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# The Regulation of Hawala and other IVTS in Post 9/11 Years: A Case Study of Pakistan's Hawala Regulation 2002

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***The Regulation of Hawala and other IVTS in Post 9/11Years: A  
Case Study of Pakistan's Hawala Regulation 2002***

A thesis submitted in fulfillment of the requirement for the award of the  
degree

Doctor of Philosophy

from

The University of Wollongong

by

Shumaila Kafeel Siddiqui

School of Law

2014

## **Certification**

I, Shumaila Kafeel Siddiqui, declare that this thesis, submitted in fulfillment of the requirements for the award of Doctor of Philosophy, at the School of Law, University of Wollongong, is wholly my own work, unless otherwise referenced or acknowledged below. The document has not been submitted for qualifications at any other academic institution.

Shumaila Kafeel Siddiqui

May 2014

(resubmitted with minor revisions in November 2014)

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## List of Terms and Abbreviations

AML	Anti Money Laundering
APGML	Asia Pacific Group on Money Laundering
APTTA	Afghanistan Pakistan Transit Trade Agreement
ARS	Alternative Remittance Systems
ATT	Afghan Transit Trade
<i>Bara</i>	Market selling smuggled goods
CDD	Customer Due Diligence
CFT	Countering Financing of Terrorism
<i>Chamak</i>	Meaning ‘glitter’ in English: a pool of funds <i>hawaladar</i> collects abroad and uses for payments and settlement
<i>Chowk Yadgar</i>	Foreign Currency and Money Transfer Market in Peshawar City close to the Pakistan-Afghanistan border
<i>Darra Adam Khel</i>	Town near FATA
FATA	Federally Administered Tribal Areas
FATF	Financial Action Task Force
FBR	Federal Board of Revenue
FCR	Frontier Crimes Regulation
FERA	Foreign Exchange Regulations Act
FIA	Federal Investigation Agency
FIU	Financial Intelligence Unit

FR	Frontier Region
<i>Hadith</i>	[Arabic] ‘saying of Prophet Muhammad’
<i>Hawala</i>	from Arabic meaning ‘to transfer’; method of informal money transfer
<i>Hawaladar</i>	<i>Hawala</i> operator
HOSSP	<i>Hawala</i> and Other Similar Service Providers
<i>Hundi</i>	from Sanskrit meaning ‘to collect’; method of informal money transfer
IDP	Internally Displaced Person
IFTS	Informal Fund Transfer Systems
IMF	International Monetary Fund
IVTM	Informal Value Transfer Methods
IVTS	Informal Value Transfer Systems
<i>jihad</i>	[Arabic] ‘struggle in the way of Allah’; in Islamic warfare a holy war
<i>Jirga</i>	Tribal Council of Elders
KPK	Khyber Pakhtunkhwa (Province in Northern Pakistan bordering Afghanistan)
KYC	‘Know Your Customer’
<i>Landi Kotal</i>	Tribal Town in FATA
<i>Malik</i>	[Arabic] ‘tribal elder’
MEC/EC	Money Exchange Company

Memon	Ethnic South Asian community from Sindh and Indian Gujrat (often merchants and traders)
MSB	Money Service Business
<i>Muhajir/Mohajir</i>	[Arabic] ‘immigrant’
<i>Mujahid</i>	[Arabic] ‘one who does jihad’
MTO	Money Transfer Organization
NAB	National Accountability Bureau
NBP	National Bank of Pakistan (large commercial bank)
Pashtun/Pakhtun	Ethnic Afghan (in Afghanistan) or Pathan (in western Pakistan) people
PERA	Protection of Economic Reforms Act
<i>Saraf</i>	[Farsi] ‘money changer’
SBP	State Bank of Pakistan
SR	Special Recommendation
SRO	Statutory Regulatory Order
Taliban	[Arab/Pushto] ‘students’ — an Islamic Fundamentalist Political Movement that originated in Afghanistan in the 1990s and enforced strict Islamic laws
UNODC	United Nations Office on Drugs and Crimes
UOW	University of Wollongong
US	The United States of America (especially when used as an adjective)
WRT	Wholesale and Retail Trade



## Abstract

In 2002, the State Bank of Pakistan (SBP) created Money Exchange Companies with the aim to create a well-documented, corporatized foreign exchange market in order to eliminate the informal, undocumented and illegal *hawala*. This has not happened. The purpose of this research was to investigate why the 2002 reforms have failed to eliminate *hawala* in Pakistan. It is a descriptive case study analysis, which has relied on both primary and secondary data sources. The secondary data comprised the available literature and other published sources while primary research data was gathered by conducting semi-structured interviews with the various *hawala* market stakeholders so as to describe the ‘on the ground’ implementation of the reforms and explain the operational dynamics of the market in the post reform years. It was found that despite the 2002 reforms two types of *hawala* markets are functioning in Pakistan. One comprises exchange companies, their dealers and agents and the other is ‘pure *hawala*’ in Pakistan-Afghanistan border cities. It was also found that the formally regulated exchange companies and the unregulated *hawala* market are closely integrated, having domestic and international networks. Moreover, the project that the SBP initiated to counter *hawala*’s inherent incentive is mired in scandal and corruption in which billions have allegedly been doled out from the public exchequer as a result of alleged collusion between commercial banks and officials of the SBP. The 2002 reforms were fundamentally ill-conceived and introduced without taking steps that were required to mitigate the impact of those factors that directly challenge *hawala* regulation in Pakistan. These include the existence of a Frontier Crimes Regulation that excluded the Federally Administered Tribal Areas, the shadow economy and its criminal elements, rampant tax evasion, ineffective and overriding legislation and corruption and tax evasion by the Pakistani elite. Failure to address these factors led to the failure of the 2002 reforms.

Funds which are generated through tax evasion and corruption constitute a large part of Pakistan’s shadow economy and are subsequently siphoned off through the use of *hawala*. The Pakistani ruling governments are unwilling to take action to introduce fundamental taxation reforms as the majority of the elected politicians do not themselves pay income tax. An active role by the international donors who could have used their substantial influence to push the Pakistani ruling elite for essential reforms has remained elusive.

The integration of *hawala* in today's globalized world is due to disparities and irregularities in international trade as well as repressive and restrictive government policies. Regulations that attempt to control *hawala* with the reporting and compliance standards applicable to banking and other formal structures could not produce successful results in mitigating the risks of abuse of the informal transfer systems as long as policy prescriptions do not consider the salient features of *hawala*-type informal systems that make them a preferable choice in the different geographical, economic and cultural realities. In Pakistan's case, the 'dual function' of *hawala* — channelling development finance to the poor and the underserved as well as facilitating illicit financial flows — is the critical policy factor that needs to be considered for effective regulation of these informal transfer systems. Whilst Pakistan's peculiar geo-political situation and administrative and institutional issues require a multi-track *hawala* regulatory strategy, the weak and failing Pakistani state lacks the capacity to undertake multifarious regulatory responsibilities. The SBP therefore, needs to review its *hawala* regulatory strategy from that of one which views *hawala* as completely outlawed to a more inclusive one by bringing the *hawaladars* into the legal network by offering them suitable incentives.

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**1.1 Current Interest in *Hawala***

‘*Hawala*’ is one type of a number of Informal Value Transfer Systems<sup>1</sup> (‘IVTS’) that came under public scrutiny after the September 11, 2001 terrorist attacks on the United States (‘9/11’) and in the context of the US led ‘War on Terror’.<sup>2</sup> It could be argued that the increased international interest in *hawala* is largely driven by the global efforts toward countering terrorism financing.<sup>3</sup> However, 9/11 is not the starting point of international interest in *hawala*. The starting point for the interest of international organizations and financial regulatory agencies in *hawala*-type informal transfers was in the mid 1980s when efforts were being made to tighten the control and regulation of financial crimes such as money laundering.<sup>4</sup> This in turn was part of the global response, driven by the United Nations, to combat the illicit sale of narcotic and psychotropic drugs.<sup>5</sup> Around the same time, the international development agencies such as the World Bank and the IMF noticed that large volumes of remittances were being transferred by migrant workers working in the high-income economies of the West and the North through the use of informal transfer channels to their countries of residence, mostly in the low and middle-income economies of the South and the East.<sup>6</sup> They also suspected that the volume of these transfers might surpass, if recorded, other (formal) inflows such as development aid and foreign direct investment to these countries.<sup>7</sup> Hence, initial interest in IVTS can be attributed to both these

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<sup>1</sup> *Hawala* and IVTS are used interchangeably throughout the thesis. *Hawala* is one of the many IVTSs that have developed over time. These ‘arrange for transfer and receipt of funds or equivalent value and settle through trade, cash, and net settlement over a long period of time’ and are distinguished by ‘their use of non bank settlement methods’: FATF, *The Role of Hawala and Other Similar Service Providers in Money Laundering and Terrorist Financing* (3 December 2013) <<http://www.fatf-gafi.org/topics/methodsandtrends/documents/role-hawalas-in-ml-tf.html>>. The equivalence of these IVTS is noted in FATF’s reference to them as ‘*Hawala* and Other Similar Service Providers’ (HOSSPs). See Chapter 2 for detailed explanation.

<sup>2</sup> Following 9/11, President Bush addressed a joint session of the US Congress and the nation on 20 September 2001, and rallied support for ‘War on Terror’. For transcript of complete speech see Media Mill Works, ‘Text: President Bush Addresses the Nation’, *Washington Post*, 20 September 2001 <[http://www.washingtonpost.com/wp-srv/nation/specials/attacked/transcripts/bushaddress\\_092001.html](http://www.washingtonpost.com/wp-srv/nation/specials/attacked/transcripts/bushaddress_092001.html)>.

<sup>3</sup> See Thomas J Biersteker and Sue E Eckert (eds), *Countering the Financing of Terrorism* (Routledge, 2008).

<sup>4</sup> See Mark Pieth (ed), *Financing Terrorism* (Kluwer Academic, 2002).

<sup>5</sup> *Ibid.*

<sup>6</sup> Paul Allan Schott, *Reference Guide to Anti Money Laundering and Combating the Financing of Terrorism* (World Bank 2<sup>nd</sup> ed, 2006).

<sup>7</sup> Dilip Ratha, ‘Workers’ Remittances: An Important and Stable Source of External Development Finance’ in World Bank, *Global Development Finance* (The World Bank, 2003).

factors. Subsequently, in the early 1990s, globalization of international trade and finance and technological advancements that radically increased the speed with which capital, goods and labour can be moved around the globe along with equally radical reductions in the cost of so doing has created a ‘borderless world’,<sup>8</sup> particularly when it comes to the instantaneous electronic movement of funds across the globe.<sup>9</sup> All of these factors have raised interest in the use of IVTS and highlighted the need for research into the mechanisms used and the effects of such transactions. On the other hand, the informality of value transfers allegedly ‘outside’ the conventionally regulated banking and financial systems raises regulatory alarms particularly when the use of IVTS are viewed in conjunction with international efforts towards financial regulation and transparency. The informal ways through which value or funds may be transferred has become a regulatory concern as the IVTS are believed ‘to exploit ... vulnerabilities in financial systems that allow for an inappropriate level of anonymity and non-transparency in the execution of financial transactions’.<sup>10</sup>

## 1.2 Regulatory Efforts to Counter IVTS

The United Nations *Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances 1988*<sup>11</sup> was the first international legal instrument which contains provisions combating financial crimes such as money laundering, although it does not use the specific term. The United Nations *Convention for the Suppression of the Financing of Terrorism 1999* had recognized the need to deal with terrorism financing but had not received widespread support until 9/11.<sup>12</sup> Following 9/11, in the context of the war on terror, far reaching new regulation of financial institutions and transactions has been put in place in order to detect and prevent the financing of terrorism and money laundering more

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<sup>8</sup> Janet Ceglowski, ‘Has Globalization Created a Borderless World?’ *Business Review* (March/April 1998)17–22.

<sup>9</sup> Jonathan M. Winer, ‘Globalization, Terrorist Finance, and Global Conflict: Time for a White List?’ in Mark Pieth (ed), *Financing Terrorism* (Kluwer Academic, 2002)5–40.

<sup>10</sup> International Monetary Fund, *Fact Sheet: The IMF and the Fight against Money Laundering and the Financing of Terrorism* (30 September 2013) <<http://www.imf.org/external/np/exr/facts/aml.htm>>.

<sup>11</sup> *Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances*, opened for signature 20December 1988, 1582 UNTS 95 (entered into force 11 November 1990).Subsequently referred to as the ‘*Vienna Convention*’.

<sup>12</sup> While only 41 nations had signed prior to 9/11, many signed in the immediate aftermath of the 9/11 attacks and rapidly ratified the Convention.

generally. These efforts towards establishing global standards, also referred to as Anti Money Laundering/Countering Financing of Terrorism AML/CFT regulations, are considered essential to protect the integrity of markets and the global financial framework as they mitigate the factors that facilitate financial abuse. The World Bank defines ‘money laundering’ as, ‘a process by which the illicit source of assets obtained or generated by criminal activity is concealed to obscure the link between the funds and the original criminal activity’.<sup>13</sup> ‘Terrorism financing’ refers to ‘raising and processing of funds to supply terrorists to carry out their attacks’.<sup>14</sup> The two phenomena are completely different; yet they are believed to exploit similar vulnerabilities in the financial systems and use similar techniques.<sup>15</sup> For this reason, the *Convention for the Suppression of the Financing of Terrorism 1999*, and United Nations Security Council Resolutions 1373 and 1267 impose obligations on Member States to take measures to protect their financial systems from being misused. Moreover, the United Nations *Convention against Transnational Organized Crime 2003* and the *United Nations Convention against Corruption 2005* are legal instruments that broaden the scope of the money laundering offence beyond the proceeds of drug trafficking to include all serious crimes. These Conventions urge ‘Member States to create comprehensive domestic supervisory and regulatory regime for banks and non-bank financial institutions, including natural and legal persons, as well as any entities particularly susceptible to being involved in a money laundering scheme’.<sup>16</sup> Under the obligations of these Conventions, Member States are called to ensure effective regulation through establishment of Financial Intelligence Units (FIUs).

The primary policy-making body responsible for developing worldwide standards for AML and CFT is the Financial Action Task Force on Money Laundering (FATF), currently a 36 member intergovernmental body established by the 1989 G-7 Summit in Paris. In 1990, FATF published Forty Recommendations on Money Laundering and in the aftermath of the

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<sup>13</sup> Schott, above n 6, 1.

<sup>14</sup> Ibid.

<sup>15</sup> Ibid.

<sup>16</sup> United Nations Office on Drugs and Crime (UNODC), *UN Instruments and Other Relevant International Standards on Money-Laundering and Terrorist Financing*, UNODC<<http://www.unodc.org/unodc/en/money-laundering/Instruments-Standards.html?ref=menuaside>>. See, eg, *Convention against Transnational Organized Crime*, opened for signature 15 November 2000, 2225 UNTS 213 (entered into force 29 September 2003) art 7; *Convention against Corruption*, opened for signature 31 October 2003, 2349 UNTS 41 (entered into force 14 December 2005) art 14.

2001 attacks, a further Eight Special Recommendations on Terrorism Financing were added with a Ninth Special Recommendation (on cash couriers) subsequently added in 2004. Collectively, these are called the FATF 40+9 Recommendations, and set out a framework of measures to bring about legislative and regulatory reforms in areas such as the criminal justice system, the financial sector, certain non-financial businesses and professions, and other mechanisms of international cooperation.<sup>17</sup> The FATF works in cooperation with other international organizations such as the United Nations, IMF, World Bank, Asian Development Bank and regional FATF-style bodies such as the Asia Pacific Group on Money Laundering (APGML). These organizations work to develop international AML/CFT policies, conduct financial sector assessments, provide technical assistance in the financial sector and exercise surveillance over member countries' economic systems in order to evaluate countries' compliance with the international AML/CFT standards.

An important component of the work of these organizations is the study of methods, techniques and trends within financial systems that may be used for financial crimes such as money laundering and terrorism financing. Since IVTS is an important area, FATF's Special Recommendation (SR) VI<sup>18</sup> on Alternative Remittance Systems reads:

Every country should take measures to ensure that persons or legal entities, including agents that provide a service for the transmission of money or value, including transmission of money or value through an informal money or value transfer system or network, should be licensed or registered and subject to all the FATF Recommendations that apply to banks and non-bank financial institutions. Each country should ensure that persons or legal entities that carry out this service illegally are subject to administrative, civil, or criminal sanctions.

### **1.3 Results of *Hawala* Regulation**

In pursuance of FATF's AML/CFT standards, during the past decade various countries and jurisdictions in the world have attempted compliance by introducing reforms in their

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<sup>17</sup> FATF Recommendations 1996; 2003; 2001; 2012.

<sup>18</sup> Financial Action Task Force on Money Laundering (FATF), *Combating the Abuse of Alternative Remittance System: International Best Practices (SR-VI)*, (2003)

<<http://www.fatfgafi.org/documents/documents/internationalbestpracticescombatingtheabuseofalternativeremittancesystemssrvi.html>>.

financial systems to ensure increased transparency and more thorough reporting of financial transactions. At the same time, countries have attempted different approaches<sup>19</sup> to regulate the informal value transfer systems. Many countries have involved formal banks in the remittance market and these have introduced better financial products with the aim to disincentivize the informal *hawala*-type transfer channels. It is interesting that despite such concerted efforts at the international as well as national levels, *hawala* still prevails as the most popular choice for its customers. To say that the efforts to regulate *hawala* in various countries during the past decade have largely been unsuccessful would not be an understatement. So far there has been no significant attempt to assess the post 9/11 regulatory efforts that countries have introduced to curb *hawala*-type transfers.

#### **1.4 Aims of the Study**

The research takes Pakistan's *hawala* regulation as a case study with the aim to:

- i) identify and describe the challenges that financial regulators and policy-makers face in regulating *hawala*.,
- ii) clarify our understanding of whether, and if so, how effective these regulatory activities have been, and
- iii) to the extent that the attempts to regulate *hawala* in Pakistan have proved problematic, the thesis aims to explore why is this so? What works and what does not, and why does it matter? From the answers to these questions, better solutions for regulating *hawala* in Pakistan can be developed, which in turn has implications for FATF's legal and regulatory framework that guides international regulation of the *hawala*-type transfer systems.

#### **1.5 Thesis Structure**

In order to achieve the aims of the study, it is imperative to develop an understanding of *hawala*-type systems. Terms and definitions that are used for such systems as well as the various names these systems have in different cultures and locations are explained in Chapter 2 by reviewing the available literature on *hawala*. It then explains the origin of these systems, how and why they have spread far and wide as well as their revival. Next, it

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<sup>19</sup> See Chapter 2.



introduces the issues financial regulators face in dealing with *hawala*-type financial transfers and presents the arguments for the need for regulating these systems. Various approaches that have been introduced to regulate these informal systems are discussed and the problems these approaches face are identified. Finally, the chapter sums up the *hawala* regulation debate by identifying the problem and points to the direction in which the present study will make a contribution to the knowledge gap.

After identifying the purpose of the study, Chapter 3 introduces the methodology used to achieve the stated purpose. In Chapter 3, the choice of a case study methodology for the thesis as well as the conceptual framework of the present research is justified by first explaining the choice of a case study as the methodology and then the selection of Pakistan as the country to be studied. Various stages of the case study design are explained, and research questions and propositions have been justified and data collection sources — both primary and secondary — elaborated. This chapter details the different stages of fieldwork interviews conducted by this researcher in Pakistan in order to verify on the ground results of *hawala* regulation introduced in 2002 by the State Bank of Pakistan. A summary of the findings of the fieldwork interviews detailed in chapter 3 is reflected in Table 1.1 below.

**Table 1.1 Summary of Fieldwork Interviews in Pakistan**

<b>Total Number of Interviewees</b>	<b>37</b>
<b>Interviewees included in the sample</b>	<b>17</b>
<b>Interviewee Groups</b>	<b>4</b>
<b>i) Governance</b> (government officials, investigators, prosecutors, government and market regulators)	<b>09 interviewees</b>
<b>ii) <i>Hawaladars</i></b> (operating in major cities such as Karachi, Peshawar and Islamabad)	<b>02 ---do-----</b>
<b>iii) Other Businesses (ECs, banks)</b>	<b>02 ---do-----</b>
<b>iv) Clients</b> (users of hawala market such as businessmen, traders, parents of students in foreign countries, migrant workers and their families)	<b>04 ---do-----</b>
<b>Interviewee Responses (in categories)</b>	<b>Variables</b>
i) <i>Hawala</i> Market	10
ii) Regulatory Issues	06
<b>Total No of responses</b>	<b>126</b>
<b>Percentage Response</b>	
Indicator 1. <i>Hawala</i> Market	<b>76.98%</b>
Indicator 2. Regulatory Issues	<b>23.02%</b>

From Chapter 4 to Chapter 7, the findings and propositions of the thesis are discussed in detail. In Chapter 4 the scene is set through a description of the case study environment. This chapter acquaints the reader with Pakistan’s geography, political administration and the role of remittances in the economy. It also provides requisite information about the legal

and institutional frameworks that are relevant to *hawala* regulation. The background information provided in this chapter will help the reader understand the need for the reforms that the State Bank of Pakistan introduced in 2002.

Next, the 2002 *hawala* reforms are explained in Chapter 5. After introducing the reforms, the reader is taken into the current market to see whether the 2002 reforms have worked and if there are any ‘on the ground’ changes in the structure and mechanisms of the *hawala* market. Two *hawala* markets (Karachi and Peshawar) are discussed to fully understand the *hawala* dynamics. In order for the reader to better appreciate the ‘inner workings’ of the *hawala* market, the chapter explains the State Bank’s incentive-based initiative as well as law enforcement efforts to curb *hawala*-type transfers.

Chapter 6 discusses the reasons due to which regulation in Pakistan cannot work. Set within the framework of institutional economics, this chapter presents an examination, in game theory terms, of the challenges to *hawala* regulation from the perspective of weak and failed states. It explains that these problems are ingrained in the political economy of Pakistan and include corruption at various levels. This can be seen as both a cause and an effect of the failure of regulation. There is a small minority elite that has used the state resources to its own advantage and continues to ensure protection of vested interests at the cost of state institutions. The chapter also sheds light on Pakistan’s segmented society where laws are difficult to implement and institutions remain weak and non-functional because of a lack of unity and agreement on basic public goods and institutions; and the role of the international donors such as the IMF and the US who despite their influence on successive Pakistani governments have remained weak in requiring actual change. Finally transit trade with Afghanistan and the smuggling economy it has created is discussed. Pakistan Afghanistan transit trade is primarily financed through *hawala* and is relevant to the thesis due to a realization that regulating the *hawala* type informal transfer systems is challenging because settlements are mainly trade-based and *hawala*-type systems prevail due to their competitive efficiency and the equation of supply and demand in the international financial system.

Chapter 7 analyses the policy line adopted by the State Bank of Pakistan in compliance with FATF’s international standards and provides an account of how the regulation has

proven counter-productive. In analysing Pakistan's case, the chapter comes to the position that FATF's policy on *hawala* regulation is essentially misdirected. It addresses policy issues with a view to clarifying thinking about *hawala* regulation and to explore future strategy. Indeed, discussion on the identified propositions throughout the thesis has led the research into offering recommendations for *hawala* regulation based on Pakistan's 'on the ground' realities.

Chapter 8 thus offers concluding remarks and final recommendations for future *hawala* regulation.

## **Chapter 2:**

## **Literature Review**

### **2.1 Introduction**

This chapter reviews the available literature on *hawala* with the purpose of analysing issues faced in the regulation of these systems as well as identifying gaps in current approaches. It gives an overview of the principal arguments and approaches in the available debates on *hawala* regulation. The aims of the literature review are thus to:

- 1) clarify the conceptual understanding of *hawala*, describe various terms and set out and explain the definitions;
- 2) give a historical account of the origin, development and revival of *hawala*;
- 3) examine the operational procedures and characteristics of these systems;
- 4) outline current regulatory approaches, and highlight problems with these strategies;
- 5) set out key issues and challenges; and
- 6) identify the problem statement.

### **2.2 Definitions and Terms**

*Hawala* is defined as ‘an informal channel for transferring funds from one location to another through service providers known as *hawaladars*, regardless of the nature of the transaction and the countries involved’.<sup>20</sup>

In many instances, the informal remittance systems have been referred to as ‘alternative remittance systems’ and ‘underground’ or ‘ethnic banking’. According to Passas,<sup>21</sup> banking (deposit-taking, lending and so on) is hardly ever involved in these transactions, which have been taking place quite openly in several countries for a long time. Many experts also find the term ‘alternative’ ill-chosen or problematic when used to refer to informal remittance systems because in many countries *hawala* and similar informal networks are the

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<sup>20</sup> Mohammed El-Qorchi, ‘Hawala’ (2002) 39 (4) [IMF] *Finance and Development* 31, 31.

<sup>21</sup> Nikos Passas, ‘Informal Value Transfer Systems and Criminal Organizations: A Study into So-Called Underground Banking Networks’ (Working Paper, Netherlands Ministry of Justice, 14 December 1999) <<http://ssrn.com/abstract=1327756>> (‘IVTS and Criminal Organizations’).

conventional or sole option available for all legitimate transfers.<sup>22</sup> Examples of such countries are Afghanistan and Somalia where these systems are not only used by residents but also by many aid organizations and other international agencies actively working in these regions. Moreover, use of the terms ‘alternative remittance systems’ and ‘underground banking’ is also found inappropriate for *hawala*-type informal systems because, in many cases, it is value rather than money that is transferred from place to place.<sup>23</sup>

In order to introduce conceptual clarifications regarding the informal transfer systems, Passas has introduced the term Informal Value Transfer Systems (IVTS) to define *hawala* and other informal transfer systems as, ‘any network or mechanism that can be used to transfer funds or value from place to place either without leaving a formal paper-trail of the entire transaction or without going through regulated financial institutions at all’.<sup>24</sup> In defining IVTS, Passas and others have drawn a distinction between its two types: ‘Informal Fund Transfer Systems’ (IFTS) where a fund transfer is originated transferred and delivered as a financial asset,<sup>25</sup> and ‘Informal Value Transfer Systems’ (IVTS) where value is transferred. There are also transfers that may include a combination of both funds and value, through the use of (mostly) illegal methods which are referred as ‘Informal Value Transfer Methods’ (IVTM). Passas has drawn analytical distinctions between IVTS/IFTS and IVTM based on their characteristics.<sup>26</sup> This is reflected in Table 2.1 below:

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<sup>22</sup> Samuel Munzele Maimbo, *The Money Exchange Dealers of Kabul: A Study of the Informal Funds Transfer Market in Afghanistan* (Working Paper No.13, World Bank, August 2003).

<sup>23</sup> Ibid 2.

<sup>24</sup> Nikos Passas, ‘Financial Controls of Terrorism and Informal Value Transfer Methods’ in Henk van de Bunt, Dina Siegel and Damian Zaitch (eds), *Transnational Organized Crime: Current Developments* (Kluwer, 2003)149 –158, 149.

<sup>25</sup> Nikos, Passas, ‘Informal Value Transfer Systems, Terrorism and Money Laundering’ (A Report to the National Institute of Justice, November 2003)15,16 < <https://www.ncjrs.gov/pdffiles1/nij/grants/208301.pdf>>.

<sup>26</sup> Ibid.

<u>IVTS/IFTS</u>	<u>IVTM</u>
<p>These constitute traditional ethnic fund and value transfer operations and businesses.</p>	<p>They involve small groups or networks, which employ methods of transferring both money and value informally but mostly illegally.</p>
<p>They have originated on the Indian subcontinent and in China, but have spread following waves of immigration and economic globalization.</p>	<p>They do not require the existence of widespread networks of people. Most of them can be accomplished by a couple of individuals on either an ad hoc or regular basis.</p>
<p>These networks are currently subject to regulations designed for the so-called ‘money services businesses’.</p>	<p>They involve the use of the formal financial system, but they leave no trail for anyone wishing to monitor or reconstruct the route of a transaction intended to remain secret.</p>
<p>The clients and services using IVTS/IFTS are for the most part well established, known to their respective local community.</p>	<p>They are very often part of legitimate or legitimate-looking trade transactions, which effectively obfuscate substantial value transfers.</p>
<p>The underlying feature of these networks is that the transfer is originated, transferred and delivered as a financial asset.</p>	<p>They are always criminal and usually combine with other offences (e.g. tax evasion, subsidy fraud, embargo busting, capital flight, funding of militant groups, smuggling).</p>
	<p>They have the capacity to transfer very substantial amounts of money (much higher amounts than IFTS). So, terrorists and other criminals can conveniently use these methods.</p>

**Table 2.1: Distinction between IVTS/IFTS and IVTM. Source: Passas, ‘Informal Value Transfer Systems, Terrorism and Money Laundering’, 2003.**

The Financial Action Task Force has defined Alternative Remittance Systems (an overarching term comprising IVTS/IFTS and IVTM) as:

any system used for transferring money from one location to another and generally operating outside the banking channels. The services encompassed by this broad definition of ARS range from those managed by large multinational companies to small local networks. They can be of legal or illegal nature and make use of a variety of methods and tools to transfer the money.<sup>27</sup>

### 2.2.1 Meanings of Terms

Etymologically, *hawala* is an Arabic term. In Arabic, the root h-w-l signifies ‘change’ or ‘transformation’.<sup>28</sup> The word ‘*hawala*’ is derived from this root and is defined as a bill of exchange or promissory note.<sup>29</sup> *Hawala* denotes a ‘transfer’, and in commercial terms the practice of transferring money and value from one place to another through service providers, who are known as *hawaladars*.<sup>30</sup> In Arabic legal commentaries, *hawal* is mentioned as the ‘exchange of debt’, particularly in its historical context of long distance trade.<sup>31</sup> This was adopted into Hindi and Urdu — the national languages of India and Pakistan — in more or less the same sense, but gained the additional meanings of ‘trust’ and ‘reference’ which reflects the code of functions of the system. Afghans involved in the trade tend to call themselves ‘*sarafi*’, or in the singular, ‘*saraf*’, which means money changer.<sup>32</sup> Similarly, the term ‘*hundi*’ is etymologically rooted in Sanskrit language and means ‘to collect’, which is synonymous with promissory note, bill of exchange, or *hawala*. *Hundi* is a kind of bill of exchange or written order for payment that its drawers used in

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<sup>27</sup> Financial Action Task Force, *Money Laundering and Terrorist Financing Typologies 2004–2005*(FATF/OECD, 10 June 2005)3 <[http://www.imolin.org/pdf/imolin/FATF\\_Yearly\\_typol\\_04-05\\_incl\\_typologies.pdf](http://www.imolin.org/pdf/imolin/FATF_Yearly_typol_04-05_incl_typologies.pdf)>.

<sup>28</sup> Patrick M Jost, and Harjit Singh Sandhu, ‘The *Hawala* Alternative Remittance System and Its Role in Money Laundering’ (Paper prepared by the Financial Crimes Enforcement Network (FinCEN) in cooperation with INTERPOL/FOPAC, January 2000) <http://www.treasury.gov/resource-center/terrorist-illicit-finance/documents/fincen-hawala-rpt.pdf>.

<sup>29</sup> Ibid 15.

<sup>30</sup> Edwina Thompson, ‘An Introduction to the Concept and Origin of *Hawala*’ (2008)10(1)*Journal of the History of International Law*83, 94.

<sup>31</sup> Ibid.

<sup>32</sup> Ibid.



much the same way as Americans use cheques to draw on their cheque accounts.<sup>33</sup> In order to draw a *hundi*, a client had to open up an account and maintain a correspondence relationship with the *hundi* operator.<sup>34</sup> It follows that the terms *hundi* and *hawala* are essentially the same and used interchangeably. Though it is more popular in contemporary times, *hawala* is an Arabic term while *hundi* is its Indian and Pakistani variant.<sup>35</sup> In addition to *hundi* (India, Pakistan, Bangladesh) and *hawala* (Pakistan, Afghanistan, the Middle East and parts of Africa), the various forms of IVTS are geographically known under different names for example *fei ch'ien* (China), *hui kwan* (Hong Kong), *phai kwan* (Thailand) and *padala* (Philippines).<sup>36</sup>

### 2.3 Origins and Revival

*Hawala* is believed to have originated in the Indian sub-continent and China and these networks were the established means of transferring valuables and money long before any of the formal banking methods were conceived.<sup>37</sup> The links of these networks with international trade and commerce can be traced thousands of years to about 1120 BCE in the biographical sketches of 'huozhilezhuan' (literally 'moneymakers') that are contained in historical biographies written by the Great Sima Qian (circa 145–86 BCE) in his *Records of the Grand Historian*, which traces more than two thousand years of Chinese history.<sup>38</sup> Reference to *hawala* as 'transfer of debt' is also found in Islamic texts as Prophet Muhammad's sayings (*Hadith*) which show that the Prophet of Islam as a trader by profession was aware of these informal financial transfer systems.<sup>39</sup> It emerges that after the Prophet's demise, Islamic jurists prescribed the practice of delegation of debt as *al-hawala*.<sup>40</sup>

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<sup>33</sup> Divya Sharma, Historical Traces of *Hundi*, Sociocultural Understanding, and Criminal Abuses of *Hawala* (2006) 16 (2) *International Criminal Justice Review*99, 104.

<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid* 105.

<sup>36</sup> Passas, 'Informal Value Transfer Systems and Criminal Organizations', above n 21, 11.

<sup>37</sup> Jost and Sandhu, 'The *Hawala* Alternative Remittance System and Its Role in Money Laundering', above n 28, 5.

<sup>38</sup> Thompson, 'An Introduction to the Concept and Origin of *Hawala*', above n30, 92.

<sup>39</sup> *Ibid* 95.

<sup>40</sup> *Ibid.*

Among the more strong theories regarding the origins of *hawala* networks is that during the T'ang Dynasty (617–907 CE) in China, the growing Chinese tea trade required a means of transferring money to the South of China from the Imperial Capital without the burden and risk of carrying large sums of money between the two locations. To solve this problem, provincial governors maintained special courts in the capital that issued certificates to merchants who could present the certificates to the provincial governors and redeem their money in the southern province. Since, this system was based on 'chits' or 'tokens', the Chinese would refer to these as *fei'chen*, meaning 'the flying money'.<sup>41</sup> A similar system was adopted by the Arab traders to avoid robbery while travelling along the Silk Road.<sup>42</sup>

It appears that nothing can be said with certainty about the true origin of *hawala*-type systems. These networks nonetheless, can be traced to ancient times where they were adopted to facilitate trade and commerce across geographical, political and cultural borders in either the absence of or weak or conflicting formal institutions. Some view that *hawala* and other IVTS were born out of political turmoil.<sup>43</sup> Additionally, individuals are found to choose IVTS as a result of inefficient banking services or to bypass rules, laws, or currency restrictions.<sup>44</sup>

In modern times, this 'rhizome'<sup>45</sup> of informal finance re-emerged in the 1960s and 1970s to facilitate the transfer of wages of migrant labourers, coming mainly from the low-income economies of the global South but working in the high-income economies of the North and the West.<sup>46</sup> These overseas workers who regularly send money back home to their families constitute by far the single largest group of customers for the *hawala* market as they are the

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<sup>41</sup> Joseph Wheatley, 'Ancient Banking, Modern Crimes: How Hawala Secretly Transfers the Finances of Criminals and Thwarts Existing Laws' (2005)26 (2) *University of Pennsylvania Journal of International Economic Law*347, 348.

<sup>42</sup> Ibid 352.

<sup>43</sup> K O' Hara, 'Underground Banking and Money Laundering' *The Resister*(Spring-Summer 1997) 1.

<sup>44</sup> Passas, 'Informal Value Transfer Systems, Terrorism and Money Laundering', above n 25,12.

<sup>45</sup> William Vlcek, 'Alongside Global Political Economy — A Rhizome of Informal Finance' (2010) 13 *Journal of International Relations and Development* 429.

<sup>46</sup> Roger Ballard, 'Coalitions of Reciprocity and the Maintenance of Financial Integrity within Informal Value Transmission Systems: The Operational Dynamics of Contemporary *Hawala* Networks' (2005) 6(4) *Journal of Banking Regulation* 319.

source of supply of liquidity of funds to *hawaladars* in the developed economies.<sup>47</sup> This pool of funds is offset by another pool of funds in the developing economies that is commonly used by labour migrants, refugees, humanitarian organizations and transnational businesses involved in import/export, foreign exchange, travel and/or jewellery<sup>48</sup> to circumvent official currency restrictions and bans on gold imports in South and Southeast Asia<sup>49</sup> and increasingly by those involved in money laundering and terrorism<sup>50</sup> though many refute the view that *hawala* has much to do with either terrorism or money laundering.<sup>51</sup>

*Hawala's* revival, in modern times can also be attributed to the role that these informal networks have played in regions affected by war and conflict, during civil unrest and economic crises and in the presence of weak or non-existent political systems. An International Monetary Fund study<sup>52</sup> found that IVTS is highly adaptable to such events and provides an efficient mechanism for funds transfer during war and in conflict zones. In Afghanistan *hawaladars* were instrumental in a positive manner where they facilitated the movement of millions of dollars of humanitarian funds that ensured the smooth running of the first national democratic elections in early 2000s, after almost three decades of war and conflict.<sup>53</sup> Being the sole fund transfer system available to the international aid organizations, *hawala* helped in the construction of hundreds of kilometres of road, the implementation of agricultural assistance programs, and the building of educational facilities.<sup>54</sup> In other refugee or internally displaced person (IDP) settlements in Iraq and across Africa and South Asia, *hawala*-type IVTS have been widely due to the collapse or

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<sup>47</sup> 'Terrorists and Hawala Banking: Cheap and Trusted. Homing in on Networks of Informal Money Transfers', *The Economist*, 22 November 2001, 77.

<sup>48</sup> Matthias Schramm and Markus Taube, 'Evolution and Institutional Foundation of the Hawala Financial System' (2003) 12 *International Review of Financial Analysis* 405,408.

<sup>49</sup> Sam Vakín, 'Hawala, or the Bank that Never Was', *UPI International*, Business News 17 October 2001. For updated 2005 version, see <<http://samvak.tripod.com/nm104.html>>.

<sup>50</sup> Ibid.

<sup>51</sup> Diogo Teixeira and Shahjehan Cheema, 'Bring Underground Payment Systems into the Mainstream', *American Banker* (Vol.166, Issue 196, 12 October 2001)14.

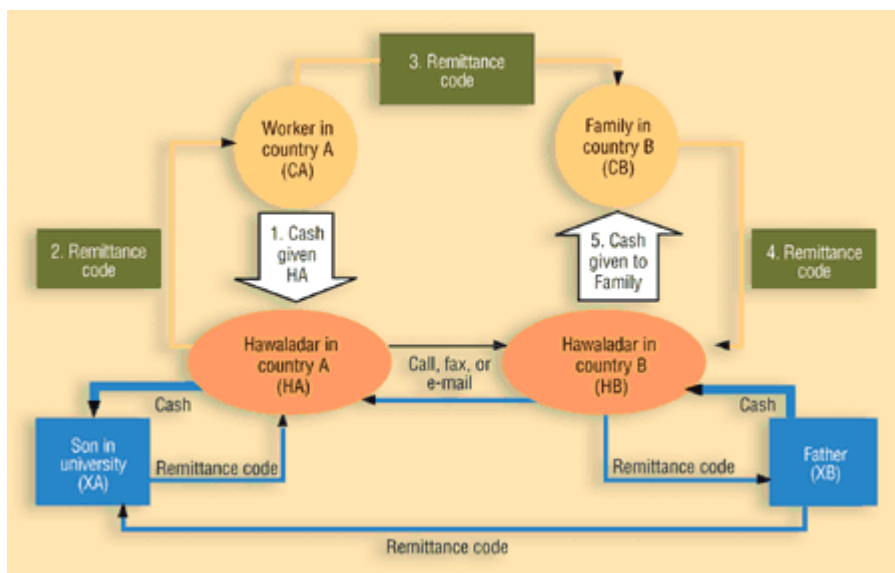
<sup>52</sup> Mohammed El-Qorchi, Samuel Munzele Maimbo and John F Wilson, 'Informal Fund Transfer Systems: An Analysis of the Hawala System' (Occasional Paper No 222, International Monetary Fund, 2003)9.

<sup>53</sup> Thompson, 'An Introduction to the Concept and Origin of *Hawala*', above n 30, 84.

<sup>54</sup> Ibid.

weakening of formal institutions.<sup>55</sup> Thompson has illustrated this with the example of the aftermath 2005 Tsunami, when money dealers reportedly established an emergency communications system using local mobile phone network to help migrants locate their families and arrange for the delivery of funds either to functioning bank accounts or directly to the IDP camps themselves.<sup>56</sup>

## 2.4 A Simple *Hawala* Model



**Figure 2.1: A Simple *Hawala* Model** Source: El-Qorchi, 2002

In theoretical terms, a basic *hawala* operation can be explained through a simple relationship requiring two customers and two *hawaladars*, in order to complete the transaction. In practice however it is a ‘multi-nodal value transmission network’<sup>57</sup> whereby each participant stands in a ‘constantly shifting position of debit and credit with each of the other members of the network’.<sup>58</sup> It also means that once the components of the contract are varied, it can lead to exponentially confusing networks of transfers and accounts. El-Qorchi

<sup>55</sup> Ibid.

<sup>56</sup> Ibid.

<sup>57</sup> Ballard, ‘Coalitions of Reciprocity’, above n 46, 327.

<sup>58</sup> Ibid.

outlines a simple *hawala* transaction and builds a model (Figure 2.1) to represent both the initial transaction and the reverse *hawala* transaction that may ensue as a result.<sup>59</sup>

### 2.4.1 *Hawala* Payments

In El-Qorchi's *hawala* model (Figure 2.1), worker CA in country A remits payment to his family CB in country B through *hawaladar* HA paying the HA in the local currency of A. The *hawaladar* contacts his counterpart HB in country B who makes payment to the designated family CB in the local currency of that country. For authentication the remitter may receive a code to pass on to his family to receive the payment. The *hawaladar* HA may charge a small fee or gain profit through the exchange rate spread. Consequent upon completion of this transaction, HA has a liability on HB which will be settled over time by various means, either financial or in terms of goods and services, involving 'reverse *hawala*'. A reverse *hawala* transaction is often used for investment purposes or to cover travel, medical, or education expenses from a developing country. In these countries there are often foreign exchange and capital controls, so a customer (XB) desiring to transfer funds to a developed country (for instance for the payment for university tuition for his son) provides local currency to HB and requests that the equivalent amount be made available to his (the customer's) son (XA) in that country (A). HB may use HA directly if funds are needed by XB in country A or indirectly by asking him to use another correspondent in another country, where funds are expected to be delivered. A reverse *hawala* transaction does not necessarily involve the same *hawaladars*; it could involve other *hawaladars* and be tied to a different transaction: simple or complex. In another scenario, settlement can also take place through import transactions. For instance, HA would settle his debt by financing exports to country B, where HB could be the importer or an intermediary. It can be understood that an increase in even one variable, such as the number of *hawaladars* in the market, would greatly increase the complexity of the transaction. For example, since each *hawaladar* would have an account with all of the other *hawaladars*, clearing of debts becomes much more complex.

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<sup>59</sup> El-Qorchi, 'Hawala: How Does this Informal Funds Transfer System Work?', above n 20, 31–3.

**Table 2.2 Complexities in Settlement of *Hawala* Debt**

<i>Hawala's</i> common and unique features	Law enforcement challenges
<ul style="list-style-type: none"> <li>• Trust among clients and operators</li> <li>• Use of codes</li> <li>• Lack of records</li> <li>• Too many records to sort through</li> <li>• Honest money goes through it</li> <li>• Distrust of authorities</li> <li>• Messaging (payment instructions) does not follow the same path as the funds</li> <li>• Linguistic Difficulties</li> <li>• Cultural Specificities</li> </ul>	<ul style="list-style-type: none"> <li>• Lack of record keeping and difficulties in deciphering records</li> <li>• Mixing of legitimate and criminal businesses</li> <li>• Asymmetric legal treatment around the globe for instance, some jurisdictions outlaw <i>hawala</i> while many western countries allow free capital flows</li> <li>• Use of illegal networks for settlement</li> <li>• Very large number of innocent customers</li> </ul>

**Source:** Passas, ‘Law Enforcement Challenges in *Hawala*-related Investigations’, 2004.

**2.4.2 *Hawala* Settlements**

In order to deal with the issue of complexity in settlement of debts, *hawaladars* keep a record of every transaction.<sup>60</sup> This is contrary to the common perception that *hawala* transactions have no records.<sup>61</sup> The reason for the maintenance of records by the *hawaladar* is that the network can get complicated quickly and all details of the transactions become difficult to retain in the memory. These records are, however often written in a code to deter potential theft, and are promptly discarded after use hence the authorities have problems following *hawala* transactions through to their end<sup>62</sup> (See Table 2.2). Experts have argued that, although reverse *hawala* transaction appears to be a simple way of balancing accounts, the probability of its actual occurrence is very low. This is explained in the asymmetry in international remittance flows which tend to be greater from industrialized countries to developing countries than in the opposite direction.<sup>63</sup> It implicitly means that *hawaladars*

<sup>60</sup> Passas, ‘Informal Value Transfer Systems, Terrorism and Money Laundering’, above n 25, 66.

<sup>61</sup> Ibid 66–68.

<sup>62</sup> Roger Ballard, ‘A Background Report on the Operation of Informal Value Transfer Systems (*Hawala*)’ (6 April 2003) <<http://archiv.ub.uni-heidelberg.de/savifadok/271/1/hawala.pdf>>.

<sup>63</sup> John F Wilson, ‘*Hawala* and Other Informal Payment Systems: An Economic Perspective’ (Speech delivered at a Seminar on Current Developments in Monetary and Financial Law, IMF, 16 May 2002) 7 et seq; 16 Figure 4 [‘Clearing and Settlement of *Hawala* Transactions’] <<http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/wilson.pdf>>.

are forced to find alternative means of debt consolidation. Wilson specifies five methods that are commonly used to clear and settle accounts between *hawaladars*.<sup>64</sup>

- 1) **Bilateral Financial Settlement through Banks:** This involves one *hawaladar* paying into another *hawaladar*'s formal bank account (usually from an industrialized country to a developing country). Wilson argues that this method is less likely to be used because the preferred payment into a developing country is usually in US dollars and many such countries have currency restrictions that disallow this inflow. When a large sum of foreign currency (US dollars) is deposited, local authorities typically replace this with local currency, which is not favourable for the *hawaladar* in that country.
- 2) **Bilateral Settlement or Financing of Exports.** This involves a *hawaladar* from country A financing the importation of goods into country B for a *hawaladar* there. These goods may be from country A or from any other country. This alternative poses a problem for the international community by encouraging smuggling of goods across borders. Continual gold smuggling between Dubai and India/Pakistan is a case in point.<sup>65</sup>
- 3) **Clearing by Means of International Services (CMIS)** is another alternative to reverse hawala remittance, and is similar to a reverse remittance transfer except that the funds are not remitted but are used for the purchase of consumer goods and services. These goods and services mostly come in the form of medical, education, and travel expenses.<sup>66</sup>
- 4) **Clearing by Means of Asset Purchase** is the fourth option and is closely related to CMIS. The difference is that goods and services are not purchased but the *hawaladar* in country (B) purchases assets for the *hawaladar* in country A and hands them to him. These assets can take the form of property or simple financial assets such as investment in stock market, other portfolio investment.
- 5) Finally, some countries have adopted a 'no questions asked' policy in regard to foreign exchange. This permits *hawaladars* to transfer funds in any currency into another *hawaladar*'s bank account, without fear that authorities will convert the currency.<sup>67</sup>

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<sup>64</sup> Ibid7–9; 16 [Figure 4].

<sup>65</sup> Ibid 8.

<sup>66</sup> Ibid 7–8.

<sup>67</sup> Ibid 9.

All of the above options allow *hawaladars* to settle accounts with one another. In this manner, there is apparently no need for *hawaladars* to purchase any foreign exchange in order to consolidate debt<sup>68</sup> and hence the transfer of funds (usually US dollars) remains undetected by authorities in either country. However, once settled, the funds typically re-enter the formal banking system one way or another

## 2.5 *Hawala's* Comparison with the Formal Banking Procedures

<b>Banks (Formal institutions)</b>	<b><i>Hawala</i></b>
Value is moved	Value is moved
Agents work on behalf of individuals	<i>Hawaladars</i> work on behalf of individuals
Records are kept to monitor activity	Records are kept simply as reminders but not for monitoring purposes.
Impartial third parties monitor & enforce laws	The system is self-regulatory & trust-based.
Settlement of accounts is done through netting between corresponding branches	Settlement of accounts is done through netting between <i>hawaladars</i> .

**Table 2.3: Comparison between *Hawala* and Formal Banking Procedures**

Although IVTS is considered an alternative to fund transfers through the formal banking channels, the processes involved in both are quite similar. Formal value transfers can take several forms: these may use cash couriers, banks, exchange houses, and money remitters.<sup>69</sup> Apart from cash carriers, formal value transfer systems do not physically move cash or valuables, but an agent forwards a sum to an individual on behalf of another agent representing a different individual.

In contrast to the banks, even though *hawaladars* do keep records of transactions these records are kept not to monitor their activity but simply as reminders concerning the details

<sup>68</sup> Ibid 9.

<sup>69</sup> Ibid 5.



of individual accounts, transactions, and balances. This record keeping is a matter of individual practice in contrast with the standardized procedures followed by the formal sector. The settlement process for *hawala* can also use the same basis as the formal system: open accounts are kept and there is occasional netting off between *hawaladars* to settle accounts, although they may not necessarily use banking channels.<sup>70</sup>

The largest discrepancy between the two systems involves the monitoring process. The formal system relies on an impartial third party to monitor all transactions and ensure adherence to the rules. Any party departing from fair transactions would become liable to penalties imposed by the legislation governing the system.<sup>71</sup> An illustration of this can be seen in the transfer of funds through Western Union. In this and similar instances, detailed records are kept which are then netted and settled through formal banking sectors, while impartial third parties monitor and enforce rules and regulations for the formal sector. By contrast, the informal system does not rely on third party monitoring.<sup>72</sup> Since the *hawaladars* form an extended community, the system becomes self-regulating and it is extremely rare for them to defraud one another or a client. The self-regulatory mechanism is such that even if no disciplinary action is taken against a *hawaladar* who commits fraud, 'word gets around' that he cannot be trusted and without the trust of other *hawaladars* he cannot function for long. Being ostracized is a very painful experience, and such sentences are not only imposed on the *hawaladar* but also on his extended family.<sup>73</sup> Hence, the detailed documentation required to monitor the formal system is missing from the informal mechanism. Although *hawaladars* keep a record of each transaction, their records are not maintained in any standardized manner that can be readily accessible to monitoring agents as can occur in the formal system.

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<sup>70</sup> Ibid 5.

<sup>71</sup> Nauman, M.Farooqi, 'Curbing the use of Hawala for Money Laundering and Terrorist Financing: Global Regulatory Response and Future Challenges' (2010)5(1-2)*Int. J. Business Governance and Ethics*64,68.

<sup>72</sup> Ibid.

<sup>73</sup> Bala Shanmugum, 'Hawala and Money Laundering: A Malaysian Perspective' (2004) 8 (1) *Journal of Money Laundering Control*37.

From the above discussion, it emerges that *hawala* and other forms of IVTS are operationally efficient. IVTS are culturally convenient,<sup>74</sup> lower in transaction costs than conventional banking due to the ‘relational contracts’,<sup>75</sup> trust-worthy,<sup>76</sup> and efficient.<sup>77</sup> Despite the relative efficiency for which these systems are preferred, there are risks associated with the use of *hawala* and similar IVTS, such as erosion of profits of formal banking and money remittance systems,<sup>78</sup> loss in tax revenues,<sup>79</sup> inefficient monetary and fiscal policies,<sup>80</sup> limited paper trails,<sup>81</sup> and the potential increase in financial crime.<sup>82</sup>

## 2.6 Impact on the Global Economy

Financial markets and transactions play an important role in maintaining the stability of the overall global economic system. The ability of financial markets and governments to ensure this stability is dependent upon accurate and complete information concerning the flow of funds. The IVTS, being non-documented transactions, do not register on the radars of the financial markets, leading to anomalies, information gaps and distortions, which creates an imperfect picture of global economic health.<sup>83</sup> A study has highlighted the impact of informal remittance transfers on the global economy through a simulation model of 15 developing countries which estimated that over USD300 billion have been transferred informally into these countries during the last 20 years.<sup>84</sup> Ballard estimates that unrecorded migrant worker’s remittance flows through IVTS such as *hawala* are 100 per cent higher than recorded flows through the formal channels.<sup>85</sup> Remittances are often considered a by-product of migration, which has been growing steadily over the past 30 years. Migration is

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<sup>74</sup> Marie Chêne, ‘Hawala Remittance System and Money Laundering’ (2008) *U4 Expert Answer*, U4 Anti-Corruption Resource Centre(23 May 2008) <<http://www.u4.no/helpdesk/helpdesk/query.cfm?id=170>>.

<sup>75</sup> Schramm and Taube, ‘Evolution and Institutional Foundations of Hawala Financial System’, above n 48,410.

<sup>76</sup> *Ibid* 411.

<sup>77</sup> *Ibid* 416.

<sup>78</sup> Passas, ‘IVTS and Criminal Organizations’, above n 21, 43.

<sup>79</sup> El-Qorchi, ‘Hawala: How Does this Informal Funds Transfer System Work’, above n 20, 33.

<sup>80</sup> *Ibid*.

<sup>81</sup> Passas, ‘IVTS and Criminal Organizations’, above n 21, 43.

<sup>82</sup> *Ibid*.

<sup>83</sup> Smriti Nakhasi, ‘Western Unionizing the Hawala?: The Privatization of Hawalas and Lender Liability’(2007) 27(2) *Northwestern Journal of International Law and Business*475.

<sup>84</sup> El-Qorchi, Maimbo and Wilson, ‘Informal Fund Transfer Systems:An Analysis of the Hawala System’ above n 52, 52–53.

<sup>85</sup> Ballard, ‘Coalitions of Reciprocity’, above n 46, 322.

likely to continue to grow, given international migration patterns and steady emergence of diasporic communities. The United Nations estimates that nearly 230 million people worldwide lived outside of their country of birth in 2013.<sup>86</sup> The remittances sent home by these migrant workers are estimated USD542 billion in 2013.<sup>87</sup> Further increases in the number of migrants will increase the monetary value of remittances worldwide and ensure more fund inflows to developing countries.<sup>88</sup> However given that huge volumes of these inflows remain undetected on the international economic radar, they have macroeconomic impact on individual economies, state sovereignty, international financial markets, financial regulation and monetary policy.<sup>89</sup> *Hawala*-type transfers indirectly drain a country of much needed foreign exchange by working in conjunction with oppressive government regulations to keep the needed foreign currencies from coming into the country. According to a KPMG report published in 2008,<sup>90</sup> over USD1 trillion is being laundered every year by drug dealers, arms traffickers and other criminals in India. Under-invoicing exports and over-invoicing imports are chronic problems in countries where *hawala* is prevalent.<sup>91</sup> As more businesses seek the *hawala* alternative to traditional trade financing, local *hawala* brokers raise the exchange rate and weaken the currency.<sup>92</sup> Hence, the anonymity associated with *hawala*-type IVTS has long raised concerns in the law-enforcement community in general and in developing countries in particular. In countries such as India and Pakistan governments have been so concerned about the evasion of currency controls due to these informal systems as to ban them completely. It was only after the events of 9/11 and worries about terrorist finance that it has become a focus of international regulatory attention.

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<sup>86</sup> The World Bank, Migration, Remittances and Diaspora Blog available at <<http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20648762~pagePK:64257043~piPK:437376~theSitePK:4607,00.html>>

<sup>87</sup> Ibid.

<sup>88</sup> S F Martin, 'Remittance Flows and Impact' (Institute for the Study of International Migration, Georgetown University, Washington, DC, 2001). [Originally published as a Paper presented at Remittances as a Development Tool: A Regional Conference, Washington DC, 17 May 2001].

<sup>89</sup> See Beate Reszat, 'Currency Trading and International Financial Instability' (1999) 34(2) *InterEconomic:Review of European Economic Policy* 64,69 –71.

<sup>90</sup> '1 Trillion Laundered Every Year in India: Report', *The Times of India*, 5 August 2008. Also reported as '1 Trillion Laundered Every Year in India: Report' *Thaindian News*, 5 August 2008 <[http://www.thaindian.com/newsportal/business/1-trillion-laundered-every-year-in-india-report\\_10080253.html](http://www.thaindian.com/newsportal/business/1-trillion-laundered-every-year-in-india-report_10080253.html)>.

<sup>91</sup> See Passas, above n 21; Ballard, above n 46; El-Qorchi, above n 20.

<sup>92</sup> Ibid.

## 2.7 Need for Regulation

On the occasion of the First International Conference on *Hawala* in 2002 by the UAE government under the leadership of the UAE Central Bank, Harish Pawani observed that the economic efficiency and trustworthiness that give the *hawala* system its advantage over the corrupt official financial sector have a downside to them. The same advantages that make *hawala* customers' first choice make them vulnerable to illegal activities, such as money laundering, terrorist financing, organized crime or drug trafficking.<sup>93</sup> There is unanimous opinion among the experts that the main vulnerability of the system is in the process of settlements of debts between *hawaladars*. In this connection, Passas has explained that as *hawaladars* use local cash pools to pay for overseas remittances, there are chances that funds of legitimate clients are occasionally co-mingled with illicit funds, such that someone in Pakistan whose father sent honestly earned funds from the United States or the UAE could actually receive the cash that a corrupt official or smuggler wishes to launder or secretly take out of the country.<sup>94</sup> These cash pools on which *hawaladars* draw for payments are always asymmetrical, as each operator transfers funds to and from multiple locations every day and so, apart from compensatory payments, other ways of balancing accounts may include formal transfers (check, wire, bank-to-bank, and so on), the use of couriers and payments in kind, as well as through commercial transactions, falsified invoices and third parties. Commercial and financial transactions also form integral components of the settlement process given there is little to no transparency and verification of transactions in the import/export business.<sup>95</sup> The problem, as Passas states, 'is not merely theoretical; there is evidence that money derived from drug trafficking, illegal arms sales, body part trade, corruption, tax evasion, and all kinds of fraud have indeed moved through *hawala* and trading networks'.<sup>96</sup> In light of this and the attention *hawala*-type transfers have received in the wake of 9/11, the collective view is that leaving

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<sup>93</sup> Harish Pawani *Hawala and the Myth Surrounding It: A Street Perspective*, Central Bank of the UAE, 15 May 2002 cited by Ion Pohoata and Irina Caunic, 'Informal Value Transfer System –Hawala' (2007) 4(509) *Theoretical and Applied Economics* 3, 4.

<sup>94</sup> Nikos Passas, 'Formalizing the Informal? Problems in the National and International Regulation of *Hawala*' in International Monetary Fund, *Regulatory Frameworks for Hawala and Other Remittance Systems* (IMF, 2005) 407,409.

<sup>95</sup> Ibid.

<sup>96</sup> Ibid.

*hawala* completely unregulated, as was the case in many parts of the world before 9/11, is no longer realistic. The pressing question for international financial regulators and policy makers nevertheless is how to regulate *hawala* and other IVTS?

## **2.8 Regulatory Approaches and Solutions Adopted To Date**

The author Samuel Maimbo<sup>97</sup> has categorized the current available approaches and strategies to regulate informal remittance systems as follows:

### **1) Legal and Prudential Regulatory Approach**

Following the events of 9/11, FATF's response to the concerns on linkages between terrorism and informal remittance systems has resulted in the issuance of nine special recommendations aimed at combating terrorist financing. The Special Recommendation VI (hereafter SR VI) specifically addresses IVTS and calls for countries to license or register all the informal remittance businesses, as well as subject them to all of the other FATF recommendations that apply to banks and non-banks SR-VI reads:

Each country should take measures to ensure that persons or legal entities, including agents, that provide a service for the transmission of money or value, including transmission through an informal money or value transfer system or network, should be licensed or registered and subject to all the FATF Recommendations that apply to banks and non-bank financial institutions. Each country should ensure that persons or legal entities that carry out this service illegally are subject to administrative, civil or criminal sanctions.

Driven by the vulnerability of countries to the potential abuse of IVTS, the objective of SR-VI is to increase the transparency of inflows by recommending that countries impose consistent AML/CFT measures — as applicable to banks and other financial institutions — on all forms of IVTS. The rationale for introducing the regulatory framework has been that licensing and registration will help isolate legal from illegal remittance service providers;

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<sup>97</sup> Samuel Munzele Maimbo, 'The Regulation and Supervision of Informal remittance Systems: Emerging Oversight Strategies' (Paper presented at the [IMF] Seminar on Current Developments in Monetary and Financial Law, Washington, 24 May – 4 June 2004) 3–9. See also Samuel Munzele Maimbo, 'The Regulation and Supervision of Informal Remittances: Emerging Oversight Strategies' in International Monetary Fund, *Current Developments in Monetary and Financial Law*, vol 4 (IMF, 2005) 481–501.

that those who operate legally will report suspicious transactions enabling regulators to report financial abuses to the law enforcement agencies. Hence, FATF's reporting requirements and standards are aimed at mitigating the risks<sup>98</sup> and reducing the financial abuse of the informal systems that, if they are used within the reporting and regulatory framework can, otherwise provide a valuable remittance transfer service.

A major problem with FATF's legal and regulatory approach is that among different countries the reporting and record keeping standards are very asymmetric.<sup>99</sup> In many countries, including India and Pakistan, *hawala* is illegal. There are laws that prohibit speculation in these countries' local currency and foreign exchange transactions at a rate other than the official exchange rate, which makes *hawala* systems as they currently operate illegal. Licensing or registration of informal remittance service providers is problematic in these jurisdictions because it will amount to legalizing an essentially outlawed practice. Similarly, some European countries (such as France and Spain) also allow no informal transfer operations at all, and so the question of international cooperation does not arise.

Another problem is that FATF's reporting requirements and standards are more suited to formal financial institutions.<sup>100</sup> Consequently, compliance in FATF's reporting standards has resulted in the design, development and implementation of a patchwork of laws and regulations for regulating IVTS businesses, which have been put in place by financial regulators in various jurisdictions. These rules and regulations do not complement each other and often cause these businesses to either close or 'go underground'.<sup>101</sup> In the United States, the *USAPATRIOT Act 2001*, the *Money Laundering Control Act 1986*, and Financial Crimes Enforcement Unit of the US Department of the Treasury ('FinCEN' (the FIU)) are three tools that the United States has in place against money laundering. Apart from various federal laws, the Money Services Businesses (MSBs) in the United States also have to comply with a host of state rules and regulations. These vary from state to state and become

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<sup>98</sup> Matteo Vaccani, *Alternative Remittance Systems and Terrorism Financing: Issues in Risk Management* (Working Paper No 180, World Bank, November 2009)5.

<sup>99</sup> Nikos Passas, 'Setting Global CFT Standards: A Critique and Suggestions' (2006) 9(3) *Journal of Money Laundering Control* 281, 284.

<sup>100</sup> See Passas, 'Formalizing the Informal?', above n 94,410.

<sup>101</sup> *Ibid.*

prohibitively expensive for a small MSB operator to comply with.<sup>102</sup> In Canada, the original *Proceeds of Crime (Money Laundering) Act* was enacted in 1991 and required many financial institutions to identify customers and to maintain records. These measures did not, however, withstand the scrutiny of FATF's evaluation of member countries, which in 1997 pointed out Canada's lack of mandatory reporting requirements and absence of a centralized FIU. As a result, three years later the *Proceeds of Crime Act* was amended to introduce new reporting requirements and create the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC). In December 2001, Canadian Parliament enacted the *Anti-Terrorism Act*, which added combating terrorist financing activity to FINTRAC's mandate. The Canadian federal government also amended Bill C-25 as part of its ongoing fight against money laundering and terrorism financing and required all MSBs to register with FINTRAC by 23 June 2008. As part of these new changes, real estate agents have also been required to report on suspicious property transactions.<sup>103</sup> In Australia, new<sup>104</sup> AML/CTF legislation was developed between 2004 and 2006 on the basis that it would be introduced in two tranches. The first tranche regulates financial and gambling sectors and the second tranche, which has largely failed to materialise, will extend regulation to non-financial businesses and professionals such as lawyers, accountants, jewellers and real estate agents. The legal framework comprises the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006(Cth)* (*AML/CTF Act 2006*), which establishes obligations that are supervised and regulated by the Australian Transactions Report and Analysis Centre (AUSTRAC).<sup>105</sup>

## 2) Financial Sector Development Strategy.

The central argument of this regulatory approach to *hawala* and other IVTS hinges on countries' particular domestic circumstances — on the stage of national economic development in general and that of financial sector norms in particular. A case in point is the United Arab Emirates, which has been resistant to western regulatory efforts. The

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<sup>102</sup> Passas, 'Setting Global CFT Standards:', above n 99, 284.

<sup>103</sup> Farooqi, above n 71, 72.

<sup>104</sup> The *Cash Transaction Reports Act 1988* (Cth) was part of a suit of laws introduced in 1988 that also covered proceeds of crime and criminalisation of money laundering.

<sup>105</sup> Australian Government, Australian Transaction Reports and Analysis Centre, *About AUSTRAC* (4 May 2013) <[http://www.austrac.gov.au/about\\_austrac.html](http://www.austrac.gov.au/about_austrac.html)>.

United Arab Emirates has openly defended the legitimacy of *hawala* networks and has advocated an approach that takes divergent economic and cultural realities into account, in contrast to the ‘black and white’ approach of a complete shutdown of *hawala* networks.<sup>106</sup>

In their study of informal remittance systems, El-Qorchi, Maimbo and Wilson<sup>107</sup> have argued that prescribing regulations alone would not ensure compliance. According to these authors, the informal remittance systems cannot be eliminated through restrictive policies, prohibition orders or criminal proceedings until the practical reasons for the customers’ choice of these systems over the formal financial systems, cease to exist. High transaction costs, long delays in effecting money remittances, exchange controls and overly bureaucratic policies and procedures for simple money transfers are major incentives for the continued existence of the informal financial system. Hence El-Qorchi, Maimbo and Wilson have argued for a strategy to bridge the gap between the informal and the formal remittance systems such that both benefit from their mutual deficiencies and each tend to expand when the condition of the other is impaired. Some of the proposed solutions in this approach have included lower taxes on remittances, floating currency rates, and the relaxation of currency regulations and interest rates.<sup>108</sup> In other words liberation of the economy, social and economic stability and reliable financial institutions are important factors in migrants’ choice to remit through formal institutions rather than through the informal. Based on this, Buencamino and Gorbunov have made a case, using the example from a study of six major labour exporting countries in Europe and North America that a rise in the black market premium by 10 per cent results in a decline in official remittances by 3 per cent. For these authors, doing away with dual and parallel exchange markets is an effective strategy to channel remittances through the formal channels.<sup>109</sup>

In the past years, some countries have introduced incentive based strategies to encourage migrants to remit through the formal channels. For example, relaxing foreign exchange

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<sup>106</sup> Rachna Pathak, ‘The Obstacles to Regulating the *Hawala*: A Cultural Norm or a Terrorist Hotbed? (2003) 27 (6:5) *Fordham International Law Journal* 2007.

<sup>107</sup> Mohammed El-Qorchi, Samuel Munzele Maimbo and John F Wilson, ‘Informal Fund Transfer Systems: An Analysis of the Hawala System’, above n 52, 42–43.

<sup>108</sup> Leonides Buencamino and Sergei Gorbunov, ‘Informal Money Transfer Systems: Opportunities and Challenges for Development Finance’ (Discussion Paper No 26, United Nations Department of Economic and Social Affairs (DESA), November 2002)8.

<sup>109</sup> *Ibid.*



regulations on migrant foreign currency accounts and offering above market interest rates on these accounts have been introduced in Pakistan, Bangladesh, India and Vietnam. In other countries such as Egypt, Poland and Turkey, premium exchange rates have been offered for conversion of foreign currency into local currency.<sup>110</sup> Buencamino and Gourbanov argue that this strategy has shown mixed results. The reason cited by the authors is that such incentives are more attractive for professional and high-skilled migrants who have higher incomes and funds for investment rather than benefitting the low-income and low-skilled migrant workers who are in majority and should be the real target group of any strategy.<sup>111</sup>

### 3) Institutional Payments System Strategy

This approach is closely related to financial sector development strategies and attempts to regulate the informal remittance systems by challenging these systems on economic grounds through competitive formal remittance systems. Proponents of this approach argue that as *hawala* proliferates due to its efficiency, it stands to reason that if the private banking and other payments systems were more competitive, *hawala* would gradually disappear.<sup>112</sup> Some governments have adopted this strategy by approving partnerships between corporate wire transfer corporations and postal services or banking operations. For instance, Pakistan Post collaborated with the Western Union and the Indian government approved a partnership between Western Union and its national postal service to operate in cities around the country. Similarly, in Egypt, Jordan, Lebanon, the Persian Gulf, and in the Philippines, banks and exchange companies offer door-to-door delivery.<sup>113</sup> Other proposals included the suggestion that a tax may be levied on *hawala*<sup>114</sup> or that *hawaladars* form exchange companies and adhere to reporting requirements. The latter strategy was adopted by the State Bank of Pakistan in 2002 when it converted hundreds of money changers into exchange companies, in order to introduce a corporate culture in money changing business, as well as to eliminate the informal ‘kerb-side’ foreign exchange market and *hawala*

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<sup>110</sup> Ibid.

<sup>111</sup> Ibid.

<sup>112</sup> Mohammed El-Qorchi, Samuel Munzele Maimbo and John F Wilson, ‘Informal Fund Transfer Systems: An Analysis of the Hawala System’, above n 52,43.

<sup>113</sup> Buencamino and Gorbunov, above n 108,9.

<sup>114</sup> David C Faith, ‘The *Hawala* System’ (2011) 2 (1)*Global Security Studies*23,29.

transfers.<sup>115</sup> The idea behind these strategies is for *hawala*'s incorporation into the current global financial structure by converting them into formally regulated structures. Nakhasi argues that this essentially 'Western Unionizing'<sup>116</sup> approach fails to consider or meet the following six major concerns, which are the reasons that customers choose *hawala* money remittance system, namely:

- i) The proposal does not address the need for secrecy and anonymity of those customers who use *hawala*-type systems to avoid capital, exchange, or administrative controls;
- ii) Privatized remittance systems such as the Western Union, are inherently bureaucratic, and cannot compete with the efficiency of the simplistic 'no over-heads' operations of the *hawala* system;
- iii) Privatized and formalized money remitters are not as reliable as *hawaladars*, who are often tied with kinship, ethnic and personal relations with their customers;
- iv) *Hawala* systems have an advantage over the privatized regulated systems in terms of cost-efficiency;
- v) *Hawaladars* are better equipped to meet the needs of customers who are not located in large cities; and
- vi) Finally, the *hawala* system uniquely meets the religious concerns of many of its customers as they are located in cultures where religious and family traditions require women to maintain minimal contacts with the world outside their homes and families. Moreover, as El-Qorchi has provided that a trusted *hawaladar* who is well aware of the social codes would be an acceptable intermediary, being seen as protecting women from having direct dealings with banks and other agents.<sup>117</sup>

It is noteworthy that as far as the recent competitive efforts by the formal financial institutions to increase their share of the remittance market are concerned, many experts are

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<sup>115</sup> Asif Asrar Usmani, 'Exchange Companies Ready to Replace Money Changers' (2003) 34(1) *Economic Review*9, 9.

<sup>116</sup> Nakhasi, 'Western Unionizing the Hawala?', above n 83, 482.

<sup>117</sup> El-Qorchi, 'Hawala', above n 20,33.

of the view that by lowering fees, widening their networks and using better technology by the formal institutions alongwith the recent law enforcement and regulatory attention that *hawala* has drawn have increased operating costs in the informal sector. Yet, despite the competitive strategies used by the formal sector in the remittance market, *hawala* continues to remain the most financially efficient option for most of the immigrants.

**Table 2.4 Competitive Efficiency of *Hawala***

<b>Comparative cost of sending US\$100 from Dubai to South Asia</b>			
<b>Institution</b>	<b>Charges (US\$)</b>		<b>Rate of AED/US\$</b>
	Bank Draft	Telegraphic Transfer	
Exchange House	1.36–2.722	9.52–16.33	3.6735–3.68
Bank	2.722–6.80	12.25–27.22	3.678–3.693
Western Union	9.52	-	3.7
<i>Hawala</i>	0		3.673–3.6736
<b>Comparative Amounts Received in Pakistan for remittance of US\$100 from Dubai, UAE</b>			
<b>Method of Remittance</b>	<b>Charges</b>	<b>Total Paid</b>	<b>PK Rupees Received</b>
Draft (exchange house)	1.36–2.722	101.36–102.722	5901–5910
Draft (bank)	2.722–6.80	102.722–106.80	5890
TT (exchange house)	9.52–16.33	109.52–116.33	5901–5910
TT (bank)	12.25–27.22	112.25–127.22	5890
Western Union	9.52	109.52	5858
<i>Hawala</i>	0	100	5920

**Source: Passas, ‘Formalizing the Informal’, 2005.**

Nikos Passas<sup>118</sup> illustrates this cost efficiency competitiveness of *hawala*. Table 2.3 presents a comparison of the costs of sending US\$100 from the UAE to South Asia (Pakistan). The costs reflected in the table include exchange rates, telegraphic transfer charges or bank drafts and also fees charged by the Western Union. It can be seen that *hawala* offers the best exchange rate with no fees charged. Similarly, in the second part of Table 2.3, the financial benefits to the remitters’ family in Pakistan are even clearer. The amount received in cash by the beneficiary is higher than all other options of cash transfer making *hawala* the best option for remittance transfer.

<sup>118</sup> Passas, ‘Formalizing the Informal?’ above n 94, 408.

#### 4) Anthropological Approach

Maimbo has identified the under-researched anthropological approach to regulating informal remittance systems based on the levels of social cooperation and trust associated with the informal payments systems. According to this author, the anthropological approach helps to investigate the various sources of ‘trust – a key element in *hawala* transfers’, associated with equally powerful emotions of rivalry, competition and jealousy within the same kinship networks. This phenomenon has been explained by Monsutti who provides us a firsthand account of the dimensions of trust and kinship in *hawala* networks.<sup>119</sup> Monsutti has characterized four types of actors within the *hawala* system. The first are close relatives, with which he identifies feelings of solidarity arising among individuals connected through the mother’s side of the family. Familial relationships stemming from the father’s side tend to be characterized by direct competition and conflict. Second are distant relatives and friends. These groups are the people of choice for engaging in business partnerships and lending activities. The third type is people from the same locality, ethnic or social group who ‘may be linked by the *hawala* system but may not be engaged in a close economic partnership’.<sup>120</sup> Fourth, and most importantly, transfers of funds involve people from the host society, and those outside of the familiar circles of ethnicity or social background, According to the author, ‘[w]ithout the intervention of the latter [outsiders], each social network would be an inefficient, isolated structure’.<sup>121</sup>

Focusing on the Hazara community of Afghanistan, Monsutti has argued that the *hawala* remittance system ‘allows the reproduction of social ties despite insecurity and dispersion. The exchanges taking place through the circulation of people, documents and money bring together religious, judicial, political, economic and family ties’. As a result of these exchanges, not only are material needs satisfied but constant social ties are produced and reproduced between the members of society. According to this author, the relationship between material and social ties is reciprocal. Monsutti concludes, ‘The *hawala* system, a

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<sup>119</sup> Alexander Monsutti, ‘Cooperation, Remittances, and Kinship among the Hazaras’ (2004) 37(2) *Iranian Studies* 219.

<sup>120</sup> *Ibid* 224.

<sup>121</sup> *Ibid* 225.

complex set of solidarity and completion relationships, explains how Afghan society, despite war and migration, has not collapsed into a Hobbesian chaos'.<sup>122</sup>

Similarly, in a study on Mexican migrants, Hernandez-Coss<sup>123</sup> has observed that the decision to choose an informal remittance channel over a formal one was driven by personal relations, mainly for the following reasons:

- i) The remittance channels represent a personal social link to back home as do the Home Town Associations (HTAs);
- ii) IVTS operating between Mexico and the United States are mainly an extension of the cross-border connections between the migrants and their home communities in Mexico;
- iii) Contrary to the traditional *hawala* systems that have developed to facilitate trade, the IVTS between Mexico and the United States facilitate the movement of funds as well as letters, food and other goods. In many cases, channels that facilitate fund transfers are the same as those that have facilitated the migration of the worker;
- iv) HTAs are regional associations that have over time sent workers into a particular US city where the migrants have now organized themselves as an expatriate community. Thus, regional corridors within the main US-Mexico corridor have been formed;
- v) These HTAs help to organize small scale development projects in the migrants' hometown community, and the social links and networks offered by the HTA provide an opportunity for the migrant to stay involved in the hometown community; and
- vi) Due to strong links between the migrants and their home communities in Mexico, the immigrants raise money to utilize for public services (such as laying water pipes, and building churches and roads in Mexico). The funds required for these building projects are

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<sup>122</sup> Ibid 235.

<sup>123</sup> Raúl Hernández-Coss, 'Lessons from the US-Mexico Remittances Corridor on Shifting from Informal to Formal Transfer Systems (Working Paper No 47, World Bank, 2004), cited by Samuel Munzele Maimbo, 'The Regulation and Supervision of Informal Remittance Systems: Emerging Oversight Strategies' (Paper presented at the [IMF] Seminar on Current Developments in Monetary and Financial Law, Washington, 24 May – 4 June 2004) 3–9.

normally hand-carried by a member of the community when someone goes to Mexico to visit family.

Clearly, the idea behind exploring the anthropological approach is to find regulatory solution by involving the *hawala* community in the regulatory process. Although rarely practised, this approach reflects a recent shift of paradigm in understanding issues in *hawala* regulation by analysts and experts who have realized that unless financial regulators work through policies of cooperation and inclusion of *hawaladars* and the community, successful regulation of *hawala* will remain problematic.<sup>124</sup>

## **2.9 Issues and Gaps in Regulation**

One of the leading problems in *hawala* regulation is that although regulations have been enacted in various countries around the world, the adequate enforcement of these regulations remains a matter of debate.<sup>125</sup> Traditional IVTS (such as, *hawala*, *hundi*, and *fei ch'ien*) are ancient and ingrained in the culture of many ethnic groups and communities. Enforcement of the regulations within migrant communities becomes practically difficult because these networks are advertised in the ethnic press or in the local vernaculars or in native languages. Enforcement is also an issue in countries where governance is generally weak and institutional capacity is lacking. But more importantly, it is noteworthy that despite regulatory regimes over the years, the use of IVTS continues due to the economic efficiency and cost effectiveness of these systems. Passas has noted that *hawala* continues to be used primarily for legitimate purposes all over the world.<sup>126</sup> This author has argued that the scale and frequency of serious criminal activity (aside from tax evasion and currency controls) under *hawala* is minimal, and that no drastic measures should be taken against these systems without substantive evidence. In Passas' view, a more indirect regulatory approach should be to first 'test the waters' because any substantial change in the system where *hawala* prevails may force completely legitimate users of *hawala* to rely on criminal means to transfer funds. The author has therefore argued for a right balance

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<sup>124</sup> See Nikos Passas and Samuel Munzele Maimbo, 'The Design, Development, and Implementation of Regulatory and Supervisory Frameworks for Informal Funds Transfer Systems' in Thomas J Biersteker and Sue E Eckert (eds), *Countering the Financing of Terrorism* (Routledge 2008) 174–192, 189.

<sup>125</sup> Ibid 187.

<sup>126</sup> Passas, 'IVTS and Criminal Organizations', above n 21, 23.

between economic objectives and anti-money laundering/countering the finance of terrorism efforts.<sup>127</sup> In this author's view, the current regulatory regimes and enforcement activities have proved to be ineffective and counter-productive and so he has proposed a comprehensive cost-benefit analysis of the regulatory frameworks and the results of financial controls put in place.

One of the major concerns in the regulation debate is the idea that *hawala* is an 'economic phenomenon' and will exist regardless of controls and regulations.<sup>128</sup> It would therefore be imprudent to declare *hawala* illegal out-right. Instead, regulatory mechanisms and policies need to be developed that should incorporate *hawala*'s self-monitoring features; and the 'personal relationship' that *hawaladars* maintain with their customers and most especially those with whom they engage in large-scale transactions.<sup>129</sup> These *hawaladars* maintain their own 'know-your-customer' scheme to ensure the system's safe and judicious use.<sup>130</sup> Due to these characteristics, experts have taken the view that strangling *hawala* out of existence may cause *hawaladars* to submerge underground and make monitoring even more difficult. Moreover, as Passas<sup>131</sup> has suggested that since *hawala* is not harmful in itself, regulators should exclude potential abusers from the network so that benefits of the system can accrue fully to the legitimate players. This objective can be accomplished through effective monitoring by understanding these networks and by the identification of criminal networks that potentially abuse the system. The task is difficult because *hawala* can become a conduit for any criminal activity, but as the author Farooqi has reiterated:

[*H*]awala, in its essence, is a naturally efficient medium of transferring funds that has withstood the test of time. It has resolved information and asymmetry problems without the need of an impartial third party. It is this that has shaped *hawala* into a fascinating economic and sociological institution. The *hawala* system should be studied and eulogized for what it has accomplished and not penalized because criminals have abused it. Illegal activity will exist in both formal and informal channels

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<sup>127</sup> Nikos Passas, 'Fighting Terror with Error: The Counter-Productive Regulation of Informal Value Transfers' (2006) 45(4-5) *Crime Law and Social Change* 315, 316.

<sup>128</sup> Wilson, 'Hawala and Other Informal Payment Systems: An Economic Perspective', above n 63, 12.

<sup>129</sup> Ballard, 'A Background Report on IVTS *Hawala*', above n 62, 4.

<sup>130</sup> See Maimbo, 'The Money Exchange Dealers of Kabul', above n 22, 7.

<sup>131</sup> Passas, 'IVTS and Criminal Organizations', above n 21, 67.

of the international financial system as long as there are incentives and lacunae in procedures and mechanisms.<sup>132</sup>

A critical gap in the available literature on *hawala* — and like IVTS, is the lack of research towards understanding the inner workings<sup>133</sup> of *hawala*-type systems that would enable a cost-benefit analysis of the regulations imposed and thereafter a critical evaluation of regulatory frameworks that have been introduced. Samuel Maimbo<sup>134</sup> indicates that the regulatory community does not have an understanding of the issues surrounding the regulating of *hawala*-type IVTS. According to this author, there needs to be a concerted and systematic evaluation of the regulatory objectives and supervisory strategies, tools and mechanisms applicable to informal remittance systems. The problem is that the literature on regulating and supervising informal remittance systems is still in its infancy and is generally lacking in practical examples of the regulatory frameworks introduced since 9/11 to curtail *hawala* and other IVTS.<sup>135</sup> In other words, had there been more country studies or ‘best practices’ showing how different countries have made systematic efforts towards regulating *hawala* and other IVTS, and the results they have achieved, it would have helped to assess the regulations that were introduced after 9/11. However, such specific country studies are virtually missing from the available literature on *hawala* regulation. The present research seeks to contribute in this direction, by focusing on Pakistan’s regulation of *hawala* since 2002.

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<sup>132</sup> Farooqi, above n 71, 73.

<sup>133</sup> Nikos Passas, ‘Demystifying *Hawala*: A Look into its Social Organisation and Mechanics’ (2006) 7(1) *Journal of Scandinavian Studies in Criminology and Crime Prevention* 46, 59.

<sup>134</sup> Maimbo, ‘The Regulation and Supervision of Informal Remittance Systems’, above n 97, 9.

<sup>135</sup> Passas, ‘Formalizing the Informal?’ above n 94, 410.



## **Chapter 3:**

## **Methodology**

### **3.1 Research Method**

Methodically, this is a qualitative, descriptive, single, within-case study of *hawala* regulation, with specific focus on the Pakistani *hawala* market since 2002. In its design and method, the research has largely conformed to the Yin<sup>136</sup> and Stark<sup>137</sup> methodology of qualitative case study.

#### **3.1.1 Choice of Case Study**

According to Yin,<sup>138</sup> a case study design should be considered when:

- (i) The focus of the study is to answer ‘how’ and ‘why’ questions;
- (ii) You cannot manipulate the behaviour of those involved in the study;
- (iii) You want to cover contextual conditions because you believe they are relevant to the phenomenon under study; or
- (iv) The boundaries are not clear between the phenomenon and context.

The present research seeks to determine the impact of *hawala* regulation and factors that influence the regulation of *hawala* in Pakistan. A case study is chosen because the case is the regulation of *hawala*, but the case could not be considered without the context: Pakistan, and more specifically the setting: the *hawala* market. It was to regulate this market that reforms were implemented by the State Bank of Pakistan. It would not have been impossible for this researcher to have a true picture of the impact of post 2002 *hawala* regulation without considering the context in which the reforms to regulate the *hawala* market occurred. Hence, the unit of analysis or the case (*hawala* regulation) is being studied

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<sup>136</sup> Robert K Yin, *Case Study Research. Design and Methods* (Sage, 2<sup>nd</sup>ed, 2003).

<sup>137</sup> Robert Stark, ‘Case Studies’ in Norman Denzin and Yvonna Lincoln (eds), *Strategies of Qualitative Inquiry* (Sage, 1998).

<sup>138</sup> Yin, above n 135, 4–7.

in a context<sup>139</sup> (Pakistan) and setting (*hawala* market). In order to ensure that the study remains reasonable in scope, the case study has been bound by time<sup>140</sup> (since 2002).

### **3.1.2. Justification for the Choice of Pakistan**

Geographically, Pakistan lies in the region where *hawala* originated and so it has historically remained a *hawala* prevalent country. Indeed, due to the popularity of *hawala* as well as its impact on the country's macro-economic policies, Pakistan has traditionally remained under strict currency controls that prohibit speculation in exchange rates other than the government prescribed rates. *Hawala*-type informal transfers are illegal in Pakistan and there are stringent policies for moving foreign exchange into and out of the country. Despite these strict controls, Pakistani financial regulators have remained concerned about the informal *hawala*-type transfer systems and made many attempts to channelize inward remittances into the country through the formal banking channels. The 2002 reforms introduced by the State Bank of Pakistan (SBP) were also aimed to curb *hawala* and channel funds through the formally regulated institutions. However, as the author Passas has pointed out, so far there has not been any systematic attempt to study the regulations that countries have introduced to regulate *hawala*-type transfers in the post 9/11 scenario. By adopting a systematic empirical approach, this research contributes towards redressing this imbalance. Two specific contributions are made through this research: first, it examines the impact of the post 9/11 regulations in Pakistan and second, it analyzes the challenges to *hawala* regulation in this key country.

In terms of country selection, Pakistan has been under-researched, and so it still demands a great deal more attention. Pakistan has a significant diaspora, many of whom are located in major western economies such as the United Kingdom and the United States, and, to a lesser extent in countries like Canada and Australia. Many ex patriot Pakistanis have developed businesses which generate significant cash flows within the expatriate community (for example travel agencies) as well as in the wider economy in which they

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<sup>139</sup> Matthew B Miles and A Michael Huberman, *Qualitative Data Analysis: An Expanded Sourcebook* (Sage, 2<sup>nd</sup> ed, 1994)25.

<sup>140</sup> JohnW Creswell, *Research Design: Qualitative, Quantitative and Mixed Method Approaches* (Sage, 2<sup>nd</sup>ed, 2003)21.

operate. This means that there is a large pool of funds which may be intended to be remitted to family within Pakistan. In addition, there are large numbers of migrant Pakistani workers in developing economies who wish to remit their much more meagre funds to families in Pakistan. The result is a large pool of funds off shore which can be matched to the desire of those in Pakistan seeking to ‘export’ corrupt income and/or avoid taxation liabilities. Pakistan is therefore a country where the demand for *hawala* services is high. Moreover, by choosing to study the case of regulation of Pakistani *hawala* market, it will be possible to assess whether or not purported challenges to *hawala* regulation correlate with the international regulation that guides various countries’ policy to curb *hawala*-type informal transfer systems.

## **3.2. Research Design**

### **3.2.1 Type of Case Study**

There are different terms to describe a variety of case studies, for instance Yin<sup>141</sup> has categorized case studies as explanatory, exploratory, or descriptive. Yin has also distinguished between single, holistic and multiple case studies. On the other hand, Stake<sup>142</sup> has identified cases as intrinsic, instrumental or collective. In order to determine which category of case study the present research falls into, the sources of available background information about *hawala* regulation in Pakistan since 2002 have been reviewed, as follows:

- 1) **Academic Literature:** The available literature on *hawala* regulation provides analytical evidence of the failure of reforms and regulations that have been introduced since 9/11 to regulate *hawala*-type transfers in the sense that it informs that *hawala* is still prevalent and popular. As mentioned in the literature review section, there is dearth of ‘practical examples or case studies’ of regulations since 9/11 in the literature.
- 2) **Professional Reports and Evaluations:** Two recent reports on Pakistan are available that confirm the information that *hawala* is still used in the country. Among these, the first report is the Asia-Pacific Group on Money Laundering (APGML) *Mutual Evaluation*

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<sup>141</sup> Yin, above n 135, 3.

<sup>142</sup> See Robert E Stake, *The Art of Case Study Research* (Sage, 1995).

*Report 2009* and the second is the World Bank's 2009 Report, *Bringing Finance to Pakistan's Poor: A Study on Access to Finance for the Undeserved and Small Enterprises*. In terms of evidence, both these reports can be counted as confirmation of the use of *hawala* after 2002 reforms. Both are general commentaries without any critical analysis of *hawala* regulation post 9/11.

- 3) **State Bank of Pakistan:** Since it introduced reforms in 2002, the SBP has projected a continuous increase in the volumes of home remittances coming through the formally regulated banking channels. As such, the statements of the SBP on public record suggest that as a result of the reforms, *hawala*-type transfers have been curbed and greater funds are now channelled through the banks. Such impressions by SBP are obviously in contradiction of other available evidence.
- 4) **Press Reports and Articles:** Frequently, news and reports about *hawala* are circulated in the Pakistani press, particularly in the contexts of rising inflation, depreciation in the value of Pakistani currency and depletion of official foreign exchange reserves or non-availability of foreign exchange in the market. Again, these sources can be considered confirmation of *hawala* presence which may be taken as counter-factual to SBP's claims that *hawala* has been side-lined but not mistaken for a systematic analysis of reforms.
- 5) **Personal experience:** The researcher is a Pakistani national and has knowledge regarding *hawala* use in Pakistan. Moreover, the researcher has professional work experience at Pakistan's Ministry of Interior and can confirm the availability of *hawala* channels and transfers for easy access by any user of foreign exchange market. However, personal knowledge cannot be cited as evidence for analysis of reforms, unless treated in a methodical manner.

From the above-mentioned available sources, it is recognized that despite regulation *hawala* still prevails and is widely used in Pakistan. What is not known is why and how the 2002 reforms or *hawala* regulation failed. Such information requires market investigation in order to determine if the reforms have worked and what specific changes have occurred in the market due to these regulations. This will help in getting a holistic view of the reasons for SBP's 2002 reforms failure and the implications of that failure. In addition, a number of related propositions have emerged from a review of the above-mentioned available sources

of information on *hawala* regulation. To be able to analyze the research questions and propositions, the most suitable case study design for the study is ‘descriptive’, because it ‘completely’ describes an intervention and the real life context in which it occurred’.<sup>143</sup> Besides, the present research is ‘single case’<sup>144</sup> because *hawala* regulation is looked at in one environment (Pakistani *hawala* market); however there are embedded units (Karachi and Peshawar markets) within the larger case which have been analyzed, making the research also an ‘embedded or within’<sup>145</sup> case study.

### 3.3 Research Questions and Propositions

The over-arching research question for this project is:

*Why have, the regulatory reforms introduced by the State Bank of Pakistan in 2002, to control hawala in Pakistan, not been successful, and what are the regulatory challenges to curbing hawala-type informal value transfer systems?*

In other words, how have the regulatory challenges to *hawala* manifested themselves in Pakistan? This involves a number of related propositions, which have been identified as a result of reviewing the existing literature and other available information:

**Proposition 1: The regulators and law enforcement do not have information about ‘the inner workings of *hawala* market’:** Analysis of this proposition requires field investigation in order to deal with the following:

- **Geographical distribution:** Are there ‘hotspots’ of *Hawala* in Pakistan? Geographical distribution is important from the regulatory policy perspective since the identification of hotspots facilitate appropriate effective law-enforcement. The more that is understood about the *hawala* market structure and operations, the more informed regulatory strategies will be. Geographical distribution over time has implications for the anthropological approach to *hawala* regulation as well.
- **Demographic profile of *hawaladars* and users:** Who are the *hawaladars*, who are their customers? What are their ethnicities? Where do they reside? Are they educated/literate?

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<sup>143</sup> Yin, above n 135, 36.

<sup>144</sup> Ibid 47.

<sup>145</sup> Ibid 50.

What are the customers' occupations? This information helps to build a common profile of a *hawaladar* and their customers in a market. This kind of profiling provides explanations of *hawala* networks in terms of cultural traditions, tribal ties, personal choice and preference, social and economic deprivation and globalization.

- **Group Characteristics:** What are the group dynamics in *hawala* market? Are there identifiable leaders? Group characteristics are important for understanding the type of social interaction that takes place, which is vital for assessing the relevance of explanations of *hawala* as a trust-based value transfer system.
- **International dimensions and associations:** Are the *hawaladars* internationally networked? Does trans-border communication occur? If so, where to? Have there been contacts with foreign networks; and, if so, what has been the significance of this (efficiency? trust? support?). Additionally, has there been contact/networking between domestic *hawaladars*? Such international associations help understand the extent to which the *hawala*-networks are truly inter-linked in the globalized world.
- **Role of the Internet:** Has the internet been used for:
  - a) Fund transfers
  - b) Communication with others abroad or at home.
  - c) The role of the internet is again relevant to understanding the globalized nature of *hawala*-systems.
- **Operational activity:**
  - a) **Cultural behaviour**
    - i) Is *hawala* the sole transfer option (due to distance, non-access to formal facilities)?
    - ii) Is *hawala* the preferable transfer option (due to tribal, family or religious traditions, convenience)?
  - b) **Economic behaviour**

Is *hawala* the most economically efficient transfer option available (better rates than formal systems, swift transfer, *hawaladars* offering loans on credit, no documentation, government policy, economic sanctions)?

**Proposition 2: State is weak and failing:** Analysis of this proposition will take into account internal and external influences that impede regulation of informal transfers. This will include Pakistan's shadow economy, tax evasion and corruption, vested interests, governance and institutional issues, role of transit trade with Afghanistan, the IMF and US War on Terror in order to understand whether or not regulation of *hawala*-type IVTS is problematic due to the State being 'weak' or 'failing'.

**Proposition 3: *Hawala* prevails due to demand and supply:** One of the leading issues in regulation is *hawala*'s economic efficiency. It has been extensively argued in the literature that regulation fails because *hawala* is more efficient than formal remittance systems, hence it prevails. While this is true, *hawala*'s prevalence and popularity is also a classic example of supply and demand in today's globalized world. Whether or not regulatory solutions consider this aspect or not, will be questioned and analyzed.

**Proposition 4: The international *hawala* regulation is misdirected:** This proposition essentially questions FATF's international regulatory framework that attempts to counter *hawala*-type IVTS and critically analyzes FATF's approach to regulate *hawala* in order to determine whether the right medicine for the disease is being prescribed or if there is a problem with the policy itself?

### **3.4 Data Sources**

#### **3.4.1 Secondary Sources**

This research relies upon secondary as well as primary data and information in order to achieve triangulation of sources vital for case study. Secondary information used in the research has been obtained from open-source materials. The main secondary sources utilized are as follows:

- 1) Various forms of press release or online information by the financial regulator (SBP) and law enforcement agencies (such as the Federal Investigation Agency (FIA)) and market sources, such as the exchange companies' association;
- 2) Press reports (the single largest source of information on the market); and
- 3) Other published accounts, such as academic studies and reports.

All sources of secondary data were primarily sought and acquired online, utilizing specific websites (for example [www.sbp.gov.pk](http://www.sbp.gov.pk) for State Bank of Pakistan, newspaper websites for press reports.) The search engine 'Google' (and 'Google Scholar') were also used as a means for searching the internet for information. This was useful for unearthing information which might not have been found by referring to sites or sources already known. The University of Wollongong (UOW) library and online publications and research material were also utilized. Each source was assessed in terms of reliability and validity. Press reports vary in reliability and validity. In instances, an uncorroborated report and information is shared or passed on by many members of the press and there are multiple accounts of the same information, but the information is not necessarily true. In order to assess the worth of the press report it is necessary to

- 1) Consider the source (for example the reputation of the newspaper, news agency or even the news reporter);
- 2) Strive for sources with local access to the case (for example, Pakistani news and media); and
- 3) Assess the extent to which the reported news is factual observation or subjective judgement (the former is more reliable).

Finally, other publications such as academic reports were also assessed on the basis of references cited and according to the validity of analyses or conclusions drawn.



Primary Data Source	Interviewees	Selection Criteria for Inclusion/Exclusion	Final sample
Semi-structured interviews	4 target groups – 36 participants i) <b>Governance</b> (government regulators, investigators, prosecutors, law enforcement, market regulators) ii) <b>Hawaladars</b> (operators in the informal market) iii) <b>Other Businesses</b> (foreign exchange companies, bankers, dealers in the formal market) iv) <b>Clients</b> (traders, importers, exporters, migrant workers, their families, students, tourists)	i) Pakistani adult in one of the four target groups. ii) Questions were asked to see if the market has changed due to 2002 reforms iii) Participation based on relevance and experience in the <i>hawala</i> market. iv) Willingness to participate in the research v) Principles of informed consent, privacy of the participants and confidentiality of information. vi) No questions regarding criminal use of <i>hawala</i> <b>Reasons for Exclusion:</b> i) incomplete responses ii) non-availability for interview iii) lack of sufficient information and evidence pertaining to <i>hawala</i> market structure and regulation	17 participants

**Table 3.1 Fieldwork Interviews**

### 3.4.2 Primary Source: Field Interviews

Primary qualitative data for the research has been gathered through semi-structured interviews planned with four target groups relevant to Pakistan’s *hawala* market (see Table 3.1). These are:

**Group 1- GOVERNANCE:** Interviewees included Pakistan government’s financial policy makers, prosecutors, regulators, investigators and law enforcement officials as well as foreign exchange market regulators.

**Group 2- HAWALADARS:** Interviewees included *hawaladars* in the informal remittance market.

**Group 3- OTHER BUSINESSES:** Interviewees included bankers, foreign exchange company owners and dealers in the formally regulated market.

**Group 4- CLIENTS:** Interviewees included users of foreign exchange market such as businessmen, traders, importers, exporters, students studying abroad, parents of student/s, migrant workers, family members of migrant worker, tourists and other travellers.

Interviewees were selected according to pre-defined criteria. The criteria for selection and inclusion/exclusion were determined as follows:

- i) The participant is an adult member and healthy stakeholder of the Pakistani *hawala* market in one of the identified four target groups.
- ii) The focus is on the *hawala* market from 2002 (when reforms to regulate *hawala* were introduced) therefore there must be evidence of *hawala* activity after the reforms were introduced (in comparison with how the market operated prior to the reforms). Questions regarding market structure and operations post the 2002 reforms were asked in order to compare and contrast the responses with *hawala* activity prior to 2002, in order to determine whether —and if so how — the market has changed since the 2002 reforms were introduced. Sample questionnaires are appended at ‘D’.
- iii) Participation in the research is based on relevance and experience in the area as well as a willingness to participate in the research. Those participants who did not show a willingness to participate in the research have not been included.
- iv) The research was conducted in accordance with the approval of the UOW Human Research Ethics Committee. Such approval was obtained prior to conducting interviews in the field concerning the ethical issues associated with *hawala* transfers. The principles of informed consent, privacy of the participants and confidentiality of information shared by them were observed in accordance with the principles of human research ethics. These processes are explained in the data collection section of this chapter.
- v) Participants were not asked specific questions regarding the criminal use of the informal remittance/value transfer systems.

These criteria were meant to be followed strictly; however a reasonable margin was kept in mind regarding interviewees who will have to be excluded because of incomplete responses or last minute lack of availability for one reason (or pretext) or another. For example, some

government officials were unavailable due to urgent official engagements or important participants in the Peshawar money market were not available when the researcher reached there. Such eventualities were kept in mind by the researcher who was aware of the culture and environment of the case country and had an alternative plan in place in order to meet any uncalled-for occurrence. By maintaining a standard of inclusion of relevance and direct stake holding in Pakistan's *hawala* market, the current research is focusing on interviewees who have the most relevant evidence available with them. This can be interpreted in different ways. On the one hand, it represents authentic information, where involvement in the market is so deep that the evidence is irrefutable, or where the market has attracted sufficient attention from law enforcement agencies to uncover inside information. A potential counter-argument to this is that information pertaining only to those instances where *hawala* had been a subject to a 'crack-down' has been shared by law enforcement agencies as evidence of the networks' operations. Although this argument seems to have relevance to the court cases involving money-exchange companies which were allegedly conducting unreported *hawala*-type transfers (with information regarding these cases shared by the law enforcement agencies), it is also true that such cases have resulted in exhaustive investigations by law enforcement agencies into *hawala* market structure and operations and these agencies have shared large quantities of useful information.

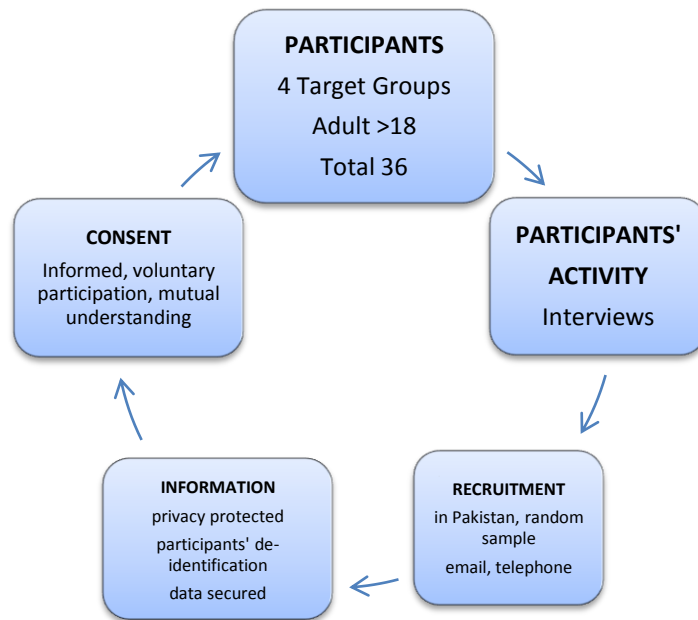
Essentially, there is great disparity between illegal *hawala* activity that results in a prosecution and *hawala* activity that is known about by the regulators and law enforcement officials. However, knowledge of this is restricted to intelligence level. The only counter-actions that are taken are suspension of exchange companies licences or imposition of penalties under the foreign exchange regulations. But frequently officials 'turn a blind eye' to the known cases of *hawala* activity. Some plausible explanations can be offered for this approach: i) Connivance of officials with the *hawaladars* ii) life security threats to officials (especially in Peshawar *hawala* market)

Although the current research has specifically focused on regulatory issues pertaining to *hawala* rather than the criminal use of these networks, yet a high level of confidence can be entrusted in its outcomes, conclusions and minimized false positives. I emphasize this

because sufficient research and information is available on the ethical aspect of hawala transfers.

The end result of the fieldwork process is a sample of 17 interviews. These have been examined and findings are summarized later in the chapter, while detailed analysis is provided in Chapters 4–7.

### 3.4.3 Human Research Ethics



**Figure 3.1: The Human Research Cycle**

As mentioned earlier, *hawala* is illegal in Pakistan. The scope of the study excluded the ethical issues associated with the criminal use of *hawala* but given that *hawala* has become synonymous with terrorism and terrorist financing in post 9/11 years, it was likely that any research on *hawala* would raise similar alarm from the human research ethics perspective as any terrorism field research would do.<sup>146</sup> Hence, fieldwork interviews in Pakistan required prior approval by the UOW Human Research Ethics Committee (HREC) through

<sup>146</sup> For more details, see Adam Dolnik, 'Conducting Field Research on Terrorism: A Brief Primer' (2011)5(2) *Perspectives on Terrorism*3.

an application that explained how the fieldwork involving human participants will be conducted in accordance with the principles of human research ethics, as follows:

### **1) Participant Recruitment**

Participants in the research are a random opportunity sample, based on experience in the area and willingness to participate in the research. All the participants were initially contacted in Pakistan when the researcher was preparing a research proposal seeking admission to the PhD course at UOW. They were re-contacted once fieldwork was approved. Most of the participants in the research (such as government officers and authorities, bankers, foreign exchange dealers and users of foreign exchange market in the urban cities of Pakistan) have been approached directly by the researcher. It is noteworthy that part of the researcher's networking in Pakistan's public sector can be credited to her work experience in the Ministry of Interior Affairs, which is the administrative ministry for the FIA, the law enforcement and prosecution agency in *hawala* cases.

#### **a) Recruitment through Liaison**

Some of the participants in the research were initially approached through liaison. These participants mainly included *hawaladars* and users of remittances in villages and remote areas of Pakistan and constitute part of two important target groups, which could not have been excluded; else it would adversely affect the aims of the research. In all, five intermediaries were involved from different parts of Pakistan in order to approach the participants in this target group. These intermediaries were people from the public and private sector whom the researcher knew well as colleagues and acquaintances. Although working and living in urban cities, these intermediaries belonged to Peshawar and other far-flung areas and could introduce the researcher to participants from their home-towns and/or villages.

The justification for approaching participants through intermediaries is that it was not possible for the researcher to have found a sample of participants from the informal sector and remote areas, without first being introduced to the participants through a trusted contact. Most of the participants interviewed in Peshawar and Islamabad cities belong to rural and remote areas in the Punjab province and the tribal areas in northern Pakistan

where cultural and traditional norms do not appreciate a direct approach from people. Also, unlike urban city centres, free movement of a stranger (particularly a woman) going door to door, or — in Peshawar’s money market — asking people for participation in the research would not be culturally acceptable in these locations. Another reason is that although commonly used, *hawala* is essentially outlawed in Pakistan, and no participant would agree to talk about being in the business to a stranger. A trusted intermediary who is either resident or familiar with the area and its cultural norms was the most viable option to approach these participants. In this manner, the liaison had introduced the researcher in advance to the participants to remove any apprehensions in their minds vis-à-vis the researcher or the study.

The intermediaries involved in this project were made aware of the need for the confidentiality and privacy of participants to be maintained due to human research ethics. The role of the intermediary was to introduce the researcher to a few participants, brief them about the aims of the project, and determine their willingness to participate as well as ask their permission to forward their contact number to the researcher, for direct, one-to-one contact. After confirming the willingness of the persons to participate, the intermediary provided lists of such contacts to the researcher. Random participants were selected from the lists and approached directly by the researcher; the aims and benefits of the research were explained and their willingness to participate determined and consent obtained without any third party involvement. The participants were informed that their identities will not be disclosed in the research or in the published thesis, and their privacy will be protected. In this way, although the initial introduction and contact with the participants was through a third party, their consent to participate in the research was obtained by the researcher directly, and they have been so selected and made part of the research in a manner that the confidentiality of their participation and their privacy remains protected.

#### **b) Location of Interviews**

The majority of the participants in the research were based in major cities in Pakistan, such as Karachi, Lahore, Islamabad, and Peshawar. Some participants, mainly regular users of migrant workers’ remittances were based in some remote areas and villages in Pakistan. Interviews took place individually in settings of the participants’ choosing. These were

mainly government offices in the case of government officials. Although prior approval from higher government authorities is required under the protocols and procedures applicable for civil servants, most of the officials who agreed to participate avoided these formalities as they did not want the meetings publicized within their organizations. In particular cases, some officials avoided meeting in their offices and preferred meeting in an outside public environment. Meetings with bankers, foreign exchange dealers and users of the remittance market in urban cities took place in offices and other public places such as cafes or restaurants, which did not require any management approval.

It needs be emphasized that gender segregation is observed in some parts of Pakistan and family and cultural traditions do not allow free interaction between men and women. In such cases, keeping in view participants' cultural, family, and religious traditions, some interviews were conducted in private spaces, such as segregated/partitioned rooms within public spaces or, in a few cases, the participant's home.

A total of 36 participants have been interviewed during the project. All the interviews were conducted in Pakistan, in two phases, each of four months duration during 2012. In the first phase, the researcher covered the northern part of Pakistan and interviewed participants in the cities of Peshawar at *Chowk Yadgar* money market, participants from the FIA, and Customs officials at the Pakistan-Afghanistan border (*Torkham*). Interviews were also conducted in Islamabad with government officials and users of the market. The second phase of interviews was conducted in Karachi city mainly with the officials at State bank, FIA, foreign exchange dealers, bankers and customers. A summary of examination, results and findings is presented in Chapter 4.

## **2) Informed Consent and Willingness to Participate**

Participation in the research has remained completely voluntary. Participants were not engaged in any relationship (of favour or indebtedness) with the researcher that would impact their participation in the research. All the participants were fully informed of the nature of the research and how their information will be used. Based on mutual understanding between the researcher and the participants and having their consent, appointments for interviews were requested in advance. Advance contact with the

participants, their willingness to meet the researcher and verbal consent to participate in the research provides evidence of their informed consent. Besides, the participants appeared convinced that their participation in the research will contribute to the benefit of the larger community and hence they agreed to meet the researcher and answer questions. All the interviewees welcomed the researcher in accordance with the social protocols of courtesy and cooperation practised in Pakistani society.

### **3) Ethical Considerations**

The following ethical considerations have remained relevant during the course of interviews in the field.

**a) Participants' Welfare:** Participants have not been exposed to any potentially harmful situations and were interviewed in a setting chosen by them. Participants have not been identified by names in the research. All information shared by the participants has been treated as confidential.

It is *highly* unlikely that the interviews have caused distress or harm to the individuals involved. There is no risk of retribution from anyone who might take offence to information/opinions that participants share, because they will not be identified in the research. During the interviews, the researcher reconciled the interviewees' responses with her personal notes and ensured that names, designations or posting in case of government officials and authorities will not be mentioned. Similarly, names, locations and other demographic details will either not be mentioned or, if required, altered with near-by or similar details in case of bankers, foreign exchange dealers, informal operators and users of the market. The questions asked during the interviews are related to their work and expertise in the field of policy making, financial regulation and investigation or, as dealers/service providers or regular users of foreign exchange and remittance market.

**b) Participants' Rights:** Participants were informed of their right to refuse or cease participation at any time, without giving any reason for such action. They were also informed that they are welcome to copies of any notes from interviews in which they participated, and that they can request that certain information not be included in the thesis, even after the interviews.



**c) Beliefs, Perceptions, Customs and Cultural Heritage:** None of these were negatively affected in any way from participating in this research. The researcher was aware of the fact that some people can show reluctance in sharing views considering the ethical issues associated with alternative remittance transfers. For this reason, research aims were explained to the participants in advance. During the interview process, the researcher showed respect for participants' opinions and reasonably accommodated individuals, their family, cultural and religious traditions during the course of their participation.

It needs be noted that ethical issues associated with the use of *hawala* remittance systems did not arise during the study as the research is not designed to investigate criminal use of the informal remittance/value transfer systems. The present research focuses on the regulatory aspects of informal remittance transfer systems commonly used in Pakistan. It attempts to improve understanding of the regulatory challenges in order to appreciate reforms and regulations implemented in this area. The questions to the participants during the research focused on the structure of the market, their preference for formal or informal remittance transfer systems based on comparative cost and efficiency of these systems, with the purpose of evaluating policies implemented by the SBP in the foreign exchange remittance market to regulate *hawala*-type transfers. However, in the instances where some participants expressed views regarding criminal use of the *hawala*-type informal remittance systems, the researcher has taken care to confirm if the views shared by these participants relate to the overall aims of the present study, and have retained relevant records only.

There has been no instance during the course of various interviews that the researcher was exposed to any classified or otherwise legally protected information that might compromise the integrity of participants or else raise further ethical issues. The scope of the study did not require any such information during interviews with the participants. Moreover, most of the participants simply did not have this kind of information, and those who did (regulators or investigation officers) were well-versed in what they could and could not disclose or share. However, before the interviews the researcher reassured these participants that any 'sensitive' information will not be published in the thesis, and the researcher will delete any record of it.

The aim of the fieldwork interviews was to paint a picture of the market structure and regulatory issues (establishing the who, what, where, when and why of the *hawala* market in Pakistan)

#### **3.4.4 Limitations of Data**

The most common limitation in interviewing data is the interviewer's bias. In order to cope with bias and to avoid error in data, researchers are often advised to complement the interviews with other data-collection techniques such as transient observation and document analysis.<sup>147</sup> Through the use of these techniques, the researcher is able to overcome the weaknesses in data collection as either new information is unearthed or available information is corroborated through the use of these complementary data collection techniques. Whilst in the current research, triangulation of data has been applied as a technique through use of primary and secondary data sources, in order to avoid limitations such as prior information on the case and personal bias during interviews, the researcher has used an additional technique of transient observation in at least two clear instances. In the first event, the researcher attended a formal presentation given by the Chairman of the Federal Board of Revenue to the Parliamentary Committee on Commerce and Trade on the subject of the Afghanistan-Pakistan Transit Trade. Here the researcher was allowed the opportunity to attend the meeting as a guest observer, on the condition that she would not ask any questions. Hence, the researcher's status was that of a confirmed transient observer. The information gathered as a result of this observation provided valuable information that was used to corroborate interviewees' information; particularly in dealing with Afghan Transit Trade issues (see Chapter 7). On another occasion, the researcher was scheduled to interview *hawaladars* in Peshawar's *Chowk Yadgar* money market. The researcher and interviewees (*hawaladars*) were joined by more *hawaladars* from the same market who were guests of the interviewees and contributed their input in the discussion. In this group too, the researcher utilized the transient observer technique and listened to the discussion between the *hawaladars* on market dynamics as well as regulatory efforts to curb *hawala*.

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<sup>147</sup> J T Murphy, *Getting the Facts: A Fieldwork Guide for Evaluators and Policy Analysts* (Goodyear, 1980). See 'Coping with Bias and Error' 57–72; 'Intensive Interviewing' 75–107; 'Transient Observation and Document Analysis,' 111–28.

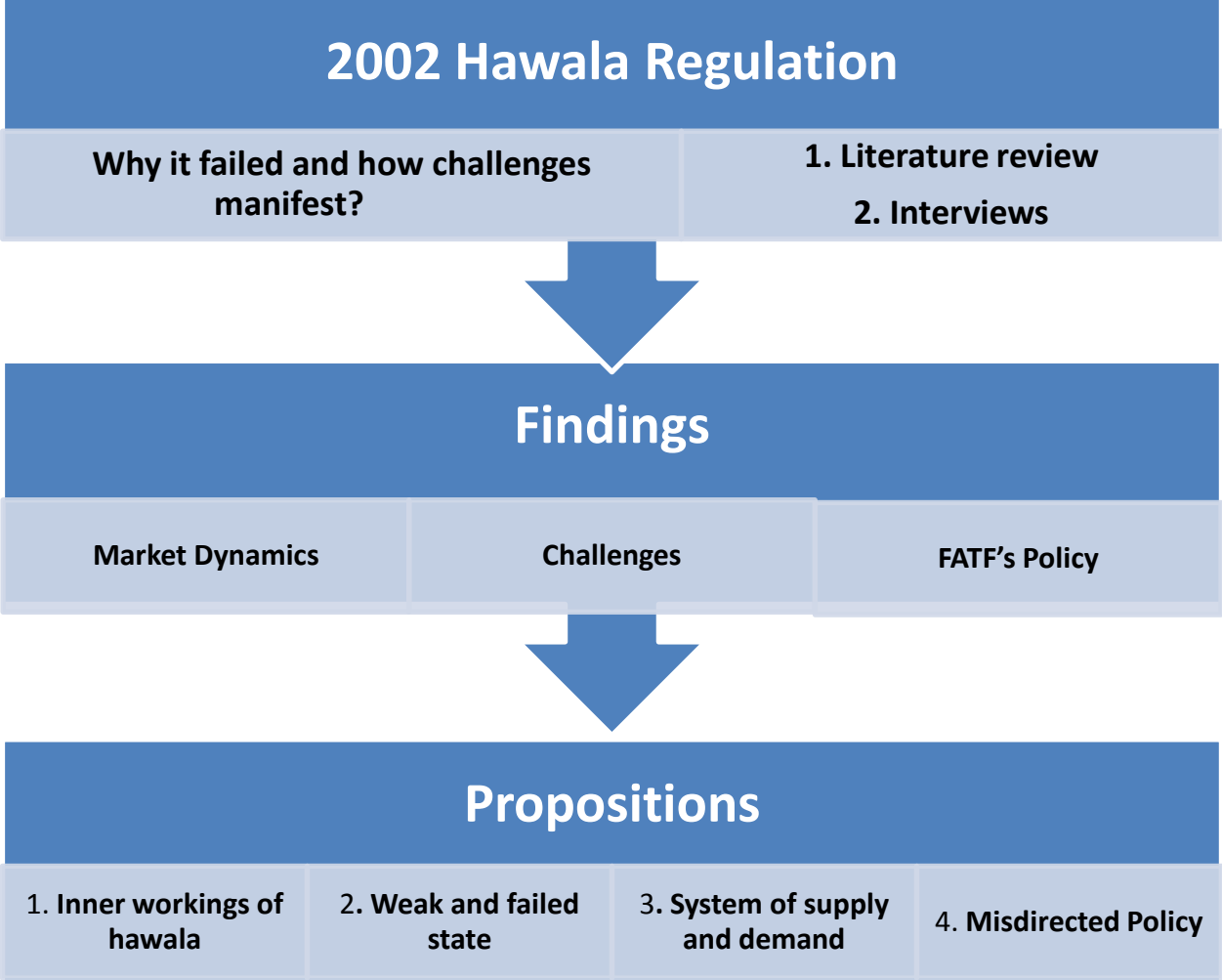
One limitation that must be mentioned relates to the scope of the study which excludes investigation into specific criminal activity through *hawala* and binds the research by not indulging ethical issues related to these informal networks. This has limited the scope of the research. Complementary future research would be to conduct a study with wider scope regarding *hawala* operations in Pakistan, thereby achieving a representation of the aspects not covered in this study.

In its complete form, this research should be taken as an investigation into the causes of the prevalence of *hawala*-type transfers in Pakistan despite the attempts to regulate the market. The study should be taken as on-ground verification of the presence, popularity and efficiency of *hawala* despite the claims by financial regulators and policy-makers that it has been side-lined by formal remittance transfers, and hence, the study should be considered a report on how and why attempts to regulate *hawala* are not bearing fruitful results.

**3.5 Conceptual Framework**

Based on the application of the above explained research methodology and design, the conceptual framework for the present study can be illustrated as follows:

**Figure 3.2: Conceptual Framework**



### 3.6 Summary of Fieldwork Findings

As mentioned in the preceding sections of this chapter, out of the 36 participants interviewed for this research 17 interviewees (in four groups) were included in the final sample to examine Pakistan’s *hawala* market since 2002, when reforms to regulate *hawala* were introduced. Appendix A lists these interviewees in order of group classification. Since their names have not been disclosed in the research, the interviewees are identifiable as officials of government regulatory bodies, ministries/divisions, law enforcement and other market regulators and, by their respective profession/role in case of non-officiating individuals.

Based on the responses of participants in each group, key words for different variables have been selected from the interviews to indicate the nature of responses. These interview key words have been summarized in order to calculate results and chart the findings. A summary of the responses and key words for each group of participants is appended at ‘B.’

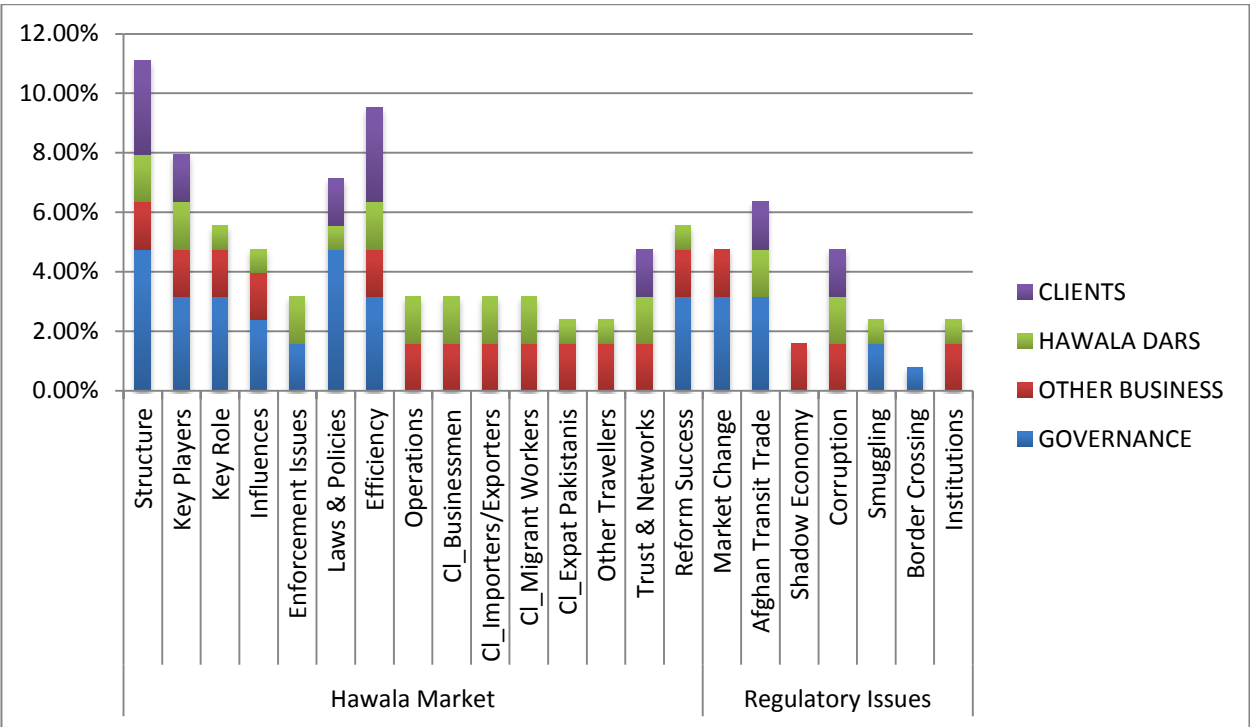
**Table 3.2: Fieldwork Findings**

Total participants in the final sample	Group classification	Group ID	Categories of responses	Total number of responses	Percentage (%)
17	i) Governance ii) <i>Hawaladars</i> iii) Other Businesses iv) Clients	G H OB C	i) <i>Hawala</i> market  ii) Regulatory issues	126	76.98  23.02

To tabulate results, interviewees have been assigned an ID, an alphabetical code comprising the first letter of interviewee group name followed by abbreviation of their identity in a combination of letters and numerical digits. For example, interviewees from the State Bank of Pakistan (Governance group) have been identified as ‘G.SBP.01’ and ‘G.SBP.02’.

Responses of the participants have been tabulated against two broad categories viz ‘*Hawala* Market’ and ‘Regulatory Issues’. Each response in the selected variables of these two categories is recorded as 1. Hence 1 in any column indicates a response while 0 indicates no

response by the participant. The total on the chart is 126 responses. The participants' responses are then turned into percentages by dividing each response by the total number of responses and multiplying by 100 ( $1/126 = 0.0079 \times 100 = 0.79\%$ ). As a result of this calculation, 76.98 per cent of responses relate to the *hawala* market while 23.02 per cent are in regard to the regulatory issues. Appendix C provides detailed statistical tabulation of the results explained above.



**Figure 3.2: Fieldwork Findings**

Figure 3.2 above summarizes the findings of the research. It shows responses in two broad categories received from the four interviewee groups. As can be seen, the main data collected as a result of interviews in the field relate to the *hawala* market structure and operations and the regulatory issues faced in controlling informal value transfers in Pakistan. It is clear that most of the information on different market variables and regulatory issues has been shared by the ‘Governance’ group — mainly comprising the regulatory, investigatory and prosecuting agencies. For instance, the bulk of the information on the *hawala* market structure, operations and other dynamics has been obtained from the

FIA officials. This information was subsequently counter checked and confirmed through other sources identified earlier. Other than the FIA, the ‘other businesses’ group — mainly the money exchange companies — was a source of major information on the different market and regulatory variables.

It is obvious that information obtained from both these groups was different. Whereas, the exchange companies’ representatives explained the on-ground, regular market procedures and operations, the FIA officials brought forth information which explained the overall market dynamics and ‘game-changer’ role of the various *hawala* market players. Conversely, interviews with the *hawaladars*, clients and also exchange companies and bankers shed light on the role of regulation and law enforcement thus confirming not only the prevalence of *hawala* in a regulated environment but also serious regulatory issues within the so-called regulated exchange companies’ operations.

As for the regulatory challenges to control *hawala* in Pakistan, the percentage of responses shown in Figure 4.1 above is relatively low (23 per cent). This may be because not many participants such as clients or *hawaladars* could relate the informal transfers with deeper problems in the political economy, geography and transit trade issues of the country. Nevertheless, the responses, mainly from the ‘governance’ and ‘other businesses’ groups, were valuable because of the relevance of the observations of these participants who are directly involved with these issues.

Detailed, descriptive findings are available in Chapters 4–7 in the thesis.

## **Chapter 4: Description of the Case Study Environment**

### **4.1 Introduction**

This chapter introduces Pakistan's geography, political administration and the legal, institutional and regulatory frameworks relevant to *hawala* regulation. The purpose of providing the reader with the requisite background information is twofold. Firstly, it helps to highlight the peculiar geo-strategic role of Pakistan in a region where *hawala* originated and has been practiced for many centuries. Secondly, it provides a snapshot of the political, institutional and economic situation of a country which relies heavily on inward remittances to sustain its many economic problems. It is essential that the reader understands 'the environment' in which the regulation of informal *hawala*-type transfers is required, in pursuance of Pakistan's international commitment to weed out financial crimes and terrorism. Whether this objective is necessary or achievable is addressed in Chapter 7.

With this view, the chapter begins by providing an overview of Pakistan's geography and location. Next, it explains the political administration in the country focusing mainly on the Federally Administered Tribal Areas (FATA) and introduces the reader with the exclusive pre-colonial legal and administrative framework that is practised in these areas. After this, the economy and the role of inward remittances in the economy is discussed, in order to understand in the following section, the manner in which the dark side of Pakistan's shadow economy facilitates as well as necessitates the regulation of the informal transfers. Finally, there is a discussion of the legal and institutional frameworks that are directly relevant to *hawala* regulation, such as the State Bank of Pakistan (SBP) and the Federal Investigation Agency (FIA).





**Figure 4.1 Geographical Map of Pakistan<sup>148</sup>**

## 4.2 Geography

Spread over an area of 796,095 square kilometres the Islamic Republic of Pakistan<sup>149</sup> is located in South Asia, and has a population estimated to exceed 195 million.<sup>150</sup> Geographically Pakistan lies at the crossroads of the strategically important regions of South Asia, Central Asia and Western Asia. It has a 1,046-kilometre coastline along the Arabian Sea and the Gulf of Oman in the South.<sup>151</sup> Pakistan is bordered by Afghanistan

<sup>148</sup> Available online at <<http://geography.about.com/library/cia/blcpakistan.htm>>. Both the map and information are derived from the Central Intelligence Agency, *CIA Factbook: Pakistan* (last updated 11 March 2014) <<https://www.cia.gov/library/publications/the-world-factbook/geos/pk.html>>.

<sup>149</sup> Third largest Muslim population of the World (10.5%), after Indonesia (13.1%) and India (11%): *CIA Factbook: Pakistan*, above n 147.

<sup>150</sup> It is the sixth most populous country in the World: *ibid*.

<sup>151</sup> For more details on Pakistan-Oman marine border see Joseph A Kechichian, *Oman and the World: The Emergence of an Independent Foreign Policy* (Rand Corporation, 1995)235.

in the West and North, China in far north-east, India to the east and Iran to the southwest.<sup>152</sup>  
 The narrow *Wakhan*<sup>153</sup> corridor in north Afghanistan separates Pakistan from Tajikistan.



**Figure 5.2 Political Map of Pakistan**<sup>154</sup>

<sup>152</sup> Ashraf Qureshi, *Geography of Pakistan* (Book Center, 2003)11.

<sup>153</sup> Area linking North-eastern Afghanistan with China.

<sup>154</sup> Maps of World available online at < <http://www.mapsofworld.com/pakistan/pakistan-political-map.html>>.

### 4.3 Political Administration

In its political administration, Pakistan is a federation of four provinces. These comprise Punjab, Sindh, Khyber Pakhtunkhwa (KPK) and Balochistan, as well as the Islamabad Capital Territory (ICT) and the Federally Administered Tribal Areas (FATA) in the northwest.

#### 4.3.1 The Federally Administered Tribal Areas (FATA)

The Federally Administered Tribal Areas (FATA) in Pakistan is spread across about 27,220 square kilometres<sup>155</sup> between Afghanistan to the West, Balochistan province to the South, and KPK province to the East, and is mostly inhabited by Pashtun<sup>156</sup> tribes. FATA is comprised of seven Agencies<sup>157</sup> (tribal districts) and six Frontier Regions<sup>158</sup> (FRs). According to the fifth population census conducted in 1998, FATA's population stood at a little over 3.1 million.<sup>159</sup> This figure has been recently contested and the population of FATA is said to be more than 6.0 million people.<sup>160</sup>

Due to its strategic location, FATA has a history of war and conflict. For instance, in the 19<sup>th</sup> century the British tried to occupy Afghanistan in order to secure their Indian dominion from a Czarist Russia; but, despite various attacks, British attempts to invade Afghanistan failed such that in 1842 an 18,000-strong British army had to retreat from Kabul. To avoid further conflict, and as a result of compromise between the British and Afghan rulers, a chunk of Pashtun territory was separated from Afghanistan and amalgamated into British India. The border known as the 'Durand Line' was then created and is currently the border between Pakistan and Afghanistan. Since the Durand Line cuts through the Pashtun

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<sup>155</sup> Sayed Wiqar Ali Shah, 'Political Reforms in the Federally Administered Tribal Areas of Pakistan (FATA): Will it End the Current Militancy?' (Working Paper No 64, South Asia Institute Department of Political Science, *Heidelberg Papers in South Asian and Comparative Politics*, January 2012)3.

<sup>156</sup> Ethnic Pathan and Afghan people.

<sup>157</sup> These seven agencies are Khyber, Kurram, South Waziristan, North Waziristan, Mohmand, Bajaur, and Aurakzai: Ali Shah, above n 154, 3.

<sup>158</sup> The six settled frontier regions/districts under the Khyber Pakhtunkhwa provincial administrative setup, known as the Provincially Administered Tribal Areas (PATA) are F.R. Peshawar, F.R. Kohat, F.R. Bannu, F.R. Lakki Marwat, F.R. Tank, and F.R. Dera Ismail Khan: Ibid.

<sup>159</sup> Ibid [n 2], citing S Iftikhar Hussain, *Some Major Pukhtoon Tribes along the Pak-Afghan Border* (Area Study Centre (Russia and Central Asia) University of Peshawar, 2000) 7.

<sup>160</sup> Ibid [n 3], citing Rahimullah Yusufzai, 'Some Real Changes', *The News* (Islamabad), 16 August 2011.

heartland dividing tribes, clans, and even households, it is crossed with impunity by Pashtuns who live on either side of what is currently the Pakistan-Afghanistan border.<sup>161</sup>

Regardless of compromise and administrative arrangements, and despite being under its direct control, the Pashtuns remained a continuous threat to the British rule in India due to their obstinacy and refusal to accept foreign domination. Consequently, British imperialism faced severe resistance in FATA. In 1842, a part of FATA called Waziristan could not be subdued by 40,000 British troops.<sup>162</sup> Ultimately, the British had to resolve matters with the Pashtuns and the Baloch<sup>163</sup> through a special administrative code. This administrative arrangement allowed the British to continue using FATA's tribal region as a buffer zone. Interestingly, even after independence from its British rulers in 1947, successive Pakistani governments have continued with the legacy of the British colonial policies in FATA without bringing any fundamental changes to the governance system and administration in the tribal areas.

#### **4.3.2. Frontier Crimes Regulation (FCR) 1901**

Frontier Crimes Regulation (FCR) of 1901 is the colonial era legal and administrative framework which the British used to govern the tribal areas between Pakistan and Afghanistan. After independence from British India, Pakistan has retained FCR to govern the tribal belt located in the north-west of Pakistan. Article 247<sup>164</sup> of Pakistan's Constitution excludes FATA from constitutional coverage and vests the power of law making in FATA solely with the President of Pakistan. In this manner, FATA is governed directly by the federal government. Under FCR and Articles 246 and 247 of the Constitution, conventional

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<sup>161</sup> Ayaz Khan Achakzai, 'Point of View: To Bring Peace to Afghanistan, the International Community Must Understand Pashtuns' (2010) 98 (4) *Colby Magazine*, 10.

<sup>162</sup> *Ibid.*

<sup>163</sup> Balochistan was divided by the British into the so-called 'A-areas' and 'B-Areas'. The A-areas comprise cities and towns, roughly 5 per cent of the province, which falls under the control of Balochistan police; the B-areas refer to the remaining 95 per cent of the rural or unsettled part of Balochistan which are manned by a special police force, called 'the Levies'. However, unlike FATA where the FCR is in force, and where conventional laws of Pakistan are not applicable, Balochistan's A-areas and B-areas both fall under the jurisdiction of the Constitution of Pakistan and regular laws, namely the *Criminal Procedure Code 1898*, and the *Pakistan Penal Code 1860*, apply there. Similarly, all legal proceedings take place at regular courts of Judicial Magistrates and Districts and Sessions Judges as they do elsewhere in Pakistan.

<sup>164</sup> *Constitution of Pakistan* available at <<http://www.pakistani.org/pakistan/constitution/part12.ch3.html>>. For text of the entire *Constitution of Pakistan*, see <<http://www.pakistani.org/pakistan/constitution/>>.

Pakistani laws do not apply to FATA, nor do any other constitutional clauses, including those protecting fundamental rights of speech, assembly, fair trial and dignity. The FCR effectively takes FATA out of the mainstream political and administrative system and does not comply with the *International Covenant on Civil and Political Rights (ICCPR)*.<sup>165</sup> Acts of Parliament are not applicable in FATA unless the President directs otherwise. Basic citizenship rights, such as the right of adult franchise was extended to FATA in 1997, and the *Political Parties Act 1962*, was extended to the FATA region in 2011.<sup>166</sup>

In FATA, Pakistan government's conventional tax collection, policing and judicial systems do not exist. Alternatively, FATA is administered by civil servants known as Political Agents (PAs), who govern in consultation with the tribal elders called *maliks*.<sup>167</sup> Policing functions in FATA and Balochistan B-Areas are carried out through a special police force called 'the Levies'. The number of levies in FATA and Balochistan is estimated at 6,779 and 12,000 respectively.<sup>168</sup> Levies are responsible for policing in tribal areas and carrying out law and order functions under their respective PAs.

The PAs exercise judicial authority in FATA in consultation with the tribal council of elders (*jirga*). The *jirga* is presided over by the tribal (male) elders (*maliks*), who receive financial privileges from the PAs in return for helping maintain social peace and suppress crime.<sup>169</sup> Distribution of allowances and other economic incentives to certain tribal leaders in return for loyalty and facilitating the spread of local administration's authority over the region, a colonial strategy, have been possible due to the specific legal framework provided by the FCR.<sup>170</sup> *Jirgas* enforce customary law, often considered selective and discriminatory by various human rights organizations.<sup>171</sup>

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<sup>165</sup> Sustainable Development Policy Institute and UNODC, *Examining the Dimensions, Scale and Dynamics of the Illegal Economy: A Study of Pakistan in the Region* (Report submitted to the United Nations Office on Drugs and Crime, November 2011).

<sup>166</sup> Syed Bukhar Shah, 'Extension of Political Parties Act to FATA', *The News* (Pakistan), 10 August 2011.

<sup>167</sup> Marco Mezzera and Safiya Aftab, 'Pakistan State-Society Analysis' Country Case Study: Pakistan' (Netherlands Institute of International Relations, January 2009) 11.

<sup>168</sup> SDPI and UNODC Report, above n164,8.

<sup>169</sup> Shehryar Fazli, *Taming a "Strange Land"*, International Crisis Group, 27 June 2011

<<http://www.crisisgroup.org/en/regions/asia/south-asia/pakistan/fazli-taming-a-strange-land.aspx>>.

<sup>170</sup> Ibid.

<sup>171</sup> Ibid.

In recent years, the unbridled executive, judicial and financial authority of the PAs has invited severe criticism. Most criticized among the PAs' discretionary powers under the FCR is their power to impose economic blockades or sieges on 'hostile' or 'unfriendly' tribes and to inflict fines on whole communities where certain crimes took place. For example, in 2004, South Waziristan administration shut down and later threatened to demolish, the Agency's central marketplace when members of a prominent tribe failed to capture foreign militants there, leaving many residents without an income.<sup>172</sup> In addition to this, the most notorious provision of the FCR is its Schedule 40, which deals with collective responsibility issues. Under FCR 40, the PAs can punish any tribe, or sub-tribe whenever they deem fit.<sup>173</sup> This means if somebody damages a government property in, say, Area A, the PAs can punish people from Area B on the basis of mere suspicion and impose heavy penalties. If a crime takes place in area C, the tribe living in the area is responsible for redemption, even though miscreants or rivals might be responsible for the act. Moreover, FCR 40 empowered the political administration to jail anyone for three years without assigning a reason. In relation to their judicial powers, the decision of the PAs could not be challenged in superior Pakistani courts until 2011 when, as a result of amendments in the FCR,<sup>174</sup> a three member bench comprising Peshawar High Court judges has been constituted to hear appeals against decisions of the PAs.<sup>175</sup>

Although some amendments have been introduced, the FCR nevertheless has still not been abolished and serves as the law of the land for FATA. The question remains why an independent, sovereign state would require an exclusive law in its border areas, and who are the real beneficiaries of such exclusion?

The most common argument for retaining FCR has been that tribal Pashtuns would resent the Pakhtun code of traditional conduct being breached by the introduction of regular laws and government.<sup>176</sup> Some analysts decry this position as propaganda carried out by a

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<sup>172</sup> Imtiaz Gul, 'Tribal Areas craving for FCR Abolition', *Weekly Pulse* (Islamabad) 10 April 2007.

<sup>173</sup> Ibid.

<sup>174</sup> In 2011, two fundamental reforms were announced for FATA. Firstly, the *Political Parties Act 1962* has been extended which will allow political process in the FATA. Secondly, the clause regarding collective punishment in FCR has been amended to exclude children, women and the old; and in addition an appellate bench has been formed in which the verdicts of the Political Agent can be challenged.

<sup>175</sup> Khadim Hussain, 'Political Rallies in FATA', *Dawn* (Pakistan), 7 August 2012.

<sup>176</sup> Fazli, 'Taming a Strange Land', above n 167.

powerful elite group who are the real beneficiaries of a weak government writ in FATA.<sup>177</sup> Others contend that such claim is impossible to reconcile with the daily misery and risk that the FCR has wrought.<sup>178</sup> Proponents of these views argue that the government's writ in FATA is tenuous by design; benefitting a few thousand state and non-state actors including the Pakistan military, civil bureaucracy, tribal leaders, politicians and businessmen.<sup>179</sup> On the contrary, the inhabitants of FATA, who should have been the real beneficiaries of the incentives and facilities enjoyed by their leaders, are economically under-developed. The FATA is one of the poorest and least developed areas in Pakistan with a literacy rate of 17.42 per cent compared with the national average of 40 per cent.<sup>180</sup> The female literacy rate in FATA is 3 per cent compared with a national average of 32 per cent. Almost 66 per cent people live below the poverty line and per capita income is USD250, half of the national average of USD500.<sup>181</sup> A survey conducted under the FATA Poverty Assessment has revealed a number of 'common indicators of poverty' that indicated the extent of FATA's extreme poverty, illiteracy, small agricultural holdings and lack of industrial enterprise across the region. These were:

...landlessness or ownership of just small areas of land; lack of livestock; little or no food; lack of nutritious food; tattered clothing and no shoes; poor quality or condition of house; unemployment; high dependency on others for food and income; women working to supplement household income; ill health and disability; increased risk of conflict; lack of access to public services; lack of influence and powerlessness; and belonging to a powerless tribe are indicators of poverty across the FATA.<sup>182</sup>

Little surprise then if FATA deprived of economic development, has remained a kind of playground for smugglers and criminals of every stripe. Illegal trade of arms and narcotics, transit trade to Afghanistan through Pakistan, foreign exchange transactions through

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<sup>177</sup> See Gul, 'Tribal Areas craving for FCR Abolition', above n 170.

<sup>178</sup> Fazli, above n 167.

<sup>179</sup> Gul, above n 170.

<sup>180</sup> Mona Naseer, 'Waking up to FATA', *Daily Times* (Pakistan) 20 January 2014.

<<http://www.dailytimes.com.pk/opinion/20-Jan-2014/waking-up-to-fata>>.

<sup>181</sup> Ibid.

<sup>182</sup> *Between Hope and Despair: Pakistan Participatory Poverty Assessment: Federally Administered Tribal Areas Report* (Department for International Development (DFID), September 2003) 16.

*hawala/hundi*, and goods transport are the main major businesses in the tribal areas.<sup>183</sup> The Pakistani military has also used the strategically located region to promote its perceived interests in Afghanistan through local and Afghan proxies.<sup>184</sup> In 1978, the military regime in Pakistan under General Zia-ul-Haq decided to gain maximum benefit from the Afghan conflict, and started providing organizational training to the Afghan *mujahidins* (holy warriors). The United States, through its Central Intelligence Agency (CIA), and some western European countries supported Zia-ul-Haq through the generous provision of both funds and ammunition to topple the pro-Soviet regime in Afghanistan.<sup>185</sup> The Soviet invasion of Afghanistan in 1979 had its immediate repercussions on the tribal areas of Pakistan whose land and resources both were used to serve the objectives of the Afghan *jihad* (holy war).<sup>186</sup> Ever since, FATA has become a haven for many local, regional and international *jihadi* groups.

Two important factors regarding FATA from the perspective of *hawala* regulation need be noted. Firstly, in the years following the withdrawal of Soviet troops from Afghanistan, the influence of the Afghan businessmen in FATA has increased manifold due to the massive funds they had received in the name of anti-Soviet jihad.<sup>187</sup> Once the war was over, these funds were used to start businesses in FATA.<sup>188</sup> A second simultaneous significant development was that thousands of tribesmen acquired Afghan passports and left for the United States, European countries and the Middle East. These tribesmen have relied on *hawala* transactions to send money home, which has sustained family income levels as well as strengthened *hawala* networks in the tribal areas. In addition to this, the illegal trade in narcotics and arms — as well as smuggling through the Afghan Transit Trade<sup>189</sup> — creates a substantive pool of local funds that can be settled through the pool of funds collected as a

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<sup>183</sup> Asif Mian, 'FATA: Tribal Economy in the Context of Ongoing Militancy' (2009) 2(3) *Conflict and Peace Studies* 91, 92.

<sup>184</sup> Raheem ul-Haque, "Strategic Depth": Does it Promote Pakistan's Strategic Interests?' (2011) *Quarterly Research and News* 7.

<sup>185</sup> *Ibid* 7–8.

<sup>186</sup> Shuja Nawaz, 'FATA—A Most Dangerous Place: Meeting the Challenge of Militancy and Terror in the Federally Administered Tribal Areas of Pakistan' (Centre for Strategic and International Studies (CSIS) Press, 2009).

<sup>187</sup> Mian, above n 182, 92.

<sup>188</sup> *Ibid*.

<sup>189</sup> *Ibid*.



result of migrant remittances abroad, making *hawala* a vibrant financial system in the tribal areas.

#### 4.4 Economy and Home Remittances

Pakistan's economy can be classified as one of the emerging economies of the world. With a Gross Domestic Product (GDP) estimated to be between USD240 and USD260 billion, it is among world's largest remittance recipient countries.<sup>190</sup> Home remittances constitute the second largest source of foreign exchange in Pakistan after exports.<sup>191</sup> These inward remittances exceed foreign direct investment and compared with foreign loans which have associated costs in the form of mark up or other conditionalities, home remittances have been a valuable and inexpensive source of foreign exchange available for the government for the economic development of the country as these are not received subject to strict and difficult terms.<sup>192</sup> Many economists are of the view that remittances from abroad have helped sustain Pakistan's economy despite political instability, high oil prices and costly imports.<sup>193</sup> At around 55 per cent of the total export of goods and services (around USD26 billion in 2011–12) and corresponding imports (USD40 billion) inward remittances have provided support to the country's current account balance.<sup>194</sup> Some authors argue that these remittances have served to play a crucial role in the growth profile of Pakistan which helped in poverty alleviation in rural areas as well as provided support in the wake of natural disasters, such as the earthquake that hit Northern Pakistan in 2005.<sup>195</sup> In addition to this, home remittances (which account for the second largest source of inflow of US dollars) have remained one of the major sources countering the negative pressure on

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<sup>190</sup> World Bank, *Remittances vs Major Exports in Some Countries* (Migration and Remittances Prospects) World

Bank<<http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0,,contentMDK:21121930~menuPK:3145470~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html>> accessed 4 May 2014.

<sup>191</sup> Rashid Amjad, M Irfan and G M Arif, 'How to Increase Formal Inflows of Remittances: An Analysis of the Remittance Market in Pakistan' (Working Paper, Graduate Institute of Developmental Studies, International Growth Centre (IGC) and Pakistan Institute of Development Economics (PIDE), February 2013).

<sup>192</sup> For example Coalition Support Fund (CSF) USD1.18 billion pa: Ibid.

<sup>193</sup> Ashfaq H Khan, 'Role of Remittances', *The News*(Pakistan), 8 September 2009.

<sup>194</sup> Amjad, Irfan and Arif, above n 190, 2.

<sup>195</sup> Abid Qaiyum Suleri and Kevin Savage, 'Remittances in Crises: A Case Study from Pakistan' (Sustainable Development Policy Institute Report Series No 10, 2006).

exchange parity and in the manner that these inflows have consistently kept a check on free fall of the Pakistani rupee (PKR) against the US dollar (USD).<sup>196</sup>

Interestingly, the record rise in remittance inflows into Pakistan during the last few years has occurred at a time when the world economy is still unsteady and most countries have witnessed declines in workers' remittances. At a time when a decline in home remittances was expected as a result of major lay-offs in the aftermath of worldwide financial crisis, Pakistan defied the trend as its home remittances increased in 2009–10 and thereafter. It was surprising that in the midst of the global economic meltdown and a rise in unemployment, remittances grew by over 21 per cent in 2008–09.<sup>197</sup> The surge in inflows was not only limited to Pakistan but South Asia overall registered an increase of 33 per cent. Several views can be cited to explain this reported increase in remittances in South Asia in general and Pakistan in particular. Firstly, some migrants have apparently lost their jobs in host countries and have returned with their savings; hence, the jump in remittances flows.<sup>198</sup> Secondly, Saudi Arabia, UAE and other Gulf Cooperation Council (GCC) countries are major destinations for the Pakistani migrants and since these countries have not sent Pakistani workers back home in large numbers, there is an increased remittance numbers.<sup>199</sup> A third reason, to which authors attribute the increased remittances are falling property prices, rising interest rate differentials and a sharp depreciation of exchange rate. These are thought to have played important roles in attracting large remittance inflows for investment purposes as opposed to consumption purposes.<sup>200</sup> Last but not least, the record rise in remittances is explained by many experts as the inflow of laundered money that was initially transferred through *hawala*, coming back into the economy as inward remittances through the formal banking channels.<sup>201</sup>

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<sup>196</sup> Ashfaq Khan, above n 192.

<sup>197</sup> Ibid.

<sup>198</sup> Amjad, Irfan and Arif, above n 190, 7.

<sup>199</sup> Ibid 11–13.

<sup>200</sup> Ibid 7.

<sup>201</sup> Ibid 14–15; Also see Ikram Hoti, 'Money Changers Helping Massive Whitening of Dollars', *The News*(Pakistan), 5 December 2011.

## 4.5 Shadow Economy

The assumption regarding funds initially transferring through *hawala* and then returning as inward remittances through the formal channels has clear application to Pakistan. These include the size of Pakistan's shadow economy, rampant tax evasion (both a cause of and the effect of the shadow economy) and criminal economy which accounts for a large part of the shadow economy as well as creating many other problems.

### 4.5.1 The Size Problem

Whilst the shadow economy is global in its dimensions, calculating precise estimates for its extent is an ongoing problem for policy makers due to non-availability of precise information. Consequently, several approaches are used to find the estimates for the shadow economy. Among these, the most popular is the monetary approach, which is based on the assumption that the shadow economy is based on cash transactions in order to avoid detection. Other approaches include the labour market approach, fiscal approach, MIMIC (multiple indicators multiple causes) approach, and so on. The major problem with all of these approaches is that they do not give the actual estimates of the shadow economy, instead they give trend estimates for it. This means that various indicators show whether the shadow economy is going up or down.

### 4.5.2 Terms and Definition Problem

There is also no commonly acceptable definition or term that can be used for the 'dark side' of the world economy; instead there is a 'plethora of appellations'<sup>202</sup> such as 'black', 'grey', 'hidden', 'shadow', 'informal', 'illegal', 'unreported', 'underground', 'unrecorded', 'undeclared', 'second', and 'parallel'.

The 'informal economy' refers to that part of the economy which is outside the government's control.<sup>203</sup> It usually involves money-based transactions, including barter trade, mutual self-help, odd-jobs, street trading and so on. Income generated by the

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<sup>202</sup> Stavros Katios, 'The Shadow Economy and Corruption in Greece'(2006)1 *South Eastern Journal of Economics* 61.

<sup>203</sup> Vito Tanzi, 'The Shadow Economy, Its Causes and Its Consequences' (Lecture Given at the International Seminar in Brazil Brazilian Institute of Ethics in Competition, Rio de Janeiro, 12 March 2002).

informal economy is generally not recorded for taxation purposes, and information is unavailable for GDP calculations. Very close to the informal economy is the ‘black economy’, which includes essentially illegal and even criminal activities such as distributing drugs, smuggling and trading in contraband goods, prostitution and gambling. It is important to note that while the informal economy may not be taxed or regulated by the government, it can still include legal economic activities whereas the black market essentially comprises illegal activities. The black market is also distinct from the ‘grey market’, in which commodities are distributed through channels, which while legal, are unauthorized, unofficial and unintended by the original manufacturer.

The problem of term and definition has been resolved by Katsios<sup>204</sup> who settles this issue of ‘legal’ and ‘illegal’ by using a single term ‘shadow economy’ that includes the use and/or production of legal as well as illegal goods and services. Tax evasion<sup>205</sup> associated with legal activities is itself illegal and subject to criminal punishment. Similarly, investment of tax evasion proceeds from legal activities still remains ‘money laundering’, as the proceeds are related to a criminal activity. A broad definition of a shadow economy then, would include unreported income from all economic activities that would generally be taxable were they reported to the authorities<sup>206</sup> as reflected in Table 5.1 below.

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<sup>204</sup> Katsios, ‘The Shadow Economy and Corruption in Greece’, above n 201,62.

<sup>205</sup> Tax evasion and tax avoidance are two significantly different terms. Tax evasion refers to illegal way of avoiding taxes and tax avoidance is a lawful arrangement or planning in order to reduce the tax liability.

<sup>206</sup> Katsios, ‘The Shadow Economy and Corruption in Greece’, above n 200,64.

**Table 4.1: A Taxonomy of Types of Underground Economic Activities**

<b>Type of Activity</b>	<b>Monetary Transactions</b>		<b>Non-Monetary Transactions</b>	
ILLEGAL ACTIVITIES	Trade in stolen goods; drug dealing and manufacturing; prostitution; gambling; smuggling, fraud etc.		Barter: drugs, stolen goods: smuggling etc: producing or growing drugs for own use: Theft for own use.	
	<b>Tax Evasion</b>	<b>Tax Avoidance</b>	<b>Tax Evasion</b>	<b>Tax Avoidance</b>
LEGAL ACTIVITIES	Unreported income from self-employment;  Wages, salaries and assets from un reported work related to legal services and goods	Employee discounts,  Fringe benefits	Barter of legal services and goods	All do-it yourself work and  Neighbour help

**Source: Katsios 2006.**

### 4.5.3 Informal Economy — A Global Phenomenon

According to a 2013 ILO report,<sup>207</sup> the number of unemployed people across the globe is over 200 million and is likely to increase in the post global financial crises years. The findings of this report provide that over the past five years the incidence of long-term unemployment has increased in 60 per cent of the advanced and developing economies. This has occurred alongside the increase in the incidence of informal employment to up to half of the total labour market in countries like Germany and Hungary. In developing and emerging economies, the share of informal employment stands at 40 per cent, demonstrating that the shadow economy is a significant part of many developing countries. Although difficult to determine precisely, the value of shadow economies around the world may total about USD10 trillion a year.<sup>208</sup> A World Bank study<sup>209</sup> estimated the size of shadow economies for 162 countries over the period 1999 –2006/7 and revealed that the weighted average size of the shadow economy as a percentage of GDP in Sub-Saharan Africa is 38.4 per cent; in Europe and Central Asia it is 36.5 per cent, and in high income OECD countries, it is 13.5 per cent. The ILO estimates that the shadow economy comprises half to three-quarters of all non-agricultural employment in developing countries. If agricultural workers in developing countries are included, the estimate of the number of informal workers in developing countries would be 2,000 million people.<sup>210</sup> Shadow economies are generally associated with poor employment conditions and increasing poverty, and the labour force is exposed to lack of protection in the event of non-payment of wages, compulsory overtime or extra shifts, lay-offs without notice or compensation, unsafe working conditions and the absence of social benefits such as pensions, sick pay and health insurance.<sup>211</sup> Illicit work can take many shapes. The ‘underground’ use of labour

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<sup>207</sup> Raymond Torres (eds), ‘Repairing the Economic and Social Fabric’ *World of Work Report* (International Labor Organization and International Institute for Labor Studies, 2013).

<sup>208</sup> Robert Neuwirth, *Stealth of Nations: The Global Rise of the Informal Economy* (Anchor, 2012) 27.

<sup>209</sup> Friedrich Schneider, Andreas Buehn and Claudio E. Montenegro, ‘Shadow Economies All over the World: New Estimates for 162 Countries from 1999 to 2007’ (Policy Research Working Paper 5356, *The World Bank Development Research Group*, Poverty and Inequality Team & Europe and Central Asia Region Human Development Economics Unit, July 2010).

<sup>210</sup> Friedrich Schneider, ‘The Shadow Economy and Shadow Economy Labor Force: What Do We (Not) Know’ (Discussion Paper No5769, IZA [*Institut zur Zukunft der Arbeit* (Institute for the Study of Labor)] June 2011) 23.

<sup>211</sup> International Labor Organization, *Informal Economy*(nd)

<<http://www.ilo.org/global/topics/employment-promotion/informal-economy/lang--en/index.htm>>.

may consist of a second job after (or even during) regular working hours. A second form is informal economy work by individuals who do not participate in the official labour market. A third component is the employment of people (such as clandestine or illegal immigrants), who are not allowed to work in the official economy. Given all these approximations, it is not difficult to understand the volumes of unrecorded funds generated in the shadow economies both in the formal as well as informal sectors that are available for settlement purposes in case of *hawala* transactions.

#### 4.6 Size of Pakistan's Shadow Economy

The economists Kemal and Qasim<sup>212</sup> have taken stock of the shortcomings of the existing approaches that are commonly used to calculate the size of shadow economy. They have used a new 'discrepancy' approach to calculate precise estimates of Pakistan's shadow economy. The discrepancy approach calculates total private consumption from the household survey for the total population, and adjusts it for trade mis-invoicing. True estimates of the GDP are then compared with the GDP estimates reported in the National Accounts. The difference between the two values, according to these authors, is the size of the shadow economy. According to their estimates, the informal economy of Pakistan was 91 per cent of the formal economy in 2007–08<sup>213</sup> which, considering Pakistan's GDP of USD231 billion in 2012–13,<sup>214</sup> easily comes to USD211 billion. If the estimate of these authors is indeed true, this also indicates the true size of Pakistan's GDP as USD440 billion, almost double its present value and bringing it on par with countries such as Austria (USD398 billion), South Africa (USD384 billion) and close to Taiwan (USD473 billion).<sup>215</sup>

Different international authors have used other approaches to estimate Pakistan's shadow economy; for instance, Schneider, Buehn and Montenegro have used the multiple causes multiple variables approach to estimate shadow economies for 151 countries between 1996 and 2006/7. For developing countries, these authors have used cause variables: the size of the government, the unemployment rate, government effectiveness, and GDP per capita. As

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<sup>212</sup> M Ali Kemal and Ahmed Waqar Qasim, *Precise Estimates of the Informal Economy* (2012) 51(4) *Pakistan Development Review* 505, 506.

<sup>213</sup> *Ibid* 512.

<sup>214</sup> Ministry of Finance, *Pakistan Economic Survey 2012–13* <[http://finance.gov.pk/survey\\_1213.html](http://finance.gov.pk/survey_1213.html)>.

<sup>215</sup> International Monetary Fund, World Economic Outlook Database, 'Report for Selected Countries and Subjects', April 2013 <<https://www.imf.org/external/pubs/ft/weo/2013/01/weodata/index.aspx>>.

indicator variables they have used currency, the growth rate of GDP per capita, and the labour force participation rate. According to the estimates calculated by these authors, the average size of Pakistan's shadow economy is around 35.7 per cent<sup>216</sup> of GDP, which is a middle distribution level among developing countries compared with the smallest shadow economies, such as China (12.8 per cent), Singapore (13.0 per cent), and Vietnam (15.2 per cent). The highest shadow economies include Peru (58.7 per cent), Panama (63.5 per cent), and Bolivia (66.6 per cent).

Pakistan's Federal Bureau of Revenue (FBR) states that the country's shadow economy had already touched over USD100 billion, while considering the total GDP of USD166 billion in 2008–09.<sup>217</sup> An FBR report has estimated that the country's shadow economy expanded at the rate of 9 per cent between 1977 and 2000. Similarly, United Nations Office on Drugs and Crime (UNODC) research has estimated the size of Pakistan's informal economy in between 20 and 30 per cent of the formal economy.<sup>218</sup> Research by Arby, Malik and Hanif (2010)<sup>219</sup> has estimated the size of shadow economy as 30 per cent of the total economy. According to Gulzar, Junaid and Haider (2011)<sup>220</sup> the size of shadow economy is around 28 per cent of the formal economy.

In view of these various calculations, conservative estimates of the size of Pakistan's shadow economy can be anywhere between 30 and 90 per cent of its formal, documented economy.<sup>221</sup>

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<sup>216</sup> Schneider, Buehn and Montenegro, above n 208, 63.

<sup>217</sup> Federal Board of Revenue, *Annual Report 2011–2012*, 92

<<http://download1.fbr.gov.pk/Docs/20132201123540770AnnualReport201112.pdf>>; Also see Shahnawaz Akhter, 'Black Economy More than Half of Formal: FBR Study', *The News*(Pakistan), 16 August 2012.

<sup>218</sup> Conducted jointly by Sustainable Development Policy Institute (SDPI) and UNODC; this report deals with illegal and criminal activities such as drug trade, human smuggling, arms trade and other crime. See Sustainable Development Policy Institute, *Examining the Dimensions, Scale and Dynamics of the Illegal Economy*, above n 164, vii.

<sup>219</sup> Muhammad Farooq Arby, Muhammad Jahanzaib Malik, and Muhammad Nadim Hanif, 'The Size of Informal Economy in Pakistan' (Working Paper No 33, State Bank of Pakistan, 2010)12.

<sup>220</sup> Ahmed Gulzar, Novaira Junaid, and Adnan Haider, 'What is Hidden in the Hidden Economy of Pakistan? Size, Causes, Issues and Implications' (2012)49(4)*Pakistan Development Review* 665, 678.

<sup>221</sup> S Akbar Zaidi, 'Pakistan's Roller Coaster Economy: Tax Evasion Stifles Growth' (Policy Brief No 88, Carnegie Endowment for International Peace, September 2010)5.



## 4.7 Indicators of Pakistan's Shadow Economy

### 4.7.1 Low Tax Revenues

According to World Bank Data,<sup>222</sup> Pakistan's tax revenue as a percentage of GDP (also referred as the 'tax-to-GDP ratio') was 9.3 in 2011, one of the world's lowest. Developing economies usually have a tax-to-GDP ratio from 13 per cent to 18 per cent. Compared with other South Asian economies, India stood at 10.4 per cent, Bangladesh 10 per cent and Sri Lanka 12.4 per cent. A low tax-to-GDP ratio means that a country incurs high budget deficits which must be financed by either printing money or borrowing. This adds to the country's debt burden and creates inflationary pressures. At present, Pakistan has an inflation rate that is second only in Asia to that of Vietnam.<sup>223</sup> Low tax revenues also mean that fewer resources are available for essential social services.

The composition of Pakistan's GDP is such that it becomes easy to avoid tax, especially in sectors that have largely remained untaxed, for example the agricultural sector employs 45 per cent of the country's total workforce with a 22 per cent share in the GDP,<sup>224</sup> and yet its contribution to tax revenue is roughly 1 per cent.<sup>225</sup> The same is the case with the services sector (53 per cent of GDP) which includes retail, transportation and general government services. According to the quarterly review of the Federal Board of Revenue for the first half of the fiscal year 2012–13, the total number of registered employees in the services sector was 122,000, a figure that has grown significantly over the years. During the last six years, income tax collection from this sector hovered around PKR 4–5 billion, and the share of total direct taxes could not increase above 1 per cent rather it has been declining since 2009–10.<sup>226</sup>

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<sup>222</sup> World Bank. *Tax Revenue (% of GDP)* World Bank  
<<http://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS>> accessed 30 June 2013.

<sup>223</sup> Ibid.

<sup>224</sup> Ministry of Finance, Government of Pakistan, *Pakistan Economic Survey 2012–13* (2013)  
<[http://finance.gov.pk/survey\\_1213.html](http://finance.gov.pk/survey_1213.html)>. See esp 'Overview' vi [agriculture], xii [unemployment]; Imtiaz Ahmed, 'Growth and Investment' 9; Omer Farooq, 'Agriculture' 17.

<sup>225</sup> Zaidi, above n 220, 9.

<sup>226</sup> *FBR Quarterly Review* (2012) vol 12(2), above n 216, 25.

To illustrate this mismatch between revenue contribution and share in GDP, the FBR report<sup>227</sup> cites the example of the leading component of the services sector — wholesale and retail trade (WRT). WRT constitutes 17 per cent in the overall GDP and within services sector its share is about 34 per cent however, its contribution to the federal taxes is only 0.5 per cent. According to FBR estimates, there are about 1.5 million wholesale and retail trade units in Pakistan. These include sale, maintenance or repair of motor vehicle, wholesale trade and commission agents and retail trade. Nearly 85 per cent are in the retail trade, followed by sale or repair 11 per cent and wholesale 4 per cent. Within the retail trade, almost 54 per cent of units are engaged in sale of food, drinks or tobacco. The growth in this sector necessitates greater employment which the report substantiates by providing that a total of 9.0 million people being employed in this sector, which is around 16 per cent of the total labour force.<sup>228</sup> Around 59 per cent of the people within WRT sector are employed in retail trade and the sale and purchase of goods, as untapped unregistered workers.

#### **4.7.2 Tax Evasion**

Only 1.4 million (0.9 per cent) Pakistanis pay tax — a small proportion of a total population of over 180 million.<sup>229</sup> A 2003 Lahore University of Management Sciences (LUMS) study has been cited showing that out of every PKR100, the government receives only PKR38, and PKR62 is pocketed by the tax payer, tax collector and the tax practitioner. According to the findings, PKR720 billion tax collection was only 38 per cent of around PKR2 trillion which should have been collected by the FBR.<sup>230</sup> If these calculations are applied, then the PKR1.939 billion revenue collected by FBR in fiscal year 2012–13<sup>231</sup> should have been PKR3.132 trillion.

A comparison of key indicators of financial inclusion in Pakistan with those of other countries in the region confirms the presence of a growing shadow economy. According to

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<sup>227</sup> Ibid 15. See esp Naeem Ahmed, ‘Wholesale and Retail Trade Sector in Pakistan’ 14–32.

<sup>228</sup> There are 57.24 million civilian labour in Pakistan out of which 3.4 million are unemployed: *Pakistan Economic Survey 2012–13*, 162.

<sup>229</sup> FBR Annual Report 2011, 86; Also see Enum Naseer, ‘Tax Evasion in Pakistan: A Critical Analysis’, *Business Recorder*(Pakistan), 15 May 2013.

<sup>230</sup> Shahnawaz Akhter, above n 216.

<sup>231</sup> *Federal Board of Revenue Year Book 2012–2013* (Ministry of Finance, Revenue Division 2013)

<[http://download1.fbr.gov.pk/Docs/2013923169417516RevenueDivisionYearbook2012-13\(20Sep13\)Final.pdf](http://download1.fbr.gov.pk/Docs/2013923169417516RevenueDivisionYearbook2012-13(20Sep13)Final.pdf)>.

the World Bank Financial Inclusion data 2011,<sup>232</sup> only 10 per cent of Pakistani adults have an account at a formal financial institution. The comparable figure for India is 35.23 per cent, China 63.81 per cent, Sri Lanka 68.52 per cent and Bangladesh 39.55 per cent. Similarly, only 5 per cent of adult Pakistanis use a bank account to receive wages and only 1 per cent use bank accounts to receive remittances.

Some financial analysts argue that the problem in Pakistan is that of fiscal inclusion, rather than financial inclusion as the international financial institutions suggest in their studies. According to these experts, there are between 20 and 30 million bank accounts in Pakistan, suggesting that each household maintains at least one bank account. By contrast, the number of income-tax paying people is about 2 million only.

The key question remains: why aren't government revenues higher? Zaidi<sup>233</sup> considers tax evasion as the main culprit for the problem. In his view, tax evasion is caused by three things: poor legal frameworks and bureaucratic capabilities with regards to revenue extraction; corruption in the form of a predatory class that privileges certain sectors and vested interests with unjustified 'tax exemptions'; and elites who cut deals with the state to avoid taxation. This is further substantiated by the fact that those attempting to restructure Pakistan's tax regime in 2001 have backed down in the face of massive popular revolt to the proposal to register traders and shop owners.<sup>234</sup> Also, after the government imposed the first-ever sales tax of 16 per cent on tractors in March 2011, above-ground purchases of the vehicles hit a low of 369 units in January, as compared to 5,673 a year earlier. Tractor makers Fiat and Massey Ferguson suspended local production, forcing the government to cut the tax to 5 per cent.<sup>235</sup>

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<sup>232</sup> World Bank, *Financial Inclusion Data*, World Bank Database

<<http://datatopics.worldbank.org/financialinclusion/country/pakistan>>.

<sup>233</sup> Zaidi, above n 220, 9.

<sup>234</sup> Ibid 10.

<sup>235</sup> Naveen Mangi, 'The Secret Strength of Pakistan's Economy', *Bloomberg Business Week*, 5 April 2012.

### 4.7.3 Criminal Economy<sup>236</sup>

At the even ‘darker end’ of the shadow economy spectrum is the thriving illegal economy orchestrated by complex informal and formal organized criminal networks of supplier rings, wholesalers, financiers, protectors and patrons. A 2011 study by the Sustainable Development Policy Institute (SDPI) and the UNODC<sup>237</sup> has estimated the scale and dynamics of illegal economy in Pakistan, and its links with regional and global security. According to the findings of this study, the most lucrative business for organized criminals is trafficking in drugs and their precursors, followed by migrant smuggling and human trafficking, the illegal timber trade and kidnapping for ransom.

#### **i) Trafficking in Drugs and Precursors**

Pakistan’s geographical proximity with Afghanistan places it in a vulnerable position with respect to the illicit trafficking of opiates and their precursors. Afghanistan is now the source for more than 90 per cent of the world’s opium and a significant cannabis producer much of which is harvested in provinces bordering Pakistan. According to UNODC, Pakistan itself has over 1,000 hectares under poppy cultivation in the Federally Administered Tribal Areas (FATA) bordering Afghanistan.<sup>238</sup> Consequently, large quantities of opium, heroin, and cannabis are trafficked via Pakistan to Iran, the Middle East, Africa, East Asia and Western countries. Approximately 44 per cent of the heroin produced in Afghanistan is estimated to be trafficked through Pakistan. Pakistan is also a major transit country for the precursors entering Afghanistan.<sup>239</sup>

#### **ii) Human Trafficking and Migrant Smuggling**

Pakistan is also a destination, transit and source country for both human trafficking and migrant smuggling. Human trafficking to and from Pakistan includes the trafficking of mostly women and children for the sex trade, child labour, and bonded labour. Migrant

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<sup>236</sup> Data in this section is largely drawn from SDPI and UNODC, *Examining the Dimensions, Scale and Dynamics of the Illegal Economy: Pakistan*, above n 164, unless otherwise cited.

<sup>237</sup> Ibid.

<sup>238</sup> UNODC, Country Profile: Pakistan(2014) <<http://www.unodc.org/pakistan/en/country-profile.html>>.

<sup>239</sup> For example, all acetic anhydride used for heroin production has to be smuggled into Afghanistan as no production facilities for the substance exist in the country and there is no reported legitimate use of the chemical there.

smuggling is more prevalent than other forms of human trafficking and it primarily involves emigration to Europe and the Middle East. Illegal emigration of Afghans to Europe, the Middle East, and to a lesser extent to Australia is also transited through Pakistan.

### **iii) Arms Smuggling**

In addition to drugs and human trafficking, there is also evidence of arms trafficking. The proliferation of small arms in Pakistan reportedly originates from two sources. The first is diversions from the estimated USD2 billion worth of arms which were meant to transit through Pakistan to Afghanistan in the period from 1979 to 1989. Estimates are that 70 per cent of these arms never made it to Afghanistan and ended up on the black market in Pakistan. The second major source is the unorganized and largely unregulated private ordinance manufacturing enterprises in the towns of Darra Adam Khel and Landi Kotal in FATA. Darra Adam Khel alone is estimated to have some 2,600 arms manufacturing outlets, with a capacity to produce 100 AK 47 assault rifles per day.

### **iv) Illegal Timber Trade**

Timber prices in Pakistani cities are generally higher than the world average. This provides an incentive for timber contractors to harvest the country's state controlled natural forests beyond sustainable and legal limits. In addition, high value timber varieties are smuggled into Pakistan from Afghanistan. Illegally harvested timber is mostly consumed domestically while the high value cedar wood from Afghan and domestic sources, is smuggled out of the country, mainly to Dubai. Pakistan's formal importation of timber is less than one-fifth of local timber production. There is no formal importation of fuel wood. The 2011 SDPI/UNODC study has estimated that the proceeds from illegal timber trade (consisting of illegal logging in Pakistan and the smuggling of illegally logged timber from Afghanistan into Pakistan) stand at around USD23 million.

### **v) Kidnapping for Ransom**

Cases of kidnapping for ransom in all major cities of Pakistan are on a rise since 2007. Organized gangs involved in kidnapping for ransom often have threefold set-up. One team

is responsible for kidnapping and handing over the victim to a middleman; the middleman then transfers the kidnapped to a third party. This party keeps the hostage until a successful bargain with the person's family is complete. In this process, there is also a possibility of failed deals resulting in the death or re-selling of the kidnapped person. The hostages are usually kept in areas such as the tribal regions where law enforcement agencies have weak control. According to conservative estimates, proceeds from kidnapping for ransom may be just over USD10 million.

## **4.8 Institutional, Legal and Regulatory Frameworks**

### **4.8.1 Complex Institutional Frameworks**

Pakistan has a complex institutional framework and an extensive security apparatus to deal with organized or isolated crimes. Under the Constitution of 1973, law and order is a provincial subject whereas immigration and border control are national subjects being dealt with at the federal government level. The federal government employs an estimated 210,000 law enforcement personnel<sup>240</sup> spread across several agencies and involved in a wide variety of law enforcement, internal security and intelligence roles with country-wide jurisdiction. The strength of provincial governments' police personnel is estimated at 354,221.<sup>241</sup> According to the UNODC, law enforcement agencies struggle to interdict trafficking and smuggling of various kinds and on various scales, particularly at the borders. Resources available to these agencies are insufficient and low personnel numbers make for sub-optimal investigations and enforcement. Information sharing between agencies is ad-hoc and their relationships are often competitive rather than cooperative.<sup>242</sup> An example of this is that during the past 30 years, the National Accountability Bureau (NAB), the Federal Investigation Agency (FIA), Anti-Narcotics Force (ANF) and Federal

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<sup>240</sup> Hassan Abbas, 'Reforming Pakistan's Police and Law Enforcement Infrastructure; Is it too Flawed to Fix?' (Special Report No 266, United States Institute of Peace, 2011)4.

<sup>241</sup> Ibid 6.

<sup>242</sup> SDPI and UNODC Report, above n 164, 7.

Board of Revenue (FBR) have not been able to establish a joint task force to book and prosecute the individuals and networks involved in smuggling and money laundering.<sup>243</sup>

#### **4.8.2 State Bank of Pakistan**

The State Bank of Pakistan (SBP) is the apex financial regulator regulating the foreign exchange market. The policies and regulations are administered through the Exchange Policy Department (EPD) in the SBP. The EPD is structured into three divisions namely the Policy Division, Investment Division, and Exchange Companies Division. Recently, as a result of a redistribution of responsibilities, work pertaining to issuance of Authorized Dealers' licences has been reallocated from Exchange Companies Division to Policy Division of EPD. Consequently, while the Exchange Companies Division is responsible for formulation of policies for establishing exchange companies and developing framework for their licensing, operations, supervision and monitoring the issuance of these licenses is taken care of by the Policy Division.

##### **i) Foreign Exchange Regulations Act (FERA) 1947**

Foreign exchange business is regulated under the *Foreign Exchange Regulations Act (FERA 1947)*. *FERA 1947* prohibits *hawala-type* transfers, in that it clearly lays down the procedure for dealing in foreign exchange,<sup>244</sup> thus making the use of any IVTS illegal and criminal in Pakistan. The Foreign Exchange Manual 2002 outlines the rules and regulations governing foreign exchange business for the guidance of exchange companies, authorized dealers, the general public and other stakeholders.

##### **ii) Contraventions of *FERA 1947***

Whereas *FERA 1947* stipulates the regulation of foreign exchange transactions, in 1992 the incumbent government of Prime Minister Nawaz Sharif introduced a new law called the

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<sup>243</sup> Ikramul Haque, 'Combatting Financing of Terrorism' ((Paper presented at the International Judicial Conference, Islamabad, 19–21 April 2013) 8. This conference was held under the auspices of the Law and Justice Commission of Pakistan.

<sup>244</sup> Section 4(1) of *FERA 1947* states, '... no person other than an authorised dealer shall in Pakistan, and no person resident in Pakistan, buy or borrow from, or sell or lend to, or exchange with, any person not being an authorised dealer, any foreign exchange'.

*Protection of Economic Reforms Act (PERA)1992*. Sections 5<sup>245</sup> and 9<sup>246</sup> of *PERA* provide complete freedom to an individual to bring, hold, sell, transfer and take out foreign exchange within or outside Pakistan. This legislation has a clear overriding effect on *FERA 1947*, making the legislation controlling foreign exchange regulations contradictory. Under this situation, the Central Bank is in a difficult position to effectively monitor and supervise foreign exchange activities. An example of this is that under *FERA 1947*, an individual cannot take out of the country an amount more than USD10,000 in cash, whereas *PERA 1992* provides complete freedom to this effect. Another legal provision in section 111(4)<sup>247</sup> of the Pakistan Income Tax Ordinance 2001 states that, if a person is bringing foreign exchange from abroad through normal banking channels, the tax authorities cannot pose any questions about the source of these funds if the foreign exchange is surrendered and funds are converted into Pakistani rupees. Hence, in such cases, banks also shelter under these laws to withhold information from the tax and regulatory authorities.

It is obvious that in the presence of such ‘protective laws’, the SBP’s financial regulation and control of foreign exchange market has remained ineffective. Consequently, despite the desire to effectively regulate the informal sector in the foreign exchange market, the SBP has not been able to effectively regulate the informal foreign exchange activities.

### **4.8.3 Federal Investigation Agency (FIA)**

The Federal Investigation Agency (FIA) is a federal government organization which reports to the Pakistan’s Ministry of Internal Affairs. Among its other responsibilities, the FIA is the law enforcement agency responsible for apprehension, investigation and prosecution of

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<sup>245</sup> Section 5: Immunities to Foreign Currency Accounts-

(1) All citizens of Pakistan resident in Pakistan or outside Pakistan who hold foreign currency accounts in Pakistan, and all other persons who hold such accounts, shall continue to enjoy immunity against any inquiry from the Income Tax Department or any other taxation authority as to the source of financing of the foreign currency accounts.

(2) The balances in the foreign currency accounts and income there from shall continue to remain exempted from the levy of wealth-tax and income tax and compulsory deduction of *Zakat* at source.

(3) The banks shall maintain complete secrecy in respect of transactions in the foreign currency accounts.

(4) The State Bank of Pakistan or other banks shall not impose any restrictions on deposits in and withdrawals from the foreign currency accounts and restrictions if any shall stand withdrawn forthwith.

<sup>246</sup> Section 9: Secrecy of Banking Transaction- ‘Secrecy of bonafide banking transactions shall be strictly observed by all banks and financial institutions, by whosoever owned, controlled or managed’.

<sup>247</sup> Section 111(4)(1) does not apply to any amount of foreign exchange remitted by a person from outside Pakistan through normal banking channels that is converted into rupees by a scheduled bank and a certificate from such bank is produced to that effect.



*hawala* related cases in Pakistan. Under the provisions of the *Foreign Exchange Regulations Act 1947*, FIA can raid, seize funds, and investigate *hawala* offences, on a complaint from the State Bank of Pakistan, along with one other complainant.

Organizationally, the FIA is divided into four zones or directorates: Sindh, Punjab, Balochistan, and Khyber-Pukhtunkhwa (KPK), with its headquarters in Islamabad. The agency has the authority to carry out operations all over the country, except in the FATA region. For *hawala* investigations and prosecutions, the Agency follows the rules and procedures of the Pakistan Code of Criminal Procedures 1898 and Pakistan Electronic Crime Ordinance 2002. The total manpower of FIA is nearly 3,000.<sup>248</sup>

#### **4.8.4 The Anti Money Laundering Act 2010**

Under tremendous international pressure, the Pakistan government has passed the *Anti-Money Laundering (AML) Act 2010* but provisions of corresponding laws such as the *Protection of Economic Reforms Act 1992* and Income Tax Ordinance 2001 allow a free hand to money launderers. In the presence of these laws, the *AML Act 2010* has virtually become a dormant law whose provisions have rarely been invoked.<sup>249</sup>

Many legal experts view that the *AML Act 2010* as inherently flawed.<sup>250</sup> For instance, the *Constitution* of Pakistan excludes B-areas in Balochistan, and areas in Khyber Pukhtunkhwa (KPK) provinces from the parliament's legislative coverage. This means the Act does not extend into these areas and transactions occurring there are not subject to legal scrutiny. Moreover, according to the Research Society of International Law (RSIL), the Act does not apply to fiscal offences such as smuggling of otherwise legal goods for the purpose of evading customs duties or income tax.<sup>251</sup> This is viewed as a practical loophole for money launderers using IVTS, since smuggling based repatriation of value — once converted to cash — can be deposited with formal financial institutions.

Consequently, the effectiveness of the Financial Monitoring Unit (FMU) — created under section 6 of the *AML Act 2010* — has also become questionable due to contradictory laws

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<sup>248</sup> Abbas, above n 237, 16.

<sup>249</sup> Haque, above n 239, 8.

<sup>250</sup> Taimur Malik, 'Analysis of Pakistan's Anti Money Laundering Bill', *Dawn* (Pakistan), 20 February 2007.

<sup>251</sup> *Ibid.*

which provide legal cover to the banks. The banks share very few ‘suspicious transactions’ (a subjective term)<sup>252</sup> with the FMU. Besides, under the provisions of AML Act, the Financial Monitoring Unit monitors transactions in formal financial institutions only. This means that money laundering occurring through *hawala/hundi* channels has no oversight in place, leaving a window for money launderers, to conveniently transfer their funds to international tax havens and off-shore accounts.

#### **4.9 Conclusion**

The purpose of this chapter was to provide an overview of the administrative, legal and institutional frameworks relevant to *hawala* regulation in Pakistan. The background information clearly shows that a number of factors in Pakistan’s domestic environment — mainly the existence of FCR and exclusion of FATA, the shadow economy and the criminal elements of it, rampant tax evasion and ineffective and overriding legislations (the causes as well as the consequences of non-regulation) — necessitate effective regulation of *hawala* type IVTS. Hence, the 2002 *hawala* regulation introduced by the SBP discussed in the next chapter is required to be viewed in this perspective. The information provided in this chapter clearly shows that whilst Pakistan was under international pressure to implement FATF’s *hawala* regulation following 9/11 terrorist attacks, SBP’s 2002 *hawala* reforms could well be seen as a reaction to the domestic policy concerns. Following chapters will shed more light on this perspective.

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<sup>252</sup> Haque, above n 239, 8.

## **Chapter 5:**

## **Pakistan's *Hawala* Market**

### **5.1 Introduction**

Pakistan is a labour exporting country. About seven million of its emigrants make up the world's seventh largest diaspora.<sup>253</sup> From the mid seventies onwards, Pakistan's economy has experienced a dramatic increase in emigration of both skilled and unskilled labour to countries in the Middle East and Europe, and the United States. Remittances received from foreign countries have traditionally been handled by Pakistani banks as well as the informal *hawala* system. *Hawala* has operated in Pakistan in a predominantly unregulated environment for years, although the SBP took initiatives from time to time to encourage capital to stay in the country or eventually flow into the regulated financial system. Two such initiatives were the Foreign Exchange Bearer Certificates (FEBCs) Scheme in 1985 and the Foreign Currency Bearer Certificates (FCBCs) introduced in 1992.<sup>254</sup> These initiatives were clearly aimed at attracting funds from Pakistanis in overseas countries and to reduce the attraction of *hawala* networks but none could succeed in eliminating *hawala*.

Money changers were initially authorized by the State Bank in 1991. These authorized money changers were required to obtain a licence from the SBP but were not allowed to undertake money transfers, which were legally permitted only through the banks. The money changers however freely used the *hawala* system. In March 2002, the SBP took major steps towards *hawala* regulation and took the initiative of converting the business of money changers into Money Exchange Companies (MECs or ECs). Under the introduced reforms, the newly created Exchange Companies provide both money transfer and currency exchange business. The purpose of these purported reforms was to corporatize the foreign exchange business in Pakistan as well as get rid of the informal foreign exchange dealings and transfers. But, have these objectives been achieved? This chapter attempts to explore this question. It explains the 2002 creation of exchange companies by the SBP and the reporting requirements that these formally regulated entities have to abide by. Next, it describes the regulated market structure and operations in the years post 2002. The various

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<sup>253</sup> World Bank, *Migration and Remittances Fact Book* (World Bank, 2011)

<<http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1199807908806/Top10.pdf>>.

<sup>254</sup> Passas, 'Informal Value Transfer Systems', above n 25, 63–64.

market dynamics are explained in detail with the aim of understanding the ‘inner’ market workings and mechanisms and see the extent to which the 2002 *hawala* regulation has taken effect. It concludes the reforms failed to meet their stated objectives and explains why this occurred.

## 5.2 Why Were the 2002 Reforms Introduced?

Three popular theories have frequently been invoked to explain the 2002 foreign exchange market reforms by the SBP. The foremost relates to the role of the IMF; and its infamous, ‘conditionalities’.<sup>255</sup> Pakistan has remained under IMF assistance since the late eighties and as part of its structural adjustment program for Pakistan, the IMF has been pressing the different Pakistani governments to bring about economic and governance reforms in various areas.<sup>256</sup> One of the key areas where the IMF continuously desired reforms included foreign exchange liberalization and the merger of the two — interbank and the kerbed — markets. In the late 1990s, often dubbed as the lost decade for the country’s economy due to poor growth indicators,<sup>257</sup> Pakistan had yet again sought IMF assistance and had embarked on a structural reform program under the military government that had taken control in October 1999. While the government was still initiating reforms in different sectors 9/11 occurred, and so, very close to the IMF’s role, another theory views the 2002 forex reforms in connection with the events following 9/11. This view holds that regulations against *hawala* were enforced because the United States thought that such regulations would starve global terror of funds.<sup>258</sup>

Notwithstanding the international pressure for cooperation, a more localized view suggests that the idea of creating foreign exchange companies had remained with the SBP officials

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<sup>255</sup> These are loan conditions that a borrowing country government agrees to adjust its economic policies that led it to seek financial assistance from the international community. See Meekal Aziz Ahmed, ‘The IMF and Pakistan: A Road to Nowhere’ (PIDE Lecture Series, Pakistan Institute of Development Economics, 2012).

<sup>256</sup> For greater details, see resources available at International Monetary Fund, ‘Pakistan and the IMF’ (11 April 2014) <<http://www.imf.org/external/country/pak/index.htm?pn=15>>.

<sup>257</sup> In the 1990s, economic growth plummeted to 4 per cent, poverty rose to 34 per cent, inflation was in double digits and the external debt mounted from USD20 billion in 1990 to USD43 billion (47.6 per cent of GDP) in 1998: Ishrat Hussain, ‘The Role of Politics in Pakistan’s Economy’ (2009) 63(1) *Journal of International Affairs* 1,6–7.

<sup>258</sup> See, eg, 2001 address by President George Bush: For a partial transcript see CNN, ‘Bush: We Will Starve the Terrorists’, 24 September 2001, <<http://edition.cnn.com/2001/US/09/24/ret.bush.transcript/index.html>>

as part of their proposals to control foreign exchange crises in the country.<sup>259</sup> According to this view, the 2002 reforms were a long time priority of both the Pakistani government and the SBP, which has been trying to stop *hawala* transfers, and increase inflows of home remittances from overseas Pakistanis through the formal channels.<sup>260</sup>

It could be argued that all of the above explained theories to the 2002 reforms may be taken as sound and true to some extent. Indeed, both the IMF and the US did play a role and influenced Pakistan to impose strict regulations to eliminate *hawala* and consequently the government which had long wanted to restructure the market introduced reforms. The important question however, is not who or what prompted the reforms or, whether these were a result of home-grown policies or foreign pressure; what should be critical to any discussion is to understand whether Pakistan's domestic policy concerns (explained earlier) necessitate regulation and whether reforms are indeed beneficial to its own interests.

### **5.3 Money Exchange Companies (MECs)**

Money exchange companies are governed under the *Foreign Exchange Regulation Act (FERA) 1947*. The SBP issues licenses to them. These companies have to be incorporated under the *Companies Ordinance Act* and therefore register with the Securities and Exchange Commission of Pakistan (SECP) separately. Hence, under the 2002 regulatory reform, MECs require both licensing and registration.

There are two types of Exchange Companies: 'A' category and 'B' category. 'A' category Exchange Companies were established in 2002. These can carry out both money exchange as well as remittance business. The subsequent 'B' category was introduced in 2004. 'B' category exchange companies are allowed only to undertake sale/purchase in foreign currency (money changers). It is noteworthy that since the formation of ECs entailed a minimum capital requirement of PKR100 million, it became an impediment for many small scale operators, hence a subsequent B category was introduced by the SBP two years later with a lower capital requirement (PKR25 million) and limited operational scope. The minimum capital requirement licensing condition was relaxed by the SBP such that a

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<sup>259</sup> Usmani, above n115, 9.

<sup>260</sup> Ibid.

minimum of five previous operators could pool resources to form an EC. As a result, the SBP's website shows a list of 28 ECs of category A and 29 ECs of B category. In other words, the SBP tried to maximize the number of operators that could be licensed and be part of the regulated sector. It could be argued, however, that the licensing and registration regulation entails a capital requirement and other regulatory costs, and is not completely free or involve bare minimum over-heads as is the case of *hawala*.

### **5.3.1 Reporting Requirements**

Under the SBP's revised 'know your customer'/'customer due diligence'( KYC/CDD) reporting requirements, banks are required to obtain and maintain full originator information for both domestic and cross-border wire transfers regardless of the amount, throughout the payment chain. The money exchange companies are not permitted to undertake domestic wire transfers.<sup>261</sup> ECs are required to collect basic customer identification, undertake record keeping and suspicious transaction reporting. For remittance transfers, the procedure stipulates that names, addresses and other particulars of both the remitter as well as the beneficiary should be mentioned on the receipt regardless of the amount. Information on outward remittances above USD5,000 must be submitted to the SBP with the following information: the name of the remitter, computerized national identity card (CNIC) or passport number of the remitter, address of the remitter, name and address of beneficiary, account number of beneficiary abroad, amount and currency of the outward remittance, and the account number of the exchange company used for remittance.

It is important to mention here that the reporting requirement for outward remittance above USD5,000 was again a result of the SPB's review of its initial policy. According to the original policy, identification documents and details were required for every outward transaction irrespective of the amount being transferred. This means that the exchange companies were required to obtain complete sender details for an outward remittance even if it was USD1. During our interviews with the officials of Exchange Companies Association of Pakistan, it was confirmed that the decision to create exchange companies

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<sup>261</sup> Tatiana Nenove, Cecile Thioro Niang and Anjum Ahmad, 'Bringing Finance to Pakistan's Poor: A Study on Access to Finance for the Underserved and Small Enterprises' (Report No 48672, World Bank, May 2005)147.

did not involve consultations with the currency dealers. Consequently, the SBP was facing pressure from exchange companies on reporting conditions such as producing ID card on even a single dollar purchase/sale or remittance transfer. Acceding to their pressure, the SPB relaxed its earlier policy and decided upon a threshold of USD5,000 above which exchange companies are required to observe regulations. Moreover, as far as the regulations stipulate, MECs are required to secure the prior approval of the SBP before undertaking outward remittances involving USD50,000 or above (or equivalent in other foreign currencies), and use banks if cross-border transfer exceeds USD3,000.

It is noticeably evident from the above explanation of the SBP's reforms that firstly, the cost of regulation for the money transfer operation has escalated by many fold, and secondly the reporting requirements have made the system much more complex and difficult from what the money changers/*hawaladars* practised prior to 2002. The obvious question is how these operators have adjusted to the regulation that has apparently increased their costs as well as complexities in business by new and many reporting requirements. The following sections delve into these details.

## **5.4 Market Structure**

### **5.4.1 Formal Sector**

Structurally, Pakistan's foreign exchange market can be divided between the formal and the informal sectors. Table 5.1 below shows this division in the market. In the formal sector, the market is comprised of banks, money exchange companies and their authorized dealers, agents and vendors, and other money transfer organizations (predominantly Western Union and Money Gram which work through mediation). Following the 2002 reforms, commercial banks such as the National Bank of Pakistan (NBP) has also ventured into the market and established exchange companies through which it carries out sale and purchase of foreign exchange as well as remittance transfers.

### **5.4.2 Informal Sector**

In the informal sector, money is carried out by hand, through cash-couriers and IVTS. Foreign exchange is conveniently available in the black US dollar market. The actual size

of this black market remains undetermined but it is estimated to have competitive — or even higher volumes — as compared with the formal market. The black market offers

**Table 5.1: Market Structure and Operations**

<b>Karachi foreign exchange market (formal, regulated)</b>				
<b>Structure</b>		<b>Operation</b>	<b>Players</b>	<b>Clients</b>
<b>Formal</b>	<b>Informal</b>			
Banks	Cash-couriers	Exchange companies dominate retail sale and purchase of foreign exchange	Exchange companies	Pilgrims/ Tourists
Exchange companies	<i>Hawala</i>		Dealers/ Agents/sub agents	Patients
Dealers/ Agents	Black US dollar market	Customer ID required but black market runs parallel and serves clients with no documentation	Black market operators	Students
Western Union/ Money Gram		Non-US dollar currency exported to Dubai (both cash and bank transfers)	<i>hawaladars</i>	Migrant workers
				Expatriate families
				Pakistanis settling abroad
				Credit card users
				Traders
				Other illegal transfers
<b>Peshawar <i>hawala</i> market (informal, unregulated)</b>				
<b>Structure</b>		<b>Operation</b>	<b>Players</b>	<b>Clients</b>
Informal		<i>Hawaladars</i> facilitate payments to foreign destinations	Pashtun Afghan <i>hawaladars</i>	Migrant workers & families
			exchange companies dealers/ agents	Traders
				Other Illegal transfers



better exchange rates for US currency than can be obtained in the open market.<sup>262</sup> For example, if the open market rates hover around PKR99.25 to PKR99.35 per US dollar, then in the black market, depending on the demand for US currency, the rate may be as high as PKR102 and not less than PKR101. Also, the purchase of foreign currency from the black market requires no documentation or information unlike the formal open market where reporting conditions require the buyer to submit a form and disclose the reason for buying even USD500. On the other hand, the black market neither provides any receipt for the purchase, nor there is any other information of its operation.<sup>263</sup> An interesting observation drawn from the fieldwork during the research was that the black US dollar market is indiscriminately used by all the customers of foreign exchange. As a matter of fact, an ordinary customer may not be able to distinguish between the formal and the black currency market due to the strong links and connections between them. Subsequent sections will further explain and clarify the dynamics of this deep integration between the formal and the informal currency businesses.

## **5.5 Karachi's Foreign Exchange Market**

### **5.5.1 Purchase/Sale of Foreign Exchange**

Karachi's market is mainly dominated by Money Exchange Companies. Foreign exchange is officially traded in the interbank market and available for purchase/sale in the open market at exchange companies' counters and kiosks, through authorized dealers and agents. Banks in Pakistan do not serve 'walk-in' or retail foreign exchange customers. The SBP has authorized exchange companies to deal with the retail clients (Also see Table 5.1). A simple illustration of the sale/purchase procedure of foreign exchange can be understood as follows: An Australian citizen visiting Pakistan wishes to exchange Australian dollars (AUD) (or any other currency) for Pakistani rupees (PKR). He goes to a bank branch in Karachi. Since the bank cannot give the Australian citizen Pakistani rupees in exchange for Australian dollars, the bank manager directs him to an exchange company in the open money market where the man can sell his Australian dollars and purchase Pakistani rupees. The exchange company, as part of its KYC requirements, will take a copy of his passport

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<sup>262</sup> Shahid Iqbal, 'Dollar Hits Rs 102 in Black Market', *Daily Dawn* (Pakistan), 12 March 2013.

<sup>263</sup> Ibid.

for their records. Alternatively, a Pakistani national wanting Pakistani rupees for his/her foreign exchange walks into an exchange company, gets Pakistani rupees at the agreed rate but may choose not to produce any identification. An exchange company owner shared with us that, *'local people do not want to produce their ID cards; they just don't want to disclose their identities'*.<sup>264</sup>

It is noteworthy that despite non-availability of the identification documents or the simple refusal of customers to produce any documentation, exchange companies are ready to serve these customers. This also explains how the so called regulated sector is complying with the reporting requirements. The operations of the 'black' market (mentioned above) are also clearly understandable.

### **5.5.2 Export of Foreign Exchange to Dubai**

Representatives of the Association of Exchange Companies of Pakistan interviewed during the research explained the formally authorized (by SBP) procedure involved in processing the foreign exchange as follows: *'All foreign currency except US\$ is (physically) exported to Dubai as we have no clearing house in Pakistan, and also because UAE is the nearest destination for us'*.<sup>265</sup> In Dubai, MECs buy US dollars against the exported currency and import the dollars back into Pakistan. Under the SBP's new regulations, MECs will deposit 20 per cent of the imported US dollars in the interbank. In principle, all the transactions involved in the process of export of currency are to be recorded on the counters of the National Bank of Pakistan at the airport(s). In reality, the National Bank of Pakistan decided to set up a subsidiary to act as a money exchange company for reasons that involve its experience of running one such company with local partnership in Dubai, and also because it has been handling (on behalf of the State Bank) the export of non-dollar currencies to Dubai. In other words, consequent upon reforms, the National Bank of Pakistan has now become a market competitor as well as (official) facilitator of foreign exchange that is exported to Dubai, converted to US dollars and brought back into Pakistan. As one interviewee commented: *'There are two ways to import US\$ in Pakistan. One is*

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<sup>264</sup> Interview with O-EC-01(Karachi, 4 October 2012) 230.

<sup>265</sup> Interview with G-FAP-01(Karachi, 4 October 2012) 228.

*importing cash dollars, and second is through bank accounts*'.<sup>266</sup> According to an Exchange Companies' Association official,

*[W]e cannot afford to import US dollars directly from the UAE as it is quite expensive. Furthermore, since 2002 SBP has imposed restrictions on the import of cash dollar. ECs are also not importing US dollars through the State Bank. We transfer dollar through bank (TT) in our Pakistani accounts. After consuming our requirement, extra foreign exchange is sold to the banks.*<sup>267</sup>

It has been reported that prior to the 2002 reforms, the SBP was periodically purchasing foreign exchange from offshore money changers. It purchased USD1.4 billion in 2001–2002 alone.<sup>268</sup> Since it has introduced policy reforms, the SBP does not directly contact the informal/offshore dealers but makes purchases through the interbank market.

*If we have extra dollars in ECs' accounts, we would sell to the banks. But it depends on the rates. When the gap between the interbank and kerb rises ie when interbank rate is higher than the kerb market, we hold the dollars but when it shrinks, these are sold.*<sup>269</sup>

### **5.5.3 Supply of USD in the Market**

One would like to know the sources that supply liquidity in the market. According to exchange companies, foreign exchange is supplied in the formally regulated market through sale/purchase of foreign currencies at different authorized outlets/counters in various cities throughout the country. Prior to 2002, many independent dealers operated in different villages, towns and small cities. These small-scale agents collected lots of foreign exchange from visiting overseas workers, expatriates, travellers and so on. The interviewees related that some of these vendors were so abundant in supply, that when rates rise in the interbank market they would hold foreign exchange, thus affecting supply and causing shortage of US dollars in the market. Normally, under such circumstances, speculation in foreign currency would increase depreciating the value of local currency. This means that the process of

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<sup>266</sup> Ibid 228.

<sup>267</sup> Ibid 228.

<sup>268</sup> Adil Anwar Daudi, 'The Invisible Bank: Regulating the *Hawala* System in India, Pakistan and the United Arab Emirates' (2005) 15 *IND. INT'L & COMP. L. REV.* 619, 645.

<sup>269</sup> Interview with G-FAP-02 (Karachi, 5 September 2012) 228.

depreciation of local Pakistani rupee versus US dollar would be faster. Such situation was witnessed in Iran and Afghanistan where speculation in US dollar fatally affected local currencies. The exchange companies explained that due to the presence of such unauthorized dealers and agents, remittances through legal banking channels suffered and the *hundi/hawala* business flourished.

The representatives of the Association of Exchange Companies of Pakistan who were interviewed during the research related that following the 2002 reforms, Exchange Companies have made efforts to curb the scattered selling of foreign currencies in the market by ‘allowing “franchises” in smaller cities and remote rural areas of Pakistan where many migrant workers or other expatriate Pakistanis and their families visit on a daily basis and are carrying foreign currencies’.<sup>270</sup> It means that one leading exchange company in Karachi or Peshawar can run more than 35 to 40 franchises around the country, comprising hundreds of dealers and agents. ECs’ representatives are of the view that by allowing franchises they keep the market stable and provide better rates to customers:

*It keeps the equilibrium of exchange rate in the market and also helps the exchange companies to keep official record of foreign money holders in villages and small cities. In this manner, ECs cover the market from panic and speculative buying by maintaining equilibrium and required liquidity through networking.*<sup>271</sup>

According to these representatives, this has led to the culmination of illegal money transfer practices as customers are dealing with the ‘registered money exchange companies or their representatives’ to exchange foreign currency or transfer money. We were told in the interviews that, ‘in this manner, the beneficiaries get better exchange rates and it helps in documenting remittances. It also helps curb the speculation of small vendors in the market who would hold the foreign currency in order to raise exchange rates’.<sup>272</sup>

From the explanation of procedures provided by the exchange companies, it can be seen with certainty that in the post reform years, Pakistan’s currency market has become more centralized in the sense that instead of many ‘anonymous’ independent, small-scale dealers

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<sup>270</sup> Ibid 228.

<sup>271</sup> Ibid 228.

<sup>272</sup> Ibid 228.

and agents, there are licensed and registered exchange companies, their authorized dealers, agents and sub-agents working in the formally created, ‘documented’ sector. Whether or not these formal entities have shed their old habits of *hawala* at the operational level needs to be investigated further.

#### **5.5.4 The Market Players — MECs, their Agents and Sub-Agents**

One of the most important considerations during the fieldwork of this research was to understand the SBP’s assumption that through the creation of exchange companies, *hawala* in Pakistan will be eliminated despite the market being comprised of the same players, who, at the operational level, include dealers who have for generations maintained their presence in the market. Interestingly, these market players have adjusted their ‘labels’ over time, according to the need of the hour and they have moved from informal currency dealers to authorized money changers in 1991, to exchange companies in 2002. Hence in the post 2002 ‘reformed and regulated’ market, money exchange companies, their authorized dealers, agents, sub-agents and sub-sub agents are the main market players alongwith ‘pure’ *hawaladars* and other informal operators in the black market (See Table 5.1).

Officials at the Federal Investigation Agency (FIA) (which is the law enforcement agency investigating and prosecuting *hawala* and money laundering cases) were interviewed during the research. These officials confirmed the involvement of foreign exchange companies and their agents in *hawala*-type transfers. According to the FIA Karachi officials, ‘*hawala business (in Karachi) is primarily facilitated by the exchange companies that are monopolized*<sup>273</sup> *by a few Karachi-based businessmen*’.<sup>274</sup>

In Karachi, owners of the leading exchange companies mostly belong to the powerful *Memon*, and other Gujarati-speaking communities. These communities have been in trade and currency businesses for centuries and as a result of migration and resettlement, are spread far and wide in the world (particularly in the Middle East, Africa, UK and the United States).<sup>275</sup> Members of the *Memon* community were well entrenched in business and

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<sup>273</sup> There are many Pashtun dealers and agents in Karachi.

<sup>274</sup> Interview with G-FIA-01 (Karachi, 8 September 2012) 229.

<sup>275</sup> Abdur Razzaq Thaplawala, ‘Memon Community and Preservation of Identity’

<<http://www.as-sidq.org/memoni/identity.htm>> 6 August 2013.

industry at the time of Pakistan's birth and continued to increase their power and wealth so as to be among what was dubbed as the '22 families' in the 1970s.<sup>276</sup> To say that this community has global financial and trading links and networks would not be wrong. Many members of these communities are powerful and influential owners of exchange companies in the foreign exchange market where *hawala* deals and settlements are finalized. Another powerful group in the market comprise Pashtun owners of exchange companies (their relative role in the market is discussed in the subsequent section).

### 5.5.5 MEC Operations

In the post 2002 market, all the major urban centres in Pakistan have franchises of the MECs from where they can network with their dealers and agents into villages and other remote areas. Under the foreign exchange law and regulations, A-category foreign exchange companies cannot transfer money directly but only by using banks. So, in order to overcome this regulatory hitch, the MECs have bought licences for international money transfer companies such as Western Union and Money Gram. Being an international franchise, an MEC can transfer money abroad albeit only through banks. Similarly, B-category foreign exchange companies can only buy and sell foreign exchange and are not allowed fund transfers yet, according to one interviewee, they '*are all involved in hawala. They have inner back offices where transactions are processed*'.<sup>277</sup>

Karachi FIA officials also disclosed that few owners of exchange companies control supply and demand in the foreign exchange market. They deplete US dollars in the market by holding the dollar and create artificial demand for foreign exchange to manipulate rates. Foreign exchange is available on cash as well as 'credit' for outward remittance transfers however rates for both differ; '*if cash deal is +1 Rs/\$ then credit rate is +2 Rs/\$*'.<sup>278</sup>

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<sup>276</sup> In 1968, Dr Mahbubul Haq, then Chief Economist at the Planning Commission of Pakistan, identified 22 families/groups in Pakistan that were dominating the financial and economic life of the country controlling 66% of the industrial assets and 87% of the banking: Mahbub ul Haq, Speech, Karachi, 21 April 1968, referred to in Mahbub ul Haq, 'System is to Blame for the 22 Wealthy Families', *London Times*, 22 March 1973. List available <http://m.paycheck.pk/main/salary/celebrity-income/richest-families-in-pakistan/the-22-families/>>.

<sup>277</sup> Interview with G-FIA-01 (Karachi, 8 September 2012) 229.

<sup>278</sup> Ibid 229.

### 5.5.6 MEC Customers

Owners of MECs interviewed during this research related that the size of the market which ECs cater to amounts to around one million travellers in a year, mainly in the following categories:

- i) Pilgrims: Around 0.5 million Pakistanis travel to Mecca (Saudi Arabia) each year. In addition to this, there are pilgrims travelling to Iran and Iraq.
- ii) Tourists
- iii) Patients travelling abroad for medical treatment,
- iv) Students studying in foreign countries,
- v) Migrant workers and expatriate Pakistanis,
- vi) Pakistanis settling in a foreign country,
- v) Credit card users.

For obvious reasons, the information shared by the ECs about their customers did not include businessmen, importers and exporters who, according to the investigations of this research, settle up to 70 per cent of trade payments using the *hawala* channels.<sup>279</sup> The ECs also excluded those customers from their list who transfer their wealth overseas, ‘off-the-record’. This shows that the market turn-over figures of ‘PKR 5-6 million daily’ provided by the MECs<sup>280</sup> are possibly the numbers they show ‘on paper’ while actual market volumes are much more.

Two important observations were drawn after interviewing the customers using the market operated by foreign exchange companies, their franchises or authorized dealers and agents. Firstly, for an ordinary customer such as a student travelling abroad, it is impossible to distinguish between the formal and the black currency markets as the two are so well-integrated. One customer informed us, ‘*The same dealer who informs you of the shortage of*

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<sup>279</sup> See Chapter 7: Afghan Transit Trade section for details.

<sup>280</sup> See Appendix B.

*US dollars in the market tells you where you can buy it from in the black and at what rate*.<sup>281</sup>

Secondly, despite the reforms and formation of exchange companies, the perception of an ordinary customer regarding a money changer is still that of a '*hundiwala*'.<sup>282</sup> Given the operation of the black US dollar market discussed in the preceding section (see 5.4.2 above), it could be argued that the perception of the customers is not completely wrong.

## **5.6 Peshawar's Chowk Yadgar Currency Exchange/ Money Transfer Market**

### **5.6.1 Size and Volumes**

Around 190 kms away from Pakistan's capital city Islamabad is Peshawar the provincial capital of Khyber Pakhtunkhwa (KPK) province, bordering Afghanistan. The Chowk Yadgar money market is in Peshawar's central business district and '*provides the largest hawala facility in Asia*'.<sup>283</sup> An identical facility is available in the border city of Quetta, the capital of Balochistan province. The FIA estimates the presence of 400 shops in Chowk Yadgar although definitive counts are refuted due to the complexities involved in layering of business activities. Out of these shops, only four are registered currency exchange businesses. All the rest operate informally. The total daily transaction volume of the Chowk Yadgar currency market is estimated by FIA Peshawar, at about PKR1 billion or USD12 million. The *hawaladars* did not provide any sure estimates about the size of the market.

### **5.6.2 Market Players**

In Chowk Yadgar, Pashtun operators predominate or 'run the show'. These include both Pashtuns from Pakistan's tribal areas as well as Afghanistan. The money market at Chowk Yadgar in Peshawar is heavily populated by Afghan *hawaladars*. As the majority of Afghans working in the markets are of Pashtun origin, to an outsider they are barely distinguishable amongst their fellow non-Afghan traders from KPK or FATA. Moreover during the past 30 years, most Afghans have obtained Pakistani CNICs, many were even born here. To discriminate between a Pashtun from FATA or from Kabul is a challenging

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<sup>281</sup> Interview with CFMW-01 (Islamabad, 28 April 2012) 231.

<sup>282</sup> Synonym for *Hawaladar*, 'one who sells hundi'

<sup>283</sup> Interview with GFIA-02 (Peshawar, 4 September 2012) 229.



task even for the border and intelligence law enforcement agencies in Pakistan. Consequently, foreign exchange stocks, including dollars and euros, for currency conversion are conveniently transported by carriers across borders based on demand. Besides this, Chowk Yadgar houses franchises and kiosks of all major exchange companies showing that alongside *hawala*, formally regulated exchange companies also operate in this market.

### **5.6.3 Chowk Yadgar Customers**

Over time, the Chowk Yadgar market in Peshawar (and the identical market in Quetta) have integrated with the Afghanistan money market. To say that these markets essentially operate as one would not be an underestimation. The integration between Afghan and Pakistani markets has been attributed to the steady flows of refugees, migrants and goods from Afghanistan to Pakistan, as well as large exports from Pakistan to Afghanistan. According to Thompson,<sup>284</sup> '*hawaladars* in Afghanistan consider their links to Pakistan crucial to their survival as a large part of the Afghan market relies heavily on Peshawar, and also Quetta, as a conduit for the delivery of money from places further afield'.<sup>285</sup> Also, in the past years, many NGOs and other international agencies have frequently sent their funds to Pakistan from where the money has been paid in Afghanistan through *hawala*. Peshawar is also a recipient of substantial inward remittances from family members living overseas, in countries such as Germany, the UAE and the UK. These funds are routinely forwarded to other family members who stayed behind in Afghanistan, and constitute an important part of their subsistence in Afghanistan's coping economy.<sup>286</sup>

In this manner, the main customers of Peshawar's Chowk Yadgar market comprise migrant workers and transit trade businessmen.

### **5.6.4 Operational Efficiency**

Interviews conducted with *hawaladars* in the Chowk Yadgar market, confirmed that business is done through *hawala*, and that *hawala* has been used for centuries: '*We use*

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<sup>284</sup> Edwina Thompson, *Trust is the Coin of the Realm: Lessons from the Money Men in Afghanistan* (Oxford University Press, 2011) 236.

<sup>285</sup> Ibid.

<sup>286</sup> Ibid 237.

*hawala because it is easy and convenient*'.<sup>287</sup> These *hawaladars* find banking procedures arduous and complain about rules and requirements that keep changing every day: '*Most of us here do not know any other language than Pushto*'.<sup>288</sup> Some of these *hawaladars* did not speak Urdu or English, neither were they formally educated. They did not think this should prevent them from participating in the market. Indeed one asked rhetorically: '*Should we not do business then?*'<sup>289</sup>

The apparent aversion of *hawaladars* towards banking procedures however does not mean that *hawaladars* in Peshawar do not use banks. Money dealers in Chowk Yadgar operate multiple bank accounts in various banks operating in Pakistan.<sup>290</sup> But, when they compare their own trade with banks that require documents and have lengthy and time-consuming procedures, the *hawaladars* find *hawala* cost-effective and efficient: '*Tell us which bank in the world will loan a trader 100 million on a verbal promise of return in 10 days time?*'<sup>291</sup> For the Chowk Yadgar *hawaladars*, issues pertaining to financial transparency, regulation and monitoring are relative concepts. In their eyes, *hawala* is the most efficient and self-enforcing system based on personal contacts and trust: '*We know who we are dealing with and there is no chance of fraud*'.<sup>292</sup> Business is done on the principles of 'honour', 'promise', and 'trust' making the system more personalized and transparent as compared with the western banking system which relies on written contracts and third party evaluation. Dispute resolution is done in accordance with the tribal norms, through the council of tribal elders (*jirga*).

## **5.7 Banks and *Hawala***

An important point that comes forth as a result of fieldwork in Karachi and Peshawar is that the *hawala* system cannot be viewed in isolation from the formal banking sector. We have explained earlier the procedures of export and import of foreign exchange to Dubai, the transfer of funds into the Pakistani bank accounts of exchange companies and remittance transfers through banks. Moreover, as mentioned earlier, Pakistani banks have a 'no

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<sup>287</sup> Interview with H.U-01 (Peshawar, 13 March 2013) 231.

<sup>288</sup> Ibid 231.

<sup>289</sup> Ibid 231.

<sup>290</sup> Daily Dawn, Friday 16th September 2011

<sup>291</sup> Interview with H.U-01 (Peshawar, 13 March 2013) 231.

<sup>292</sup> Interview with H.U-02 (Peshawar, 2 September 2012) 231.

questions asked’ policy regarding incoming foreign remittances. All this confirms that banks are fully integrated into the *hawala* market in Pakistan as one of the exchange dealers we interviewed retorted: ‘...and do you think *hawala* is possible without involving the banks? How else is money transferred?’<sup>293</sup>

Interviews from Chowk Yadgar *hawaladars* also confirm that these operators are well-connected and linked with the rest of the country’s money exchange companies, dealers and agents and have international connections as well. The linkages between the Karachi and Peshawar markets could be validated as the Chowk Yadgar money market houses nearly all leading exchange companies’ counters and banks. The *hawaladars*, the exchange companies and the banks were found to operate within the same area — in some cases within the same building. In this manner, *hawaladars* at Chowk Yadgar are deeply integrated with other national and international money exchange networks and cannot be viewed in isolation from the so called ‘formal’ sector.

## **5.8 Payments and Settlements**

During the fieldwork, it was found that *Chamak* (meaning ‘glitter’ in English) is used to trade foreign currency to complete transactions. In local parlance, *Chamak* refers to a pool of excess funds that a *hawaladar* accumulates abroad. For example, a *hawaladar* collects a pool of UAE dirhams as a result of migrant remittances. He will then search for customers interested in clearing their debts, perhaps to a foreign exporter. These customers, usually Pakistani or Afghan importers or businessmen can utilize the services of a local *hawaladar* to make payment to the exporter through the foreign *hawaladar*. *Chamak* here refers to a bright prospect for a customer who wants to pay his debt, or for *hawaladars* to settle accounts among themselves.

### **5.8.1 Role of Dubai**

Dubbed as the ‘Singapore of the Middle East’,<sup>294</sup> Dubai provides an off-shore financial space to South Asian, and more specifically Indian, Pakistani and increasingly Afghan businessmen to strike *hawala* deals. It has been mentioned earlier that Pakistan (and also

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<sup>293</sup> Interview with O-EC-01 (Karachi, 5 September 2012) 230.

<sup>294</sup> J Henderson, ‘The Truth about Dubai’ on *Mises Daily*, Ludwig von Mises Institute, 9 March 2006.

India) have a history of currency controls and these countries impose strict licensing requirements on money-remitters and foreign exchange dealers. Strict regulations also contribute to the existence and use of *hawala*.<sup>295</sup> Under these circumstances, Dubai provides a ready facility to those who want to move their money out of the country.

The total number of Pakistani expatriates in the United Arab Emirates is 1.723 million.<sup>296</sup> Of these, 400,000 live in Dubai. According to the Pakistan-UAE Business Council, 6,000 Pakistani companies are operating in Dubai. Pakistanis were the third leading expatriate property investors in Dubai real estate in 2013 and invested AED3billion.<sup>297</sup> Interviews with FIA officials in Karachi have reported that most of the wealth invested in Dubai has been transferred through *hawala*. Findings of FIA investigations into *hawala* cases have established that family, ethnic, and cultural ties play a definitive role in *hawala* transactions. According to a FIA interviewee: '*Exchange companies in Pakistan have subsidiary (limited) companies in Dubai, run by close kin or partners, from where deals are communicated*'.<sup>298</sup> To explain this further, FIA officials showed us the trail of emails in one of the *hawala* cases investigated and prosecuted by FIA where an exchange company family member (a nephew) was running a limited company in Dubai. He would strike deals and send email instructions for payments to the Karachi office. Similarly, *hawaladars* at Chowk Yadgar market also confirmed their international links and franchises in major financial centres, including Dubai.

It is clear that geographical proximity with Dubai makes *hawala* regulation much more challenging for the Pakistani regulators and law enforcement. From the regulatory perspective, Dubai is a contentious off-shore albeit legal financial hub of all *hawala* activity from where *hawaladars* can settle their accounts and move money freely. Two main factors that complement Dubai's status as such include the large population of expatriate workers using the *hawala* facility to send money home as well as its large gold market which is the

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<sup>295</sup> Jost and Sandhu, above n 28,11.

<sup>296</sup> United Arab Emirates: Encyclopedia Britannica World Data <<http://www.britannica.com/new-multimedia/pdf/wordat207.pdf>> accessed 17 March 2014.

<sup>297</sup> Secretariat General, Dubai Economic Council, *Dubai Economic Outlook – Q1-2013*, Economic and Policy Research Center <<http://www.dec.org.ae/reports-publications/details.aspx?id=142>> accessed 17 March 2014. Note: AED is the ISO code for UAE dirham.

<sup>298</sup> Interview with G-FIA-01 (Karachi, 8 September 2012) 229.

source of much of the gold sent (legally and illegally) to Pakistan and India.<sup>299</sup> In contrast with Pakistan and India who have strict financial and currency controls, Dubai is widely recognized as the central clearing house for *hawala* transactions, or in Ballard's words, the 'lynch-pin' of the contemporary global *hawala* system.<sup>300</sup> Here customers operate within a free financial space where there are no foreign exchange controls, quotas or trade barriers and import duties are extremely low, providing them with an essentially unregulated financial space from where money can easily be wired to anywhere in the world. Once a transaction is processed within Dubai's offshore spaces, it can be wired in less than a few seconds to any international bank where there is a correspondent relationship. In an electronic banking world, it is no surprise that payments to any destination on the globe can be made 'in the blink of an eye'. As one *hawaladar* recounted, '*No matter how much the amount is, it will be paid within half-an-hour to the recipient at the required destination*'.<sup>301</sup>

### 5.8.2 UAE Free Trade Zones

The globalization of trade and foreign investment over the past decade has led to the development of Free Trade Zones (FTZs) all over the world. The first FTZ in the UAE came into existence in 1985 to increase UAE's share of non-oil exports in anticipation of the inevitable decline in oil reserves. Today there are more than two dozen industry specific FTZs all over UAE.<sup>302</sup>

Each FTZ is governed by an independent Free Zone Authority (FZA), the agency responsible for issuing FTZ operating licences and assisting companies establish their businesses. Companies operating within the FTZs are treated as 'offshore' entities in that they fall outside the UAE's judicial and regulatory boundaries. This special legal status provides these companies following benefits:

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<sup>299</sup> Jost and Sandhu, above n 28, 11.

<sup>300</sup> Roger Ballard, '*Hawala Transformed: Remittance-Driven Transnational Networks in the Post-Imperial Economic Order*' Revised version of a paper originally entitled '*Processes of Consolidation and Settlement in Remittance-Driven Hawala Transactions*' (Presented at a World Bank/DFID International Conference on Migrant Remittances: Development Impact, Opportunities for the Financial Sector and Future Prospects, London, 9–10 October 2003) 13.

<<http://www.casas.org.uk/papers/pdfpapers/transformed.pdf>>.

<sup>301</sup> Interview with H.U-02 (Peshawar, 2 September 2012) 231.

<sup>302</sup> PKF, *Free Zones in the United Arab Emirates*, PKF-UAE 2009 (2009),1.

<<https://www.pkf.com/media/135638/free%20zones%20in%20the%20uae%202009.pdf>>.

100% foreign ownership	Full repatriation of capital and profits
100% tax exemption	Extended leases
Quick approval procedures	Abundant and inexpensive energy

In her ground-breaking work on Afghan *hawaladars*, Edwina Thompson<sup>303</sup> reports that Dubai Free Zones are the most attractive transit points for Afghan imports. These imports include cars arriving from Japan and Germany, electronics sent from China, or edible oil that is exported from the Gulf. According to her investigations, in Dubai's Jebel Ali Free Zone Authority (JAFZA) many registered Afghan export/import businesses are taking advantage of the Free Zone incentives. Thompson has also reported that within the export processing and Free zones governed by JAFZA, the most noticeable commodity chain was the trade in cars. The Dubai Cars and Automotive Zone (DUCAMZ) covers a one million square metre bonded area that was established with the objective of re-exporting cars to the Asian and African regions where the demand exists and continue to grow. The Afghan car dealers that operate there are able to make use of Dubai's global transport and distribution system, which includes ports served by a large and growing number of international lines. The gateway to this global centre of trade is neighbouring Iran, which has consistently remained the primary destination of Dubai re-exports and its free trade zones over the past ten years. According to Thompson's investigations, majority of the Afghan importers benefit from this improved transportation infrastructure as the goods enter Dubai through its various ports, and in turn pass by sea to Iran's port at Bandar Abbas. They then travel by road to Islam Qala in Western Afghanistan, and on to Herat Customs for being smuggled into Pakistan.<sup>304</sup>

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<sup>303</sup> Thompson, *Trust in the Coin of the Realm*, above n 276, 201.

<sup>304</sup> Ibid.

## 5.9 International/Global Dimension

During interviews, Chowk Yadgar money changers confirmed that they ‘operate franchises in multiple (4-5) locations, typically in FATA, Dubai, Oman and Saudi Arabia’.<sup>305</sup> They also said: ‘We have our agents in China, Hong Kong, Dubai, Malaysia and elsewhere. It is just a matter of a phone call. There is no chance of a miss, and payment can even be made in advance if needed and settled later’.<sup>306</sup> We have also highlighted the *modus operandi* that MECs adopt to transfer funds. The global nature of *hawala* has also been validated by many experts and authors who argue that without the regulatory regimes of cities such as Dubai, the *hawala* system would not have a platform from which to integrate fully into the global political economy. For instance, Thompson has criticized the approach that alleges that *hawala* provides criminals with the cover of anonymity and an opportunity to launder money in the presence of financial centres such as Dubai that provide *hawala* dealers with the strongest link to the global economy.<sup>307</sup>

## 5.10 State Bank of Pakistan’s *Hawala* Regulatory Approach

The 2002 SBP strategy to regulate *hawala* transactions goes beyond mere licensing and registration of *hawaladars*. Along with the creation of exchange companies, SBP took initiatives to improve banking practices and regulations. It phased-out the reforms by initially allowing the informal market to co-exist with formal banks for a period of time, as well as to provide alternative remittance products. Like its previous efforts, SBP’s aim in 2002 was to reduce the incentive for *hawala*-type transfers and channelize inflows through the formally regulated sector. But in this instance the SBP went beyond introducing competitive products for this purpose. As part of 2002 reforms, the Central Bank has encouraged the banking sector to tap the unexplored remittance market<sup>308</sup> traditionally dominated by *hawaladars*.

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<sup>305</sup> Interview with H.U-02 (Peshawar, 2 September 2012) 231.

<sup>306</sup> Interview with H.U-01 (Peshawar, 13 March 2013) 231.

<sup>307</sup> Thompson, *Trust in the Coin of the Realm*, above n 276, 204.

<sup>308</sup> State Bank of Pakistan, ‘Federal Government, State Bank Launch Historic Pakistan Remittance Initiative’ (Media Release, 22 August 2009) <<http://www.sbp.org.pk/press/2009/PRI-22-Aug-09.pdf>>.

### 5.10.1 Pakistan Remittance Initiative

The Pakistan Remittance Initiative (PRI) is a collaborative venture of the State Bank of Pakistan along with the Ministries of Finance and Overseas Pakistanis. Under this five year program initially launched in 2004, and continuing, commercial banks have been ‘sponsored’ to venture into the remittance market by the offer of incentives to them. PRI initially provided Pakistani banks and international exchange companies the incentive of getting PKR1 for each dollar remitted through their network. Later this policy was replaced with a ‘commission’ as a form of fee reimbursement for every transaction. Banks and companies are not supposed to charge their international customers for remitting money through their network, and the SPB pays them an amount per transaction to reimburse them for the costs incurred in each wire transaction because these costs cannot be recouped from the customer. Official reports and statements record that since PRI has been launched, five big banks in Pakistan — namely the National Bank of Pakistan (NBP), Habib Bank Ltd (HBL), Allied Bank Ltd (ABL), Muslim Commercial Bank (MCB), and United Bank Ltd (UBL) — have set up specialized home remittance cells in their respective head offices and sped up remittance transfers among their branches. These banks work in partnership with other international money transfer operators (MTOs) and banks in various countries to facilitate remittance transfers, for instance HBL works in partnership with the Al-Rajhi Bank in Saudi Arabia, through which free of cost remittances can be transferred to Pakistan. HBL also has an agreement with Travelex, an MTO based in the United Kingdom.<sup>309</sup>

During interviews, SBP officials explained that the basic aim in launching the PRI was to speed up the remittance delivery process. Prior to the PRI it could take up to two weeks for the money to arrive through banking channels whereas *hundi/hawala* could facilitate the transaction within a day. According to the SBP, some USD14–16 billion in remittances is sent yearly; however, many workers prefer *hundi* and *hawala* systems due to the speed and ease of transaction despite a poorer rate of exchange.<sup>310</sup> On average, only 50 per cent of the workers inflows travel through banking channels. As highlighted earlier, the main reason for a workers’ preference for *hawala* is its economic efficiency. For a migrant worker,

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<sup>309</sup> Nenove, Niang and Ahmad, above n 258, 149.

<sup>310</sup> Amjad, Irfan and Arif, above n 190, 20.



exchange rate may not be the most significant consideration as he has to send money to his family to meet their monthly expenditures.<sup>311</sup> Unlike investors and speculators, migrant workers do not hold back their savings if they find that the rupee is weakening in the near term, giving *hawala* an even greater competitive advantage as *hawaladars* accumulate funds from migrant workers' earnings.

The PRI is housed in the SBP and is a holding company. Its budget is allocated by the Finance Division in the Federal Government, by taking less than one percent of the total home remittances received. The banks are offered 25 Saudi riyals (SAR25) for every transaction to share with the international counter-part foreign exchange companies. The SBP does not allow local MECs to participate in PRI because '*they are not willing to shut down their back office operations*',<sup>312</sup> an SBP official said in the interview. Consequently, the PRI is a project that the SBP is running in collaboration with Pakistani banks and international MTOs (such as Western Union) by excluding the local MECs because, according to the SBP officials, '*they do hawala*'.<sup>313</sup>

Reports suggest that an inquiry has recently been constituted into PRI affairs by the National Accountability Bureau (NAB).<sup>314</sup> According to these reports, from July 2001 to January 2012, a total of USD69 billion home remittances were received and 6.67 per cent was reimbursed to banks with the SBP's approval.<sup>315</sup> MECs interviewed during the research provided details about PRI's 'actual' working: '*[A]s soon as a remittance is received, it is broken into four packages by SBP [\$1000 equals \$250x4] in order to claim commission equivalent to four transactions instead of one*'.<sup>316</sup> It is important to note that this handling of the remittance does not involve the remitter's knowledge nor is the remitter receiving any benefit from it. Reportedly, the amounts that are claimed (as 'commissions') on the transactions are shared among the colluding officers of banks as well as the SBP. In addition, the minimum amount of remittance USD200 that was earlier set by the SBP to qualify for the reimbursement of charges has been reduced to USD100 or equivalent in

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<sup>311</sup> Ibid 21–23.

<sup>312</sup> Interview with G-SBP-01 (Karachi, 8 October 2012) 228.

<sup>313</sup> Ibid

<sup>314</sup> The NAB officials have confirmed with this researcher that such inquiry has been initiated.

<sup>315</sup> Asim Yasin, 'NAB to Probe Pakistan Remittance Initiative Scam', *The News* (Pakistan), 11 October 2012.

<sup>316</sup> Interview with O-EC-02 (Karachi, 5 September 2012) 230.

other currency. The reimbursement rate of SAR20 has also been increased to SAR25 for each transaction, further increasing the ‘return’ to personnel involved.<sup>317</sup>

It has been estimated that the ‘scam’ (involving officers from a number of banks and the SBP) has meant a loss to the national exchequer of some USD4.9 billion in the 11 years to January 2012. It has been also alleged that the Al-Raaji Bank of the Kingdom of Saudi Arabia (KSA) is involved in the fraud.<sup>318</sup> The constitution of this inquiry by the NAB has been extensively reported in the local Pakistani press and electronic media; however, the inquiry has not been concluded at the time of writing of the thesis.

### **5.11 Enforcement of 2002 Regulation: The FIA and *Hawala***

Since the creation of Foreign Exchange Companies in 2002, the role of FIA in countering *hawala* in Pakistan has become significant. The FIA has in the past detected many *hawala* operations. Two cases involving foreign exchange companies that the FIA has investigated and prosecuted on alleged *hawala* transfers are particularly important:

#### ***i) Khanani and Kalia Foreign Exchange Company Case***

In 2008, the State Bank of Pakistan and the Ministry of Finance reported that Pakistan’s foreign exchange reserves had diminished from USD16 billion in October 2007 to USD7 billion in February 2008. These regulators requested the Ministry of Interior to probe the matter of smuggling of US dollars into Afghanistan through its Special Investigation Group (SIG) at the FIA.<sup>319</sup> The SIG/FIA submitted an investigation report to the Ministry of Interior confirming the smuggling of US dollars from the country, stating that a foreign exchange crisis would occur if smuggling of foreign currency through Afghanistan was not stopped. Hence, in light of the investigations, the FIA cracked down on the largest foreign exchange company in Pakistan for running a separate and unregistered *hawala* counter. The two directors at the Khanani and Kalia Foreign Exchange Company were arrested on

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<sup>317</sup> State Bank of Pakistan, FE Circular No 40, ‘Reimbursement of TT Charges against Home Remittances’ (29 November 2000) <<http://www.sbp.org.pk/epd/2000/c27.htm>>.

<sup>318</sup> Yasin, above n 312. See also National Accountability Bureau, ‘Executive Board Meeting (EBM)’ (Press Release, 10 October 2012) <<http://www.nab.gov.pk/PRESS/NEW.ASP?629>>.

<sup>319</sup> Faraz Khan and Tahir Niaz, ‘Government Widens Dollar Scam Investigation’, *Daily Times* (Pakistan), 10 November 2008 <<http://archives.dailytimes.com.pk/Reporter/faraz-khan-and--tahir-niaz>>.

allegations that they had transferred USD10 billion out of Pakistan using the *hawala* channels.<sup>320</sup> During investigations, the arrested directors reportedly confessed to have transferred millions of dollars of funds for politicians, bureaucrats, army officers and businessmen, to pay for their children's education abroad.<sup>321</sup> According to the FIA statements that have been widely publicized in the press and electronic media, Khanani and Kalia also paid instalments on costly properties in real estate abroad.<sup>322</sup> In addition to these directors, a few bankers and employees at the National Database Registration Authority (NADRA) were also accused of collusion in providing counterfeit identity cards through which the alleged transfers would take place.<sup>323</sup>

Consequently, the SBP suspended the company's licence and a case was prosecuted against the company in the banking court. In 2011, all the accused persons in the case were acquitted. The reason for their acquittal was a lack of substantive evidence from the FIA directly implicating the Foreign Exchange Company or its directors or associates in the case. Instead, 'the evidence turned out to be non-specific descriptions of illegal money transfer systems'.<sup>324</sup>

## ii) *ZARCO Exchange Company Case*

Later in 2008, the FIA clamped down on another leading foreign exchange company, ZARCO. The FIA investigation report stated that the Chief Executive Officer of ZARCO had illegally transferred PKR1,870 million to his bank accounts abroad, while his company performed Foreign Telegraphic Transfers (FTTs) amounting to USD346.71 million under the *hawala* business between January and November 2008.<sup>325</sup> According to the FIA report,

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<sup>320</sup> Syed Fazl-e-Hyder, 'Pakistan Forex Raid Just the Start' *Asia Times*, (South Asia), 13 November 2008.

<sup>321</sup> *Ibid.*

<sup>322</sup> *Ibid.*

<sup>323</sup> *Ibid.*

<sup>324</sup> Zeeshan Mujahid, '*Hawala* Case:Khanani and Kalia Acquitted', *Express Tribune* (Pakistan), 5 March 2011. See also Jamal Khurshid, 'Khanani and Kalia Directors Acquitted', *The International News* (Pakistan), 30 October 2013 <<http://www.thenews.com.pk/Todays-News-4-211016-Khanani-and-Kalia-directors-acquitted>>; Agha Khalid, 'The Khanani & Kalia Saga: Deception par Excellence', *The International News* (Pakistan), 23 January 2014 <<http://www.thenews.com.pk/Todays-News-13-28107-The-Khanani-&-Kalia-saga-Deception-par-excellence>>.

<sup>325</sup> 'ZARCO Transferred \$346m through *Hawala*: FIA', *Daily Times* (Pakistan), 21 August 2009. See also ;Kamran Siddiqui and Saima Hussain, 'Failure of Corporate Governance at ZARCO Exchange Company (Private) Limited' (Paper presented at the 3<sup>rd</sup> South Asian Conference, Lahore, 28–29 December 2011) <<http://saicon2011.citlahore.edu.pk/Business%20Ethics/1088.pdf>>.

the alleged *hawala* transfers resulted in the loss of capital and foreign exchange depletion in the country. As a result, the SBP suspended ZARCO's licence. The company's headquarters, its branches, franchises, payment booths as well as currency exchange booths were barred from undertaking any kind of foreign exchange business activity and its complete operations both in Pakistan and internationally were shut-down.

Subsequent to this, the Chief Executive Officer of ZARCO lodged an FIR (first information report) alleging that his company employees had embezzled PKR1.25 billion through fake accounts. The FIA arrested the nominated employees and the latest reports in the case are that FIA has charged former employees of the ZARCO company for siphoning off PKR250 million from the company's accounts. The FIA has stated that SBP officials will also be investigated for their possible role in the case.<sup>326</sup> On the other hand, the CEO of ZARCO has been acquitted by the banking court; again (as in the *Khanani and Kalia Foreign Exchange Company Case*) for want of evidence from the FIA.<sup>327</sup>

Two points merit consideration in view of the cases of foreign exchange companies' alleged involvement in *hawala* transfers. Firstly, involvement of the so called 'corporate bodies' created by the SBP in 2002 in *hawala* practices shows a corporate governance failure.<sup>328</sup> Clearly, the SBP has failed to govern the corporate bodies that it created in 2002 and instruct in and ensure the application of the principles of due diligence against the non due diligent *hawala* practices. This corporate foreign exchange market that was created to curb and side-line *hawala* is not working as the purported regulated entities are involved in non-compliance with regulations.

A second important point relates to the failure in prosecuting *hawala* cases in Pakistan. As mentioned earlier, *hawala* is illegal in Pakistan. As such the law does not acknowledge *hawala* type transfers and there are prescribed procedures to declare a transaction 'legal'. In the cases of these accused exchange companies, the investigation and prosecution by the FIA involved accusations that the companies are carrying out *hawala* transactions (meaning

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<sup>326</sup> 'New Scam: FIA Launches Probe into Forex Scandal', *Express Tribune*(Pakistan), 12 April 2013.

<sup>327</sup> Asad Kharal, 'Man Accused of Illegal Rs67b Transfer Freed', *Express Tribune* (Pakistan), 8 February 2011.

<sup>328</sup> Saima Hussain and Kamran Siddiqui, 'Failure of Corporate Governance at ZARCO Exchange Company' (2013) 12(4) *IUP Journal of Corporate Governance* 57.

no actual ‘legal’ transaction took place at all). Consequently, prosecution was carried out against these companies on charges of *hawala* transfers framed under the *FERA 1947*. This means that the findings of the FIA investigations did not prove fruitful as prosecution under *FERA* took these cases as irregularities in contravention of laid-down procedures for foreign exchange transactions and not money laundering through *hawala*. The confessions of the accused company directors before the FIA where they admitted to having transferred funds of various powerful people abroad became irrelevant to the legal proceedings against these forex dealers as these charges were not covered under the law. As has already been pointed out earlier, the overriding legislations (*PERA 1992 overrides FERA 1947*) essentially protect rather than assist in the prosecution of the offenders. Consequently, the FIA could neither produce enough witnesses to prove *hawala* transactions nor prove the fraudulent transfer of funds abroad. Instead, these cases (of *hawala* transfers) were technically viewed by the banking courts under the provisions of *FERA 1947*, as a contravention of the law.

Lastly, it needs be noted that the penalty and procedure of contravention in *FERA 1947*, although it makes the offence cognizable, punishment for such offence is a maximum of two years imprisonment, or a fine, or a both and is bailable.<sup>329</sup> It is clear that the FIA officials find these laws the biggest impediment to enforcement of the regulation: ‘*[E]ven if I arrest a hawaladar, he gets a bail, returns to the market within two days and becomes a threat to my life*’.<sup>330</sup> This also explains why the number of *hawala* cases registered and prosecuted by the FIA during 2009–12 (see Tables 6.1 and 6.2(below)) by no means capture the *hawala* activity in Pakistan where over 10,000 *hawaladars* are reported to be operating in the city of Karachi alone.

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<sup>329</sup> *Foreign Exchange Regulation Act 1947*, sct 4(23) available

<[http://www.sbp.org.pk/fe\\_manual/appendix%20files/appendix%201/appendix1.htm#23](http://www.sbp.org.pk/fe_manual/appendix%20files/appendix%201/appendix1.htm#23)>.

<sup>330</sup> Interview with GFIA-02 (Peshawar, 4 September 2012) 229.

**Table 5.2: Number of *Hawala*-related cases 2009–2012**

<b>Zone</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Punjab	0	0	0	0
Sindh	0	0	0	0
Islamabad	0	26	2	0
KPK	23	29	15	10
Balochistan	1	1	0	0
<b>Total</b>	<b>24</b>	<b>46</b>	<b>17</b>	<b>10</b>

**Table 5.3: Number of *Hawala*-related convictions 2009–2012**

<b>Zone</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Punjab	0	0	0	0
Sindh	0	0	0	0
Islamabad	0	14	0	0
KPK	14	18	8	4
Balochistan	0	0	0	0
<b>Total</b>	<b>14</b>	<b>32</b>	<b>8</b>	<b>4</b>

**Original Source: SDPI and UNODC Report on Pakistan’s Illegal Economy<sup>331</sup>, updated during Interviews with FIA Officials.**

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<sup>331</sup> SDPI and UNODC, *Examining the Dimensions, Scale and Dynamics of the Illegal Economy: Pakistan*, above n 164.

## 5.12 Conclusion

In this chapter the critical question we examined was whether the 2002 reforms introduced by the SBP to curb *hawala* have been successful. To achieve this aim, fieldwork interviews were conducted to see whether the 2002 creation of exchange companies has reformed the market into a regulated corporate sector that complied with due diligence standards. It was found that despite the reforms, two types of *hawala* markets are openly functioning. One comprises exchange companies, their dealers and agents who have not shed their old habits of *hawala* transfers. The other type is ‘pure *hawala*’ in Pakistan-Afghanistan border cities such as Peshawar and Quetta. Moreover, the procedures and operations followed by the regulated exchange companies show their integration with the unregulated *hawala* market as well as the commercial banks. The linkages between the formal and the informal players are so deep that a customer cannot discriminate between the formal and the informal elements as both these operate in the same space and have networks and connections — both domestic and international.

Prevalence of *hawala* despite reforms shows that once again the SBP could not achieve the objective of eliminating *hawala* in Pakistan. Moreover, involvement of corporate bodies in *hawala* shows corporate governance failure as a result of non-compliance with regulations. The project that the SBP has launched to counter *hawala*’s inherent incentive has also proven to have outcomes quite contrary to its claims and is reportedly producing financial incentives for corruption in commercial banks, their personnel and among the officials of SBP.

It needs to be emphasized that although on ground investigations have established the prevalence of *hawala* and a failure of enforcement of regulation in Pakistan, this constitutes just ‘the tip of the iceberg’. The real, deeper political and economic issues that make regulation of *hawala* problematic are worth exploring further in order to gain clearer insights into the causes that make these informal transfer systems invincible in relation to Pakistani regulators and law enforcement. The next chapter will investigate the issues and challenges faced in regulating *hawala* in Pakistan.

## **Chapter 6: Challenges to Regulate *Hawala* in Pakistan**

### **6.1 Introduction**

As we have seen, *hawala* has continued unabated despite the introduction of regulatory approaches by SBP in 2002 and subsequent changes to that system. What are the factors which have led to this situation? Is Pakistan unable to regulate effectively or simply unwilling to do so? Part of the answer can be found in an analysis of why states fail.

Many policy debates assume that disorder and chaos prevail where the basic state institutions necessary for liberal, democratic, political, economic and social orders are either absent or dysfunctional.<sup>332</sup> In many instances, weak and failed states have also been linked with terrorism.<sup>333</sup> It is generally understood that in weak and failed states, informal contracts and arrangements prevail because of the lack or absence of the formal institutions. The popularity of *hawala* and similar IVTS in countries such as Afghanistan and Somalia has been cited frequently in support of the view that the absence of formal institutions and structures has created disorder and chaos and that such instability poses a potential threat to the health and stability of the international financial edifice.<sup>334</sup> Whilst this approach clearly regards *hawala* as being a financial instrument which is restricted to only being used in weak and failed states, it also tends to ignore the competitive efficiency and ‘globalized’ character of *hawala*-type IVTS in the contemporary world. While *hawala* is found in weak and failed states it is also found in developed economies. We need to address these issues surrounding *hawala* and other IVTS to be able to better appreciate the challenges faced in regulating these informal systems. In order to achieve this purpose, this chapter is divided into the following three parts:

i) In the first part, the chapter builds upon the framework of institutional approach to state regulation. It describes the primary functions that a ‘State’ is required to perform on the

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<sup>332</sup> Edwina A Thompson, ‘Misplaced Blame: Islam, Terrorism and the Origins of *Hawala*’ in Armin von Bogdandy and Rüdiger Wolfrum (eds), *Max Planck Yearbook of United Nations Law* vol 11 (2007)279,282.

<sup>333</sup> Anna Simons and David Tucker, ‘The Misleading Problem of Failed States: A Socio-geography of Terrorism in the post-9/11 Era’ (2007)28(2)*Third World Quarterly*387,387.

<sup>334</sup> Nayef R F Al-Rodhan, *Policy Briefs on the Trans-cultural Aspects of Security and Stability* (LIT, 2006)1–4.



basis of which it can be relatively categorized as ‘strong’, ‘weak’, ‘failing’ or ‘failed’. Next, the institutional theory of state regulation and the respective roles that formal and informal institutions play in state-building are explained. Within this framework the current international effort towards ‘reconstruction of failed and weak states’ is discussed implicitly in game theory terms

ii) Part II applies the ‘weak’ and ‘failing’ states framework so discussed in Pakistan’s case. It explains that there are influences and vested interests that obstruct the essentially required reforms and regulation to make the Pakistani state perform effectively. Among these challenges, the chapter identifies the different forms of corruption prevalent in Pakistan and discusses its various dimensions and the role informal channels of money transfer play in transferring the proceeds of corruption and other ill-earned money. The chapter highlights the role of the corrupt Pakistani political elite who is resistant to any essentially required reforms alongwith other key structural and governance issues hampering the reform agenda. The role of the major international donors engaged with Pakistan over a long period is also underscored in order to understand the different vested interests that challenge reform and regulation.

iii) Finally, Part III brings the entire discussion into perspective. It takes the Pakistan-Afghanistan Transit Trade as an example of failed regulation to show that in the political and legal environment discussed in chapter 4 which legally excludes the tribal areas from the operation of laws and regulatory processes operating in other parts of the country, as well as the challenges to regulation highlighted in part II above, to demonstrate that the failure to effectively regulate *hawala* is the result of a number of factors.

It would be a serious misunderstanding to see the continuation of *hawala* as a substitute informal institution which is only prevalent because the state is incapacitated in regard to regulating and protecting formal institutions effectively. Notwithstanding the need for essentially required reforms, the discussion underscores that *hawala* is taking advantage of the disparities in government policies (such as exchange and tariff rates), and has become an efficient alternative to the often expensive and complicated formal financial sector. The discussion on Pakistan Afghanistan Transit Trade establishes the comparative ‘efficiency’ of the *hawala*-type IVTS which is most prevalent in the international trade settlements

where ‘gigantic sections of the world economy operate under the radar’<sup>335</sup> and is a continuous challenge for the authorities. While it may seem that the prevalence of *hawala* in weak or failing states is evidence that the existence of *hawala* is a consequence of the failure of government in such states, its existence (indeed effective operation) in London, New York, Berlin and Singapore puts the lie to this over simplification.

## **Part I): Why States Fail?**

### **6.2 Why Do States Fail?**

The prime function of a state is to provide key political goods to its citizens. These include security; freedom; essential public services such as health and education; sound infrastructure; a beneficent fiscal and institutional context within which citizens can pursue personal entrepreneurial goals; the promotion of civil society; and methods of regulating the sharing of environmental commons.<sup>336</sup> This means that the performance of the state to provide these goods and services to its citizens determines whether the state in question is a strong state or relatively weak. Strong states will be those that perform well in service delivery and weak states will perform poorly. It also means that constant weakness may edge the state toward failure (hence the term ‘failing state’). It is most unlikely that a state fails completely in providing all the different categories of goods and services unless it loses the very essence of its existence as it may happen in the case of a civil war or a foreign invasion. Rutberg states that nation states fail because ‘they are convulsed by internal violence and can no longer deliver positive political goods to their inhabitants. Their governments lose legitimacy, and the very nature of the particular nation-state itself becomes illegitimate in the eyes and in the hearts of a growing plurality of its citizens’.<sup>337</sup>

This explains that failure or collapse of nation states is a complex situation and that most of the states lie between the strong and weak continuum of ‘service delivery’ assessment criteria. While strong states perform well in providing their citizens with a full range and high quality political goods and services, weak states may show mixed results, fulfilling

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<sup>335</sup> Passas, ‘Formalizing the Informal?’ above n 94, 412.

<sup>336</sup> Robert I Rutberg, ‘The Failure and Collapse of Nation-States: Breakdown, Prevention and Repair’ in Robert I Rutberg (ed), *When States Fail* (Princeton, 2004) 1.

<sup>337</sup> *Ibid* 1.

expectations in some areas while performing poorly in others. Within this context, state failure is ‘relative’, driven by the under-performance of the state in service delivery causing economic degradation and poverty, which in turn is related to governance failures, corruption and rent-seeking, distortion in markets and the absence of democracy.<sup>338</sup>

Another possibility is that some states are inherently weak due to their specific geographical, physical or fundamental economic constraints — these may be weak temporarily or situationally, due to internal antagonisms, management flaws, greed, despotism or external attacks.<sup>339</sup> In certain states (as in East Asian economies) the state may be transiting through a phase of social transformation — from pre-capitalist and pre-industrial economies to a dynamic industrial capitalist economy.<sup>340</sup> In such situations, state failure could be driven by lack of institutional capacities, and more importantly, the incompatibility of institutional capacities with pre-existing distribution of powers. Proponents of the ‘institutional approach’ argue that the more critical area of a state failure has been the absence of political and institutional capacity in many developing country states to assist and accelerate a dynamic transformation. Supporters of this opinion contend that sustained progress in service delivery is unlikely in the absence of strategies to enhance political and institutional capacity.<sup>341</sup>

### **6.3 The Institutional Approach to State Regulation**

According to the institutional approach to state regulation the role of a state is based on its claim to the monopoly of legitimate violence. The ‘State’ is the only body in a society which can legitimately enforce institutions, collect taxes, redistribute income and wealth, represent and enforce social cohesion or resolve conflicts, through ‘institutions’ comprising constitutions, rules and laws. An institution is thus defined as the set of both the formal and informal rules which constrain and govern the action of agents subject to that institution. In

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<sup>338</sup> Mushtaq Khan, ‘State Failure in Weak States: A Critique of New Institutional Explanations’ in J Harris, J Hunter, and C Lewis (eds), *The New Institutional Economics and Third World Development* (Routledge, 1995) 71.

<sup>339</sup> Rutberg, above n 334, 4.

<sup>340</sup> See Ha-Joon Chang, ‘Breaking the Mould: An Institutional Political Economy Alternative to the Neoliberal Theory of the Market and the State’ (Social Policy and Development Program Paper No 6, Nations Research Institute for Social Development, 2011).

<sup>341</sup> Mushtaq Khan, ‘State Failure in Weak States’, above n 336.

other words, institutions are the rules of the game;<sup>342</sup> these are systems that structure human interaction within a state — they provide incentives and disincentives for people to behave in certain ways; and if the state institutions are effective, they facilitate in structuring the economic, social and political activities. In short, effective institutions play a key role in the state-building of any country.

By this definition, state regulation is part of the ‘formal institutional structure’ which includes constitutions, laws, property rights, taxes and subsidies. In this manner the state is responsible for enforcement and protection of all formal property rights. It is interesting to note that whereas both formal and informal institutions affect economic outcomes because they condition the opportunities and incentives of the various agents, the institutional analysis views the state as closely associated with the protection and maintenance of the ‘formal institutions’ and the processes through which these are changed and reformed. In such a situation, the term ‘state failure’ becomes rather descriptive as it involves only a judgment about the potential benefits of informal institutions<sup>343</sup> without extending any protection to them.

#### **6.4 The Informal Rules of the Game**

It could be argued that due to its focus on the formal rules of the game, the institutional stream of thought rather overlooks the role of the informally shared set of rules. These informal rules are the usually unwritten regulations that are created, communicated, and enforced outside the officially sanctioned channels<sup>344</sup> or what Ostrom<sup>345</sup> has termed ‘rules in force’.

When defining ‘informal institutions’, a distinction is required between ‘informal’, ‘weak’ or ‘ineffective’ institutions. For example, if rules that exist on paper are widely circumvented or ignored in a formal institution (such as abuse of executive authority), the circumvention or abuse of rules is an institutional weakness and not an informal

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<sup>342</sup> Douglas C North, *Institutions, Institutional Change and Economic Performance* (Cambridge University Press, 1990) 3.

<sup>343</sup> See Mushtaq Khan, ‘State Failure in Weak States’, above n336.

<sup>344</sup> Gretchen Helmke and Steven Levitsky, ‘Informal Institutions and Comparative Politics: A Research Agenda’ (2004) 2(4) *Perspectives on Politics* 725, 727.

<sup>345</sup> Elinor Ostrom, *Understanding Institutional Diversity* (Princeton University Press, 2005) 111–113.

institution.<sup>346</sup> Similarly, an informal institution needs to be distinguished from informal behavioural irregularity. For instance, public graft can be categorized as a behaviour pattern, unless the graft is enforced from above, or it is rooted in widely shared expectations among citizens and public officials and a refusal to ‘go along’ risks incurring serious costs, then the corruption is an informal institution.<sup>347</sup> Another important difference is between informal institutions and informal ‘organizations’ such as, mafias or clans<sup>348</sup> which can be classified as informal organizations. Lastly, informal institutions are different from ‘culture’. Culture is a set of shared values whereas informal institutions may be viewed more narrowly as a set of shared expectations.<sup>349</sup>

The interaction and relationships between the formal and informal institutions are multi-dimensional. Following the informal rules may lead to a similar result as following the formal rules or the outcome may be substantively different. When the results of following the informal rules are closely similar to those resulting from the use of the formal set of rules, institutions converge, and where the results are different, the institutions diverge. A second dimension relates to the effectiveness of the formal institutions meaning the extent to which written rules are enforced and followed. Based on these two dimensions, the authors Helmke and Levitsky<sup>350</sup> have categorized institutions as:

- i) **Complementary Informal Institutions** – these address contingencies not dealt with by the formal rules or by facilitating the pursuit of individual goals within the formal institutional framework. These serve to ‘fill-in-the-gaps’, creating or strengthening incentives to comply with formal rules that might otherwise exist merely on paper. An illustration of the complementary institutions is that in 2013 the effectiveness of the Election Commission of Pakistan (ECP) in holding free and fair elections was linked to a complementary set of shared beliefs and expectations among the citizens who demanded transparency in elections

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<sup>346</sup> See Claudia R Williamson, ‘Informal Institutions Rule: Institutional Arrangements and Economic Performance’ (2009)139*Public Choice*371. Williamson maps out the relationship between formal and informal institutions for development. She observes that Pakistan has ‘formal restraints’ but ‘what appears to be lacking are the informal constraints’: at 377. She notes that the latter may be required for the former to be effective: id.

<sup>347</sup> Helmke and Levitsky, above n342, 727.

<sup>348</sup> Kathleen Collins, ‘The Logic of Clan Politics: Evidence from the Central Asian Trajectories’ (2004)56(2) *World Politics*224. Collins defines ‘clans’ as informal identity networks based on kin or fictive kin bonds:224.

<sup>349</sup> Helmke and Levitsky, above n342, 728.

<sup>350</sup> Ibid 728–730.

and promptly reported rigging and cases of violence on electronic and social media, leading the ECP to cancel polling for that day and announce re-elections in the disputed constituencies.<sup>351</sup>

- ii) **Accommodating Informal Institutions** – these are often created by those actors who dislike outcomes generated by the formal rules but are unable to change or violate these rules. As such, the accommodating informal institutions help to reconcile these actors’ interests with the existing formal institutions. An example is that under the 2002 reforms introduced by the SBP, foreign exchange companies were initially required to obtain identification documentation from their customers even if the amount of transaction was equivalent to USD1. Later, this policy was amended as a result of ‘negotiations and compromise’. The SBP relaxed the rule and set the reporting limit to USD5,000. Although this arrangement violated the basic spirit of AML/CFT regulations, it resolved the conflict thereby enhancing market stability at the expense of at least one of the basic objectives the reforms were designed to achieve.
- iii) **Competing Informal Institutions** – these institutions structure incentives in ways that are incompatible with the formal rules. To follow one rule, the actors must violate another. Clientelism and corruption are the most common examples of such institutions. An illustration of this has been explained in Chapter 5 in the politics of clientelism in the Pakistan foreign exchange and remittance market which has traditionally remained dominated by a few families and ethnic groups.
- iv) **Substitutive informal institutions** – these act as defacto formal institutions because the formal institutions have failed to achieve what they were designed for. For example, in Afghanistan in the absence of a functional western banking system, *hawala* networks provide financial services which have been used by the international organizations and western aid agencies.<sup>352</sup>

A pertinent question that is often raised concerns the contribution of informal institutions to the development of the formal institutions, particularly when accommodating institutions violate the formal rules, and substitutive institutions replace the formal institutions. To

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<sup>351</sup> Irfan Ghauri and Rabia Ali, ‘Election Anomalies: ECP Announces Re-polling Schedule’, *Express Tribune* (Pakistan), 15 May 2013.

<sup>352</sup> Maimbo, ‘The Money Exchange Dealers of Kabul’, above n 22.

answer these queries, scholars have delved into the motivations for the creation of informal rules particularly in the presence of formal institutions. There can be three major motivations for actors to create informal institutions. First, actors create informal institutions because formal institutions are incomplete. Second, informal institutions can be a ‘second-best’ strategy for those actors who can either not achieve a formal institution or do not have the power to change the formal rules. A third and final motivation for creating informal institutions is the pursuit of goals not considered publicly acceptable. For instance, politicians may create informal rules (of coalition bargaining) for government formation and alter formal institutions that do not function to their benefits.<sup>353</sup> Similarly, the processes for the emergence of informal institutions may also vary. In some cases, the informal institutions may emerge as a result of elite design or imposition, while in other cases these may be a result of interaction between many actors. Informal institutions may have emerged as a product of compromise or conflict or their informal rules may have been transmitted through social networks or political organizations.<sup>354</sup>

## 6.5 Reconstruction of Weak and Failed States

Within the above framework, if attempts to regulate the IVTS during the past decade are viewed from the perspective of the international efforts towards reconstruction of the failed or weak states to establish formal institutions which can be protected, maintained and regulated by the state, it could be argued that these reconstruction efforts suffer from a ‘nirvana fallacy’.<sup>355</sup> The ‘nirvana fallacy’ is essentially the fallacious reform mindset which assumes that foreign interventions, via occupation or reconstruction, can generate preferable outcomes or better solutions to the problems of these countries in comparison to that which would occur if interventions were not present.<sup>356</sup> But, what this ‘reforms’ mindset tends to ignore is that in the absence of formal institutions or contracts, many informal mechanisms have evolved and are enforced to fill the void that was created as a result of the ‘no state’ or ‘despite the state’ situation. Coyne has studied the case of Somalia

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<sup>353</sup> Carol A Mershon, ‘Expectations and Informal Rules in Coalition Formation’ (1994)27(1) *Comparative Political Studies*40, 43.

<sup>354</sup> Helmke and Levitsky, above n342, 731.

<sup>355</sup> Christopher J Coyne, ‘Reconstructing Weak and Failed States: Foreign Intervention and the Nirvana Fallacy’(2006)2*Foreign Policy Analysis*343, 344.

<sup>356</sup> Ibid.

where in the absence of a central government, the private sector has developed coping governance mechanisms which substituted for state institutions.<sup>357</sup> The same is true for Afghanistan, where the informal *hawala* system provided financial services as a result of collapse of banking institutions.<sup>358</sup> These examples further reinforce the argument that the reconstruction efforts aimed at bringing ‘order’ by formalizing the informal practices have seemingly overlooked the indigenous (albeit informal) practices embedded in the societies and cultures of the weak and failed countries.

In game theory terms, this argument can be explained as the reconstruction efforts focus on resolving the meta-level game (of creating self-sustaining formal institutions), it ignores the various nested games embedded within the general meta-game. The ‘nested game’ framework has been developed by Tsebelis.<sup>359</sup> His focus is that during a game if, with adequate information, an actor’s choices appear to be sub-optimal, it is because the observer’s perspective is incomplete. The observer focuses attention on only one game, but the actor is involved in a whole network of games. What appears suboptimal from the perspective of only one game is in fact optimal when the whole network of games is considered. In short, if actors in a game are not opting for what appears to be the optimizing strategy, the reason is because they are involved in nested games where various factors and considerations have an overriding importance for the actors which are not visible to the observer. As Tsebelis puts it,

Instead of the concept of rationality as a model of human behaviour, I propose the concept of rationality as a subset of human behaviour. The change in perspective is important; I do not claim that rational choice can explain every phenomenon and that there is no room for other explanations, but I do claim that rational choice is a better approach to situations in which the actors’ identity and goals are established and the rules of the interaction are precise and known to the interacting agents. As the actors’

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<sup>357</sup> Ibid 345.

<sup>358</sup> Maimbo, ‘The Money Exchange Dealers of Kabul’, above n 22.

<sup>359</sup> George Tsebelis, *Nested Games: Rational Choice in Comparative Politics* (University of California Press, 1990).



goals become fuzzy, or as the rules of the interaction become more fluid and imprecise, rational choice explanations will become less applicable.<sup>360</sup>

Tsebelis has used the game theoretic framework to tackle the problem of institution creation and restructuring. He argues that in real political situations, the rules of the game are constantly subject to change. Actors who lose under a particular set of institutions continue working within them hoping that on another occasion, outside conditions will work to their advantage. The end result is that institutional rules may sometimes serve as constraints and at others the object of self-interested redesigns. According to Tsebelis, different types of institutional solutions may reflect different purposes, from equity to redistributing power to consolidating power. These solutions are never neutral in their consequences and will consequently always reflect, ‘conscious choices of the actors involved once they realize that the previously existing institutions were in constant conflict with their interests’.<sup>361</sup> The *Hawala* reforms of 2002 and their failure if viewed in the nested game framework and in conjunction with the analysis of why states fail has clear application to Pakistan.

## **Part II                      Regulating *Hawala* in Pakistan**

### **6.1                      Corruption**

In earlier chapters, factors such as the exclusion of the FATA, the application of the FCR, the size of Pakistan’s shadow economy and rampant tax evasion in Pakistan have been discussed. Corruption accounts for a large part of Pakistan’s shadow economy as well as creating many other problems, although from a theoretical point of view a symbiotic relationship between corruption and the shadow economy has remained ambiguous.<sup>362</sup>

Corruption is most commonly defined as ‘the abuse of public office for private gain’.<sup>363</sup> In economic literature it is also referred to as ‘rent-seeking’<sup>364</sup> which occurs when individuals and groups from the private sector interface with the state through a variety of mechanisms

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<sup>360</sup> Ibid 32–33.

<sup>361</sup> Ibid 103.

<sup>362</sup> Andreas Buehn and Friedrich G Schneider, ‘Corruption and the Shadow Economy: A Structural Equation Model Approach’ (IZA Discussion Paper No 4182, 2009).

<sup>363</sup> Raymond Baker, *Capitalism’s Achilles Heel* (Wiley 2005) 50.

<sup>364</sup> Anne O Krueger, ‘The Political Economy of the Rent Seeking Society’ (1974) 64(3) *American Economic Review* 291, 291–3.

to transfer public resources to themselves. Pakistan is plagued with corruption at public, private and institutional levels and hence the implications for the transfer of (illicit) funds are far too many through the use of the unregulated financial channels.

### 6.1.1 Causes of Corruption

Corruption can be rooted in a country's political development, legal development, social history, bureaucratic traditions, economic conditions and general policy-making. Buehen and Schneider<sup>365</sup> highlight that the economic causes of corruption are related to the deficiencies in the political and judicial systems. According to these authors, sound administrative systems, clear rules and a long tradition of institution building are factors that deter corruption. Sometimes corruption is also grounded in the social and cultural traditions of a society<sup>366</sup> (for example, presenting gifts to show gratitude for favourable decisions). In other situations, corruption is related with the increased interference of the government in the economy in terms of the regulatory environment and the fiscal burden imposed on individuals.<sup>367</sup> Buehen and Schneider argue that greater government interference increases corruption by causing both bribe takers and bribe seekers to engage in activities that circumvent rules and regulations.<sup>368</sup> In some South Asian countries (including Pakistan), political turmoil and the continuous expulsion of political regimes has resulted in the prevalence of official misconduct among politicians and administrators and the concomitant spread of corruption among business people.<sup>369</sup> Alternatively, due to pervasive corruption in political governments, a politically motivated military would take over as *ultima ratio* by bringing down the government. This has happened five times in Pakistan since its independence.<sup>370</sup>

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<sup>365</sup> Buehn and Schneider, above n 360, 15.

<sup>366</sup> Ibid 16.

<sup>367</sup> Ibid 17.

<sup>368</sup> Ibid.

<sup>369</sup> Khalid Maqbool, 'Combating Corruption in Pakistan' in *Progress in the Fight against Corruption in Asia and the Pacific: Proceedings of the 2<sup>nd</sup> Regional Anti-Corruption Conference 2000* 43.

<sup>370</sup> Amina Ibrahim, 'Guarding the State or Protecting the Economy? The Economic Factors of Pakistan's Military Coups' (Occasional Paper No 8, Crisis States Research Centre, LSE Destin Development Studies Institute, 2009).

<<http://www.lse.ac.uk/internationalDevelopment/pdf/WP/WP92.pdf>>.

## 6.1.2 Categories of Corruption in Pakistan

Sayeed<sup>371</sup> has categorized corruption in Pakistan in three broad areas as: collusion between private sector and the state; corruption and extortion by state actors; and institutionalized corruption.

### i) Collusion between Private Sector and the State

According to Sayeed, collusion between the private sector and the state primarily involves the allocation and processing of land transactions. The author has traced the genesis of this form of corruption in the early years after partition of the sub-continent in 1947 and the resettlement of millions of refugees who migrated to Pakistani territory from post partition India. In the aftermath of the partition, the Pakistani state adopted a policy of granting land and housing that had been left behind by the migrating Hindus — and termed ‘Evacuee Property’ — to the incoming Muslim refugees. The government policy was to compensate ‘property claims’ of these refugees based on what they had left behind in India. Qadir provides that the use of influence and money as a form of patronage by the bureaucrats and politicians in granting such claims had ‘seeped corruption into Pakistani society surreptitiously spreading its tentacles elsewhere’.<sup>372</sup> According to Sayeed,<sup>373</sup> the ‘evacuee property’ policy resulted in the creation of a class of ‘propertied’ migrants. He considers this, the first form of ‘primitive accumulation’ carried out in the newly born Pakistani state.

It could be argued that over the years the acquisition of land has been taken to new levels in Pakistan. Land-grabbing by the so-called ‘land mafia’<sup>374</sup> is prevalent, particularly in and around the major urban centres such as Karachi, Lahore and Islamabad; and government housing authorities are allegedly colluding with the private property developers, ‘who

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<sup>371</sup> Asad Sayeed, ‘Contextualizing Corruption in Pakistan’ (2010)2(1)*Social Sciences and Policy Bulletin*(Lahore University of Management Sciences) 10.

<sup>372</sup> Mansoor Qadir, ‘Report on Present Situation, Problems and Solutions in the Legal System Related to Corruption Control and Corruption Cases in Pakistan’(2003)74(1)*International Review of Penal Law*515, 518.

<sup>373</sup> Sayeed, above n369,11.

<sup>374</sup> Transparency International, *Mafia Land Grab* (undated)  
<[http://www.transparency.org/news/story/mafia\\_land\\_grab](http://www.transparency.org/news/story/mafia_land_grab)>.

employ private militias to secure the land.<sup>375</sup> Moreover, to facilitate the practice of ‘land grabs’ (of both urban and rural land) the *Acquisition of Land Act (1894)* has been modified periodically.<sup>376</sup> The real estate sector comprising residential colonies and commercial ventures that have been developed caters largely to the more affluent sections of society and provides an important conduit for ‘whitening’ of the black money acquired through corruption and other criminal activities.<sup>377</sup>

A 1987 report by the Pakistan National Taxation Commission tabled before the Parliament documented that ‘the bulk of Pakistan’s black money is held in non-productive investments... real estate and undeclared business assets’.<sup>378</sup> According to Sayeed, due to taxation loopholes, usually more than two-thirds of the money paid in a land or property transaction remains unrecorded.<sup>379</sup> This means that cash or other informal payment methods are used to complete the transaction. In this manner, the true value of the asset cannot be estimated because it is neither declared nor documented. Consequently, large amounts of black money are circulating in the economy that can conveniently be used for settlement of *hawala* deals.

Another important form of rent-seeking that has bred corruption in Pakistan over time has occurred due to the state interventionist policies and discretionary powers exercised in the award of official permits, licences and quotas. A 1979 White Paper issued by the military government on the misuse of banks by political governments stated:

the aggregate amount of advances of half million rupees and above which were classified as doubtful or irregular in the State Bank Inspection Report of 31 December 1975 is over PKR1,340 million. Advances of half million rupees or above given by the banks after nationalization which have been found to be bad, doubtful or irregular *ab initio* amounted to PKR510 million.

The same White Paper also stated that the nationalized commercial banks sanctioned loans worth PKR562 million under irresistible political and administrative pressure or influence

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<sup>375</sup> Ibid.

<sup>376</sup> Sayeed, above n369, 11.

<sup>377</sup> Ibid.

<sup>378</sup> Anthony Hyman, Muhammed Ghayur and Naresh Kaushik, *Pakistan: Zia and After* (Abhinav, 1989)94.

<sup>379</sup> Sayeed, above n363, 11.

between 1974 and 1977.<sup>380</sup> Many economists support the view that in the early stages of economic development, preferential treatment of the state in allocating resources to preferred industries leads to creating artificial monopolies (and hence inefficiency) and the process of seeking rents creates a deadweight loss to the economy,<sup>381</sup> however, in the industrial development model it is arguably prudent to allocate resources at early stages of industrialization to sectors which create greater externalities and are geared towards creating dynamic comparative advantage in the long run.<sup>382</sup> In this manner although corruption would exist, the long term returns to the economy would outweigh the deadweight loss incurred in seeking rents. The East Asian ‘protective industrial policies model’ is often associated as evidence of this process of capitalist development in the post liberalization era. In Pakistan’s case too, such form of corruption have remained prevalent until the economy was liberalized in the early 1990s. However, state-led industrialization did not show results in Pakistan (and also in India) that were similar to those generated in the East Asian countries.<sup>383</sup> According to Cheema,<sup>384</sup> corruption became an end in itself rather than a necessary means for accumulating capital for productive purposes. He has concluded that by the end of the 1980s, ‘economic graft was no longer restricted to funding individual members of the bureaucracy ... but also included financing key political factions in dominant political parties and the army’.<sup>385</sup>

The liberalization of the economy in the 1990s was meant to create opportunities for the emergence of a vigorous, independent entrepreneurial class as organizers of the economic activity in the country.<sup>386</sup> Conversely, privatization policies in the early 1990s resulted in creating unregulated cartels in Pakistan that took control across a range of industries, such as banking, automobile, cement, and sugar sectors.<sup>387</sup> Another significant development

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<sup>380</sup> Shahid-ur-Rehman, *Who Owns Pakistan* (Mr Books, 1998)93.

<sup>381</sup> See Krueger, above n362.

<sup>382</sup> See Ha-Joon Chang, *The Political Economy of Industrial Policy* (McMillan, 1994).

<sup>383</sup> Mushtaq H Khan, ‘The Political Economy of Industrial Policy in Pakistan 1947-1971’ (Working Paper No 98, University of London, School of Oriental and African Studies, Dept of Economics, 2000).

<sup>384</sup> Ali Cheema, ‘The Role of Corruption in Pakistan’s Industrialization’ (2002)7(4) *NIPA Journal 1*.

<sup>385</sup> *Ibid*32.

<sup>386</sup> Imran Ali and Adeel Malik, ‘The Political Economy of Industrial Development in Pakistan: A Long-Term Perspective’ (2004)14 *Lahore Journal of Economics 29*.

<sup>387</sup> Privatization had resulted in a monopoly in the cement market, as five cement factories were all privatized to Mian Mansha. He also acquired the Muslim Commercial Bank (MCB). Another major beneficiary, the

during this decade was the abuse of the financial sector for generating rents for the political incumbents. The authors Ali and Malik have documented a chronological history of the political economy of Pakistan's industrial development, arguing that the alliance between the banking officials, government bureaucracy, and the industrialist class has created serious distortions in the management of the private sector.<sup>388</sup> As a result, the decade of the 1990s has remained marked by huge loan defaults by politically connected and influential industrialists continued public financial assistance of the public and private sector resource-sucking sick industries, and the occurrence of massive corporate failures. Bad loans which totalled PKR1,340 million in 1979 swelled to PKR80 billion in August 1993, PKR126 billion in November 1996 and PKR130 billion in January 1997.<sup>389</sup> It is worth noting that despite that the SBP announced incentives in exemptions to recover loans from the defaulters, such as the repayment of only the principal loan amount plus interest of 5 per cent of the principal (instead of the full amount of accrued interest), the response ratio for repayment of these loans was only 30 to 40 per cent. Evidently, the banks incurred losses as they could not detect the majority of the defaulters or recover loans from them. A rich defaulter class has ended with up this stolen wealth in the black economy, or in many cases it has simply left Pakistan altogether.<sup>390</sup>

## ii) Corruption and Extortion by State Actors

The involvement of the state actors in corruption ranges from petty and straight forward bribery of a policeman or a building authority clerk to middle level corruption<sup>391</sup> of extortion from individuals and businesses to various forms of domestic and international 'kickbacks' on procurements of material and other services.<sup>392</sup> In this connection, the civil bureaucracy has been often criticized for executing the state-led corruption. The bureaucracy is said to be 'in the loop' of all corrupt transactions as the 'deal executors'. The reason is that the bureaucrats carry out the requisite documentation and are most familiar

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Schon Group, acquired Pak-China Fertilizer and National Fibre, and Sikandar Jatoi acquired Metropolitan Steel, Zeal Pak Cement, and Shikarpur Rice: Ibid.

<sup>388</sup> Ali and Malik, above n 384, 45.

<sup>389</sup> ur-Rehman, above n 378, 94.

<sup>390</sup> Ali and Malik, above n384, 45–46.

<sup>391</sup> Umbreen Jawaid, 'Corruption and Its Deep Impact on Good Governance in Pakistan' (2010)48(1)*Pakistan Economic and Social Review*123,125.

<sup>392</sup> Sayeed, above n 369,12.

with all the relevant rules, regulations, loopholes and lacunae.<sup>393</sup> However, as Sayeed argues, apart from the receipt of petty bribes and generally minor extortion, the civil bureaucrat is not the sole beneficiary of large scale corruption. According to the author, over the years the civil bureaucracy has lost its clout and political power to the civilian politicians and the military rulers who have taken turns to control executive power in the country for periods of time.<sup>394</sup>

This means that in the ‘new corruption order’ of the state led corruption, where the military junta and the civil politicians are the chief protagonists. Nevertheless, whilst both the military and the politicians are at the forefront of the state led corruption, the civil politicians are more accountable for their conduct than their military counterparts. Sayeed<sup>395</sup> gives three main reasons for this:

- i) The logic of electoral democracy holds politicians accountable for their misdeeds and lack of delivery to the electorate. Poor performance or charges of corruption might risk a political career or chances of being re-elected; while the other hand, the military men do not have to contest elections and so are at no risk of retribution from the voters.
- ii) Various audit and accountability laws apply to the politicians, leaving them relatively more susceptible to legal provisions than their uniformed counterparts. The military, on the other hand, is powerful enough to evade public accountability. The military’s budget in Pakistan is neither presented in detail to the Parliament nor are the public representatives allowed to debate the military expenditures publicly. Moreover, the military budget is not audited by the civilian audit authorities; and, under the law of the land, the serving military personnel are exempt from any investigation by the civil investigative and anti-corruption agencies.
- iii) Politicians have a greater interaction with the public as well as the media. Also, due to the very nature of the civil-military imbalance in Pakistan, investigation and reporting of military ‘scandals’, as opposed to those of politicians, is a much more hazardous proposition for an otherwise free media.

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<sup>393</sup> Ibid.

<sup>394</sup> Ibid.

<sup>395</sup> Ibid.

### iii) Institutionalized Corruption

As explained earlier (in the institutional and legal frameworks' section), there are enough tax and legal lacunae through which black money can be laundered. The most salient scheme in this regard is the 'no questions asked' private inward remittance in foreign exchange policy. According to the foreign exchange law, any individual can receive any amount of foreign exchange into the country tax-free through the formally regulated banking channels without being questioned about the source of these funds. This policy has served as the most common conduit for money laundering of illicit funds generated as a result of land transactions, tax evasion and other criminal activities. In addition to the foreign exchange relaxations, state institutions such as, the Federal Board of Revenue (FBR) periodically provides tax amnesty schemes to 'whiten' black money at a nominal rate of taxation.<sup>396</sup>

Another form of institutionalized corruption is the grant of land to the military personnel.<sup>397</sup> Since the 1960s, senior army officers have been granted residential, commercial and agricultural land, as service entitlement at highly subsidized prices. In the case of residential land, numerous societies have been developed by the armed forces on Pakistan's urban landscape where infrastructure is developed largely at the state expense and the land is allotted to military personnel at subsidized rates. Once the land has been allotted to the officers, they can sell it at the (much higher) market rates and extract a hefty premium. Similarly, developed agricultural land is also provided at subsidized rates and, in some cases, army personnel are officially deputed to tend this land at the state expenses. As a result, an influential section of the army establishment is now closely integrated with the landed and business classes in Pakistan.<sup>398</sup>

Finally, institutionalized corruption is related to the Pakistani state's covert operations and security policy during the past three decades. Most pronounced of these operations has been the country's nuclear program. In 2004, Dr AQ Khan (founder of the nuclear program)

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<sup>396</sup> During the past two decades, four amnesty schemes have been announced.

<sup>397</sup> For more details on military capital that is used for the personal benefits of the military officers but is neither recorded nor part of the defence budget, see Ayesha Siddiqi, *Military Inc: Inside Pakistan's Military Economy* (Pluto Press, 2007).

<sup>398</sup> Ponna Vignaraja and Akmal Hussain (eds), *The Challenge in South Asia: Development, Democracy and Regional Cooperation* (United Nations, 1989) 214.



confessed that he had supplied contraband material to other countries in return for cash. Dr Khan's confession provides an important insight into the nature of money laundering operations involved in such activities. Reports suggest that in the formative phase of the program, material and equipment was purchased illegally on the international market. According to Levy and Scott-Clark,<sup>399</sup> this process involved a large number of international state and non-state actors and intermediaries that laundered state money for this purpose. Other major elements in the same vein of secret operations are those that have been conducted in Afghanistan and Kashmir by the Pakistani state. The fact that the entire war effort was conducted through non-state actors, including training, provision of arms and ammunition as well as logistic support means that large amounts of state funds were diverted to accomplish these operations. Many versions are available as evidence of the covert funding provided by the American CIA, and the role of the Saudi General Intelligence Department (GID) in the Afghan jihad in the 1980s is also well documented. For example, Gregory states:

Neither, the CIA nor the GID, had clear and tight oversight of what the ISI (and by extension the Pakistan military government) was doing with the money or the arms. It has since become clear that the ISI siphoned off hundreds of millions of dollars for its own purposes as well as millions of small arms.<sup>400</sup>

Nawaz<sup>401</sup> has provided an account of how private Saudi money was channelled during the Afghan war through various formal and informal – including *hawala* – that were used to deliver funds speedily to specified recipients merely through oral instructions and simple code words. Other investigations suggest that the undisclosed amounts of money that was transferred were laundered through a variety of bank accounts, both domestic and international. According to Sayeed, much of this money probably made its way back into

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<sup>399</sup> Adrian Levy and Catherine Scott-Clark, *Deception: Pakistan, the United States and the Global Nuclear Weapons Conspiracy* (Atlantic, 2007)124–137. For example, at p 126 Levy and Scott-Clark report that the Bank for Credit and Commerce International (BCCI) was an important channel through which Pakistani agents made payments to suppliers, disseminating funds in over 70 countries. BCCI also allowed its network to be used for transferring CIA money intended for the Afghan jihad into the country's nuclear program.

<sup>400</sup> Shaun Gregory, 'The ISI and the War on Terrorism' (Brief No 28, Pakistan Security Research Unit, January 2008)4; Also see Levy and Scott-Clark, above n 397, 125. The money was held in bank accounts in the BCCI, National Bank of Pakistan and the Bank of Oman (partly owned by BCCI).

<sup>401</sup> Nawaz Shuja, *Crossed Swords: Pakistan, Its Army and the Wars Within* (Oxford University Press, 2008)372–373.

Pakistan and has been invested in real estate and other sectors without being detected. He states:

The most important implication of institutionalized corruption is that the actors involved—be they state or non-state—wield so much influence and power that bringing them under the ‘due process’ of anti-corruption laws appears virtually impossible.<sup>402</sup>

## 6.2 The Conundrum of Political Elite

Corruption by powerful groups of state and non state actors has clear implications for *hawala* regulation in Pakistan — non-regulation means *hawala* can be used as a preferred conduit for these groups to siphon off their ill-gotten, illegally obtained and criminal money. It follows that these groups of powerful political elites who have been using the Pakistani state for their personal gains are the real problem due to which regulatory policies (and consequently the state) have failed.

Pakistani economist Ishrat Hussain<sup>403</sup> has examined the political economy of Pakistan’s growth in the decades following its independence in 1947 and has propounded that Pakistan has historically remained dominated by a group of elites; mainly drawn from the landlords, political parties, the military, civil service, big businesses and the professional class. These influential elite groups, which in Hussain’s view, are not more than one per cent of the total population, have been maximizing their rent-collecting activities and thus preventing the poor from equitable access to public services and the acquisition of physical and human capital. According to Hussain,

the failure of governance and the consistent domination of political power and the state apparatus by the narrowly based elite seeking to advance its private and parochial interests lay at the heart of the problem in Pakistan.<sup>404</sup>

Hussain’s thesis echoes the views of Dr Mahbub-ul Haq, Pakistan Planning Commission’s Chief Economist in the 1960s, who in a famous speech had stated that 22 industrial family

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<sup>402</sup> Sayeed, above n369,13.

<sup>403</sup> Ishrat Hussain, *Pakistan: The Economy of an Elitist State* (Oxford University Press, 1999).

<sup>404</sup> Ibid 353.

groups had come to dominate the economic and financial life of Pakistan.<sup>405</sup> Focusing on the real growth issues such as income distribution and social justice, Haq was particularly perturbed by the collusion between the private sector and the state authorities and explained the dynamics of this collusion as,

the 22 families had become by 1968 both the planning commission and the ministry of finance for the private sector. They pre-empted most investment permits, import licenses, foreign credits and government patronage because they controlled or influenced most of the decision-making forums handing out such permissions.<sup>406</sup>

Haq had viewed these 22 industrial families as merely a ‘symptom’ whilst the real problem to him was the system of antiquated laws and primitive institutions that caused such alliances to work.<sup>407</sup> Unfortunately, what Haq had considered mere symptom then has become the real cause of Pakistan’s problems in the present time. A few thousand individuals control the economic, social and political scene of the country and all the economic and political power gravitates towards advancing the personal fortunes of these elite groups and those of their clients and patrons.<sup>408</sup>

It would not be wrong to say that because of this minority ruling elite Pakistan has one of the lowest tax-to-GDP ratios in the world. Under *Article 77* of the Constitution, Parliament is the sole authority able to impose taxes —but how will the elected Parliament legislate on taxation when nearly half of all its sitting lawmakers paid no income tax and more than 10 per cent did not even have a national tax number which is required to file tax returns. A 2013 study<sup>409</sup> has analysed the record of all members of national and provincial assemblies who won the 2013 general elections in Pakistan. The study has examined the income and tax declarations these legislators made in their nomination papers filed with the Election Commission of Pakistan (ECP) and the Federal Board of Revenue (FBR). It was found that of the 1,070 members of all the assemblies (including four provincial and one national

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<sup>405</sup> Haq, above n 275.

<sup>406</sup> Ibid.

<sup>407</sup> Ibid.

<sup>408</sup> Ishrat Hussain, *Pakistan: The Economy of an Elitist State*, above n 401.

<sup>409</sup> Umar Cheema, ‘*Taxation by Misrepresentation: A Comparative Study of Public Representatives’ Income and Tax Declarations for 2012*’ (Report by Sustainable Development Policy Institute (SDPI) and Centre for Investigative Reporting in Pakistan (CIRP), 2013)

<<http://www.cirp.pk/TAXATION%20BY%20MISREPRESENTATION.pdf>>.

assembly) information was only available for 1,016 of those members. Among those whose information was missing are 123 law makers and a provincial financial minister who did not have national tax numbers. There are 461 non-tax paying legislators while records of 51 candidates who won the elections are not available. Table 7.1<sup>410</sup> below summarizes these numbers.

<b>Assembly</b>	<b>Total Members</b>	<b>Non-tax Paying</b>	<b>Percentage</b>
National	342	125	36%
Punjab	371	161	43%
Sindh	168	59	35%
KPK	124	80	64%
Balochistan	65	36	55%
<b>Total</b>	<b>1070</b>	<b>461</b>	<b>43%</b>

**Table6.1: Non-Tax Paying Legislators**

Table (6.1 above) shows that the National Assembly has 125 non-tax paying legislators, including two ministers and eight prominent politicians; the Punjab assembly has 161 such members, including 2 ministers; there are 59 non-tax paying members in the Sindh assembly; and 80 in the KPK assembly who did not pay tax (with this number including four ministers, speaker and deputy speaker as well). Also, the 36 non-tax-paying members of the Balochistan provincial assembly includes 8 ministers.

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<sup>410</sup> Ibid 10.

<b>Cases of Income Declarations</b>	<b>680</b>
<b>No of Discrepancies</b>	<b>169</b>
<b>Cases of Tax Returns</b>	<b>550</b>
<b>No of Discrepancies</b>	<b>171</b>

**Table 6.2 Number of Discrepancies**

Table (6.2<sup>411</sup> above) shows discrepancies exist even where candidates have claimed to declare their incomes and filed tax returns. For example, details provided by the Parliamentarians in their nomination papers have been found at variance with FBR's record and many declarations have been disputed by the FBR.

This shows how the ruling elite is a major cause of fundamental institutional problems like corruption and tax evasion that have eroded the domestic resource generating capacity of the country. Moreover, as a result of collusion between the tax-evaders and the tax-collectors the state has become virtually incapacitated as regards the possibility of judiciously utilizing finances for priority investment needs as well as to promote equity. The tax evaded or 'black money' is legalized by governments first introducing frequent schemes to 'whiten' such funds as well as there being laws and channels available through which the laundered funds can be injected back into the system (through foreign exchange bearer certificates or other similar schemes). In this way, the powerful ruling classes are not only the primary cause for the failure of essentially required reforms but are also responsible for many other problems the Pakistani state is facing, including the abuse of the otherwise benign informal transfer systems that are channelling the much required development finance to the poor and underserved in many remote areas of Pakistan. A recent study concludes the conundrum of the Pakistani political elite in the following words:

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<sup>411</sup> Ibid 11.

Pakistan's most serious problems have more to do with a selfish elite wedded to a status quo that consigns some 40 percent of the population to dire poverty with little or no education or health care, than with terrorism or religious fundamentalism.<sup>412</sup>

### **6.3 Polarization in Society**

Besides the political elite hypothesis, another cause that has often been argued to have inhibited essential reforms and contributed to the state failure is the polarization of the Pakistani society into linguistic, religious and regional factions.<sup>413</sup> It has been argued that those societies which are divided and segmented find it difficult to agree on essential public goods and institutions which are required for state-building and to prevent rent-seeking in the society.<sup>414</sup>

#### **6.3.1 Troubled Political History**

The primary cause of segmentation in Pakistani society has been a troubled political history marred by conflict and instability. It has been argued that right from its promulgation in 1930, the 'idea Pakistan' has remained in a flux.<sup>415</sup> Easterly argues that the cultural and geographical homeland of the Pakistan idea in British India lay outside the boundaries of what is today Pakistan.<sup>416</sup> He has stated,

Ironically, significant areas of what is today Pakistan supported other political parties including Indian Congress Party, than the Pakistan founding Muslim League in pre-Independence elections and only shortly before the partition of the sub-continent did the north-west Muslim majority provinces embrace the idea of Pakistan.<sup>417</sup>

Hence, Pakistani nationalism has always remained a contested idea and the debates of national identity and cohesion have haunted the state ever since its foundation.

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<sup>412</sup> Woodrow Wilson International Center for Scholars, 'Aiding Without Abetting: Making US Civilian Assistance to Pakistan Work for Both Sides' (Report, Wilson Centre Working Group on Pakistan, Woodrow Wilson International Center for Scholars, 2011)6.

<sup>413</sup> William Easterly, 'The Political Economy of Growth Without Development: A Case Study of Pakistan' (World Bank, 2001).

<sup>414</sup> Ibid 27.

<sup>415</sup> Stephen P Cohen, *The Future of Pakistan* (Brookings Institution, 2011)27.

<sup>416</sup> Easterly, above n 411, 24.

<sup>417</sup> Ibid 25.

### **6.3.2 Political Instability**

Another indicator of polarization in the society is political instability. In Pakistan, during the initial ten years after its independence in 1947, seven successive non-military governments were appointed. Throughout the 1960s, the country was ruled by military rulers. In 1971, East Pakistan was separated. A democratic government was installed after the secession of East Pakistan but again, another military government took over in 1978. Democracy was revived between 1988 and 1998 with an alternation in power between the country's two leading political parties. Neither of the parties could, however, complete their constitutional terms in the government and both were ousted on charges of corruption. In 1999, another military government took power. The democratic system was restored in 2008 when an elected government was installed; and again in 2013, when for the first time in the history of Pakistan, transition from one elected government to another has been achieved successfully. Continuous political polarization and instability in Pakistan has nevertheless led to institutional deterioration and poor quality of governance.<sup>418</sup> An example of institutional deterioration is often cited in the deterioration of the institution of civil bureaucracy from the 1970s onwards when a political government encouraged lateral entries and quota allocations in the meritorious civil service as a result of politicization of the institution.<sup>419</sup>

### **6.3.3 Ethno-linguistic Diversity**

Another factor that has caused fragmentation in Pakistan is ethno-linguistic diversity. Pakistan is home to a variety of ethnic and linguistic groups speaking different languages and dialects. Its founding fathers chose 'Urdu' as Pakistan's national language which only 8 per cent of the total population speaks.<sup>420</sup> Before the secession of East Pakistan, linguistic polarization was even greater as the Bengalis wanted their language to be declared the second national language along with Urdu.<sup>421</sup> Furthermore, despite Urdu being the national language in Pakistan, the English language is used in government offices for official

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<sup>418</sup> Ibid 23.

<sup>419</sup> Andrew Wilder, 'The Politics of Civil Service Reform in Pakistan' (2009) 63(1)*Journal of International Affairs* 19, 22.

<sup>420</sup> Easterly, above n 411, 26.

<sup>421</sup> Ibid.

communication because Pakistan has retained most of the colonial English laws and administrative institutions. At the societal level, the elite — and increasingly the urban middle classes — prefer English as a medium of communication and education, creating further schisms in regard to the medium of language in which basic education needs be delivered.

Another division in Pakistan has remained between the native inhabitants of the region that became Pakistan and the immigrants (*Muhajirs*) who came from India at the time of partition. The communal violence witnessed in Sindh province since the mid 1980s has been cited as a cause of the perception among the *Muhajirs* that they have remained marginalized compared to the ‘sons of the soil’.<sup>422</sup> Similarly, the Baloch have tried to secede in the 1950s as well as in the 1970s, but these attempts were responded to with brutal force by the Pakistani army. The separatist insurgency is presently continuing in Balochistan.<sup>423</sup> The demand for a combined Pushtunland has also ‘remained on the cards’.<sup>424</sup> A final and significant segmentation is between the variants of Islamic belief and the non-Muslim minorities, and by the debate as to whether the Pakistani state should be secular or Islamic. In recent years, the growing trend of the so-called ‘Talibanization’ of the society has further exacerbated the existing fissures between the Islamists and the liberals.<sup>425</sup>

It is worth contemplating the situation of a divided society where corruption is rampant and the successive governments have shown an unwillingness to take action to increase revenues and introduce other corrective measures for fundamental reforms to improve services for the majority of the people — yet Pakistan continues to receive financial assistance from the international community. The question remains: Why has the international community not used its influence for fundamental reforms in Pakistan which has remained a recipient of its financial assistance for many decades? The answer can be explored in Pakistan’s relations with the major international donors

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<sup>422</sup> Charles H Kennedy, ‘The Politics of Ethnicity in Sindh’(1991)31(10) *Asian Survey*938, 941.

<sup>423</sup> Jason Heeg, ‘Insurgency in Balochistan’ (Kansas State University, 2012)

<[http://fmso.leavenworth.army.mil/collaboration/universities/balochistan\\_final.pdf](http://fmso.leavenworth.army.mil/collaboration/universities/balochistan_final.pdf)>.

<sup>424</sup> Jahanzeb Khan, ‘Greater Pukhtunistan’ *Sahar-The Voice of Pushtuns*, February 2010,15–22.

<sup>425</sup> Fatima Ahmed Yousufzai, ‘Why Pakistan Can Never Defeat the Taliban’ *Sahar-The Voice of Pushtuns*, February 2010,8–14.



## **6.4 International Donors – The IMF and the United States**

### **6.4.1 Relations with the IMF**

Since the late 1980s, Pakistan has remained a recipient of continuous assistance from the IMF, a situation that is often accompanied by a number of demands and obligations imposed by the ‘Fund’. As a starting point, approaching the ‘Fund’ shows that a country’s economy is in dire straits as the IMF is often considered ‘the lender of last resort’ and countries only turn to it in times of grave economic crisis. This means that when a country wants to be ‘bailed out’ by the IMF, its economic managers have accepted their failure of control over the economy. As a result, under the financial assistance package, the Fund has leverage over that country’s economic and financial policies. This view is often refuted in IMF’s defence and it is argued that the ‘reforms program’ a country has to follow under the financial assistance package is not what the Fund wants it to do but what the member-country thinks is doable and politically and socially acceptable in view of its ‘ground realities’.<sup>426</sup>

### **6.4.2 The Decade of the 1990s**

Pakistan’s economy has remained highly volatile and instable since the late 1980s. The decade preceding the 2002 foreign exchange market reforms was a period of heightened political instability in the history of Pakistan comparable only with the political instability of the 1950s. Nine different governments — including four interim, four elected and, one appointed after the 1999 military coup — ruled the country during the 1990s.<sup>427</sup> A natural consequence of this political instability and the frequent changes in the governments followed by a reversal of decisions taken by the preceding government was an overall environment of uncertainty that prevailed throughout this period.<sup>428</sup> Lack of political will and ownership of the governments resulted in the failure of various ‘structural adjustment programs’ initiated under the IMF assistance during this decade. According to Meekal Aziz Ahmed, ‘the lack of ownership of the program is translated into faltering implementation, a

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<sup>426</sup> See, Ahmed, above n 254; Joseph Stiglitz, *Globalization and Its Discontents* (Norton, 2003).

<sup>427</sup> Ishrat Hussain, ‘The Role of Politics’, above n 256, 9.

<sup>428</sup> *Ibid* 7.

sleight of hand to meet the targets and roll-back of reforms'.<sup>429</sup> An example of the 'roll-back' of reforms is the removal of exemptions and concessions as part of IMF conditionality. Once the program is abandoned or terminated by a government, these exemptions and concessions are restored, normally through Statutory Regulatory Orders (SROs), again fragmenting the tax base and leading to a loss of revenues.<sup>430</sup>

The democratically elected governments of the 1990s — and the 2000s — that have come to power in Pakistan after prolonged periods of military dictatorship behaved like Mancur Olson's<sup>431</sup> 'roving bandit' (that is, who loots for the day) rather than the 'stationary bandit' (that is, one who takes his theft in the form of taxation and at the same time ensures provision of public goods). The two major political parties who ruled Pakistan during the 1990s were more focused on making 'friends' and influencing people and more so, replenishing their coffers for personal enrichment and re-election.<sup>432</sup> According to the economist Hussain, 'personal, parochial and party loyalty considerations dominated decision making while institutions were bypassed'.<sup>433</sup> The laxity of these democratically elected governments increased the loopholes in taxation system because preferential taxation regimes were facilitated through SROs that overrode legislation. Four consecutive political governments during this period were ousted on charges of misgovernance and corruption. Overall, the 1990s has been dubbed as a 'lost decade'<sup>434</sup> due to faltering economic and governance targets by Pakistan's domestic as well as the international economic managers.

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<sup>429</sup> Ahmed, above n 254, 4.

<sup>430</sup> Ibid.

<sup>431</sup> Mancur Olson, 'Dictatorship, Democracy, and Development' (1993)87(3)*American Political Science Review*567,568.

<sup>432</sup> Ehtisham Ahmed and Azizali Mohammed, 'Pakistan, the United States and the IMF: Great Game or a Curious Case of Dutch Disease without the Oil?' (Working Paper No 57, London School of Economics, Asia Research Centre, 2012).

<sup>433</sup> Ishrat Hussain, 'The Role of Politics', above n 256, 7.

<sup>434</sup> Ishrat Hussain, 'Pakistan and the IMF: 1988–2002. A Case Study' (Paper presented at the International Expert Workshop organized by the German Foundation for Development (DSE) at Berlin, July –2 July 2002)1.

### 6.4.3 Military Take-over 1999

When the military government took over in late 1999, Pakistan was faced with economic as well as institutional turmoil. The country was on the verge of a default on its huge foreign loans.<sup>435</sup> This crisis was further exacerbated by the imposition of economic sanctions and the disruption of external economic assistance as a result of the nuclear testing conducted in May 1998.<sup>436</sup> Thousands of wealthy Pakistanis had pulled their assets out of the country and the local and foreign investment was at a halt.<sup>437</sup> In the midst of this economic crisis, Pakistan again sought IMF assistance in late the 2000. The Fund made a loan to Pakistan for ten months to save the country from defaulting, but this assistance was subject to stringent conditions to ‘set the house in order’ so as to receive further financial aid.<sup>438</sup> Consequently, General Parvez Musharraf’s government carried out some economic reforms, including the devaluation of the Pakistani currency, raising the prices of petrol, gas and electricity, and attempting to broaden the tax base.<sup>439</sup> The military government was focused on bringing the economy back on track while also ensuring that the program targets were met.

This explains why the Musharraf government was too weak to open any new fronts without initially getting some foothold on the economy. It is inconceivable that under the economic hardships that the government was facing where the country’s foreign exchange reserves had been alarmingly depleted and official remittances were all time low that the SBP could plan any attempts to ‘regulate’ *hawala*, particularly when the unofficial remittances through *hawala* were perhaps the only source of inflows in the cash-strapped country. It could be argued that even though increasing the inward remittances through formal banking channels had remained SBP’s long-term priority, the timing (late 1990s) was just not right for the

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<sup>435</sup> Ahmed Rashid, ‘Pakistan wins £425m loan from the IMF’, *Telegraph* (United Kingdom), 1 December 2000.

<sup>436</sup> *Ibid.*

<sup>437</sup> *Ibid.*

<sup>438</sup> *Ibid.*

<sup>439</sup> *Ibid.* See also Ishrat Hussain, ‘The Role of Politics’, above n 256; Ishrat Hussain, ‘Pakistan and the IMF’, above n 432.

government/SBP to curb *hawala* at a juncture when the SBP was itself periodically purchasing billions of dollars from the off-shore money changers.<sup>440</sup>

#### 6.4.4 September 9/11 and Pakistan

There are two dimensions to the events following 9/11 and Pakistan's participation in the so-called 'War on Terrorism'. After the tragic events of 9/11, the United States pressurized the governments internationally for political and moral support for the United States' War on Terrorism.<sup>441</sup> President Bush had stated to the world, 'every nation, in every region, now has a decision to make. Either you are with us, or you are with the terrorists'.<sup>442</sup> On the other hand, General Pervez Musharraf who had come to power as a result of a *coup d'état* wanted to legitimize his military rule. Military leaders are generally deplored in the western democracies and cooperation on an international agenda such as the war on terrorism would result in the stamp of western approval to Musharraf's autocratic rule,<sup>443</sup> just as it had done to the rule of General Zia-ul-Haq once he had agreed to fight the United States' proxy war against the Soviets. In his autobiographical account, General Pervez Musharraf has related that his decision to participate in the War on Terrorism was driven by a mighty United States and India:

[T]he question was: if we do not join them, can we confront them and withstand the onslaught? The answer was no, we could not, on three counts. First was our military weakness as compared with the strength of the United States. Second was our economic weakness. We had no oil and we did not have the capacity to sustain our economy in the face of an attack by the U.S. Third and worst of all, was our social weakness. We lacked the homogeneity to galvanize the entire nation into an active confrontation... India had already tried to step in by offering its bases to the U.S.<sup>444</sup>

As a result of the alliance with the United States, Pakistan received many economic rewards in accordance with the US policies of economic statecraft. These economic rewards included removal of the three economic sanctions that had been imposed on Pakistan for

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<sup>440</sup> See Daudi, above n 267.

<sup>441</sup> Bessma Momani, 'The IMF, the US War on Terrorism, and Pakistan' (2004)31(1) *AsianAffairs*41, 42.

<sup>442</sup> Ibid.

<sup>443</sup> Ibid 44.

<sup>444</sup> Pervez Musharraf, *In the Line of Fire: A Memoir* (Simon and Schuster, 2006)201–2.

testing and acquiring nuclear arsenal.<sup>445</sup> Along with this, foreign assistance and aid amounting to USD1.2 billion and USD600 million in cash transfers were given to the Pakistani government to pay its international debts.<sup>446</sup> Moreover, the United States agreed to reschedule a USD379 million bilateral debt through the ‘Paris Club’ as well as promising support for the rescheduling of other outstanding bilateral debts.<sup>447</sup> The United States also allowed several trade concessions by agreeing to lower tariffs and quota restrictions on Pakistan.<sup>448</sup> This extensive economic foreign assistance from the United States that followed 9/11 was only comparable to the amount of security and economic aid given to Pakistan when it was front-lining the United States’ proxy war in Afghanistan against the Soviets during the 1980s.

In exchange for the economic benefits, the Musharraf regime joined the United States led coalition in global efforts to counter terrorism. Among many other steps, the introduction of international regulation to curb *hawala* was the United States’ and the international regulatory agencies’ ‘knee-jerk response’<sup>449</sup> to starve the global networks of terrorism finance. Pakistan cooperated in these efforts by complying with the international AML/CFT legislation and standards. It introduced reforms in the financial market that would, at least in principle, eliminate informal and unreported transfers. It could be argued that if it were not for the United States’ pressure after the events of 9/11, the Pakistani government was economically, institutionally and morally too weak to enforce these regulations. It needs be emphasized that the structural changes introduced in the market such as creation of exchange companies were essentially ‘ill-timed’, as the requisite ‘ground-work’ or pre-reform measures that were mandated before such reforms are introduced could not be taken.

#### **6.4.5 Roles of the United States and the IMF**

Following Pakistan’s collaboration in the ‘War on Terrorism’, the United States claimed it had lobbied for its ‘ally’ and ‘friend’ at various multilateral agencies, including the IMF

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<sup>445</sup> Ibid 44. The economic sanctions included Symington Amendment (1978), the Pressler Amendment (1990) and the Glenn Amendment (1998).

<sup>446</sup> Ibid.

<sup>447</sup> Ibid 45.

<sup>448</sup> Ibid.

<sup>449</sup> Nikos Passas, ‘*Hawala* and Other Informal Value Transfer Systems: How to Regulate Them’ (2003) *5RiskManagement* 49, 50.

which had disbursed the final tranche of a USD135 million loan in late September 2001.<sup>450</sup> Consequently, the SBP, keeping the United States and the IMF in confidence, created foreign exchange companies that replaced the licensed money changers with the objective of eliminating *hawala* and corporatizing the foreign exchange market in Pakistan.

Ahmed and Mohammed argue that large inflows to Pakistan that have coincided with the US proxy-war in Afghanistan with the Soviets during the 1980s and again after the 9/11 have a ‘flipside’ to them. These inflows and continuous foreign financial assistance has led to behavioural changes and higher expectations in successive Pakistani governments. Constant foreign assistance has not only created distortions in the incentives structure in society and the desire of the governments for self-reliance<sup>451</sup> it has also led to the creation of a ‘rentier state’ which has remained dependent on external hand-outs and rents rather than correcting the structural flaws that impede provision of essential public goods and development of the state institutions.<sup>452</sup>

#### **6.4.6 Pakistan — Limited Access Order**

Absence or lack of effective institutions has consolidated the Pakistani state into a ‘Limited Access Order’ (LAO) state.<sup>453</sup> North et al argue that countries that are characterized LAOs have social, political and economic systems based on limited entry and rent-creation. Elites in the LAOs use these rents to maintain order and to hold the social order together. The political system manipulates the economy to generate rents that bind the interests of the economic actors to support the current political system. In contrast to the LAO state is the Open Access Order (OAO) state where access to economic, social and political organizations, including the freedom to form them, is open to all citizens. According to North et al, almost all developing countries lie along the fragile, basic and mature LAO spectrum. Such states can regress and develop — as well as stagnate — along this spectrum based on the capability of their respective state institutions that can restrain rents. Whilst a

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<sup>450</sup> Momani, above n 439, 46.

<sup>451</sup> Ahmed and Mohammed, above n 430.

<sup>452</sup> Ibid.

<sup>453</sup> Douglas C North, John Joseph Wallis, Steven B Webb, Barry R Weingast, ‘Limited Access Orders in the Developing World: A New Approach to the Problems of Development’ (World Bank, 2007).

fragile LAO state can barely sustain itself, in the basic LAO state there is a stable organizational structure, and the mature LAO state has durable institutional structures.<sup>454</sup>

Analysis of the Pakistani state within the LAO framework explains that alongside the existence of a ruling political elite, the attitude of the international donors (the United States, the IMF and the World Bank) has also been instrumental in encouraging the maintenance of the status quo that has hindered attempts towards serious reforms.<sup>455</sup> The international community could be criticized for not pushing the various governments enough to introduce essential reforms despite these donors having leverage on Pakistan's economic and financial policies. The IMF generally takes the position that it does not 'dictate' terms to the local authorities because it presumes that the local officials are better acquainted with the ground realities and political constraints.<sup>456</sup> In Pakistan's case, the Fund's proclaimed acquiescence has allowed implementation of highly controversial and infamous policies such as 'the no questions asked' and 'no tax foreign currency accounts' 64 per cent of which belong to residents (the remaining 36 percent to non-residents and institutional investors).<sup>457</sup> The IMF knowingly agreed with the Pakistani authorities' proposal for the 'no questions asked' foreign exchange policy, paving the way for a brazen money laundering scheme that was introduced in the garb of capital account liberalization.<sup>458</sup>

Moreover, during the past decades both the IMF and the World Bank have allowed continuous flexibility, waivers and favourable conditionalities to Pakistan despite its failure to achieve even 'soft' reform targets. The IMF has always bailed out Pakistan and not let it default, even though Pakistan's reputation within the Fund is that of a 'stop-go'<sup>459</sup> country due to its continuous track record of either not completing the agreements or abandoning or rolling-back program conditionalities. In reality, the IMF has always willingly agreed on a 'new loan program' without much reflection on the failures of the past. One of the reasons

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<sup>454</sup> Ibid, 6–8.

<sup>455</sup> See Ahmed and Mohammed, above n 430, 14–19; Muhammad Yaqub, IMF Follies in Pakistan, *The News* (Pakistan) 19 June 2013.

<sup>456</sup> Ahmed, above n 254, 5.

<sup>457</sup> Ibid.

<sup>458</sup> Ibid.

<sup>459</sup> Ahmed and Mohammed, above n 430, 9.

for the international community's preference to continuously remain engaged with Pakistan and not let the country sink could arguably be that the world powers find it increasingly risky to let a nuclear armed state become vulnerable.<sup>460</sup> Hence, even though the United States was not directly providing financial assistance to Pakistan in the years following the end of the Cold War until 9/11, it did not oppose bilateral aid to Pakistan through other bilateral agencies. Another plausible explanation holds that the IMF's soft approach towards Pakistan is driven by its own financial interests. The IMF agrees to roll over a program to get the loan instalments repaid to itself while the economy sinks. In this manner, every time the IMF shows eagerness to enter a new loan program, it is ensuring payments of the loan instalments rather than focusing on the economy of the country.<sup>461</sup>

Many critics have argued that such relaxations allowed by the United States as well as the international financial institutions have created a predictable pattern of behaviour which has been used by the Pakistani authorities to their advantage and so different governments have avoided the fundamental issue of domestic resource mobilization measures underpinning the various reforms' agenda. Consequently, during the last three decades, every military and political government has resisted fundamental reforms such as broadening the tax-base, modernizing tax administration, closing preferential schemes and other loopholes, among the essentially required reforms. Critics have argued that by not using their clout for the introduction of fundamental reforms within the economy and in the governance structures, the international donor community has 'played in cahoots' with the ruling elite of Pakistan.<sup>462</sup>

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<sup>460</sup> Ibid 6 ; Also see Woodrow Wilson Centre Report, above n 410.

<sup>461</sup> Yaqub, above n 453; Ahmed and Mohammed, above n 430.

<sup>462</sup> Ahmed, above n 250, 6.



## Part III: Pakistan Afghanistan Transit Trade

### 6.1 Trade Relations with Afghanistan:

Community based trade and commerce between tribes on both sides of the Durand Line has been in place for centuries, based on tribal affiliations.<sup>463</sup> Before the partition of the sub-continent, the Afghan goods were allowed to transit by the British under the obligations of the international laws.<sup>464</sup> Problems between Afghanistan and the newly created Pakistan started when, at the time of partition of the sub-continent, Afghanistan supported the movement of an independent 'Pashtunistan'<sup>465</sup> (the idea of the unification of borderlands on both sides of the Durand Line). The idea was rejected by Pakistan but Afghanistan's position on a sovereign Pakhtunland was unrelenting.<sup>466</sup> After the creation of Pakistan in 1947, the new government continued treating the tribal belt as a buffer zone between Pakistan and then hostile Afghanistan. The Pakistan government granted some concessions to the tribal people, by allowing free interaction between families and households across the border but the Afghan government refused to recognize the Durand Line and the division of Pakhtuns in the United Nations.<sup>467</sup> In order to normalize severed relations with its landlocked neighbour after the 1962 border closure crises,<sup>468</sup> Pakistan agreed to provide Afghanistan a commercial transit corridor. According to Syed Waqar Hussain, Pakistan's agreement with Afghanistan on 2 March 1965, known as the Afghan Transit Trade Agreement (ATTA) can be viewed partly as efforts to normalize diplomatic ties with Afghanistan and partly as efforts to meet the obligation under the international law.<sup>469</sup>

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<sup>463</sup> Noreen Naseer, 'Pak-Afghan Transit Trade Treaty 2010 and Pakhtuns Involvement across the Durand Line' (Paper presented at the International Conference on 'The Dynamics of Change in Conflict Societies: Pakhtun Region in Perspective', Department of Political Science, University of Peshawar 14–15 November 2011)38–51.

<sup>464</sup> Martin Ira Glassner, 'Transit Problems of Three Asian Land Locked Countries: Afghanistan, Nepal, and Laos' *Occasional Papers / Reprint Series No 4(57)* (University of Maryland, 1983)

<<http://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1056&context=mscas>>.

<sup>465</sup> The terms 'Pashtun' and 'Pakhtun' are used interchangeably; refer to ethnic Afghan people.

<sup>466</sup> Glassner, above n 463, 10.

<sup>467</sup> Naseer, 'Pak-Afghan Transit Trade Treaty 2010', above n 462, 39.

<sup>468</sup> Glassner, above n 463, 11.

<sup>469</sup> Syed Waqar Hussain, *The Impact of Afghan Transit Trade on the Economy of N.W.F.P 1990-2000* (PhD Thesis, University of Peshawar, 2004)6.

With the signing of the ATTA, Pakistan became Afghanistan's largest trading partner. Official trade<sup>470</sup> between the two countries amounted to USD 1.5 billion in 2011–12 and around USD1 billion in 2012–13. On average, bilateral trade between Pakistan and Afghanistan during the past five years has fluctuated around USD1 billion.<sup>471</sup> The trade balance is heavily tilted in Pakistan's favour with over 90 per cent of the total trade consisting of Pakistani exports to Afghanistan. Official imports from Afghanistan were valued at USD140,000 in 2011–12.<sup>472</sup>

## 6.2 Economic Drivers of the ATTA

One of the objectives that the Pakistani government was aiming to achieve through the ATTA was to win support of the FATA tribes, vis-à-vis the independent *Pashtunistan* movement, by providing them an economic package in the form of a transit treaty. Naseer relates:

the Pakistan authorities had a very clear idea that the Afghan imported duty free items would ultimately be smuggled back into Pakistan. This was a tolerable price to pay by Pakistan, since the chief beneficiaries would be the tribes of FATA who were vulnerable to Afghan interference. Therefore the major objective of the 1965 treaty was to win over support by the pro-Pakistan *Maliks*, and this approach worked well in helping impoverished tribesmen.<sup>473</sup>

Indeed, in the long run, the transit treaty was aimed at providing Pakhtuns on both sides of the Durand Line employment and livelihood opportunities as trade is complemented by the development of service industries. As mentioned earlier, the FATA is a difficult terrain comprising high mountains and narrow rocky valleys. Almost 80 per cent of the land is barren and difficult to cultivate. Similarly, the Afghan-Pashtun border along the FATA is also extremely impoverished and conflict ridden. The World Bank has estimated that poverty in this area is more than 58 per cent<sup>474</sup> which is far higher than among the FATA

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<sup>470</sup> Data has been extracted from the official website of Pakistan's Board of Investment available at <[www.pakboi.gov.pk](http://www.pakboi.gov.pk)> last accessed on 30 July 2013.

<sup>471</sup> Ibid.

<sup>472</sup> Ibid.

<sup>473</sup> Naseer, above n 462, 48.

<sup>474</sup> The World Bank Afghanistan Country Data, available at <<http://data.worldbank.org/country/afghanistan>>last accessed 30 July 2013.

residents as some of the FATA residents still have access to urban areas of Pakistan for education, employment and business. The harsh geographical situation and continued conflict has kept the Afghan tribal borderlands isolated from the rest of the urban Afghanistan<sup>475</sup> (just as the FATA is isolated from the rest of Pakistan). Consequently, similar living standards and tribal connections have made the border areas more dependent on each other for creating common employment opportunities and markets rather than relying on their respective governments. Formal trade relations between Afghanistan and Pakistan have resulted in the creation of employment in diverse economic activities for the tribal workforce. These range from clearing and shipping services to unloading, trucking, transportation, and other allied services, such as employment at fuel stations, garages, shops, and tea houses along the transit routes.<sup>476</sup> Most of these businesses (particularly transportation of transit goods from Pakistan through to Afghanistan) are completely dominated by the tribal traders.<sup>477</sup>

### **6.3 Unauthorized Trade under the ATT**

In addition to being engaged in the business industries related to the transit trade, the tribal traders and businessmen are simultaneously engaged in the illegal trade of arms and narcotics, currency trade through *hundi/hawala* as well as smuggling of goods across the borders.<sup>478</sup> Indeed, the economic and tribal alliances between the FATA and Afghan tribes have been instrumental in creating a smuggling economy that primarily developed in the 1970s when Afghan-Pakistani trucking merchants, predominantly the *Afridi* Pashtun tribes, became a growing economic force.<sup>479</sup>

#### **6.3.1 The Smuggling Economy**

There are two ways through which the transit trade goods are smuggled into Pakistan:

**i) Re-export:** Transit trade goods legally enter Afghanistan but are smuggled back into Pakistan across the porous borders.

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<sup>475</sup> Naseer, above n 462, 40.

<sup>476</sup> Syed Waqar Hussain, *The Impact of the Afghan Transit Trade*, above n 468, 226–227.

<sup>477</sup> Mian, above n 182, 92.

<sup>478</sup> Ibid.

<sup>479</sup> Jonathan Goodhand, 'Frontiers and Wars: The Opium Economy in Afghanistan'(2005)5(2) *Journal of Agrarian Change*191, 197.

**ii) Transit diversion:** Transit goods do not enter Afghanistan at all, and transit trucks are instead diverted for sale in Pakistan.<sup>480</sup>

Syed Waqar Hussain has observed that ever since the first ATTA was signed, trucks containing transit trade goods have routinely been crossing into Afghanistan, some goods sold in Kabul and then turned around to smuggle the remaining consignment into Pakistan where these goods were sold in the ‘*Bara*’ markets.<sup>481</sup> According to Hussain: ‘It was a flourishing but limited business, giving Pakistan access to duty free foreign consumer goods particularly, Japanese electronics’.<sup>482</sup>

In a January 2012 presentation before the Parliament Standing Committee on Finance,<sup>483</sup> the Chairman of Pakistan FBR informed the members of the Committee that a total of 28,802 ATT trucks were found to have been missing between 2009 and 2011.<sup>484</sup> According to the FBR, of these missing containers, only 560 trucks could be traced. The loss sustained by the government due to the disappearance of these containers has been estimated at around PKR50 billion. A subsequent investigation conducted by the FBR Directorate of Intelligence and Investigation has revealed that in 2010 alone, 3000 ATT containers did not leave Karachi and the goods were shifted to the local warehouses.<sup>485</sup> The FBR has placed the onus of this negligence in transit trade procedures on Pakistan Customs Services (PCS) officials.

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<sup>480</sup> USAid/Pakistan, ‘Unauthorized Trade between Pakistan and Afghanistan: A Preliminary Assessment of its Extent and Economic Impact’ (Trade Project Report, USAid/Pakistan, December 2009)9.

<sup>481</sup> Markets selling smuggled goods.

<sup>482</sup> Syed Waqar Hussain, above 468, 11.

<sup>483</sup> The session was attended by the researcher through special permission,

<sup>484</sup> A subsequent inquiry by FBR’s Directorate of Intelligence and Investigations has rejected the departmental inquiry and held Pakistan Customs’ officials responsible of the corruption.

<sup>485</sup> ‘3000 Afghan Transit Trade Containers Never Leave Karachi’, *The News* (Pakistan), 21 June 2013.

**Table 6.3 Customs Procedure<sup>486</sup> for Afghan Transit Trade<sup>487</sup>**

- Karachi Port (Gate-in); declaration of goods by the importer.
- Examination of 5–25 per cent of the consignment by the Customs officials. The containers are then sealed.
- Torkham (Gate-out): The consignment is weighed and if the weight is more than 500–1000 kg from that of Gate-in, the importer’s profile is scrutinized by the Customs officials.
- If the weight difference is around a ton, the consignment is examined to check if the seals have been tampered with. Penalties of custom duties in between 2 and 10 per cent of the consignment value may apply if customs procedures have been violated.

### **6.3.2 Transit Trade Customs Procedures**

A review of customs procedures, obtained during the interviews with PCS officials (Table 6.3 above) explains the ease with which goods bound for Afghanistan can be diverted anywhere in Pakistan. Following two points merit special attention: At the entry point in Karachi, a maximum of 25 per cent part of the consignment is examined before it is ‘sealed’. Understandably, this examination is manually carried out, cursorily done, and in many cases could be avoided because goods are not essentially carried in closed containers but in open trucks.<sup>488</sup> Similarly at the exit point (*Torkham* Pakistan-Afghanistan border) inspection procedures involve weighing the consignment, checking importers’ profile and the tampered seals. This only serves to emphasize that collusion between the smugglers and the officials cannot be overstated. In the words of Hussein:

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<sup>486</sup> Identical procedures are carried out at Chaman-Spinboldak border at Balochistan.

<sup>487</sup> Interview with G-PCS (Peshawar, 15 March 2012) 230.

<sup>488</sup> Syed Waqar Hussain, *The Impact of the Afghan Transit Trade*, above n 468, 9.

In view of these checks and counter checks, it can hardly be believed that these goods-in-transit may either be diverted or re-exported in the goods market of Pakistan. But such a comprehensive checking itself explains that the trade is prone to abuse.<sup>489</sup>

### 6.3.3 Smuggling Volumes

Hilali has reported the existence of country wide ‘*Bara*’ markets selling transit trade smuggled goods bound for Afghanistan which has resulted in lost revenues for Pakistan. These losses were estimated in the late 1990s to be around PKR4.7 billion annually that would have come to the state exchequer as a result of the duties and taxes paid on legal import of these goods.<sup>490</sup> In the Parliament Standing Committee’s meeting, the FBR officials informed those present that around USD5 billion worth of smuggled goods enter Pakistan annually through the ATT channels. The revenue loss to the state represented by the FBR is about USD2.5 billion per annum. According to the FBR officials, 75 per cent of the total smuggling in Pakistan can be attributed to the ATT.

Goods that have been identified as particularly prone to smuggling through the ATT include:

- i) **Tea:** The Afghans prefer green tea to black tea; however, huge quantities of black tea have been imported under the ATT that have ended up in Pakistan markets. It is estimated that 40 million kilograms of tea, which forms almost 40 per cent of the total legal import of Pakistan’s requirement is smuggled into the country.<sup>491</sup>
- ii) **Power Generators and Electrical Equipment:** The increase in demand for electrical items such dry cell batteries, rechargeable lights, generators and uninterruptable power supplies has increased the imports of these goods through the ATT, presumably for Pakistani consumers.<sup>492</sup>

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<sup>489</sup> Ibid 7.

<sup>490</sup> A.Z.Hilali, ‘Costs and Benefits of Afghan War for Pakistan’ (2002)11(3) *Contemporary South Asia*291, 299.

<sup>491</sup> Syed Waqar Hussain, *The Impact of the Afghan Transit Trade*, above n 468, 9.

<sup>492</sup> USAid/Pakistan Trade Report, above n 479, 9.

**iii) Tyres:** It is reported that as much as 75 per cent of the domestic demand in Pakistan for bus and truck tyres is supplied through the ATT.<sup>493</sup>

**iv) Air Conditioners:** Although these figures are dated now, in 1994 Pakistan imported air conditioners worth PKR30 million while Afghanistan, with little electricity and very low domestic demand, recorded import of air conditioners of PKR1 billion. A large number of these air-conditioners were re-exported to appear in the Pakistani markets.<sup>494</sup>

#### **6.3.4 Drivers of the Smuggling Economy**

Smuggling and selling of goods in Pakistani markets has prompted governments to review the commodities imported under the ATT. Pakistani authorities have revised these commodities lists in 1996, 2000, and 2005, subsequently identifying those commodities that cannot be imported under the ATT. However, as Naseer points out, the revision of commodities lists was of no use because — along with the smuggling problems — trade as a subject matter between Pakistan and Afghanistan had become a much more complicated issue.<sup>495</sup> Asif has accounted for this complicated scenario:

Smuggled goods are big business in all seven tribal districts, and traders in nearly every FATA agency have defined their niche market; if one agency is known as a trading hub for smuggled tyres another deals exclusively in smuggled cars, weapons, or chemicals. Whenever the government of Pakistan introduces any changes in the taxation system that would push up the prices of any such goods, or cracks down more vigorously on the illegal weapons trade, smuggling of these commodities into Pakistan begins through these routes.<sup>496</sup>

Interviews conducted during the course of this research in Peshawar city's Chowk Yadgar money market have confirmed that *hawala* finance is used in the tribal belt which is geographically isolated and has scarce infrastructure. The tribal areas in both the FATA and

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<sup>493</sup> Ibid.

<sup>494</sup> Ibid.

<sup>495</sup> Naseer, 'Pak-Afghan Transit Trade Treaty 2010', above n 462, 44.

<sup>496</sup> Mian, above n 182, 93.

Afghanistan have a well-established *hawala* system',<sup>497</sup> and 'anyone wishing to make a financial transfer with an individual or institution anywhere in the world can do so in the tribal areas, irrespective of the amount involved and without any concern over the transaction's reliability'.<sup>498</sup>

#### **6.4 From Smuggling to War Economy**

Starting in the 1970s, the smuggling economy has gained increased impetus as a result of the Soviet invasion of Afghanistan in 1979 and subsequent massive migration of Afghan refugees to Pakistan and Iran. During the war, the Muslim resistance fighters (*mujahidins*) set up their supply bases inside Pakistan's FATA from where the ISI supplied (the United States' provided) arms to the resistance commanders fighting inside Afghanistan.<sup>499</sup> The arms and ammunition were moved into Afghanistan by private teamsters, mostly tribesmen, who served as logistical conduits between the external and internal resistance commanders.<sup>500</sup> According to Rubin, 'the pipeline of arms and humanitarian aid supplied capital to build up regional smuggling networks'.<sup>501</sup> Ironically many of the trucks used to move war supplies to Afghanistan were the same as used for ATT. The transit trade trucks were also leased for arms transport<sup>502</sup> and profits accumulated by commanders and traders were reinvested in illicit activities including the drug and cross border smuggling economies. Daniel Pearl and Steve Stecklow have reported on the smuggling of electronics, tires, crockery and textiles which gave some of the *mujahidin* commanders a way to enrich themselves and keep supporters employed.<sup>503</sup>

According to Jonathan Goodhand, the Taliban take-over of Afghanistan in the early 1990s should be seen in the perspective of protection of the 'economic' state and non-state interests in Pakistan. Goodhand has argued that through the instalment of a pliant regime in Kabul, the Pakistan government wanted to further its pursuit of strategic depth in relation to

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<sup>497</sup> Ibid 94.

<sup>498</sup> Ibid.

<sup>499</sup> Barnett R Rubin, 'The Political Economy of War and Peace in Afghanistan'(2000)28(10) *World Development*1789, 1792.

<sup>500</sup> Ibid.

<sup>501</sup> Ibid.

<sup>502</sup> Ibid.

<sup>503</sup> Daniel Pearl and Steve Stecklow, 'Taliban Banned TV but Collected Profits on Smuggled Sonys', *Wall Street Journal*(New York) 9January2002.



its confrontation with India as well as establish political influence in the region's 'New Great Game' through the construction of oil and gas pipelines to Central Asia. A salient feature of the Taliban take-over and rule was that they were supported by the Afghan-Pakistan transport sector who wanted stability and security in order to safeguard their economic interests which were adversely affected by continuous warlordism and conflict.<sup>504</sup> Consequently, during the Taliban rule in the late 1990s, cross border smuggling under ATT flourished. A World Bank study in 1996–97 estimated that cross border trade between Pakistan and Afghanistan was worth approximately USD2.5 billion.<sup>505</sup> The amount of the revenue that Taliban generated by taxing this trade has been estimated at USD75 million<sup>506</sup> which, according to the study, is still much less than the taxes and duties the transit traders would have to pay in case of a formal trade.

## **6.5 Afghanistan – The Regional Trading Gateway**

The disintegration of the Soviet Union into Central Asian Republics (CARs) has changed the geo-political status of Afghanistan from a buffer zone into a regional trading gateway. In the post Cold War years, Afghanistan is facilitating transnational trading networks — both licit and illicit — through multiple trade routes to Iran, the Persian Gulf and the Central Asia. Conrad Schetter has argued that as a result of the post Cold War geo-economics of the region, many disparities have emerged in the trade policies of countries in this region. Afghanistan is taking advantage of these disparities and consequently it imports consumer goods such as television sets from Dubai which is the largest free port in the world; fuel is imported from Iran where oil products are subsidized and fuel costs less than USD0.04 per litre; and automobile spare parts are imported from Turkmenistan into Afghanistan.<sup>507</sup>

It requires no special effort to understand that most of these goods have little or no use in Afghanistan and are destined to be smuggled into Pakistan, through the same transportation networks that integrate Afghanistan into the region. Consequently, the ATT has extended

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<sup>504</sup> Goodhand, above n 478, 199.

<sup>505</sup> Zareen F Naqvi, *Afghanistan–Pakistan Trade Relations* (World Bank, 1999) .

<sup>506</sup> Ibid.

<sup>507</sup> Conrad Schetter, 'The Bazaar Economy of Afghanistan: A Comprehensive Approach' (2004)3 *SudasiensInformationen*. [The text originally appeared in the collection: Christine Noelle-Carimi, Conrad Schetter and Reinhard Schlagentweit, *Afghanistan: A Country without a State?* (IKO Verlag, 2002)]11.

well beyond Pakistan and Afghanistan into the region through these trading networks. Rubin has provided an illustration of the transformation of ATT into trans-border trade through its extension to Dubai where the third largest Pashtun population resides (after the Pakistani cities of Karachi and Peshawar). According to Rubin, these transnational trading networks make Afghanistan and Pakistan the second largest trading partners of the UAE from where Afghan and Pakistani traders purchase duty-free goods in Dubai and ship them to be smuggled into Pakistan through Afghanistan.<sup>508</sup>

It could be argued that despite being termed a country ‘without a state’, today’s Afghanistan is at the cross roads of the global trade, exporting emeralds and drugs to the developed countries as well as importing war material, fuel and manufactured consumer goods of a variety of products from the international global markets.<sup>509</sup> In Ahmed Rashid’s view, what is euphemistically referred to as the Afghan Transit Trade has in reality become the biggest smuggling racket in the world. The author provides that the border posts between ‘Chaman’ in Pakistan’s Balochistan province and ‘Spin Boldak’ in Afghanistan are the prime locations for watching the operations of the smuggling racket. He has estimated that almost 300 trucks cross over from Afghanistan to Pakistan on a daily basis. The goods that these trucks carry have no invoice and cross up to six international frontiers without possessing route permits, driving licences or even passports. The consignments on these trucks:

range from Japanese camcorders to English underwear and Earl Grey Tea, Chinese silk to American computer parts, Afghan heroin to Pakistani wheat and sugar, East European Kalashnikov to Iranian petroleum.<sup>510</sup>

Ahmed Rashid has further related that the trading networks that facilitate this transnational trade include smugglers, transporters, drug barons, bureaucrats, politicians, police and army officers, not only in Pakistan but also in Iran, Turkmenistan, and Dubai.<sup>511</sup> Jonathan Goodhand has elaborated more on these networks. He argues that it would be a difficult

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<sup>508</sup> Rubin, above n 498, 1798.

<sup>509</sup> Schetter, above n 506, 11.

<sup>510</sup> Ahmed Rashid, *Taliban, Militant Islam, Oil and Fundamentalism in Central Asia* (Yale University Press, 2000)189.

<sup>511</sup> Ibid.

task to find linkages between the more criminal trade in drugs and arms and a rather ‘licit transit trade’ as well as to distinguish an arms smuggler from a transit trader. The reason supplied by the author is that the connecting nodes are multiple and fairly intricate, particularly ‘in the middle of the commodity chain there is a lot of integration linking the military, political and economic power’.<sup>512</sup>

## 6.6 Trans-border Trade Financing: The *Hawala* Networks

At the heart of the transit trade networks is the *hawaladar* or ‘*saraf*’,<sup>513</sup> — an important node in the transnational trading chain. The *hawaladar* facilitates efficient, cheap, and reliable international and domestic payments in the absence of the enforcement of formal transactions. ATT provides that because despite being informal in structure and mechanisms, the *hawala* system has sustained coordination among intricate linkages and connections between various licit and illicit state and non-state actors. This serves to explain why these systems have survived and have transformed into transnational networks and also clarifies the common perception that such networks flourish in tribal or rural societies and cultures only.<sup>514</sup>

Emily Schaeffer has given an overview of the literature on self enforcing exchange relationships. While the intention here is not to delve into the vast literature on the subject, it is noteworthy that scholars in this area have focused on small groups of traders who develop reputation mechanisms. These informal reputation mechanisms keep their costs low and sustain communication, as long as they remain a small group. Conversely, if the size of the group becomes larger, costs of communication would become prohibitively higher causing the exchange mechanisms to break down. A principal scholar in this stream of thought is Douglas North who states:

[R]ealizing the economic potential of the gains from trade in a high technology world of enormous specialization and division of labour characterized by impersonal

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<sup>512</sup> Goodhand, above n 478, 211.

<sup>513</sup> Persian derivative of *Hawaladar*.

<sup>514</sup> See, for example Charles B Bowers, ‘*Hawala*, Money Laundering, and Terrorism Finance: Micro Lending as an End to Illicit Remittance’ (2009)37(3)*Denver Journal of International Law and Policy*379. Bowers proposes a solution for *hawala* regulation on the model of the Grameen microfinance bank founded in rural Bangladesh.

exchange is extremely rare, because one does not necessarily have repeated dealings, nor knows the other party, nor deals with a small number of other people.

On the other hand, the contesting stream of argument supports the proposition that self enforcing exchanges can be equally effective across larger populations and greater distances.<sup>515</sup> As an illustration to this view, Emily Schaeffer has analysed the reputation mechanisms in *hawala* networks which cover large populations of traders across the globe. She has concluded that the *hawala* systems are, ‘substitute institutions for highly regulated, unenforceable, or nonexistent formal systems’, and that these informal networks ‘also persist when the costs of using formal systems are prohibitive’.<sup>516</sup>

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<sup>515</sup> Emily C Schaeffer, ‘Remittances and Reputations in Hawala Money Transfer Systems: Self Enforcing Exchange on an International Level’ (2008)24(1) *Journal of Private Enterprise*1, 97.

<sup>516</sup> Ibid 113.

## 6.7 Why Do Traders Prefer *Hawala*?

**Table 6.4** Reasons That Traders Prefer *Hawala*?<sup>517</sup>

- There is relationship of trust between the trader and the *hawaladar*.
- Due to a personalized relationship, the trader has access to foreign exchange on credit to be paid back once the goods arrive.
- Duration of the credit is extendable until the arrival of the consignment.
- Premium rate for 6 month credit is in between PKR4– PKR5 per dollar. For 1 year credit, the rate can be in between PKR5– PKR10 per dollar.
- Exporters demand that at least half of the payment is made to them through *hawala* due to the higher than market minimum export price (MEP) set by the government.
- The State Bank of Pakistan stipulates that the exporters deposit foreign exchange within 6 months or their Letter of Credit (bank guarantee) will be cancelled. It is a practical issue in trade because sometimes it takes even more than a year for the export order to complete and payment cleared.
- Banks in Pakistan neither provide for nor accept guarantees from the banks in Afghanistan.
- There are international sanctions on Iran due to which formal exchanges are difficult.
- For all the trade to Afghanistan and Iran, payments are made in Dubai. The mode of payment is as follows: A Pakistani exporter sends goods to Afghanistan. The Afghan importer pays him through a Dubai-based *hawaladar*. The *hawaladar* transfers money in the exporters' bank account in Peshawar or Karachi.

Schaeffer's conclusions regarding *hawala* are further substantiated by the author Srinivas.<sup>518</sup> He has argued that *hawala* trade financing begins when a law obstructs natural trade or artificially raises the value of goods and services. He illustrates this point through an example of the minimum export price (MEP) set by the Indian government for *basmati* rice. According to the author, the Indian government's price for *basmati* rice is USD900 per

<sup>517</sup> Interview with G-C-03 (Karachi, 19 October 2012); interview with G-C-04 (Karachi, 19 October 2012) 232.

<sup>518</sup> Nidhi Nath Srinivas, 'Hawala is Business by Another Name', *Economic Times* (India), 5 January 2012.

ton whereas its market value is USD700 per ton. This leaves the exporter in a quandary because he can neither follow the government's higher price nor sell his product on the market price. As a way out, the exporter would either 'over-invoice' the *basmati* consignment by labelling it 'non-*basmati*' (which does not have MEP) or use *hawala* for payment. *Hawala* is always a better option for the exporter as he needs a reverse trade flow not bound by the regulation.

During the course of this research, traders and businessmen were interviewed and questions regarding *hawala* trade financing were raised with them. Their practical reasons for the choice for informal financial have been summarized in Table 7.4 above. The responses of the traders (importers and exporters) have served to endorse the argument that in the absence of efficient formal enforcement networks due to restrictive government policies and high costs associated with the use of formal financial institutions, *hawala* networks have filled a significant gap by providing the exchange mechanisms requisite for the ongoing economic activity in the region.

Finally, the author Conrad Schetter has argued with reference to the role of trans-border *hawala* trading networks in the Afghan war economy, 'Perhaps, in a world which, in the political sense, is only conceivable in terms of states, the disappearance of the state structures and the state order is considered inconceivable'.<sup>519</sup> Many supporting scholars have also viewed that informal systems result in disorder and chaos. In a free market economy however, the absence or collapse of the state order may not always create disorder and chaos rather, as Schetter argues it may 'result in an economic advantage for that country by offering opportunities for economic practices which are not internationally available or authorized'.<sup>520</sup> He has illustrated *hawala* financed trans-border trade as a classic example of a free market economy that regulated all economic activities in the absence of any state regulation in Afghanistan war economy:

Private trade constitutes the most important economic activity and the influence of a public sphere almost completely disappear[s]. Furthermore, the Afghan economy is not

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<sup>519</sup> Schetter, above n 506, 3.

<sup>520</sup> Ibid.

contained by its national borders, but interwoven with the world market through an informal transnational network.<sup>521</sup>

The global integration of *hawala* with the international financial system, then, needs be appreciated in the context of the discrepancies in the ‘formal’ financial practices. This aspect is illustrated in the trade settlements between Iran and India which are facilitated by the Japanese banks.<sup>522</sup> Srinivas has reported that due to international sanctions, Iran could not trade in the US dollars and conversely the Indian exporter had no use for the Iranian currency. To resolve this problem, the Iranian buyer would deposit an equivalent amount of the Iranian ‘*rial*’ with his local bank. The bank would, in turn, use a country that traded with both Iran and India for the settlement of these payments. According to Srinivas, Japan — which imports oil from Iran and also trades with India—facilitated these payments. The Japanese bank would use some of the money it owes Iran to clear its dues with India.

Another explanation of the integration of *hawala* in the global financial system as well as the inconsistency in formal financial practices was acquired during our interviewees with the Pakistani traders who have related their experience of purchase of foreign exchange ‘on credit’ from the ‘*hawala/foreign exchange market*’. Purchase of foreign exchange on credit leaves the impression that the *hawaladars* are ready to operate ‘on credit’. The perception however is misleading. In reality, the *hawaladars/foreign exchange dealers* are exploiting the gains of the formal currency market which facilitates its customers to avoid currency controls. In the international foreign exchange market, leading international banks in off-shore financial centres, such as Dubai, Singapore, Hong Kong, and London are ready to offer ‘non-deliverable forward contracts<sup>523</sup>’ in the Pakistani rupee. Because the Pakistani rupee is ‘non-convertible’, companies and investors hedge their rupee-dollar currency risk through the purchase of these ‘forward contracts’ which are exclusively designed to ‘get

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<sup>521</sup> Ibid.

<sup>522</sup> Srinivas, above n 516.

<sup>523</sup> This is an exchange of two currencies at a rate fixed at the time the transaction is agreed with maturities stretching days, months or even years into the future. There are specific exchange rates for each forward maturity. As long as there is no matching position of equal amount and maturity, but of opposite sign, in the same currency there is an exposure towards risk which can be exploited for currency speculation. Forward contracts have the advantage that in this market generally no accounts are debited or credited. This means no money actually changes hands, until the maturity date. Forward contracts are mostly tailor-made to meet customers' needs with non-standard amounts or maturities.

around' currency controls. Srinivas thus concludes the discussion on the 'formal' banking currency trade:

In this market, no exchange takes place of the two currencies' principal sums. The only cash flow is the movement of the difference between the contract rate and the rupee's prevailing spot market rate.<sup>524</sup> The amount is settled in dollars on the settlement date. Not a single rupee leaves the country.<sup>525</sup>

## **6.8 Afghanistan Pakistan Transit Trade Treaty (APTTA) 2010**

In 2010, the United States has facilitated a revised Afghanistan Pakistan Transit Trade Agreement (APTTA).<sup>526</sup> This agreement came into force in late 2011. According to the official text, the revised treaty aims to strengthen the economic ties between Pakistan and Afghanistan, while recognizing the right of Afghanistan to freedom of access to the sea as an essential principle for the expansion of its international trade and economic development. Simultaneously, there is also the recognition of the importance of the North-South corridor for Pakistan in relation with trade with the CARs. The revised treaty highlights the current economic realities such as, trade with India and the new international transit requirements. It could arguably be stated that since trade is already operational on these routes, albeit through informal channels, the provisions of the revised agreement are not of much significance.

A significant concern that has been dealt with in the revised treaty relates to the various measures that have been taken to curb the smuggling of the transit trade commodities. Smuggling of transit goods has been prioritized by both the Afghanistan and the Pakistan governments, as an important issue which has been affecting the socio-economic environment of these countries. Consequently, in the revised treaty, various steps have been introduced to prevent smuggling and pilferage of the transit goods. These measures include:

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<sup>524</sup> A spot transaction is an exchange of two currencies for settlement within two business days. A dealer who buys US dollars against Pakistani rupee has an open position in dollar which is exposed to the risk of a change in the exchange rate as long as there is no matching position such as a due dollar payment of equal amount. When the dollar rises against the rupee the position can be sold at a higher price. Therefore, if the dollar is expected to rise people may become tempted to buy dollars spot and hold them until their expectations prove right - or wrong. In this, they are not bound to the period of two days. If the exchange rate rises in between, the position can be closed instantaneously by selling the dollars again.

<sup>525</sup> Srinivas, above n 516.

<sup>526</sup> USAid/Pakistan Trade Report, above n 479.



installation of tracking devices on the transportation units, permitting only sealed containers of cargo, and financial securities/guarantees for duties and taxes to be submitted before the release of consignments from the port.<sup>527</sup> In order to ensure proper inspection of the transit cargo, a container scanner system has also been set up at the Pakistan International Container Terminal.<sup>528</sup>

In addition with the smuggling control measures, the 2010 revised agreement has introduced a passage tax (*rahdari*) to be paid to the Afghan Customs when Pakistani transit goods to Central Asia enter Afghanistan. Ahmed Vaqar and Samad Ghulam argue that *rahdari* and other tax duties included, the Pakistani transit goods to Central Asia would be taxed 110 per cent of the total value of the goods that would be paid as security to the Afghan government.<sup>529</sup> On the other hand, the Afghan traders are required to provide a bank guarantee equivalent to the duties and the taxes on imported goods as security to Pakistani authorities. This means that the Afghan importers will deposit huge amounts of money in the bank against each container as well as arrange to install tracking devices on each carrier.<sup>530</sup> Besides this, the Afghan traders will not be allowed to carry their goods in open trucks but goods will only be carried in sealed containers (of international specifications).

In principle, both the Pakistan and Afghanistan governments have adopted the various provisions of the revised treaty to ensure that the pilferage of goods and their sale in domestic markets is curbed. It is evident however that these revised mechanisms involve high costs for the traders for example, securing bank guarantees is a very expensive arrangement which involves both obvious and hidden costs. As a result, Afghan traders have reportedly diverted towards the Iranian routes that have developed as a result of Iran opening its *Chahbahar* and *Bandar Abbas* ports.<sup>531</sup>

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<sup>527</sup> PILDAT [Pakistan Institute of Legislative Development and Transparency], 'Pak-Afghan Trade' (PILDAT Discussion Paper 2011).

<sup>528</sup> Ibid.

<sup>529</sup> Ahmed Vaqar and Samad Ghulam, 'Trade Facilitation for Economic Corridors in South Asia: The Perspective of Pakistan' (MPRA Paper No 31368, Pakistan Institute of Development Economics, 2011) <<http://mpr.ub.uni-muenchen.de/31368/>>.

<sup>530</sup> Naseer, 'Pak-Afghan Transit Trade Treaty 2010', above n 462, 47.

<sup>531</sup> 'Decline in Afghan Transit Trade', *Daily Dawn* (Pakistan), 29 April 2013.

For Pakistan, this diversion of trade routes has resulted in a decline in the number of imported commercial containers used in the transit trade. These containers have declined from 60,338 in 2012 to 28,813 in 2013, showing a 54 per cent decline in transit trade in the fiscal year 2012–13.<sup>532</sup> This significant decline in transit trade has been attributed to factors such as the revised agreement containing stringent conditions of financial guarantees, insufficient infrastructure, additional taxation/extortion, the poor law and order situation and high freight charges.<sup>533</sup> It is clear that among the reasons that have been cited for the substantive decline, the revised agreement and its provisions are the only ‘new’ factors as the rest of the conditions persisted previously as well. On the contrary, a 2011 report by the Civil Military Fusion Centre has quoted Pakistan’s FBR that the 54 per cent decline in the number of containers is essentially a decline in the smuggling due to the successful implementation of the revised trade treaty.<sup>534</sup>

It would be ironical if with such success in curbing smuggling through the successful implementation of the revised trade conditions, the Pakistani authorities have simultaneously allowed a number of ‘concessions’ requested by the Afghan customs officials and importers’.<sup>535</sup> Steven Zyck reports, ‘Containers being imported into Afghanistan under the APTTA will not need to be stamped with the words “In Transit to Afghanistan” and open-air (rather than sealed) containers may be used in transporting fruits and vegetables from Pakistan to Afghanistan’.<sup>536</sup> The author further provides that, ‘the paperwork and number of licences obtained by the Afghan importers will also be simplified,’ and that ‘the Pakistani customs officials have allowed Afghan importers to pay customs guarantees directly to the Pakistani government rather than using insurance companies, which charge a fee’.<sup>537</sup> The traders that were interviewed during this research have also confirmed (see Table 7.2) that all the payments for trade with Afghanistan and Iran are done in Dubai from where the money is subsequently transferred into the Pakistani

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<sup>532</sup> Ibid.

<sup>533</sup> Ibid.

<sup>534</sup> Steven A Zyck, ‘Transit Trade in Transition: The APTTA and the Afghan Economy’ (Civil Military Fusion Centre Report, 2011)6.

<[https://www.cimicweb.org/cmo/afg/Documents/Economic/Afghanistan\\_Pakistan\\_Transit\\_Trade.pdf](https://www.cimicweb.org/cmo/afg/Documents/Economic/Afghanistan_Pakistan_Transit_Trade.pdf)>

<sup>535</sup> Ibid 7.

<sup>536</sup> Ibid.

<sup>537</sup> Ibid.

account in Peshawar or Karachi. Putting it simply, neither has there been any substantive change in the transit trade procedures as a result of the revised agreement nor has the smuggling under the transit trade stopped.

## 6.9 Conclusion

The aim of this chapter was to understand the causes of failure of 2002 *hawala* regulatory reforms in Pakistan. In order to achieve this aim, the framework of the role of state has been applied to understand the essential functions a state performs and the respective roles formal and informal institutions play in categorizing a state as ‘strong’, ‘weak’, ‘failed’ or ‘failing’. It has emerged that both the ‘formal’ as well as the ‘informal’ rules of the game are essential for the state to deliver its essential functions. In the context of the international ‘reconstruction’ efforts of the ‘weak’ and ‘failed’ states, the chapter has argued that these efforts suffer from a ‘nirvana fallacy’ which is the mindset that finds a cure to the problems of these states in the western, liberal, democratic systems while necessarily ignoring the endogenous practices embedded in the local cultures and traditions of these countries. The specific example of *hawala* regulation in game theory terms has explained that in order to solve the meta-game of regulating *hawala*, the many embedded micro level ‘nested games’ are ignored and consequently the regulatory efforts have failed. The chapter has provided a practical application of the ‘nested’ games in the case of Pakistan where rampant corruption and tax evasion in an essentially ‘segmentary society’<sup>538</sup> with deep-rooted elite interests are factors due to which institutional reforms could not work. Mezzera and Aftab have rightly documented the state of Pakistan’s affairs:

Behind the façade of the state, its laws and procedures, it is socio-economic structures and networks, cultural norms and expectations, and the exercise of personal power that shape governance and inhibits transparency.<sup>539</sup>

It has been argued that Pakistan’s main problem is the unwillingness of its ruling classes to take action against the problems of tax evasion and corruption and improve service delivery for the poor. The international community, particularly the United States and the IMF which have remained engaged with Pakistan for a long time, could have used their

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<sup>538</sup> Robert D Kaplan, ‘What’s Wrong with Pakistan?’ *Foreign Policy* (18 June 2012).

<sup>539</sup> Mezzera and Aftab, above n 166, 22.

influence to pressurize the various governments to introduce essential reforms. The chapter has argued that the role of these international donors has so far been elusive in using their clout to push for requisite reforms. As a result, lack of fundamental structural and governance reforms mainly to prevent corruption and tax evasion that should have preceded the 2002 *hawala* reforms introduced by the SBP remains the challenge that impede regulation of *hawala* in Pakistan.

It is interesting that despite the failure of the 2002 reforms, this chapter has maintained that these reforms were essentially ‘ill-timed’. As mentioned earlier, structural and governance corrective measures were required in order to prepare the ground for the *hawala* regulation and in the absence of these fundamental reforms, the Pakistani state did not have the capacity to enforce the much required *hawala* regulation introduced in 2002. Logically, this means that FATF Special Recommendation VI (SR-VI) on Alternative Remittance Systems<sup>540</sup> that Pakistan has attempted to implement since 2002 has not been successful because of Pakistan’s domestic problems. This means that if Pakistan could take the necessary steps to control the economic and governance problems, then FATF’s SR-VI can be implemented successfully. However, is that really the case? Is FATF’s SR-VI a good rule that has been badly implemented and consequently failed in Pakistan?

Evidence suggests that the FATF *hawala* regulation has not worked anywhere else as well. This indicates that there may be something wrong in the manner the regulation is being implemented and if this be true, it also means that even if Pakistan’s domestic problems were not there, FATF’s *hawala* regulatory policy may still be impossible to implement in Pakistan as it does not address the country’s peculiar domestic situation. Moreover, failure of the regulation to curb *hawala* has also raised many questions regarding the counter-productivity of the regulatory objectives. The discussion on Afghanistan Pakistan Transit Trade illustrates that the existence of *hawala* and other similar IVTS in today’s globalized

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<sup>540</sup> ‘Every country should take measures to ensure that persons or legal entities, including agents that provide a service for the transmission of money or value, including transmission of money or value through an informal money or value transfer system or network, should be licensed or registered and subject to all the FATF Recommendations that apply to banks and non-bank financial institutions. Each country should ensure that persons or legal entities that carry out this service illegally are subject to administrative, civil, or criminal sanctions.’

world needs to be understood in the context of the basic economic principles of supply and demand. *Hawala* is an informal financial instrument which is working efficiently because there is an abundant supply of funds in the developed world in the form of migrant remittances and other ‘undocumented’ funds that can be off-set by an equivalent demand for these funds in many developing countries’ cash-intensive economies while settlements between *hawaladars* can very conveniently be trade-based. In regulating *hawala*, there needs to be a realization that *hawala* trade finance is mainly due to the disparities in government policies (such as exchange and tariff rates) which has made *hawala* an efficient alternative to the often expensive and complicated formal financial sector. Keeping in view these key policy issues, in the next chapter the counter-productivity of *hawala* regulation in Pakistan is discussed, in order to analyse FATF’s approach to *hawala* regulation and summarize key policy issues.

## **Chapter 7:                      Analysis of FATF’s *Hawala* Regulation**

### **7.1 Introduction:**

In previous chapters, it has been explained that the 2002 reforms program that the State Bank of Pakistan’s initiated through the creation of Exchange Companies was part of Pakistan’s multiple track strategy to rein in the undocumented sector in the financial markets in compliance with the international AML/CFT standards.<sup>541</sup> The 2002 reforms envisioned that over a period of two years, *hawala* would be phased out and will eventually be replaced by a well-documented, self-regulatory, corporate system.<sup>542</sup> This has not happened. One reason is because the 2002 reforms were introduced without taking requisite corrective measures that would prepare the ground for *hawala* regulation in Pakistan.

The Pakistani government has in principle, complied with the FATF SR-VI on Alternative Remittance Systems; however, in practice *hawala* still prevails. An evaluation of Pakistan’s AML/CFT efforts by FATF Asia Pacific Group on Money Laundering reads:

Use of *hawala* still exists and remains to pose a challenge to authorities. The authorities acknowledge that it is still been used to transfer illicit proceeds abroad. It is important that the authorities continue to crack down on illegal operations through the use of *hawala* system. However, the focus has been on regulated entities (exchange companies) that were providing parallel services. While this effort should not be understated, authorities should put more emphasis on going after those who are yet to operate with a licence. It is essential not to drive the formal sector players to underground or those operating underground to remain underground.<sup>543</sup>

The eventuality of *hawala* continuing ‘underground’ in Pakistan if regulations were enforced was inevitable because, in the first place, *hawala* is essentially ‘outlawed’ in Pakistan. In this way, although it has been prevalent and used extensively, it has never been ‘legal’. The reason it has continued unabated (in the full knowledge of its financial regulators) despite being illegal has more to do with the peculiar role these informal transfer

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<sup>541</sup> Ishrat Hussain, ‘The Financial War on Terrorism: The Contribution of Islamic Banking’ (Paper presented at Royal United Services Institute for Defence Studies Conference, London, 7–8 April 2003).

<sup>542</sup> Ibid.

<sup>543</sup> ‘Pakistan Mutual Evaluation Report on Anti Money Laundering and Combating the Financing of Terrorism’ (World Bank and Asia Pacific Group on Money Laundering, 2009) 166.

systems play in the economy. As explained earlier, *hawala* is channelling the much needed development finance in the form of migrant remittances to the poor and unbanked populations in far-flung areas of Pakistan where basic utilities and public goods, let alone banking institutions, are not available. Along with this, *hawala* has a peculiar role in Pakistan's economy, particularly the banking sector, which uses *hawala* to cover for the 'moral hazard' of the borrowers. Due to this reason — the unique role of *hawala* — it could be argued that the SBP duplicitously agreed to comply with the FATF international *hawala* regulation and best practices to attempt to 'control' *hawala* while being aware that practical enforcement of the regulation would remain impossible. The reason is simple. FATF's international *hawala* regulation approach does not address Pakistan's domestic circumstances (or that of many developing economies) because it necessarily assumes a capacity to implement such requirements which is missing in weak and failing states, ignores legitimate demands for efficient value transfer systems and ignores the levels of corruption inherent in Pakistan. As a result, not only have the 2002 reforms failed but they have also resulted in 'collateral damage.'<sup>544</sup> This chapter will discuss the counter productivity of 2002 SBP reforms with the aim to sum up the policy issues in the approaches with which FATF has attempted to regulate the *hawala*-type IVTS.

## **7.2 The Counter-Productivity of *Hawala* Regulation**

*Hawala* has a 'unique' role in the Pakistan economy although it has never been legally recognized under the law of the land. It has prevailed in a predominantly unregulated environment for many years and has remained a major channel of capital inflows that has supplied liquidity in times of national crisis, such as during the international sanctions that followed the 1998 nuclear tests.<sup>545</sup> At the same time, *hawala* is channelling the much required finance in those areas of Pakistan where government outreach is minimal and formal financial institutions are not available. Most importantly *hawala* (an informal system) has an interesting interface with the Pakistani banks (formal systems) as it allows these banks to control the 'moral hazard' of the borrowers.

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<sup>544</sup> Passas, 'Formalizing the Informal?', above n 94, 414.

<sup>545</sup> Ballard, 'A Background Report', above n 62, 23.

Imagine a country with a non-functional regulatory system where if a borrower defaults on a bank loan, then the bank has practically no way of recovering its money or seizing control of any collateral that was pledged for the loan. As explained in detail in the previous chapter, Pakistan has a long history of ‘loan defaulters’ and so it is challenging for the banks to prevent loan defaults despite guarantees and collateral. Under these circumstances, the only collateral a banker in Pakistan can rely on is the ‘cash collateral’.<sup>546</sup> The ‘undeclared’ wealth of a potential borrower that is first transferred abroad through *hawala* is subsequently transferred in the bank’s account and can be used as cash collateral. In this manner, the ‘undeclared’ funds of the borrower are now ‘legalized’ as they are treated as foreign remittances that have come into the country through the (formal) banking channels. Conversely, the banker has enough cash collateral to secure the bank in case of a default. In this manner, the banks in Pakistan control for ‘moral hazard’ of borrowers.<sup>547</sup>

It was because of this peculiar role that *hawala* plays in Pakistan that many experts were sceptical of the government’s optimism in 2002 that creating a few exchange companies would eradicate the ‘kerbed’ market in foreign exchange as well as the practice of transferring money through *hundi/hawala*. One expert, Aftab, argued:

If the government, however, succeeds in the open market in forex, then how will it affect capital inflows, outflows and flight of capital, smuggling and gold brought in from Dubai that is financed with undocumented private dollars?<sup>548</sup>

Moreover, law enforcement problems faced by the Pakistani government led further credence to the impracticability of the reforms which were based on the assumption that the creation of a few MECs would replace thousands of formal and informal money changers and create a forex market subject to the same monitoring and documentation procedures as applicable to the banks. The various factors prevailing in the political economy that feed the informal transfers raised serious concerns in the event that SBP reforms would not achieve their stated objectives. Hence, Aftab concluded:

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<sup>546</sup> Hammad Siddiqi, ‘Hawala and the Middlemen’, *Daily Dawn* (Pakistan), 24 November 2008.

<sup>547</sup> Ibid.

<sup>548</sup> Muhammad Aftab, ‘Pakistan: The Fate of Forex Kerb, *Hawala*’, *Arab News*(KSA) 5 August 2002.



Will the people engaged in smuggling seek documentation and, also pay all local taxes on them by operating through MECs? The fact that a number of such customers will not like to be documented and taxed points to the emergence of yet another parallel market in the event the government fails to realize its objectives.<sup>549</sup>

These cautions were prophetic. The fieldwork findings have confirmed that in the years following the reforms, concerns regarding a parallel underground market were indeed warranted and the market a reality. The fieldwork conducted during this research has confirmed that despite SBP reforms, the ‘kerbed’ market and the *hawala* still prevail. Moreover, as identified earlier, there are serious regulatory issues in the so-called ‘reformed’ market structure as well as its operations. These issues are further complicated by the governance and institutional problems Pakistan is facing and present staggering regulatory challenges to the AML/CFT objectives that the FATF aims to achieve through implementation of its international standards. The following sections delve into the counter-productivity of the FATF *hawala* regulation that Pakistan has attempted to comply with by introducing the 2002 reforms.

Mainly, the 2002 SBP reforms have proven counter-productive on three accounts as follows:

**i) Cost of Regulation**

It has been widely stated that the efficiency of *hawala* lies in its informality. *Hawala* networks are based on the principles of trust and honour and use informal mechanisms of dispute resolution. The *hawala* market is generally self-regulated through widely adopted normative guidance on operators’ (*hawaladars*) obligations to each other and to their customers.<sup>550</sup> Loss of honour and reputation in the event of mismanagement or cheating provides deterrence and ensures transparency during the transactions. In this manner, the informality of the *hawala* system makes it economically efficient as its operations require minimal overheads with almost 99 per cent rate of customer protection. Unlike the formal banking institutions, *hawala* does not require consumer protection mechanisms such as bond or capitalization requirements to run a business. Hence, the regulatory strategy of

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<sup>549</sup> Ibid.

<sup>550</sup> Passas, ‘Fighting Terror with Error’, above n 126, 317.

licensing or/and registration of *hawala* businesses (in SR-VI) that entails bond or capitalization requirements on the *hawaladars* and subsequent taxes on the entities thus formed is not economically efficient for the *hawaladars* as it automatically increases their overheads. The manner in which the regulation is approached in SR-VI means additional costs for the *hawala* operators because it would increase their business expenses whereas in an unregulated environment, the system works on minimal or no overheads basis. The SBP's 2002 moves to implement FATF SR-VI by attempting to formalize the informal *hawala* networks through the creation of exchange companies by fixing minimum capital requirement to set up an MEC failed to incentivize the *hawaladars*, primarily because it incurred additional costs for them. Many small scale currency changers and *hawala* operators who did not have the requisite liquidity of PKR100 million to start an exchange company were left out of the market and subsequently, the SBP had to make provision for a second category of exchange companies with lower capital requirement of PKR25 million. Despite these relaxations, tens of thousands of *hawaladars* are still operating in Pakistan without being licensed or registered. The regulation which was introduced to 'formalize' the informal sector has now become even more problematic because the so-called 'regulated' and 'formal' exchange companies are found to be involved in parallel *hawala* transactions.

## **ii) Enforcement Issues**

Enforcement of regulatory standards and controls has always remained problematic and often impossible for Pakistani authorities due to the structural problems and a lack of institutional capacity. According to North et al,<sup>551</sup> this is a common situation in LAOs where despite the availability of the law, rule of law is absent. This inconsistency between the law and the rule of law can be illustrated in the formal, legal independence of the State Bank of Pakistan which does not correspond with its actual independence. In Pakistan's 'limited access society', the Central Bank (and its independence) is virtually incapacitated by the ruling elite class that prevails in the system. Consequently, the SBP is knowingly

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<sup>551</sup> North et al, above n 451.

oblivious of the ‘undocumented funds’ which are periodically transferred out of the country through *hawala* (for instance, through the ‘export’ of gold jewellery).<sup>552</sup>

Sufficient information is readily available regarding the smuggling of gold between Pakistan and India with payments settled in Dubai — the world’s largest gold market.<sup>553</sup> This information is irrelevant if different governments are themselves favouring benefits and exemptions to taxes and tariffs.<sup>554</sup> Normally the import of gold is allowed provided that the importers declare the amounts at the customs and pay the required duty. In Pakistan however, continuous relaxations in this rule are regularly allowed through the ‘SRO’ culture in which the governments allow duty free import of gold. For example, in the financial year 2012–2013, importers were allowed duty-free import of an amount of gold which was proportionate to the value of jewellery they had exported in the preceding eight months.<sup>555</sup> As a result, gold imports surged over 100 per cent.<sup>556</sup> Reports suggest that gold importers showed fake value (on paper only) for the exported jewellery and imported gold against it. Due to regulatory loopholes, this imported gold was later sold locally and also smuggled (to India) where tariffs on gold import are higher.<sup>557</sup> The gold importers are also a common front for illicit fund transfers in the garb of gold exports. The common procedure for the transfer of funds through the gold importers is that gold is purchased on behalf of the remitter and is exported in the form of jewellery to Dubai where the jewellery is converted back into gold bars and sold in the local market to reclaim the funds.<sup>558</sup> In this manner, the enforcement of regulatory controls has remained increasingly problematic for the Pakistani authorities because of the geographical and cultural proximity with the UAE.

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<sup>552</sup> This was pointed out by the exchange company owners interviewed during the course of this research.

<sup>553</sup> Jost and Sandhu, above n 28, 11.

<sup>554</sup> Sajid Choudhry, ‘SRO Culture Should be Eliminated’, *Daily Times*(Pakistan), 19 December 2012.

<sup>555</sup> Kazim Alam, ‘Cheating the Tax-man: Gold Traders Drain Precious Foreign Reserves’, *Express Tribune* (Pakistan), 7 August, 2013.

<sup>556</sup> *Ibid.*

<sup>557</sup> *Ibid.*

<sup>558</sup> *Ibid.*

### iii) Collateral Damage

The immediate crack down on the *hawala* networks in the finance warfare that emerged as a major instrument of the Bush administration's anti-terrorism strategy has caused substantive collateral damage to the success of *hawala* regulation at the international level. Contrary to initial reports and allegations, subsequent investigations have found almost negligible involvement of the *hawala* or other informal systems in moving terrorist funds. Nikos Passas has reported that there have been no terrorist finance cases involving Al-Qaeda and *hawala* or similar informal networks in the North America. In Europe, there has been one such case where funds were sent from Sweden to Northern Iraq supporting the insurgency.<sup>559</sup> As a matter of fact, investigations soon revealed that the 9/11 hijackers used the formal banking systems and operated through credit cards, bank accounts and wire transfers. Despite the evidence of the non-involvement of *hawala* in any major terrorist attack, the western mainly but by no means solely the United States regulatory and law enforcement authorities have continued a heavy-handed approach towards ethnic remittance service providers along with their 'naming and shaming' in the public and media. In many instances, IVTS have been stereotyped as the 'lifeblood of the terrorist operations' and, implicitly the *hawaladars* as the financiers of terrorism.<sup>560</sup> The example of the Somali remittance provider *Al-Barakat* has been cited by many authors in support of the heavy-handed approach that western law makers have adopted for IVTS. In 2001, *Al-Barakat* was cracked down upon by the US authorities with accusations of financing Osama Bin Laden's networks; however, after more than four years of exhaustive investigations there was no formal indictment on the charges of terrorism financing against this remittance service provider.<sup>561</sup>

It is noteworthy that the problems faced by the Somali as well as the other ethnic communities in the face of post 9/11 regulatory approach to *hawala* and other IVTS have evoked feelings of being marginalized and victimized among the migrant ethnic communities. The political fall-out of the AML/CFT efforts has been the 'anti-west' and

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<sup>559</sup> Passas, 'Fighting Terror with Error', above n 126, 324.

<sup>560</sup> Ibid 330–333.

<sup>561</sup> Ibid 330.

more particularly ‘anti-US’ sentiments.<sup>562</sup> Moreover, these sentiments are also reflected when it comes to the international ‘reconstruction’ efforts in war torn and conflict-ridden countries. For instance, in Afghanistan and Somalia the international reconstruction efforts (to introduce western, liberal institutional frameworks) are often viewed by their local citizens as an attack on the cultural values and indigenous traditions and practices of these societies, such as *hawala*. Consequently just like the *hawala* regulation, reconstruction of the failed and weak states efforts have also been by and large counter-productive.<sup>563</sup>

The application of the ‘collateral damage’ in Pakistan can be understood by Parvez Musharraf’s decision to participate in the United States ‘War on Terror’ which did not have the popular political and public support, particularly in Pakistan’s tribal areas. As a result, this decision has faced domestic backlash and resistance.<sup>564</sup> Given that the 2002 SBP reforms were also part of the steps that the government/SBP took in collaboration with the international AML/CFT efforts, it could be argued that the *hawala* market, particularly in the tribal areas where *hawala* is traditionally practiced, did not show interest in compliance. Popular opinion among the tribal citizens was that the SBP 2002 regulation (to curb *hawala*) as part of Musharraf government’s policies were implemented in order to ‘please the US masters,’ rather than a serious effort towards regulating the criminal use of the informal systems. In other words, the SBP could not muster sufficient support from the *hawaladar* community for compliance that would have made the reforms successful. The *hawaladars* have preferred to continue operating ‘illegally’ rather than become part of the ‘legal’ and ‘documented’ market primarily because the purported reforms did not offer sufficient incentives to them to get ‘licensed and registered’ with the SBP.

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<sup>562</sup> Marieke de Goede, ‘*Hawala* Discourses and the War on Terrorist Finance’ (2003)21(5)*Environment and Planning D:Society and Space*515.

<sup>563</sup> See, eg, Coyne, above n 353.

<sup>564</sup> Manzoor Ahmed, ‘Implications for the War on Terror for Khyber Pukhtunkhwa, Pakistan’ (2010)3 *Journal of Critical Globalization Studies*102,106.

<[http://www.criticalglobalisation.com/Issue3/102\\_113\\_IMPLICATIONS\\_WOT\\_JCGS3.pdf](http://www.criticalglobalisation.com/Issue3/102_113_IMPLICATIONS_WOT_JCGS3.pdf)>

### 7.3 Is FATF Recommendation a Good Rule Badly Implemented?

Hypothetically, one would like to argue that implementation of FATF SR-VI has been problematic in Pakistan because of the state's weak institutional and law enforcement capacity as well as other governance issues. This implies that if Pakistan's specific problems did not exist, FATF's SR-VI is a good rule that could be implemented if circumstances were other than they are — that is, it is a good rule which could not be implemented in a bad environment. However, that the regulation has not worked successfully anywhere else and *hawala* still prevails as the most popular choice has raised several questions about the regulation itself. More so, the situation of non-compliance in the formally regulated banking sector for which FATF AML/CFT reporting standards were actually designed since mid 1980s further endorses a view that FATF regulations and controls have remained far from realistic and practicable. Evidence from many international banks shows that since the imposition of the FATF's AML statutory regulations, banks have not been able to observe compliance and consequently several multi-million dollar fines have been imposed on leading global banks that have allegedly exposed the international financial system to money laundering, drug trafficking and terrorist financing risks due to their poor AML controls.<sup>565</sup> Among these leading banks, HSBC's Mexican unit has been fined USD27.5 million,<sup>566</sup> the UK division of South Africa's Standard Bank GBP7.6 million<sup>567</sup> and the Doha Bank's branch in the United States USD5 million.<sup>568</sup> These are but a few examples of non-compliance with the costly regulations and standards. The question remains: If FATF's regulations and controls are not implementable in the formal banking sector for which these were originally designed, can these standards be

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<sup>565</sup> Homeland Security and Government Affairs, Permanent Subcommittee on Investigations, 'HSBC Exposed U.S. Financial System to Money Laundering, Drug, Terrorist Financing Risks, Senate Subcommittee Holds Hearing and Releases Report' (Media Release, Monday, 16 July 2012) <<http://www.hsgac.senate.gov/subcommittees/investigations/media/hsbc-exposed-us-finacial-system-to-money-laundering-drug-terrorist-financing-risks>>.

<sup>566</sup> Ambreen Choudhury and Nacha Cuttan, 'HSBC Fined \$27.5 Million in Mexican Money Laundering Probe' *Bloomberg News*(online), 25 July 2012.

<sup>567</sup> Kirstin Ridley, 'Update 2: UK Fines Standard Bank for Lax Anti-money Laundering Controls' Reuters (London), 23 January 2014.

<sup>568</sup> Financial Crimes Enforcement Network Office of the Comptroller of the Currency, 'FinCEN and OCC Assess Civil Money Penalties against the New York Branch of Doha Bank' (Joint Release, 21 April 2009) <[http://www.fincen.gov/news\\_room/nr/html/20090421.html](http://www.fincen.gov/news_room/nr/html/20090421.html)>.

implemented on the informal IVTS? We take the example of implementation of SR-VI in Pakistan's case.

Earlier, it has been explained that IVTS has a 'dual' function in Pakistan — *hawala* is used to channel the much needed migrant remittances as well as simultaneously facilitating the transfer of funds generated in the shadow economy as a result of economic crimes, such as corruption and tax and tariff evasion. Consequently, Pakistani regulators have faced a 'moral dilemma' in regulating *hawala*. The economic interests of a cash strapped country that requires more foreign exchange are clearly in conflict with the international AML/CFT objectives of regulating the informal *hawala*-type IVTS in order to mitigate risks associated with money laundering, drug and terrorism financing. As a result, the application of international standards and best practices has created more hurdles for implementation in a country where regulation is most required but cannot be implemented. This begs analysis of issues in FATF *hawala* standards and best practices, in order to appreciate the shortcomings of these rules in regulating the *hawala*-type IVTS.

#### **7.4 Issues in FATF Recommendations and Standards**

##### **i) Wholesale Transfer Procedures**

In both letter and spirit, the FATF's approach to regulating the IVTS is similar to the manner in which it approaches the regulation of the formal banking institutions. In this way, FATF's 40+9 recommendations and best practices attempt to superimpose the agreed international regulatory standards and reporting requirements applicable to the formal financial sector upon the informal *hawala*-type systems.<sup>569</sup> Thus, whilst the *hawala* model (explained in Chapter 2) includes a sender, a recipient and two *hawala* operators at the respective ends, in the post 9/11 framework it now includes the additional legal/regulatory requirements that have been enforced in the form of registration and/or licensing, customer identification requirements, record keeping and reporting of suspicious transactions to the regulatory authorities. Critics have argued that this kind of 'wholesale transfer'<sup>570</sup> of the

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<sup>569</sup> Maimbo, 'Regulation and Supervision of Informal Remittance Systems', above n 97, 4.

<sup>570</sup> Anand Ajay Shah, 'The International Regulation of Informal Value Transfer Systems' (2007)3(2) *Utrecht Law Review*193, 205.

formal regulatory procedures that were originally designed for the formal financial sector by the international regulatory authorities has not been helpful in optimizing the regulatory objectives for the informal fund transfer systems.

FATF insists that jurisdictions comply with SR-VI which requires either the licensing or registration, or both, of the remittance and the currency exchange services. The FATF has further recommended that to maintain consistency with the obligations imposed on other financial institutions, jurisdictions should introduce transaction reporting in line with their current reporting requirements for financial institutions. Specifically, the FATF has recommended that:

Jurisdictions may consider issuing specific guidance as to what may constitute a suspicious transaction to the MVT service industry. Some currently used indicators of suspicious financial activity, such as those found in the FATF's Guidance for Financial Institutions in Detecting Terrorist Financing, are likely to be relevant for money/value transfer service activity. However, particular activities and indicators that are unique to this sector should be further developed. The second half of FATF Special Recommendation VII on Wire Transfers should also be taken into account when developing guidance in this area. For example, operators that receive funds/value should ensure that the necessary originator information is included. The lack of complete originator information may be considered as a factor in assessing whether a transaction is suspicious and, as appropriate, whether it is thus required to be reported to the Financial Intelligence Unit or other competent authorities. If this information is not included, the operator should report suspicious activity to the local FIU or other competent authority if appropriate.<sup>571</sup>

## **ii) Tracking Suspicious '*Hawala*' Transactions**

In ascertaining the practicality of the AML/CFT regulatory objectives for *hawala*-type informal systems, there is always a risk in relation to the movement of funds generated in the global informal sector. In many instances, it has been noted that the misuse of the *hawala* system is not confined to money laundering or financing of terrorism; rather the bulk of the funds that are transferred through the *hawala* channels are those which are

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<sup>571</sup> FATF International Best Practices, above n 18, 8.



generated through fiscal offences (such as, by-passing currency controls, tax evasion or irregular trade). Identifying and separating money laundering and terrorism financing offences from the various fiscal offences and then tracking suspicious transactions in accordance with FATF's guidelines is an impossible proposition.

Moreover regulating *hawala* with reference to a specific list of clients, according to the 'originator information,'<sup>572</sup> is again not a regulatory option. *Hawaladars* do not operate in terms of 'origination of funds' for the funds that they facilitate to transfer. For this reason, tracking a *hawala* transaction and identifying the relevant parties is a difficult proposition as the *hawaladars* only retain records of the information which they and their immediate partners require to have access to in order to process the transactions in which they themselves are involved.<sup>573</sup> It is noteworthy that in the multi-layered chain through which an IVTS transaction moves, the records held by any one *hawaladar* are not likely to provide a complete picture of the entire transaction trail. From the *hawaladar's* point of view, he needs to know only his own part in the total chain in order to successfully carry out a transaction. This is contrary to the AML/CFT regulatory framework as it works through a 'follow the money' approach where the origin of transaction is a critical detail but the same cannot be applied precisely in a *hawala* transaction.

### iii) What's In a Name!<sup>574</sup>

A major problem in the FATF *hawala* regulatory framework is that of legal terminology. To date, there is neither a single definition nor a common term by which the *hawala*-type informal systems can be referred to. A variety of terms and definitions<sup>575</sup> are used to refer to the informal transfer systems in academic literature as well as at the international policy-making forums. Use of various terms for IVTS may not be a concern from an academic,

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<sup>572</sup> Special Recommendation VII: 'Wire Transfers: Countries should take measures to require financial institutions, including money remitters, to include accurate and meaningful originator information (name, address and account number) on funds transfers and related messages that are sent, and the information should remain with the transfer or related message through the payment chain. Countries should take measures to ensure that financial institutions, including money remitters, conduct enhanced scrutiny of and monitor for suspicious activity funds transfers which do not contain complete originator information (name, address and account number).'

<sup>573</sup> Ballard, 'A Background Report', above n 62, 33.

<sup>574</sup> Anand Ajay Shah, above n 569, 194.

<sup>575</sup> Terms and definitions have been discussed in Chapter 2.

political or economic point of view; however, fruitful legal discourse becomes problematic if the practice aimed to be regulated is lacking in a uniform definition at different policy-making forums. The *Abu Dhabi Declaration*, which was the first official forum to discuss the informal financial practices, used the term ‘*hawala* and other informal remittance systems’ and referred specifically to ‘informal money or value transfer systems or networks outside the formal financial sector’.<sup>576</sup> This was not an all-encompassing definition and could not be used for meaningful legal discussions. The Asia Pacific Group on Money Laundering (APGML) uses the general terms ‘underground banking’ and ‘alternative remittance services’ and defines the services as, ‘informal mechanisms based on the networks of trust used to remit monies’.<sup>577</sup> This definition is not an improvement on the *Abu Dhabi Declaration* and limits the informal transfer systems to money remitting networks. In June 2003, the FATF issued a Best Practices Paper on combating the abuse of the alternative remittance systems. Here, it has adopted a broad definition for the informal transfer systems by adopting the term ‘Money or Value Transfer Service’ (MVT service) which refers to:

[a] financial service that accepts cash, checks, other monetary instruments or other stores of value in one location and pays a corresponding sum in cash or other form to a beneficiary in another location by means of a communication, message, transfer or through a clearing network to which the MVT service belongs. Transactions performed by such services can involve one or more intermediaries and a third party final payment.<sup>578</sup>

FATF used an inclusive and comprehensive definition and considered as many possibilities as there can be for the use of the informal systems. The Best Practices Paper also noted that an MVT service may be provided by persons (natural or legal) formally through the regulated financial system or informally through entities that operate outside the regulated system; that in some jurisdictions, informal systems are frequently referred to as alternative remittance services or underground (or parallel) banking systems; and that often these

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<sup>576</sup> Text of *Abu Dhabi Declaration on Hawala* available at <<https://www.hSDL.org/?view&did=455469>>.

<sup>577</sup> Asia Pacific Group on Money Laundering website<<http://www.apgml.org/methods-and-trends/page>>

<sup>578</sup> FATF Best Practices, above n 18, 2.

systems have ties to particular geographic regions and are therefore described using a variety of specific terms which include *hawala*, *hundi*, *fei-chien*, and the black market *peso* exchange.

In 2010, the FATF has arguably taken a shift from its earlier position on the MVT services and used the term ‘informal money remittance services,’ defined as ‘underground banking channels in which the transactions are settled by offsetting an equivalent sum at the receiving location’.<sup>579</sup> In FATF’s 2010 definition, *hawala*-type systems have been categorized as an ‘underground’ activity having similar accounting methods to banking. FATF’s stance on the informal transfer systems appears rather condescending. It shows a clear shift from the earlier position which was more inclusive and defined the informal transfer systems within a broad term ‘Money or Value Transfer Service’. Could it arguably be said that the change in FATF’s position is due to its failure in regulating *hawala*? The discussion gets further confusing when it states:

Detecting these underground systems is by definition very difficult. In countries with alternative money remittance systems, it is often difficult to prove illegal activities in these systems as they are often trust-based, secretive and unregistered, with indirect fund movements.<sup>580</sup>

FATF’s defeatism becomes clear as the discussion concludes: ‘[I]t is difficult to assess the degree of compliance even when informal value transfer service providers are legal’.<sup>581</sup>

#### **iv) Registration and Licensing Approaches to Regulate *Hawala***

Within the FATF Special Recommendation VI, there are two approaches to the regulation of *hawala*: a minimalist ‘registration’ of the IVTS operators or a more optimal method of ‘licensing’ that ensures that people with dubious backgrounds are not given legal status to operate. ‘Licensing’ and ‘registration’ of IVTS businesses are considered the first step in bringing IVTS operations under the supervisory and regulatory framework of the state. The Interpretative Note to SR VI defines these terms as follows:

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<sup>579</sup> Financial Action Task Force, ‘Report on Money Laundering through Money Remittance and Currency Exchange Providers’ (2010)34.

<sup>580</sup> Ibid.

<sup>581</sup> Ibid.

Licensing means a requirement to obtain permission from a designated competent authority in order to operate a money/value transfer service legally. Registration (...) means a requirement to register with or declare to a designated competent authority the existence of a money/value transfer service in order for the business to operate legally.<sup>582</sup>

While both the licensing and registration would at the very least allow the competent regulatory body to be aware of an IVTS operation in its jurisdiction, ‘the difference between the two is that licensing implies that the regulatory body has sanctioned the particular operation before it commences business, whereas registration implies that the operator has informed the regulatory body of its existence’.<sup>583</sup> The registration or licensing approaches are nevertheless problematic in jurisdictions where *hawala* is essentially outlawed. Pakistan is such an example, where licensing or registration of IVTS/*hawala* is impossible, because that would be calling for the regulation of an unlawful act. As a result, Pakistan has neither licensed nor registered *hawala per se*, but has created new, formal entities (exchange companies) in 2002 that could be both licensed and registered and regulated accordingly to carry out foreign exchange and remittance businesses. This point regarding licensing and registration is explained further.

In certain jurisdictions, a transaction is considered ‘legal’ if it is carried out by a registered entity and an audit trail is available. The registration approach is hence, suitable for those countries which have well-structured financial systems and are advanced in their capital/current account convertibility. In these countries MSBs can be registered without imposing any further regulatory measures that could be detrimental to everyday financial business; and so, the registration approach allows the regulatory and law enforcement agencies a straightforward way of contacting IVTS operators for both specific investigations as well as research purposes. On the other hand, in countries where *hawala* is illegal, implementation of FATF’s licensing and registration approaches becomes impossible. For instance, movement of foreign exchange into and from the country has always remained a regulatory concern for the Pakistani authorities and therefore Pakistan

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<sup>582</sup> Ibid 2.

<sup>583</sup> Asia/Pacific Group on Money Laundering, APG Typologies Working Group on Alternative Remittance and Underground Banking Systems, ‘Alternative Remittance Regulation Implementation Package’(2003) 21.

has a history of strict currency controls. In an environment where *hawala* is an illegal act in Pakistan, the SBP cannot be restricted to only registration and audit trails when it is setting the regimes for money transmitters. For the SBP, adopting regulatory measures such as registration, licensing and audit trails are not sufficient to declare any transaction legal and regular in Pakistan. As a result, in order to satisfy the objectives of the international AML/CFT compliance as well as keeping up with its domestic policy concerns regarding movement of the capital, the SBP has a comprehensive regulatory framework for financial institutions in order to consider any transaction as legally authorized. This comprises:<sup>584</sup> whether the financial institution a) follows the prescribed procedures, b) adheres to liquidity reserve requirements c) possesses authorization for business activities, d) has procedures for any arrangement with other entities including the settlement mechanisms, e) has adopted and follows KYC/CDD mechanisms, f) conducts an annual statutory audit, g) reporting requirements, h) meets the inspection and supervisory requirements of the central bank, i) possesses internal controls, and j) undertakes periodic renewal of its licence.

It is clear from these procedures that in Pakistan, following the financial regulatory regime is complicated and cumbersome even for the formal financial industry. In the case of the outlawed *hawala*, SR-VI is simply not implementable. This is not a small problem because Pakistan is a ‘hotbed’ of *hawala*. The government has attempted to implement SR-VI by creating formal entities (exchange companies) that would embrace the various small scale operators and bring them within the regulatory net; but this has not happened and *hawala* is still prevalent. The only available option financial authorities are left with in countries (like Pakistan) where there are legal impediments in the implementation of SR-VI is strict law enforcement as is done by labour importing countries, such as Japan and Saudi Arabia. However, as explained earlier, law enforcement in Pakistan is ineffective and is hampered by various factors including antiquated laws and weak institutions. As a result, *hawala* remains largely unregulated in Pakistan despite the international standards that call for its regulation as well as various attempts of Pakistani authorities to curb the informal transfers.

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<sup>584</sup> State Bank of Pakistan, *Foreign Exchange Manual*, Chapter 2, available at <[www.sbp.org.pk/fe\\_manual/chapters/chapter2.htm](http://www.sbp.org.pk/fe_manual/chapters/chapter2.htm)> .

## v) Consolidation and Settlement

Another major issue in *hawala* regulation is that the consolidation and settlements of transactions are similar to those for international payments that go through the banking systems. Just as it happens in *hawala*, banks also do not move physical cash between branches or correspondent banks when effecting transfers. Wilson has explained the consolidation of debt in *hawala* transfers thus:

[I]ntermediaries consolidate small positions into larger subtotals in fewer hands. Such entities ... are larger scale operators than the small scale *hawaladar* .... Where are such entities concentrated? It cannot be ascertained for certain, but for various reasons Dubai, in the United Arab Emirates, has often been singled out as a location where many *hawala* transactions are consolidated and cleared.<sup>585</sup>

Passas states that ‘there is no doubt that there are several layers of *hawaladars* who may play a part in the global networks’.<sup>586</sup> Roger Ballard has explained the consolidation mechanism in *hawala* between various layers of *hawaladars* in South Asian settlements in the United Kingdom — a complex network of agents and sub-agents whom he categorizes as ‘retail’, ‘wholesale’ and ‘global’ *hawaladars*. According to this explanation, on the lowest rung, local/retail *hawaladars* collect deposits in hard currencies from migrant workers, note the details of the recipient to whom an agreed upon sum of rupees is to be delivered (perhaps in India or Pakistan) and then transmit (by fax or email) a tranche of details of payments to those *hawaladars* who are running considerably bigger operations in other South Asian settlements in the Britain. This bigger business — the ‘wholesale’ *hawaladar* — is ‘then able to take advantage of very substantial economies of scale by bundling whole tranches of instructions together in a single fax, a series of which are then sent off to specific partners in India or Pakistan’.<sup>587</sup> The business credentials of the ‘wholesale’ *hawaladars* are accepted by local bank branches to enable them to set up foreign exchange accounts which could handle such a daily volume of business at relatively low rate of commission.

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<sup>585</sup> Wilson, above n 65, 2.

<sup>586</sup> Passas, ‘Informal Value Transfer Systems’ above n 25, 49.

<sup>587</sup> Ballard, ‘A Background Report’, above n 62, 18.

Roger Ballard's explanation can be imitated to understand how few big foreign exchange companies (wholesale *hawaladars*) consolidate payments in Pakistan. These companies have their agents, sub-agents and sub-sub agents across the country. The agents (retail *hawaladars*) purchase hard currency in foreign exchange from the tourists, visiting migrants or their families, and even from private citizens. The big companies arrange for the physical transfer of the non-dollar currency to Dubai for which they have legal permission from the SBP. In Dubai, many of these companies have counterpart organizations and they also have access to the global fund transfer facilities. Funds are consolidated in voluminous records of transactions, albeit the record of account numbers and beneficiary of each transaction is available in the bank statements of the wholesale *hawaladars*, in compliance with the due diligence procedures and other regulatory controls.

It could be argued that the area where the FATF recommendations and international standards are most deficient in addressing the informal transfer systems is the settlement side of *hawala* transfers. For instance, FATF recommendations are silent on the 'global' *hawaladars* who are stationed in major financial centres (for example, Dubai) and 'have no contact whatsoever with the relatively tiny sums remitted by the labour migrants'.<sup>588</sup> Instead, as Roger Ballard has explained, 'such *hawaladars* characteristically broker deals on behalf of lower-level *hawaladars*, both wholesale and retail, and also on behalf of large commercial clients'.<sup>589</sup> A pertinent question that has been asked by many is whether these 'facilitators' are legally covered under the FATF standards, as these are neither *hawala* operators nor remittance service providers. A SBP Task Force Report<sup>590</sup> proposed that if *hawala* has to be regulated then there should be an internationally defined mechanism of settlement akin to *hawala*-type settlement method which is acceptable to all jurisdictions.

In view of the above analysis it can be seen that FATF's policies want *hawala* to operate in a bank-like manner; and given *hawala*'s own characteristics and in-built mechanisms, this has remained impossible. Hence, in terms of the policy, FATF's regulation has been unsuccessful (and counter-productive) because to begin with the regulation is aimed at

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<sup>588</sup> Ibid 26.

<sup>589</sup> Ibid 27.

<sup>590</sup> 'Understanding Hawala', Task Force Report on Home Remittances, June 2006 (unpublished) (Circulated among Participants at the Workshop on Banking Practices Organized by the State Bank of Pakistan, Karachi, 15 June 2006).

transforming *hawala* rather than preventing or reducing the impact of criminal uses of the IVTS. In the context of Pakistan, it shows that even if the country were not facing the structural and governance problems that it does, the 2002 reforms were doomed to fail because the objectives of the reforms was not to stop or reduce illicit transfers through *hawala* but to implement the *hawala* regulatory framework that calls for *hawala* to be regulated in the same manner and with similar set of procedures as formal banks do and as explained, this was not workable.

There should be no confusion as to whether *hawala* needs to be regulated in Pakistan, and elsewhere, as much as the formal financial institutions are required to be regulated. Both the banking institutions as well as the IVTS are vulnerable to abuse as both can be used to transfer illicit funds. Regulation is essential to mitigate the risks of abuse in both *hawala* as well as in the banks. Nevertheless, IVTS and banks cannot be regulated in the same manner and with the same set of rules, primarily because the formal banking regulations are not workable for *hawala*. We have demonstrated that *hawala* is filling an essential void that is created due to the non-availability of effective formal financial institutions in many parts of Pakistan and that it is effectively substituting for the formal institutions (for perfectly benign purposes) in the transfer of remittances the Pakistani migrant labour force earns in foreign countries. For this purpose, *hawala* is an efficient tool of value transfer for the poor and the unbanked populations who do not have access to the formal financial facilities. *Hawala* serves them as an instrument of essential public service in the Pakistani state. Simultaneously, it is a conduit for tax-evaders, corrupt officials and smugglers who wish to siphon away their illicit funds. Pakistan therefore needs a *hawala* regulatory policy that can prevent ‘the wrong use’ of these informal networks or reduce their impact for criminal uses. The question remains how can Pakistan achieve this objective?

## **7.5 Shift in Regulatory Paradigm**

In more recent years, an apparent paradigm shift regarding regulation of *hawala*-type transactions could be seen in many policy debates. Many experts and scholars have argued the case for open-ended and flexible solutions to regulate informal transfer systems depending on individual countries’ economic and cultural circumstances for instance, the anthropological approach that takes into account the social relations between individual



families and the broader social communities.<sup>591</sup> Interestingly, this paradigm shift is so far not reflected in the official policy line of the international financial institutions such as the FATF, although it has remained at the forefront of understanding the multifarious challenges in regulating *hawala*-type transfer systems. The international policy making forums have continued to pursue their ‘formal-centric’ approach that aims to transpose *hawala* into formal banking systems. As a result, dogmatic solutions have been implemented to regulate *hawala* which are based on sponsoring formal financial institutions to compete with *hawala* by introducing processes and products that would eventually disincentivize *hawala*, such as better outreach, cheaper remittance transfers, speedier transactions and other financial products. One such project (discussed in Chapter 5) has been launched in Pakistan as well.

By now it is very clear that the formal banking sector cannot overcome the informal *hawala* systems and so concentrating on regulatory ideas that advocate unrelenting support for western banking institutions (to increase their outreach and eventually cause the *hawala* systems to disappear) may not be an optimal strategy. Indeed, such purported patronage of the western banking systems vis-à-vis *hawala* has been detrimental to the regulation of IVTS because, firstly, such an approach places the western formal banking systems as the sole legitimate universal standard,<sup>592</sup> essentially ignoring the indigenous systems and practices that prevail in the absence of conventional western banking systems in many countries.<sup>593</sup> On the other hand, this kind of approach is fundamentally ethnocentric — it is the post Second World War philosophy of diffusion of western capital, technology and institutional innovations, which is reflected in the contemporary prioritization of the western forms of governance and modernity.<sup>594</sup> The mindset that explores the panacea of state weaknesses and failures in the context of western liberal values and standards

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<sup>591</sup> Maimbo, ‘Regulation and Supervision of Informal Remittance Systems’, above n 97, 8.

<sup>592</sup> Goede, above n 561, 515; Thompson, ‘Misplaced Blame’, above n 325, 279–305

<sup>593</sup> Ibid.

<sup>594</sup> David Slater and Morag Bell, ‘Aid and the Geo Politics of the Post Colonial: Critical Reflections on the New Labour’s Overseas Development Strategy’ (2002) 33(2) *Development and Change* 335, 336.

arguably places the endogenous cultural and informal practices of these countries at an inferior level.<sup>595</sup>

In the manner that the FATF has approached *hawala* regulation so far, it appears that in the eyes of this international regulator, the western banks are the sole standard by which *hawala*-type practices could be regulated. In reality, an appraisal of FATF's international standards and best practices that have been introduced during the past decade to ensure transparency in financial transactions shows that there is still a need on part of the international community to understand the informal transfer systems in order to appreciate that these cannot be regulated with a similar set of rules and standards to those that are required for the formal banking institutions. Also, in reality the international regulatory standards and best practices have achieved much less than was desired even in the formal financial systems. As mentioned earlier, there have been many instances of the western banks 'exposing the financial system to risks due to their non-compliance with the due diligence standards and lack of transparency'. Indeed, following the global financial crisis that hit the world in 2007, another analogous debate albeit in a different setting, regarding the health as well as the legitimacy of the conventional western financial system has sprung up.<sup>596</sup>

### **7.5.1 Can *Hawala* Become an Alternative Financial Instrument?**

In the Global Financial Crisis (GFC), the Islamic banks (as opposed to the western banks) seemed to have fared differently and relatively better.<sup>597</sup> It has been reported that the Islamic banks have exhibited stronger resilience to the GFC and they now constitute one of the fastest growing segments of the global financial industry. The Global Islamic Finance Report (GIFR) provides that in 2008 the size of the global Islamic banking industry was estimated about USD820 billion. It is now closer to USD1.35 trillion, and expected to

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<sup>595</sup> See Dulce Redin, Reyes Calderon, Ignacio Ferrero, 'Cultural Financial Traditions and Universal Ethics: The Case of *Hawala*' (Working Paper No 08/12, Universidad de Navarra, 2012).

<sup>596</sup> See Noam Chomsky, 'The Legitimacy of Financial System and State Capitalism' in N Dobos, C Barry and T Pagge (eds), *Global Financial Crisis: The Ethical Issues* (Palgrave-Macmillan, 2011) 52.

<sup>597</sup> Muni Sekhar Amba and Fayza Al Mukharraq, 'Impact of the Financial Crisis on Profitability of the Islamic Banks vs Conventional Bank: Evidence from GCC' (2013)4(3) *International Journal of Financial Research* 83, 83.

exceed USD1.6 trillion within this year.<sup>598</sup> The Islamic financial industry comprises 430 banks and financial institutions. In addition, around 191 conventional banks have Islamic banking windows operating in more than 75 countries.<sup>599</sup> Pakistan has also adopted Islamic banking as a parallel banking system in 2002 and, presently it constitutes about 8 per cent of its local banking industry.<sup>600</sup>

Presently, there are two parallel banking systems simultaneously operating in the global financial order despite fundamental differences between them:

i) As opposed to the western banking system where the central concept is profit, Islamic banking and finance works on the concept of justice, which is achieved mainly through the sharing of risk.<sup>601</sup> In the Islamic banking model, stakeholders/partners are supposed to share profits and losses and charging interest is prohibited under the precepts of the Islamic *Shariah* law.<sup>602</sup>

ii) Financial intermediation in western banking is largely debt based and allows for risk transfer. Islamic intermediation, by contrast, is asset based and allocates risk sharing between the partners.<sup>603</sup> Being asset based Islamic banking features a close link with the real economy.<sup>604</sup>

In this way, the proximity between financial practices and the real economy in the Islamic banking model that does not allow investing in or financing speculative instruments such as toxic assets, derivatives, and other conventional financial institution securities,<sup>605</sup> essentially reduces any contribution to excesses and ‘bubbles’<sup>606</sup> that may lead to a meltdown and trigger a financial crisis. Thus, the Islamic banking institutions also enjoy a ‘head start’ in mitigating the risks of money laundering and terrorism financing because

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<sup>598</sup> Khurram Baig, ‘Islamic Financial System Shows Inherent Resistance to Global Crisis’, *Express Tribune* (Pakistan), 17 December 2012.

<sup>599</sup> Ibid.

<sup>600</sup> Ibid.

<sup>601</sup> Kassim Dakhllallah and HelaMiniaoui, ‘Islamic Banks vs Non-Islamic–Ethical Dimensions’ (2<sup>nd</sup> International Conference on Business and Economic Research, ICBER, Malaysia, 2011) 2141.

<sup>602</sup> Ibid.

<sup>603</sup> Ibid.

<sup>604</sup> Redin, Calderon and Ferrero, above n 593, 10.

<sup>605</sup> Ibid.

<sup>606</sup> Ibid.

unlike their western competitors that rely on documentary evidence and usually have impersonal relationships with the majority of their clients, the Islamic banks have more stringent ‘Know Your Customer’ (KYC) requirements. Ishrat Hussain<sup>607</sup> has explained the reasons for this. The western banks rely on fixed pre-determined return frameworks and due to this reason are less concerned about the character and credibility of their customers as they are more interested in the underlying securities and assets. On the contrary, since the Islamic banking model is based on a quasi profit-loss sharing partnership with the customer, it is important for the Islamic banks to know their clients, the nature of their businesses, their sources of income as well as uses of bank financing, in order to determine the authenticity and legitimacy of their client-partners. Due to this in-built risk mitigating strategy that comes with the bank’s relationship with its clients, the Islamic banks are better equipped to detect, prevent and disengage from suspicious customers and transactions as compared with the western banking institutions.

It could be argued that this model is applicable to the IVTS as well. *Hawala* is essentially an instrument of trade financing, exchange of goods and services and remittance transfers that ensures a link with the real economy. Similar to Islamic banking, *hawala* also offers an alternative to the conventional western finance and has its own ingrained KYC/CDD features. Arguably then, if despite fundamental differences both the Islamic and western banks can co-exist in the new financial order, then the possibilities of exploring *hawala* and the other IVTS as an alternative or parallel financial instrument can be far and many, particularly for countries like Pakistan where these networks are prevalent.

## **7.6 Conclusion:**

The aim of this chapter was to understand the counter productivity of the 2002 *hawala* regulation in Pakistan with the view to analysing policy issues in FATF’s *hawala* regulatory regime. It has been argued that in its letter and spirit, the FATF wants to regulate *hawala* by ‘transforming’ these informal practices into formal bank-like structures and then monitor them with similar set of regulations to those that are used to monitor the banks. Such an approach has proven counter-productive to the objectives of the regulation as,

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<sup>607</sup> Ishrat Hussain, ‘Islamic Finance for Asia: Development, Prospects and Inclusive Growth’ (Paper presented at the Conference on Islamic Finance for Asia, Manila, Philippines, 4 –5 November 2013).

firstly it has increased the cost of the regulation which became a disincentive for the *hawaladars*. Secondly, the enforcement of the regulation has remained problematic in many countries and finally, the regulatory approach has essentially resulted in political backlash and incurred collateral damage.

This chapter has argued that there are various issues in following the FATF licensing and registration regulation in Pakistan where *hawala* is illegal. It follows that whilst *hawala* regulation is essentially required in Pakistan, it cannot be implemented in its present form because it does not address Pakistan's domestic circumstances. Moreover, FATF's approach attempts to regulate *hawala*-type systems with the same set of rules as those for banks, which is an impossible proposition to implement due to the inbuilt mechanisms of these informal transfer systems. This chapter has concluded that Pakistan's peculiar domestic, economic and cultural realities demand a regulatory approach where the benefits of *hawala* as an essential public service tool can be utilized while simultaneously reducing the impact of its criminal use in transferring illicit funds abroad. This requires a change in the current approach to regulating these systems. We have concluded that the possibilities to explore *hawala* as an alternative financial instrument in Pakistan can be considered on similar lines as Islamic banks are operating parallel to the conventional western banks, despite fundamental differences.

## **Chapter 8**

## **Conclusions and Recommendations**

### **8.1 Conclusions**

In conclusion, this thesis has attempted to understand why the far-reaching international AML/CFT regulation to curb informal value transfer systems, such as *hawala*, that were put in place in the aftermath of the 9/11 terrorist attacks in the United States and the ensuing ‘War on Terrorism’, have not borne fruitful results. In studying the example of Pakistan, the thesis has aimed to elaborate the challenges and issues that engulf the regulation of *hawala*-type IVTS. While Pakistan is only one of many countries where *hawala* is prevalent and while solutions that may work in one jurisdiction are not necessarily transferrable to other situations, the lessons we can learn from the Pakistan experience do have wider implications. The purpose of the thesis is to draw lessons from Pakistan in order to highlight the regulatory issues as well as short-comings in the existing regulatory prescription that attempts to counter IVTS with the objective of replacing these systems with formalized structures that can be regulated in the same manner as formal banking institutions are monitored.

The thesis has argued that in order to keep up with its international obligations under and commitment to the ‘War on Terrorism’ as well as due to its domestic policy concerns that warrant *hawala* regulation, the SBP created licensed and registered money exchange companies in 2002. The idea was that within a period of two years, a well-documented corporate foreign exchange sector would be established and *hawala* would cease to exist. Unfortunately, the SBP’s attempt at *hawala* regulation through the creation of a corporate order has not been successful. *Hawala* continues to prevail while the regulatory efforts have resulted in alarming consequences and resulted in an alternative ‘grey market’, comprising the so-called formally regulated exchange companies that are found to be operating, thus showing corporate governance failure in Pakistan. It has been concluded that the SBP has not been able to create sustainable corporate institutions that it could effectively protect and regulate. On the other hand, SBP’s Pakistan Remittance Initiative, which was meant to counter *hawala* in a free market through competition, has turned out to be state patronage of the commercial banks. The project is mired in scandal and corruption in which billions have

allegedly been doled out from the public exchequer as a result of alleged collusion between commercial banks and officials of the SBP.

Notwithstanding the failure of the 2002 reforms, it has been argued that these reforms need to be viewed in perspective because the reforms were fundamentally ill-conceived and introduced without taking steps that were required to mitigate the impact of those factors that directly challenge *hawala* regulation. Among these problems are mainly corruption and tax evasion by the Pakistani elite. Funds which are generated through tax evasion and corruption constitute a large part of Pakistan's shadow economy and are subsequently siphoned off through the use of these informal transfer systems. The Pakistani ruling governments are unwilling to take action to introduce fundamental taxation reforms as most of the elected politicians do not themselves pay income tax, yet Pakistan continues to receive financial assistance from the international community. Whilst these factors emphasize why regulatory reforms in Pakistan are necessary, it has also raised questions about the role of international donors who have not used their substantial influence to push the Pakistani elite for essential reforms; instead they continue to finance the country with the money their citizens pay in taxes. The question remains: if the Pakistani elite are unwilling to take action to introduce taxation reforms, increase revenues and improve services for the poor, will the international community use its influence to push for the essential reforms required? So far, the role of the international donors has remained elusive in regard to the required essential reforms.

It has also been argued that *hawala* prevails in today's globalized world due to the disparities and irregularities in international trade and finance. Large sections of the world operate 'under the radar' and as a result financing of transnational transit trade by the *hawala* networks which are facilitated by migrant workers in major labour importing countries such as, UAE and Saudi Arabia is just one example of *hawala*'s integration into the global financial edifice. We have argued that *hawala* is being used as a logical business solution and reaction to repressive and restrictive government policies and so, even though a view may be taken that with strict regulatory frameworks and effective law enforcement the source countries can deal with terrorism financing and other financial crimes, one can argue that *hawala* will continue to prevail as long as disparities in government polices and

regulatory loopholes exist making *hawala* the most cost effective and efficient option for its customers.

The problem with the current international approach is that it views IVTS through the prism of the formal financial systems. The international regulatory community tends to ignore that fact that despite being similar to the western banking, *hawala* is a distinct fund transfer system that needs to be viewed on its own merits. Unfortunately, the focus of FATF's *hawala* regulatory efforts has remained on 'converting' or 'transforming' *hawala* into bank-like structures, without appreciating that attempts to deprive these networks of their distinct identity by way of regulation have not been successful and regulation has largely failed in countries where it is most required. One such example is Pakistan where the licensing and registration regulation through the creation of exchange companies has been counter-productive on mainly three accounts. Firstly, it has increased the cost of the *hawala* operations because the creation of exchange companies entailed an initial capital requirement which was a costly venture against the minimal overheads of *hawala*. Secondly, the weak Pakistani state does not have the institutional capacity for enforcement of the regulation. Lastly, since the regulation did not consider the social fabric and cultural realities of Pakistan, particularly in the tribal areas where *hawala* is engrained in the cultural traditions, the regulatory efforts have been taken by the local population as an authoritarian attack on the traditional practices rather than a serious attempt at reform.

The apparent failure of the regulation in Pakistan (and elsewhere) has raised many questions about FATF's approach to IVTS regulation. FATF wants *hawala* to comply with the reporting and compliance standards applicable to banking and other formal structures. The thesis has questioned whether such an approach is realistic and if so, can a country like Pakistan comply with these standards, in spirit, when *hawala*-type transfers are essentially outlawed in its jurisdiction. As an example of the impracticable implementation of the regulations, the thesis has argued that over the years FATF transparency and compliance standards have remained far from successful even for banking institutions for which these were originally designed. As a result, many leading banks have incurred millions of dollars of fines for non-compliance with FATF's AML/CFT standards.



Based on the discussion in the thesis, financial policy makers need to be clear regarding the objective of regulating *hawala*-type systems. In Pakistan's case the vast bulk of funds which are transferred through the *hawala* channels comprise migrant remittances which are facilitated and channelled to the unbanked and underserved populations who have no easy access to formal financial facilities. On the other hand, *hawala* is also facilitating the transfer of funds generated from fiscal offences such as corruption and tax-evasion as well as criminal offences. This means that Pakistan essentially requires a *hawala* regulatory strategy that takes into account the 'dual function' of IVTS in its economy. This 'dual function' of *hawala* is evidently the critical policy factor from Pakistan's perspective. Pakistan would not want *hawala* to stop because it is essentially filling a critical gap by providing easy access to finance to the many poor and the underprivileged. At the same time, the impact of illicit financial flows (proceeds of corruption, tax evasion and smuggling through transit trade, and across borders to Afghanistan and Dubai) needs to be prevented.

In view of Pakistan's peculiar policy concerns discussed in the thesis, it is argued that for Pakistan, a single track *hawala* regulatory strategy may not be sufficient, because of its peculiar geo political situation, administrative and institutional issues. Instead, a multi-track strategy is required that involves coordination between the various government agencies at different levels as well as international cooperation. This would be a challenging task, given that the Pakistani state is weak and failing (corruption is prevalent, laws are over-ridden, and vested interests are deep rooted). We take the view that the Pakistani state lacks the capacity required to undertake multifarious regulatory responsibilities that would result from the adoption of a multi-track strategy. The international community could have played a significant role by pushing the successive governments to take action for essential reforms, such as improving tax collection or reducing corruption but, as discussed, the international donors mainly the United States and the IMF have so far remained elusive to requisite reforms and have, in this manner, supported the status quo. A most recent example where, despite international involvement, reforms have not worked is that of the United States' facilitation in improving Pakistan-Afghanistan transit trade procedures and control to prevent smuggling but where no real

success has been achieved. We argue that reforms in the sense of improving systems is perhaps a very tall order due to Pakistan's peculiar economic, political and cultural realities as well as the other geo-political dynamics discussed in the thesis.

In these circumstances, Pakistan should rethink its approach to *hawala* regulation for the following reasons:

i) It is by now clear that the western banks cannot overcome or disincentivize *hawala*. The SBP has introduced many financial products and incentives through the Pakistani banks. The latest of these incentives, the 'Pakistan Remittance Initiative', has also failed to eliminate *hawala* or reduce its impact. *Hawala* still prevails in Pakistan as the most popular choice.

ii) Western regulatory models may not work in Pakistan due to its peculiar geo-political, economic and cultural circumstances. Moreover these regulatory models are essentially devised for formal institutions as the modern western thinking is not familiar with informal financial instruments that are based on personalized values. Hence, 'trust-based' systems — carrying out financial transactions in the absence of conventional documentation, guarantees, insurances and third party interventions — are unusual for the western policy makers. For them, trust is a value more suited to personal relationships and interactions rather than to the performance of financial exchange functions, for which the western modernization has devised specialized banking institutions. On the other hand, the geographical and cultural realities of Pakistan, where informal institutions and practices are prevalent, are different. Hence Pakistan should give credence to its 'peculiar' circumstances in devising regulatory policies.

iii) There is nothing inherently wrong with IVTS. *Hawala* is essentially an instrument of trade financing and exchange of goods and services much in the same manner that banking is. In this way, it can be used as an instrument of essential public service and simultaneously is vulnerable to abuse in similar manner as banks are. The view that the informality of *hawala* increases its vulnerability to abuse is misled and requires review.

iv) If Pakistan can operate two parallel banking systems —western and Islamic banking— simultaneously, then why can't *hawala*, which is similar to the Islamic banking in the sense

that it keeps a close link with the real economy, operate legally as a parallel financial instrument?

v) Last but not least, the objective of *hawala* regulation should be to stop or reduce the criminal use of IVTS and not simply adopt formalism and legalism for the sake of ‘window dressing’ in order to impress the international community while *hawala* continues unabated in an unregulated environment. As suggested by experts,<sup>608</sup> *hawala* regulatory strategy can be based on flexibility and creative thinking. We argue that Pakistan can devise regulation in consideration of its ground realities instead of implementation of FATF’s impossible to adopt regulation.

Based on the above discussion, we are basically arguing a case for a ‘soft approach’ to *hawala*-type IVTS in Pakistan instead of completely declaring these systems outlawed. It is the ‘if you can’t beat them, join them’ approach that the Pakistan government requires in order to gain optimum benefits of *hawala* and at the same time regulate these systems to prevent or reduce their abuse. On the basis of the fieldwork findings of this research, it is recommended that a regulatory approach based on two key elements may achieve the objective of effective *hawala* regulation in Pakistan:

i) **Incentives for *Hawaladars*:** So far, Pakistan’s *hawala* regulatory approach has remained focused on providing incentives to the formal banking sector. The various initiatives that the SBP has taken over the years to regulate the informal sector have focused on providing benefits or incentives to the commercial banks to channel more and more funds. This approach has evidently ignored the majority of Pakistan’s population which has no access to the formal banking channels and is catered for by *hawaladars* in the informal sector. Simultaneously, whilst the *hawaladars* are important stakeholders in the financial network operations in Pakistan, they remain excluded from the system because in the eyes of the law they do not exist. Although in 2002 the SBP (through the licensing and registration regulation) has attempted to bring the *hawaladars* into the legal and regulatory net SBP’s otherwise well-intentioned efforts failed because the reforms did not provide

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<sup>608</sup> Maimbo, ‘Regulation and Supervision of Informal Remittance Systems’, above n 97,10; Passas, ‘Formalizing the Informal?’, above n 94, 411.

enough incentives to the *hawaladars* to become registered with and licensed by the government.

It is clear that if regulation increases the costs of the *hawala* operations, it will never work. The *hawaladars* require an incentive that provides them legal cover while not increasing the cost of their operations. The government/SBP needs to consider such an incentive for the *hawaladars* to operate legally. This may include policies that entail negligible initial costs or tax exemptions or alternatively accept *hawala* as a parallel trade financing instrument based on its own settlement procedures and other built-in mechanisms as regulatory standards.

**ii) Community Participation:** A key element of the Pakistan government *hawala* regulatory strategy should focus on involving the *hawaladar* community. We know that *hawala* are community based networks and hence it is reasonable to believe that the *hawaladars* not only personally know each other but are also protective of each other's interests, particularly if they believe that the objective of the regulation is detrimental to their collective business interests. In this connection, the Exchange Companies Association in Karachi and the *Saraf* Association in Peshawar (and also Quetta) markets can play important bridging roles between the *hawaladar* community and the government. Such approach will generate positive feelings in the community regarding the objective of the regulation as beneficial to them and to the country's interests. At the same time, such an approach will enable the law enforcement agencies to separate and identify the criminal elements in the market with the help of the community, through a more inclusive 'follow the *hawaladar*' as opposed to the 'follow the money'<sup>609</sup> approach.

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<sup>609</sup> Peter Shields, 'Finance Warfare, Surveillance and Collateral Damage' (2004)16(3) *Peace Review: A Journal of Social Justice*357, 358.

## 8.2 Recommendations

Based on the findings and conclusions of this research, the specific recommendations for *hawala* regulation in Pakistan are as follows:

1. Pakistan's *hawala* regulatory policy needs to be devised keeping in view its geographical, economic and cultural realities as well as *hawala*'s relative operational efficiency compared with the formal banking institutions.
2. The government/ SBP should consider legalizing *hawala*.
3. The government/SBP should consider exploring regulatory mechanisms that allow incentives to the *hawaladars*, as follows:
  - i) Negligible initial costs to legalize their businesses.
  - ii) Tax exemptions.
  - iii) Accepting *hawala* as an alternative financial instrument based on its own settlement procedures and other built-in mechanisms as regulatory standards.
4. Representatives from the *hawaladar* community should be involved in the regulatory process. The Exchange Companies and the *Saraf* Associations can play a role to bridge the gap between the *hawaladars* and the government and convince the *hawaladars* to cooperate with the law enforcement agencies in identifying the criminal elements in the market. In this manner, a more inclusive, 'follow the *hawaladar*' regulatory strategy can emerge.

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## **2. CONVENTIONS**

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## **3. TREATY**

*International Covenant on Civil and Political Rights*, opened for signature 16 December 1966, 999 UNTS 171 and 1057 UNTS 407 (entered into force 23 March 1976, in accordance with article 49, for all provisions except those of article 41 ; 28 March 1979 for the provisions of article 41)



#### **4. LEGISLATION**

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## **Appendix A:**

## **List of Interviewees**

### **Group 1: Governance**

1. Official of the State Bank of Pakistan (G-SBP01)
2. Official of the State Bank of Pakistan (G-SBP02)
3. Representative of the Forex Association of Pakistan (G-FAP01)
4. Representative of the Forex Association of Pakistan (G-FAP02)
5. Official of the Federal Investigation Agency in Karachi (G-FIA01)
6. Official of the Federal Investigation Agency in Peshawar (G-FIA02)
7. Official of the Federal Ministry of Trade and Commerce (G-MCT01)
8. Senior Official of the Federal Board of Revenue (G-FBR.01)
9. Official of Pakistan Customs Service (G-PCS 01)

### **Group 2: Hawaladars**

1. Hawaladar in Peshawar (G-H01)
2. Hawaladar in Peshawar (G-H02)

### **Group 3: Other Businesses**

1. Exchange Company owner in Karachi (G-OB01)
2. Banker in Peshawar (G-OB03)

### **Group 4: Customers**

1. Migrant Worker from a village in Punjab province (G-C01)
2. Migrant Workers' Family from Peshawar (G-C02)
3. Importer from Karachi (G-C03)
4. Exporter in Peshawar (G-C04)

**1. Questions for Financial Regulators and Policy makers**

- What was foreign exchange market structure before 2002 when State Bank of Pakistan introduced foreign exchange market reforms?
- How do you see the 2002 foreign exchange market reforms introduced by the SBP in retrospect? Have these reforms been successful in eliminating the kerb and the unreported remittance transfers, unify the markets and create sufficient financial deepening as envisioned by SBP? If no, why? If yes, how so?
- What is the “lure of kerb” in Pakistan’s foreign exchange market?
- When replacing traditional money changers with exchange companies, what were the assumptions of State Bank of Pakistan regarding the change to occur on an operational level? How far has this change occurred?
- Were aspects of informal transfer systems that make it a source of public service to the poor and the deprived considered by the State Bank?
- Why were some policies implemented in 2002 relaxed by the State Bank later on? Was there a back-lash or revolt from the market?
- What are the loop-holes in the present regulatory structure governing foreign exchange and remittance transfers in Pakistan and how are they being addressed?
- Are the laws and regulations governing foreign exchange and remittance transfers sufficient to prosecute miscreants in the formal remittance business?
- Other than weak legal and regulatory structure, what practical challenges do you see for financial regulators in the Pakistani foreign exchange market?
- What steps are being taken to address regulatory challenges for financial regulation Pakistan is facing as a result of its international obligations through agreements such as Pak-Afghan Transit Trade Agreement?

## **2. Questions for Financial Investigators and Prosecutors**

- Are the laws and regulations governing foreign exchange and remittance transfers sufficient to investigate miscreants in the formal remittance business?
- Other than weak legal and regulatory structure, what practical challenges do you see for financial investigators in the Pakistani foreign exchange market?
- What steps are being taken to address regulatory challenges for financial regulation Pakistan is facing as a result of its international obligations through agreements such as Pak-Afghan Transit Trade Agreement?
- What capacity building is required for better financial investigation in Pakistan?

## **3. Questions for Bankers and Foreign Exchange Dealers.**

- What is the structure of Pakistan's foreign exchange remittance market? Who are the key players and what roles and influences can be observed in overall market operations?
- What, in your view, should be done to eliminate the "kerb" in the foreign exchange market?
- Has the State Bank's decision to replace traditional money changers with exchange companies in 2002 been successful in introducing a corporate culture and unification of markets in the forex business. Has it created sufficient financial deepening as envisioned in the reforms package?
- What practical and operational changes have occurred in forex business since 2002?
- Is the present regulatory structure impractical in view of the market operations? If yes, why was the market in favour of these reforms? Was the market taken on-board with the decision? Was the market divided in support of these reforms? Was there a back-lash from the market?
- What are the operational difficulties faced by the "formal" remittance sector?

- What are the practical and operational differences between formal and informal remittance transfers in Pakistan? PI focus on costs, speed, convenience?
- What is the level of competition between the formal and the informal remittance markets and, why or why not?
- Do social relations, links and trust between various market players work to achieve profitable transactions?
- Do social norms influence the market dynamics? How?
- Are ethnic, community, family and cultural ties important in market/business decision-making? How?
- Is it true that customers prefer informal remittance systems because the formal procedures are cumbersome, always changing and bureaucratic?
- Does poverty and lack of education affect customers' choice for formal remittance systems?

#### **4. Questions for *Hawaladars*.**

- What are the practical and operational differences between formal and informal remittance transfers in Pakistan? PI focus on costs, speed, convenience?
- What is the level of competition between the formal and the informal remittance markets and, why or why not?
- Do social relations, links and trust between various market players work to achieve profitable transactions?
- Do social norms influence the market dynamics? How?
- Are ethnic, community, family and cultural ties important in market/business decision-making? How?
- Is it true that customers prefer informal remittance systems because the formal procedures are cumbersome, always changing and bureaucratic?



- Does poverty and lack of education affect customers' choice for formal remittance systems?

## 5. Questions for *Hawala* Customers

### **a) Migrant Workers, their Families.**

- Are “formal” financial facilities available in your home town, village or area? If yes, do you use these, if they are available and you don't use them, why?
- Are you a frequent sender or receiver of foreign remittances? If yes, what remittance transfer method do you prefer and why?
- Other than cost efficiency, what are the factors that may affect your choice?
- Do social relations, ethnic or linguistic ties with remittance service providers play a role in determining your choice? If yes, do you get discounts or bargains in transactions because of these relationships?
- Do you “trust” formal institutions during financial transactions? If yes, why? If no, would you like to explain your reasons for distrust?
- Do you think that customers prefer informal remittance transfer systems or cash payment because the formal procedures are cumbersome, always changing, and bureaucratic?
- Does poverty and lack of education affect customers' choice for formal systems and procedures?

### **b) Businessmen, Importers, Exporters**

- Are you a frequent buyer or seller of foreign exchange? If yes, do you prefer open market rates or inter-bank rates? Why?
- Do social relations, ethnic or linguistic ties with foreign exchange dealers play a role in determining your choice? If yes, do you get discounts or bargains in transactions because of these relationships?
- Do you “trust” formal institutions during financial transactions? If yes, why? If no, would you like to explain your reasons for distrust?

**c) Parents of Students Studying Abroad, Travellers.**

- Are you a frequent buyer of foreign exchange or sender of foreign remittances? If yes, what remittance transfer method do you prefer and why?
- Other than cost efficiency, what are the factors that may affect your choice?
- Do social relations, ethnic or linguistic ties with money changers and remittance service providers play a role in determining your choice? If yes, do you get discounts or bargains in transactions because of these relationships?
- Do you “trust” formal institutions during financial transactions? If yes, why? If no, would you like to explain your reasons for distrust?
- Do you think that customers prefer informal remittance transfer systems or cash payment because the formal procedures are cumbersome, always changing, and bureaucratic?

### Appendix C: Summary of Interviews

My Key Words	Interview Key Word	Interviewee	Responses	Argument	Economic	Political	Social	Legal
1. Structure	Structure	G-SBP -01	Banks, forex comp & Hawala	SBP side-lined/reduced Hawala since 2002;				L
Clients	Reforms' Success	G-SBP-02	Pak. Remittance Initiative's success	corporatized market, Involved banks	E			
Key Players	Operational Change		Money Exchange Companies replaced money changers	Create a self-regulatory corporate culture; introduced formality				L
Type of Business	Hawala's public service		Hawala helped poor & unbanked populations	Hawala is filling the void left by the commercial banks				L
Size (customer /annum)	policies relaxed		Successful transition; no market revolt; SBP has disturbed the status-quo	SBP has to keep all stakeholders on board				L
Volume (US\$/day)	laws & policies		FERA is a self-contained law; SBP keeps updating policies	Policies are updated in view of the market situation				L
	Efficiency		Hawala rates are better than banks and kerb	Hawala's rates are a issue of supply/demand, filling void left by banks	E			
2. Market Operations	Structure	G-FAP-01	banks, forex companies	ECs have taken hawala in their fold				L
How do MECs get US\$?	Key Players	G-FAP-02	banks, forex companies, some people are doing hawala	Hawala is still going on				L
	Roles		formal vs Illegal; forex companies not involved in hawala	some people are still doing hawala				L
3. Regulatory Issues	Influences		if any forex company is involved then it is reported to SBP	clandestine dealings in currencies (is going on)				L
Shadow Economy	Regulatory Issues		liaison required between SBP & FBR;	Monitoring is required				L
Tax Evasion			documentation of the economy; corruption control measures are required	There are issues in hawala regulation				L
Corruption			improve tax collection					
Laws (FCR)	Efficiency		hawala can never be stopped because it is very efficient	Funds generated in the informal sector will need a channel	E			
Institutions (FIA)								
Smuggling (ATT)	Laws	G-FIA -01	Two complainants are required to register a	Law is the main challenge in				L

			case under FERA; FERA is an out-dated	enforcement				
	Enforcement Issues	G-FIA-02	law; FERA protects miscreants .The arrested hawaladar is					
			bailed in 1 day; immediately back in business;					
4. Hawala Enablers			becomes a threat to law-enforcement, PECO lapsed;	No cyber crime law since 2010				L
Trust			FATA; cross border movement; Afghan nationals	tribal links with Afghanistan; Transit Trade		P	S	L
Networks								
Family Connections	Market Players		Memon-Gujrati; Pushtun&Afghan	ethnic, linguistic ties; groups spread internationally through migration & resettlement				
	Market Structure		A &B category forex companies;Peshawar ChowkYadgar market is largest hawala facility	A category MEC owners control themarket				L
			in Asia;400 shops,4 registered	B category MECsdo hawala; networks in Dubai	E			L
5. Hawala Efficiency				Peshawar market caters ATT, migrants	E			L
Rates								
Speed	Market operation		MEC franchises are all over Pakistan and international					
lack of documentation			Big businessmen deplete dollars, create artificial demand.					
Regulations/Sanctions			MECs have sister concerns in Dubai. Foreign exchange is available on cash and credit; <i>Chamak</i> is the rate of exchange		E	P	S	L
	Efficiency							
	Market Volume/day		Peshawar market \$10-12 million daily					L
	Afghan Transit Trade	G-MCT-01	Revisedtransit trade agreement since 2010. Afghan trucks will carry cargo	stringent regulations to curb smuggling and dumping				

	Smuggling		to Khi. Pakistani trucks to Central Asia.					
			Tracking devices on trucks; financial guarantees					L
					E			L
	Afghan Transit Trade	G-FBR -01	Total ATT trucks missing during 2009-11 were 28,802; only 560 could be traced.	ATT is the cause of 75 per cent smuggling in Pakistan	E			L
	Smuggling		Loss to govt. PKR 50 billion.	Recommendations are to bring down duties; valuate goods, restrict quantities				
				Afghan importers to open LCs with localAfghan banks				L
	border crossing	G-PCS-01	100 containers cross-over daily.	People are border crossing without documents				L
			20-50000 people cross border daily , only5 per cent have documents.					L
			ATT trucks re-routed through FATA					L
	Market Operation	G-OB-01	30 MECs,15000 hawala operators	hawala still operational				L
	Market Volume/day	G-OB-02	non-dollar currency exportedto Dubai; US\$ brought in officially	physical transfer of foreign exchange				L
			No cash US\$ import anymore, transfer through banks.	Foreign exchange transfer into Pakistani bank accounts				L
	Challenges		kerb turn-over 5-6 million daily	size of black market not known				L
	Efficiency		hawala rates are better. Hawala caters to the undocumented economy, both domestic and international. Examples of the kind of funds transferredare: migrant workers' extra income, expat businessman's untaxed income, foreign exchange acquired by resident citizens.	economic advantage of hawala	E			
				People buy US\$ and keep inprivate lockers , travelers bring in foreign exchange everyday	E			L
	Regulations		Restrictive policies are responsible for hawala. For example, ban on gold import or that the	formal sector is offering same efficiency	E			

		MECs cannot do trade treaty.					
Size		MEC clients one million/annum	formality vs informality				L
Different Dynamics		MEC report and document transactions. They are legal entities. MECs deposit extra US\$ in the inter-bank.	formal is strong if there is liquidity	E			
Networks		competition b/w formal & informal depends on liquidity in the market. without trust & networks market cannot function	trust relations and networks are important in foreign exchange	E		S	L
Efficiency	G-H-01	better rates than formal, quickest transfer anywhere internationally, within half hr; advance	More efficient than formal	E			L
	G-H-02	payment settled later, rate margin 0.10-0.30					
Networks		agents in major financial centers; cultural ties	transnational networks		P	S	
		business concentration					
Clients		Migrants, Importers, businessmen	caters to a variety of clients	E			
Comparison Formal		trader loaned 100 million on promise to return in 10 days.	hawala is simple and uncomplicated, no documents	E			L
		Hawala caters to uneducated, non-english speaking customers in foreign countries.					
Trust		KNC, no cheating, no delay	KYC mechanism inbuilt	E			L
Regulation		tribal elders resolve disputes	dispute resolution mechanism	E			L
law enforcement		harrasment by agencies; money is confiscated	law enforcement detrimental to market				L
Formal market	G-C-01	formal facilities not available in village, remittances are received either through the	hawala is filling the void	E			
	G-C-02	hawaladar or the postman					
Efficiency of hawala	G-C-03	On the spot receipt; home delivery, minimal documentation	hawala is simple and uncomplicated	E			
hawala vs banks	G-C-04	banks require at least one week, procedures	hawala is simple and	E			

		are cumbersome , bureaucratic and always changing.	uncomplicated				
hawala trade financing		forex bought to clear import bills; available on cash and credit	trust relationships play a role in trade financing			S	
		Rate for foreign exchange on credit is more; trust relationships	access to credit based on personal relations				
		Foreign exporters demand hawala mode of payment; government regulations and traderoutes matter such as payments for Iran and Afghanistan are done in Dubai.	hawala becomes business logic	E	P		L

### Appendix D: Detailed Statistical Tabulation of Results

Interviewee Groups	Groups	Interviewee ID	Hawala Market														Regulatory Issues							
			Structure	Key Players	Key Role	Influences	Enforcement Issues	Laws & Policies	Efficiency	Operations	CI_Businessmen	CI_Importers/Exporters	CI_Migrant Workers	CI_Expat Pakistanis	Other Travellers	Trust & Networks	Reform Success	Market Change	Afghan Transit Trade	Shadow Economy	Corruption	Smuggling	Border Crossing	Institutions
Governance	Exchange companies Association of Pakistan	G.FAP.01	1	1	1	0	0	1	0	0	0	0	0	0	0	0	1	1	0	0	0	0	0	0
		G.FAP.02	1	1	1	1	0	1	1	0	0	0	0	0	0	0	1	1	0	0	0	0	0	0
	State Bank of Pakistan	G.SPB.01	1	0	0	0	0	1	1	0	0	0	0	0	0	0	1	1	0	0	0	0	0	0
		G.SPB.02	1	1	0	0	0	1	0	0	0	0	0	0	0	0	1	1	0	0	0	0	0	0
	Federal Investigation Agency	G.FIA.01	1	1	1	1	1	1	1	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
		G.FIA.02	1	0	1	1	1	1	1	0	0	0	0	0	0	0	0	0	1	0	0	0	0	0
	Pakistan Customs Service	G.PCS.01	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1	0	0	0	1	0
	Federal Board of Revenue	G.FBR.01	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1	0	0	1	0	0
Ministry of Commerce and Trade	G.MCT.01	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1	0	0	1	0	0	
Other Business	Exchange Companies/banks	G.OB.01	1	1	1	1	0	0	1	1	1	1	1	1	1	1	1	1	0	1	1	0	0	1
		G.OB.02	1	1	1	1	0	0	1	1	1	1	1	1	1	1	1	1	0	1	1	0	0	1
HawalaDar	Unspecified	G-H.01	1	1	1	1	1	1	1	1	1	1	1	0	0	1	1	0	1	0	1	1	0	1
		G-H.02	1	1	0	0	1	0	1	1	1	1	1	1	1	1	0	0	1	0	1	0	0	0
Clients	Migrant Workers	G-C.01	1	0	0	0	0	0	1	0	0	0	0	0	0	1	0	0	0	0	0	0	0	0



	Family of Migrant Workers	G-C.02	1	0	0	0	0	0	1	0	0	0	0	0	0	0	1	0	0	0	0	0	0	0
	Importers	G-C.03	1	1	0	0	0	1	1	0	0	0	0	0	0	0	0	0	1	0	1	0	0	0
	Exporters	G-C.04	1	1	0	0	0	1	1	0	0	0	0	0	0	0	0	0	1	0	1	0	0	0

**Appendix D: Detailed Statistical Tabulation of Results (%)**

Interviewee Groups	Groups	Interviewee ID	Hawala Market														Regulatory Issues								
			Structure	Key Players	Key Role	Influences	Enforcement Issues	Laws & Policies	Efficiency	Operations	CI_Business men	CI_Importers /Exporters	CI_Migrant Workers	CI_Expat Pakistanis	Other Travellers	Trust & Networks	Reform Success	Market Change	Afghan Transit Trade	Shadow Economy	Corruption	Smuggling	Border Crossing	Institutions	
Governance	Exchange companies Association of Pakistan	G.FAP.01	0.79%	0.79%	0.79%	0.00%	0.00%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	
		G.FAP.02	0.79%	0.79%	0.79%	0.79%	0.00%	0.79%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
	State Bank of Pakistan	G.SPB.01	0.79%	0.00%	0.00%	0.00%	0.00%	0.79%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
		G.SPB.02	0.79%	0.79%	0.00%	0.00%	0.00%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
	Federal Investigation Agency	G.FIA.01	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
		G.FIA.02	0.79%	0.00%	0.79%	0.79%	0.79%	0.79%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%
	Pakistan Customs Service	G.PCS.01	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.00%	0.00%	0.00%	0.79%	0.00%
	Federal Board of Revenue	G.FBR.01	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.00%	0.00%	0.79%	0.00%	0.00%
Minsitry of Commerce and Trade	G.MCT.01	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.00%	0.00%	0.79%	0.00%	0.00%	
Other	Exchange	G-OB.01	0.79%	0.79%	0.79%	0.79%	0.00%	0.00%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.00%	0.79%	0.79%	0.00%	0.00%	0.79%

Business	Companies		%	%	%	%	%	%	%	%	%	%	%	%	%	%	%	9%	%	%	%	%	%	9%	
		G-OB.02	0.79%	0.79%	0.79%	0.79%	0.00%	0.00%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.00%	0.00%	0.79%	0.79%	0.00%	0.00%
Hawala Dar	Unspecified	G-H.01	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.00%	0.00%	0.79%	0.79%	0.00%	0.79%	0.00%	0.79%	0.79%	0.00%	0.00%	0.79%
		G-H.02	0.79%	0.79%	0.00%	0.00%	0.79%	0.00%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.79%	0.00%	0.00%	0.79%	0.00%	0.79%	0.00%	0.00%	0.00%
Clients	Migrant Workers	G-C.01	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
	Family of Migrant Workers	G-C.02	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
	Importers	G-C.03	0.79%	0.79%	0.00%	0.00%	0.00%	0.79%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.00%	0.79%	0.00%	0.00%	0.00%	0.00%
	Exporters	G-C.04	0.79%	0.79%	0.00%	0.00%	0.00%	0.79%	0.79%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.79%	0.00%	0.79%	0.00%	0.00%	0.00%	0.00%

<b>HAWALA MARKET</b>	<b>76.98%</b>
<b>REGULATORY ISSUES</b>	<b>23.02%</b>

**Appendix D:Detailed Statistical Tabulation of Results (% contd.)**

Interviewee Groups	Hawala Market															Regulatory Issues						
	Structure	Key Players	Key Role	Influences	Enforcement Issues	Laws & Policies	Efficiency	Operations	CI_Businessmen	CI_Importers/Exporters	CI_Migrant Workers	CI_Expat Pakistanis	Other Travellers	Trust & Networks	Reform Success	Market Change	Afghan Transit Trade	Shadow Economy	Corruption	Smuggling	Border Crossing	Institutions
GOVERNANCE	4.76%	3.17%	3.17%	2.38%	1.59%	4.76%	3.17%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	3.17%	3.17%	3.17%	0.00%	0.00%	1.59%	0.79%	0.00%
OTHER BUSINESS	1.59%	1.59%	1.59%	1.59%	0.00%	0.00%	1.59%	1.59%	1.59%	1.59%	1.59%	1.59%	1.59%	1.59%	1.59%	1.59%	0.00%	1.59%	1.59%	0.00%	0.00%	1.59%
HAWALADARS	1.59%	1.59%	0.79%	0.79%	1.59%	0.79%	1.59%	1.59%	1.59%	1.59%	1.59%	0.79%	0.79%	1.59%	0.79%	0.00%	1.59%	0.00%	1.59%	0.79%	0.00%	0.79%
CLIENTS	3.17%	1.59%	0.00%	0.00%	0.00%	1.59%	3.17%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	1.59%	0.00%	0.00%	1.59%	0.00%	1.59%	0.00%	0.00%	0.00%

