INTEL BRIEFING

Pakistan Cracks Down on Illicit Economy Amid Economic Crisis

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Contents

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COVER: Pakistani paramilitary soldiers stand guard at the closed border checkpost of Chaman on the Pakistan-Afghanistan border in January 2008. (Asghar Achakzai /AFP via Getty Images)

Trucks are parked along a road near the Pakistan-Afghanistan border in Torkham. The border closed Sept. 6, 2023, after border clashes between the two countries. (ABDUL MAJEED/AFP via Getty Images)

Executive Summary

Pakistan's illicit economy, a subset of its broader informal economy, has posed a major economic and security challenge for the country over the last few decades. The fall of Kabul in August 2021, however, marked an inflection point: The economic shock in Afghanistan from the exit of international forces, coupled with growing macroeconomic and political instability, led to a dramatic surge in the scale of Pakistan's illicit economy.

This paper provides insights about the nature, scale, and impact of the illicit economy in Pakistan, highlighting that:

- The illicit economy in Pakistan relies on collusion among Pakistan's law enforcement institutions, political elites, and criminal and militant networks operating in the border regions of Afghanistan, Pakistan, and Iran.
- Demand for foreign currency in Afghanistan in the aftermath of the fall of Kabul in August 2021 significantly bolstered the scale and nature of the illicit foreign exchange market in Pakistan, which in part caused a major divergence in the price of the U.S. dollar in the formal banking and illicit currency exchange markets.
- The economic fallout from the growth of the illicit economy has forced policymakers, led by the chief of Pakistan's military, to launch a crackdown against smuggling, particularly the illicit trade of currency.
- This policy shift has been accompanied by the repatriation of over 450,000 Afghans who had been residing in Pakistan without documentation, with the Pakistani government arguing that these measures are necessary to improve the economy.
- The government has also taken action against individuals involved in the broader illicit economy, including military officers and personnel. In recent weeks, at least 90 government officials and 29 politicians have been found to be involved in the smuggling of Iranian petrol.
- The evolving policy in Pakistan offers an opening to U.S. policymakers to engage with Pakistani authorities and explore ways in which U.S. support can help the country positively deal with this challenge.
- Given the involvement of criminal and militant networks in this economy, it is vital for the U.S. to both monitor the scale and evolution of this economy and partner with Pakistan to achieve shared objectives that help reduce the ability of non-state and sanctioned actors to finance their operations through the illicit trade of goods and money between Pakistan, Iran, and Afghanistan.

Introduction

The illicit economy has been a perennial challenge for Pakistan, with policymakers making numerous attempts to curb the illicit flow of goods and currency into and out of the country. Over the last few years, this illicit economy – which consists of everything from drugs and foreign currency to consumer goods such as soap – has thrived, providing an economic lifeline to the Afghan Taliban regime in Kabul in the form of a much-needed influx of foreign currency.

Rising energy prices have also created a parallel economy in the smuggling and sale of illicit petroleum products from Iran, with Pakistan's Federal Bureau of Revenue (FBR) estimating that the country lost out on almost $1.5 billion in tax revenues due to such smuggling.[1] The Iranian regime, squeezed by international sanctions, has used the growth of this illicit economy as an economic lifeline and a mechanism to access dollars.

The illicit economy in Pakistan relies on collusion among Pakistan's law enforcement institutions, political elites, and criminal and militant networks operating in the border regions of Afghanistan, Pakistan, and Iran. Its growth has provided a mechanism through which criminal and militant networks including the Afghan Taliban, the Iranian regime, and other groups such as the Pakistani Taliban, can access financial resources to sustain and grow their presence in the region.

In an attempt to ease the burden on its faltering economy, Pakistan is now waging a war against the smuggling of goods into and out from the country. The country's leadership, including the army chief, has decided to take forceful action, particularly along its 2,670-kilometer (1,659-mile)-long border with Afghanistan; Pakistan claims to have fenced over 98 percent of it.[2] In the aftermath of this decision, Pakistani authorities have introduced routine closures of border crossings, an increasing tempo of raids in order to deter smuggling, and policy changes to prevent the smuggling of tariff-free goods meant for Afghanistan into Pakistan.

In addition, policymakers have taken action against security and government personnel who are believed to have been involved in smuggling rackets, including in the inflow of Iranian petroleum products. Policymakers in Islamabad, including the finance ministry and the prime minister's office, also are increasingly scrutinizing money changers, arguing that these companies have been involved in illegal trades of currency, especially the U.S. dollar.

Whether this effort can be sustained remains to be seen. For the time being, policymakers in Islamabad and Rawalpindi (home of the Pakistan Army's headquarters) are confident that their action is bearing fruit.

The scale and evolution of this illicit economy ought to be of serious interest to U.S. policymakers, especially given the way in which this economy intersects with groups and actors that have a history of acting against U.S. interests, both in the region and globally. U.S. stakeholders should engage with their counterparts in Pakistan to explore ways in which both countries can cooperate, including in ways that help bolster Pakistan's own capacity to combat smuggling, especially in the border regions of Afghanistan and Iran.

In addition, sustainably dealing with the illicit economy is important, given Pakistan's perennial economic challenges and its need for regular bailouts from the International Monetary Fund (IMF) as well as multilateral and bilateral lenders. The negative economic fallout of the illicit economy only adds to the broader economic instability in the country. As a result, it is important for U.S. policymakers to coordinate their strategy with multilateral and bilateral actors including Saudi Arabia and China.

This report analyzes the key drivers behind the dramatic growth of the illicit economy in Pakistan, the ways in which goods and currencies are smuggled into and out of the country, and how this economy is linked to elites who represent key constituencies and hold sway over the country's political economy.

While official data is difficult to come by, this report relies on open-source research and private conversations with experts on the ground to highlight how this illicit economy has impacted Pakistan, empowered criminal networks, and provided a lifeline to both the Afghan Taliban regime in Kabul and the Iranian regime in Tehran.

Key Drivers of the Illicit Economy in Pakistan

Pakistan's illicit economy has posed a challenge for decades. A working paper published by the Pakistan Institute of Development Economics in 2015 offers a detailed estimate of the "underground economy" in Pakistan.[3] The authors define the underground economy as consisting of four key components:

- The illegal economy, which consists of things that are illegal under the law, such as drugs and alcohol.
- The unreported economy, which includes activities for which taxes are evaded.
- The unrecorded economy, which includes activities not captured by statistical authorities.
- The informal economy, which operates outside of the legal and regulatory system in the country and has no access to courts, banking, and other formal institutions.

Only a subset of the underground economy is being discussed in this report, primarily covering the illegal economy, given that the smuggling of goods and currency into and out of Pakistan is a criminal offense.

According to the report, the size of the underground economy reached 102 percent of Pakistan's GDP in 1998, soon after the country was placed under sanctions after conducting nuclear tests. The removal of sanctions led to a decline in the size of the underground economy, and the authors estimate that by 2013, the informal economy hovered around 40 percent of GDP, which was about $92 billion at the time.

This research also highlights some critical drivers of the underground economy in Pakistan:

- Political instability and capacity.
- Terrorism and related violence.
- Capital controls and divergence in formal and informal exchange rate markets.

Based on the estimates provided in the working paper, it would be prudent to assume that the current size of the underground economy in Pakistan is at least $150 billion, or 40 percent of Pakistan's 2022 GDP of $375 billion. Given the ongoing economic, political, and security crisis in the country, this figure is likely higher.

This is primarily due to:

- The fall of Kabul in August 2021 and the economic impact of the U.S. exit from Afghanistan, which caused both a spike in terrorism and an increase in capital controls in Afghanistan.
- The dramatic increase in political and economic instability in Pakistan since 2018, which fostered greater political instability.
- A shock to global energy prices, in particular petroleum products, following the Russian invasion of Ukraine in 2022, which subsequently forced Pakistan to adopt capital controls and make efforts to control the price of the currency.

The economic and security fallout from the growth of this

Afghan refugees board a bus from Karachi, Pakistan, to Afghanistan in September, 2023. Millions of Afghans poured into Pakistan during successive decades of wars. About 1.3 million are registered refugees and 880,000 more have legal status to remain, according to the latest United Nations figures. (Rizwan Tabassum / AFP via Getty Images)

illicit economy in Pakistan has been severe. The pressure on the rupee, in part due to the growth of demand for the dollar in the informal market in Pakistan, the loss of tax revenue, and the dramatic surge in terrorist attacks conducted in Pakistan have forced institutions and policymakers, in particular the Pakistan army, to take forceful action to curb smuggling and control the broader illicit economy.

While a last-minute $3 billion stand-by agreement with the IMF, which was reached in the summer of 2023, helped avert default and economic chaos, the economy was still facing growing headwinds.[4] Inflation continued to pose a challenge, while dwindling foreign reserves made it difficult for the government to finance essential imports and maintain exchange rate stability.

These pressures led Pakistan's civilian and military authorities, particularly the army chief of staff, to regularly hold meetings with the officials across the country in order to push them for action against the illicit economy. Policymakers believed that this illicit economy, particularly its linkages to the flow of goods and dollars into and out of Afghanistan, was distorting Pakistani markets, bleeding scarce foreign exchange reserves, and weakening the rupee.

Key products smuggled into and out of Pakistan include petroleum products, particularly diesel; gold, which mainly enters through the ports; consumer products such as tea and electronics, through both Iran and the Afghan transit trade route; and foreign currencies, particularly the U.S. dollar.

Based on research conducted by economic experts, including the working paper mentioned above, these three developments would be expected to drive an increase in the scale of the illicit economy in Pakistan. Below are some details about how these three events drove this uptick in the scale of the illicit economy.

The Fall of Kabul in August 2021

Following the collapse of the Ashraf Ghani regime in Kabul and the exit of U.S. forces from Afghanistan, Kabul was cut off from billions of dollars in annual inflows. According to the World Bank's April 2022 Afghanistan Development Update, the "cessation of grant inflows, loss of access to overseas central bank assets, and breakdown of international banking relationships caused economic output over the last months of 2021 to decline by one-third."[5] As a result, per capita incomes fell by over 30 percent in the aftermath of the fall of Kabul, and some estimates place "97% of Afghans below the poverty line by mid-2022."[6]

While the rapid collapse of the Ghani regime in Kabul was a surprise, Pakistan also showed an inability to conduct robust scenario planning in terms of not just the security fallout but more importantly the economic impact of the U.S. exit. Even prior to the Taliban seizure, Pakistan's security situation was precarious, with deleterious effects on its economy. As a result, the country was not fully prepared for the ensuing impact on its political economy.

The economic crisis impacted Pakistan's formal trade surplus with Afghanistan, which fell from almost $1 billion between July 2018 and June 2019 to $400 million between July 2021 and June 2022, according to data provided by the State Bank of Pakistan. Total trade also fell dramatically, declining from an annual average of $1.4 billion from 2015 to 2019 to $633 million in 2022, according to data provided by the State Bank of Pakistan.[7]

This shock to formal trade flows was also compounded by the humanitarian disaster in Afghanistan in the weeks and months following the fall of Kabul. Almost 300,000 Afghans sought refuge in Pakistan by the end of 2021, further complicating the economic situation in Pakistan and adding to the broader demand for basic necessities east of the Durand Line.[8]

The economic and humanitarian crisis also affected currency markets across the country, distorting formal markets and catalyzing the growth of the illicit economy.[9] In the months after the fall of Kabul, Pakistan's currency fell almost 10 percent against the U.S. dollar, with the chairman of the currency traders association in Pakistan, saying that around 25% of the total available dollars in Pakistan are going to Afghanistan from Peshawar.[10] While there are no detailed studies on the scale and impact of the fall of Kabul on the broader illicit economy in Pakistan, reports from that period and estimates cited above indicate that August 2021 was a major inflection point that led to a dramatic spike in the broader illicit economy in the Pakistan-Afghanistan trade corridor.

The most recent World Bank report on Afghanistan indicates that the annual trade deficit stands at over $6 billion.[11] The report argues that "many of these increased imports are not intended for Afghanistan. These are not paid from Afghanistan's forex market and explain the currency appreciation despite the widening trade deficit." In addition, the World Bank says that most transactions in Afghanistan are "using the informal Hawala channel." The growth of this informal economy, especially as it relates to the illicit flow of goods and currency, has had a disastrous

Key Border Crossings

impact on Pakistan's internal economic dynamics.

Pakistan's Worsening Crisis

Pakistan's economy began to weaken significantly ahead of the general elections in August 2018. Soon after Prime Minister Imran Khan entered office, his government had to seek an IMF bailout, in addition to bilateral support from countries such as China and Saudi Arabia.[12] This crisis led to a devaluation of the Pakistani rupee, a slowdown in economic growth, and a sharp increase in inflation.

The COVID-19 pandemic exacerbated the crisis, with Pakistan's economy entering a recession for only the second time since its founding.[13] Inflation continued to remain high, while the rupee continued its downward trajectory against the U.S. dollar. The crisis worsened in early 2022, as an alliance of opposition parties sought to oust Khan in a vote of no confidence in parliament.[14] These developments overlapped with Russia's invasion of Ukraine, which had led to a significant increase in global oil prices.

In a bid to maintain a grip on power, Khan's government rolled out a petroleum subsidy, fixing the price of petroleum products, which blew up the fiscal deficit and put the ongoing IMF program off track.[15] Khan was ousted from power, and his replacement, Shehbaz Sharif, entered office with an unsustainably large and growing subsidy bill. To bring the IMF program back on track, the government did away with the subsidy, but at great economic cost. Inflation increased further, the currency depreciated, and economic uncertainty continued to grow.

Amid this crisis, the government continued to run high fiscal deficits, which were financed through domestic borrowing. The result was a dramatic increase in money supply and cash in circulation in the economy. As a result, cash in circulation, which hovered around 22 percent of total money supply in the country in 2013, climbed to over 29 percent in 2023.[16] Other policy choices, including more onerous compliance requirements imposed on the banking sector in the wake of Pakistan's gray-listing by the money laundering watchdog group Financial Action Task Force, incentivized citizens and households to operate in the cash economy.[17] This growth of the cash economy continues to play a key role in the broader illicit economy, particularly as it relates to the flow of illicit goods and the growing dollarization in the economy.

The ensuing outcome of this crisis has been a sky-high rate of inflation: Pakistan's consumer price index has grown by over 100 percent since January 2019, compared to about 30 percent in both India and Bangladesh.[18] This economic turbulence has created incentives for households to dollarize, with government policies focused on controlling the price of the U.S. dollar creating a currency black market as well.

As a result, formal inflows of remittances have declined, while curbs imposed on formal imports of products – in a bid to save scarce foreign exchange – have incentivized the illicit flow of both products and currency.

In addition, the political crisis created space for influential business and political groups to operate in a way that exacerbates the illicit economic challenge for Pakistan. An inquiry commission report published in 2020, which focused on the ways in which the sugar industry operates, provides some insights into how "aid for farmers inevitably ends up lining the pockets of mill owners."[19] The findings show that sugar mill owners underreport their production, engage in speculative and collusive trades, and frequently violate rules and laws governing the sector.

Another inquiry report, this time investigating the behavior of market participants in the petroleum sector, offers more insights. Also published in 2020, the report says that companies made 6-8 billion rupees (approximately $35-50 million) in profits during a shortage of petroleum products in June 2020 and "in contravention of license conditions, slowed down the supply of petrol to their filling stations."[20] The report further highlighted that the person in charge of regulating the oil industry was "a veterinary physician by training" and that he "had no previous experience of working in the oil sector."

The Russian Invasion of Ukraine

The political crisis in Pakistan escalated just as Russia's invasion of Ukraine was roiling the global economy. As food and energy prices climbed, Pakistan's teetering economy suffered a body blow. The country's yawning fiscal deficit had to be bridged as part of the IMF's conditions for resumption of the bailout package. The government was forced to increase taxes on petroleum products, which only fueled the inflationary fire.

Pakistan began experiencing an increase in the flow of smuggled petroleum products from Iran. Reports indicated that these products, smuggled through border crossings in the province of Balochistan, were finding their way into the markets of Karachi and Punjab. In May 2023, the Pakistan Petroleum Dealers Association said "that up to 35% of diesel sold" in the county was coming illegally from Iran.[21] The country's energy ministry agreed with the industry association, arguing that the 40 percent decline in diesel sales was in large part due to the influx of smuggled goods.

The combination of high energy prices, high inflation, and growing economic and political uncertainty incentivized the growth of the illicit economy in Pakistan, creating an economic and national security crisis. With this trend accelerating in summer 2023, policymakers decided to take action, primarily due to the continued depreciation of the rupee against the dollar and the widening gap between the price of the dollar in the banking, retail, and informal markets.

Before discussing the impact of this decision on the illicit economy, it is important to understand the nature and contents of the illicit economy in Pakistan.

Consumer Price Index Comparison

Sources: Pakistan Bureau of Statistics, Bangladesh Bureau of Statistics, and Indian Ministry of Statistics and Programme Implementation

Smuggling Corridors and Products

The ongoing action against the illicit economy provides some much-needed information about the key products that are traded in the illicit economy. According to the data collected from across Pakistan, sugar, the U.S. dollar and other currencies, petroleum products, car engines, drugs such as heroin and opioids, shampoos, clothes, handbags, cigarettes, and consumer products such as chocolates and energy drinks are either being illegally brought into or smuggled out of Pakistan.

The ongoing crackdown has provided some near-term data. For example, data collected from the government agencies revealed that the government seized goods worth 1.3 billion rupees from Sindh province in September 2023; at current exchange rates, this amounts to almost $5 million.[22]

Visits to markets in major cities like Karachi and Lahore provide evidence of the scale and nature of the illicit economy. In the markets of Karachi adjacent to the Sindh City Courts building, visitors can purchase everything from illicit tobacco products to consumer goods products to saffron, all of which make their way into the markets via illegal channels. In addition, communities on the outskirts of cities, especially in Karachi, have large quantities of Iranian products, including Iranian energy and dairy drinks. In addition, despite recent curbs on imports of products due to limited foreign exchange reserves, large supermarkets selling imported consumer goods hardly faced any shortages, despite official data suggesting a significant decline in imports of these product categories.

Given that much of this illicit flow occurs from the border regions of Afghanistan and Iran, the government has started paying more attention to key centers of activity close to the border.

Narcotics

The illicit flow of drugs into and out of Afghanistan, which is the largest opium grower in the world, is one of the major issues facing Pakistan. According to the Pakistan Anti-Narcotic Force (ANF), at least 40% of drugs cultivated in Afghanistan pass through Pakistani trade routes. Its data from 2015 shows that around 7 million people in Pakistan consume drugs.[23]

Following the Taliban's takeover of Kabul in August 2021, the leaders of the Islamist group had promised that they would place a complete ban on drug production in the country, but that promise has yet to be fulfilled.[24] The United Nations Office on Drugs and Crimes has stated that there has been a "95 per cent drop in the supply of opium, from 6,200 tons in 2022 to just 333 tons in 2023."[25] Despite this, officials in Pakistan say drug trafficking has not stopped even after the arrival of the Taliban interim government in Afghanistan, adding that a huge quantity of banned substances is still reaching Balochistan and Karachi.[26] Reports suggest that the decline in opium production has been offset by the exponential growth of methamphetamine smuggling, which has provided new revenue streams for networks involved in the narcotics trade.[27]

This illicit flow of drugs and associated currency has provided a lifeline to the Afghan Taliban, helping bridge a growing deficit in excess of $6 billion, according to the World Bank.[28]

In 2022, Pakistan's navy and customs seized 3,000 kilograms (approximately 6,600 pounds) of "high-quality hashish" in a raid in Balochistan's coastal area of Pasni.[29] The FBR said the value of the seized hashish was 750 million rupees on the international market, which is about $2.7 million at current exchange rates.

In another major raid in June 2023, the ANF recovered 26.5 kilograms (58.4 pounds) of crystal methamphetamine or ice bound

Police burn 1,300 kilograms (1.4 tons) of drugs in Faisalabad in January 2020. The drugs were siezed during various operations. (Mohammad Sharif Shayeq / NurPhoto via Getty Images)

for Malaysia in a raid at a seaport in Karachi. In September 2023, the interior ministry's figures revealed Pakistan had seized 43 tons of smuggled drugs in raids across the country; at least 246 people were arrested during those raids.

After the government tightened security at its borders, drug traffickers found another way of smuggling drugs from Pakistan. Recently, the ANF busted a drug trafficking network led by an official of Lahore police's anti-narcotics wing.[30] The traffickers were using aerial drones to smuggle drugs into India's state of Punjab from Pakistan's Punjab province, investigations revealed.[31] The ANF says the official remains on the run, but they have arrested four police employees for facilitating drug smugglers. In a raid at the official's house, the authorities recovered a significant quantity of drugs.[32]

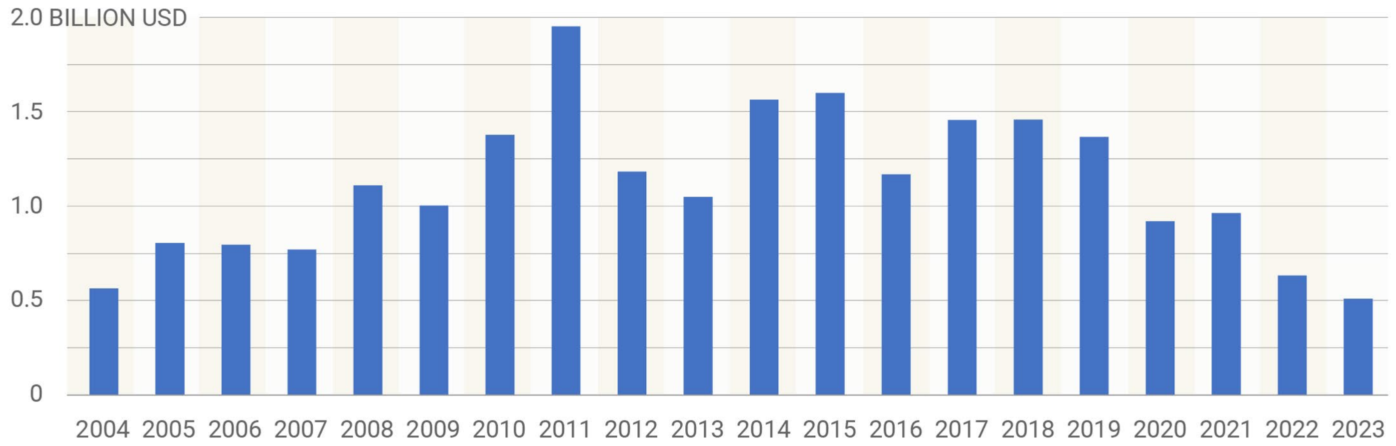
To stop the trafficking of drugs, the caretaker government in Pakistan, according to a statement, intends to form a new counternarcotics center that would strengthen the country's intelligence capabilities. The government also says it will establish more rehabilitation centers across the country to help addicts.

Afghanistan

Pakistan shares a 2,670-kilometer (1,659-mile) border with Afghanistan with multiple border crossings. Officials and money exchange companies in Pakistan often blame Afghanistan for smuggling of dollars and other commodities such as sugar and urea. In February this year, the exchange companies of Pakistan Association had revealed that at least $5 million in U.S. currency was being smuggled into Afghanistan from Pakistan on a daily basis.[33] If this claim is taken at face value, then the total annualized flow of the currency alone amounts to over $1.8 billion.

Before Pakistan launched a crackdown in the last week of August 2023, the rupee was under

Formal Trade Between Afghanistan and Pakistan



Source: State Bank of Pakistan

constant pressure, trading at over 310 rupees against the U.S. dollar. Once the government sprung to action, the rupee began to gain value dramatically, and as of Jan. 9, 2024, it is trading at about 280 per dollar.

A key driver of this flow of currency was Pakistan's conciliatory policy toward the Afghan Taliban. Following the fall of Kabul, the Taliban was "supported by Pakistan to counter purported Indian influence in the country."[34] One way in which Islamabad attempted to support the Afghan Taliban was by importing coal, and by July 2022 Afghanistan was "exporting about 10,000 tons of coal a day to Pakistan."[35]

The payment for these imports was made in Pakistani rupees, which were converted into dollars through Pakistan's foreign exchange markets. This led to a dramatic increase in the demand for dollars in Pakistan to meet the foreign exchange needs of the Taliban regime.

The process through which this activity occurs is not easy to assess. Pakistani authorities say that the country has completed fencing along 98 percent of the border with Afghanistan to stop smuggling and cross border attacks, which independent reports corroborate.[36] Despite this investment and a high presence of soldiers in the border regions, smuggling continues unabated.

"It will all be stopped once [security officials] decide to make it stop," said a civilian official who was posted at the northwestern Torkham border crossing. "We have a long border with Afghanistan, and I don't think that even complete fencing could stop smuggling." The official refused to be identified by his name because he is not authorized to speak with the media.

But it was not just economics that forced Islamabad's hand. Following the fall of Kabul, Pakistan also began experiencing growing insecurity. With sanctuaries in Afghanistan, the Tehrik-i-Taliban Pakistan (TTP), which swears allegiance to the Afghan Taliban, began to attack Pakistani security forces. While the Khan-led government had taken a more conciliatory approach to the TTP, new civilian and military leadership led to a new approach. The confluence of security and economic threats from Afghanistan prompted military leadership in Pakistan to crack down on the illicit economy that was thriving across the Durand Line.

According to the civilian official, smuggling millions of dollars into Afghanistan from Pakistan through the border "seems like a big exaggeration" and that the money exchangers and black market might be blaming Afghanistan to make a fortune. Other reports have backed this claim, with a business magazine explaining that prior to the crackdown, currency dealers across Pakistan were running an illegal "parallel market."[37] To stop this behavior, "officials from multiple agencies put in place strict monitoring measures," including surveillance. This action has deterred companies from engaging in illicit currency trades for the time being, helping drive a recent strengthening of the rupee.

But the illicit economy also thrives away from the offices of money changers. During a mid-2023 visit to the Torkham border crossing by a co-author of this report, the civilian official pointed out several children carrying bags and plastic shoppers, claiming they were being used for smuggling into and outside Afghanistan.

According to the United Nations refugee agency, there are over 3.7 million Afghans living in Pakistan.[38] The number was expected to go down after the government instructed 1.7 million illegal refugees to leave the country by Nov. 1;[39] as of early December 2023, Pakistan said around 450,000 undocumented Afghans have left.[40] The civilian border official told the co-author that those leaving for Afghanistan through Torkham are allowed to carry a maximum of $5,000.

"For example, if five Afghans are leaving Pakistan, they can safely carry $5,000 each and all of them are legally taking $25,000 away from Pakistan," he added. On normal days, around 5,000 Afghan citizens enter or leave Pakistan from a single border crossing, according to border officials.

The Pakistani government has also admitted that smuggling has boomed because of the involvement of those who are actually supposed to act against it. At a press conference in Islamabad in the first week of October, Pakistan's caretaker interior minister Sarfraz Bugti, who is responsible for internal security, told the media that Chief of Army Staff Gen. Asim Munir warned officials they will face a court-martial if they are found to be involved in cross-border smuggling.[41]

In a report seen by the co-author, the Pakistani government claims it seized currency worth 658.47 million rupees from illegal markets in the month of September alone – almost $2.5 million. The growing pressure on the rupee and its associated impact on economic sentiment and inflation has forced the military to intervene and control the price of the U.S. dollar.[42]

Munir met with prominent business figures in Karachi and Lahore to ask them to play a role in stopping the illegal trading of the dollar and shutting down underground black markets. Soon after the meeting, the Inter-Services Intelligence (ISI) raided several illegal currency markets.[43]

Demand for the U.S. dollar fell after the crackdown against illegal currency dealers and smugglers began. The declining price of the dollar against the Pakistani rupees forced people to sell dollars into regulated open markets. In addition, policy changes were introduced to prevent the duty-free import of goods from Pakistan to Afghanistan. This, Pakistani officials and business leaders argue, was incentivizing the smuggling of goods into Pakistan from Afghanistan. The issue, they say, lies with the Afghan-Pakistan Transit Trade Agreement (APTTA). Signed in 2010, the agreement allows Afghanistan to use Pakistani ports for its imports without any tariffs. Stakeholders in Pakistan claim that the agreements between the countries are being misused and damaging the country's economy.

In their reports, Pakistani law enforcement agencies have noted several times that Afghan transit trade containers were being used to smuggle goods into Pakistan.[44] They further claim that items Afghanistan was importing through Pakistan were being paid for by dollars acquired from Pakistani currency markets that drove the country's own currency to the ground. Sometimes, the reports suggest, the imported items never made it to Afghanistan but were instead sold in Pakistan.

To stop smuggling and easing pressure on the local currency, Pakistan banned Afghanistan from importing several items prone to smuggling through its sea and land. For example, Afghanistan can no longer import tires, black tea, nuts and dry fruits, fabrics, cosmetics, vacuum flasks and home appliances under the transit trade agreement. Pakistan has also imposed a 10% fee on the import of chocolates, footwear, machinery, blankets and garments.[45]

Shabbar Zaidi, a chartered accountant by profession who also served as the chairman of the FBR under Khan's government, sees the Afghan transit trade agreement as a "problem" for Pakistan's economy.

"Afghan transit trade has always been a problem for Pakistan as the goods imported by Afghanistan

> Other officials blame smuggling for the hike in sugar price. The caretaker government had ordered a crackdown against the sugar smugglers as well ...

are often used in Pakistan, and indirectly it is a kind of smuggling," Zaidi explained in an interview.[46] "The Taliban government is not a recognized one abroad, so all the imports for Afghanistan are being paid from dollars in Pakistan."

He believes currency markets in the country will not see stability until Pakistan puts a stop to the practice of allowing the use of its dollars for Afghan imports. "The actual value of the dollar is between 250 and 275 rupees but this problem [Afghan transit trade] made the price of dollars cross 300 rupees," Zaidi added.

Another core component of the illicit economy is sugar. Pakistan, according to the Trade Development Authority, is the fifth-largest producer of sugar and is ranked ninth in the production of sugar cane. There are approximately 72 sugar mills across the country. Despite being a major producer of sugar, the country has been facing a shortage in its market, and its price has drastically gone up in recent months.

In March 2023, Pakistan granted the mills permission to export sugar even after the opposition of the Trade Corporation of Pakistan.[47] The sugar price, according to the Pakistan Bureau of Statistics, was recorded at 92 rupees per kilogram in mid-January 2023 but had climbed to 160 rupees per kilogram by August.[48]

Other officials blame smuggling for the hike in sugar price.[49] The caretaker government had ordered a crackdown against the sugar smugglers as well, and press releases by the law enforcement departments show that sugar was being smuggled from Pakistan into Afghanistan.[50]

Sarfraz Bugti, the caretaker minister responsible for security in Pakistan, confirmed in October 2023 that trucks were being used for smuggling of wheat and sugar from Pakistan. "Smuggling hasn't happened on camel backs. It has happened via trucks," he said.[51]

Since the crackdown began, Pakistani law enforcement agencies have seized 2,157 metric tons of wheat, 8,220 metric tons of sugar, and 4,239 metric tons of urea, according to the government figures. These crackdowns are not new; successive governments have conducted inquiries into smuggling of these products, highlighting how collusion by large businesses and the influence of politically influential groups distort prices.

Iran

Another key product category is Iranian petroleum products. Pakistan shares a 909-kilometer (about 565-mile) border with Iran, which has been under sanctions for decades. Despite these sanctions, products worth billions of dollars, according to the government officials and local traders, are smuggled into Pakistan from Iranian border areas. These smuggling operations from Iran are not unique to Pakistan, and in recent years the U.S. government has targeted smuggling networks led by the Islamic Revolutionary Guard Corps' Quds Force.[52]

"Chocolates, biscuits, tea, oil and so many other things are brought into Balochistan from Iranian borders areas," Imran Kakar, a leader of traders in Chaman, the city that connects Pakistan with Afghan province of Kandahar, told the co-author.

In recent months, the caretaker government in Pakistan turned its attention to the Iranian border in an attempt to stop the smuggling of Iranian oil and diesel. According to the country's ministry of interior, law enforcement agencies seized Iranian oil worth 126 million rupees (around $500,000) from several locations in Pakistan in September 2023.

However, other officials say the smuggling of Iranian oil into Pakistan is doing more damage to Pakistan than anyone could imagine. Jan Achakzai, the caretaker information minister in Balochistan, claimed in an interview that illegal trade of smuggled Iranian oil worth 60 billion rupees ($200 million) is done in his province in a year.[53] "The smuggling mafia has made a vast network here," Achakzai said, adding that the smugglers likely have some support from "people in the government, bureaucrats and politicians."

Iranian petroleum products, especially diesel, comes to Balochistan from many places, including the active border crossings between the two countries, multiple sources in the border towns told the co-author. They all refused to be identified by their names because they do not want to get into trouble with the authorities and the smugglers. The vehicles that smuggle Iranian oil into Pakistan are called Zamyad, and they could be seen on the major highways of Balochistan.[54]

"There are hundreds of checkpoints in Balochistan alone. How do the smuggled products reach other parts of the country?" asked Kakar, the trade leader.

One of Pakistan's civilian intelligence agencies revealed in a report that around 90 government officials and 29 politicians were involved in the smuggling of Iranian petrol.[55] The report also said that some militant organizations were also involved in the business of smuggled Iranian oil in Balochistan.

While the government has not publicly commented on this report, two law enforcement sources have confirmed to the authors the content of the report without naming the politicians or officials named in the report.

Days after the report was aired by some media outlets in Pakistan, authorities terminated the employment of over a dozen personnel of the Balochistan Levies, a paramilitary force in Balochistan. Authorities in Balochistan have confirmed that the personnel were sacked after they were found involved in the smuggling of Iranian oil into Pakistan.[56]

It was also reported that these personnel allowed 40 to 60 vehicles carrying 500,000 to 700,000 liters of Iranian oil into Pakistan every day for 14 months. A businessman in Quetta, the capital of Balochistan, who requested anonymity told the authors that the recent crackdown against the smugglers has had an impact on those doing legal businesses.

"The agencies have made it all really very difficult," he said. "Our vehicles that carry fruits and dry fruits to other parts of the country are stopped at every checkpoint and the security personnel waste our valuable time."

He added, "Those who are involved in the business of smuggling are allowed easy access to all the areas because they pay money to those who can give them access to other areas."

According to Kakar, smuggling through active border crossings such as Chaman is almost impossible due to the tight security measures taken in recent days. He, however, said people coming into or leaving Pakistan through Chaman are allowed 10 to 12 kilograms (22 to 26 pounds) of luggage.

"They are properly checked, but it's not really foolproof, and sometimes they may be able to smuggle things such as mobile phones, dry fruits, and other products in their bags," he explained. "Around 5,000 to 7,000 people travel to Afghanistan from the Chaman border crossing every day, and if you make a rough estimate, then they can smuggle a load of 55,000 to 60,000 kilograms in their bags."

Others in Balochistan believe the government's plan to completely stop smuggling will face resistance from locals. Plagued by separatist and Islamist militancy, Balochistan is one of the poorest provinces of Pakistan as more than 60 percent of its people live below the poverty line, according to the Hague Academy.[57]

Ali Shah, a veteran journalist who has been covering Balochistan for over two decades, told the authors that the government has taken a principled position to act against smuggling but that doing so would be an uphill task.

"People understand that smuggling is illegal and a crime, but they still do that. Why? Because they have no other option to put food on the table for their families," Shah said. "Not everyone is a big smuggler like those who travel in convoys."

In border areas, according to Shah, many people can be seen bringing small things such as flour and cooking oil into Pakistan.

"How do you stop them without giving them an alternate way of

Abdul Qader Azizi stands on top of his fully loaded truck transporting coal bound for Pakistan near Kabul, Afghanistan on Sept. 7, 2022. The Taliban regime had been focusing on streamlining transport and channeled trade to formal border crossings, while tightening border security to reduce smuggling. (Marcus Yam / Los Angeles Times)

earning their livelihood?" Shah said, adding that the province doesn't have big companies or industries that could give jobs to locals.

The political parties in Balochistan have protested the crackdown. A sit-in was organized in Balochistan's Kech district in September 2023 in which the local politicians opposed the ban on Iranian oil and claimed it wasn't smuggling but "legal supply."[58]

It is also worth noting that the Iranian oil smuggling issue has been a growing problem for years. The 2020 inquiry into the shortage of petroleum products in Pakistan noted that "it is almost an open secret that petroleum products (especially [gasoline and diesel]) are being smuggled into Pakistan from the western border of Taftan/Iran."[59]

The report also provides some data about the scale of this smuggling, highlighting that from July 2019 to June 2020, the Federal Bureau of Revenue confiscated almost 28 million liters of gasoline and almost 1 billion liters of diesel. The net loss in terms of tax revenue alone amounted to 48 billion rupees (almost $300 million based on the average exchange rate during that period).

The report argues that this estimate is only based on 20 percent of the total amount of fuel smuggled from Iran into Pakistan. As a result, the report says that the total annual tax revenue loss to Pakistan amounted to almost $1.5 billion in the reporting period.

Based on this data and given the evidence provided by officials that the scale of Iranian oil smuggling into Pakistan has continued to increase in recent months, it would be safe to conclude that billions of dollars in annual tax revenues have been lost through the illicit flow of petroleum products from Iran. In addition, this inflow of products has provided a foreign currency lifeline to Iran at a time when the regime has been under international sanctions and facing growing domestic economic and political challenges.

Path Forward

For the United States

Given the fact that Pakistan's illicit economy in large part thrives in the border regions of Afghanistan and Iran, it is critical for U.S. policymakers to pay close attention to the scale and evolution of this economy. This is especially important in the context of Iran, which has found new markets through which it can evade sanctions and earn much-needed foreign currency to keep its economy stable. In addition, militant networks, many of which pose a threat to U.S. national security interests, are deeply enmeshed in the illicit economy, which provides them with the financing needed to sustain and even grow their operational footprint in the region.

Given the ongoing crackdown on the illicit economy in Pakistan, it is vital for U.S. policymakers to engage with their counterparts in Islamabad and Rawalpindi to explore ways in which the U.S. can support Pakistan's efforts. Assistance can focus both on providing intelligence to Pakistan, especially as it relates to networks involved in the global narcotics trade. In addition, capacity building of civilian forces, which are on the front lines of combating smuggling networks across the country, should be explored. Finally, two key drivers of the illicit economy, particularly in the regions bordering Afghanistan and Iran, are the poor economic conditions and lack of economic opportunity. Investments that bolster human and economic development in these areas, particularly in Balochistan, are an opportunity for cooperation between both the United States and Pakistan.

While a cooperative approach to engagement should be the priority, U.S. policymakers must also candidly engage with their counterparts in Pakistan, especially Rawalpindi, about how collusion between security officials and illicit smuggling networks is a threat to U.S. national security interests. This should be communicated especially in the context of smuggling networks from Iran, which provide a significant economic lifeline to the Iranian regime. U.S. policymakers should also highlight how these networks undermine Pakistan's own national security interests, given how this illicit economy provides access to funding to militant groups that have recently increased the tempo and scale of attacks on Pakistani security forces.

Overall, a continued focus on this illicit economy between Pakistan, Afghanistan, and Iran is needed, as the convergence of criminal, militant, and state-sponsored networks involved in this economy can pose a significant threat to the United States' interests in the region and beyond.

For Pakistan

Pakistan's weak law enforcement system is one of the major obstacles to stopping smuggling, and the illicit economy will continue to flourish if the country does not enact far-reaching reforms.

The recent crackdown against smugglers began only after the military's intervention, which itself was the result of growing economic discontent in the country. The intervention by the military clearly indicates that the country's civilian authorities are either not serious or are not allowed to do their jobs. Only after the military leadership decided that the illicit economy posed both an economic and national security threat did the state apparatus act.

This leads to a major concern: What happens when the military leadership loses interest in the illicit economy and prioritizes other issues, including the broader political dynamics in the country? If the status quo were to be restored in the context of the ongoing economic uncertainty in Pakistan, the problem may continue to grow and become unmanageable in the near future.

Another key issue is the continuous encroachment of the military's apparatus into what should ideally be the domain of civilian institutions.

Pakistan has several other civilian agencies such as the Federal Investigation Agency and Intelligence Bureau that can deal with such crimes.

At the same time, blaming civilian officials for the growth of the illicit economy is also unfair. It is likely that military officers, especially those in border regions, are heavily involved in the illicit economy. While the crackdown and threat of legal action is a step in the right direction, the sustainability of these actions remains in question.

While Pakistan will have to strengthen its civilian departments in order to curb the growth of the illicit economy, its policymakers will also have to deal with its underlying drivers such as economic and political uncertainty, the rise of the Afghan Taliban in Kabul, and the broader increase in global energy prices following Russia's invasion of Ukraine. Two of these three factors are exogenous shocks, and with both Afghanistan and Iran cut off from global markets, the incentive to smuggle goods, currency, and drugs into and out of the border regions will remain.

In addition, this illicit economy thrives due to the collusion among Pakistan's law enforcement institutions, political elites, and criminal and militant networks operating in the border regions of Afghanistan, Pakistan, and Iran.

Its growth has enriched active participants in the process because of their influential position in state institutions. Whether a more permanent break in this collusion can be achieved is a major question, and individuals involved in the ongoing crackdown argue that it may not be sustainable due to these linkages.

One way to ease some of these challenges caused in particular by the Afghan trade route is to permit the flow of goods to and from India from Afghanistan. Given that India is a much larger market than Pakistan, the integration of the Afghan economy with India through transit trade via Pakistan can help ease some of the pressures experienced in Pakistani markets, especially as it relates to the demand for foreign currency and food products.

In addition, Pakistani policymakers must look at the ways in which market interventions distort the broader economy, creating incentives to smuggle subsidized products out of Pakistan into markets where the price is higher. This is especially true for wheat, sugar, and fertilizer, all of which are heavily regulated markets in Pakistan.

Finally, while it is likely true that the pressure on the Pakistani rupee is due to the growth of the illicit economy, economic experts also argue that the underlying issue is macroeconomic instability in Pakistan. The yawning fiscal deficit and the associated growth in the money supply, including cash in circulation, feeds the growth of the illicit economy and incentivizes dollarization. Without controlling the fiscal deficit and curbing the growth of money supply, pressures on the currency will remain, pushing households to protect the real value of their savings through dollarization.

The ongoing crackdown on the illicit economy has led to some shifts in behavior among market participants in Pakistan, but whether this momentum can be sustained in the run-up and aftermath of elections in 2024 remains to be seen. To sustainably deal with this challenge, however, policymakers will have to look at structural reforms that help alleviate the pressures driving the growth of the illicit economy. ☐

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