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PAKISTAN'S PARALLEL FX MARKET

Navigating Informal Networks, Regulatory Challenges & Economic Impact

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POLICY PAPER

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Executive Summary

The parallel foreign exchange (FX) market in Pakistan operates alongside the formal banking system, creating a complex and primarily informal financial network. Central to this system is the *hundi/hawala* network, extensively employed by overseas Pakistanis to remit funds back to their homeland. However, the lack of transparency within this network introduces a heightened risk of fraudulent activities in foreign exchange transactions.

The FX market structure consists of three primary layers: the interbank market, the kerb market, and the *hawala* brokers:

- The interbank market facilitates approved FX transactions within the formal banking system, determining the official exchange rate through the interplay of demand and supply.
- Conversely, the kerb market, primarily composed of exchange companies, deals with remittances and dollar purchases, offering a more accessible alternative for the public.
- The *hawala* brokers, operating on trust and social networks, span regions globally, enabling transactions without formal documentation.

Recent developments have witnessed the emergence of a black market for dollars due to scarcity at money-changing firms, resulting in a 10% premium for dollar exchange. Government efforts to curb illegal trading have strengthened the rupee, alleviating pressure on the interbank market. Migrant workers have become significant contributors to this black market due to its more favourable exchange rates, diverting a substantial portion of exchange business away from official channels. Extensive media coverage highlights the significance of this phenomenon and raises questions about regulatory efficacy.

The *hundi*/*hawala* network and informal sectors present unique regulatory challenges due to their complex and unregulated nature. Balancing the need for regulation to prevent illicit activities with facilitation of legitimate transactions poses a significant policy challenge. Strategies may include formalizing the *hawala* network within the regulatory framework of the formal financial sector or improving financial inclusion to reduce reliance on informal value transfer systems.

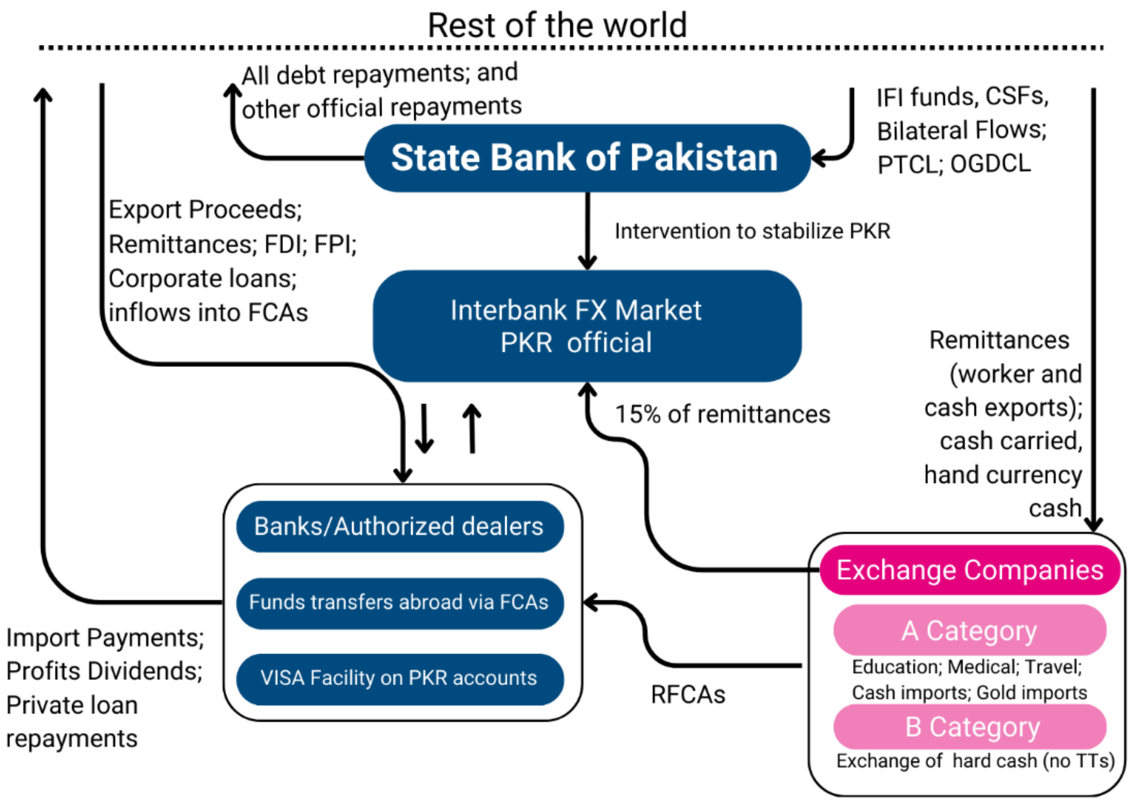
Addressing the complexities of Pakistan's parallel FX market requires a multifaceted approach. Formalizing informal networks, strengthening regulatory frameworks, and enhancing transparency are vital steps toward ensuring stability and integrity within the FX market. Balancing these strategies will be pivotal in fostering a more robust and secure financial ecosystem for Pakistan.

1. Introduction

In Pakistan, a parallel foreign exchange (FX) market operates in tandem with the formal banking system, forming a complex and primarily informal financial network. Central to this system is the *hundi/hawala* network, extensively employed by overseas Pakistanis to remit money back to their homeland. However, the lack of transparency within this network elevates the risk of fraudulent activities within foreign exchange transactions in the country. The structure of Pakistan's FX market is delineated into three distinct layers. Firstly, the interbank market encompasses all sanctioned FX transactions conducted within the formal banking system. This includes activities such as export proceeds, official home remittances, foreign private investment, and the transfer of funds from abroad through foreign currency accounts (FCAs). The interbank market crucially determines the official exchange rate based on the interplay between the demand for and supply of FX. In contrast, the kerb market primarily consists of exchange companies, colloquially referred to as moneychangers. This sector handles major inflows like workers' remittances and dollar purchases from the public, as well as outflows for various purposes such as medical expenses, travel, and education. Unlike the interbank market, the public predominantly interacts with exchange companies for their FX transactions. Operating on a foundation of trust and social networks, *hawala* brokers are dispersed across regions spanning from the Middle East, the Indian Subcontinent, Africa, to even the US and UK. This network operates on mutual trust, enabling transactions to be executed without the need for formal documentation or credentials. However, this lack of transparency heightens the vulnerability to fraudulent activities within foreign exchange transactions in Pakistan (Khalid, 2014).

Recent developments in the FX market have seen the emergence of a black market for dollars due to the scarcity of US currency at money-changing firms. In this parallel market, dollars are being exchanged at a premium of 10%. The Pakistani government's crackdown on illegal dollar trading has resulted in a notable strengthening of the rupee by nearly 10% in the retail market within a single week. This development has alleviated pressure on the key interbank market, signifying positive implications for overall FX market stability. Migrant workers have emerged as a significant source of dollars in this burgeoning black market, drawn by the more favourable exchange rates it offers. This shift has led to a substantial diversion of over 90% of the exchange business away from official channels, as reported by exchange companies. Media coverage of this situation has been extensive, with news outlets such as Bloomberg, Arab News, and The Star providing comprehensive reporting (Ahmed, 2023; Ismail & Yap, 2023; Mangi & Yap, 2022). The emergence of the black market for dollars raises pertinent questions about the efficacy of regulatory measures and the broader stability of Pakistan's FX market.

Figure 1: Structure of Pakistan's FX Market



The interplay between Pakistan's parallel FX market and the *hawala* network underscores the intricacies and challenges in regulating informal financial systems. As the situation with the black market for dollars evolves, it is imperative for regulators to carefully navigate these challenges and formulate effective strategies to maintain stability and transparency in Pakistan's FX market.

2. Informal Sectors of Pakistan's Economy

The informal sector in Pakistan comprises small and medium enterprises (SMEs), which include self-employed entrepreneurs, small businesses, informal associations, and other unregistered entities (Wasti, 2021; Wahid, 2023). The informal economy in Pakistan is characterized by several decent work deficits and challenges, including rights at work, child and bonded labour, social protection, lack of sustainable employment, working poverty, and gender-based discriminations (ILO in Pakistan, 2022). The size of Pakistan's informal economy is estimated to be as much as 56% of the country's GDP as of 2019 (Ejaz, 2021).

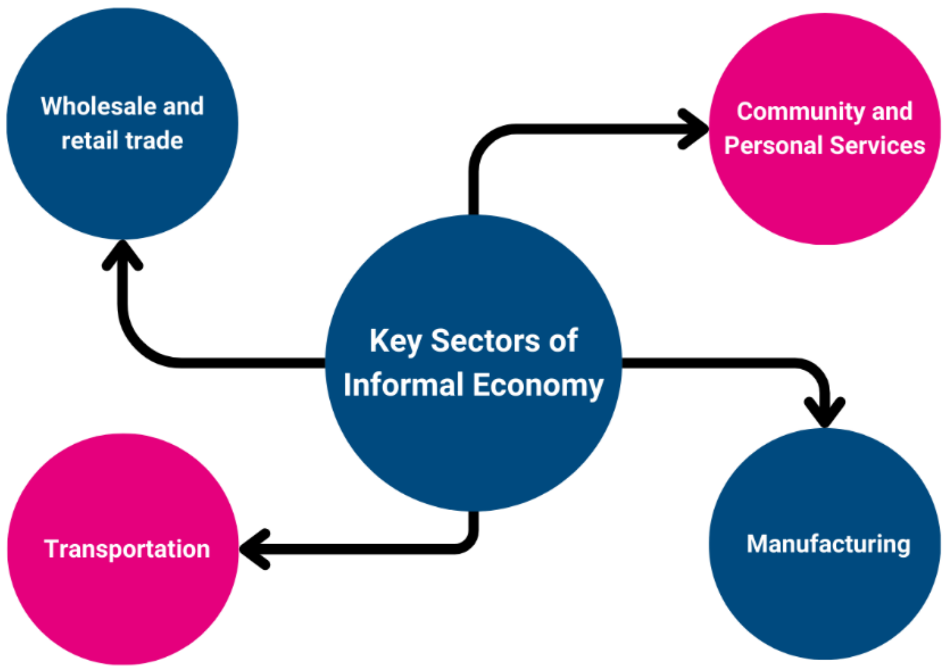
The informal sector in Pakistan also includes small-scale agriculture, retail shops, street vendors, domestic workers, and various small enterprises (Akram, 2023).

The informal economy in Pakistan is significant, and it comprises several sectors, including wholesale and retail trade, community and personal services, manufacturing, and transportation. The informal sector in Pakistan faces several challenges, including decent work deficits, poverty, and gender-based discriminations (Mughal & Schneider, 2020).

Recently an operation against Dollar Hoarders, Smugglers, and H2 dealers, the govt. conducted extensive crackdowns across provinces. Key individuals engaged in illicit activities have been apprehended, curbing the flow of dollars to Afghanistan. This crackdown led to a 10% surge in the Rupee against the USD, with exchange rates dropping from Rs 333.50 to Rs 300.15. Additionally, the Dollar gained 11.1% against the Afghani, causing remittances to rise by 3.1% to $2.09 billion. Forecasts predict a further 10% increase in September.

MECs responded by surrendering $20 million on September 7th-8th, with weekly surrenders expected to reach $120-150 million. These measures mark a significant stride in curbing illicit financial activities and stabilizing the economic landscape.

Figure 2: Key Sectors of Informal Economy in Pakistan



Distinguishing the *Hundi/Hawala* Network from Traditional Banking Systems in Pakistan

The *hundi/hawala* network diverges from traditional banking systems in Pakistan across several dimensions:

1. Regulation: The *hundi/hawala* network operates informally and lacks regulatory oversight, while traditional banking systems are strictly regulated by the State Bank of Pakistan.

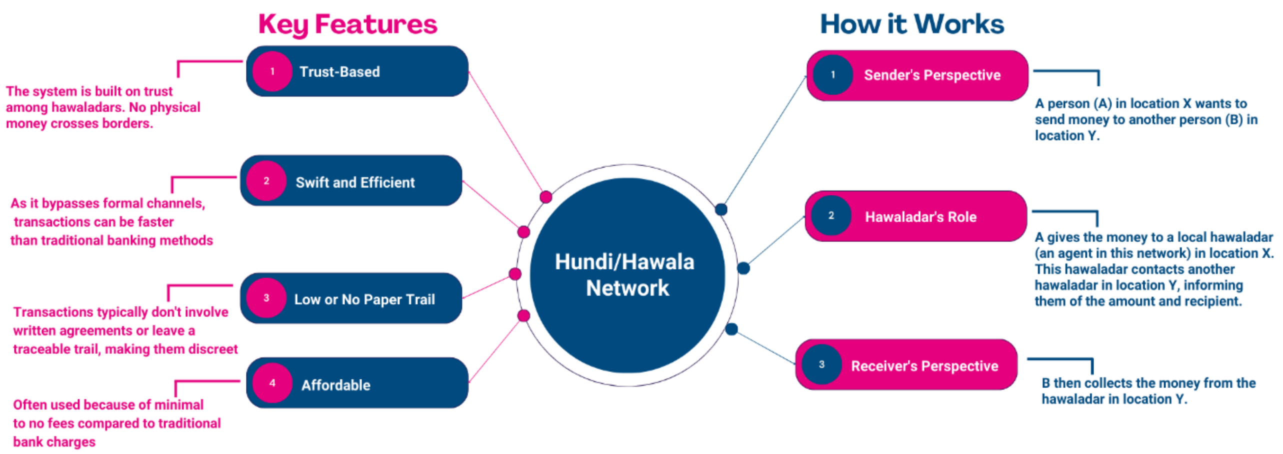
2. Documentation: Unlike traditional banking systems, the *hundi/hawala* network relies on trust and social networks, operating without formal documentation.

3. Speed and Convenience: The *hundi/hawala* network offers faster and more convenient services, especially appealing to blue-collar workers, while traditional banking systems may not always provide the same accessibility and convenience.
4. Commission: *Hawala* brokers typically charge lower commissions compared to traditional banking systems.

5. Transparency: The *hundi/hawala* network lacks transparency, in contrast to the stringent transparency requirements in traditional banking systems.

6. Movement of Currency: The *hundi/hawala* network may not always involve the physical movement of currency across borders, unlike traditional banking systems.

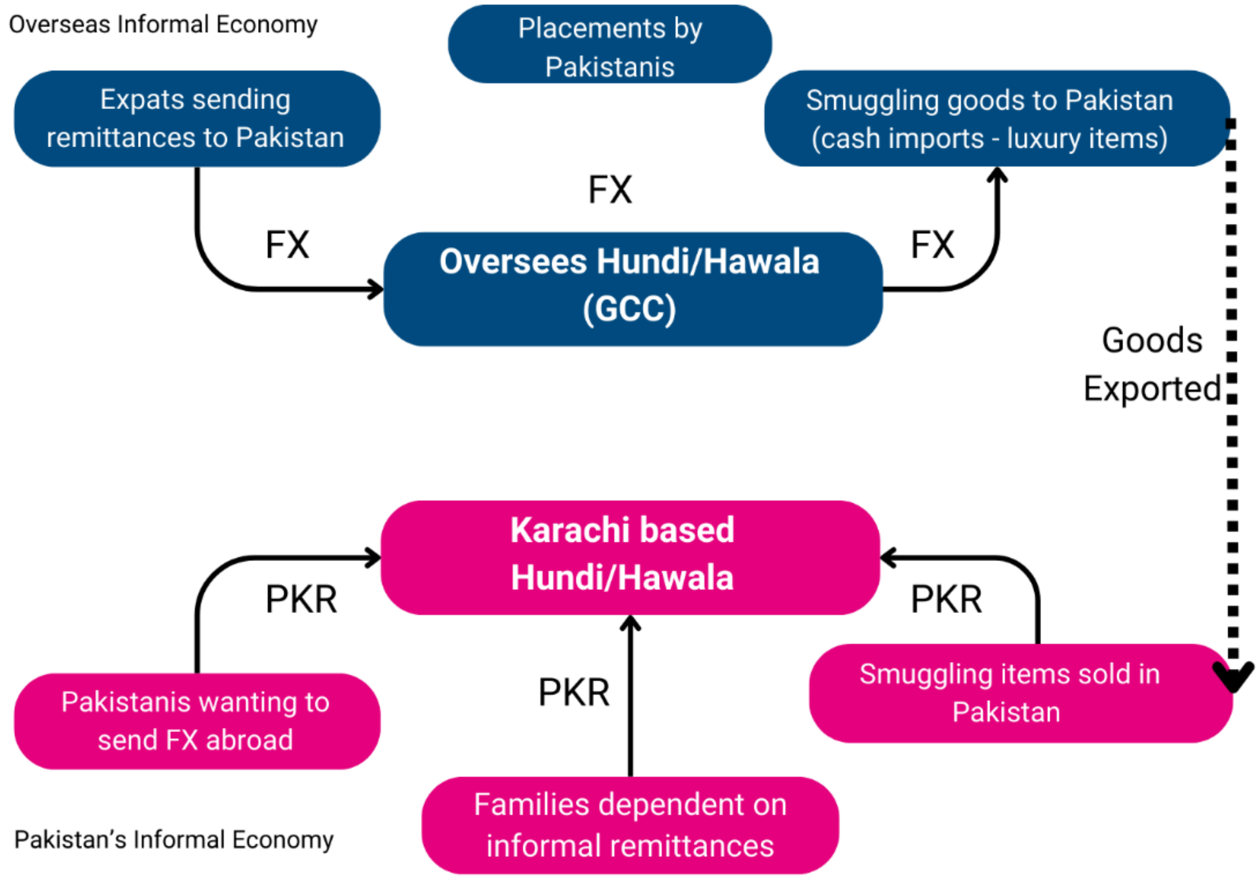
Figure 3: *Hundi/Hawala* How it works?



Hundi/Hawala Network Operation in Pakistan

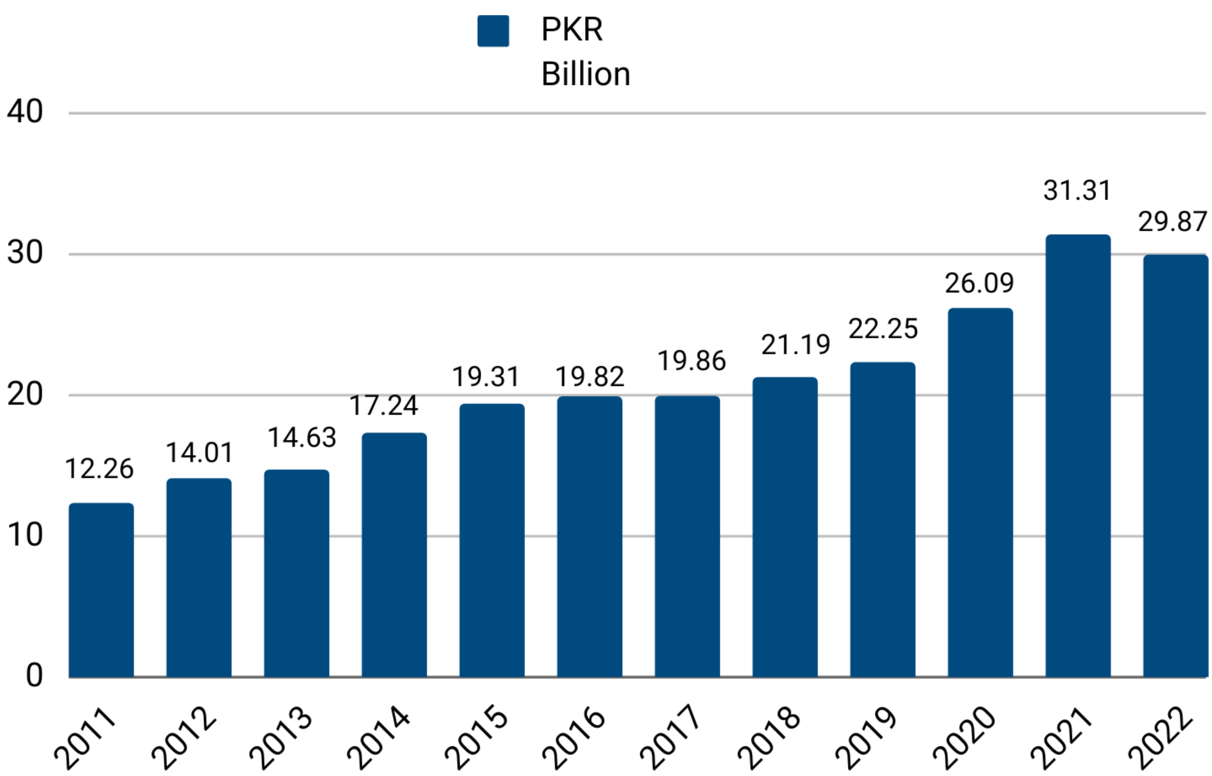
The *hundi/hawala* network functions as an informal foreign exchange market through a network of *hawala* brokers located in various regions. These brokers offer more affordable and convenient services, primarily catering to the blue-collar Pakistani workforce, redirecting remittances away from official channels. Although this network poses regulatory challenges, exchange companies find it exceedingly challenging to sever their ties with the *hawala* network.

Figure 4: *Hundi/Hawala* Transaction Flow Chart



It is clear that there has been a significant increase in the amount of money sent by individuals, which can probably be attributed to better accessibility to financial services, globalization, and the rising number of migrant workers globally. This is supported by the consistent upward trend in remittance flow observed over the recent years. Given the potential effects of formalizing informal remittance channels, which are characterized by cash transactions or non-bank methods and make up a sizeable portion of the total remittance flow, doing so would probably result in a significant increase in the recorded remittance figures.

Figure 5: Remittances Inflow



3. *Hundi/Hawala* Network vs Traditional Banking Systems

In comparison to Pakistan's conventional banking institutions, the *hundi/hawala* network provides quick and more practical services. Since the *hawala* network is unregulated and based on social networks and mutual trust, transactions can happen more quickly. Traditional banking systems, on the other hand, demand documentation for each transaction, which might slow down the procedure. Comparing the *hawala* network to conventional banking systems, the *hawala* network offers a reduced commission for its services. However, there are risks and uncertainties for users of the *hawala* network who depend on its lack of regulation and transparency.

Additionally, the *hawala* network enjoys special popularity in Pakistan's rural areas, where access to banking services is limited. The speedier, less expensive, more effective, and more convenient flows of remittances into the country are the foundation of the informal money transfer market's success. Pakistani labourers have been drawn to this industry since it enables prompt and hassle-free delivery to the client at their home. Remittances that go through the *hawala* system do not always indicate a real-time entry of foreign currency into the nation. The transactions are netted off (in the Gulf countries) due to the two coincident wants, and only the rupee equivalent is provided to the beneficiary in Pakistan.

Regulatory Challenges and Consideration

The *hundi/hawala* network and the informal sectors of the economy pose regulatory challenges due to their complex and informal nature. The *hawala* system is an informal value transfer system that is not regulated in many countries. It relies on a network of *hawala* brokers (*hawala*dars), who transfer money on behalf of clients without the use of a traditional financial institution (FI). The *hawala* system has legitimate uses, such as transferring money internationally in countries with underdeveloped formal banking systems (Abouzied, 2023). However, it is also used for illicit purposes, such as money laundering and terrorist financing (Wheatley, 2005). The informality of the *hawala* system makes it difficult for governments to effectively regulate and monitor its activities.

Challenges specific to *hawala* networks include the following: the lack of transparency and traceability, the difficulty in identifying the parties involved in a transaction, and the potential for abuse by criminals and terrorists (Passas, 2005).In most countries, *hawala* and other similar service providers have not traditionally been subject to any regulatory oversight. The chances of succeeding in regulating the informal sector are slim, particularly if the informal sector is not consulted (Qorchi, et al., 2003).

Policy makers face the challenge of balancing the need to regulate the *hawala* system to prevent illicit activities while not affecting legitimate users (Abouzied, 2023). Potential strategies for regulation include formalizing the *hawala* system by bringing it under the regulatory framework of the formal financial sector. This would require the *hawala* system to comply with the same regulations as traditional financial institutions, such as anti-money laundering (AML) and counter-terrorist financing (CTF) regulations (Wheatley, 2005; FATF, 2013).

Another method is to increase financial inclusion by building formal financial institutions in nations where banking systems are underdeveloped. This would minimize the need for *hawala* and other informal value transfer mechanisms.

Due to their complexity and informal nature, the *hundi/hawala* network and the informal sectors of the economy provide regulatory issues. Policymakers must strike a compromise between the necessity to regulate the *hawala* system to prevent illicit operations and the need to protect legitimate users. Potential strategies for regulation include formalizing the *hawala* system by bringing it under the regulatory framework of the formal financial sector and improving financial inclusion by developing formal financial systems in countries with underdeveloped banking systems.

Economic Impact of Parallel FX Market

When assessing the economic impact of Pakistan's parallel FX market, it is critical to analyze its impact on currency rates, inflation, and general economic stability. According to a UNCTAD report, frontier technologies currently represent a $350 billion sector that might expand to $3.2 trillion by 2025 (UNCTAD, 2023). The development of a parallel FX market, however, has the potential to undermine Pakistan's overall economic stability by causing economic inefficiencies such pricing distortions and resource misallocation. The core causes of the parallel FX market, such as a shortage of foreign exchange reserves or a lack of faith in the government's economic policies, need to be addressed by policymakers (Wheatley, 2005). Improvements to the formal financial system, more financial inclusion, and formalizing the parallel FX market by bringing it within the formal financial sector's regulatory umbrella are all potential methods for diminishing the power of the parallel FX market in Pakistan.

4. Policy Recommendations

Here are some specific policy recommendations for regulating the *hundi*/*hawala* network, managing the informal sectors, and ensuring the stability and integrity of Pakistan's FX market:

1. Bring the informal sectors under the formal financial sector's regulatory umbrella to formalize it. As a result, the network would be governed by the same laws against money laundering (AML) and countering terrorism financing (CTF) that are imposed on traditional financial institutions.

2. Create a comprehensive regulatory framework for the *hundi*/*hawala* network, including regulatory control, international rules, anonymity, and minimal documentation.

3. The government may collaborate with the FATF and other international organizations to create a unified approach to regulating the *hawala* system and sharing information across borders.

4. Both official and informal remittance enterprises may seek for licenses or registration, and they are subject to any applicable FATF guidelines.

5. To increase financial inclusion in Pakistan, the formal financial system should be made more efficient. Improvements could include:

    a. Developing a centralized FX trading platform to improve the transparency and efficiency of the FX market.

    b. Increasing market surveillance to prevent market manipulation and other fraudulent activities.

    c. Providing incentives for informal sector workers to transition to the formal sector, such as tax breaks and access to credit.

    d. Developing policies that address the root causes of the informal sector, such as a lack of access to formal employment opportunities and a lack of social protection

6. Strengthen the regulatory and supervisory framework for financial institutions, particularly the *hundi*/*hawala* network, to ensure compliance with AML and CTF legislation.

5. Conclusion

Formalizing the *hundi*/*hawala* network, developing a comprehensive regulatory framework for the *hundi*/*hawala* network, improving financial inclusion, providing incentives for informal sector workers to transition to the formal sector, increasing foreign exchange reserves, and strengthening the regulatory and supervisory framework for financial institutions are all part of regulating the *hundi*/*hawala* network, managing the informal sectors, and ensuring the stability and integrity of Pakistan's FX market.

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