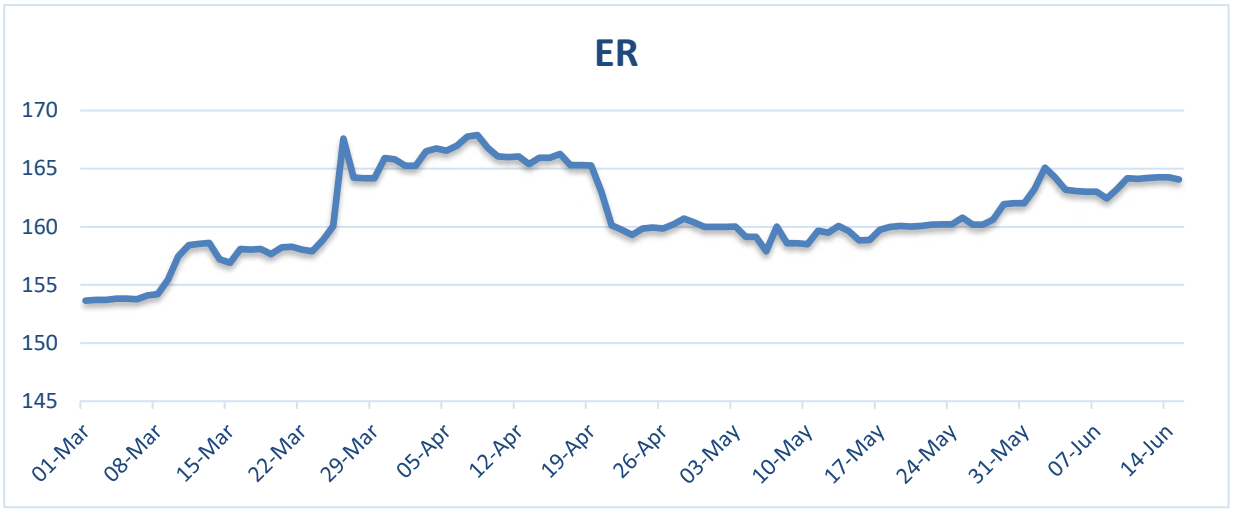


Figure 1.1: Shows the exchange rate from 1st March to 15th June 2020.

5.2 Impact of COVID-19 on Pakistan's Exchange Rate

As the pandemic spread globally, it triggered significant disruption in international trade and investment. The Pakistani rupee began depreciating in early March 2020, reflecting both domestic and international investor panic. Global economic disintegration, widespread lockdowns, and declining demand led to sharp contractions in exports and supply chains. Foreign investors began withdrawing funds from riskier emerging markets, including Pakistan, to reinvest in safe-haven currencies like the US dollar. This capital flight further weakened the rupee.

Domestically, rising COVID-19 cases and nationwide lockdowns dampened consumer and investor confidence. To stimulate the economy, the SBP cut its policy rate by a total of 525 basis points, from 13.25% to 8%. While this decision supported local businesses, it simultaneously reduced the attractiveness of Pakistani debt instruments for foreign investors, leading to significant outflows of "hot money." Foreign exchange reserves declined, increasing the burden of external debt and creating substantial pressure on the exchange rate.

5.3 Speculation and Investor Behavior

Speculative behavior further exacerbated the rupee's depreciation. Amid economic uncertainty, forex investors began hoarding dollars, anticipating future depreciation of the local currency. This drove up demand for foreign exchange, outpacing supply, and contributed to further currency weakening. Many speculators acted on asymmetric information and expected further rate cuts by the SBP, prompting them to exit the rupee in anticipation of its depreciation. The SBP's own projections, such as those shared on April 6, 2020, indicated intense exchange rate volatility. Some analysts even projected the rupee to fall to Rs. 170–175 per USD by mid-2020. However, this scenario was avoided due to emergency lending from the IMF, World Bank, ADB, and China's Infrastructure Bank.

Interestingly, the global drop in oil prices during the pandemic helped offset some of the external account pressures by reducing Pakistan's import bill. This mitigated, to some extent, the impact on the exchange rate.

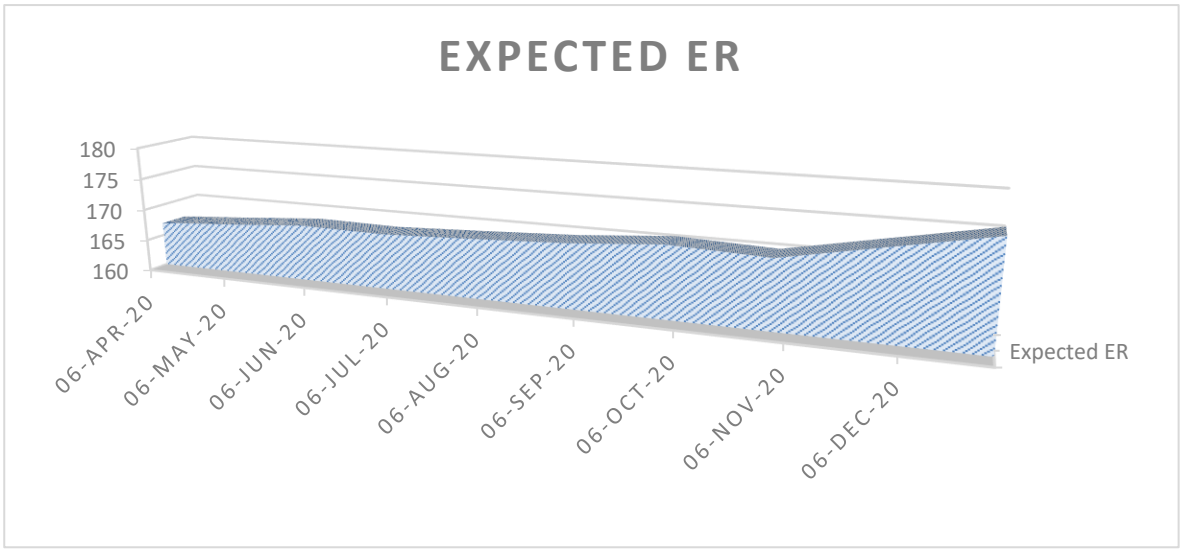


Fig 1.2: Source SBP, Revaluation of ER for year 2020.

5.4 External Debt, Reserves, and Remittances

Pakistan's persistent reliance on external borrowing remained a critical issue. Scheduled debt repayments of approximately $4 billion between April and June 2020, coupled with declining reserves, signaled the risk of a debt crisis. While emergency inflows—$1.4 billion from the IMF, $300 million from the World Bank, and additional support from ADB and China—temporarily increased net reserves to $10.1 billion in June 2020, the downward trend continued. A clear negative relationship between declining reserves and the rupee's value was observed.

Remittance inflows—an important stabilizer for Pakistan's current account—also became volatile. While February 2020 showed a year-on-year increase of 15.3%, remittances declined in subsequent months. The UK, US, and Gulf countries—all major sources of remittances—faced their own economic contractions and lockdowns, limiting workers' ability to send money home. If prolonged, this trend could drastically reduce inflows, further widening the trade deficit.

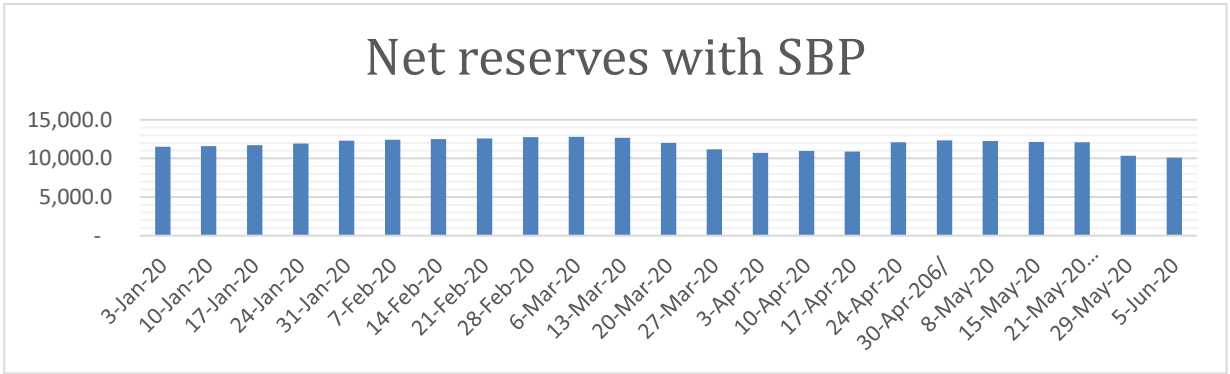
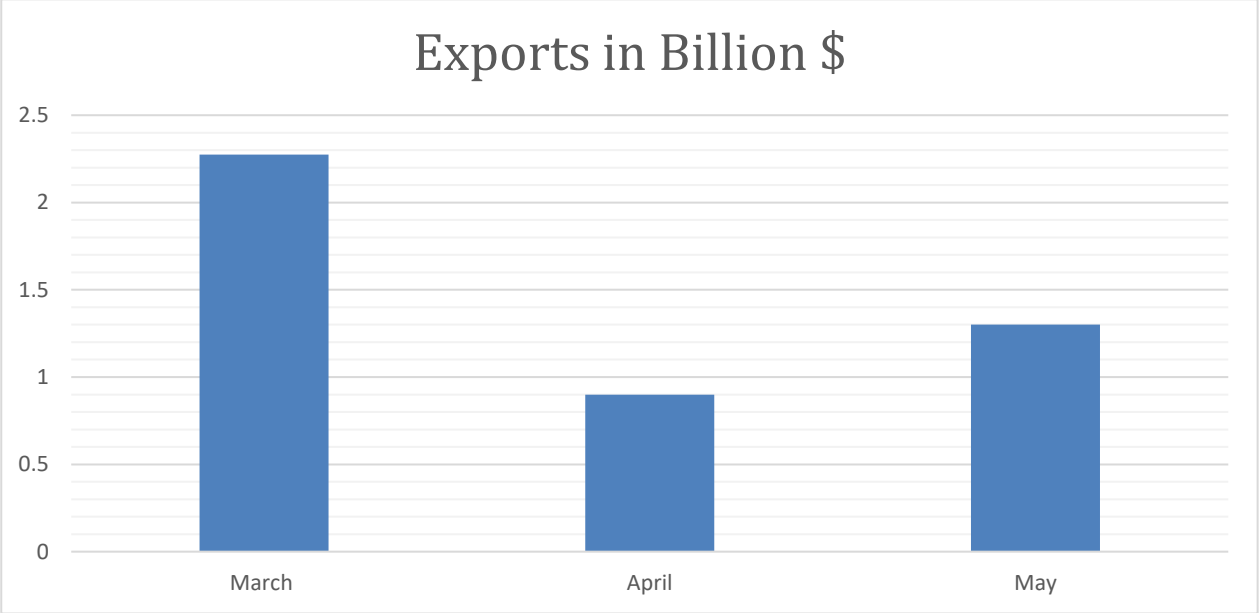


Fig 1.3: Source SBP

5.5 Export Performance and Import Trends

Pakistan's exports also declined sharply during the initial phase of the pandemic. Textile orders worth approximately $1.3 billion were either canceled or postponed. Export volumes fell from $1.97 billion in March 2020 to $1.39 billion by May 2020. Though a slight recovery was observed in May compared to April, the year-on-year decline stood at 33.4%. The domestic production slowdown due to lockdowns and the collapse of international demand further limited export recovery.

Nonetheless, a simultaneous drop in global oil prices reduced the country's import bill, particularly in petroleum products, providing partial relief to the trade balance. Pakistan's import contraction helped cushion the exchange rate impact but could not fully offset the steep decline in foreign exchange inflows from exports and remittances.



Pakistan's Monthly Exports in US $ (Source SBP)

5.6 Inflation and FDI Trends

Pakistan experienced inflationary pressures due to currency depreciation and disrupted supply chains. Inflation peaked at 11.5% in FY2020, driven by higher food prices and a weaker rupee. Rising inflation also reduced Pakistan's export competitiveness, as domestic producers faced higher input costs.

Foreign direct investment (FDI) was also adversely affected. Investor uncertainty and global recessionary trends delayed or canceled planned projects, especially in energy and textiles. With reduced FDI and weakening remittances, the country faced a growing balance of payments gap, leading to further pressure on the rupee.

6. Conclusion & Policy Recommendations

6.1 Conclusion

The COVID-19 pandemic has exposed and exacerbated structural weaknesses in Pakistan's external sector. As a developing economy already burdened by macroeconomic imbalances—such as high external debt, reliance on remittances, and dependence on short-term capital inflows—Pakistan was ill-prepared to absorb the economic shock triggered by the global health crisis. While safe-haven currencies like the US dollar and Japanese yen demonstrated relative resilience, the Pakistani rupee experienced substantial depreciation during the initial months of the pandemic.

Prior to the pandemic, the exchange rate had shown signs of stabilization, largely due to high interest rates that attracted foreign portfolio investment and temporarily boosted reserves. However, the rapid withdrawal of this "hot money" following interest rate cuts by the State Bank of Pakistan in early 2020 revealed the unsustainable nature of this stabilization strategy. As foreign exchange reserves dwindled and remittances declined, the rupee came under intense pressure from both speculative and structural factors.

This analysis highlights that the relative stability of the country's exchange rate prior to the pandemic was bolstered by the State Bank of Pakistan's (SBP) contractionary monetary policy, which involved maintaining elevated interest rates to attract foreign investment. This strategy resulted in a notable inflow of over $3 billion in foreign exchange, alongside an increase in remittances, both of which play critical roles in stabilizing the ER.

International investors typically gravitate towards nations exhibiting robust economic indicators, thereby diverting capital from countries characterized by higher political and economic risks. Conversely, financial instability can erode confidence in a nation's currency, particularly in favor of currencies from more stable economies. The pandemic has unequivocally revealed the vulnerabilities of Pakistan's currency, which has shown excessive reliance on short-term Treasury Bills (hot money) and remittances.

As a nation heavily reliant on foreign debt, the initial 225-basis-point reduction in interest rates has led to a comparable depreciation of the ER, paralleling the pandemic's widespread repercussions. The indirect consequences of COVID-19 manifest as declines in exports, adverse speculation, escalating foreign debt, dwindling forex reserves, and increased economic uncertainty. Further reductions in policy rates will likely exacerbate the devaluation of the Pakistani rupee against the dollar if this pandemic continues to unfold, given that its impacts differ markedly from those of a conventional financial crisis.

This study demonstrates that the pandemic's impact on the exchange rate was not merely a reflection of short-term panic but rather the outcome of deeper systemic dependencies. Decreased exports, a surge in external debt, declining FDI, and reduced remittances all contributed to the rupee's vulnerability. The qualitative evidence suggests that treating COVID-19 as a standard financial crisis overlooks its dual nature: both a health emergency and a global economic disruptor. Therefore, conventional fiscal and monetary tools—while necessary—were insufficient on their own to manage the exchange rate in the face of such a multifaceted crisis.

To strengthen the exchange rate in the long term, Pakistan must pursue structural reforms aimed at reducing reliance on volatile financial inflows and building economic resilience through export diversification, investment in human capital, and institutional capacity enhancement.

Pakistan's exchange rate (ER) is currently grappling with the profound effects of the COVID-19 pandemic. While both developing and developed economies are contending with this crisis, safe-haven currencies such as the Yen, Euro, and Dollar are predicted to experience less volatility. The repercussions for Pakistan's ER, however, are expected to be significantly more severe, primarily due to entrenched macroeconomic imbalances that have persisted for decades.

6.2 Policy recommendations

1. **Diversify Export Base and Enhance Supply Chains**

   - The government should support domestic industries, especially textiles, surgical instruments, and pharmaceuticals—to capitalise on increased global demand for medical goods and protective equipment. This will require investment in logistics, quality certification, and uninterrupted supply chains.

   - Pakistani exporters should seize the opportunities arising from the growing demand for medical equipment, health garments, pharmaceutical products, sheets, towels, and basic clothing—goods that the Pakistani industry is well-equipped to manufacture. However, sustaining these prospects relies on the integrity of both domestic and global supply chains. The textile sector in Pakistan possesses the potential and capability to produce

personal protective equipment PPEs(such as safety suits, gloves, and masks) and the surgical industry is equipped to manufacture medical surgical instruments (MSIs).

- In light of the current circumstances, as domestic investors have lost confidence, it is crucial to support them with attractive policy rates, ideally set at around 8%. For the textile sector and surgical industry, a rate of approximately 6% is recommended. Although this may lead to short-term currency depreciation, it would ultimately boost domestic production, enhance producer confidence, and lower production costs.

- With global demand for PPEs and MSIs significantly increasing, now is the opportune moment to focus on the export sector. This strategic emphasis will enhance export competitiveness. It is essential to provide special leverage and support to textile and surgical firms engaged in the production of PPEs and MSIs, which will consequently decrease imports of these items as well.

2. **Reduce Exchange Rate Misalignment and Import Dependency**

   The government must address the overvaluation of the real effective exchange rate (REER) through prudent fiscal adjustments and incentives for import substitution. Input subsidies, tax relief, and tariff exemptions for local producers can help reduce production costs and inflation.

3. **Stabilize Forex Markets and Manage Speculation**

   SBP should enhance its surveillance of speculative forex activity and promote forward guidance strategies to reduce uncertainty. Development of derivative markets for hedging purposes can help businesses manage currency risk.

4. **Rationalize Foreign Borrowing and Improve Debt Management**

   External debt should be prioritized for productive uses only. Transparent debt management policies and stronger parliamentary oversight are essential to ensure that new borrowings do not add undue pressure on the exchange rate.

5. **Expand Domestic Capital Markets**

   By developing deeper domestic financial markets, Pakistan can reduce its reliance on short-term foreign inflows. Capital market reforms, including improved governance, listing incentives, and digital infrastructure, can help mobilize long-term domestic savings.

6. **Invest in Digital Trade Infrastructure**

   To support resilient exports and financial transactions, Pakistan must accelerate digitalization in customs, port operations, and cross-border payments. This can also facilitate smoother inflows of FDI and remittances.

By implementing these structural reforms and adopting a more nuanced policy approach, Pakistan can insulate its exchange rate from future external shocks and lay the foundation for long-term economic resilience.

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