

PAKISTAN

Kidnapped



At an anti-U.S. demonstration in Karachi, supporters of Osama bin Laden display their ire.

World Nation

Welcome to Pakistan, America's front-line ally in the war on terror, where culture and economy conspire against even the best intentions.
by Richard Behar

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LIES ARE LANDING ON Abdul Khaliq Siddiqi's body. But the secretary-general of Sipah-e-Sahaba—one of the deadliest terror groups in Pakistan—is very much alive and doesn't notice. "We were worried about the World Trade Center families that were destroyed," Siddiqi says, sitting in a circle with fellow militants, cross-legged and sipping black tea, at the group's office in Quetta. "But after the U.S. attacked Afghanistan, it is our commitment that they are great men who destroyed the World Trade Center." Shaking his fist, FORTUNE's host slips into a 20-minute diatribe, saying that Sept. 11 was "all the fault of Jews," vowing that "God will destroy Bush," blaming President Pervez Musharraf for the Taliban's defeat, and providing details about the cash, supplies, and soldiers Sipah had slipped across the porous border to aid the Taliban. "God willing, that day is not far when the Islamic flag will be hoisted at the top of America's buildings."

Across town, the scene is just as chilling at Al-Badar Mujahideen's "House of Martyrs," where a visitor is expected to remove his shoes on one of three flags taped to the floor—U.S., Israeli, and Indian. "You're the only American we've allowed inside," says Umer Inqlabi, the 36-year-old bearded commander, as he invites a FORTUNE reporter to eat curry with fellow guerrillas and watch a video of the group's violent escapades in Afghanistan, Kashmir, and Chechnya. "Today you are my guest—my brother! But you belong to the enemy side. If I see you at the war field, I will just kill you."

As the abduction and brutal murder of



Black-market moneychangers, like this one in Karachi, are undermining Pakistan's economy—and keeping it afloat.

Wall Street Journal reporter Daniel Pearl makes clear, that war field now includes the streets of Pakistan. Pearl's death and the mid-March bombing of a Protestant church in Islamabad are only the most visible signs of a dysfunctional nation—call it Problemistan—a country that professes to be an ally of the U.S. in its war on terrorism but probably harbors more terrorists than any place on earth. It is the most unstable nuclear power in the world, a land where even the best intentions are undermined by some of the world's worst economic conditions. Despite some bold moves by Musharraf and a talented team of ministers to steer the country in a new direction, Pakistan is teetering on the edge of bankruptcy, overwhelmed by poverty, vulnerable to a fourth war with neighboring India, and unable to control thousands of jobless *jihadis* whose anger is fueled by religious fundamentalists.

"You people just woke up to something that's been simmering for more than 20 years," says Mahmoud El Said, Egypt's ambassador to Pakistan, whose own embassy in Islamabad was bombed in 1995. "We as Arabs and Mus-

lims have a lot of soul-searching to do. We let those fanatics hijack the religion."

And, so it would seem, a nation. A ten-week journey through Pakistan—and dozens of interviews with suicide bombers, government ministers, Western-trained bankers, tribal gun dealers, and illegal moneychangers—confirms this notion of a society held hostage. Corruption is so deeply ingrained in all aspects of Pakistani life, from the stock market to the country's own intelligence services, that rooting it out will require Herculean efforts. (It has even apparently penetrated the U.S. embassy in Islamabad, according to a former employee, who told

FORTUNE that a ring of American and Pakistani employees ran a visa-selling racket there for at least three years, until after Sept. 11—a charge the embassy says it will investigate.)

A list of Pakistan's problems reads like an encyclopedia of disaster. In a nation of 140 million people, only one million tax returns are filed each year, forcing the government to run

up a debt almost equal to its GDP. Annual per capita income is \$430, the infant mortality rate is as high as in sub-Saharan Africa, and nearly two-thirds of school-age children don't attend school. Many of those who do are enrolled in religious academies called *madrassahs*, where the only textbook is the Koran. Not surprisingly, more than half of the population is illiterate. Roads are in terrible shape, much of the population doesn't have access to clean water, there are frequent power outages, and the legal system is in shambles.

Truth itself seems in short supply. When Musharraf's spokesman, Maj. Gen. Rashid Qureshi, told FORTUNE that "before Sept. 11, I for one had not heard of al Qaeda" and that he was "quite sure" Musharraf hadn't either, he must have conveniently forgotten that the U.S. had bombed al Qaeda targets in Afghanistan in 1998. And when Musharraf declared that less than 15% of Pakistan's population was extremist-minded, he must not have seen a Gallup poll released in mid-October, which found that 82% of urban Pakistanis viewed Osama bin Laden as a freedom fighter.

Today, everyone from the American media to Musharraf's own spin machine paints the Pakistani leader as an apolitical pragmatist on a tightrope, struggling to crack down on terrorism and bring his country into the 21st century. But even if you grant Musharraf's sincerity, it's an open question whether he has the will or the power to take on the cancerous elite who have gotten rich

The *hundi* system is used to facilitate drug trafficking, terrorism, and tax evasion.



Bin Laden's face is a pop icon, available even on candy wrappers.

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from smuggling, black markets, a crooked stock market, and an illegal moneychanging system—and who have helped turn Pakistan into a hothouse for terrorism.

GROUND ZERO FOR PAKISTAN'S economic reform movement is the country's Securities & Exchange Commission, launched in 1999 and modeled after America's SEC, where Chairman Khalid Mirza, a Western-trained expert in capital markets, is battling to institute basic disclosure and governance rules for public companies. It seems a reasonable enough mission. But, says Mirza, "nobody is supporting it. It's like the Greek myth of Ajax battling the elements. Transparency? Accountability? Who wants it?"

Mirza's effort to reform the stock market has led brokers to take to the streets with placards labeling him an "American agent." Behind the scenes, the situation is even grimmer. "They [brokers] told me that people who do this don't last long," says Mirza—adding with a nervous laugh, "in office, I mean." Still, his friends have told him he needs to look after his own safety. "I'm not liked," he says. "In fact, I'm considerably hated."

Mirza arrived on the job in March 2000 to find the stock market a cesspool of Ponzi-like trading schemes. When measured by its capitalization (only \$6 billion), the market had "the most phenomenal turnover, the most volatile anywhere in the world," Mirza says. "And no dot-coms!" Almost all of the trading was in just 30 stocks (the other 735 were listed largely for tax advantages). The Karachi Stock Exchange, the country's premier bourse, was run by six brokers. Fund diversion to crafty directors was commonplace, margin requirements were nonexistent, and small investors were regularly scalped. Even commercial banks were in on the action, lending money to crooked brokers, who in turn loaned the money at 20% interest rates to the client-investors that the brokers would ultimately gang up on and devour, a practice known as "cornering." Shareholder meetings took place nine months after closing the books, and many weren't held at all. Only six firms went public in 2001. Instead, the trend was to buy back shares at the low points, delist, and liquidate assets—in effect a deindustrialization of the economy.

And today? Although Mirza says the stock market is "a bit cleaner," massive manipulation still takes place. "They [brokers] paid off everyone—government officials, intelligence agencies," says one of Mirza's deputies, who asked not to be identified.

While new SEC regulations prevent brokers from managing the exchange, they still control 60% of the board. The SEC was recently given a mandate to regulate accountants, but the maximum fine for cooking the books is only \$30 per offense. "There are vested interests," complains Mirza.

The roots of corruption run deep. Last year the U.N. contracted one of Canada's leading fraud experts, Wayne Blackburn, to prepare a report on the country's money-laundering problems. "The whole economy is predicated on avoiding taxes," Blackburn says, adding that about 85% of all transactions are in cash, compared with 3% in North America. "Our culture is money flow," says Jameel Yusuf, who runs the Citizens-Police Liaison Committee, one of the country's most sophisticated police agencies. "Nobody follows it."

Estimates of the size of the country's

hawala, flying money—primarily to serve poor people who are uncomfortable entering banks or don't have access to them. But *hundi* has also been used to facilitate drug trafficking, smuggling, terrorism, and tax evasion. (Even the U.N. has moved funds into Pakistan in recent months through an illegal money-exchange company in Quetta, according to U.N. memos reviewed by FORTUNE.) A Citigroup banker says the *hundi* flows are "so robust that this economy defies gravity." Pakistan should have had hyperinflation in 1998 after its nuclear bomb tests caused capital flight, he says, and it should have had plummeting foreign-exchange rates after Sept. 11. But neither of those things happened. The reason: *Hundi* is both killing the economy and keeping it afloat.

Pakistan's financial situation is so precarious it came close to sovereign default



On Chundrigar Road in Karachi, armed guards stand watch outside a Citibank branch.

black-market economy, which includes everything from underground banking to narcotics to the smuggling of consumer goods, range up to 100% of the so-called formal sector. That ratio "is probably the most severe" of any country in the world, says Muhammad Mansoor Ali, one of Pakistan's leading economists. "It is essentially a parallel economy."

At the heart of this black-market economy is *hundi*, a network of brokers and moneychangers who transmit funds to and from Pakistan without moving money across borders or creating a paper trail. Similar systems exist all over the world—

on its foreign debt last year, according to government documents obtained by FORTUNE. The documents, prepared for the Finance Ministry, reveal that nearly \$8 billion was being remitted into the country each year by overseas Pakistanis through the *hundi* system—none of it taxed—a far greater amount than previously estimated and eight times what flows in through the country's banks. And the documents don't even mention the \$100 billion in capital that government leaders estimate has been taken out of Pakistan in recent years.

Most experts say they either don't know or are too scared to identify who controls

the *hundi* system. But central bank insiders tell FORTUNE that six men, all members of the Memon ethnic group, sit at its apex, which they describe as a “mafia” or “cartel.” The six have their bases in Karachi and Dubai and use each other’s networks, which stretch from Peshawar to New York. They keep a low profile, driving broken-down cars and wearing traditional Pakistani clothes. But the power they wield is enormous. “*Hundi* saps the very vitals of the country,” says Razi-ur-Rahman Khan, who runs J.P. Morgan’s banking operations in Pakistan. “If *hundi* is stopped, it would be a boon.”

It’s difficult to pin down whether *hundi* is even illegal in Pakistan. Central bank governor Ishrat Husain concedes there is much confusion. “It is not illegal if done through licensed moneychangers who keep documentation,” he says. At the Karachi headquarters of Khanani & Kalia Intl., the country’s largest licensed chain of moneychangers, visitors must get past guards carrying AK-47s and men counting stacks of bills to reach the office of Owais Kalia, one of four brothers who run the enterprise. He insists his company doesn’t engage in illegal money transfers, but documents obtained by FORTUNE detail five *hundi* transfers from Kalia’s Las Vegas office to Pakistan in recent years. One of Husain’s deputies says *hundi* is often arranged secretly by companies behind the licensed changers and that it is illegal “in any form”—a position held by U.S. officials and backed by the central bank’s published rules. What gives? The deputy says the bank winks at moneychangers big enough to maintain foreign currency accounts in banks “either here, in Dubai, or abroad,” as long as they use those accounts as one layer in a *hundi* transfer.

Another reason for Husain’s position may be that the central bank is itself knee-deep in the muck. Since 1999 it has purchased \$4.4 billion from dealers to shore up dwindling dollar reserves and finance its trade deficits. “I had no other option,” says Husain, who insists that the purchases were made from “reputable Pakistani firms based in the U.A.E.” But the United Arab Emirates has been the region’s undisputed financial hub for drug and terror money, including funds used for the Sept. 11 attacks. And by buying dollars in Dubai, complains the treasurer of one of Pakistan’s largest foreign banks, the government has institutionalized *hundi* to a degree that doesn’t exist anywhere else. “Here,” he says, “the tail wags the dog.”

EVERY NIGHT WOODEN BOATS LADEN with cigarettes and auto parts and TVs set sail from Dubai for Karachi. The cargo is bound for Afghanistan, thanks to a treaty that allows the landlocked country to receive goods via Pakistan duty-free. In reality most of the merchandise winds up staying in Pakistan—or quickly returning there—evading import duties as high as 80%. That means cheap goods for consumers on the streets of Karachi, but it’s also destroying local industry.

The smuggling racket, fueled by *hundi* and estimated at \$5 billion a year, is half the size of Pakistan’s legal imports. It also helped feed the Taliban treasury. Interior Minister Moinuddin Haider says he met with Taliban leaders three times to get them to knock it off. “I said, ‘You don’t like TVs for your people, and you say it’s a satanic box, but you don’t mind dumping them to your Pakistani brothers without duties and taxes.’ We did not get much cooperation.” Pakistan could shut the smuggler markets today—places like Quetta’s silk market, a byzantine sprawl of stalls filled with acres of smuggled fabrics. But shutting it, says Haider, “would be very hard on the people.”

The government could also crack down on money smuggling by requiring the five million Pakistanis living abroad to remit a minimum amount through the country’s banks each year or forfeit citizenship—a plan Pakistani officials considered and rejected before Sept. 11. It was the terror attacks that finally sparked a change, as overseas Pakistanis, fearing their accounts could be frozen by Western governments, began sending money back through the banking system. That helped bolster Pakistan’s dollar reserves to \$5 billion, up from \$1 billion in 1999. And it inspired the central bank to propose incorporating *hundi* into the banking system, so Pakistanis at home and abroad could more easily send money through legitimate banking channels. “We are asking the banks to mimic *hundi*,” says Husain. But how can banks do that, when Finance Minister Shaukat Aziz, a former Citibank executive in Pakistan,

tells FORTUNE that they “need to learn to say no,” and that “walk-in transactions should be discouraged”? Husain says the time is right to go after the moneychangers, but he’s afraid that *hundi* dealers will join with extremist parties to protest. “We can’t predict whether we’ll succeed or not,” he adds. “They are very powerful—and some are very unhappy.”

A Gallup poll last fall found that 82% of urban Pakistanis viewed Osama bin Laden as a freedom fighter.



The battle over who gets to control the flow of money is being waged across Pakistan. So far the reformers’ prospects don’t look good. Last July the head of Pakistan State Oil, who was preparing to privatize the company, was murdered after allegedly unearthing massive corruption in the state-owned oil business. And in December the brother of Interior Minister Haider was gunned down on a Karachi street, days after Haider had criticized the country’s radical mullahs.

The crime has not been solved, even though Haider, a close friend of Musharraf’s, presides over the country’s largest nonmilitary intelligence agency.

A LAW STILL ON THE BOOKS IN PAKISTAN calls for 80 lashes for Muslims caught drinking alcohol. Even in the big cities, commoners sipping a can of beer are often jailed for three months. But the rich? That’s another story. At a party at the lavish Islamabad home of one of Pakistan’s top hoteliers, the liquor flows freely as Roedad Khan, an advisor to six Presidents and author of the political memoir *Pakistan—A Dream Gone Sour*, talks about Musharraf’s chances at reform. “It’s too early to know,” he says. “There’s no accountability and too much corruption.”

Yet one can’t help but admire the perseverance of Pakistan’s younger generation—the top model in Lahore who, in a country where 75% of the women are illiterate, talks openly about “chick power”; the rising-star banker in Karachi who says a new generation of Pakistanis, trained at Wharton and Harvard, understands the need to invest in family businesses rather than focus on short-term profits. “They’re forcing changes,” says the banker, Munawar Noorani. “They

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understand globalization and the need to be competitive.”

Finance Minister Aziz is one of those who gets it. “This is a government of professionals,” he says. “There’s no talk of scandal and corruption at the top. It’s a government that believes that it’s not the government’s business to be in business.” Aziz points to Musharraf’s economic accomplishments: deregulating interest rates, opening up markets, improving the skills of government workers. But he admits he’s worried about the enormity of Pakistan’s problems. “The level of poverty is an issue that keeps me up,” Aziz says. “A feeling of injustice leads to extreme behavior—no hope, no jobs. They could become radicalized, and that’s not good for Pakistan or the world.” One need only drive through Korangi, one of the poorest sections of Karachi, to understand Aziz’s concerns: Inside a Kentucky Fried Chicken store, teenage employees, spiffy in their KFC uniforms, pose for pictures and shout, “We like Osama!” And those are the ones who have jobs.

One Western diplomat in Pakistan says his embassy calculates that for every 10% drop in textile exports to the U.S.—the biggest destination for Pakistan’s exports—some 300,000 Pakistanis are put out of work. But there doesn’t seem to be much appetite in Washington to take on domestic textile manufacturers and open U.S. markets to more Pakistani imports. After touring a textile plant in Lahore in November, U.S. Ambassador Wendy Chamberlin said it was “patriotic” for Americans to buy Pakistani goods—a comment that caused a backlash back home. She hasn’t repeated the statement since.

Pakistan’s Commerce Minister Abdul Razak Dawood warns that this is short-sighted. He tells a story about a textile worker who lost his job and went to his production manager for an explanation. He was told that America is not

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placing orders. “Now what goes through his mind?” asks Dawood. “He said, ‘I thought we were on the same side as the Americans. What have I done wrong?’ Next Friday he goes to prayers and then joins the procession. Next, hundreds and then thousands will do it. It snowballs. The West has to realize that there is no safety net here.”

HOW SERIOUS IS PAKISTAN IN THE WAR on terror? “We are working on it on a 24-hour basis,” says Saiyed Mohib Asad, chief of the Federal Investigation Agency—Pakistan’s FBI—widely perceived to be one of the country’s most inept agencies.

While dozens of suspected terrorists have been arrested in recent weeks, some in joint operations with U.S. officials, it’s not clear how far Musharraf’s commitment extends. His own spokesman, Gen. Qureshi, told FORTUNE that no radical groups in Pakistan have links to al Qaeda and that the government hasn’t seen any evidence of terrorism funds moving through Pakistan.

Counterterrorism investigator Mazhar Hussain, an ex-air force sergeant, disagrees. He says several of the more than 50 radical groups currently operating in Pakistan have links to al Qaeda. “Osama is not alone,” Hussain says. “He has a big organization, in every city, in every district

here.” Indeed, Pakistan has long been to terrorism what Las Vegas was to the Mafia—a free zone, where any hood from any “family” can pass through with impunity.

The government doesn’t have the law-enforcement capability to deal with the problem. Until last August the nation’s provincial police—the primary investigators of terror in Pakistan—didn’t have the authority to demand records from banks, let alone from *hundi* operators. “If a terrorist has funds and influence, he is free and can move anywhere in the country,” says Zafar Anjum, who runs one of Pakistan’s only corporate investigative agencies. “We have laws on the books, but there is no practical

enforcement in Pakistan. Where are the task forces on money laundering, organized crime, or terrorism? We don’t have a criminal database like the FBI. People are afraid to do investigations.”

In late October officials let Said Bahaji, the alleged Sept. 11 logistical mastermind, slip through their fingers at the Karachi airport, FORTUNE has learned, because his name wasn’t on an exit control list. And when it comes to freezing terror funds, it’s hard not to conclude that Pakistan is leaving extremists just enough time to clean out their bank accounts. So far Pakistan has managed to freeze roughly \$300,000 in terrorist funds out of over \$100 million seized worldwide. Some of the highlights: \$323.65 seized from the Taliban consulate in Quetta; \$1.50 hauled off from an account belonging to Jaish-e-Muhammad, the radical group suspected of involvement in the murder of Daniel Pearl. “I find it hard to believe there weren’t more assets in Pakistan banks,” says John Bauman, U.S. consul general in Karachi.

The government’s slowness in cracking down on groups such as Al-Badar and Sipah—both of which are believed to have links to al Qaeda—raises questions about how far Pakistan is willing to go in the war on terror. Sipah, which police suspect is responsible for the deaths of ten Shiite Muslims in a mosque in February, has been calling for jihads against the West for a year. It wasn’t banned by Pakistan until January, shortly after its meeting with FORTUNE. Al-Badar, one of the largest militant groups in Kashmir, is still operating in Pakistan even though a year has passed since the group’s leader announced that “jihad has become the foremost duty of the Muslim community against the U.S., Israel, and India.”

Two years ago, when the newsroom of the highly regarded *Business Recorder* in Karachi was torched following publication of a story linking religious extremists to smuggling, Musharraf paid a visit. “I told him the sectarian killing must stop,” deputy CEO Arshad Zuberi recalls. “I said, ‘You have to take on these bearded fellows.’ He said, ‘Yeah, we’re trying.’”

Whether Musharraf, who is seeking another five years in office, is trying hard enough—and many say he isn’t—the odds are stacked against him. “Nothing’s going to change here,” says Naeem Zakeria, a gun dealer based near Peshawar who says he lost a big order when the Taliban was driven from power. “Musharraf will go eventually, and it will be back to business as usual. Just an endless cycle of cancer.” **F**

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TORU YAMANAKA - AFP