FOREIGN EXCHANGE REGULATIONS IN PAKISTAN: A REVIEW

Author: Aniqa Arshad

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Arguably, foreign exchange regulations in Pakistan impose unnecessary controls on the flow of capital. These regulations directly impact entities dealing with foreign direct investment related capital. Though monitoring of these flows is essential from a money laundering perspective, it unfortunately comes at the cost of flow of legitimate capital. This report traces the historical changes in these regulations, analyses them from a business lens and provides a comparative outlook with other emerging economies.

Historical changes in Regulations on Foreign Exchange

Within Pakistan, all foreign exchange dealings are regulated and administered under the Foreign Exchange Regulation Act, 1947 (FERA). This is an act to regulate certain payments, dealings in foreign exchange and securities and the import and export of currency and bullion. Under FERA, the State Bank of Pakistan is responsible for day to day administration of foreign exchange policy which is exercised through its Exchange Policy Department. According to FERA it is expedient in the economic and financial interest of Pakistan to provide for such a regulation.

It was not until 1987, that an amendment to FERA was first made. During Zia ul Haq's regime, some importer and exporter lobbies appealed to the president that violations under FERA should not be ruled under the Code of Criminal Procedure,1898. They appealed against harassment from security authorities and mentioned being treated for violations as white-collared individuals. Violators of FERA were then trialed through a Foreign Exchange Tribunal under Article 23A of FERA.

Under Section 23A, violations were punishable with imprisonment for a term which may extend to two years or with fine or with both, and any such tribunal trying any such contravention may, if it thinks fit, and in addition to any sentence which it may impose for such contravention, direct that any currency, security, gold or silver, or goods or other property in respect of which the contravention has taken place shall be confiscated. In addition to this notwithstanding anything contained in the Code of Criminal Procedure, 1898, any offense punishable under this section shall be cognizable and non-bailable for such period as the Federal Government may from time to time, by notification in the official Gazette, declare.

Through the Act of Parliament, in 1987, a bill was proposed and consequently passed from both houses which introduced article 23B to FERA. Under Article 23B the Federal Government was allowed to authorize in relation to any area specified in the notification any officer of the State Bank to act as the Adjudicating Officer. The amendment now abolished rulings for violators through the Code of Criminal Procedure, 1989; removed imprisonment and confiscation as possible sentences and introduced violators to be liable to a penalty not exceeding five times the amount or value involved in such contravention or five thousand rupees, whichever is more, by the Adjudicating Officer.

Prior to the Protection of Economic Reforms Act (PERA), 1992 foreign currency could only be dealt or exchanged through Authorized Dealers, Authorized Money Changer or Authorized Exchange Company. However after PERA was passed in 1992, under article 4, subsection (1) it allowed "All citizens of Pakistan

resident in Pakistan or outside Pakistan and all other persons shall be entitled and free to bring, hold, sell, transfer and take out foreign exchange within or out of Pakistan in any form."

Certain immunities were also granted under the 1992 Act to all citizens of Pakistan resident in Pakistan or outside Pakistan who held foreign currency accounts in Pakistan. PERA significantly reduced the controls and restrictions imposed by FERA. In 1999 a presidential ordinance was issued, by then president Rafiq Tarar, whereby immunity from inquiries to citizens of Pakistan residing in Pakistan in respect of any balance in new foreign currency accounts opened after December 16, 1999 was withdrawn.

In 2016, a major amendment was introduced to FERA, 1947 adding article 23K to the act. The article stated that "whoever contravenes, attempts to contravene or abets the contravention of any of the provisions of section 3, section 3A, section 3AA, section 3B, sub-section (2) of section 4 and clause (c) of subsection (1) of section 20, shall be liable to a penalty of up to five hundred thousand rupees for each contravention, and where the contravention is a continuing one with a further penalty which may extend to ten thousand rupees for each day during which such contravention continues. The State Bank of Pakistan was given authority to exercise this right and penalize entities such as banks, hotels, and dealers etc., who were formerly not liable for penalty. Previously all such cases were dealt with by adjudicating officers, who often did not have any formal legal background. This led to hearings being unfruitful, where violators were either not penalized or disputes lasted several years before they were resolved.

In April 2018, PERA was amended to bar individuals and entities not filing taxes from operating foreign currency bank accounts. At the time, Pakistan had a yawning current account deficit in addition to mounting pressure on its foreign exchange reserves which had shrunk to $17.64 billion in April 2018 from $24.46 billion in October 2016.

While PERA was initially introduced to facilitate citizens and businesses, its misuse has led to serious consequences for Pakistan. In June 2018, the country was dragged into the terror financing watch list of the Financial Action Task Force (FATF). This led to an increase in regulations and increased red tape for businesses dealing with foreign investment. Businesses were impacted negatively due to these increased regulations, as operations now needed additional approvals from relevantauthorities. Despite repercussions, the former Chairman of Federal Board of Revenue, Shabbar Zaidi commented that no authority, including the SBP, had the right to question individuals about the source of income parked in foreign currency accounts.

There have been some recent changes in FERA through supplementary finance bills in the years 2017, 2018 and 2019. The act was amended to regulate outflow of funds through foreign currency accounts and local transportation of foreign exchange through greater clarity to the legal system. The recent changes to FERA may be classified as part of the government's efforts to enhance transparency of financial transactions. This is aligned with the current government's objectives which are at large interested in curbing corruption and money laundering.

There have been propositions from the State Bank to further amend the Foreign Exchange Regulations Act, 1947. The bill was introduced in the senate on 1 January, 2020. It proposes to amend section 23 of the FERA, by enhancing the punishment, making the offence punishable under the section as cognizable and non-bailable, adding new provisos give explicit powers to FIA to take prompt action against illegal foreign exchange operators without requirement of any formal complaint from SBP and empowering the tribunals to take action against illegal foreign exchange operators in expeditious and time-bound manner. The finance ministry further said that, a new section 8A is inserted to restrict the free movement of foreign exchange within the country without any limit.

On 27th October 2020, SBP introduced a new mechanism to enable companies to conveniently remit out disinvestment proceeds to their foreign shareholders. The stated goal of this initiative is to make Pakistan a more attractive place for investment by increasing investors' confidence and support ease of doing business. As per the previous mechanism, a designated bank required from the SBP to remit out disinvestment proceeds above market value for listed securities and, above breakup value for unlisted securities. Under the new mechanism, the bank designated by the company has been delegated the authority to remit the entire disinvestment proceeds to foreign shareholders upon submission of required documents, by following a convenient mechanism without referring the case to SBP. The number of required documents would be in accordance with the size of the transaction.

Business Impact of FERA

Exchange controls were first introduced in Pakistan in 1952, when the Rupee was first overvalued. To regulate foreign exchange flows and ensure that foreign exchange payments do not exceed receipts, exporters were required to directly deposit their foreign exchange earnings with the State Bank.

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Pakistan has always retained an import substitution regime resulting in ceilings for import volume of products, complex licensing procedures and several other deterrents.

A paper on regulations in Pakistan states that "[SBP] took into consideration expected receipts through exports and foreign assistance and then made allocation to private and public sectors through import licenses issued to commercial and industrial users by the Chief Controller of Imports and Exports (CCI&E).

The Exchange Control System was made up of an elaborate licensing procedure, where the ceilings were fixed for the import of each product. Three types of import licenses were issued - commercial, industrial, and investment. The government relied on licensing rather than tariffs to restrict imports, due to unstable prices, unavailability of accurate projections of demand and supply of foreign exchange, and an insufficient level of foreign exchange reserves."

It is of significance that Pakistan acceded to Article VIII of the International Monetary Fund in 1950s. Article VIII provides in Sections 2 and 3 that members shall not impose or engage in certain measures, namely restrictions on the making of payments and transfers for current international transactions, discriminatory currency arrangements, or multiple currency practices, without the approval of the Fund.

[1]Kemal, A. (2002). Regulatory Framework in Pakistan. The Pakistan Development Review, 41(4), 319-332. Retrieved February 1, 2020, from www.jstor.org/stable/41260478

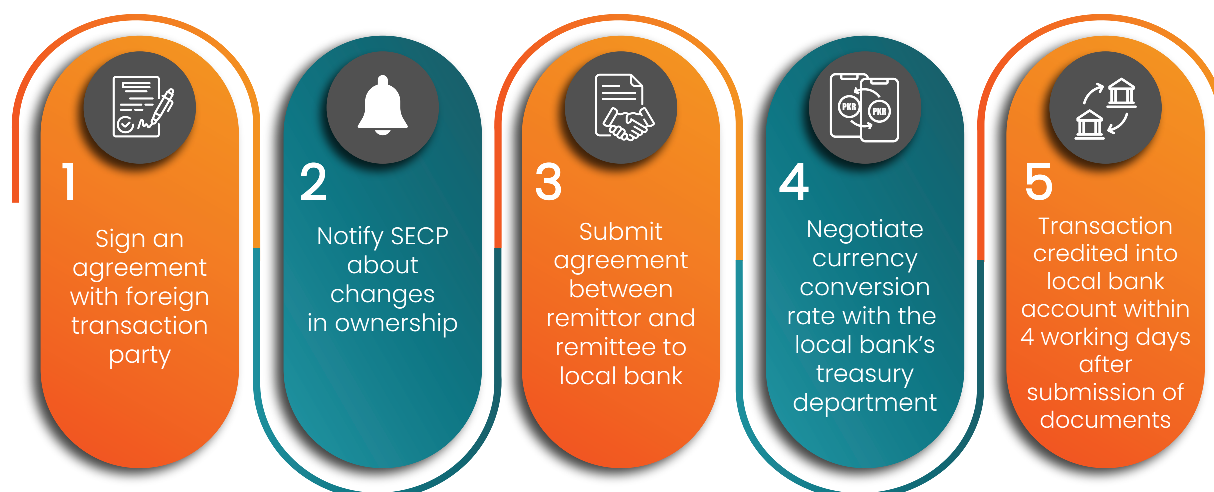
The guiding principle in ascertaining whether a measure is a restriction on payments and transfers for current transactions under Article VIII, Section 2, is whether it involves a direct governmental limitation on the availability or use of exchange as such.

However the IMF staff report for 2017 states that Pakistan maintained an exchange restriction and multiple currency practice, arising from imposing a 100 percent cash margin requirement on a list of different types of consumer goods imports. This tightening measure introduced a cash margin requirement for letters of credit opened for imports in addition to no longer allowing residents who are not tax filers to credit their foreign exchange accounts with cash in foreign currencies. According to a report by the IMF, in Pakistan the exchange restriction arose from the imposition of a cash margin requirement on some imports in February 2017 to contain the widening current account deficit. In contrast, a number of countries relaxed their exchange controls by eliminating restrictive measures that apply to different transactions. Additionally Pakistan also introduced a cash margin requirement for letters of credit opened for imports. The cash margin requirement was made more stringent in 2018, adding an additional 131 non-essential items to the list. This was later waived off 100% in 2019 for various goods against five HS codes.

This kind of volatile environment is neither good for existing businesses nor good for the investment climate. Some segments of the business community believe that foreign exchange regulations in Pakistan impose unnecessary controls on capital flows. These excessive controls disturb the flow of legitimate capital, particularly for entities dealing with foreign direct investment related capital.

Apart from the need to contain illegal flow of money from the country, Pakistan has also had to introduce some reforms within foreign exchange regulations to fulfill international obligations regarding terror financing. In June 2018, Pakistan was officially placed on the Financial Action Task Force (FATF) 'grey list', as according to the organization it had been unsuccessful in taking measures against terror financing. Though monitoring of these flows is essential from a money laundering perspective, it should not come at the cost of flow of legitimate capital.

Figure 1: Required procedures for processing inward remittance[2]



Problems faced by business firms

To understand the problems faced by commercial firms dealing with the capital inflows, three business firms were interviewed, two in real estate and another importing solar panels to Pakistan. While the operations of these businesses were different, they faced similar issues with regards to capital inflows, as under:

1. Pakistan's forex regulations are designed to hinder movement of currency from Pakistan, particularly outflows.

2. Regulatory policies by the State Bank of Pakistan and other regulators are not conducive to attracting FDI in the country. These regulatory constraints inhibit entry, proper utilization and exit of funds for any foreign investor to invest in startups/VC firms in Pakistan.

3. Raising equity share capital is too difficult because of uncertainty and unnecessary restrictions.

4. Clauses in the Foreign Exchange Manual issued by the SBP inhibit Pakistani tax residents from acquiring shares in foreign companies, without prior consent of the SBP.

5. The regulations keep changing constantly causing uncertainty in the business environment.

6. Delayed processes, inefficient communications and lack of standard operating procedures caused losses to both investors and the company.

7. State Bank of Pakistan deals through intermediary banks; all communication is conducted verbally and hence there is little to no proof of records for formal proceedings. Explanations to queries often become prolonged and take up to several months before the dispute can be resolved.

8. According to the State Bank of Pakistan, Chapter 19 Section 15 of its Foreign Exchange Manual, "Foreign controlled companies are permitted to contract foreign currency loans from banks/financial institutions abroad or from their Head Offices/or from other overseas branches/associates for meeting their working capital requirements. The repayment period should not exceed twelve months and the rate of interest should not exceed 1% over LIBOR. Such loans can however be rolled over for further periods not exceeding twelve months each."

9. When Pakistan's forex reserves shrink, the government along with the state bank impose all sort of regulation to stop capital flight. This comes at the cost of loss in potential investment and at the misery of local businesses.

Comparison with other countries' foreign exchange regulations

In this section, a comparison is drawn between some international and regional economies and regulations in Pakistan with those applicable in these countries.

[3]White Paper, National Incubation Center, September 2020,https://nicpakistan.pk/wp-content/uploads/2020/09/IRT-2.0-White-Paper-V4-DIGITAL-Version.pdf

[4]Ibid

The section will also try to determine the impact of policy on foreign direct investment within these economies.

Internationally, countries whose GDP has grown at high rates have been countries which relatively have lesser restrictions on entry of capital as well as foreign direct investment. The analysis, includes four countries, namely China, India, Malaysia and Turkey. These countries started off with similar economies and economic policies pertaining to foreign exchange regulations, however overtime these countries adapted policies and measures to open their economy and ensure financial freedom for increased investments, in addition to having stable policies unlike Pakistan's ever changing policies.

China

Recently, China has taken initiatives pertaining to foreign exchange in order to facilitate businesses and investors by easing cross-border transactions. The measures include:

1. Removing the restrictions on domestic equity investment of capital fund of foreign investment enterprises not engaging in investment activities.

2. Expanding the pilot scheme to facilitate foreign exchange of capital.

3. Easing the restrictions on the use of foreign exchange settlement of capital account.

4. Reforming the registration of foreign loan.

5. Removing limits to the number of foreign exchange accounts opened for capital.

6. Expanding the pilot plan of domestic credit assets transfer to foreign countries.

These measures were introduced by China's State Administration of Foreign Exchange and aim at easing investment financing requirements as well as cross-border trade controls. These were introduced in an attempt to create a more facilitative business environment for foreign investors alongside domestic enterprises. Prior to these rules, there was rigidity in investment structures for foreign investors; however these are more flexible. China also established a pilot scheme under which the government announced a "one window operation" setup for goods and services trade. This catered to customs clearance, documentation, IT, regulatory oversight of shipments, and connections with other major ports. This operation has been extended to now include foreign exchange of capital. These new initiatives ease restrictions around the use of foreign investors' deposit account while simultaneously speeding up the equity transactions between local businesses and foreign investors.

In addition to these, quotas for enterprises holding China's foreign exchange earnings under the current account have been raised several times; enterprises with authentic trade activities have been allowed to purchase foreign exchange in advance to pay foreign counterparties; enterprises' foreign exchange accounts under the current account have been managed on a recording basis; and foreign exchange purchase and payment procedures for trade in services have been simplified. Since 2007, annual foreign exchange purchases and sales quotas for individuals have been set at US$ 50,000 to meet their needs for holding and using foreign exchange. After 2007 although the net inflows for foreign direct investments have continued to be on the rise, the ratio of FDI net inflows to GDP went down because China's GDP growth has outpaced the growth of FDI net inflows.

It is to be noted that while China maintains control over its capital outflows it does not have policies which prevent or hinder foreign direct investment. This is validated by China's stable rates of portfolio investments in comparison to other emerging economies and are also indicative of the regulations being effective.

Malaysia

Comparatively, there are mostly minimal restrictions on foreign investment in Malaysia. Subject to the qualifications set out below, foreign investors can hold 100% equity in all investments in new projects, as well as investments in expansion and/or diversification projects in existing companies. For every industry there are sector-specific regulations issued by the relevant governmental departments. Some sectoral regulations impose certain restrictions on the foreign ownership of the equity of a company, and some require prior regulatory approvals before the commencement of business operations. While exchange transactions are regulated by Bank Negara Malaysia (the central Bank), the foreign exchange administration rules of Malaysia have been progressively liberalized to create a competitive business environment. Currently, the rules allow, among other things:

1. Access to domestic financing.

2. Settlement for trade in goods and services.

3. The repatriation of a foreign direct investor's investments, including capital, profits, dividends, divestment proceeds and interest.

4. The ability of non-residents to borrow in local currency to finance activities.

India

India's foreign exchange control regime is governed by the Foreign Exchange Management Act (FEMA), enacted with the objective of facilitating external trade and payments, promoting the orderly development and maintenance of the foreign exchange market in India and the liberalization of economic policies.

Under FEMA, provisions for capital account transactions impose no restriction on residents holding, owning, transferring or investing in foreign currency, foreign security or any immovable property situated outside India. However, the Reserve Bank of India holds the right to prohibit, restrict, or regulate establishment of a branch, office or other place of business in India by a person resident outside India. It is evident that these restrictions, though more liberal than Pakistan's FERA, are similar in nature to it.

Turkey

The last comparator economy Turkey is the world's 17th largest economy with $721bn GDP. GDP per capita tripled between 2002 and 2016 to $10,512. Following economic crisis in 2001, Turkey undertook major structural changes in the finance sector, which, coupled with subsequent economic and political stability, led to an average growth rate of 5%, with its share of ups and downs.Regarding portfolio investments, legal residents outside Turkey can freely purchase and sell all kinds of Turkish securities and other capital market instruments using banks and brokerage firms in Turkey as intermediaries. There are no restrictions on foreign investors purchasing or

[5]China: the evolution of foreign exchange controls and the consequences of capital flows. Date accessed: January 22, 2020. Retrieved: https:// www.bis.org/publ/bppdf/bispap44h.pdf

selling a Turkish company's securities, provided the transaction is made through an authorised brokerage firm in Turkey. However, there are special prior approval requirements for owning shares and/or voting rights reaching certain thresholds in certain types of regulated companies.

Turkey's foreign investment legislation was revised most recently in 2003 through structural reforms. The procedures for foreign investment were simplified, some bureaucratic formalities abandoned, and the principle of equal treatment reemphasized. The major step realized was the introduction of a more investor-friendly Foreign Direct Investment Law (No. 4875). According to the Foreign Direct Investment Law, foreign investors are no longer required to obtain permissions or approvals. Foreign investors will only be asked to provide certain statistical information to the General Directorate of Incentive Practices and Foreign Capital for the purpose of developing an information system regarding foreign investments in Turkey.

Under the Foreign Direct Investment Law there are no restrictions on foreign entities establishing branches in Turkey, however all companies are required to report annually, and notify completed transactions to the General Directorate of Incentive Practices and Foreign Capital. These recent regulations have improved Turkey's business climate and it ranks 68th on the Economic Freedom of World (EFW) Index, with a score of 64.6. However, critical impediments to more dynamic foreign investment flows include lingering bureaucracy and the lack of transparency.

Conclusion

This paper concludes that:

1. Countries need to maintain friendly and open foreign exchange regimes.

2. To improve capital inflows and enjoy spillover effects of open regimes, countries need to have a conducive business environment, stable regulations and an active competitiveness policy.

3. Countries such as Turkey and Malaysia improved their economy as a result of foreign direct investment. They were able to do so, by having more transparent operations and reduction government regulations which lead to a decreased role of bureaucracy, consequently leading to lesser corruption.

4. Simplifying procedures for foreign investment, reemphasizing equal treatment for both foreign and local firms in addition to abandoning some bureaucratic formalities can help Pakistan build a healthy environment for all business firm.

5. Pakistan has a weak business environment, and needs to work on making regulations more dependable and transparent.

6. There is a gap between regulating authorities and the private sector. Irrespective of whether the business is small, medium or large in scale, it should have constant and continuous linkage with the State Bank of Pakistan to ensure a conducive business environment and smooth flow of operations.

7. Improving upon ease of doing business, access to imports, and labour markets will lead to a better business environment and consequently have a positive spillover effect on Pakistan's economy.

Recommendations

1. Pakistan needs to adopt measures to open up its economy and ensure freedom of capital for encouraging investments. Through structural reforms it needs to simplify procedures for foreign investment, introduce transparent operations and reduce regulations

2. Currently, firms operating in Pakistan cannot make advance payments for availing international services. After necessary scrutiny, all such firms should be allowed to repatriate advances.

3. Government should set up a task force to study the reforms introduced by Turkey, Malaysia and China and adopt these measures after necessary evaluation.

4. Interaction between regulating authorities and the private sector is infrequent and informal. A business facilitation cell should be established at the State Bank to address issues and help curtail the regulatory gap.

5. The private sector should have direct access to the State Bank of Pakistan, to lodge complaints and enlist enquires regarding rules and regulations imposed by the authorities. These complaints should be formally documented and their progress should be traceable and open access. Responses from both sides should be time bound to enhance efficiency.

6. The State Bank should hold periodic audits of companies to help differentiate between and categorize entities. For example companies which have enabled capital inflows from those which attracted no FDI and entities assuming forex risk upon themselves compared to those who do not assume the risk. Restrictions and regulations should then vary for both.

7. Currently, firms operating in Pakistan cannot make advance payments for availing international services. After necessary scrutiny, all such firms should be allowed to repatriate advances.

8. Provide open, transparent and dependable conditions for all kinds of firms, whether foreign or domestic, including: ease of doing business, access to imports, relatively flexible labour markets and protection of intellectual property rights.