

Money Makes the World Go Around

The Black Market for Currency, its Determinants and the Rise of Cryptocurrencies

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A popular American Sitcom *Sienfeld* has an episode in its 7th season called “The Shower Head.” The plot of the episode revolves around the eponymous character and his shower-loving friends Kramer and Newman trying to buy a shower-head on the black market. Not only are their antics hilarious, but they are also a great introduction to Black Markets.

Black Markets usually conjure up images of shady characters in dark alleys with suitcases full of dollar bills. But in reality, it is just a normal marketplace with law-abiding citizens as participants who want commodities that the government might not be too willing to give them. An underground economy or what is commonly known as a ‘Black Economy’ is a stealth market where illegal transactions take place. This is the type of market people reach out for in order to get the commodities that are not available legally. This includes drugs, arms, human trafficking, and currency. Yes, money itself is traded on the black market. It is this trade in currency that we aim to uncover in the paper.

Currency Black Market

The currency black market exists along with its official counterpart which includes banks and other financial institutions. Due to restraints on financial openness and imperfect monitoring of currency exchange channels, the black market for currency thrives. It’s not so legal status makes it smaller when compared to its legal counterpart. It’s location specific, transactions are carried out mostly in cash that leaves no paper trails and carry some level of risk. The risk comes from the possibility of confiscation by

government authorities and the chance of being swindled or robbed. In all countries where this kind of black market exists, such exchanges are usually carried out in convenience stores, illegal and local money changers offices and border crossings. While its unregulated nature might attract criminals, it is not the only purpose it serves. A black market for currency may develop for one or more of several reasons:

1. **Fixed Exchange Rate:** In a fixed Exchange Rate regime, the government officially fixes or pegs the rate of exchange of its currency with that of other currencies, typically the US Dollar. The government pegs the local currency at some arbitrary level to another currency that does not reflect its true market value and often over-values the local currency relative to what its market value would be if it were a floating currency. In a floating exchange rate system, the currency is determined on the basis of supply and demand mechanisms. Fixing the exchange rate at a level below the floating equilibrium leads to excess supply of the economy in the local market. Those with access to the currency to which the local currency is pegged, or the undervalued currency, find it better and much cheaper to use the black market to buy the local currency at better exchange rates than they can get officially. These include expatriates and tourists.

Under the Bretton Woods monetary order (1946-1971), most countries had a system of fixed exchange rate and imposed controls. The Foreign Exchange Trilemma meant that they could not have capital mobility and as a result, most countries had black markets to some degree. Only a few countries were completely devoid of parallel markets, including, ironically, Venezuela – previously considered to be a paragon of monetary virtue.

After Bretton Woods collapsed in 1971, many countries continued to retain controls to navigate the financial chaos following the oil shocks, commodity price swings and the early 1980s recession and debt crises. This was mostly true for developing nations in Africa and Latin America, but even developed economies continued to impose restrictions. Until 1979, British holidaymakers were not allowed to take more than £50 spending money out of the home country and passports were marked with the amount of foreign exchange bought at the bank.

2. **A government makes it difficult or illegal for its citizens to own much or any foreign currency:** Sometimes people trade for currency on black market because their government allows them to own only a specific amount of currency and they might need more than that or when they are being taxed while buying/selling foreign currency. This phenomenon has been increasingly observed in emerging market economies and less developed countries where it is fairly easy to acquire foreign exchange through officially established channels like the Central Bank. If foreign currency is difficult or illegal for local citizens to acquire, they will pay a premium to acquire it.
3. **The government taxes exchanging the local currency with other currencies, either in one direction or both (e.g. foreigners are taxed to buy local currency, or residents are taxed to buy foreign currency).**
4. **Counterfeiting of currency.**

5. **Illegally acquired currency that needs to be laundered before the money can be used:** One problem of criminal activities is accounting for the proceeds without raising the suspicion of law enforcement agencies. Considerable time and effort may be put into strategies which enable the safe use of those proceeds without raising suspicion. Implementing such strategies is generally called money laundering. After money has been laundered it can be used for legitimate purposes.

There are several ways to launder money and avoid suspicion. The most common are structuring or Smurfing- which basically refers to cash being broken into smaller deposits of money(hence Smurfs), used to defeat suspicion of money laundering and to avoid anti-money laundering reporting requirements. Another method is to use smaller amounts of cash to purchase bearer instruments, such as money orders, and then ultimately deposit those, again in small amounts; Shell companies and trusts; Round-tripping, in which money is deposited in a controlled foreign corporation offshore, preferably in a tax haven where minimal records are kept, and then shipped back as a foreign direct investment, exempt from taxation.

Black Market Premiums

Black markets arise when controls on foreign exchange restrict access to the official markets, forcing people to resort to unofficial channels. This typically gives rise to a premium over the official rate known as the black market premium.

Many factors determine the black market premium. On the demand side, anything that signals depreciation – for example, a deteriorating balance of payments – leads to an increase in the demand for foreign currency. If the public expects depreciation in the future, they'd like to sell their domestic currency holdings in exchange for foreign currency. This is because after depreciation, the domestic currency will buy less of foreign currency. As a result, people take their investments out of the domestic country, a phenomenon known as capital flight. In the absence of official channels for capital mobility, they turn to the black market. On the supply side, anything that affects the willingness of exporters, tourists and expatriates to transfer foreign exchange from official to illegal channels is likely to affect the premium. But the most important determinant is the severity of the foreign exchange controls. The black market premium primarily reflects the severity of the restrictions. Higher the restrictions, higher rises the premium. When the controls are strict, the stock of foreign assets is fixed, such that any increase in demand will result in a steep rise in the premium. Premiums can also rise due to an anticipation of devaluation. In Tanzania, the parallel premium increased tremendously in the run up to the 1986 devaluation to 800%. From 1984, anticipation was rife that a major agreement with the IMF would happen imminently and include a major devaluation. Capital flight ensued and the black market premium continued to surge. The actual devaluation was followed by, the premium falling rapidly to reflect the new official rate. Sometimes, however, the causality runs the other way. It was the growing black market premium itself that led Venezuela to devalue 3 times during the 1980s. The graphs below give a better picture.

Tanzania

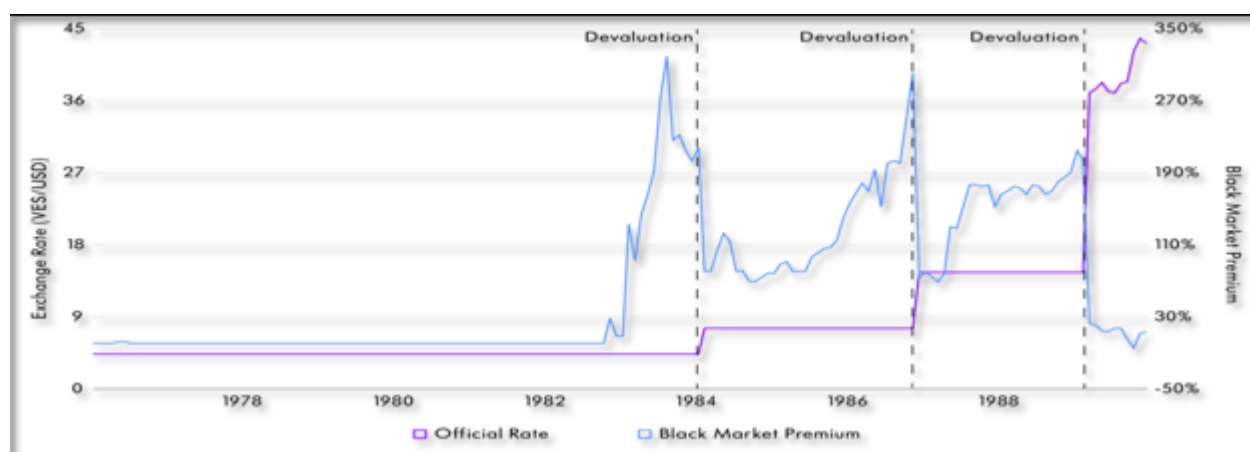


Figure 4: Credits: <https://www.winton.com/longer-view/currency-black-market-exchange-rates>

Venezuela

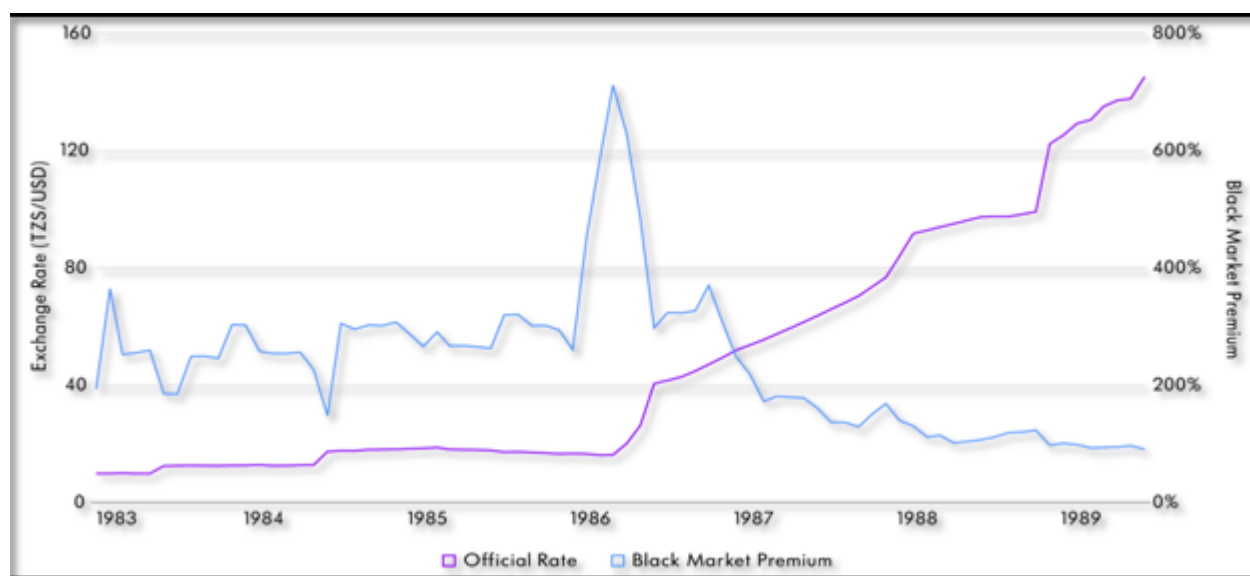


Figure 5: Credits: <https://www.winton.com/longer-view/currency-black-market-exchange-rates>

Effect of Several Policy Measures on the Market Exchange Rate

A devaluation of the official exchange rate leads to a steady state depreciation of the black market exchange rate. Since the official devaluation reduces the attractiveness to tourists of supplying foreign currency in the second economy, in the long run there are

lower foreign currency stocks in black markets. The steady-state effect on asset markets is a nominal and real depreciation of the black-market exchange rate. The black market premium will fall since the demand for foreign currency will be reduced.

If there's an increase in the riskiness of the returns on holding domestic currency assets, perhaps due to changes in the perceived threat of savings or monetary confiscation, it reduces the attractiveness of domestic currency assets and increases portfolio demands for goods and foreign exchange. The immediate jump by exchange rates and prices onto the saddle path implies a jump appreciation of the nominal exchange rate. The immediate increase in both nominal and real black market exchange rates implies overshooting behavior in the transition economy. As foreign exchange availability adjusts, the exchange rates will gradually depreciate and return to their real and nominal levels. The initial inflation surge will be followed by a period of deflation. In the steady state, individuals will hold larger stocks of foreign exchange in their investment portfolios.

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Inclinations Towards Cryptocurrencies

But as war wages between different currencies for the position of global currency, black market traders have moved on to the supposedly next best thing on the block, Cryptocurrencies. They are part of the largest unregulated market in the world. Cryptocurrencies have transformed black markets into black 'e-commerce' giants. Cryptocurrencies have grown rapidly in price, popularity, and mainstream adoption. The numerous online cryptocurrency exchanges and markets have a daily dollar volume of around \$50 billion. Over 170 "crypto funds" have emerged (hedge funds that invest solely in cryptocurrencies), attracting around \$2.3 billion in assets under management. The rapid growth of currencies and the anonymity that they provide has created considerable regulatory challenges. While cryptocurrencies have many potential benefits including faster and more efficient settlement of payments, regulatory concerns center around their use in illegal trade (drugs, hacks and thefts, illegal pornography, even murder-for-hire), potential to fund terrorism, launder money, and avoid capital controls. There is little doubt that by providing a digital and anonymous payment mechanism, cryptocurrencies such as bitcoin have facilitated the growth of online "darknet" marketplaces in which illegal goods and services are traded.

Darknet markets or Crypto markets are e-commerce sites like Amazon and ebay that sell different illegal items through the Dark Web. The factor that makes these markets more attractive is how much they actually resemble the online e-commerce websites that we commonly use. The feedback system of these darknet markets helps them analyze which products have more demand and which buyers are more trustworthy and able in providing high quality products. This arrangement makes both parties better off. High amount of profit increases choice and competition, which in turn reduce prices, and raises demand. Cryptocurrencies help in completing illicit transactions easily and faster. These transactions are also usually untraceable and keep sellers out of the reach

of government. The value of cryptocurrencies is prone to fluctuations and hence the rate of speculation that is being done around them increases. With the advent of bitcoin, the threat to the economic power of centralised banks has increased. Transactions and trading between the parties are cost efficient and done more frequently. Digital currencies make transfer fees practically zero and hence these become more viable for the people of developing or underdeveloped countries who are unable to pay a higher price. People also reach out to these marketplaces in order to get the capital investments that they want for their start-ups.

But it is important to consider the differences between cryptocurrencies and cash. After all, cash is also largely anonymous (traceable only through serial numbers) and has therefore traditionally played an important role in facilitating crime and illegal trade. The key difference is that cryptocurrencies (similar to PayPal and credit cards) enable digital transactions and thus e-commerce.

Arguably, the ability to make digital payments has revolutionized retail and wholesale trade. Online shopping substantially affected the structure of retailing, consumption patterns, choice, marketing, competition, and ultimately supply and demand. Until cryptocurrencies, such impacts were largely limited to legal goods and services due to the traceability of digital payments. Cryptocurrencies may have changed this, by combining the anonymity of cash with digitization, which enables efficient anonymous online and cross-border commerce. Cryptocurrencies, therefore, have the potential to cause an important structural shift in how the black market operates. While the emergence of illegal darknet marketplaces illustrates that this shift may have commenced, it is not obvious to what extent the black market will adopt the opportunities for e-commerce and digital payments via cryptocurrencies.

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