

Report on Monitoring the Pricing and Broader Developments in Informal FX Markets



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1. INTRODUCTION

- 1.1. State Bank of Pakistan (SBP) aims to maintain domestic price stability and contribute to financial system's stability, while it also supports government policies for fostering development and better utilization of Pakistan's resources. To achieve these objectives, SBP performs various functions including formulation and implementation of an effective exchange rate policy. However, the activities of informal markets can destabilize formal economy, leading to loss of government revenue, distortion in market prices and undermine the effective transmission of monetary policy decisions.
- 1.2. Informal foreign currency market and other allied informal markets, may have developed due to factors like tax increases, price disparities, geographical developments, high unemployment, lack of consumer awareness, weaknesses in law enforcement, etc. These informal markets generally cater to the consumers who want to move illicit funds out of the country, desiring to make undocumented transactions, or deriving benefit from incentives provided by such markets such as efficiency, low cost, and anonymity.

2. OBJECTIVE

This report aims to identify informal FX markets operating in Pakistan and the underlying reasons for their emergence in order to understand their effects on the formal markets and the country's economy. The results of this study may be used to monitor the pricing and broader developments in the informal FX markets, identify major factors that contribute to the abnormal changes in these markets and provide input to the relevant authorities for initiation of actions on timely basis.

3. METHODOLOGY

This document has attempted to determine the root causes for the development of informal FX markets in Pakistan by analyzing its macro-economic situation, level of financial crimes, Pakistan's geographic position and other relevant factors. With respect to market functioning and level of activity, it is needed to assess the players involved, sources of inflows and outflows, and relevant geographic markers. Efforts were also made to determine the factors which may indicate an elevated activity in the informal markets. Lastly, prices of the commodities in informal markets may be identified and compared to that prevailing in formal markets.

To understand the significance of informal FX markets, international and domestic reports have been used extensively. To monitor prices in the informal markets, prices were obtained from various social media platforms such as Facebook and WhatsApp where players of the informal markets advertise their products. Further, mystery shopping was also carried out in order to assess prices of commodities in informal markets.

4. DATA LIMITATIONS

Since the informal markets are not part of documented economy, availability of relevant and reliable data for the purpose of analysis was nonexistent.

5. DEVELOPMENT OF INFORMAL MARKETS IN PAKISTAN

- 5.1. The imbalances in foreign currency inflows and outflows over the years have resulted in persistent external account deficits. This implies a significant imbalance between the inflows of foreign currency from sources such as exports, workers' remittances, foreign direct investment etc. and the outflows for imports, external debt repayments, and other non-commercial foreign currency requirements.

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- 5.2. While policy measures on part of SBP have played an important role in conserving foreign exchange reserves of the country, the demand of foreign exchange for illegal purposes like payment for smuggled goods or transfer of illegal funds, generated through various means, has created alternatives that led to the creation of informal markets.
- 5.3. Though, Pakistan's unique geographical position serves as a vital hub for trade and commerce activities; however, it also poses challenges. The rugged and porous borders can be exploited for illegal transportation of goods, currencies and other commodities. The offence of smuggling is lured by illegal profiting from purchasing less expensive commodities from one country and by selling it in other countries, including Pakistan at a higher price.

6. INDICATORS REFLECTING ELEVATED ACTIVITY IN INFORMAL FX MARKETS

Based on this assessment, some indicators have been identified which reflect the increased demand for foreign currencies in the informal FX markets.

High Premium in informal markets and consequent decline in workers' Remittances

- 6.1. The premium in informal currency market when consistently elevated above trend level is considered to represent the elevated operations of the Hawala market and currency smuggling. A high premium discourages the transfer of inward workers remittances via formal channels as overseas Pakistanis/remitters can get better rates for their remittances from the informal markets.

Gap in the Open Market Exchange Rates of Pakistan and neighboring Countries

- 6.2. One of the neighboring country has been facing balance of payment challenges, which was further aggravated by a devastating earthquake. Due to growing demand for USD in that country, a gap developed between the open market USD/PKR exchange rates in Pakistan and in that country provided an opportunity for currency smugglers to profit from the arbitrage. The increased rate difference between the two countries led to an increased level of currency smuggling.

Transit Trade

- 6.3. Under the transit trade regime, a neighboring country exports far less than what it imports. In the absence of external funding, the probability of using other avenues to fund the deficit and pay for the country's import bill have increased, with repercussions for the external account position of Pakistan.

Fluctuating Gold Prices

- 6.4. Higher international prices and their transmission to domestic gold prices could indicate lower domestic demand for gold and a decrease in gold smuggling. On the contrary, lower international prices would indicate an increasing domestic demand for gold and rising levels of gold smuggling.

Role of Pricing in the Oil Smuggling

- 6.5. The difference in prices of petroleum products (petrol and diesel) in another neighboring country and Pakistan offers a significant opportunity for smugglers and dealers / sellers of petroleum products to illegally profit from the price differential.

7. MONITORING OF PRICING IN THE INFORMAL MARKETS

Pricing in the Hawala Market

- 7.1. In Pakistan, Hawala business is illegal, and law enforcement agencies have carried out repeated crackdowns against operators of such businesses. As a result, Hawala dealers do not openly operate or disclose their daily currency rates. However, some hawaladars/dealers remain active on social

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media platforms like Facebook, WhatsApp, Telegram, etc. to offer their services. Information obtained, using mystery shopping techniques, have revealed that such dealers quote USD rates that are much higher than the open market rates. Further, the rates vary from dealer to dealer though they often have room for negotiations.

Pricing incentivized Currency Smuggling

- 7.2. Considering the significant impact of foreign currency smuggling, it is imperative to monitor the exchange rates applicable in the major currency exchange markets of neighboring countries. The exchange rates in these countries are quoted by the money changers' associations, banks or the central bank. Apart from formally quoted rates, various groups quote rates for the exchange of USD on social media groups as well.

Pricing in the Oil Smuggling

- 7.3. The rates of smuggled oil, collected through mystery shopping and other sources, revealed that the difference in prices of petroleum products (Petrol and Diesel) in a neighboring country and Pakistan is significant which provides a substantial profit-making incentive to oil smugglers. The international petroleum prices could be monitored through web sources such as www.globalpetrolprices.com, while the rates of smuggled petroleum products may be monitored through frequent mystery shopping as well as by closely monitoring the subsidized rates of petrol / diesel applicable in the neighboring country.

The Gold Smuggling

- 7.4. Like Hawala dealers, illegal gold dealers also market their products extensively via social media. However, exact rates are very seldom quoted by such dealers. The domestic official price is easily available on various websites such as forex.pk. Similarly, international gold price is also available through web sources such as www.metalsdaily.com and goldprice.org.

8. RECENT ACTIONS TO CURB THE INFORMAL FX MARKETS IN PAKISTAN

Policy and Supervisory Actions

- 8.1. SBP has recently taken various policy and regulatory measures on transactions conducted by Exchange Companies (ECs) such as introduction of biometric verification and enhanced documentation for transactions. SBP has also instructed authorized dealers to halt payments to unauthorized international electronic FX trading platforms. In terms of supervision, SBP has increased its oversight on operations of ECs and expanded enforcement actions to include administrative and restrictive measures.

Reforms in the ECs Sector

- 8.2. Exchange companies sector is being consolidated to form better governed, financially sound and well regulated institutions. These reforms are expected to result in improved services for the general public, fostering transparency and promoting competition in this sector. To ensure transparency in the foreign exchange markets, SBP has lately introduced publication of open market exchange rates on its website.

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Coordination with LEAs

8.3. SBP is facilitating LEAs to curb informal markets by taking actions against illegal operators. SBP has also launched capacity building programs for LEAs and media campaigns to raise public awareness about illegal foreign exchange operations. It has conducted surveys to identify illegal activities and shared the results with FIA for further action. SBP has identified digital channels used for illegal transactions and taken steps for their blockage. To promote accountability, SBP has introduced a dedicated email for the public to report any unauthorized foreign exchange activity.

Other Measures

8.4. The Government of Pakistan has also taken several steps to curb informal FX markets. FIA continues to crack down on illegal foreign currency dealers, arresting them and confiscating their currencies. Furthermore, Pakistan Customs has enhanced border and port controls to check currency and goods smuggling, apprehending and investigating individuals involved in dubious trade transactions.

9. CONCLUSION

- 9.1. Informal foreign currency markets operate in Pakistan whereas the demand in these markets generally derives from transactions in hundi/hawala system and activities relating to smuggling of currencies, oil and gold. The activities in the aforementioned informal markets may have significant impact on the Pakistan's external account, including the market exchange rate and FX reserves position.
- 9.2. The recent policy measures and enforcement actions taken by agencies in Pakistan have reflected positively on the USD/PKR exchange rates. For mitigating the effects of informal markets on the official exchange rates, effective coordination between regulatory bodies and law enforcement agencies is crucial.
