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Long-run nature of the relationship between the black market and the official exchange rates

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Abstract

Previous research that investigated the relationship between the black market and the official exchange rate employed cointegration analysis to establish the long-run relationship and Granger causality to detect the short-run causality between the two rates (for a small number of countries). In this paper, we employ annual data over the 1955–1995 period from 31 developing countries to show that indeed in most cases the two rates are cointegrated. Application of Johansen's weak exogeneity test reveals that in the majority of the countries, the black market exchange rate is weakly exogenous, supporting the argument that in the long-run depreciation of domestic currency in the black market induces government officials to devalue the domestic currency and unify the two rates.

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1. Introduction

Due to capital controls, especially in developing countries, the existence of a black market for foreign exchange, where the black market price of foreign currency is much higher than its official price, is a common norm. In many instances, such countries, in the name of financial reform, adhere to realignment of the official exchange rate to accommodate the development in the black market.¹ Other than the movement in the black market rate, many other factors may work as instruments that might have some impact on the governments' decision to devalue or revalue the official rate. Widespread corruption, absence of the rule of law, order, and an efficient judicial system, smuggling, money-laundering, tax-evasion, currency-substitution, domestic inflation, lack of property and contract rights, and political uncertainty are among the factors that can contribute to a wider gap between the black market and the official exchange rate. In the short-run, there is a tendency for the black market rate to deviate substantially from the official rate. However, in the long-run, when all kinds of adjustments are completed the two rates are expected to converge.

Several recent studies have tried to determine the convergence of the black market exchange rate and the official exchange rate as well as the causality between them by means of cointegration and error-correction modeling techniques. Two studies have considered the experience of Turkey. [Akgiray et al. \(1989\)](#) used monthly data and the simple Granger and Sims test to find that the two rates cause each other in the short-run.² Using the same monthly data [Booth and Mustafa \(1991\)](#) used the Engle–Granger cointegration technique and found that the black market rate and the official rate between Turkish Lira and the U.S. dollar in one relation and between Turkish Lira and German Mark in another relation are cointegrated. The finding of cointegration is considered to be an indication of informational efficiencies between the two markets. [Baghestani and Noer \(1993\)](#) considered the experience of India. Using the Engle–Granger cointegration technique and quarterly data over the 1973–1990 period, they showed that the black market exchange rate and the official rate between the Indian rupee and the U.S. dollar are cointegrated. Although both studies established the long-run relation between the two rates, none of them investigated the short-run causality between the two rates. To fill this vacuum, [Agénor and Taylor \(1993\)](#) used monthly data over the 1974–1986 period and considered experiences of 19 developing countries. They employed Johansen's cointegration technique to establish cointegration between the two exchange rates and an error-correction model to detect short-run causality between the two rates. The existence of a causal relation between the black market exchange rate and the official exchange rate is argued to be indicative of market efficiency due to the fact that market participants correctly anticipate changes in the official rate. While in previous studies cointegration was established in 14 out of 19 countries, no clear pattern concerning

¹ It is to be mentioned that the World Currency Yearbook, formerly known as the Pick's Currency Yearbook, is the sole distributor of data on the black market exchange rate for all countries on a monthly basis. It divides all countries into four categories depending on the black market condition or the degree of control: "free", "liberal", "strict", and "dictatorial". Most of the developed countries fall into the category of "free".

² A similar conclusion was reached when [Apergis \(2000\)](#) considered the case of Armenia.

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