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# Setting up an efficient, transparent, and well functioning remittances market in Pakistan

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The Pakistan economy and a significant proportion of its population depends on the flows of remittances from overseas workers and the broader Pakistani diaspora. At over US\$ 14 billion in official remittances expected in 2012/13—which is just over half the projected total export value of goods and services and corresponding imports of around US\$ 40 billion—they provide critical support to a precarious current account situation. Remittances to households also have a favorable impact on poverty reduction and job creation. Also accounting for around 5.5 percent of GDP, remittances inject much needed additional aggregate demand into an economy that has been mired in stagflation over the last five years.

Given the important role that remittances play, a major objective of policymaking is to ensure that remittances flow through official channels since this would maximize the development benefits to the economy. The main purpose of this study was to identify

factors that would facilitate the transfer of remittances through official channels. To do so, we have analyzed the remittances market and its major players both outside and within Pakistan to identify factors that drive remittances to be sent through official or unofficial channels. We have also compared Pakistan's remittances market with those in Bangladesh, the Philippines, and to some extent India, mainly to identify policy measures and new initiatives taken in these countries to attract remittances through formal channels.

An important contribution of this study is its analysis of remittances within an overall framework of a remittances market that encompasses both formal and informal players. This helps us better understand its functioning dynamics and identify factors that might explain the growth of remittances as well as forces that influence its flows through official and unofficial channels.

We build on the earlier study by Amjad et al.

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(2012) and critically examine the results of Kock and Sun (2011) who attempt to explain the growth of remittances during the period 1997–2008. Our study covers the period between 1997/98 and 2011/12.

The main conclusions of the study are as follows:

- In explaining the manifold increase in official remittances since 2001/02, it is just as important to examine the economic shocks and policy interventions that may have impacted these flows as it is to look at the increase in number of overseas workers leaving Pakistan in this period, their skill composition, and economic conditions within and outside Pakistan.
- The major shocks and policy interventions that we have identified are:
  - The freezing of foreign exchange accounts in the aftermath of Pakistan's nuclear test in May 1998.
  - The 9/11 attacks on the US, which created a sense of insecurity among the Pakistani diaspora and caused US authorities and banking and other financial institutions to scrutinize the flow of remittances far more closely.
  - The collapse of the real estate boom in 2009 in Dubai and the accompanying financial crisis, which led to a number of Pakistani professionals and workers leaving Dubai, while Pakistanis who had invested in Dubai pulled out their investments or what was left of them back into Pakistan.
  - The PRI, launched jointly by the Ministry of Finance, State Bank of Pakistan, and the Ministry of Overseas

Pakistanis, and the initiatives taken and incentives offered to Pakistani banks to increase the official flow of remittances, which has clearly contributed to its growth since 2009.

- An important finding of this study is that the remittances market is complex and geographically segmented; identifying the major factors that resulted in increases in official remittances requires examining each segment of this market to draw appropriate conclusions and policy measures and initiatives, rather than studying them at the aggregate level. The segments identified are:
  - The remittances market originating from (i) Saudi Arabia, (ii) Abu Dhabi, and (iii) Dubai.
  - The remittances market originating from the US.
  - The remittances market originating from the UK.
- Since these three segments and sub-segments account for over 70 percent of official remittances, analyzing each in depth provides important insights into their functioning and contribution to the large increase in official remittances. These main findings are:
  - The remittances market originating from Dubai is the most complex in that it serves as a major global hub of the Hundi market and is closely integrated with remittance inflows from the US and the UK. Official flows from Dubai mask investments by Pakistanis living in Pakistan as well as illegal earnings channeled back into Pakistan. The real net extent of these two flows is difficult to gauge but in examining movements and increases in flows, they appear to be significant.
- The remittances market in Saudi Arabia and Abu Dhabi, once the post-9/11 impact on the flow of official remittances works through, reflects both an increase in the number of migrant workers from Pakistan as development activities financed by rising oil prices were expanded, as well as aggressive marketing by Pakistani banks with PRI support.
- The US remittances market is where, besides Pakistani overseas professional workers, a significant part of the Pakistani diaspora resides, and its movements reflect both income transfers as well as the transfer of savings and assets to Pakistan. Since different factors influence the two flows, these need to be analyzed separately.
- The study finds that PRI's initiative has on balance played an important role in galvanizing the financial institution in Pakistan and by increasing manifold the remittance highways into Pakistan and physical outlets within Pakistan increased the share of formal remittances flowing into the country. A case in point is helping divert flows from UK financial institutions to Pakistani banks since the former appeared to transfer funds that were not reflected in official flows. Also the increase in formal flows from Saudi Arabia appear to be the result of more aggressive marketing by Pakistani banks spurred on by the PRI.
- A striking and important finding of the study, based on recent household surveys for 2009

and 2010, is that households receive almost 40 percent of their remittances through unofficial channels. Even more striking is the finding that, whether migrants are better educated or the receiving households live in rural or urban areas, makes no great difference to which channel they use. These results however should be interpreted keeping in mind two important caveats. The first that the study is based on a relatively small household survey. Second, that the survey was conducted just a year after the PRI was launched in early 2009 and its full positive impact may not be reflected in these results.

- Based on its analysis of the factors that have led to an increase in remittances—as well as diversion from unofficial to official channels—including as a result of very recent PRI incentives, the study concludes the following:

- At less than US\$ 1 billion, the official flow of remittances in 1999–2000, following the freezing of foreign currency accounts in Pakistan after the nuclear tests, can be taken as its lowest point in terms of the share of flows through official channels. Based on estimates by earlier studies, these could be taken to constitute around 20 percent of total flows.
- Post 9/11, given the heightened scrutiny and continuing economic boom in the West as well as increased economic activity in the Middle East, official remittances increased sharply. The combined effect of these factors was that, by 2005/06, the share of flows through official channels could have gone up to 60 percent of total remittances.

- The continuing increase in remittances after 2005/06, despite the global financial meltdown and real estate collapse in Dubai in 2009, can be explained by (i) the increased activity in Saudi Arabia and Abu Dhabi; (ii) the significant increase in outflow of Pakistan professionals to the US, UK, and Europe; and (iii) the PRI. These factors, we believe, could have increased further official remittances to around 70 percent or at least maintained them at around 60 percent of the total.
- Our tentative conclusion is, therefore, to scale down our estimates of the flow of remittances through unofficial channels to nearer 30–35 percent compared to the much higher estimate (up to 80 percent) in Amjad et al. (2012). It must be emphasized again that these estimates are inferred from global, regional, and national developments and interaction with “knowledgeable sources” rather than hard evidence and should be treated accordingly.
- The case studies of Bangladesh and the Philippines, where the share of informal remittances has gone down, suggest that their banking systems have focused on speed, transfer cost reduction, and income tax relief for nonresident foreign currency account holders. In addition, they appear to have undertaken measures to facilitate investment by their diaspora in real estate and industrial enterprises through the provision of tax holidays and without any requirement for a national tax number. The passage of the dual nationality law in Bangladesh, for instance, has helped in that direction.

Both countries have engaged nontraditional actors, such as MFIs, to operate in the remittances market, while Bangladesh also introduced a premium bond.

- Drawing on the experience of Bangladesh, the Philippines, and to some extent India, the study concludes that the major difference between Pakistan and these countries is that, while their measures and financial infrastructure have instilled increasing confidence in their migrants and recipient households to route remittances through official channels, there remains a major ‘confidence gap’ among Pakistani migrants and their households in the use of official channels to transfer remittances.
- It is necessary to examine some of the measures undertaken by these two countries to divert remittances from informal to formal channels. Notwithstanding the fact that Pakistan has introduced policy changes, compared especially to Bangladesh there has been relatively less progress in reducing hawala transfers. For instance, the implications of abolishing withholding tax on nonresident foreign currency accounts in Pakistan needs to be discussed with the relevant bodies such as the SBP and Ministry of Finance to understand their rationale. In addition, there is need to examine the feasibility of subjecting the vehicle import facility extended to migrants on the condition that remittances be sent through formal channels for at least the preceding year.
- A financing mechanism whereby the country can borrow from its own expatriates is not a new proposal. India opted for diaspora bonds at the time of the liquidity crises in the 1990s to support its balance of payments needs, and succeeded in raising about US\$ 40 billion. The merits and complications of

issuing such bonds to raise foreign exchange from the Pakistani diaspora need to be examined. The perceived concerns of the diaspora—such as the depreciation of the Pakistani rupee, high level of inflation, and other obstacles related to macroeconomic stability and governance—have to be addressed. The design of the bond must reckon with the economy's ground realities. Mechanisms have to be evolved to dispel expatriates' fears, which may necessitate the involvement of international financial institutions and possibly the need for their extension of partial guarantees.

- One suggestion is that it should be mandatory for all migrant workers to have bank accounts. Keeping in view the recent success of the Benazir Income Support Program in beneficiary women's use of the banking system, this recommendation is implementable. It will help to break down psychological barriers and attract more remittances through the formal channel. Moreover, Pakistani banks need to be proactive and develop closer links with migrant communities abroad, particularly in the Middle East.
- There is a need to address global factors that permit and facilitate capital flight which could have a positive and significant impact on the official inflow of remittances. Improving governance and curtailing corruption within the country will downsize the demand for foreign currency abroad. Examining the skills and occupational classification of the diaspora, particularly in the OECD, might reveal some of the structural reasons that they prefer hawala to official channels. It is possible that a section of the diaspora wants to conceal their income because of the host country's taxation system, and

hence opts for hawala.

- Finally, two further areas of study are recommended. First the functioning of the Foreign Exchange Companies in Pakistan and their role and impact on the remittance market. Second, a more extensive survey of remittance receiving households. These studies would assist further in devising measures to increase remittances through official channels as well as in better documentation of the Pakistan economy.

## **ABOUT THE AUTHOR**

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