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REPERCUSSIONS OF FINANCIAL IMBALANCES IN AN ENCLAVE ECONOMY: THE CASE OF SURINAM

Part II

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Introduction

This paper deals with the adverse consequences of excessive money creation in Surinam, a former Dutch colony on the north coast of South America with a population of less than half a million. Surinam is a typical enclave economy. Although the country is five times the size of the Netherlands, its volume of production is only about 1% of that of the former mother country. Mining and bauxite processing, almost completely in the hands of an American and a Dutch multinational, account for about three quarters of total exports and, directly and indirectly, make a significant contribution towards domestic output, employment and public revenue. This industry is linked to only a very limited extent with the other sectors of the domestic economy, which are poorly developed. Surinam's production potential is therefore underexploited, while its economic structure is dualistic and disjointed, making the country highly dependent on imports of goods, services and capital.

The monetary structure in the 1970s

Before 1980, Surinam was untroubled by an shortage of foreign exchange. Expenditure consistently exceeded domestic output, but the consequent structural current account deficit was easily financed from external sources. There were large-scale imports of foreign private capital, mainly directed towards bauxite operations. In addition, the country received fairly large sums of development aid. As a result the overall balance of payments was generally positive and international reserves were built up equivalent to five months imports of goods and services by end-1980, well above the standard of 3 months normally used by the International Monetary Fund.

Up to 1980, the influx of money from abroad was of decisive importance for the monetary climate. The net inflow of foreign money during that period even exceeded the growth of domestic liquidity, implying that domestic factors accounted for a slight net contraction of the money supply. The government resorted only modestly to domestic money creation. Banking operations were in net terms by and large monetary neutral. The Central Bank of Surinam consistently conducted a cautious monetary policy and limited the allowable creation of money by the commercial banks to the structural growth of the volume of output. In this way, the money supply was kept in line with the growing real cash requirements of the public. In addition, the Central Bank permitted the commercial banks to recycle long-term funds attracted.

However, the capital imports have insufficiently induced increases in production and exports, owing in part to a complex interaction of physical and organizational bottlenecks. Due to the development state of the Surinam economy, the government had to devote considerable resources to build up the economic and social infrastructure. Less than a third of official capital imports was used for directly promoting the expansion of output and exports. In particular, funds found their way into the agricultural sector. The gains of these investments were below expectations. Thus, the process of structural economic transformation and enlargement of the productive capacity made only slow progress. The production apparatus remained too small and one-sided to meet the demand for goods and services generated by capital imports. In other words Surinam found itself trapped in a vicious circle: the country continued to be underdeveloped simply because it was underdeveloped.

The inadequate capacity to absorb foreign capital for productive purposes generated inflationary tensions from time to time. However, these tensions were reflected only to a limited extent in domestic costs and prices, since imports of goods and services were stepped up as soon as domestic price inflation threatened to accelerate. These imports served as a safety valve for releasing excessive demand. Domestic price developments kept pace with inflation in Surinam's main trading partners, namely the United States and the Netherlands. The monetary approach to the balance of payments was therefore most relevant to Surinam. The country remained dependent on foreign capital and its external debt increased gradually -undermining the solvency of the economy. Upon the granting of independence to Surinam in 1975 solvency was restored as on that occasion outstanding debt to the Netherlands was waived. In addition, the Netherlands provided grant aid for the co-financing of a multi-annual development program. Thanks in particular to that support, Surinam remained an oasis of calm in a financial sense until the early 1980s.

Fundamental changes in the 1980s

After 1980, a number of fundamental changes took place in the financial structure. Export earnings fell sharply, due to the weak world market for aluminum products and the reduced competitiveness of Surinam's export industry. Furthermore, official capital inflows virtually dried up at the end of 1982 when the Netherlands suspended its development cooperation agreement on account of the flagrant violations of human rights by the military regime which had taken power by means of a coup in 1980. Consequently foreign receipts slumped to about a third of the 1980 level, which was reflected in a drop in government revenues of around 20%. Instead of an austerity policy to cope with this drop decline the government doubled its spending during the 1980s. The ratio of current to total public expenditure rose from 80% to 98%, and the number of public sector employees increased by a fifth, so that approximately half the active labour force now consists of public servants. In contrast, spending on development projects was reduced to barely 2%. The explosion in expenditure has taken place in the absence of a sound administration and an adequate control over the legitimacy and efficiency of spending. The collection of taxes also leaves much to be desired. The state of Surinam's public finances shows signs of anarchy.

As a result of the government's expansionary policies the budget deficit has increased from barely 5% of gross national product in 1980 to an almost world record level of over 25%. Utterly at variance with the letter and the spirit of its statutes, the Central Bank of Surinam has been involved in the monetary financing of the inflated deficit. Its loans to the government have risen at a dizzying pace. In consequence, the Bank can no longer concentrate on its main task: fostering the stability of the Surinam currency. It has degenerated into a departmental money dispenser. The country is flooded with new money. Particularly serious is also that, in contrast to the pre-1980 situation, the growth in the money supply is no longer accounted for by external factors, but originates wholly from domestic sources. In this way a highly disjointed relationship has arisen between the supply of goods and the supply of money. Expressed as a percentage of gross national product, the money supply has risen in leaps and bounds from an equilibrium value of 25% in 1980 to a dramatic peak of more than 100%. No lack of money therefore - but all the more lack of reasonably priced goods.

Consequences of the monetary expansion

Foreign revenues have become insufficient to finance imports of goods and services, resulting in growing balance of payments deficits. Initially, the deficits could be financed out of the country's international reserves, but these melted like snow before the sun. The coverage of the money supply by the international reserves has fallen from almost 100% to little more than 2%. In addition, payment arrears have been run up and external debts were raised. The country's net external financial position is steadily becoming more negative. Surinam now no longer belongs to the select group of developing countries with a comfortable level of international reserves; instead it finds itself in the company of many others suffering from an acute and permanent shortage of foreign exchange. All in all, the liquidity and solvency of the economy is seriously undermined. Surinam's international creditworthiness is nil.

Following the rapid reduction in the country's ability to make payments to other countries, increasingly stringent restrictions on foreign payments have been introduced. Imports on a cash basis have fallen from around 65% of national product in 1980 to 20% at the present time. This reduction has been partly offset to a extent by the growth in private remittances by Surinamese emigrated to the Netherlands in fairly large numbers over the years. In addition, imports are financed by means of foreign exchange obtained from unofficial sources. The drop in imports has led to a serious shortage of goods on official markets. In the meantime, material and financial reserves have been nearly exhausted. Investment has almost dried up, which is severely undermining the quality of the infrastructure and the productive capacity of the economy. Expressed as a percentage of domestic product, investment has slipped from nearly 20% to as little as 5%. Even in the bauxite industry - the lifeline of the economy of Surinam - innovative investment has been lacking. A shift is taking place in investment from the productive sector to trading activities, with a view to securing fast profits at limited risk. Speculation is being given priority over laying a solid, sustained foundation for real economic growth.

With the closure of the external safety valve the surplus of money stopped leaking away to abroad. A perilous situation has consequently arisen, with more and more money chasing fewer and fewer goods. This has given rise to a hitherto unknown and accelerating price spiral. It may be noted that the seriousness of inflation in Surinam is not fully reflected in the outdated cost of living index, partly because in calculating this index as well as other official statistics insufficient weight is attached to the transaction volumes and the actual prices in what is now a flourishing black market. The unofficial rate of the US dollar is indicative of the rapid acceleration in inflation. Among other things the black market rate has been pushed up by an uncontrollable flight of capital. The rate has increased to some 15 times the official rate - pushing inflation upon on all fronts.

A policy for the 1990s

In Surinam a broad debate in society has started concerning the socio-economic problems confronting the country. With financial support of the European Community a foreign private consultancy group made a report with far-reaching recommendations. It is clear that there is no wonder drug capable of painlessly curing the problems facing the country. There is no getting round the fact that restructuring the economy will require sacrifices, resolve, initiative and effective economic policies. The quality of the government machinery that will have to handle such an operation leaves much to be desired, among other things because a considerable number of senior officials have left the public service over the years for the private sector or have gone abroad. Once again a vicious circle arises: the poor quality of the government agencies has contributed to the political and economic crisis, while the crisis means that funds are lacking to improve those institutions. Nevertheless the situation in which Surinam finds itself is not a hopeless one; the country has a small, excellent educated, population and is manageable. The level of natural resources per head of the population is very high, while the development cooperation between the Netherlands and Surinam has been restored recently, after democratic elections were organized.

Despite the inherent differences in structure, the developments in various South and Central American countries provide evidence that although a programme of reform and adjustment is painful, the consistent implementation of such policies may be expected to generate satisfactory results in due course. According to rough estimates by international organizations, the real growth in output in these countries in the first half of the 1990s will be around 5%. This follows the general structural stagnation in the past decade resulting among other things from unsound budgetary and monetary policies. The reversal in the economic outlook for Latin America stems from what may without exaggeration be termed a silent revolution in attitudes towards the role of government in the domestic economy. Previously, the government occupied a dominant position and was involved in everything; in the new vision, the role of government should be confined to its key tasks and to creating a healthy socio-economic atmosphere for private sector activities.

On the basis of experiences in other countries, an essential precondition for the reform and restructuring of the economy of Surinam is the attainment of consensus in society. The social partners can make a material contribution in this respect by reaching agreement on the strategy to be pursued aimed at fashioning a climate in which sustained productive activity can flourish. As part of such an agreement serious understandings will need to be reached on the following economic matters:

1. A macro-economic framework within which the national goals for the next three to five years can be clearly formulated, priorities laid down and the effects of the various measures evaluated. It is important to realize that the problems cannot all be resolved at once.

2. The consistent reform of public finances in order to eliminate the budget deficit by reducing current expenditure and boosting revenues, among other things, through improving the collection of taxes. This in turn will create room for an expansion of investment. Public enterprises should be privatized. In future the government should strive to adhere to the golden rule of public finance whereby current

expenditure should be financed out of taxation, while borrowing should be permitted only for capital expenditure aimed at generating an adequate level of output and exports.

3. The restoration of sound monetary relationships by creaming off surplus liquidity. Here various options are in principle available, ranging from the implementation of a crash programme consisting of a one-off devaluation of all financial assets to a more gradual approach in which the government sells assets, such as land, state enterprises and foreign exchange to be obtained from development aid, to the private sector at realistic prices. In the latter case the money equivalent obtained will need to be simultaneously destroyed. It is vitally important that the Central Bank is no longer used as a "cheap" money factory for financing government deficits. The Bank should be given independence in its operations, be released from political caprice and be permitted to evolve into a genuinely professional organization. The Bank should confine itself largely to the promotion of price stability by means of sound monetary management. Any domestic borrowing by the government should be conducted via a public money and capital market, thereby enabling the market mechanism to do its work. The amount that the government is permitted to raise in this market should be limited to the point where its debt commitments do not impose an excessive burden on the budget and that sufficient room is left for the private sector to raise capital at attractive interest rates.

4. A strategy along three lines to increase investment, production and exports. Firstly, this policy will need to be directed at the maintenance, revitalization and expansion of the existing production capacity. In addition a number of new growth pillars will need to be created based on the available natural resources, consisting of large-scale, primarily export-oriented and, as far as possible, interrelated economic complexes. Thirdly, viable small-scale projects need to be promoted in order to meet the population's basic personal and communal needs. The government should not undertake such production itself, but must encourage small and large private

entrepreneurs, both domestic and foreign, by creating a stable and attractive social and economic climate.

5. The formulation of a cost and price policy to generate comparative advantages for production and exports. One important factor is to ensure that the rise in wages remains in line with labour productivity gains. With a view to restoring the competitiveness of the industrial sector and eliminating the black markets, there is no way around a significant formal devaluation of the currency. These goals should not be achieved by expanding official regulations, but by effective deregulation and by promoting the orderly operation of the market mechanism.

6. A social programme to support the weaker members in society. Here again various options are in principle available, such as guaranteeing the availability of a minimum package of primary necessities at an acceptable price, or broadening and deepening the system of social security benefits. The basic premise should be to get away from the notion that the government needs to subsidize virtually the entire community. Instead, the government should confine itself to the provision of temporary support to people genuinely in need. The financing of the programme must of necessity be soundly based. In addition, the government should encourage the absorption into the production process of these people by means of education and training.

7. Normalization and intensification of relations with foreign donors. In this respect, the essential precondition is for Surinam to provide clear evidence that it is committed to the consistent implementation of a sound programme of reform and restructuring. But no matter what efforts are made, the task will be beyond Surinam's resources alone. External capital as well as technical and economic know-how will be indispensable and can help appreciably to alleviate the pain of reform. Ways will also have to be explored of tapping the skills and experience of the Surinamese community in the Netherlands.

8. Entrusting the implementation of the programme of reform and

restructuring to a small, resourceful team of managers. This would ensure that the day-to-day management of the economy is not unduly influenced by short-term considerations of all sorts of pressure groups and that greater priority could be given to a policy designed to provide the highest possible domestic economic return in the long term. Charting the main lines of the policy and supervising the implementation of that policy should of course remain in the hands of the democratically elected organs.

Conclusion

The developments in Surinam demonstrate that in so-called enclave-economies, where the production structure is dominated by only one industry, special attention should be given to controlling the domestic money creation. In such economies financial stability must be ensured. This will create a climate of confidence, which is essential for a successful process of real economic growth. Money and monetary policy are therefore vitally important in building up prosperity in enclave economies. Although monetary discipline is an essential condition for sound development, in itself it is by no means a panacea. Economic growth can only be achieved by means of a coherent and synchronized package of varied measures influencing both the supply of and the demand for goods and services.

From the above it is clear that, of the various policy instruments at the governments' disposal, the management of public finance is of decisive importance for financial stability. The pressure exerted by interest groups means that there is a continual temptation for the authorities to increase the level of current expenditure. In an enclave economy, however, it rapidly becomes clear that giving in to this temptation on a large scale is counterproductive and that a high price will have to be paid for the neglect of financial stability. Unsound financial management cannot but exacerbate existing physical problems and cause serious damage, which can only be corrected by undergoing a painful process of reform and restructuring. Here again prevention is better than cure. A great deal of misery can undoubtedly be prevented if discipline is exercised to limit the growth in the domestic money supply by gearing it to the optimal real economic growth prospects in the longer term.