Sri Lanka: Rise of black economy for forex and economic collapse: Part I

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It is an undeniable fact now that the market system has broken the lives of majority Sri Lankans. Real value of wages lost all its meaning with the collapse of the rupee. Unemployment, underemployment, hunger, malnutrition, lack of essential medicines and inability to afford education are spreading like a cancer and wrecking the lives of the ordinary people. Long lines stretching beyond the horizon to secure gas and fuel are an essential daily routine.

The ruling elite's insatiable hunger for power, its ability to ignore and brutally suppress people's demands ripe with indignation and its extraordinary shamelessness are helping them hold on to office while the ground beneath it is gradually disappearing. Despite the contraction of all economic activity and lives of ordinary men and women one particular sector in the Sri Lankan economy is growing in leaps and bounds while pulling the rest of us into its vortex. The black economy has taken over not only the allocation of essentials like LP gas, fuel and food at exorbitant prices to the public and deny those who can't afford, but also under our own eyes, seized the entire foreign exchange market under its fold.

In the following analysis we will discuss the rise of the black economy for foreign exchange in Sri Lanka and place it at the centre of the economic collapse we are now facing. We begin the discussion by reviewing existing views on the causes of the current crisis. The second part aims to understand the black economy for foreign exchange within the Mundell and Fleming framework for external sector stability. Third and final part will explore the immediate collective measures to prevent the worsening of economic conditions and place the economy on a path of recovery and transformation that is inclusive and collectively rewarding than the bankruptcy and constant state of instability imposed by the market system.

The pseudo liberal explanations of the foreign exchange crisis can be boiled down to three main propositions: a. fiscal and monetary policy errors committed by the current government which we may call 'government failure', b. living beyond our means by overconsumption of imports and c. collapse of the tourism sector due to the fallout from COVID-19 pandemic or as a result of an external shock to the economy.

Proponents of the first explanation like W.A. Wijewardena, Dr. Harsha De Silva and Prof. Rohan Samarajiva assert that inappropriate fiscal and monetary policy measures of the Rajapaksa regime escalated the fiscal deficit. They collectively state that sweeping tax breaks announced in 2020 budget reduced government expenditure by Rs. 600 billion a year which in turn impelled the monetary authority to monetise public debt (print money) to fill the gap in state coffers. This led to the unprecedented depreciation of the currency and runaway inflation. They further assert that fixing the exchange rate at Rs. 200 per US$ in 2021 promoted the growth of a black market and drained the foreign exchange inflows to the formal banking system.

Let’s review this idea from its starting point. The reduction in taxes in 2020 did lead to a decline in tax revenue of Rs. 525 billion which was also contributed by lockdowns during the COVID-19 pandemic. However, its impact should be assessed by probing the net effect on the overall fiscal deficit. Since the reduction of government expenditure during the period was Rs. 300 billion the net effect was only Rs. 220 billion, far lesser than Rs. 600 billion suggested by the advocates of ‘government failure’. In 2021 tax revenue fell roughly Rs. 400 billion compared to 2019 and the fiscal deficit reached 12.3% of the GDP. The aggregate net effect is therefore half of the figure proposed by W.A. Wijewardena and them.

It should be borne in mind that Sri Lanka experienced fiscal deficits well over 10% of GDP consecutively between 1978 and 1983 and there were a number of years the deficit exceeded it since 1986. The devastating nature of the ongoing crisis therefore cannot be explained by simply citing tax cuts and the budget deficit increasing beyond 12%. It is in no way a sufficient condition to trigger an economic catastrophe of this magnitude. There is an absolute deficiency of foreign exchange in the formal banking system independently of the developments in the domestic monetary base; the former cannot be explained by the latter.

Furthermore, the exponents of ‘government failure’ hold that rupee depreciation was entirely driven by the increase in money supply as a result of ballooning fiscal deficit. However, the black market exchange rate remained stable around Rs. 250 per US$ when the Central Bank held the official exchange rate at Rs. 200 per US$ while money printing was at its peak especially throughout 2021. Black market exchange rate, which is a market determined flexible exchange rate remained stable at this level while the monetary authorities increased rupee liquidity by as much as Rs. 1,400 billion during the period.

Despite the significant increase in money supply the back market rate for the US$ did not further depreciate when the Central Bank pegged the official rate at Rs. 200 per US$. Collapse of the rupee began only when the exchange rate was floated in early March this year.

Although this does not rule out the impact of money printing on currency depreciation, it is clear from the discussion so far that collapse of the rupee was triggered by an entirely different set of circumstances much more pervasive than the reduction of tax revenue and increase in money printing suggested by Wijewardena, Dr. Harsha De Silva and Professor Rohan Samarajiva. In fact, the latest IMF review on Sri Lankan economy published early this year clearly states that inflation adjusted exchange rate or the real effective exchange rate appreciated only 17% compared to the pegged rate of Rs. 200 per US$ maintained by the Central Bank at the end of 2021. This means to say that the market determined rate of exchange of the rupee should be around Rs. 240 per US$ at the end of 2021, which is more or less in line with the black market rate of Rs. 250 per US$ during the period.

The level of inflation triggered by the expansion of fiscal deficit and money printing and due to reasons not discussed here compared to the level of inflation of our trading partners at the end of 2021 had warranted a rupee depreciation of around 17% by the end of 2021 and nothing more according to the IMF. Nevertheless, ever since Central Bank floated the currency in March this year, the rupee depreciated 90% against the US$, over five times the percentage suggested by the IMF. The scale of depreciation as I suggested earlier cannot in any way attributed to the tax cuts and ensuing money printing by the Central Bank to keep the government afloat.

Explanation of the currency’s collapse lies in the ability of foreign exchange black market which grew from strength to strength under the patronage of the Rajapaksa regime to outcompete the formal banking sector in absorbing foreign exchange already available. This is clearly seen by black market rate for US$, or in other words the free market rate proper, remaining stable throughout

2021 when Central Bank pegged the rate at Rs. 200 per US$, despite persistent money printing. This is so given that black market did not have to compete with the formal banking sector for foreign exchange by raising its rate when the official rate was fixed at Rs. 200 per US$. Hence the free market rate remained aligned with the level stipulated by the real effective exchange rate at around Rs. 250 per US$.

In this setting the effectiveness of Central Bank's monetary policy instruments like policy interest rates in controlling the course of the exchange rate disappears completely. The black market developed this capability by accumulating its own foreign reserves boosted primarily through trade mis-invoicing of the corporate elite (we will return to it in part II), controlling the internal price level of the goods it supplies and the tremendously high margins it can earn by funding the criminal economy like the drug trade, human trafficking, arms deals, etc.

However, pseudo liberal economists like W.A. Wijewardena and Dr. Harsha De Silva asserted repeatedly that raising interest rates can kill the speculative demand for foreign exchange and arrest the collapse of the rupee. Raising interest rates to increase the cost of speculation has no effect on this process simply because the rate of returns of the criminal economy cannot be matched by the interest rate of the formal banking sector without entirely decimating the rest of the economy. The activity they are trying to control through manipulating interest rates has nothing to do with speculation. Believing and publicly announcing that criminal activity will suddenly recoil and the criminals will return to earning a fair income like everyone else when Central Bank increases policy rates sufficiently, is nothing short of insanity.

For instance, the Central Bank raised its policy rates by unprecedented 700 points in April this year when the official rate was Rs. 300 per US$. However, subsequently, the currency collapsed as much as 27% to Rs. 380 per US$ in commercial banks. This was so given that black market was capable of outcompeting the formal banking channels to absorb foreign exchange by setting its own exchange rate above the official rate. It is a process engendered and stimulated entirely independent of tax cuts and money printing repeatedly highlighted by the pseudo liberals in explaining the collapse of the currency.

The second proposition on the current crisis is the belief that Sri Lankans were living beyond the means and that we consumed more foreign exchange in the form of imported goods and services without a corresponding increase in production. The gaping hole in the trade account between exports and imports is cited as proof for this assertion. However, the composition of imports paints a completely different picture.

It is well known that close to 80% of aggregate imports are in the form of intermediary goods, investment goods, raw materials and machinery necessary for production and not for personal consumption. (This is also repeated by Verite Research and Advocata to apparently prove that import controls are unfeasible as a means of reducing foreign exchange outflow). So when the advocates of this view claim that we as Sri Lankans are consuming the foreign exchange in the form of imports the question we should raise is whether the mass of the people in this country consume raw materials and machinery and rest of the investment goods? The answer is obviously 'no'.

This brings us to the point where we now have to discuss the real reasons behind the yawning deficit in the trade account of the balance of payments and its connection with the black economy for foreign exchange, which we will address in the second part of this discussion.

The last proposition we investigate is the belief that 'external shock' of COVID-19 brought the $ 4.4 billion tourism sector to a standstill and triggered the crisis. However, when analysing the impact of foreign exchange loss with the collapse of tourism we must look into net foreign exchange income it normally generated. In 2018 when the sector recorded its highest inflow of tourists and foreign income, the expenditure of outbound travel of Sri Lankans was $ 1.7 billion. Further, we need to deduct the cost of imports in supplying services to foreign tourists like transport, electricity, vehicles, food, sanitary ware, etc., that have a large import content.

According to industry standards the import cost of the tourism sector can be estimated to be approximately 25% to 30% of the gross revenue neglecting construction costs. The net foreign exchange income of the sector during its best ever year on record therefore amounts to only around $ 1.5 billion which is not even remotely sufficient to set off a crisis of the magnitude we are currently facing. In this backdrop we will discuss the fundamental factors contributing to the ongoing foreign exchange crisis in the second part of the discussion.

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