

## **Pakistan's Parallel Foreign Exchange Market**

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### **Abstract**

*This paper seeks to describe and analyze the parallel foreign exchange (FX) market in Pakistan. The very nature of this market implies that there is little formal documentation or data to describe it, and so any assessment will be, by definition, subjective. However, parties that transact in the parallel market are familiar with parts of it, on which basis this paper aims to give a comprehensive picture of the structure and evolution of this market in Pakistan. We start with a brief historical perspective, which flags the importance of workers' remittances to the country and explains how the bulk of this inflow is transacted through the hundi/hawala network (informal moneychangers). We then place this network within the context of the larger FX market and show how it interfaces with the interbank market. We also discuss how many hundi/hawala agents have evolved into formal exchange companies and list the various sources and uses of FX transacted in the kerb market. The conclusion spells out the importance and resilience of the parallel FX market, the need to push toward full amalgamation with the formal FX market, and the key role of workers' remittances in Pakistan's macro-economy.*

**Keywords:** Pakistan, foreign exchange, informal economy, hundi/hawala, macro-economy.

**JEL classification:** E44, F31.

### **1. The Evolution of Pakistan's Foreign Exchange Earnings**

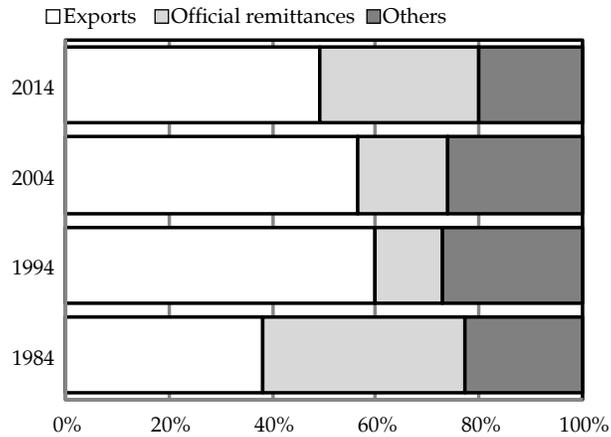
Pakistan's foreign exchange (FX) earnings are heavily skewed toward export receipts and home remittances. Around 80 percent of its FX inflows come from these two sources: while exports currently stand at US\$ 25 billion, remittances have touched US\$ 15 billion for the first time in the fiscal year (FY) 2014. Putting this in perspective, remittances financed nearly 38 percent of Pakistan's imports in FY2014.

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\* Publication Manager, Economic Policy Review Department, the State Bank of Pakistan. The views expressed in this paper are those of the author(s) and do not reflect the views of the State Bank of Pakistan. Given the nature of this study, it was based largely on discussions with foreign exchange analysts, commercial bankers, exchange companies, and other private players in the foreign exchange market. Although the State Bank of Pakistan has not endorsed this study, the author received valuable guidance from Dr Mushtaq Khan, chief economic advisor on policy development at the bank.

This distribution has seen significant changes in the last two decades: in 1983 and 1984, remittance inflows equaled export receipts (Figure 1). This was the time that the oil boom in the Gulf countries had attracted a large number of Pakistani workers to the region, resulting in a sharp increase in home remittances. The share of home remittances in Pakistan's FX earnings reached around 40 percent during this time.

**Figure 1: Composition of Pakistan's FX earnings**

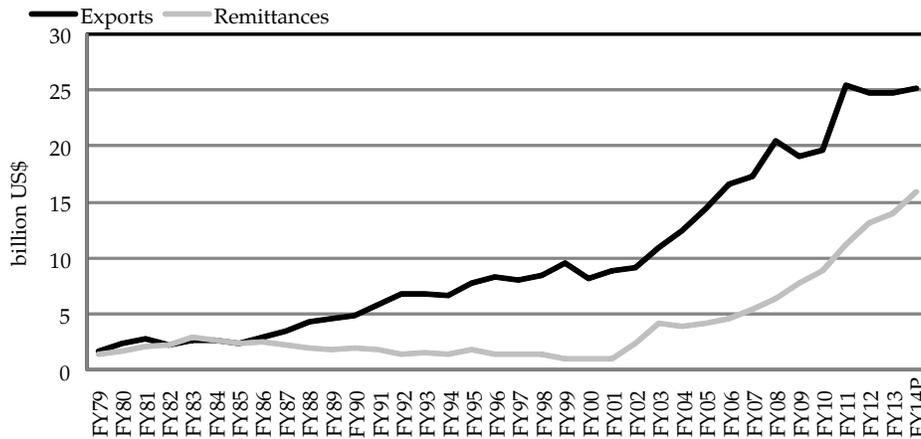


Source: State Bank of Pakistan

In the 1990s, however, the parallel FX market (or *hundi/hawala* network) based in the Gulf countries began to divert remittances away from official channels by offering cheaper and more convenient services to the largely blue-collar Pakistani workforce. The conversion rates offered by hawala brokers (*hawaladars*) in Pakistan were more attractive than those offered by banks—the so-called kerb premium. Overseas Pakistanis began using informal channels to send money to their families, as a result of which official remittances declined gradually throughout the 1990s. By end-FY2001, the share of remittances (official) fell to only 10 percent of Pakistan's total FX earnings (Figure 2).

A portion of the fall in home remittances during this period was compensated for by the mobilization of foreign currency accounts (FCAs) by commercial banks. Specifically, the Pakistan government liberalized the FX regime in 1991 and allowed residents to open and maintain FCAs with commercial banks operating in Pakistan. Since workers' remittances flowed largely through the informal market, it was easy for residents to purchase hard currency from moneychangers and deposit it in their FCAs.

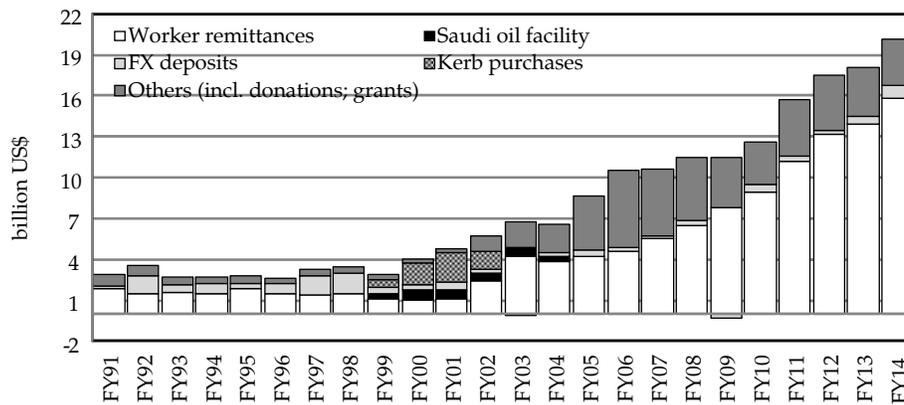
**Figure 2: Pakistan's major FX earnings**



Source: State Bank of Pakistan

In 1998, however, the government had little choice but to freeze FCAs following Pakistan's nuclear tests and subsequent international sanctions. Fresh inflows via FCAs suffered and, as a stop-gap measure, the State Bank of Pakistan (SBP) started to purchase dollars directly from the kerb market. In addition, Pakistan received a Saudi oil facility, which was meant to ease the FX situation by deferring the country's oil import bill (Figure 3).

**Figure 3: Composition of current transfers**



Source: State Bank of Pakistan

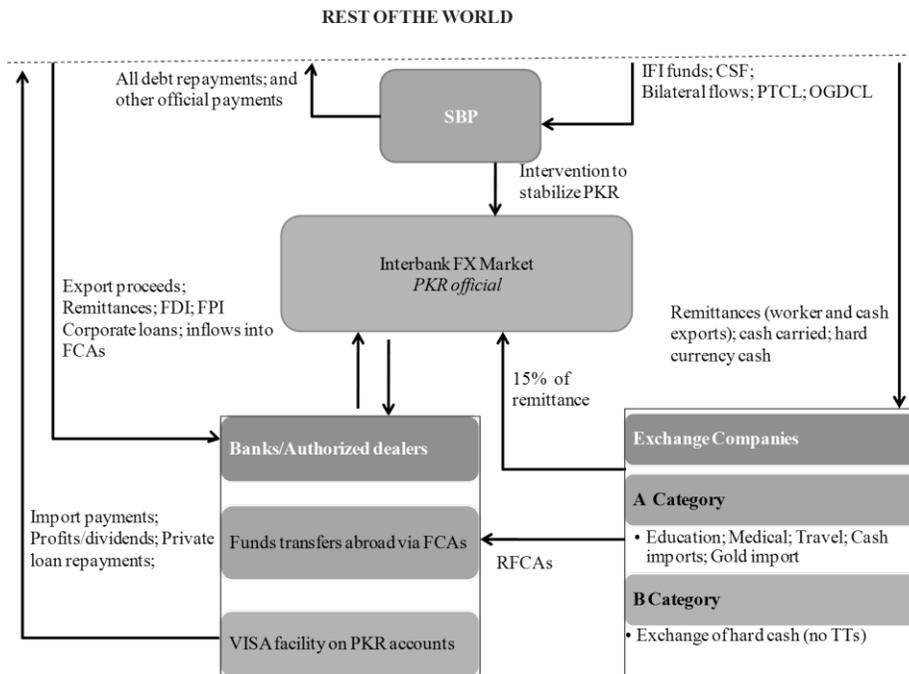
The situation was reversed suddenly after 9/11, following the US-led crackdown on the global hundi/hawala network. Since moneychangers could not execute hawala transactions openly, a large number of Pakistanis

began using official banking channels to send money home. The evidence for this can be seen in the robust growth of official remittances even during the turbulent period after the global financial crisis of 2007/08.<sup>1</sup> Competing against the hundi/hawala network may not have been easy, but the SBP has taken several initiatives to divert a growing share of remittances to formal banking channels.

## 2. The Current Structure of Pakistan's FX Market

Pakistan's FX market can broadly be categorized into three layers, as shown in Figure 4 and described in this section:

**Figure 4: Structure of Pakistan's FX market**



### 2.1. Interbank Market

All approved FX transactions that take place within the banking system are conducted via the interbank market. Major inflows include export proceeds, official home remittances, foreign private investment, funds transferred from abroad through FCAs, and FX purchases from exchange companies. Major outflows include import payments, profit

<sup>1</sup> Between 2004 and 2014, official remittances grew by 15 percent (compound annual growth rate).

repatriation by foreign firms, disinvestments, and funds transferred abroad through FCAs. The demand for and supply of FX in the interbank market determines the interbank or official exchange rate. It is important to point out here that government-related transactions do not affect the interbank market because they are conducted directly using SBP reserves. Therefore, loans from international financial institutions (such as the International Monetary Fund or the World Bank), bilateral flows (e.g., from Saudi Arabia and China), coalition support funds, and privatization proceeds (such as from the Pakistan Telecommunication Company Ltd and the Oil and Gas Development Company Ltd) affect only SBP reserves and do not enter the interbank market. Similarly, the interbank market remains immune to official FX outflows such as debt repayments.

That said, the level of SBP reserves and official transactions therein do have an impact on the interbank exchange rate through the sentiments of market participants (mainly exporters and importers). Specifically, the level of SBP reserves is perhaps the most important indicator of the country's resilience to external shocks. Furthermore, FX reserves determine the extent to which the SBP can intervene in the interbank market when exchange rate movements become volatile. Therefore, if the level of SBP reserves is too low (based on an adequacy criterion), the Pakistan rupee may come under speculative attack in the interbank market.

## **2.2. *Kerb Market***

The kerb market comprises mainly exchange companies (moneychangers). Major inflows include workers' remittances and dollar purchases from the public (see Section 3). Major outflows include hard currency bought for medical, travel, and education purposes, either in the form of hard cash or telegraphic transfers and demand drafts.

Broadly speaking, the public deals with exchange companies, rather than banks, when selling or buying FX. For instance, an individual who wishes to purchase US dollars in cash to pay his or her child's college fee or a medical bill or for travel expenses abroad will approach an exchange company. Similarly, Pakistanis returning from abroad with US dollars in cash will sell these to exchange companies for Pakistani rupees. The open market exchange rate is determined by the demand for and supply of dollars in the kerb market. The spread between the interbank and open market exchange rates is typically known as the kerb premium.

### **2.3. Hawala Brokers**

Hawala is the informal FX market based on the network of hawala brokers located in the Middle East, the Indian Subcontinent, Africa, and even the US and UK. Since this system is based solely on mutual trust and social networks, it is not regulated and is conducted by a large number of brokers. There is no physical movement of currency on spot, as claims are settled after netting out opposing transactions. Even with the existence of exchange companies, the hawala network remains operational in Pakistan.

### **3. A Primer on the Kerb Market**

Exchange companies were established in 2002 to bring informal moneychangers into the mainstream financial system (SBP, 2002). These companies were required to register with the Securities and Exchange Commission of Pakistan and then apply to the SBP for a license to commence operations. The SBP issued rules and regulations authorizing these companies to deal in foreign currency notes, coins, postal notes, money orders, bank drafts, travelers' checks, and transfers. The minimum paid-up capital for an exchange company was set at PRs 200 million.

In June 2004, the SBP also allowed the formation of 'B' category exchange companies, which were authorized to deal only with the sale and purchase of cash FX, not FX transactions (including through banks, such as wire transfers or noncash instruments). The minimum paid-up capital for these companies was set at PRs 25 million. 'B' category exchange companies are required to sell their FX holdings at the end of the day either to other 'B' category exchange companies, to full exchange companies, or to banks, so that they carry no overnight exposure.

#### **3.1. How Exchange Companies Remit FX**

Exchange companies can remit money either through telegraphic transfers and demand drafts or through global money transfer organizations such as Western Union, MoneyGram, and Xpress Money. Although exchange companies were initially allowed to hold nostro accounts with exchange companies abroad,<sup>2</sup> in 2006, the SBP made it mandatory for all such companies to hold nostros only with Pakistani banks abroad. Later, in 2008, exchange companies were disallowed from holding nostros abroad and directed to execute all transactions through

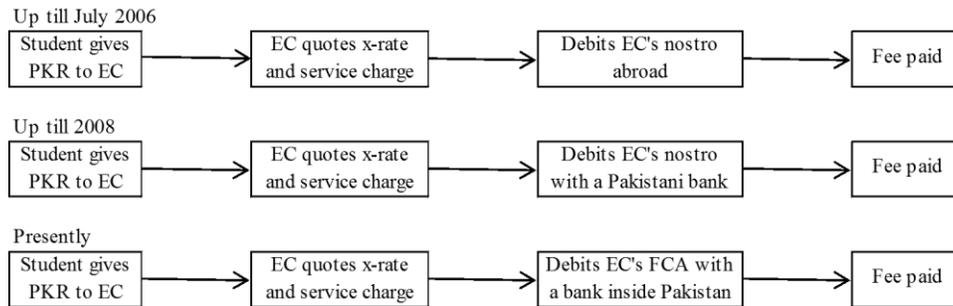
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<sup>2</sup> A nostro is an account held in a foreign country by a domestic bank (in a foreign currency) to facilitate the settlement of FX and foreign trade.

their FCAs with commercial banks in Pakistan (SBP, 2006, 2008a, 2008b). Figure 5 shows the difference in accounting treatment of a single transaction during these periods.

Similarly, the remittances business is conducted through exchange companies' FCAs held with banks operating in Pakistan. For instance, if an exchange company collects FX remittances through Western Union, the corresponding bank (on intimation from Western Union) will credit the exchange company's FX account and debit Western Union's FX account. To make payment to the beneficiary, the company will withdraw FX from its own account, convert it into Pakistani rupees by selling the FX either to a bank or other exchange company, and pay this to the beneficiary.

**Figure 5: Student paying his/her fee in FX through an exchange company**



Thus, whenever the demand for FX increases in the kerb market, exchange companies make withdrawals from their FCAs to close the demand-supply gap. However, commercial banks are not always in a position to ensure the physical supply of dollars since they keep most FX in their nostros instead of holding cash. When hard cash is in demand, it has to be physically transported to Pakistan from the country where the nostros are held—this incurs not only transportation and insurance costs for the bank, but also the foregone return during the travel time (normally two days).

Exchange companies are required to sell 15 percent of their inward remittances to commercial banks and submit the details of daily inflows and outflows under assigned categories to the SBP. In addition, they are required to bring a minimum of 25 percent of the FX they export to the FCAs they maintain with banks in Pakistan on an ongoing basis. Of this 25 percent, the companies are required to sell at least 10 percent in the interbank market.

### 3.2. Size of Exchange Companies

Although exchange companies submit daily reports on their FX inflows and outflows to the SBP, a portion of their activities remains undisclosed. There appear to be two key reasons for this. First, this parallel FX market caters to the FX requirements of a large informal economy, the size of which is estimated to be between 50 and 100 percent of the documented economy. The clients of this market are individuals and businesses who (i) wish to avoid disclosing their income and wealth to the tax authorities, (ii) avoid documentation and proper accounting of their transactions, (iii) want to invest abroad without disclosures, and (iv) are involved in smuggling and other illegal activities that cannot be transacted through a bank (see Section 2).

Second, it may also suit exchange companies to disclose less in order to avoid higher capital requirements. The guidelines for these companies limit their exposure at the close of each business day to a level not higher than 50 percent of their capital base, which caps the FX exposure allowed to exchange companies.<sup>3</sup> In addition, most of their declared transactions are not properly categorized—broadly, over 70 percent of their FX sales to individuals are categorized as ‘others,’ which makes it hard to single out major usage. This is mainly because exchange companies are not required to follow know-your customer (KYC) rules if the underlying transaction value is less than US\$ 2,500.<sup>4</sup> Therefore, if a customer makes a transaction within the prescribed limit, the exchange company will neither ask for his or her credentials nor document the purpose of the transaction. Anecdotal evidence suggests that these companies execute a large number of such transactions, but the volume per transaction remains small.

## 4. The Main Sources of FX in the Kerb Market

This section looks at the key sources of FX inflows (remittances from Pakistani workers overseas and inflows from Afghanistan).

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<sup>3</sup> The method for determining exposure is the same as prescribed for banks, i.e., the higher of the overbought or oversold positions at the close of day.

<sup>4</sup> For currency exchange transactions exceeding US\$ 2,500 (or the equivalent in other currencies), customers must provide their name, address, and national identity card number on the receipt after due verification (SBP, 2013). At the time of establishment, exchange companies were required to follow the KYC rule only when a transaction exceeded US\$ 10,000. However, in 2008, this limit was subsequently lowered to US\$ 5,000 (SBP, 2008a). In July 2013, it was further lowered to US\$ 2,500 in order to strengthen the AML/KYC regime of the exchange companies sector (SBP, 2013).

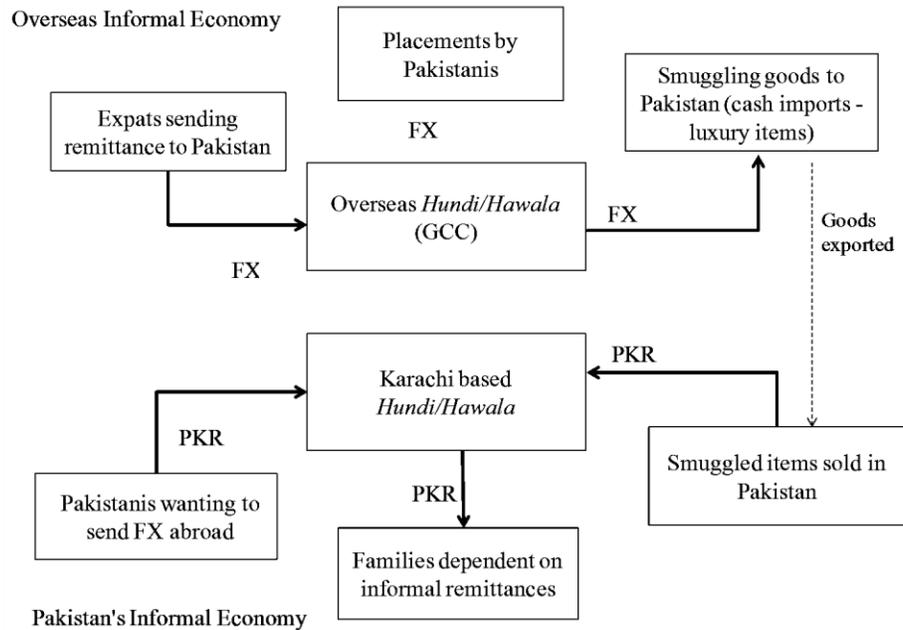
#### **4.1. Home Remittances**

Exchange companies also procure FX in the form of official home remittances. As mentioned before, these companies can use only the FCAs they hold with local commercial banks to send and receive FX. However, since exchange companies are the only source through which the public is able to exchange hard currency, it is possible that individuals involved in hawala transactions also sell cash FX to these companies.

Hawala is used primarily by those Pakistani workers who are either uncomfortable using banking services or do not know how. Instead, they rely on word-of-mouth to send money home securely and quickly. Similarly, hawala is the only option available to illegal migrants living abroad who cannot use banks or global money transfer organizations to send money home. Hawala also ensures the speedy receipt of money in remote areas in Pakistan, where banking services are not easily available.

The informal market for money transfers thrives on the basis of faster, cheaper, efficient, and convenient flows of remittances into the country. This market has attracted Pakistani workers because it allows immediate and hassle-free delivery to the recipient at their doorstep. When remittances come through the hawala system, this does not necessarily imply a realtime FX inflow into the country. Given the double coincidence of wants, those transactions are netted out (in the Gulf countries) and only the rupee counterpart is delivered to the beneficiary in Pakistan.

Figure 6 illustrates how money might be sent from the UK to Pakistan. In this case, there is a physical movement of currency within the country, but no movement of currencies across borders. For example, the hawaladar in the UK receives GBP 100 from the sender (a client), who then instructs the corresponding hawaladar in Pakistan to deliver the equivalent in Pakistani rupees to the beneficiary. Thus, there is no immediate physical movement of pounds sterling.

**Figure 6: Hawala transactions flowchart**

Simultaneously, a client in Pakistan who imports electronics and personal goods worth GBP 80 from the UK may not want this transaction documented. While the goods will be brought in physically by a *khepia* (a professional traveler who carries the goods as personal items), the payment for this transaction will be carried out through the same hawala brokers. The hawala broker will collect the Pakistani rupees from the *khepia* after the goods have been sold in Pakistan, and instruct the hawaladar in the UK to remit the amount in pounds sterling to the counterparty. Since hawaladars cater to a large number of people—some of who send money and some of who receive—instead of physically executing every transaction across borders, they settle only net commitments. In the example above, the two hawala brokers will settle only GBP 20 instead of executing two transactions totaling GBP 180.

At the time of settlement, if there is an FX inflow to Pakistan, it will remain outside the banking system unless it is deposited in an FCA and/or sold to an authorized dealer.<sup>5</sup> Similar to other individuals, hawala brokers

<sup>5</sup> Although FX inflows through these channels declined considerably after the post-9/11 crackdown on the global hawala network, the volume of inflows remains significant. Remittances used to be the major FX source in the kerb market, but in recent years, they account for an estimated 25–30 percent of total FX inflows into the kerb market.

may also approach exchange companies to exchange FX in cash for Pakistani rupees.<sup>6</sup>

#### ***4.2. Inflows From Afghanistan***

Cordesman (2012) argues that there is no reliable estimate of total international aid flows to Afghanistan, mainly because a significant portion of this aid does not pass through the Afghan central government. However, keeping in view the figures provided by the Congressional Research Services and the Office of Money and Budget, Cordesman estimates that US overall direct spending in Afghanistan reached US\$ 641.7 billion during FY2001–2013, of which US\$ 198 billion was to be spent only in 2012 and 2013. This spending was carried out with limited controls and auditing, and part of the money was reportedly smuggled out of the country to Dubai and Iran—mostly via Pakistan.

### **5. Major Uses of FX Sourced From the Kerb Market**

This section describes the main sources of FX from the kerb market: payment for unofficial imports, gold imports, and capital flight (see also Figure 7).

#### ***5.1. Payments for Unofficial Imports***

A wide range of goods is smuggled into Pakistan, including fabric, electronics, personal care items, tyres, and readymade garments. Similarly, some goods are smuggled out of Pakistan, e.g., precious stones, cotton fabric, vegetables, jewelry, and wheat flour. Cross-border smuggling with China, India, Afghanistan, and Iran involves the physical movement of goods as well as the physical exchange of FX, primarily through the hawala network. Anecdotal evidence suggests that a significant portion of imports from China is financed by purchases from the kerb market, primarily to avoid import duties, taxes, and transaction costs.<sup>7</sup>

In the case of Dubai, Thailand, and Indonesia, goods are smuggled by assigning a large number of khepias to physically transport the goods and FX across borders. FX can be taken out of the country either in the

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<sup>6</sup> Interestingly, hawala settlements can also involve a third party (country). For instance, in the above example, instead of sending GBP 20 to Pakistan, this sum may be used to settle payments due from Pakistan for the informal import of certain products from China.

<sup>7</sup> The transaction cost in the formal channel may arise at various stages: securing import/export licenses, procedural delays at customs, processing costs, and margin requirements at banks.

form of “export of currency”<sup>8</sup> or by using the US\$ 10,000 per passenger limit. In exchange for this currency movement, the khepias bring fabric, readymade garments, electronics, toys, shoes, and other consumer items to be sold in the domestic market.

### **5.2. Gold Imports**

All FX payments related to the import of gold are directed through the kerb market since banks are not allowed to make such payments. Customs data estimate the import of gold at US\$ 346 million in FY2013, payment for which was made via cash dollars bought from exchange companies. However, it is estimated that roughly 50 percent of gold imports is not reported to customs to avoid stringent regulations; the associated demand for dollars from exchange companies was, therefore, much larger than the recorded value. Over 90 percent of this gold is imported from Dubai.

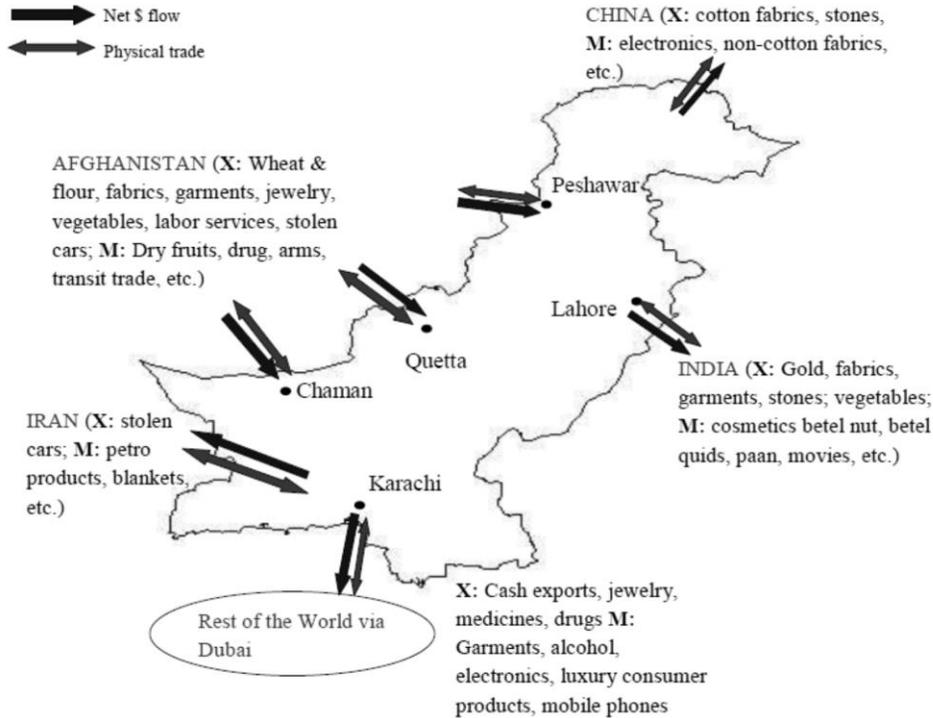
### **5.3. Capital Flight**

As mentioned above, given the easily accessible hawala network and liberal FX regime, a large volume of FX tends to leave the country as a norm. Not all this amount is used for smuggling; corruption money also makes its way abroad through these channels. A significant amount is also used for investments abroad.

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<sup>8</sup> The SBP allows exchange companies to physically export all currencies (except the US dollar) in surplus and bring back US dollars against these. We have learned that these consignments are under-invoiced: the actual value of FX leaving the country exceeds the amount that is declared.

Figure 7: Cross-border movement of FX and goods



## 6. Concluding Remarks

Several points are worth making when focusing on the macro-economy within a historical context.

First, workers' remittances should be viewed as export receipts. However, since what are being exported are labor services, which are not routed through the banking system (unlike other exports), it is very difficult to ensure that all such receipts are realized by the formal economy or the country at large. The sharp growth in remittances after 9/11 and their persistent growth during the global financial crisis of 2007/08 is sufficient proof that remittances are channeled increasingly through formal institutions.

Second, Pakistan's export of human resources is increasing in net terms, which means that the flow of remittances should continue to increase. So, even as Pakistan's economy continues to underperform, this avenue of FX revenues should remain robust. It is also important to realize that remittances do not depend on the goodwill of expatriate Pakistanis or

the state of the economy; they are a robust source of FX and, arguably, countercyclical to the performance of the domestic economy.

Given that exchange companies have evolved from moneychangers, they retain a close operating relationship with the global hundi/hawala network. Although regulated by the SBP, it is very difficult for exchange companies to sever their link with the hawala network (or the range of services it provides). As all policymakers know, it is virtually impossible to halt the services of a parallel market that offers a service for which there is a vibrant demand.

One must also consider the role of regional developments in Pakistan's FX market. There is a great deal of speculation concerning charitable flows from the Middle East that are used to fund local seminaries and the heavy inflow of cash dollars from Afghanistan. With the exit of NATO troops from Afghanistan in late 2014 and changing attitudes in Pakistan, there is some concern that these sources of hard currency may shrink. Looking at these as two components that make up the supply of hard currency flowing into Pakistan, it would either force domestic demand to fall or, more likely, increase the premium in the kerb market. However, since the kerb premium is quasi-formal—in the sense that exchange companies' rates are tracked by the SBP—it is unlikely to increase much without being investigated.

This suggests that, even if the kerb premium is contained, most underlying transactions could slip into the hundi/hawala network and threaten to segment Pakistan's FX market as it was before 9/11. However, given the emphasis on KYC in the country's financial system and ongoing international oversight to identify terrorist funding, such a situation is highly unlikely. Having said that, both the SBP and the government will have to remain vigilant in guarding against this.

Given the concentration of wealth in the country and the poor level of documentation, it is safe to say that urban Pakistanis are far richer than official statistics would suggest. The availability of high-end consumer products that are imported against cash payments and the quantum of Pakistani wealth held abroad implies that cash imports and capital flight are facts of life in the country. What is less well known is that these have been financed largely by remittances that were not realized by official channels (i.e., banks and exchange companies).

Conservative market estimates put total Pakistani remittances at about US\$ 18–20 billion per annum as against the US\$ 15 billion realized in FY2014. If Pakistan was able to channel a larger fraction of these remittances through formal avenues, the current account deficit could easily become a surplus.<sup>9</sup> With policy efforts to attract a larger fraction of remittances through the formal system or by incentivizing expatriate Pakistanis to save in Pakistan (via special investment schemes), the external sector should no longer be a source of concern. The resulting stability of the rupee and the growth in FX reserves would go a long way in boosting Pakistan's growth prospects.

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<sup>9</sup> As a matter of principle, for countries such as Pakistan that are large exporters of human resources, it is the current account gap, not the trade deficit, which should be a policy concern.

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