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IMPACT OF INFLATION, UNEMPLOYMENT, AND EXCHANGE RATE VOLATILITY ON ECONOMIC GROWTH AND STABILITY IN PAKISTAN

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Abstract
This study examines the dynamic interplay between inflation, unemployment, and exchange rate volatility and their combined impact on economic growth and macroeconomic stability in Pakistan over the period 2015–2026. Drawing on recent macroeconomic data and policy developments, the paper highlights Pakistan's transition from a balance-of-payments crisis toward a phase of cautious stabilization under International Monetary Fund (IMF)-supported reforms. The findings indicate that while headline inflation declined sharply from historic highs in 2023 to single digits by 2025, core inflation remains persistent due to structural rigidities, subsidy withdrawals, and forward-looking expectations, reflecting limitations of the traditional Phillips Curve framework in Pakistan. Despite modest GDP recovery, unemployment particularly among youth and educated individuals continues to rise, revealing a pattern of "jobless growth" driven by skills mismatches, weak industrial absorption, and limited private sector expansion. At the same time, exchange rate stabilization and improved current account balances have strengthened foreign reserves; however, high exchange rate pass-through effects continue to transmit external shocks into domestic inflation and increase the burden of external debt servicing. The study further identifies structural constraints, including energy sector inefficiencies, circular debt, low tax-to-GDP ratio, and vulnerability to climate and global economic shocks, as key impediments to sustainable growth. Additionally, the persistence of poverty, declining human development indicators, and rising inequality underscore a critical disconnect between macroeconomic stabilization and social welfare outcomes. The paper concludes that achieving durable and inclusive economic growth in Pakistan requires a balanced policy approach that goes beyond stabilization, emphasizing structural reforms, human capital development, labor market alignment, and export competitiveness to ensure long-term economic resilience and stability.

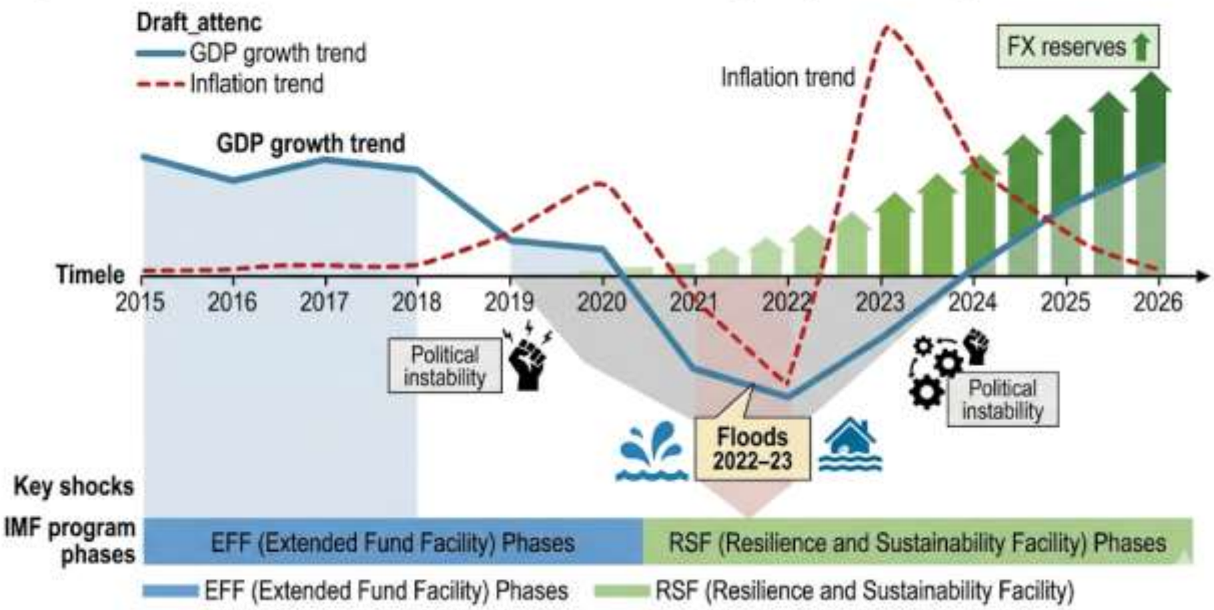
1. Introduction

The macroeconomic trajectory of Pakistan between 2015 and 2026 is a study in high-stakes stabilization, characterized by a persistent struggle to reconcile aggregate fiscal discipline with the urgent socio-economic needs of a burgeoning population (ADO, 2025). In the period leading up to 2025 and 2026, the Pakistani economy transitioned from the precipice of a balance-of-payments crisis toward a phase of tentative recovery, a shift facilitated by stringent adherence to International Monetary Fund (IMF) programs and a fundamental recalibration of monetary and fiscal policies (Ministry of Finance, 2025). While headline indicators such as Consumer Price Index (CPI) inflation, fiscal balances, and foreign exchange reserves showed marked improvement by early 2025, the underlying structural issues particularly in the labor market and energy sector continue to pose existential threats to long-term stability (Pasha, 2025). The following analysis explores the intricate causal relationships between price levels, labor utilization, currency dynamics, and the overarching growth framework of the nation (Sayeed, 2026).

2. Macroeconomic Growth and the Stabilization Framework

Pakistan's economic growth during the mid-2020s has been defined by a cyclical pattern of volatility followed by stabilization. Real GDP growth, which contracted by 0.2 percent in 2023 due to catastrophic floods and political instability, recovered to 2.5 percent in 2024 and reached 2.68 percent to 3.0 percent in fiscal year (FY) 2025 (SBP, 2025). By early 2026, the State Bank of Pakistan projected a more robust recovery, with real GDP growth expected to fall within the range of 3.75 percent to 4.75 percent for FY2026 (SBP, 2026a,). This upward revision reflects a broad-based stabilization across the industrial and services sectors, although the agricultural sector remains highly vulnerable to climate-related shocks and fluctuating input costs (UNDP, 2024). The current growth trajectory is anchored in the 37-month Extended Fund Facility (EFF) and the subsequent Resilience and Sustainability Facility (RSF) programs with the IMF. These programs have mandated a primary surplus target, which was successfully achieved at 1.3 percent to 1.8 percent of GDP in late 2024 and early 2025, marking a historic achievement after more than two decades of fiscal deficits (Arif Habib Ltd., 2025). This fiscal discipline has been essential for rebuilding investor confidence, as evidenced by the Pakistan Stock Exchange's (PSX) 50 percent return and a 78,000-point rise during FY2025. However, the growth remains "jobless" in nature, as the expansion in output has not corresponded with a reduction in poverty or a significant increase in productive employment (Eurasia Review, 2026). As shown in Figure 1, Pakistan's macroeconomic trajectory reflects a transition from crisis to gradual recovery under IMF-supported reforms.

Figure 1. Pakistan's Macroeconomic Stabilization Cycle (2015–2026)



2.1 Sectoral Contributions and Resilience

The services sector continues to dominate the Pakistani economy, accounting for 58.40 percent of GDP in FY2025. Despite its size, the sector's growth of 2.91 percent in FY2025 was moderate, reflecting a cautious recovery in wholesale and retail trade and finance (SBP, 2026c). The industrial sector, meanwhile, posted a stronger growth of 4.77 percent, driven by a rebound in manufacturing and Large-Scale Manufacturing (LSM), which witnessed a 10.37 percent increase in late 2025 (Pakistan Bureau of Statistics, 2026). This industrial activity is crucial for export diversification, yet it remains hampered by high energy costs, which reach 13-15 cents per kilowatt-hour, nearly double those of regional competitors like Bangladesh or Vietnam (Vigour Impex, 2025). Agriculture, which contributes 23.54 percent to the GDP, faced significant contraction in major crops during FY2025. Adverse weather and reduced cultivation areas led to a 13.49 percent decline in important crops, including a 30.7 percent drop in cotton and an 8.9 percent fall in wheat (IMF, 2026). This sectoral weakness has profound implications for inflation, particularly food inflation, and necessitates higher imports, which in turn strains the current account (SBP, 2026b).

Table 1: Key Macroeconomic Indicators and Projections (FY2023–FY2026)

Economic Indicator	FY2023 (Actual)	FY2024 (Actual)	FY2025 (Estimate)	FY2026 (Projected)
Real GDP Growth (percent)	-0.2	2.5	3.0	3.75 - 4.75
Primary Balance (percent of GDP)	-0.8	0.4	1.3	1.6
Current Account (percent of GDP)	-0.7	-0.6	0.5	0.0 - 1.0
FX Reserves (SBP, US$ Billion)	4.4	8.0	11.5	18.0
Investment-to-GDP (percent)	-	13.1	13.8	-
Savings-to-GDP (percent)	-	12.6	14.1	-

3. The Dynamics of Inflation and Price Stability

The inflationary environment in Pakistan experienced a dramatic transformation between 2023 and 2025. Headline inflation, which soared to 29.2 percent in FY2023 and 23.4 percent in FY2024, fell sharply to an average of 4.5 percent in FY2025 (KPMG, 2025). In April 2025, inflation hit a multi-decade low of 0.3 percent, driven by a collapse in food and energy price pressures and a stable exchange rate (Finance Division, 2025). This disinflationary period allowed the State Bank of Pakistan's Monetary Policy Committee to reduce the policy rate by a cumulative 1,150 basis points from its peak of 22 percent down to 10.5 percent by early 2026 (Kumar et al., 2025).

3.1 Drivers of Disinflation and Core Inflation Persistence

The primary driver of disinflation was the food and non-alcoholic beverages category, which saw prices decline by 1.3 percent in FY2025 compared to a 25.5 percent increase the previous year. Non-perishable food items fell by 1.7 percent, benefiting from lower international food prices and improved domestic availability (FAO, 2025). However, while headline figures showed rapid cooling, core inflation (non-food, non-energy) remained stickier. In early 2026, urban core inflation stood at 7.1 percent, while rural core inflation was higher at 8.3 percent. This persistence reflects the second-round effects of previous shocks and the impact of fiscal consolidation measures, such as the withdrawal of untargeted energy subsidies (World Bank, 2025).

The sharp decline in the Sensitive Price Indicator (SPI) further underscored the easing of inflationary pressures on the most vulnerable households, with weekly data showing marginal fluctuations in early 2026 (Kanwal & Awan, 2026). Nevertheless, the risk of a resurgence in inflation remains high, particularly due to potential climate shocks affecting crop yields and the volatility of global oil prices, which could widen the trade deficit and force a depreciation of the Pakistani Rupee (PKR) (Khan et al., 2026).

Table 2: Disaggregated CPI-National Inflation (July–April FY2025)

CPI Category (National)	FY2024 (percent Change)	July-April FY2025 (percent Change)
Headline CPI National	26.0	4.7
Food and Non-alcoholic Beverages	25.5	-1.3
Housing, Water, Electricity, Gas	28.4	8.5
Clothing and Footwear	19.8	14.4
Health	22.1	14.5
Transport	21.4	-1.1
Education	12.4	11.6

3.2 Theoretical Framework: The Phillips Curve in Pakistan

The relationship between inflation and unemployment in Pakistan has been a subject of extensive academic inquiry, particularly through the lens of the Phillips Curve. Traditional models suggest an inverse relationship, yet empirical evidence in Pakistan often indicates more nuanced dynamics (Shahbaz et al., 2011). Research on the New Keynesian Phillips Curve (NKPC) for Pakistan documented that inflation is dominated by forward-looking behavior rather than backward inertia. In this hybrid framework, current inflation is determined by a combination of previous inflation, future inflation expectations, and real marginal costs. Studies have shown that real marginal cost, rather than the output gap, is the primary driver of inflation in Pakistan (Mangnejo et al., 2020).

Furthermore, empirical evidence suggests that Pakistan exhibited a relatively steady Phillips Curve during the 1991–2019 period, with results supporting the existence of a trade-off in both the short and long run (Hyder & Hall, 2019). However, the degree of price stickiness is found to be very high, meaning that once prices are set, they do not adjust rapidly to changes in economic conditions, necessitating a credible and consistent monetary policy to anchor expectations (Satti, 2022).

4. Labor Market Structural Imbalances and Unemployment

Despite the recovery in GDP growth, the labor market continues to exhibit signs of severe distress. The overall unemployment rate in Pakistan increased from 6.3 percent in 2020-21 to 6.9 percent in 2024-25, with urban unemployment reaching 8.0 percent (CEIC, 2025). Projections for 2025-26 suggest that unemployment could rise to 8 percent as fiscal tightening and high energy costs constrain the private sector's ability to create jobs (Khabarhub, 2025).

4.1 Youth Unemployment and the Demographic Dividend at Risk (Arshad and Hayat, 2025).

The most alarming aspect of the labor market is the concentration of unemployment among the youth and the educated. Youth unemployment (ages 15-24) stands at approximately 12.5 percent, with young women facing rates as high as 13-17 percent in urban centers. Nearly 32.5 percent of young people aged 15-29 are classified as NEET (Not in Education, Employment, or Training), with rates for women reaching as high as 55 percent (International Labour Organization [ILO], 2022). This youth bulge, with 64 percent of the population under 30, represents a significant potential asset, but without productive absorption, it becomes a source of social instability (United Nations Development Programme [UNDP], 2018).

Graduate unemployment is currently three times the national average, revealing a profound disconnect between educational output and market demand (Pakistan Institute of Development Economics [PIDE], 2021). Employers frequently report a lack of job-ready skills among graduates, a situation attributed to outdated university curricula and poor industry linkages. This "skills mismatch" traps the economy in a low-value production cycle, as the labor force lacks the technical proficiency required for the fourth industrial revolution (Asian Development Bank [ADB], 2021).

Table 3: Labor Market Statistics (2024–2025)

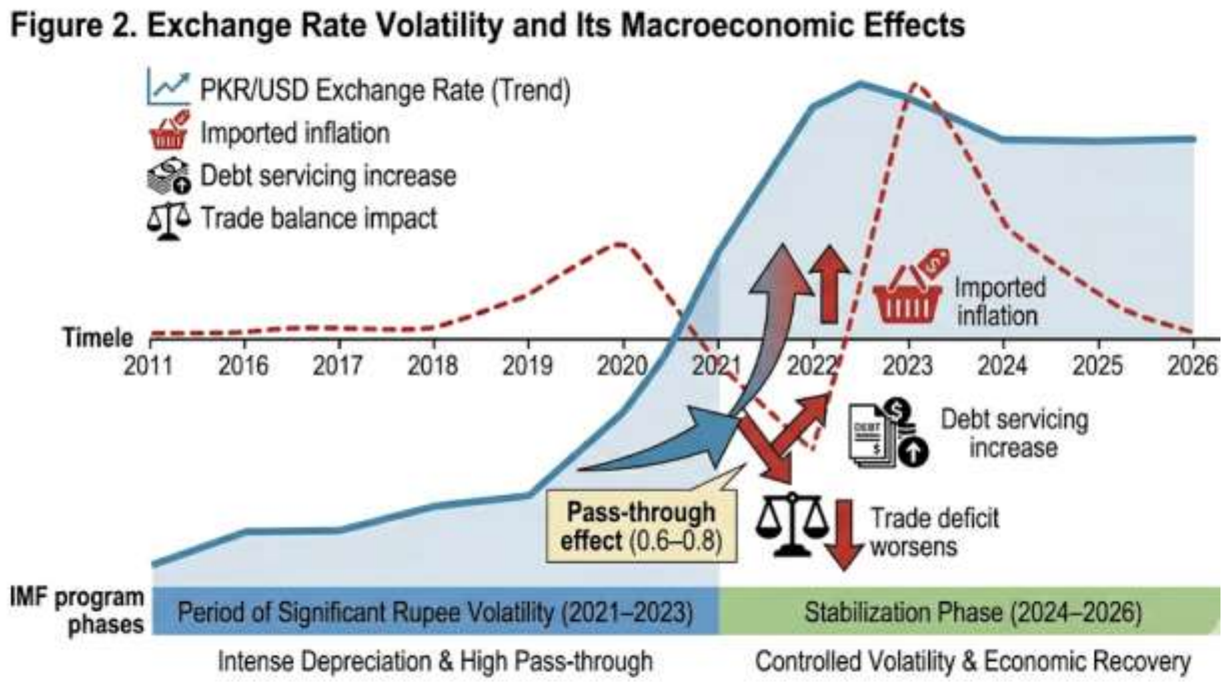
Labor Market Statistic	Value (percent)
National Unemployment Rate	6.9
Female Unemployment	9.7
Urban Female Unemployment	17.0 - 18.0
Youth Unemployment (15-24)	12.5
NEET Population (15-29)	32.5
Labor Force Participation Rate	46.3
Underemployment Rate	1.6

4.2 Socio-Economic Consequences and Brain Drain

The lack of domestic opportunity has led to a significant exodus of human capital. In 2025, nearly 4,000 doctors left Pakistan the highest number on record reflecting a broader trend of skilled professionals seeking stability abroad. In 2023 alone, over 860,000 Pakistanis migrated for work (Gallup Pakistan, 2025). While these migrants provide essential remittances, the long-term loss of talent undermines the country's innovation capacity and growth potential (Paradigm Shift, 2025). Chronic unemployment is also linked to increased rates of psychological stress, social exclusion, and mental health issues such as anxiety and depression among the youth, which can fuel deviant behavior (Jaffri et al., 2025).

5. Exchange Rate Volatility and External Sector Stability

Exchange rate management has been a cornerstone of Pakistan's stabilization efforts. After years of interventions, the SBP transitioned to a market-driven exchange rate system, leading to a nearly 39 percent depreciation of the PKR against the US Dollar in FY2023. By early 2026, the rupee had stabilized around 279-280 per USD, supported by a significant buildup of foreign exchange reserves and a contained current account deficit (SBP, 2026a, 2026b). The dynamics of exchange rate movements and their macroeconomic implications are illustrated in Figure 6.



5.1 Current Account Surplus and Reserve Accumulation

In a historic turn, Pakistan posted its first current account surplus in 14 years during FY2025, reaching US$1.9 billion to US$2.1 billion (SDPI, 2026). This surplus was driven by record remittances and a sustained rebound in technology exports. Foreign exchange reserves reached US$16.64 billion by May 2025 and are projected to increase to US$18 billion by June 2026, providing nearly three months of import cover (Arif Habib Ltd., 2025). However, this stability is fragile. The exchange rate pass-through remains high, estimated at 0.6 to 0.8, meaning that any significant currency devaluation rapidly translates into domestic price hikes for fuel, raw materials, and essential food items (UrcaPK, 2024).

5.2 External Debt Servicing and Financing Needs

External debt servicing remains a significant burden on the national exchequer. In the second quarter of FY2026, external debt servicing climbed to US$4.07 billion, up from US$3.55 billion in the previous quarter. This increase was driven primarily by principal repayments on government debt, which rose to US$2.09 billion (Mettis Global, 2026). The government's Annual Borrowing Plan for FY2025-26 outlines gross financing needs of 21 percent of GDP, to be met through a combination of multilateral loans and bilateral deposits. The depreciation of the rupee directly increases the cost of these repayments, as over 40 percent of public debt is foreign-denominated (World Bank, 2023).

Table 4: External Account Variables and Projections

External Account Variable	FY2024	FY2025	FY2026 (Projected)
Current Account Balance (US$ Billion)	-0.6	2.1	0.0 - 1.0 (Deficit)
SBP FX Reserves (US$ Billion)	8.0	11.5	18.0
Total External Debt (US$ Billion)	131.0	135.7	138.0
Remittances Trend	Robust	Record High	Sustained
Import Coverage (Months)	<1.5	~2.0	~3.0

6. Trade Competitiveness and Global Policy Frictions

Pakistan's export-oriented sectors, particularly textiles, face unprecedented challenges from shifting global trade policies (Haque & Nayab, 2020). The textile industry, which accounts for 8.5 percent of GDP and 92.8 percent of exports to the United States, is currently navigating a wave of protectionism (Tradeport, 2026a).

6.1 The Impact of US Tariffs on Textiles

In April 2025, the United States announced reciprocal tariffs on nearly 185 countries, initially hitting Pakistan with a 29 percent rate. Following diplomatic negotiations, this was reduced to 19 percent by August 2025. Despite the reduction, the 19 percent tariff has eroded the price competitiveness of Pakistani textiles. Analysts from PIDE and Tabadlab estimate that this tariff structure could lead to a loss of between US$564 million and US$2.17 billion in export revenues for FY2025-26 (Tradeport, 2026b). US demand for Pakistani textiles is projected to fall by 13 percent, potentially triggering thousands of layoffs in textile hubs like Faisalabad (The Express Tribune, 2026).

Table 5: Projected Export Losses due to 19 percent U.S. Tariff

Product Category	US Export Value (2024)	Projected Loss (19 percent Tariff)
Textiles and Apparel (Total)	US$ 5.3 Billion	20 - 30 percent
Home Textiles (Bedwear)	US$ 3.29 Billion	Significant
Towels	US$ 1.10 Billion	Moderate
Rice	US$ 380 Million	15 - 20 percent
Surgical Instruments	US$ 210 Million	10 - 15 percent

7. The Human Development and Poverty Paradox

A profound "economic paradox" characterizes Pakistan in 2026: while macroeconomic stabilization has been achieved, human development and poverty indicators have worsened. Poverty has climbed to 29 percent, an 11-year high, with multidimensional poverty affecting 38.3 percent of the population nearly 89 million people (Eurasia Review, 2026).

7.1 Stagnation in Human Development Metrics

In 2025, Pakistan's ranking on the UNDP Human Development Index (HDI) fell to 168th out of 193 nations, with a score of 0.544. Gender inequality remains a critical barrier, with Pakistan ranking 135th globally in the Gender Inequality Index. Female labor force participation remains low at 22 percent, compared to 75 percent for men (UNDP, 2026b). The "stunting" rate among children in Pakistan remains at a staggering 40 percent, leading to an increase in "learning poverty".

Furthermore, spending on health and education remains neglected, with allocations often staying below 3 percent each (SDPI, 2026).

Table 6: Human Development and Poverty Metrics (2025–2026)

Development Metric	Pakistan (2025-26)	Regional Context
HDI Rank	168	India (130), Bangladesh (136)
Population below Poverty Line	29 percent - 38.3 percent	Rising Trend
Stunting (Children <5)	40 percent	High
Gender Inequality Rank	135	Low Participation
Expenditure on Health/Education	<3 percent each	Neglected
Population Growth Rate	2.4 percent - 2.6 percent	Unmanageable

8. Fiscal Consolidation and Structural Reforms

The sustainability of Pakistan's recovery depends on deep-seated structural reforms, particularly in the energy sector. Circular debt a chain of unpaid obligations continues to grow, driven by poor bill recovery and electricity theft (European Times, 2025). The government has committed to the privatization of distribution companies (DISCOs) to improve recoveries and reduce the PKR 1 trillion annual injection required to keep the system running (Business Recorder, 2026).

Table 7: Projected Fiscal Variables (FY2025–2026)

Fiscal Variable	Value (Projected)
Tax-to-GDP Ratio	10.3 percent - 13.2 percent
Federal Fiscal Deficit (PKR Billion)	6,501
Interest Expense (PKR Billion)	8,207
Primary Surplus (PKR Billion)	1,706
Gross Financing Needs (percent of GDP)	21 percent

9. Synthesis of Economic Stability and Future Risks

The review of Pakistan's economic indicators from 2015 to 2026 reveals a fragile stability. The rapid disinflation achieved in 2025 provided the breathing room necessary for monetary easing and fiscal consolidation (PIDE, 2025). However, this progress was achieved through "blunt instruments" like currency devaluation and subsidy cuts, which have pushed millions into poverty (Eurasia Review, 2026).

Emerging risks for 2026-2027 include potential energy price spikes from the Middle East conflict and the ongoing trade war (IMF, 2026). Furthermore, the "jobless growth" model may lead to social frustration if real household incomes continue to shrink while inequality widens (MoF, 2025). Stabilization has prevented collapse, but the work of building a prosperous and resilient nation requires shifting from austerity to productivity and investing in human capital (PBS, 2026).

Conclusion

Inflation, unemployment, and exchange rate volatility remain central determinants of Pakistan's economic growth and stability, shaping both short-term macroeconomic outcomes and long-term structural resilience. The period 2015–2026 illustrates a clear pattern: high inflation (peaking in 2023) eroded purchasing power and fueled cost-push pressures, while successful disinflation by 2025 supported by fiscal consolidation and monetary tightening under IMF programs provided breathing room for rate cuts and reserve buildup. However, persistent core inflation, high price stickiness, and forward-looking expectations highlight the limitations of traditional Phillips Curve dynamics in Pakistan's context. Unemployment, particularly among youth and the educated, has risen despite modest GDP recovery, underscoring a “jobless growth” model rooted in skills mismatches, outdated curricula, and weak industry linkages. This demographic pressure risks social instability and brain drain while undermining the potential demographic dividend. Exchange rate volatility, although moderated by market-based adjustments and improved external balances, continues to transmit imported inflation and raise debt servicing costs. Structural vulnerabilities circular debt, energy sector inefficiencies, low tax-to-GDP ratio, and vulnerability to climate and global shocks continue to constrain sustainable and inclusive growth. While stabilization has prevented collapse and restored some investor confidence, translating this into broad-based, job-rich, and resilient growth will require deeper reforms in taxation, energy, education, labor markets, and export competitiveness. A balanced policy mix that prioritizes human capital development, productive investment, and inclusive macroeconomic management will be essential for Pakistan to achieve durable stability and realize its economic potential in the coming years.

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