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Impediments to the Effectiveness of Monetary Policy in Suriname

by

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Central Bank of Suriname

October 1999

*) Rakesh Adhin is Head, Research Department of the Central Bank of Suriname. The paper is written in his own capacity and the views expressed herein do not necessarily represent the views of the Bank.

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ABSTRACT

It is widely accepted that the core task of a central bank lies in the conduct of monetary policy in order to attain a certain degree of price stability. There may be, however, disturbances in the outcome of monetary policy due to factors that impact negatively on the central bank's policy to achieve its goal of low inflation. Within the conceptual framework of the monetary transmission mechanism these impediments are known as exogenous factors since they are outside the central bank's control. This paper seeks to identify these factors for Suriname and to analyse domestic inflation levels during 1990-1998.

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I. INTRODUCTION

There is a growing consensus among economists that the main goal of monetary policy must be to attain and preserve a low and stable rate of inflation (Masson et al, 1998). Within the conceptual framework of the monetary transmission mechanism, however, there are also exogenous factors (Eijffinger & Gerards, 1990) that may endanger the objective of price stability. This is consistent with the moderately monetarist view, where the impact of money on the economy is recognized but not overstated since wage and fiscal policy are also considered important (De Vries, 1990). For this reason central banks are generally critical about wage increases and fiscal deficits, especially with regard to the financing of the latter.

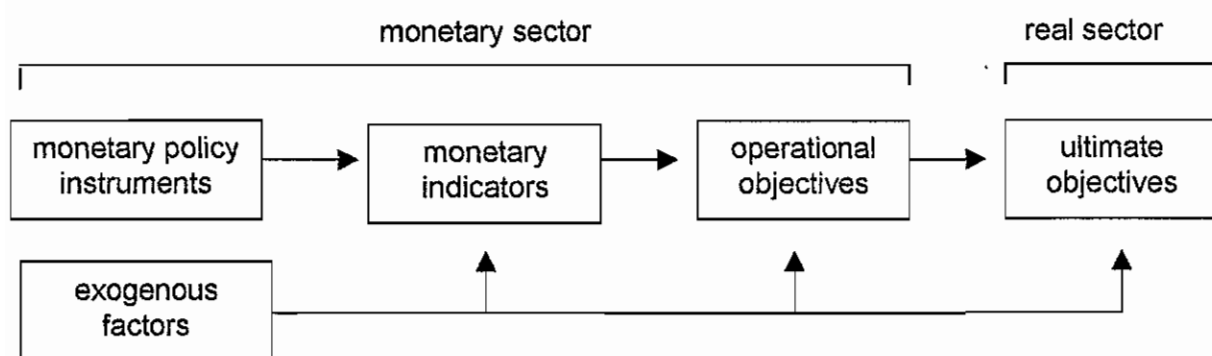
Up till now, the Central Bank of Suriname has imposed credit ceilings on the commercial banks in order to protect the balance of payments and control inflation in the context of a small open economy. Monetized fiscal deficits and substantial wage increases have, however, constrained monetary policy for the larger part of the decade. These factors, after all, led to a situation of exchange rate depreciation and domestic price inflation.

This paper deals with the inflationary impact of wage and fiscal policy in Suriname during 1990-1998 and is organized as follows. First, the transmission process of monetary policy is reviewed in general terms. Second, an overview of Suriname's monetary policy is given. Third, the inflationary influence of wages and deficits in Suriname will be assessed, followed by an analysis of domestic inflation. And finally, concluding remarks will be made with regard to what the impediments were to effective monetary policy in Suriname in the 1990s.

II. MONETARY TRANSMISSION PROCESS

The transmission of monetary policy can best be understood through the monetary transmission mechanism. This refers to the general conceptual framework within which the analysis of how changes in the money supply are transmitted to macroeconomic variables such as prices, output and employment, may be undertaken. In order to successfully conduct monetary policy, authorities must have an accurate understanding of the timing and effect of their policies on the economy (Khan, 1998). There is, however, still an imperfect understanding of the nature and size of money's transitory effects, their time frame, and the channels by which monetary impulses are transmitted to the rest of the economy (Masson et al, 1998).

Diagram 1: Transmission Process of Monetary Policy



Source: Sylvester Eijffinger

Monetary policy is aimed at influencing operational objectives (targets) which, in turn, influence ultimate objectives (goals). Targets are monetary variables such as monetary and credit aggregates, which are within reach of the central bank. Goals, on the other hand, are real variables such as price stability, economic growth and full employment. The monetary indicators offer information regarding the direction and the force of monetary policy after the application of one or more

indirect instruments. The targets are also called intermediate objectives since the central bank uses these to influence the goals or macroeconomic objectives. Finally, the process of monetary transmission is subject to exogenous factors (Eijffinger & Gerards, 1990). These include wage and fiscal policy, which, after all, do have an impact on the entire monetary transmission process (Adhin, 1996). In addition, institutional factors may play an influential role. In this vein, it is important to note that empirical evidence shows that the more independent the central bank is, the more successful it is in fighting inflation (De Haan & Eijffinger, 1996).

III. MONETARY POLICY IN SURINAME

Historical background

The most prominent instrument of monetary policy has been quantitative credit control through a system of credit ceilings. The need for this direct instrument arose from the fact that there was no domestic capital market to develop indirect policy instruments. The credit ceiling imposed on the commercial banks has been operational since the 1960s with a major adjustment in 1983, when foreign exchange receipts diminished as a result of the suspension of Dutch aid and the recession in the international bauxite sector. Since then, the commercial banks are not allowed to use designated monetary liabilities¹ as funding for their credit operations. This measure was deemed necessary to protect the international reserves and contain inflation. In 1995 severe penalties were introduced to deter banks from exceeding their credit ceiling, thus improving the overall compliance with the credit arrangement. In Suriname, commercial bank credit may not lead

¹ These are: 100% of demand deposits, 25% of short-term time deposits and 10% of savings deposits.

to net money creation. This restrictive credit policy is the result of a long history of fixed exchange rate arrangements and external current account deficits.

The period 1990-1998

The Central Bank of Suriname used the following instruments of monetary policy in the 1990s:

- (1) Credit ceiling: This traditional instrument of monetary policy in Suriname is applied to commercial banks individually and is relative in nature. After all, in accordance with the credit arrangement, the growth in commercial bank credit is closely related to the increase in the long-term bank resources. In this way, even though the credit ceiling is not a market-based instrument, it allows for competition among local commercial banks. Given its specific design, the credit ceiling implies non-monetary financing by commercial banks.
- (2) Open market type operation: Since March 1995, the Central Bank issues its own certificates denominated in grams of gold and offering a cumulative 5% gold-linked interest. Their market value in local currency is dependent on the nominal value, the cumulated interest, the international gold price and the official exchange rate. Being a stable investment, the gold certificates are generally purchased as a hedge against inflation, thereby serving as a refuge for flight capital (Adhin, 1996).
- (3) Foreign exchange market intervention: In May 1995, the Central Bank started targeted interventions in the foreign exchange market. Shortly thereafter, a fragile monetary stability was established as the exchange rate stabilized. As a consequence, inflation was reduced to zero in 1996. Since then, expansionary fiscal policy and reduced export earnings due to falling world market prices have led to an increasingly deteriorating current account balance, rendering the authorities with little room for interventions.

(4) Moral suasion: As the Bank has no formal instrument to influence interest rates it resorts to moral suasion to encourage commercial banks to set their interest rates, as much as possible, at levels that support economic activity and mobilize financial savings. The reduction of interest rates, however, requires fiscal consolidation for investors' confidence to rebuild.

Policy outlook

Shortly, reserve requirements will be introduced as a replacement for the credit ceiling. For the moment, a transitional arrangement is effective whereby banks are required to deposit their reserves, which under the current arrangement may not be used for credit funding, with the Central Bank. This is in line with standard reserve requirement procedure and intended to prevent that these funds are being tapped into through financially innovative instruments. Under the new system, a uniform ratio will apply to all deposit liabilities instead of the administratively cumbersome multiple-ratio system that is currently part of the calculated credit ceiling. The Central Bank will then have a swift instrument at its disposal to contain exchange rate pressures by adjusting the reserve ratio. Pending the introduction of the uniform reserve ratio, the overall calculated ceiling was recently reduced by 5%. Another instrument in preparation are open market operations, pertaining to the trade in government paper on the secondary market. Thus, the development of the domestic capital market can be accelerated.² For the successful introduction of these instruments, however, timely and reliable statistical data are a prerequisite. On the exchange rate front, the Bank is in a process to liberalize the managed official rate to fully reflect market forces.

² In 1994 a Stock Exchange was established that has been growing steadily over the years.

As a consequence, a convergence is taking place between the official and the parallel rate. The sustainability of the unified rate will, however, depend on the fiscal and external performance. The exchange rate will therefore only be fixed when the government budget and the balance of payments have reached a stable state of equilibrium (Goedschalk, 1998). On the legislative side, a new Central Bank Act has been drafted that eliminates the possibility of direct or indirect government borrowing. Also, a Financial Sector Reform Programme has been initiated by the Bank and supported by the government. One of the foremost limitations for accelerated economic growth is, after all, the absence of a strong and dynamic financial sector (Goedschalk, 1998).

IV. EXOGENOUS FACTORS AND INFLATION

This chapter will focus on the exogenous factors wage policy and fiscal policy. It must be acknowledged, however, that institutional factors also impact on the outcome of monetary policy. In Suriname, major institutional impediments are, for instance, the weak statistical infrastructure, the obsolete financial legislation and the underdeveloped money and capital market.

Wage policy

If wage increases exceed productivity increases, they become a threat to price stability since the need to increase prices arises, resulting in cost-push inflation. Wage demands are more often than not related to past inflation. An independent central bank with a good inflation performance will, however, be rewarded by the general public with low wage demands based on low inflationary expectations (De Haan & Eijffinger, 1996). This means that the reputation of the central bank in itself can be helpful in achieving its goals. Since wages, on average, comprise

more than 51% of total government current expenditure (table 1) and civil servants more than 63% of the employed labour force (table 2), wage policy is highly intertwined with fiscal policy in Suriname.

Table 1:

Government Current Expenditure
(in Sf million)

| Year | Wages & Salaries (I) | Total Exp. (II) | I in % of II |
|------|-------------------------|--------------------|--------------|
| 1990 | 564 | 1,030 | 54.8 |
| 1991 | 692 | 1,555 | 44.5 |
| 1992 | 887 | 1,567 | 56.6 |
| 1993 | 1,064 | 2,645 | 40.2 |
| 1994 | 3,535 | 10,443 | 33.9 |
| 1995 | 17,312 | 42,374 | 40.9 |
| 1996 | 27,598 | 57,880 | 47.7 |
| 1997 | 40,425 | 50,258 | 80.4 |
| 1998 | 73,799 | 108,868 | 67.8 |

Source: Ministry of Finance

Table 2:

Employment

| Year | Govt Empl. (I) | Total Empl. (II) | I in % of II |
|------|-------------------|---------------------|--------------|
| 1990 | 37,811 | 62,487 | 60.5 |
| 1991 | 36,757 | 60,869 | 60.4 |
| 1992 | 36,663 | 60,163 | 60.9 |
| 1993 | 37,160 | 59,235 | 62.7 |
| 1994 | 38,552 | 60,669 | 63.5 |
| 1995 | 40,652 | 62,958 | 64.6 |
| 1996 | 42,697 | 66,212 | 64.5 |
| 1997 | 42,816 | 66,118 | 64.8 |
| 1998 | 43,445 | 66,374 | 65.5 |

Source: General Bureau of Statistics

Under these conditions, the inflationary impact of wages will largely show up through monetized government deficits. The inflationary effects of wages and deficits are then virtually inseparable. Consequently, fiscal policy remains as the single most important exogenous factor in the transmission process of monetary policy in Suriname.

Fiscal policy

Fiscal deficits, and especially the financing thereof, are of major concern to central banks seeking to attain price stability. Monetization of deficits will, after all, ultimately lead to demand-pull inflation. In this paper, the term fiscal balance refers to the central government balance financed by base money creation or seigniorage revenue. The central bank can either directly or indirectly finance

government deficits. In the first case, the treasury draws a cheque on the central bank, whereas in the second case, the central bank buys treasury bills. Both of these procedures are called seigniorage (Burda & Wyplosz, 1993). If a relatively large portion of the change in the monetary base is caused by seigniorage revenue monetary instability is inevitable. In the past years, the government of Suriname has been financed by the Central Bank in accordance with the current Central Bank Act (art.21), but also through arrears with the banking system as a whole. In its Financial Statement for the year 2000, however, the government announced fiscal reforms and signalled policy intentions of not taking future recourse to seigniorage revenue. The reforms will include broadening of the tax base as well as downsizing the civil service, in a fashion that is satisfactory to the trade unions (Ministry of Finance, 1999).

Inflation analysis

According to the data, inflation during 1990-1998 has been mostly high and unstable with an annual average of 96% (table 3).

Table 3: Selected Macroeconomic Indicators

| Year | Monetary Base ¹ (Sf mln) | Int'l Reserves (US\$ mln) | Inflation (%) | Govt Balance ² (%) | Nom. GDP (Sf mln) | Liquidity Ratio ³ (%) |
|------|--|------------------------------|------------------|----------------------------------|----------------------|-------------------------------------|
| 1990 | 2,298 | 21.0 | 21.7 | 8.0 | 2,883 | 76.6 |
| 1991 | 2,911 | -20.7 | 26.0 | -18.1 | 3,421 | 85.0 |
| 1992 | 3,262 | -32.8 | 43.7 | -5.6 | 4,708 | 70.2 |
| 1993 | 5,512 | -33.2 | 143.5 | -15.8 | 10,755 | 61.9 |
| 1994 | 16,728 | 64.4 | 368.5 | 2.5 | 60,622 | 36.7 |
| 1995 | 52,055 | 185.4 | 235.6 | 4.8 | 205,369 | 27.1 |
| 1996 | 43,299 | 182.2 | -0.7 | -0.6 | 272,101 | 25.5 |
| 1997 | 44,372 | 194.5 | 7.1 | -1.9 | 293,868 | 26.7 |
| 1998 | 78,742 | 205.3 | 19.0 | -3.1 | 361,210 | 28.6 |

Source: Central Bank of Suriname and General Bureau of Statistics.

1 Commercial bank reserves and currency in active circulation.

2 Central government monetized balance divided by nominal GDP.

3 Broad money M2 divided by nominal GNP.

In 1990 the government financed its deficit through a bond issue on the domestic capital market. Because of the good response, the government raised more than its financing needs and subsequently demonetized the excess proceeds by reducing its floating debt with the Central Bank. Since there was a demonetized government surplus, inflation in 1990 must be explained by the accumulated excess liquidity that slowly began to translate into inflation. The liquidity ratio, after all, was 76.6% which is far beyond the standard of 25% - 30% that is generally accepted for Suriname. In 1991 and 1993 a particularly loose fiscal policy stance led to large government deficits. In 1991, the highest liquidity ratio was recorded, namely 85.0%. This indicated the presence of an exceptionally high degree of excess liquidity in the system mostly due to foreign exchange scarcity. Inflation, however, remained repressed as the government, at the time, provided highly subsidized basic consumer goods. In 1992 a second government bond was issued of which the proceeds could not fully satisfy the financing needs of the government. The remainder of the deficit was therefore monetized. The excess liquidity was for a large part absorbed in 1993, when inflation reached triple digits. In 1994 the government devalued the Suriname guilder as an integral part of a Structural Adjustment Programme. When the exchange rate was floated it caused massive cost-push inflation whereas the public's lack of confidence in the unpopular adjustment policies led to speculation and capital flight, adding to inflation through parallel exchange rate increases. As a result, the liquidity ratio fell sharply from 62% to 37%. In the first half of 1994 the Central Bank incurred increasing foreign exchange losses as a result of a multiple exchange regime that lasted till July 1994.³ These losses culminated in 1994 as the multiple exchange rate differentials increased. Also, in July 1994, the Bank restarted its gold purchases in local currency after more than ten years. These

³ The multiple exchange regime comprised seven official exchange rates and lasted from October 1992 till July 1994.

combined factors offer an explanation of why inflation was so high in 1994. In the second quarter of 1995 speculative attacks against the currency reached a new climax. Expectations were, however, turned around by foreign exchange interventions, which began in May 1995 and stabilized the rate in the following months. In 1994 and 1995 when the overall balance of payments improved rapidly, the Central Bank accumulated foreign exchange reserves for intervention purposes. In 1994 and 1995 the country ran trade surpluses of US\$ 100 million and US\$ 123 million (approximately 5 months of imports) respectively. This policy of accumulating reserves by restrictive import financing led to an exchange rate depreciation and inflation since the inflow of liquidity was not sterilized. The year 1996 yielded zero inflation as a result of foreign exchange interventions and restored confidence in the economy. During 1996-1998 the government's monetized deficits increased gradually. Although the international reserves increased through net external financing, the exchange rate depreciated on the parallel market due to the reduction of foreign exchange interventions. Instead of draining down the international reserves the authorities, after all, chose to focus on the management of liquidity. Finally, in the last three years, the government removed a number of subsidies and introduced a sales tax. These policy measures are all reflected in the rising inflation rates during this period.

For the period as a whole, it can be concluded that fiscal deficits, albeit through the exchange rate, were the major cause of inflation. After all, since Suriname is a small open economy exchange rate depreciations are almost immediately translated into domestic inflation.

V. CONCLUSION

Wage policy in Suriname cannot be dealt with as an independent exogenous factor since its inflationary impact is largely felt through monetized government deficits. Fiscal policy was therefore the major impediment to effective monetary policy in the 1990s. Institutional factors such as capital market development, financial legislation and statistical infrastructure, however, also had a hampering effect on the implementation and outcome of monetary policy. Although the credit ceiling in itself has performed well over the years, it is not designed to contain excess demand due to expansionary fiscal policy. The pervasiveness of fiscal policy, therefore, led to a situation of fiscal dominance that constrained monetary policy over the years. The government has, however, recently stated that it will avoid future recourse to seigniorage revenue, which will be realized through fiscal reforms and fiscal discipline. In the meantime, a new Central Bank Act has been drafted that will make the Central Bank more independent. In addition, the Central Bank of Suriname is in the process of promoting financial sector reforms and developing new market-oriented instruments with the firm intent of enhancing the effectiveness of its monetary policy. Once implemented, these measures will provide an appropriate institutional framework for Suriname's monetary policy in the new millennium.

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