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THE IMPACT OF MONETARY POLICY IN PRICE AND EXCHANGE RATE STABILITY IN SURINAME

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The Impact of Monetary Policy on Price and Exchange Rate Stability in Suriname

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ABSTRACT

In general, monetary policy as an instrument of macroeconomic management is aimed at promoting price stability, full employment, economic growth and balance of payments equilibrium.
In small open economies, however, exchange rate stability becomes a prime concern of the central bank because of its high correlation with price stability.
The commercial banks, which constitute the core of the financial system, directly influence price and exchange rate stability through their domestic credit supply, while their impact on the other macroeconomic objectives is more indirect.
Up till now, the Central Bank of Suriname has restricted credit expansion by imposing credit ceilings on the commercial banks, which limit credit growth in line with increase of long-term resources.
This implies that commercial banks are not allowed to create money which, given the economic situation in Suriname, is consistent with the balance of payments objective.
As commercial bank credit is an intermediate target of monetary policy, the Central Bank does not influence interest rates directly. However, due to high inflation in the recent past, interest rates became increasingly negative in real terms, leading to capital flight and further depreciation of the national currency. To counter these developments the Central Bank succesfully started issuing its own securities offering a real interest rate, while simultaneously intervening in the foreign exchange market.

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1. INTRODUCTION

Monetary policy is considered one of the most important instruments of macroeconomic management. In general, price stability, full employment, economic growth and external equilibrium are regarded as the basic objectives of monetary policy. Although central banks usually assign high priority to the achievement of price stability, the main focus in small open economies tends to be on exchange rate stability.

The Central Bank of Suriname has the prime responsibility of defending the national currency in order to maintain stable domestic prices. During the late 1980s and the early 1990s, however, inflation plagued the Surinamese economy mainly due to a massive depreciation of the exchange rate. The overall deterioration of Suriname's economy was the result of a decade long of monetary financing of government deficits (1983/93). Budget deficits, loss of international reserves, excessive growth of the money supply and contractions of real output were common characteristics of the economy at the time. The reliance on administrative regulation and controls generated large distortions in relative prices, and prompted widespread parallel market transactions. Moreover, during 1993/94 central bank foreign exchange losses, arising from a multiple exchange rate system, resulted in further expansion of the monetary base which accelerated inflation even further.

Against this background of economic deterioration, the Structural Adjustment Programme of Suriname was (formally) started in 1993. Within the adjustment framework, Suriname's economic performance improved markedly in 1995 owing to the conducted monetary and exchange rate policies supported by a major strenghtening of the public finances.

This paper deals with the Central Bank's contribution in achieving price and exchange rate stability in Suriname during the last five years (1991-1995).

First, the monetary policy will be reviewed, focusing on the control of commercial bank credit as this is one of the important factors directly affecting price and exchange rate stability. Within this context, the interest rate policy of the Central Bank will be mentioned as well.

Next, the exchange rate policy, which has been a major instrument in stabilizing the Surinamese economy in 1995, will be discussed, followed by a brief conclusion.

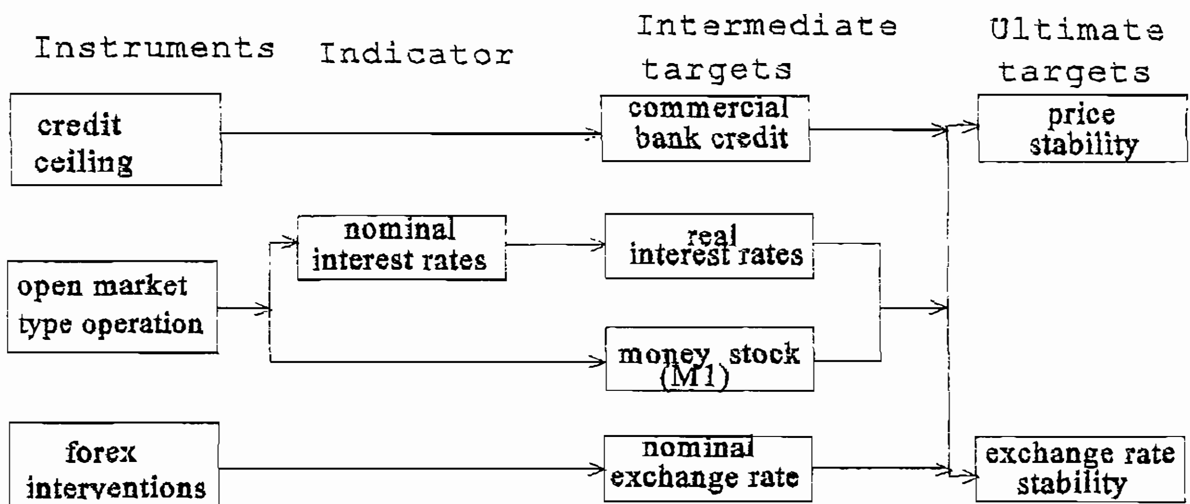
2. MONETARY POLICY

2.1 Transmission mechanism

The general approach to monetary policy in most countries can be characterized as follows:

instruments ---> indicators ---> intermediate targets ---> ultimate targets.

Monetary policy in Suriname is primarily aimed at promoting price and exchange rate stability, but due to the openness of the Surinamese economy, price stability heavily depends on the stability of the exchange rate. To achieve these goals the Central Bank, empowered by the Bank Act 1956, can employ credit ceilings, discount rates, reserve requirements and open market operations as instruments of monetary control. Up till 1994, commercial bank credit ceilings were the only formal monetary instrument in use. In 1995, however, the Central Bank started its open market type operations and foreign exchange market interventions. The following diagram illustrates the transmission mechanism of monetary policy in Suriname during 1991-1995.



2.2 Credit policy

As stated earlier, the commercial banks influence price and exchange rate objectives through their domestic credit supply. To prevent inflationary pressures from the banks, the Central Bank has, up till now, restricted domestic credit expansion by imposing credit ceilings on the commercial banks through a Gentlemen's Agreement which is renewed annually. According to this arrangement, the growth in commercial bank credit is limited to the increase in long-term resources relative to December of the preceding year.[1]

This implies that commercial banks' credit policies may not lead to net increases in the money stock in order to avoid pressure on the balance of payments. The arrangement also allowes commercial banks to carry over, individually, the remaining amounts under the ceiling ("ceiling reserve") at the year's end to their ceiling throughout the following year. Increases in bank investments, on the other hand, bring down the credit ceiling with the amount newly invested.

So far, there are no formal restrictions governing the sectoral distribution of commercial bank credit. Compliance with the credit ceiling requirement is generally satisfactory (see chart 1). In 1992 the commercial banks collectively exceeded the credit ceiling due to the increased demand for credit associated with the auctions of balance of payments support received under the Treaty for Development Co-operation with the Netherlands. The subsequent attraction of additional savings by the banks increased their credit potential and hence eliminated their excess credit position as of the end of 1993.

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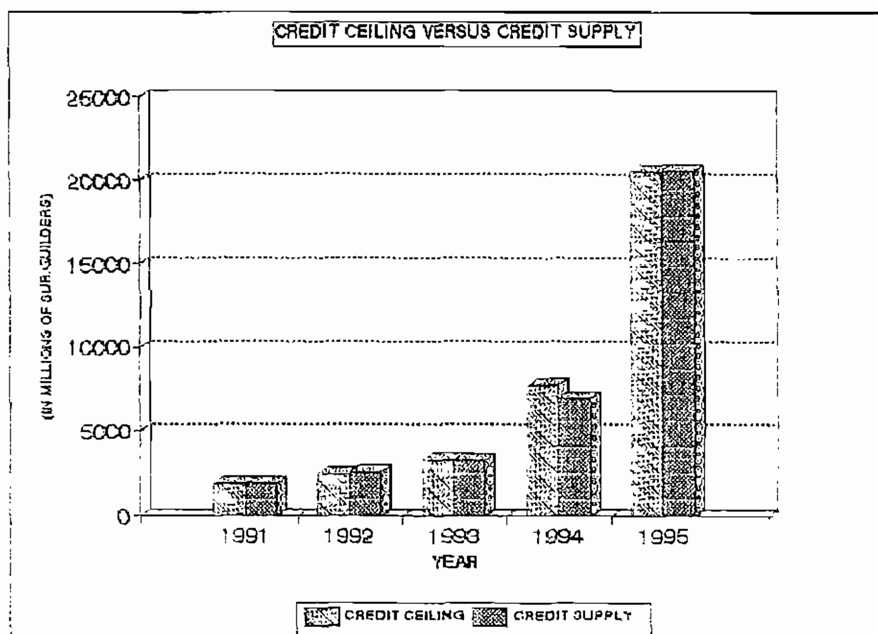
[1]Long-term resources of the commercial banks include: capital and reserves (100%), savings deposits (90%), time deposits and other liabilities with a maturity of more than one year (100%), time deposits with a maturity of one year or less (75%), non-residents' time and savings deposits (100%). The percentages in brackets indicate the relevant shares contributing to the credit ceiling.

Chart 1



Source: Central Bank of Suriname

Prior to 1995, moral suasion was the only means of ensuring compliance. However, since January 1995 enforceable penalties have been introduced to deter banks from exceeding their credit ceilings.[2] The penalties include blocking of the bank's reserves at the Central Bank to an amount equal to the excess credit, and interest payment on the blocked reserves at an interest rate of two percentage points above the highest lending rate of the bank concerned.

With the tightening of its monetary policy towards the commercial banks, the Central Bank attempted to reduce any potential upward pressure on the exchange rate as well as on domestic prices.

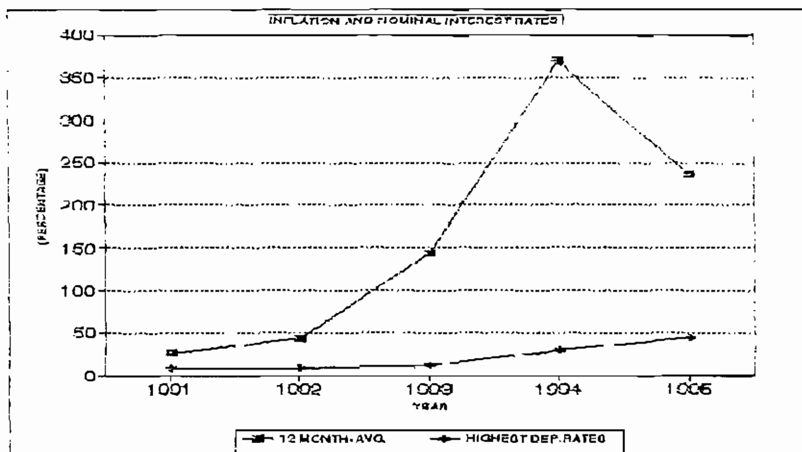
[2] To prevent individual commercial banks from exceeding their credit ceiling.

2.3 Interest rate policy

As commercial bank credit is an intermediate target of monetary policy, the Central Bank does not influence interest rates directly. Thus commercial banks are free in setting interest rates. However, during 1991-1995 nominal rates failed to keep up with inflation owing to money illusion of the public and the lack of competition in the banking sector.

In 1993, in the presence of inflation (see chart 2) the commercial banks started to increase nominal time-deposits rates after a period of quite stationary interest rates. These increases were intended to finance the higher demand for credit, arising from the foreign exchange auctions. As of the end of 1994 the highest nominal time-deposits rate offered by the commercial banks was about 40%, while the 12-month average rate of inflation amounted to 370%.

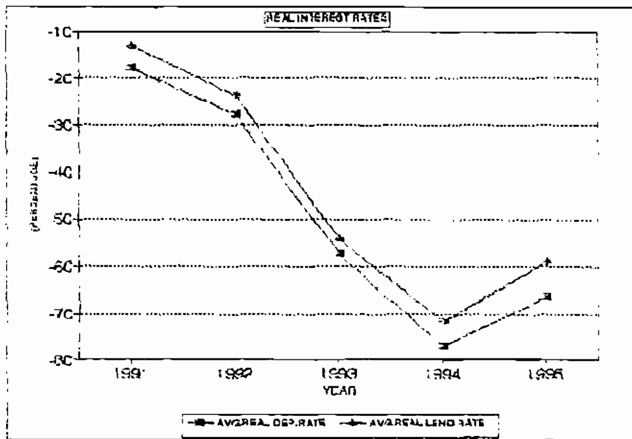
Chart 2



Source: Central Bank of Suriname /General Bureau of Statistics

The highly negative real interest rates (see chart 3) resulted in a gradual shift away from domestic financial assets in favor of real estate and foreign currency, the latter phenomenon leading to a further depreciation of the national currency.

Chart 3



Source: Central Bank of Suriname

Although the Central Bank has no direct interference with the commercial banks' interest rate policy, it acknowledged the necessity of moving interest rates to more realistic levels, as this could help reverse the rapid fall in financial savings and could contribute to the stabilization of the exchange rate. Against this background the Central Bank started issuing its gold certificates in March 1995, offering an annual gold-linked interest of 5%.[3] This open market type operation implicitly set a floor for the real interest rates of the commercial banks.

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[3] The gold certificates can be cashed on demand and are indexed to the international price of gold in US$ valued at the official exchange rate. These certificates were primarily intended to reduce monetary overhang and to increase interest rates.

After this initial step of the Central Bank, commercial banks indeed raised their deposit (and lending) rates aggresively, making domestic financial assets attractive again to the public , thereby reducing the unwillingness to hold domestic currency. The low levels of real interest rates, however, remained until the foreign exchange market interventions by the Central Bank.

3. EXCHANGE RATE POLICY

3.1 Exchange arrangements

From 1940 till mid-1994 de Surinamese guilder was pegged to the U.S. dollar, while floating against other foreign currencies (except of course for currencies also pegged to the U.S. dollar). In 1971 the Surinamese guilder appreciated from Sf. 1,90 to Sf. 1,80 per US$ as the U.S. dollar devalued in this year. In 1973, however, when the U.S. dollar devalued once again, the Surinamese authorities went along with this in order to maintain the Sf. 1,80 parity vis-à-vis the U.S. dollar. Until October 1992 Suriname had a single official exchange rate, although a parallel market for foreign currency had existed since 1983. The initial impulse to the introduction of an official multiple exchange rate system was given by the auction of balance of payments support in October 1992.[4] The multiple exchange rate regime underwent several changes during its existence (October 1992 - July 1994), and at one time comprised as many as seven official exchange rates, including a free market rate. The free foreign exchange market was established in June 1993.[5] Under the multiple exchange rate system, the Central Bank incurred large foreign exchange losses as the exchange rate operated as a means of government subsidy to specific economic sectors. The multi-currency practice constituted a transitional stage in the liberalization of the foreign exchange market. In July 1994, the authorities

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[4]The auction rate was the rate determined by the most recent auction (a total of ten auctions) of balance of payments support grants. The first auction rate was Sf. 18,-- per US$, while the last rate amounted to Sf. 55,34 per US$.

[5]In the free forex market, six commercial banks and five non-bank cambios are operational. With the establishment of the free market, the authorities in fact legalized the parallel market for foreign currency, in the sense that residents were now allowed to carry out foreign currency transactions officially.

unified the official foreign exchange market by introducing an uniform exchange rate (reflecting the free market rate), managed by the Central Bank. Upon unification the official rate (Sf. 180,-- per US$) was set (relatively) close to the prevailing parallel exchange rate (Sf. 190,-- per US$).

However, as the high demand for foreign currency was only partially accommodated by the official market, upward pressure on the parallel exchange rate was exercised. As the official rate was kept relatively constant in the presence of high inflation, the spread between the official and parallel exchange rate widened to 60% by mid-October 1994. Hereafter, the authorities depreciated the Surinamese guilder in the official market. The narrow band around the uniform rate within which the commercial banks were supposed to operate directly after the unification. was released. The banks were allowed to have transactions with their clients at their own rates. The official exchange rate published then by the Central Bank was the weighted average of the exchange rates reported by the banks and cambios, with a 10-15% margin downward. By the end of 1994 the official exchange rate diverged about 20% from the parallel rate.

3.2 Foreign exchange market interventions

As confidence in the Surinamese guilder continued to erode in the first four months of 1995, and inflation increased due to capital flight, the Central Bank decided to intervene in the forex market as of May 1995. At this point the Central Bank had built up a large stock of international reserves equivalent to US$ 80 million (-US$ 33 million as of the end of 1992), enough to cover 3,5 months

of imports of goods, while the money stock (M1) was backed for more than 100%.[6]

Since then, foreign exchange is made available through the commercial banks on the basis of the submitted import licences of their clients. Since the Central Bank accomodated, as it is still doing, a considerable part of the demand for foreign currency of the banks, the parallel market rate dropped rapidly. When the Central Bank first started its forex interventions, the parallel market rate was around Sf. 750,-- per US$ (selling rate), while the official rate stood at Sf. 497,-- per US$ (selling rate), a spread of 50%.[7] A total of US$ 6 million was required to make the parallel rate slump with 25% within a month, and to lay the basis for re-establishing confidence in the national currency. The rapid fall of the parallel market rate was not the result of a proportional decline in the money supply (chart 4). The fact that the parallel market rate dropped far more than would be expected on the basis of the changes in the underlying market conditions (demand and supply of M1), indicates that speculative attacks had apparently been a major factor attributing to the high parallel exchange rate. In the process of stabilizing the exchange rate, the relatively large stock of international reserves, which turned expections around, has been a crucial element.

As the interventions continued, the Surinamese guilder appreciated in the official market by 20% with respect to the U.S. dollar over the second half of 1995, while the spread between the official and the parallel market rate became negligible.

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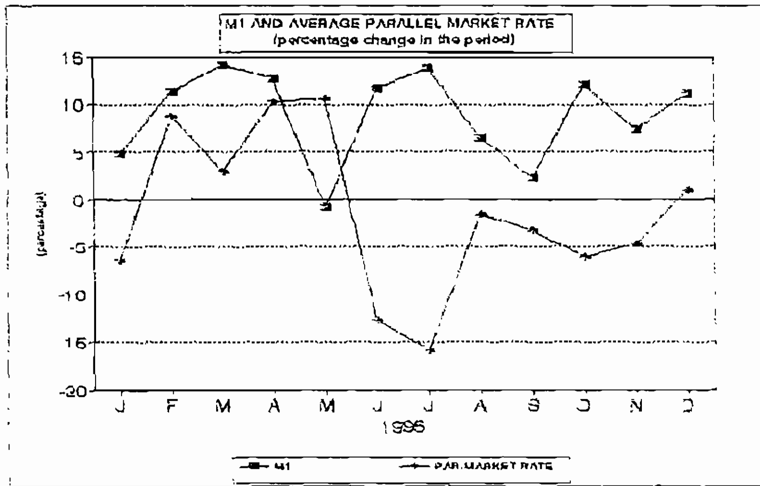
[6]Foreign exchange surrendered by the main exporting sectors and purchases of industrial gold on the local market on the one hand, and insufficient re-allocation of foreign exchange for imports on the other hand, contributed to the accumulation of reserves.

[7]The Central Bank intervened at an "intervention" rate, which laid in between the official and the parallel rate. The first intervention rate was Sf. 641,-- per US$, and was adjusted according to the movements in the parallel market rate (the parallel market rate functioned as the main guideline in setting the intervention rate). Around mid-August 1995 the intervention rate converged with the official rate.

Chart 4



Source: Central Bank of Suriname

Because of the use of the exchange rate as a nominal anchor for prices in Suriname, a significant decline in the domestic price level followed. The end-of-year inflation dropped from 587% in 1994 to 37% in 1995. As a consequence, real interest rates increased sharply, stimulating financial savings. On the other hand the demand for credit had not contracted owing to trade liberalization and the recovery in economic activity. Despite the interventions of the Central Bank with some US$ 15 million during 1995, the international reserves amounted to US$ 180 million (7 months of imports) as of the end of 1995 due to a major improvement in the current account of the balance of payments. Exports had increased in 1995 due to the rise in the price of bauxite derivatives (being the single largest foreign exchange earner) and the favourable exchange rate (following the unification). The increase in exports was only partially offset by the rise in imports in 1995 resulting from higher economic activity and the appreciation of the Surinamese guilder. Consequently, a large stock of international reserves accumulated.

4. CONCLUSION

Suriname has attained the goal of monetary stability through foreign exchange market interventions by the Central Bank. The other instruments of monetary policy are credit ceilings and open market type operations.

Fiscal stability as well as sound monetary and exchange rate policies have contributed to a remarkable economic performance since 1995. Stable exchange rates and low inflation have been quite common. Expectations are that the nominal exchange rate will remain around its present level (US$ 1 = Sf. 406), while the average rate of inflation will be in the range of 5-10% by end 1996. So far, the appreciation of the Surinamese guilder has not endangered international competitiveness. However, the prevailing high real interest rates are not encouraging for investments in the productive sectors. In this context, the authorities currently face the challenge to lower interest rates gradually, without endangering price stability. Meanwhile, as one of the structural policies, a new investment law is about to be passed to improve the overall investment climate in Suriname.

Finally, it is highly desirable that the new government continues to implement sound economic and financial policies in order to consolidate the recent gains made in the area of monetary stability.

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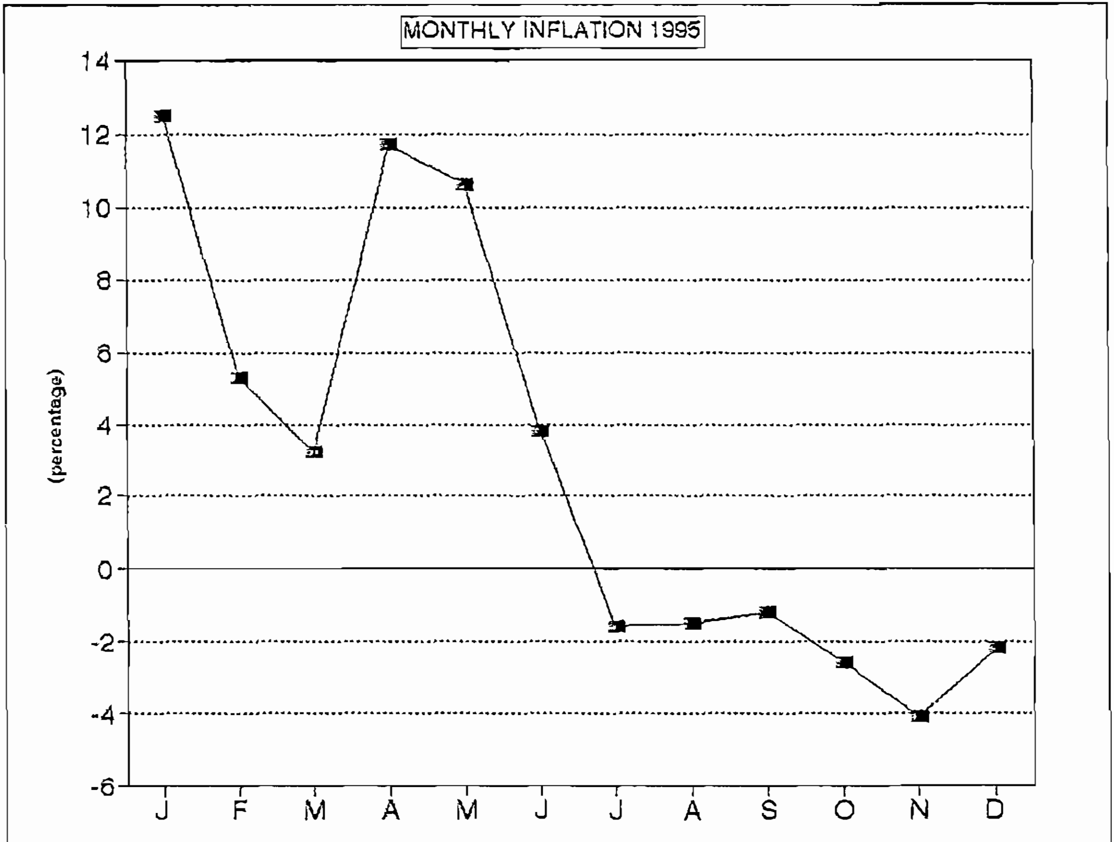
MONTHLY INFLATION 1995
(percentage)
14
12
10
8
6
4
2
0
-2
-4
-6
J
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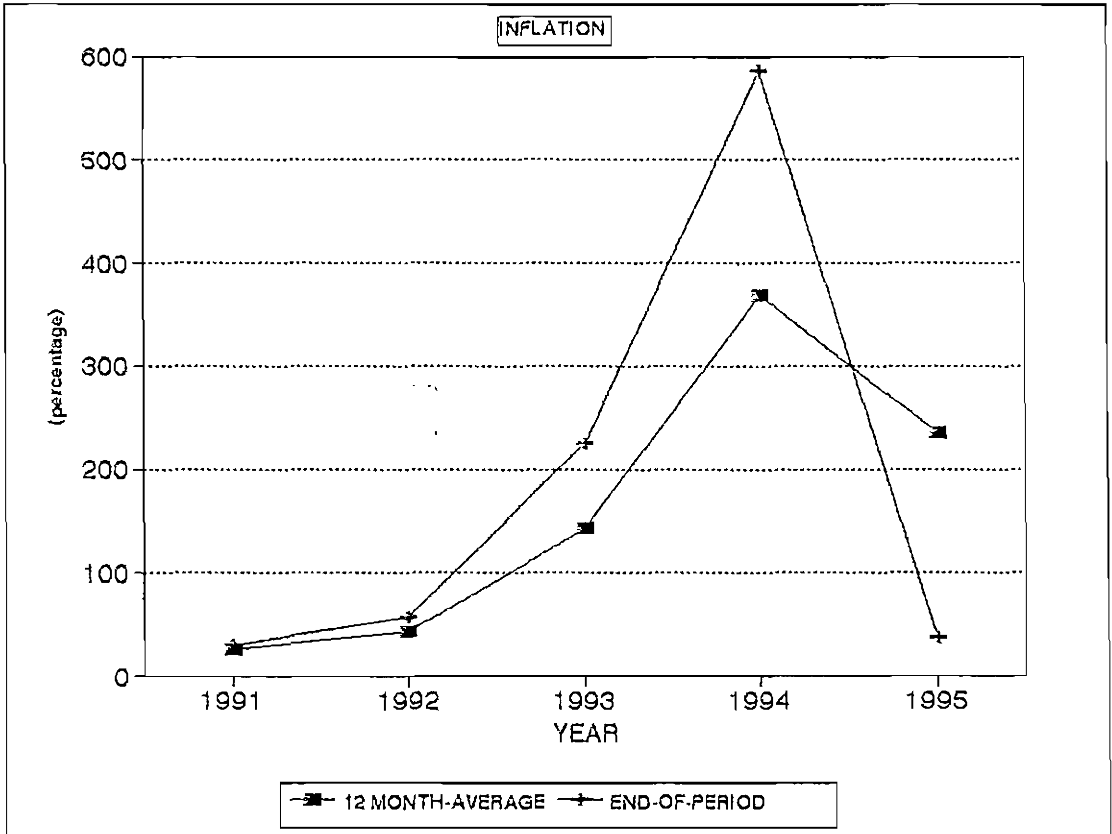
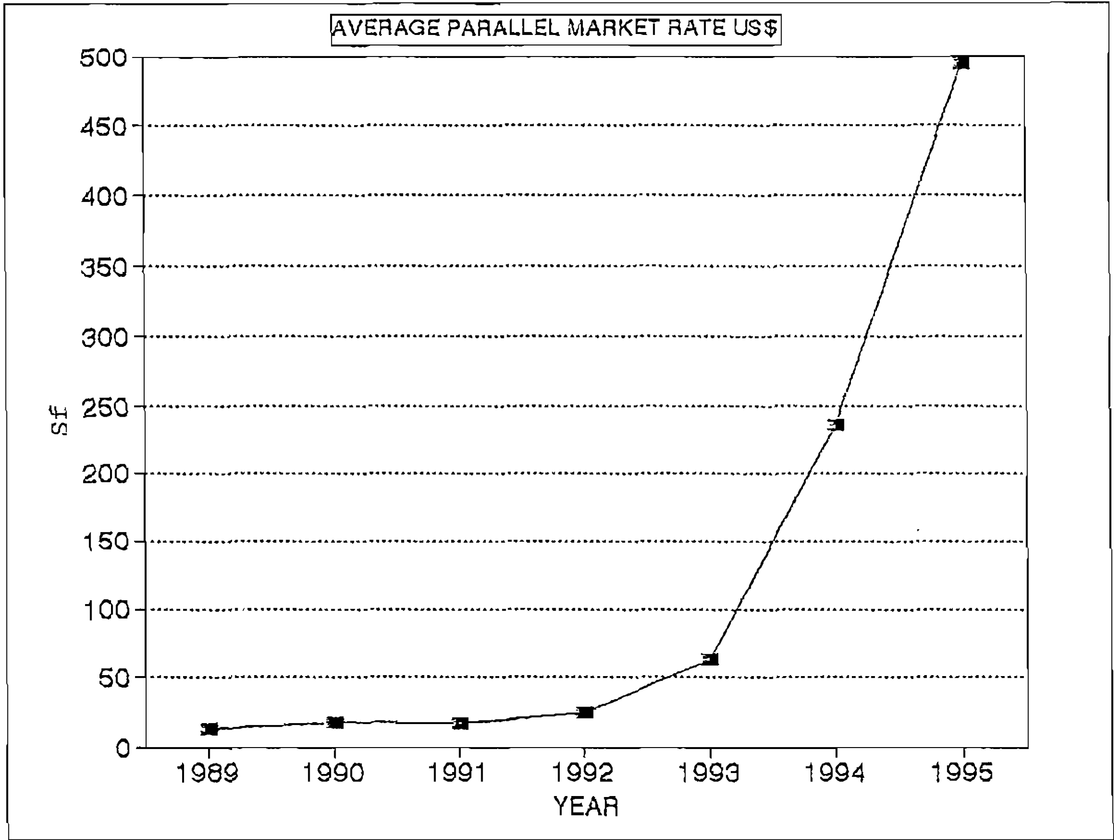

INFLATION
600
500
400
300
200
100
0
(percentage)
1991
1992
1993
1994
1995
YEAR
12 MONTH-AVERAGE
END-OF-PERIOD


AVERAGE PARALLEL MARKET RATE US$
500
450
400
350
300
250
200
150
100
50
0
S£
1989
1990
1991
1992
1993
1994
1995
YEAR