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**TOWARDS AN UNDERSTANDING OF THE DYNAMICS  
OF THE PARALLEL MARKET IN FOREIGN  
EXCHANGE: THE CASE OF SURINAM**

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<p>CHAPTER 1 NATURE AND SCOPE OF PRESENT PAPER</p>
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## 1.1 INTRODUCTION

The growing parallel market in the Surinamese economy is part of a severe economic crisis which has been marked by an acute foreign exchange shortage since the early 1980s. Official receipts from the major export sectors (primary commodities) have fallen by almost two thirds during the last nine years, due firstly to depressed international demand and an internal production crisis, and secondly to the channelling of export revenues through the parallel market. In addition, Dutch development aid, which after independence in 1975 had effectively functioned as an important source of balance of payments finance, was suspended as of end 1982. In reaction, official imports were cut by more than half from 1981 to 1988 through import restrictions, while other forms of foreign exchange rationing were also practised.

At the same time 'Own Fund' (OF) imports, presumably financed through the parallel market, have been expanding since 1984. These are imports for which the government has granted a licence to private merchants, but for which payment is not made from official reserves. In addition to the leakage from falsified trade invoicing, the parallel market is presumably also supplied by remittances to Surinamese nationals from family living abroad (mainly in The Netherlands and the USA). It is also suspected that some of the receipts from illicit drugs smuggled through Surinam enter the parallel market.

The incentives for parallel market activities partly stem from the high appreciation of the official value of the Surinamese guilder. The large government budget deficit is predominantly monetarily financed, pushing up prices of scarce goods and services which are provided through the parallel market. The parallel exchange rate increased from twofold the official exchange rate (which is fixed to the US dollar) in 1984 to over ten times in 1990.

Furthermore, there is substantial capital flight, i.e. not all foreign exchange that is acquired or channelled through the black market finds its way back into the Surinamese economy. Part of it is transferred into assets held abroad by Surinamese nationals, as these yield higher returns than those at home or are perceived as insurance for the future. This hence determines the premium on the parallel market.

## 1.2 AIM AND LIMITATION OF PRESENT STUDY

### Central focus

IMF and WB policies are based on the assumption that parallel markets are the response of market forces to controls and restrictions in the economy, imposed by the government, that try to hide or create imbalances. Market forces, according to this view, establish an equilibrium between supply and demand of foreign exchange through the working of the price mechanism (the parallel exchange rate). Both markets, the parallel and the official, can be unified if exchange controls are lifted, the official exchange rate is devalued and monetary expansion is ceased. This would not cause further inflation, because prices have already been adjusted upwards via cost-push on the basis of the parallel exchange rate.

This view downplays the importance of structural disequilibria in the economy (such as low productivity of agriculture and industry), of the motivations for government deficits, and of poorly developed financial structures, not to speak of people's expectations. That the 'free market' will be able to solve these problems is not at all self-evident. In fact, the parallel economy has its own mode of accumulation and particular articulation with the formal domestic and the external economy.

A closer scrutiny of the dynamics of the parallel market and its interaction with the formal economy and real phenomena is therefore needed to arrive at policy conclusions concerning fiscal and monetary instruments, exchange rate adjustment and trade policies.

The main objective of this paper is to arrive at such analytical explanations of the parallel market in Surinam. This will be supported with a tentative measurement of the magnitudes of flows and variables, and some of their relationships with the official economy, in both the real and monetary spheres.

### Sub-areas

The paper will cover the following aspects:

- a. measurement
  - magnitude of parallel market transactions: demand and supply volumes and their constituent parts
  - 'price' formation: what is the parallel rate a reflection of, what volumes of foreign currency, Surinamese currency and other assets are involved
- b. dynamics of the parallel economy and its relation to the formal domestic economy and external markets:
  - fiscal and monetary aspects, prices and expectations
  - national savings, capital flight and accumulation between sectors and institutions
  - investment between productive vs. non-productive sectors (and by corresponding economic groups)
- c. policy problems:
  - government intervention vs. 'free-' market; what is the cause?

- adjustment policy (to external shocks) - proposals/guidelines: fiscal & monetary; trade; exchange rate; prices & wages; finance; enforcement & punishment.

### Limitations and contribution

This study cannot be exhaustive. The very nature of the parallel or hidden economy makes it very difficult to obtain information on certain variables and magnitudes of flows. Quantitative analysis is therefore conducted on the basis of certain assumptions and limitations, while also taking some officially available data, such as on investments, expenditure and inflation, as given.

Moreover, when discussing the dynamics of the parallel market and its interaction with the real and monetary spheres of the official domestic economy and foreign markets, it is repeatedly suggested that more detailed analysis at the meso- and micro-level should be carried out in future research, in order to provide a more comprehensive understanding of the overall picture.

Nevertheless, this study will hopefully contribute to a better understanding of the parallel market in foreign exchange and goods in the Surinamese economy. Finally, it is hoped that both the theoretical framework and empirical findings are also of relevance for economic and political analysis in other Third World countries facing similar problems.

## 1.3 THEORETICAL ORIENTATION AND HYPOTHESIS

### Theoretical orientation

The analysis will rely on 'development economics' paradigms. Ultimately, all economic analysis is also political; i.e. policy conclusions proposing programmes of action in the economic field, are derived on the basis of a particular, maybe implicit, political outlook that serves particular economic groups and sectors. Speaking of 'neutral' economics or acting as if only technocrats' work is involved only perpetrates the status-quo thus benefiting the ruling economic group(s).

Therefore, although the focus of this research will be on the economic side of the development process of Third World societies, it still recognizes the broader socio-political context in which this takes place. It is so hoped that a fruitful contribution to contemporary political economic thinking will be made.

Proceeding from the major distinction used for classifying contemporary economic schools, the chosen point of departure will be the 'structuralist' approach, as against the dominant 'neo-classical' paradigm. The former perspective reflects better the historical and institutional characteristics of the accumulation and distribution process of the developing countries. Moreover, it may be considered as the inheritance of Ricardian and Marxist political economy applied to developments in the Third World.

There is another point that deserves consideration. Both practical research and analytical work on parallel markets in foreign exchange are still in their infancy. This is not in the last instance due to the relatively recent emergence of this phenomenon as a particular problem in the development process of Third World countries. Earlier, attention had been given to so-called 'informal sector' activities in both developed countries and developing countries. However, the emphasis has been either on the social and sociological aspects of the 'hidden economy', or confined to an analysis of employment creation and characteristics, evasion of law and of the tax system (especially in the case of developed countries). At the other end of the spectrum is the focus, dominant in IMF/WB literature, on measuring the exact implicit tax or subsidy of exchange controls, the parallel exchange rate premium, and subsequently the calculation of the 'right' percentage of devaluation necessary to restore macro-economic 'equilibrium'.

But it is fair to state that an applicable macro-economic framework, incorporating parallel market activities into an analytical model of accumulation and development for the economy, is still far from completed. One of the aims of this study is to contribute to this.

### Hypothesis

Departing from historically observed patterns of articulation of the national economy with the external economy and the institutional forms of production and distribution through which this has been evolving, the emergence of the parallel market in the case of Surinam cannot be seen as a means of restoring 'equilibrium'. In other words, the process of economic accumulation and distribution is not considered as economically nor socially optimal; it has not been in the past, nor is it at the present.

Nonetheless, the parallel market is seen as a response to changes in external conditions which affect the national economy and make the existing formal institutional setting obsolete for desired ways of 'survival' of the various economic groups. At the same time, specific government policies and regulations from which certain groups or individuals are exempted in the sphere of exchange and trade, also leads to specific forms of production, distribution and consumption. It will be advanced that government policy has not been neutral, but in fact favours certain economic sectors and groups, thus reinforcing an externally dependent accumulation process and skewed patterns of national income distribution.

A similar reasoning applies to certain types of fiscal and monetary policies the government employs. At the same time, however, fiscal and monetary developments are also influenced by activities and price increases arising from the parallel market itself. The proposition is forwarded that parallel markets are not the unilateral result of 'excess demand' on the basis of excess money creation and irresponsible fiscal policies, but rather that a virtually circular causal link operates between parallel market prices, inflation and money demand and supply.

While the case is made that proper monetary and fiscal policies and exchange and trade policies are needed, the feasibility of achieving a unification of the foreign exchange market via devaluation is viewed skeptically. The reason is the acknowledgement of an excess demand for

foreign exchange, persisting under certain conditions, that will be exerted and satisfied outside the limited official foreign exchange market. This will then stimulate illegal private appropriation of foreign exchange earnings, speculation and rent-seeking activities and thus the continuous existence of a secondary market for foreign exchange where a premium price is offered above the official exchange rate.

Moreover, in the long-run, the foreign exchange scarcity stemming from the underdeveloped production structure can only be resolved through structural transformation of the dependent, primary commodity exports-based economy, which would require increased output and growth, and diversification of exports.

The policy proposal derived along these lines is thus not one of advocating the 'free market', i.e. of absolute abstention from intervention by the State; rather it will be argued that on the basis of a national revival plan and socially just distribution objectives, the role of the Surinamese government should consist of an active policy supporting these. As 'the state' is class-based, the Surinamese state must have a democratic, popular-oriented basis, and be willing to cooperate and align with amenable economic groups of the private sector if a more independent and equitable society is to be constructed.

#### 1.4 RELEVANCE

The research is of relevance for development thinking and policy for the following:

- (i) problems of economic measurement and modelling;
- (ii) analysis of relationships between the parallel economy and the official economy; effects of government policies; behaviour of macro-economic aggregates, variables and processes, such as savings, investment, value added, accumulation, income distribution, inflation, real exchange rate, balance of payments aggregates, capital flight;
- (iii) the question of dependency of a small, open economy; its articulation with the external economy; effects of external shocks;
- (iv) implications for policy formulation in terms of monetary and fiscal, exchange rate, trade, credit, investment and industrialization policies.

#### 1.5 METHODOLOGY

The presentation and methodological organization of this study are as follows:

In Chapter 2 the theoretical framework will be made more explicit. The different interpretations offered by the neo-classical analysis and the structuralist approach on the parallel market in foreign exchange and its related aspects, are presented. Explanations of both theories of the causes, dynamics and effects of foreign exchange parallel markets in Third World countries will be examined.

A brief sketch of the location of the two bodies of theory within historical schools of economic thought, which implies their respective particular political economy outlook and policy agenda, is given.

In addition, from a more technical angle, some of the definitions and concepts recurring in the theoretical analysis on parallel markets, are outlined.

Chapter 3 is an application of theory to practice in the case of the particular parallel market in foreign exchange and goods in Surinam. At the same time, this country-study is conducted during a period of serious socio-economic and political crisis. One more reason for the systematic reference to this context in the analysis.

The chapter sets out to investigate the magnitude of unrecorded or hidden flows and variables of the parallel market arising from the interaction with the international economy during the 1980s. Subsequently, the integration of the parallel market with the formal economy is studied.

The macro-economic accounting framework is adjusted, and implications for the domestic and national savings-gap, national savings, output and sectoral distribution between 1984 and 1988 are analysed. The influence of the monetary financing of the government budget deficit is looked at while simultaneously analyzing the effects of the parallel market itself on sectoral savings-gaps, demand for money and inflation.

The movement of the real exchange rate will also be considered based on the dual exchange rate system and de-facto parallel market prices. Expected responses to production and investment are compared to actual responses by exporters and merchants. This reinforces the explanations about the motivations for capital flight.

The concluding Chapter 4 offers an alternative explanation of the dynamics of the parallel market in Surinam and its relationship with the socio-economic structure of the economy. This is done by integrating the major findings of the empirical work, while at the same time pointing out the socio-economic effects of the redistributive process and their implications for future growth and accumulation.

Finally, policy conclusions are drawn. The feasibility of standard policy solutions like devaluation and unification of the foreign exchange market is assessed on the grounds of the study of the nature of the foreign exchange and economic-political crises of the country. Some general theoretical conclusions and recommendations are forwarded on the basis of the Surinam experience, that are hoped to contribute to a better understanding of similar problems of parallel markets in foreign exchange and economic crises in other Third World countries.



CHAPTER 2  
THEORETICAL FRAMEWORK

## 2.1 AN INTRODUCTION

Our hypothesis postulates that a structuralist approach offers a better explanation of the causes and consequences of foreign exchange parallel markets than the neo-classical paradigm.

In this chapter we attempt to give a theoretical exposé of what these two approaches entail and in what respect they differ from each other in analyzing the secondary market for foreign exchange. We will look at the different interpretations of the origin, dynamics and effects of the foreign exchange crisis, and how policy is formulated on the basis of this. Some concepts recurring in the theory of foreign exchange parallel markets are defined first.

In the remainder of this introduction, two qualifications of a methodological nature are made.

Firstly, this broad categorization of economic theories is based on contemporary conflicting ideas on the finance of development in the less developed countries and the nature of their external sector crisis. One broad view is represented by the neo-classical or 'New-Orthodoxy' of the influential International Monetary Fund and the World Bank, which is being challenged by increasingly more scholars and policy-makers in the Third World and elsewhere from a structuralist perspective (FitzGerald and Vos, 1989).

However, acknowledging this opposition of views is not the same as saying that every economist or researcher neatly fits into either one of the categories. In practice, a wider range of sets of arguments along, and probably across, both lines of thought, can be found. But what is important for our study is to explore what the 'core' of the arguments are in terms of the analysis of the parallel market in foreign exchange.

Secondly, we need also to find a criterion for choosing the 'optimal', the more suitable and relevant analytical tool (as represented by the two mentioned bodies of theory) for the analysis of the present problematics of the Third World nations.

Some authors (Cole, et al., 1983; Edwards, 1985) have shown how these two approaches have evolved from main streams in the history of economic thought<sup>1</sup>. Contemporary neo-

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<sup>1</sup> In the book 'Why Economists Disagree' (1983) written by Ken Cole, Chris Edwards and John Cameron, these social scientists trace the fundamental difference between historical schools of economic thought as consisting of

'the particular perspective....the economist brings to the understanding of human activity,...the judgement of its worth.' (pg. 6)

Accordingly, the authors have identified three basic streams in economic theory: a. subjective preference theory of value; b. cost-of-production theory of value; and c. abstract labour theory of value.

classical economic theory emerged as a synthesis between the pure 'subjective preference' school on the one hand, and the 'cost-of-production' or neo-Keynesian school on the other. Standard neo-classical paradigms are very much based on the assumption that the basis of the economic process is formed by rational, personal-welfare optimizing individuals, who enter with each other into contracts, offering commodities and/or services, which are exchanged to satisfy individual needs or desires. The market is the place where such exchanges take place among individuals who participate freely and on the basis of presumed equality (perfect entry, perfect foresight, perfect information). Within a free market, an automatic equilibrium would always be established between supply and demand; intervention by the State is therefore eschewed, since this would create distortions and sub-optimalities. The policy implication and recommendation of neo-classical theory is therefore a straightforward advocacy of the allowance for the 'free market'; i.e. in almost all cases, a demand for privatization and a minimum of government control and regulation.

The other theoretical perspective in economics, the 'structuralist' approach, draws on both 'cost-of-production' or Keynesian or neo-Ricardian principles, and on postulates of 'abstract labour theory of value' or Marxist economic thought. According to structuralism, markets are structured and operate along the behavioural lines of the institutions involved: the State, private businesses and households. In other words, markets clear through institutional and sectoral balances of output, savings, investment and (re-) distribution, that are changeable over time on the basis of these very patterns themselves. The role of the State is seen as inevitable if any market is to function at all, for every society is beset with a legal and regulatory framework, at the least to maintain some 'order'. Moreover, as an economic agent itself, the public sector shapes the economic process, and can exert an active positive influence. The Marxist strand or tenets within the structuralist outlook see the process of economic accumulation and distribution as the outcome of the struggle over ownership of the means of production by classes, and institutions are the vehicles of different classes. The State is therefore also seen as an instrument of a particular class (or group) in the struggle over economic distribution and political power.

These theories are, however, internally consistent on the basis of a particular set of postulates and agreed rules of logic. Within their own specific theoretical framework they are equally well positioned to describe and to account for causes and consequences of economic developments, as perceived by those from a particular socio-economic group or class point of view. The ideological basis of the alternative theories rests in their faith as to which class produces the material wealth of society. On the basis of this, these theories advance their own programme of action that ultimately serves the particular group's or class' interest.

In other words, all economic analysis in the end is also political. Its policy proposals have

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Chris Edwards in his subsequent work 'The Fragmented World-Competing Perspectives on Trade, Money and Crisis' (1985) explains how a synthesis between the 'subjective preference' and 'cost-of-production' paradigms has given rise to the contemporary neo-classical approach on the one hand, and how on the other hand a synthesis between the 'abstract labour' theory and 'cost-of-production' school has evolved into a neo-Marxist (as he prefers to call it) or 'structuralist' perspective of contemporary economic problems and developments.

The interested reader is referred to both readings for an exhaustive review and analysis of the principles and propositions of the different economic theories.

advocated, because then the ruling economic group(s) will benefit. 'Neutral' economics, or pretending that only technocrats' work is involved, in principle, is untenable.

But, is it so that the choice of a particular body of theory reflects the political inclination of the scholar in question in terms of his/her commitment to particular groups and classes in society? More often than not, this is done implicitly rather than explicitly. However, being aware of the consequences, it is only logical that we explore the effects of our arguments and stances, and in fact make a clear choice as to on whose behalf we will render our intellectual services during our short life-times.

It is my personal belief that we should do so for the benefit of the poor and deprived peoples of our world. This is in no way just a naïve statement, but a considered practical outcome of a particular perception of the world, society and the human race. Humanity is distinguished from animals by a higher capability for 'reason', i.e. the capacity to construct continuously and progressively the 'technology' necessary to survive in nature. Today the **potential** technology (production-, administrative- and philosophical apparatus) exists for a **peaceful** co-existence of humanity and nature with each other under **humane** and **equitable** conditions (as well as responsible ecological conditions). Yet, at the same time we are still far from fulfilling these objectives which could be achieved through the means of a restructuring of society, the transfer of resources from destructive to development purposes, redistribution of income and economic growth.

The conclusion is that we should gear our intellectual efforts towards finding solutions to problems of poverty, starvation, illiteracy and equitable growth and towards preventing war, taking into consideration the redistributive consequences of growth (and vice versa), and the interplay of economic and socio-political forces, on the domestic and international levels. I believe that a political economy approach rather than a neo-classical one enables us to do so. 'Structuralism', which already has demonstrated some merits in defending the interests of the less developed countries in the international political economy arena, can thus be enriched by continuously adding this dimension to it.

Therefore, although the focus of this study will be mainly on the 'economics' of the parallel market in foreign exchange, it will still recognize the broader socio-political context in which this is situated.

## 2.2 SOME CONCEPTS AND DEFINITIONS

In this section, some of the most important concepts recurring in the theory of parallel markets in foreign exchange will be briefly clarified. The aim is to facilitate the discussion in the following sections on the dynamics of the foreign exchange parallel market without having to divert to definitional issues at that stage. It also serves to try and preclude any differences in interpretation of the concepts concerned that might arise between the reader and myself. It is assumed that many other concepts are familiar to the reader.

The following concepts will be treated:

1. Foreign Exchange Parallel Market

2. Real Exchange Rate, Equilibrium Real Exchange Rate, Overvaluation of the Nominal Official Exchange Rate, Devaluation
3. Capital Flight

### 2.2.1 Parallel Market in Foreign Exchange

During the last two decades a vast amount of literature has accumulated, capturing a wide sweep of different kinds of 'second economy' activities and focusing on the causes, effects and policy implications of the expanding unofficial economy in both the industrialized countries and the socialist countries of Eastern Europe and the USSR, as well as in developing countries. The developed market economies are confronted with a growing evasion of existing laws, of the tax system, and with an increase in activities regarded as immoral, unethical or otherwise 'underground', such as illicit drugs sales, gambling, prostitution, arms trade, etc.. Socialist countries experience illegal forms of production, distribution and consumption of many otherwise scarce or officially rationed goods, and other mechanisms of evasion of the strictures of the centrally planned system. In many developing countries, policy-makers are confronted with growing informal employment; parallel markets in goods and financial assets, particularly in foreign exchange; capital flight and others.

A survey of the literature reveals that there are some striking differences between these activities within countries of a different socio-political economic system, although at the same time also some common features exist (see for example Allesandrini 1987; Tanzi 1983). However, also within one socio-political economic system the nature, extent, motivations and effects of the 'second economy' differ according to specific circumstances (ibid). So as the kind of activities and their nature seem to be diverse, so are the names used to describe them. But we will not pursue these issues. Since in this paper the particular problem of parallel foreign exchange markets in developing countries is studied, we will now focus on some of the concepts connected to this phenomenon.

The parallel market for foreign exchange is not the same as the 'informal' sector or 'underground' economy in many of these Third World countries. The latter involves a broader network of alternative employment, production, distribution and consumption activities that for the greatest part fall outside the formally or officially regulated, administered and recorded framework.

Analytically, the role of the government in the economic management of the society is often put to the fore. Lindauer (1989) explicitly refers to the parallel market as 'the structure generated in response to government interventions which create a situation of excess supply or demand in a particular product or factor market'. To make this point even clearer, Jones and Roemer (1989) distinguish between parallel markets on the one hand and 'fragmented' or 'differentiated' markets on the other. The latter type being due to 'non-intervention' factors such as physical isolation, markedly different endowments, cost differentials, product differentiation, tastes, risks, technological differences and market behaviour.

The parallel foreign exchange market could be seen as only part of the financial-monetary sphere of the underground or informal sector, yet also extending beyond it. It is a specific 'market' that arises in response to controls of the official foreign exchange market or to

restrictions and tariffs imposed on external international transactions. There is, however, almost always a link with illegal international commodity trade. Furthermore, parallel trade and exchange activities may be conducted through their own channels, but sometimes could make use of official channels as well. The parallel foreign exchange market is linked to the official foreign exchange market, and also often to the informal credit market. Moreover, it is not confined to the geographical boundaries of the nation in question, but integrates external markets as well.

Keeping these qualifications in mind, a foreign exchange parallel market can thus be said to be the 'market' that arises as a reaction to official restrictions and controls on a country's external transactions (either on the quantities or on the 'price'; the official exchange rate). This, nevertheless, is a very simplified definition, because it omits the following observations, namely that:

- not all parallel market activities are illegal;
- not all parallel market activities are unrecorded; and
- not all parallel market activities are unadministered.

Parallel markets may involve legal activities. For example, a particular good is regulated up to a certain amount for which it is sold at an official price. If the excess of the quota is allowed to be sold freely, this parallel market would not be illegal. In the case of Surinam, the system of 'Own-Fund' imports (similar to that in some other Third World countries), is parallel, though completely legal and even 'administered' in that the government issues the licenses to private individuals and firms. Parallel market flows also do not always go unrecorded. Official statistics are being kept, for example, on Surinam's 'OF'-imports. Trade invoice irregularities that often constitute supply of foreign exchange on the parallel market, go unrecorded by the country in question; yet, in some instances actual figures may be estimated on the basis of some assumptions after comparison with official statistics of the trading partners. Many transactions, however, still go unrecorded: some smuggling of goods and smuggling of foreign currency in cash, not to speak of the possibility of swap arrangements. Finally, parallel foreign exchange markets do not involve transactions in forbidden goods (drugs and the like) as such, although part of these illegal proceeds may be 'laundered' on this market.

### **2.2.2 Real Exchange Rate, Equilibrium Real Exchange Rate, Official Nominal Exchange Rate, Overvaluation and Devaluation**

The nominal exchange rate (NER) is usually expressed as the relative price of domestic currency measured per unit of foreign currency. For example: Sf 1.80 = 1 US\$. The nominal exchange rate can be fixed at a certain parity to one foreign currency, or to a basket of currencies expressed through one numerator. Alternatively, its value can be left floating, i.e. the nominal value changes according to changes in the underlying variables.

While the nominal exchange rate is the nominal rate of exchange between the home currency and the foreign currency(ies) - and thus a monetary concept -, the real exchange rate (RER) can be defined as the measure of the relative real price between domestic and foreign goods. Accordingly, the nominal exchange rate is corrected for the foreign price index and the

(RER) can be defined as the measure of the relative real price between domestic and foreign goods. Accordingly, the nominal exchange rate is corrected for the foreign price index and the domestic price index. This definition is known as the purchasing power parity (PPP) real exchange rate:

$$e_{PPP} = \text{NER} * P^f / P^d$$

More recently, however, the real exchange rate has been defined in the context of models of dependent economies (Dornbusch 1974, 1980; Krueger 1978, 1982; Frenkel and Mussa 1984; Neary and Purvis 1983; Edwards 1988, 1989). Assuming that the law of one price holds for tradables and that there are no taxes on trade, the real exchange rate is expressed as:

$$\text{RER} = \text{NER} * P_T^f / P_N^d,$$

where  $P_T^f$  is the world price index of tradables (for example the foreign Wholesale Price Index or the foreign Producers Price Index), and  $P_N^d$  the domestic price index of non-tradables (Edwards 1988, 1989).

Edwards (1988, 1989) defines tradable goods as goods that enter international trade: exports and imports; and non-tradable goods as those that are domestically produced and consumed at the same time. He assumes that non-tradables are potential tradables<sup>2</sup>, and as such sees the real exchange rate as a proxy for a country's degree of competitiveness in international markets, since it would measure the cost of domestically producing the tradable goods. The RER acts as a price incentive for resource allocation between tradables and non-tradables. If the RER depreciates, i.e. more real local currency being exchanged for foreign currencies, imports become more expensive, and production shifts towards non-tradables (import substitutes), whereas exporting becomes more profitable for domestic producers (given fixed foreign currency prices of the export produce; i.e. on the basis of a 'price-taker' assumption of the small country). A depreciation of the RER would thus give rise to an improvement in the trade balance, whereas an appreciation of the RER would lead to a deterioration of the trade account.

Thomas (1989) adopts a different definition for traded and non-traded or domestically-produced goods. The most important distinction, according to him, is that non-traded goods are those for which the price is completely domestically determined, i.e. independent of the international market, whereas the domestic prices for traded goods are determined by a combination of both local and foreign factors. Therefore he would include in the traded goods category also goods that are substitutes for traded goods, though not traded internationally. For example import substitutes, which have a clear import component. He goes so far as to take the assumption of smallness of some developing countries to its logical extreme by considering a total absence of non-tradables. In other words, he presumes that all goods and products in those economies have a foreign cost component.

From the above discussion it should be clear that we cannot talk about just one RER; rather the specific country circumstances should determine the adoption of a specific definition

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<sup>2</sup> Implied in this assumption is the notion of homogeneous goods.

export and import sectors and for production for the home market. For this purpose we assume local production costs to be influenced by both foreign prices (via imported inputs and machinery) and local factors. Thus we compare foreign prices (expressed in local currency via conversion by the exchange rate) and local prices. Due to lack of disaggregated data we choose the 'general price index' or the Consumer Price Index (CPI) as the latter.

This real exchange rate is not necessarily the equilibrium real exchange rate (ERER). The ERER is defined by Edwards (1988, 1989; 8) as 'that relative price of tradables to non-tradables that, for given long-run equilibrium (or sustainable) values of other relevant variables such as trade taxes, international prices, capital and aid flows, and technology, results in the simultaneous attainment of internal and external equilibrium. In this context, internal equilibrium means that the non-tradable goods market clears in the current period and is expected to be in equilibrium in the future. External equilibrium, in contrast, means that the current account balance in the present period and the balances expected in the future satisfy the intertemporal budget constraint that states that the discounted value of the current account balances has to be equal to zero. In other words, external equilibrium means that the current account balances (current and future) are compatible with long-run sustainable capital flows.'

From this definition, we can deduce that the ERER is not an immutable number, but one that changes over time on the basis of changes in its (real) fundamentals. The fundamental determinants of the ERER are seen as those real variables that, in addition to the RER, play a large role in the determination of a country's external and internal position. External RER fundamentals include (a) the terms of trade, (b) international transfers, including flows of foreign aid, and (c) world real interest rates. Domestic RER fundamentals include policy-related variables, such as (d) import tariffs, import quotas and export taxes, (e) exchange and capital controls, (f) other taxes and subsidies, (g) the composition of government expenditure, and non-policy fundamentals, of which (h) technological progress, is the most important.

An important policy issue is the so-called RER misalignment. This would mean 'a sustained deviation of the actual real exchange rate from its long-run equilibrium' (Edwards, 1989; 8). Determining whether a country's RER is at a particular time out of line with the ERER is both theoretically and practically one of the most difficult challenges faced by economists and policy-makers under both fixed predetermined and floating nominal exchange rates. And if the RER is found to be indeed misaligned, the next problem is to derive the right policy package to correct this disequilibrium (ibid).

The most common 'distortion' referred to in the context of balance of payments problems and external imbalances of the developing countries is nominal exchange rate overvaluation (Dornbusch, 1988). An overvalued (official) nominal exchange rate gives rise to an appreciated RER and thus to a deterioration in the country's external competitiveness. Along the same line of argument it is advanced that - given a change in RER fundamentals, due to which the RER would be overvalued - a nominal devaluation is needed to correct this and re-establish the RER at its equilibrium level.

As an example, consider the following changes:  
at  $t=0$  given a NER of 3, a foreign price level for tradables of 100 and a domestic price level

for non-tradables of 100, the RER equals the

$$\text{ERER} = \text{NER} * P_T^f / P_M^d = 3 * 100/100 = 3;$$

at  $t=1$  the domestic price index increases to 150 leading to a real exchange rate appreciation:

$$\text{RER} = 3 * 100/150 = 2.$$

Assuming the ERER is still 3, the nominal official exchange rate of 3 is said to be overvalued. A devaluation of 50% of the official exchange rate is said to be necessary to restore real exchange rate equilibrium:

$$\text{RER} = \text{ERER} = 4.5 * 100/150 = 3.$$

If subsequently the terms of trade move against the country, leading to a lowering of the relative foreign price level to 90, the real exchange rate measures:

$$\text{RER} = 4.5 * 90/150 = 2.7,$$

presumably out of line with the ERER of still 3. A devaluation of 11.1% is said to be needed to restore external equilibrium:

$$\text{RER} = \text{ERER} = 5 * 90/150 = 3.$$

How this argument is sustained or refuted in both theory and practice will be explained further in the following sections.

### 2.2.3 Capital Flight

To determine what constitutes capital flight and subsequently to measure its magnitude has not proved to be an easy task for both economists and policy-makers.

A first difference in opinion in defining capital flight is whether the criterion for distinguishing between 'normal' outflow of capital as against the 'fleeing' of capital abroad, is rightly used. Traditional financial analysis holds that individuals make (and have the right to) rational portfolio decisions as to where to invest their money with the aim of obtaining maximum private returns. Dooley (1986) accordingly distinguishes between capital outflows 'motivated by normal portfolio decisions' and those 'based on the desire to place assets beyond the control of domestic authorities' (quoted in Lessard and Williamson, 1987; 203). However, if normally the government is expected to enforce law and order in society 'to protect its citizens', such an evasion of government control would indicate the existing divergence between the social optimum, as conceived of by the government, and the private or individual optimum for some or all citizens. Capital that is 'fleeing', i.e. escaping government control, is thus as well a perception of abnormal risks at home. To distinguish 'normal' from 'fleeing' on the basis of portfolio decisions thus becomes blurred once we include among the determinant factors: interest-



perception of abnormal risks at home. To distinguish 'normal' from 'fleeing' on the basis of portfolio decisions thus becomes blurred once we include among the determinant factors: interest-rate differentials, expected exchange rate changes, inflation, level of development of domestic financial systems, socio-economic and political stability, etc.. Vos (1990; 3), therefore, makes the point that such a distinction is unsatisfactory from the viewpoint of both its micro-economic determinants and its macro-economic consequences.

Sometimes, a pure judicial criterion, whether the flow is illegal or not<sup>3</sup>, is advanced. But this also leads to conceptual and practical problems, because it would imply that capital that has been regarded as 'fleeing' under one regime, would no longer be considered as such under another if this next regime changes its exchange regulations in this regard, or vice versa.

There is also the nationalist argument. Rodriguez (Lessard and Williamson, op cit.; 203) argues that the 'normal' capital outflow from a capital-short developing country should be zero. Capital flight is defined as that part of the capital owned by domestic residents that is by some criterion disadvantageous to the national economy (ibid). The obviously curious moral judgement this implies would be that we consider a Japanese investor investing abroad (say the USA) rational or 'good', but a Third World entrepreneur or citizen who does the same as 'bad' (Kuczynski in Lessard and Williamson, op cit.; 191).

Nonetheless, Lessard and Williamson, adhering to the proposition that definitions need to 'be consistent with the policy question under consideration' (op cit; 2) think capital flight '...is a problem...not because we define it to be a problem, or that we perceive things from the nationalistic viewpoint..., but because it has intensified the foreign exchange constraint on those countries to a degree that has been damaging to the prosperity of the world as a whole, and even to the collective interest of the wealthy class that has bought foreign assets' (ibid; pg. 2). This is especially so given the evidence that estimated capital flight from the developing countries has acquired huge and disruptive proportions, which undoubtedly has compounded the problem of external management and the debt crisis of these countries. They therefore suggest that all resident capital outflows should be taken as a measure of the indication of capital flight (op cit.; 204).

The present author would add to this that it is not enough simply to quantify the magnitudes of such flows. We should also attempt to explain how resources and savings used for capital flight are generated internally and from which socio-economic groups they originate. In other words, we would have to examine the process of domestic accumulation and distribution between sectors, institutions and socio-economic groups, and the articulation with the foreign capital market, while at the same time maintaining that capital should be invested where it is most needed. The implications for policy-making, however, will have to await the discussion below.

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<sup>3</sup> Vos (1990) has opted for the term 'private foreign asset accumulation', rather than 'capital flight', to circumvent the suggestive undertone of the latter concept which may suggest that only illegal transactions are involved.

## 2.3 CAUSES AND EFFECTS OF FOREIGN EXCHANGE PARALLEL MARKETS: TWO ALTERNATIVE VIEWS

### 2.3.1 Exchange Controls, Government Spending and the Parallel Foreign Exchange Market : a Standard Neo-classical Analysis

The foreign exchange market as a perfect clearing market is depicted below in figure 1 which summarizes the forces determining equilibrium in real exchange between the home country and abroad<sup>4</sup>. The horizontal axis represents the quantity of foreign exchange; the vertical axis the exchange rate as the real price of foreign currency (US-dollars) in real domestic currency (Sur. Guilders). The supply and demand for foreign currency are expressed as a function of the real exchange rate.

The supply curve reflects the amount of foreign exchange the 'exporter' (supplier of foreign exchange) is willing to offer in exchange for a certain amount of domestic currency per unit of foreign currency, given an existing production function. The rationale is that factor costs (measured in domestic currency) per unit of output of production for 'exports' have to be recapped. The slope of the curve, which is the elasticity of supply, indicates the per unit output (real) marginal factor costs.

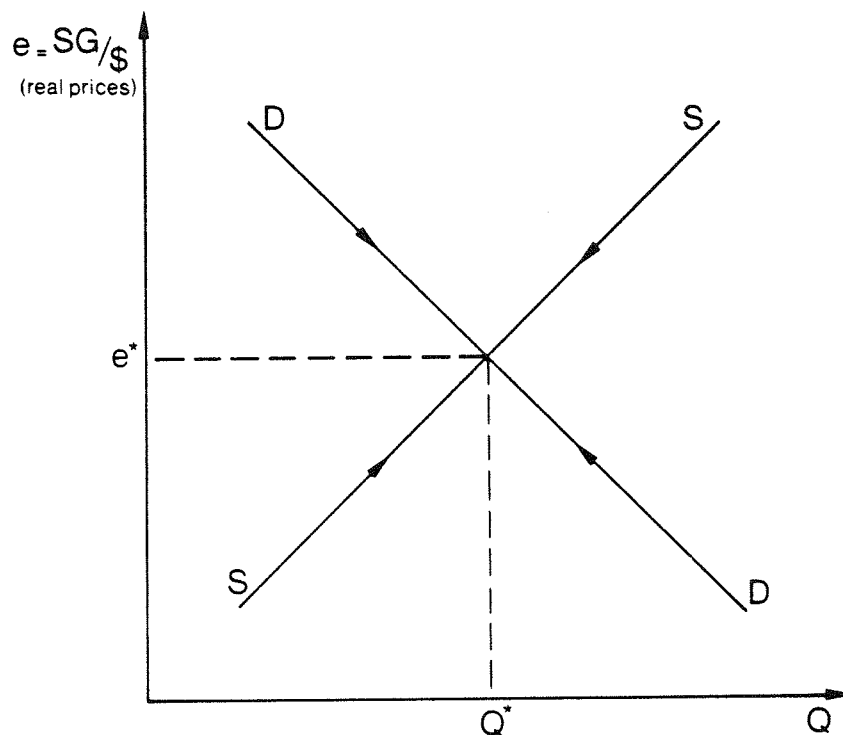
The demand curve reflects the amount of foreign exchange 'importers' (consumers of foreign exchange) are willing to buy at different levels of exchange. This demand is considered to consist of people's desire to acquire foreign exchange for conducting current account transaction, the 'transaction demand', as well as for investment in foreign assets, the 'portfolio demand'. The demand for foreign exchange is constrained by people's (real) income.

The intersection of the supply curve and the demand curve gives rise to the equilibrium real exchange rate, which is the result of real variables. In a neo-classical fashion, the market, if left to its own, would adjust automatically, regaining equilibrium after any disturbance or change in one of the underlying variables. The exchange rate would always move to a new (or the previous) equilibrium level. In this perfect clearing market, demand equals supply under a 'restriction-free' equilibrium real exchange rate.

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<sup>4</sup> Based on standard neo-classical models of demand and supply for prices and quantities (see for example Dornbusch and Fisher, Macroeconomics, McGraw Hill, 4th edition)

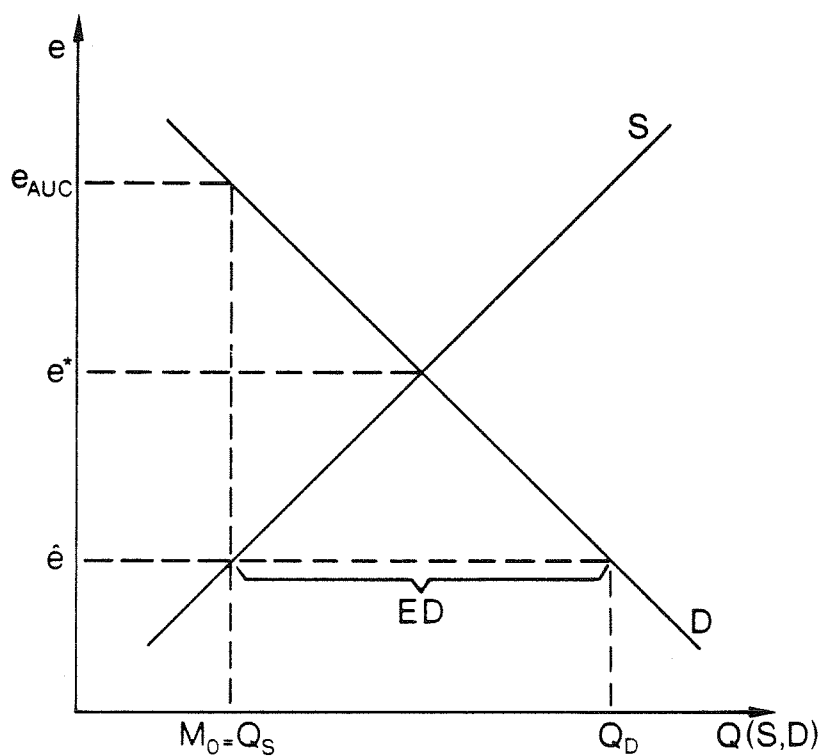
Figure 1 : Perfectly clearing foreign exchange market



However, according to the neo-classical view, there are at least two ways in which, by interfering in the official foreign exchange market, the government can create 'distortions'. This is shown in figure 2.

1. By imposing an import quota ( $M_0$  in the figure).
2. By fixing the nominal official exchange rate at a level at which in real terms it is appreciated, i.e. below the equilibrium real exchange rate ( $\hat{e} < e^*$ ).

Figure 2 : Distortion of the foreign exchange market : Excess Demand



In the first case there is foreign exchange rationing. In the second case exporters only surrender part of their foreign exchange earnings at the overvalued official rate (for simplicity, in the figure  $M_0 = Q_s$ ). It is assumed, at the same time, that there is no change in official reserves (neither accumulation nor de-accumulation). In both cases the resulting official supply does not clear the market. The effect is an excess demand for foreign exchange ( $ED = Q_d - Q_s$ ) that will be satisfied in a secondary, or parallel, market at a higher rate than in the official. This is illustrated in figure 3, which demonstrates the workings of a dual foreign exchange market.



From this simple scheme, neo-classicals point out the factors that would induce an increase in the parallel market rate (or the premium, which is the percentage differential of the parallel and the official exchange rate):

1. An increase in demand for foreign exchange; for example through increased government spending. Figure 4.
2. An appreciation of the official real exchange rate, or a smaller import quota. Figure 5.

Figure 4 : Effect of increase in government spending

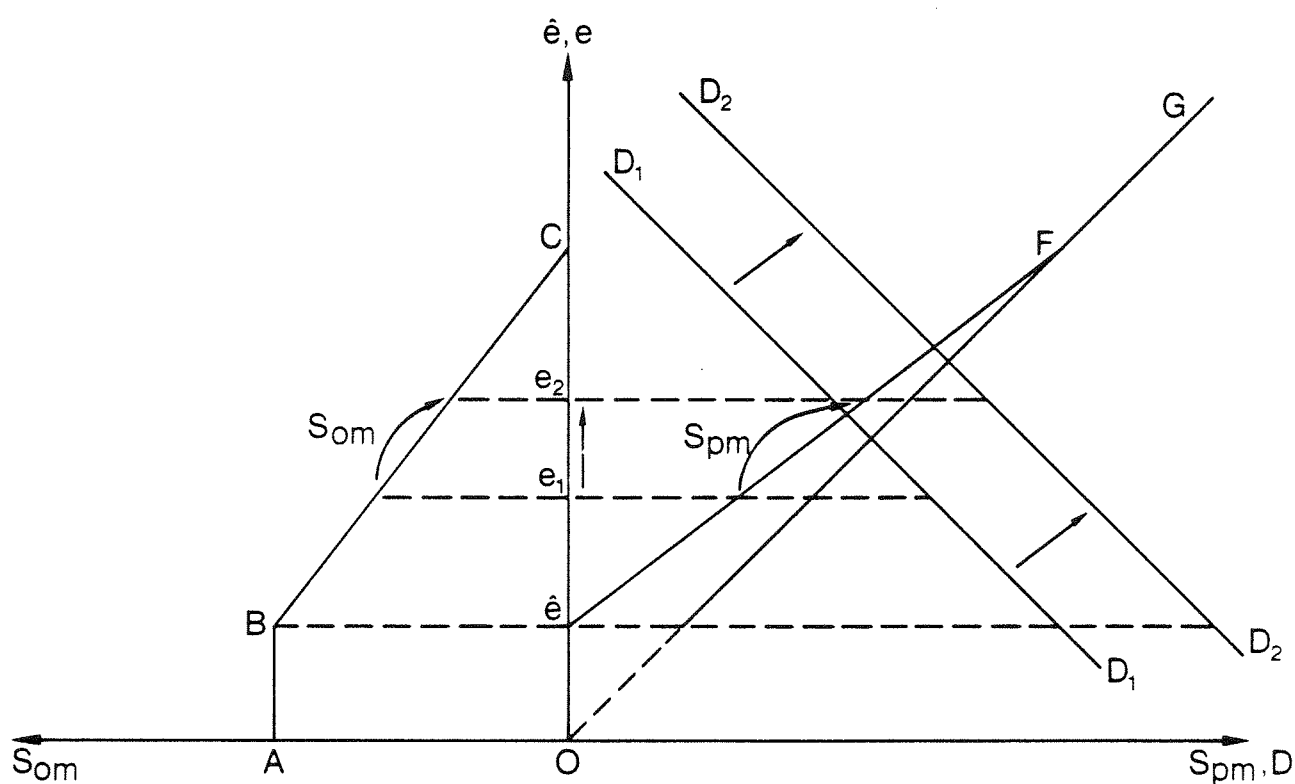
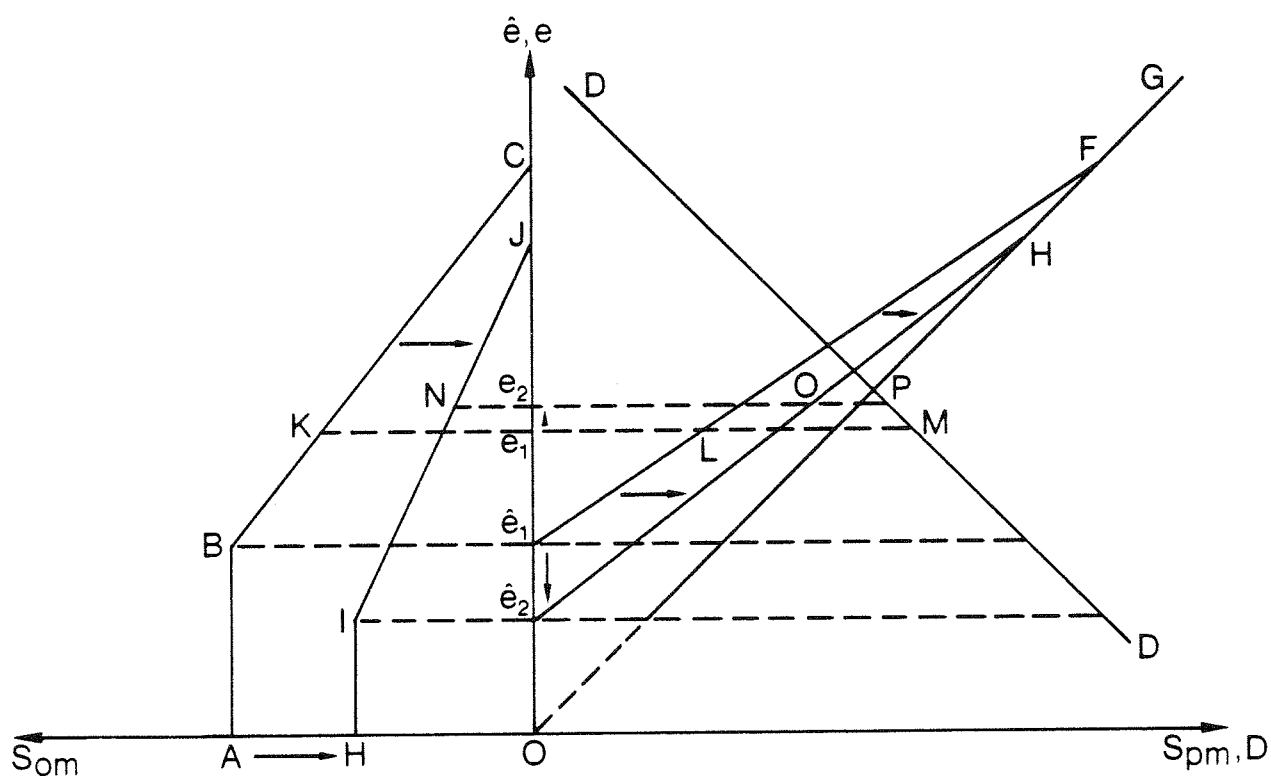


Figure 4 shows that a shift of the demand curve to the right, induced by increased government expenditure, produces excess demand for foreign exchange under the initial equilibrium parallel market exchange rate  $e_1$ , and this rate will depreciate. New equilibrium is established at  $e_2$  and at this higher parallel market exchange rate, less foreign exchange is supplied to the official market and a greater amount to the parallel market.

Figure 5 : Appreciation of official exchange rate  
or stricter import control



In figure 5 an appreciation of the official exchange rate from  $\hat{e}_1$  to  $\hat{e}_2$  induces a shift of both the official and the parallel market supply curves to the right, i.e. at each level of parallel market rates a proportionally smaller quantity of foreign exchange will be supplied to the official market, and more to the parallel market. The equilibrium moves to a higher parallel market exchange rate, from  $e_1$  to  $e_2$ . The analysis reaches similar results if, under a fixed official exchange rate, a severer import control is enforced instead. Less foreign exchange is supplied to the official market and excess demand would be even greater, exerting an upward pressure on the parallel market rate.

So, in both the above cases, not only will the parallel market grow in volume at the expense of the official market, but at the same time the parallel market exchange rate or the premium will also be increased.

When searching for the causes of the emergence of a parallel market in foreign exchange and its growth, almost invariably, neo-classical analysis identifies the restrictive trade regime imposed by the government in combination with its lax fiscal and monetary discipline.

We will now examine this argument in more detail and also look at the implications of

the parallel foreign exchange market from a neo-classical viewpoint.

Michael Nowak, a staff member of the IMF, has stated quite explicitly:

the presence of quantitative exchange and trade control in the official market .... are designed to protect depleted reserve positions and to avoid unpalatable official exchange rate adjustments in the face of balance of payments pressures. Under such a regime there exists no mechanism, such as reserve movements, to ensure that all prevailing demand for foreign exchange at the prevailing rate is met and that the official market clears. If the costs of engaging in illegal transactions are not prohibitive, the excess demand for foreign exchange in the official market is satisfied at a premium price in a secondary, or parallel market. (Nowak, 1984; 405)

He is also of the opinion that

controls do nothing to address the underlying causes of external imbalances. Indeed, by aggravating existing distortions in relative prices and resource allocation, controls may exacerbate the very problems they were intended to alleviate. (Nowak, 1985; 20)

Restrictions on trade and exchange are seen as an ineffective way of correcting the chronic balance of payments deficit faced by developing countries. It is argued that an overvalued official exchange rate and quantitative restrictions on trade create price distortions that lead to a sub-optimal allocation of resources between the tradable goods sector and the non-tradable goods sector, and between exportables and importables.

This has been identified by the World Bank as the promotion of an 'inward-looking' industrialization strategy as opposed to an 'outward-looking' strategy (World Bank, 1987; 8, 78-112). Under the former system, exporters who surrender their receipts with the monetary authorities at the artificially low fixed official exchange rate are paying an implicit tax, whereas importers that acquire officially rationed foreign exchange receive an implicit subsidy. The effect is a discouragement of export-oriented activities, often a shift towards the non-tradables sector, and induced spending on imports. At the same time, Import Substituting Industries are often favourably protected through tariffs. This leads to inefficiency in domestic production, little effort to look for less foreign-input-intensive or for more labour-intensive production techniques. The final effect, the World Bank argues, is the loss of competitiveness vis-à-vis foreign producers that will lead to further balance of payments pressures and deficits in the future.

Neo-classicals conclude that restrictions on trade and exchange are self-defeating and if government intervention is maintained for a lengthy period, this will lead to a lively parallel market in foreign exchange.

The other channel fuelling growth of the foreign exchange parallel market, according to the neo-classical approach, is the encouragement of aggregate spending as a result of expansive monetary and fiscal policies by the government, very often connected to the financing of its own budget deficit. The key to this proposition is the 'monetary approach to the balance of payments'. Proceeding from the balance sheet of assets and liabilities of the central bank, neo-classical analysis shows that any increase in domestic credit creation, other things remaining equal, spills over to the balance of payments in the form of a reduction of its current account (Dornbusch and Fisher, 1987; 745). The cause for the expansion of domestic credit is said to be the government's resorting to 'seignorage' - its ability to claim resources in return for issuing currency - in financing its budget deficit (World Bank, 1988; 57).



Thus, the causal relationship discerned by the standard analysis is in fact of a Keynesian type: by creating additional money, the government creates an additional demand. This excess demand spills over into the parallel market in two ways. Firstly, in a direct way; by increasing the demand for foreign goods and services on the parallel market, hence pushing up the premium. Secondly, in an indirect way; through inflation, by basically two means.

Inflation is seen as a fiscal phenomenon, since:

it is caused by governments with no alternative source of deficit finance resorting to money creation at a higher rate than the growth in money demand. Any hope of controlling inflation without reducing government deficits is then in vain. Excessive reliance on money creation is particularly risky if the inflation itself worsens the deficits, because expenditures keep pace with rising prices while revenues do not. This means that still more money creation becomes necessary -further worsening the inflationary spiral.' (World Bank, 1988; 57)

The impact on the parallel market is twofold. Inflation causes the fixed nominal exchange rate to become increasingly overvalued (real appreciation); as a result of which, given a constrained official market, the supply and demand of foreign exchange on the parallel market is increased and the parallel market premium rises. The other consequence is induced capital flight. This occurs as follows: inflation leads to a fall in real interest on bank deposits<sup>5</sup>; people would prefer to store their wealth in property or taking it abroad: capital flight (ibid).

Some economists in the neo-classical tradition, however, do perceive the parallel market as being sub-optimal, although they consider it far more efficient than the official exchange market. In first instance, they would say, because parallel market operations carry specific costs, like risks of detection, bribes, information costs, smuggling costs and rent-seeking (Nowak 1985; Culbertson 1989; May 1985). As a result, the parallel market exchange rate would lie above the equilibrium real exchange rate.

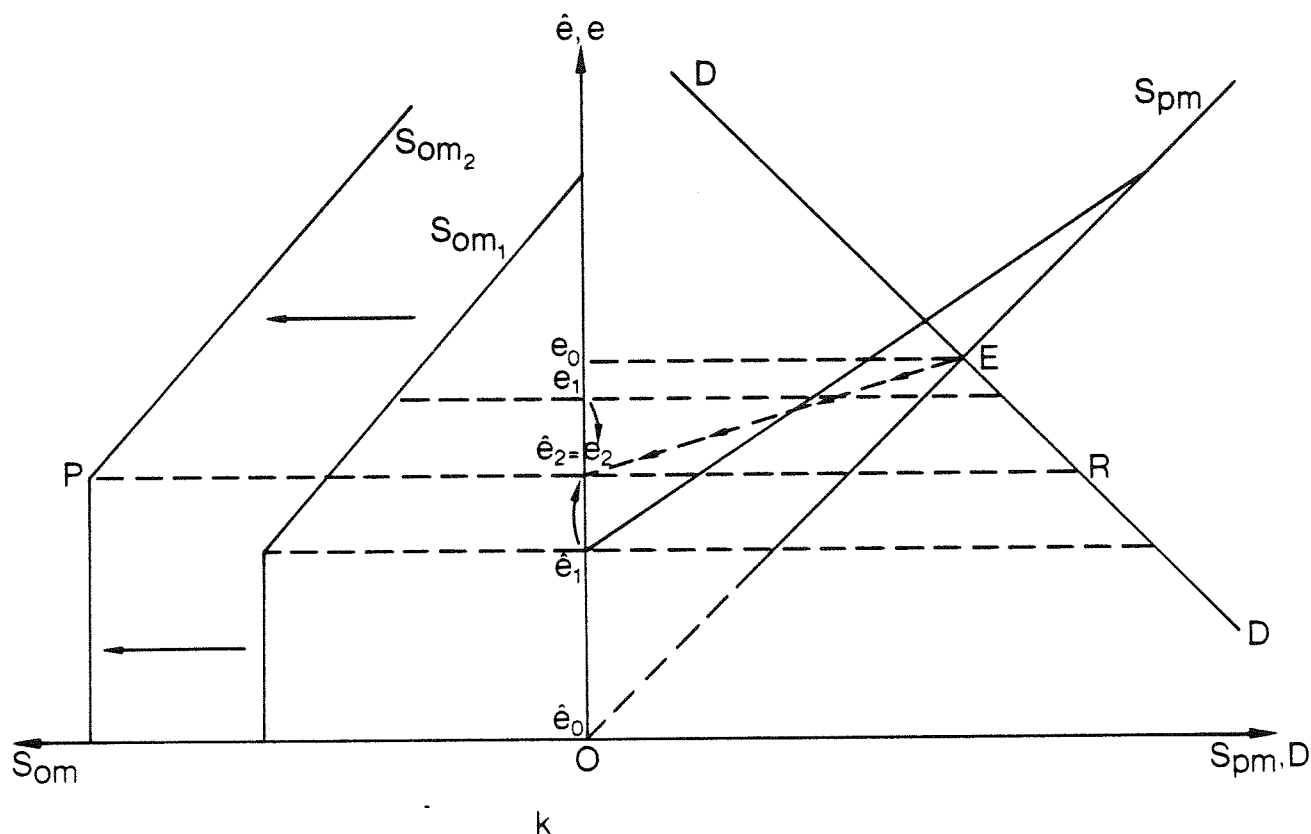
Moreover, the misuse of 'discretionary powers', the 'vested-interest' pressures and the political leverage associated with this type of government intervention are regarded as serious social costs to the economy as a whole (Nowak, 1985).

After this review of the major neo-classical arguments on the nature, causes and effects of the parallel market in foreign exchange, we will now explore the standard policy solutions advanced by the IMF/WB for correcting the country's external imbalances and eradication of the foreign exchange parallel market, i.e. their insistence on unification of the official and the parallel market for foreign exchange through devaluation. This is demonstrated by figure 6.

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<sup>5</sup> Inflation increases the demand for credit from the banking system, as people are confronted with higher prices (inflation spiral). This pushes up the banks' lending interest rates. At the same time, however, in order to counteract the inflationary pressures of money creation, often, the Central Bank, raises the reserve or portfolio requirements on commercial bank lending. The commercial banks, thus forced to hold more currency reserves, lower the deposit interest rate. The spread between deposit rates and loan rates widens, thus discouraging savers (and investors) from requesting financial intermediation from the banks.

Figure 6 : Unification of foreign exchange market



With a given demand for foreign exchange, successive devaluations of the official exchange rate produce an outward shift of the official supply curve and an accompanying lowering (appreciation) of the parallel market exchange rate. If the official exchange rate is sufficiently devalued, say to  $\hat{e}_2$ , this brings down the parallel market exchange rate to the same level ( $\hat{e}_2 = e_2$ ) and the parallel market ceases to exist, since at that exchange rate official supply of foreign exchange meets total demand.

The IMF and the World Bank, holding the government mainly responsible for 'bad management' of the economy, with serious socio-economic costs in the short and long-term, come to the conclusion that immediate adjustment is needed. Imbalances can no longer be sustained, and corrective measures should be taken without delay to achieve internal and external stability.

Their standard policy recommendation in the case of the presence of a parallel market in foreign exchange holds the following adjustment measures as indispensable for the restoration of balanced and non-inflationary growth:

1. Devaluation of the official exchange rate.
2. Liberalization of the trade regime.
3. Demand constraining measures, among which are paramount:
  - reduction in government spending and tighter monetary control
  - suppression of wage and other cost rises.

These measures together, so-called expenditure switching (1 and 2) and expenditure reducing (3), are seen as necessary to obtain a real (as opposed to nominal) devaluation, as a first prerequisite for restoring external and internal equilibrium.

The argument runs as follows: a devaluation of the nominal official exchange rate or keeping an adjustable peg would adjust the real exchange rate to its equilibrium value. This would rehabilitate the price mechanism as the prime mover of an optimal allocation of resources. Therefore exports would be increased and imports reduced, hence diminishing the current account deficit and improving the balance of payments position. The incentive for trade smuggling or false invoicing and the shifting of foreign exchange onto the parallel market would cease once the 'right' percentage of devaluation has been effected that reduced the parallel market premium to zero; thereby achieving the unification of the official and parallel market for foreign exchange.

At the same time trade liberalization is advocated in order to allow for the 'free-market' mechanism or the 'invisible hand' to determine equilibrium in the country's external account.

However, one of the objections to the IMF/WB's demand for devaluation has been that it has inflationary consequences; to which these institutions have replied that either prices have already (prior to devaluation) adjusted upwards as a result of the widespread presence of the parallel market, or that if not - which they hardly accept - the proper response would be to eliminate the source of inflation, which, in their view, consists not of the devaluation itself, but on the contrary, of the increase in the domestic money supply. The IMF and the World Bank argue that price rises can only be realized if there is an accommodating additional supply of money pumped into society. Their conclusion is that inflation or the supply of money has to be contained through a reduction in government spending, wage rise controls and suppression of other cost-push factors. This would result in a real devaluation, rather than a nominal one, as a necessary condition for the country's lasting internal and external stability.

### 2.3.2 The Structuralist Critique

A first structuralist critique of the orthodox IMF/WB policy prescriptions centres around the presumed improvement of the trade balance following a devaluation. Exports and imports react in the way predicted by the IMF/WB, only if they are 'price-elastic' (so-called Marshall-Lerner conditions). However, in practice this is not the case for most developing countries.

Most developing countries export agricultural primary products and other raw materials for which they are 'price takers' on the international market. Although with a devaluation the domestic currency return for exporters would be increased, foreign exchange earnings of the country would not be enhanced, unless supply of exports could be increased. Yet, this is the (structural) bottleneck, because output is very often inflexible in the short-run or not in line

with long-term export diversification objectives (i.e. price-inelastic in both the short- and long-run). Even if the country opts for an increase in exports, the possibility in terms of foreign demand has to be taken into account. Foreign demand for the country's exports might not be high or may be extremely volatile, which has indeed been the case for primary exports from the Third World in recent decades. The prospects for manufactured exports would in some cases be inhibited by the 'crowding-out' from the NICs, protectionism from the industrialized countries, and anyhow would require a long-term strategy depending also on accessibility to financial resources. Generally, therefore, structuralists are 'pessimistic' about the elasticities for demand and supply for developing countries' exports.

They also point to the inelasticity of demand for imports of the many basic consumer necessities, the intermediate inputs, spare parts and machinery equipment for local production. Notwithstanding a devaluation, the country depending very much on imports, will not be in a position to lower the level of imports under a minimum, unless at the expense of its productive capacity and often a reduction of imports of 'essential' consumption goods.

Moreover, the initial price incentive a devaluation offers to exporters may be eroded by the cost-push resulting from the price increase of imported productive inputs, or through wage-indexation (to inflation)<sup>6</sup>. On balance, therefore, the profitability for the exporter might not be enhanced, thus not necessarily resulting in a positive stimulus for producing more for export<sup>7</sup>.

From the above it is clear that structuralists look at structural factors and institutional characteristics of the market in assessing the performance of the export sector and the feasibility of reducing imports. They point to the dependent position of developing countries in the world economy, how this affects their terms of trade and market shares that eventually, to a large extent, determine the external balances of these countries. They cast serious doubts on the efficacy of a devaluation, as a monetary instrument in itself, and contest the view that a correction of the nominal exchange rate would suffice for the adjustment of the real exchange rate which, after all, is the result of structural factors.

In more recent literature on parallel markets in foreign exchange, there is also criticism of the IMF/WB claim that devaluation and liberalization of trade will eliminate the incentive for smuggling and the transfer of resources to the secondary foreign exchange market. The view that these measures would reduce the parallel market premium to zero thus effecting the expected unification of the official and parallel markets for foreign exchange is challenged.

Different writers (Brown 1990; Dornbusch 1990; Pinto 1990; Pitt 1989; Rocha 1990; Taylor 1983) have referred to the demand for foreign exchange on the parallel market not only as an offshoot of restrictions on current account transactions, but also on behalf of illegal capital account transactions; i.e. for the purpose of 'capital flight'. Whether capital controls are a part of the official trade regime or not, under certain circumstances there is an ongoing quest for the acquisition of foreign currency denominated assets. Factors giving rise to 'capital flight' include interest-rate differentials between countries, little diversification in domestic portfolios, low

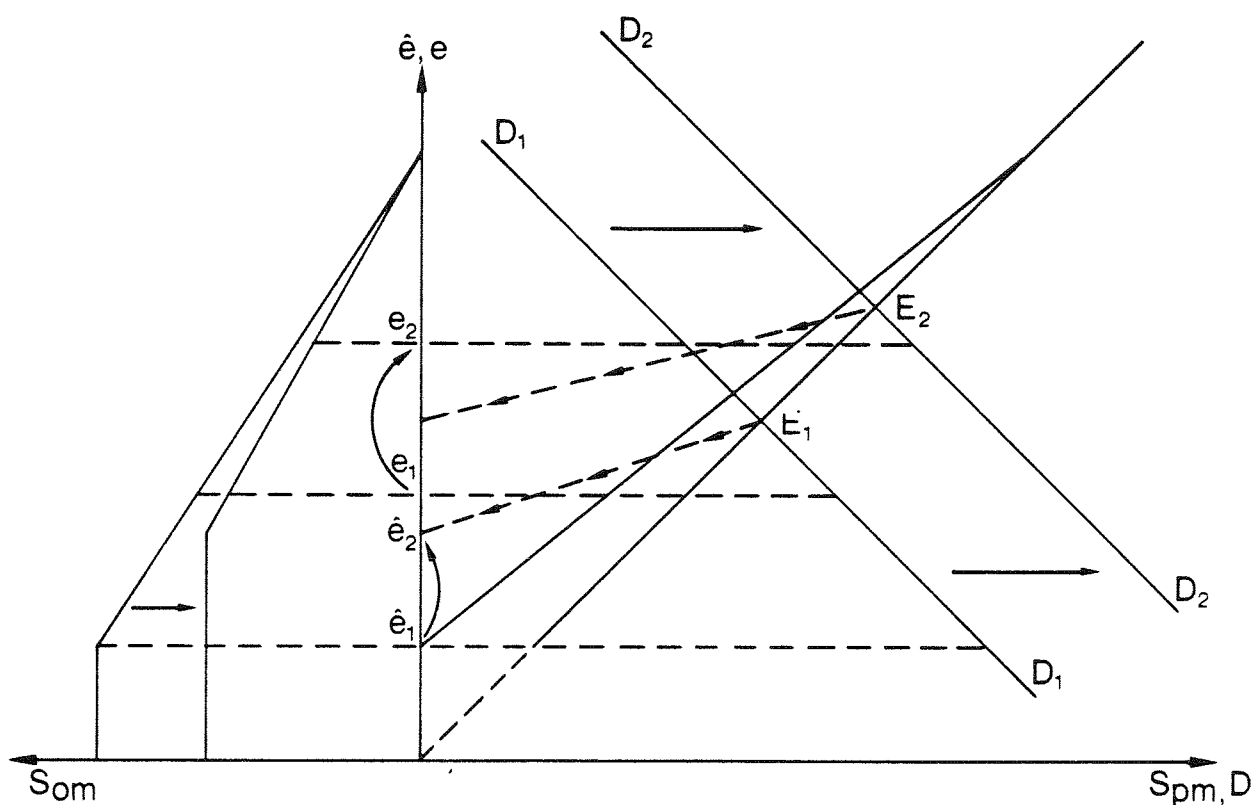
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<sup>6</sup> However, if producers operate from an oligopolistic market position, they may as well pass on higher costs to final prices. If wages react without a great lag this could lead to a devaluation-inflation-wage rise spiral.

<sup>7</sup> In some countries the price advantage of devaluation was not passed on to producers, but accrued to intermediate traders that had monopolized the market (Lipumba 1990).

returns on productive investment; however, above all the overall socio-economic and political instability faced by many of the developing countries, the continuous erosion of the purchasing power of the domestic currency due to high inflation and the expectations of forthcoming devaluations. The effects are demonstrated in figure 7.

Figure 7 : Exogenous foreign exchange demand :  
persistent excess demand in the official market



With the initial official exchange rate  $e_1$ , there is excess demand in the official foreign exchange market and a parallel market emerges which clears at  $e_1$ . The authorities devalue the currency to  $e_2$  which is believed to be the 'true' equilibrium exchange rate. However, at this rate excess demand in the official market persists. Demand for foreign exchange continues to increase (DD shifts to the right), while even less foreign exchange is surrendered to the official market (the official supply curve shifts to the right). As a result, a new (temporarily) equilibrating parallel exchange rate begins to function at a higher level than before. Upon another devaluation the process continues; excess demand persists and the parallel market exchange rate keeps going up. Unification of the foreign exchange market is not practically feasible.

On the basis of these 'push and pull' factors of capital flight, individuals that by some means or the other have been able to acquire foreign exchange will look for and always find some others to sell it at a premium with the aim of rent-seeking. In other words, as long as the underlying factors of uncertainty, speculation and protection against expected future devaluations are present, there will be a persistent incentive to divert foreign exchange from the official market, for example through trade faking, as much as there will be capital flight. Both cannot be expected to cease with a devaluation or 'freeing' of the trade and exchange regime, unless it means a continuous process of successive devaluations or a complete drain on the official reserves of the country. This would leave little ground for asserting that a devaluation will achieve a unification of the 'dual' foreign exchange market, but instead, from a different angle, again warns against holding on to the perceived advantages of this major policy recommendation of the IMF and the World Bank.

However, Vos (1990) has forwarded a distinct and additional dimension of capital flight from some Third World countries, namely the demand for foreign assets connected to the international consumption pattern and lifestyles of the wealthy dominant classes. Arguing that these elites spend part of the year abroad, or send their children to study abroad, the need often arises for them to secure foreign income generating assets abroad, which may take the form of foreign bank assets held abroad. Especially if capital controls and exchange rate risks exist, these incentives may increase. Noting this aspect of capital flight which may acquire substantial proportions<sup>8</sup>, this writer also reaches the conclusion that traditional adjustment policies, such as devaluation etc., will not counteract the phenomenon of capital flight.

Structuralists have also questioned the feasibility of achieving a 'real devaluation' in the way proposed by the IMF/WB, as they have an alternative explanation of the causes and effects of inflation.

As to the cause, they point out that inflation can be 'imported'; an increase in foreign prices of imported goods causes domestic prices to rise. But even more importantly, inflation can become quite self-fulfilling in a situation of widespread parallel markets for goods and foreign exchange, capital flight and artificially created scarcities.

Pitt (1990), for example, argues that the 'exogenous' demand for foreign exchange arising out of capital flight 'crowds out' illegal imports, hence pushing up parallel market goods prices. At the same time, the upward pressure on the parallel market exchange rate spurs inflation for all other goods and assets markets of the economy (Brown, 1990). Moreover, capital flight leading to a drain on the country's natural resources and external earnings, is a mechanism inhibiting domestic investments, growth and output of goods and services.

Certain categories of domestic producers are twice hit. Firstly, foreign exchange on the official market becomes scarce; secondly, inputs imported through the parallel market system add an extra burden to production costs. Often, these entrepreneurs may have no other means in the short run to finance the higher costs of imported productive input than to apply for bank loans. Imposing ceilings on such bank credits would be counter-productive, and the effects even more detrimental in case exports have no prospects for expansion.

The next group affected are domestic consumers, who will be faced with price increases of both imported and home goods, since the latter are often priced according to 'mark-up on

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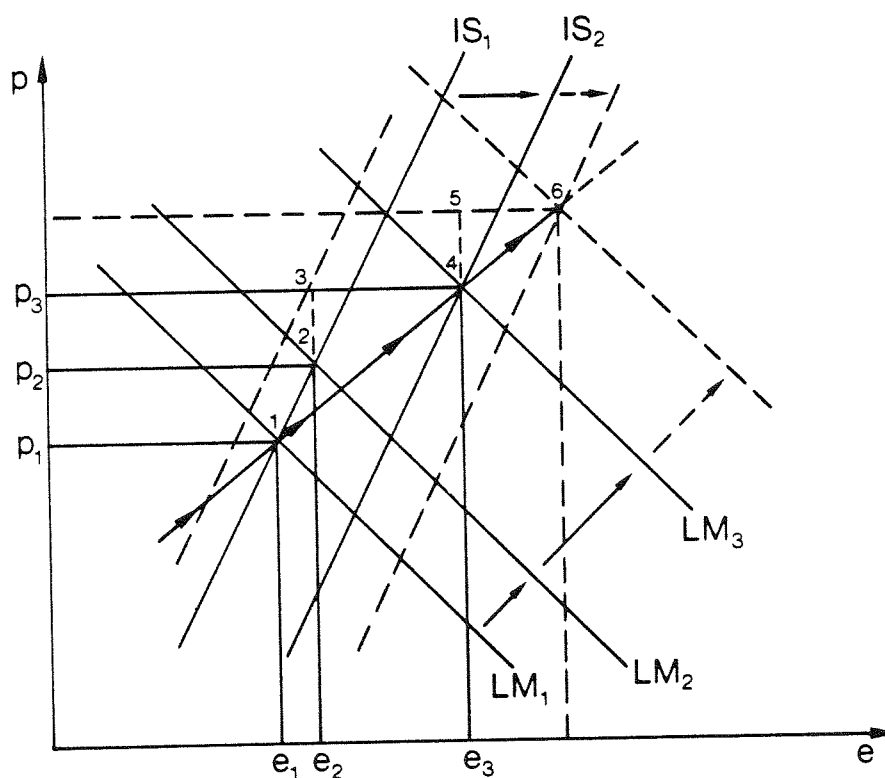
<sup>8</sup> As this researcher indicated in the case of the Philippines (Vos, op cit.; 14).

cost' rules in the case of oligopolistic market structures. Also consumers resort to bank borrowing to meet living expenditures.

The government itself will be faced with these increased prices and an upward push on its expenditures. If a devaluation is imposed, this would also increase public sector debt service payments in domestic currency, thus adding to the deficit and inducing further monetary financing.

This picture clearly demonstrates that a more complex, integrated and self-feeding process is at work, and that the simplistic view of the IMF and the World Bank holding that inflation is the result of 'overconsumption' or irresponsible spending of the government in fact cannot be supported. The actual relationship between inflation and demand and supply of money is rather the reverse of the view adhered to by the IMF/WB. Inflation spreading from the parallel market engenders demand for money, and supply in most cases follows inevitably. In other words, the money supply merely accompanies rising prices; money is virtually 'passive'.

Figure 8 : Devaluation-inflation spiral



These processes can be illustrated by movements of the IS and LM curves in a general equilibrium setting, such as presented in figure 8. Equilibrium in both the goods and the financial assets markets is obtained under specific combinations of the general domestic price level  $p$  and the real exchange rate  $e$ . Substitutability between home goods and traded goods and between domestic financial assets and foreign financial assets is assumed.

The IS-curve represents combinations of  $p$  and  $e$  that satisfy the condition that the demand for the country's output equals domestic supply. The slope is positive because higher domestic prices lead to increased output and excess supply, which should be offset by a rise (depreciation) in  $e$  to maintain equilibrium; by inducing a combination of shifting production of the home good to production of exportables and shifting demand for importables to demand for import substitutes.

The LM-curve represents equilibrium in the financial home market. It is downward sloping because an excess demand for domestic money caused by an increase in  $p$  must be matched by a fall (appreciation) in  $e$ , which lowers the domestic currency equivalent of demand for foreign financial assets.

According to structuralist analysis, however, if the parallel market exchange rate rises, or the official exchange rate is devalued (from  $e_1$  to  $e_2$ ), the demand for money increases; not only because the domestic currency cost of the demand for foreign exchange is increased, but also because devaluation feeds back into higher domestic prices (increase from  $p_1$  to  $p_2$ ) via cost-push exerted by imported inputs or through wage-indexation. In the figure the LM-curve shifts to the right. The increase in the money supply, however, usually engenders extra demand for goods. Given stagnant output in the short-run, this leads to further price increases (to  $p_3$ ). In order to attain equilibrium in the goods market the authorities might opt for another devaluation. Further depreciation of the currency on the parallel market follows as well, and the process of accommodating monetary expansion and its repercussions is repeated, leading to the well-known devaluation-inflation spiral. The arrowed path running through point 1, 4 and 6 of the figure expresses this motion.

Structuralists, therefore, contest the orthodox explanation of the cause of inflation, which in the perception of the IMF/WB-institutions is the government's own excessive spending combined with its failure to control 'overconsumption' of society. They maintain that the 'mechanism' of the inflationary spiral lies in the way in which existing income and wealth are being redistributed and shifted away from the wage and salary earners to the rentiers and merchants involved in the parallel economy and those engaged in the export of capital (Brown, *op cit.*).

The impact invariably is the continuous erosion of workers' and other non-proprietary classes' real incomes, that will also have serious repercussions on productivity and growth in the longer run. On the political scene, therefore, the resistance of these groups and classes against devaluations and the 'freeing' of the market, imposed as conditions for structural adjustment financing by the IMF and World Bank, has been growing. Instead, the people demand price controls and wage increases.

Structuralists, taking the interests of the common people into account, suggest a structural solution to the problem. According to them, simply devaluing the domestic currency is not a panacea as, under existing circumstances, the skewed accumulation and distribution process would be perpetuated and exacerbate the crisis and burden on the poor.

In the next chapter, a particular country, Surinam, is studied, and an attempt will be made to advance some policy guidelines applicable to its specific circumstances, but that may also add to the theoretical understanding of the foreign exchange crisis and the socio-economic crisis facing other Third World countries.



**CHAPTER 3**  
**FOREIGN EXCHANGE**  
**PARALLEL MARKET IN SURINAM**

### **3.1 INTRODUCTION: THE SOCIO-ECONOMIC AND POLITICAL CONTEXT**

In this chapter, the case of Surinam will be used to study the particular situation of a parallel market in foreign exchange. In the first place, there will be an attempt to establish some empirical evidence of its magnitude and extent, and to assess the various sources of supply and components of demand; while at the same time attempting to assess some of the links with the formal economy. The aim of this more quantitative analysis is to provide the empirical grounds for subsequently explaining the dynamics of the parallel economy and its interaction with the formal domestic and external economies. The consequences of the 'hidden' or unrecorded flows of actual macro-economic variables will be examined, but also, and extending beyond such explanations, an effort is made to account for the repercussions of the foreign exchange parallel market on the process of reproduction, accumulation, distribution, consumption and savings of the whole of the economy. And, moreover, how this process articulates with the international economy. Whereas these aspects relate to developments of the 'real' economy, the analysis will be integrated with an assessment of fiscal and monetary developments as well. In this regard, empirical evidence on the domestic supply and domestic demand for money is provided, while also the link between the level of the parallel market exchange rate, parallel market prices and inflation is addressed.

The whole of this analysis, however, will be only a starting point; some issues cannot be pursued in depth or only on the basis of certain assumptions, because of lack of data, and some would ideally have to be complemented by research at the meso- and micro-level, i.e. at the level of the various economic sectors, productive units and other actors within the economy, and their interaction with the external economy. Many of these aspects which could not be covered by the present paper, are therefore suggested as essential areas for attention in future research.

The final section of this chapter summarizes the major findings of the empirical work in the form of an alternative explanation of the dynamics of the parallel market, while integrating this with a discussion of its socio-economic effects and implications for growth. This leads us finally to Chapter 4, where some policy considerations and conclusions based on this empirical case-study are advanced, and at the same time related to the theoretical framework of Chapter 2. Hopefully, some points of relevance for Surinam itself and, from both a theoretical and practical point of view, also for other developing countries facing similar kinds of problems, are forwarded.

This introduction continues with a brief sketch of the socio-economic and political context of the economic crisis that Surinam faced during the 1980s, with the purpose of shedding some more light on the nature of the foreign exchange crisis and putting it within a proper framework.

The foreign exchange crisis has invariably been described as a problem of foreign exchange 'scarcity' of the formal economy, while simultaneously it is recognized that increasingly more foreign exchange is diverted to the parallel market. Yet, it should also be borne in mind that both markets are constrained by structural characteristics and limitations of expansion of the present export base of the economy as a whole. This point relates to the **potential**, given the existing domestic production structure and its position in the international division of labour and production, of foreign exchange generation and earnings by the country. At the same time, however, this is also conditioned by the actual distribution and articulation between 'institutions' and sectors within the formal economy (largely the public sector) on the one hand, and those within the parallel market economy on the other hand.

Moreover, in the past, the country had relied on foreign aid on a massive scale; proof of the fact that it is faced with a structural domestic savings-gap and dependent on the outer economy; i.e. reflecting the extreme smallness and openness of the economy.

Also, historically, an important source of foreign exchange inflows to the country have consisted of unrequited transfers to Surinamese nationals received from family living overseas and factor income payments on behalf of Surinamese migrants working abroad. This point is relevant in considering the conditions under which evasion of official channels becomes a prerequisite for 'maximizing' individual benefits. In our case study it will, moreover, be shown how subsequent redistribution and intra-group (-class) transfer of these resources will give rise to a particular pattern of savings and consumption with implications for investment and reproduction of export activities.

In the context of Surinam, the political turmoil of the 1980s also needs to be taken into account. The military coup d'état of February 1980 was followed by a series of military/civilian governments after the other, resulting in discontinuous and often ad hoc policies on the economic front. In addition, an armed struggle began in the interior of the country from mid-86 on. This has been very costly in economic and other terms, as some production facilities, such as many timber mills, have been destroyed, sabotage at several times has disrupted electricity supply from the hydro-electric dam to both the aluminium smelting plant and to the capital city and surroundings. Besides having had direct, adverse effects on production and export, these developments also lead to an insecure and unstable political climate of the 1980s, fostering disinvestment and capital flight.

An immediate and acute foreign exchange constraint emerged also from the suspension of Dutch development aid at the end of 1982, in reaction to the particular form the military involvement in internal political affairs had taken<sup>9</sup>. Aid flows amounting to approximately US\$ 80 million a year before 1982 suddenly came to a halt, and all other cooperation within the

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<sup>9</sup> This decision by the Dutch Government was taken following events of December 1982 when 15 opposition leaders to the military regime were shot dead while being held under military arrest.

framework of the Development Programme Agreement was ceased.

Coming back to a point raised earlier, it must be re-emphasized that aside from these developments and circumstances, these are structural bottlenecks limiting increases in foreign exchange export earnings caused basically by the primary commodity nature of the export sector. Surinam's principal exports are bauxite and its derivatives, which is an enclave in the economic structure, though the country's most important foreign exchange net earner; and agrarian products, such as rice, bananas, shrimps, fish, timber, vegetables and tropical fruits. Trade statistics on a transaction basis (see Appendix 3.1) indicate diminishing revenues for bauxite as well as for aluminium during the 1980s. Total export earnings from this sector declined from Sf 747 million in 1980 to Sf 515 million in 1984 to Sf 370 million in 1987, to an increase to Sf 550 million in 1988. Earnings from rice decreased just slightly for the same period, although in 1986, this was only three-quarters of the 1980 level. Performance of timber exports was very poor, while shrimp exports flourished and the other products remained more or less stable.

The potential for foreign exchange earnings from the bauxite industry depends on foreign demand, which from a long-term perspective has been decreasing due to technological innovation and material substitution in industrial production in the industrialized countries. The potential of rice exports is conditioned by LOME/ACP conventions, in which respect the country is a price-taker while having to meet a certain minimum quota of export. Demand in the Western consumer market for Surinam's long-grain quality is nowadays declining, while increased competition is being faced from lower-cost Third World producers elsewhere. In the case of the other primary commodities, of which Surinam exports relatively very small amounts, the country is a price taker and accordingly cannot influence its market position.

The structural and external bottlenecks faced by traditional exporting can only be overcome in the long-run by diversifying the export base, in combination with other sound macro- and micro-economic policies. A related problem to solving the domestic savings-gap and foreign exchange constraint is that ways should be found to reduce the dependency of production on imported inputs.

At the same time, the data suggests that the presence of the parallel market has not altered the composition of traditional exports nor reduced dependency on imports much. It appears as if it has been convenient to remain exporting agrarian primary products rather than undertaking a diversification strategy leading to a greater share of exports of manufactured goods.

The rest of this chapter examines this interaction between the parallel market of supply and demand of foreign exchange and the formal economy, both the real and monetary sphere.

## 3.2 EMPIRICAL EVIDENCE OF THE FOREIGN EXCHANGE PARALLEL MARKET IN SURINAM

### 3.2.1 Foreign Exchange Supply and Demand on the Parallel Market

#### 3.2.1.1 Supply

Sources of supply of foreign exchange on the parallel market<sup>10</sup> consist of:

- export underinvoicing and non-transfer of export earnings;
- import overinvoicing and shifting of part of foreign exchange acquired via the official foreign exchange market; and
- other unrecorded current and capital account transactions (primary factor income, family remittances, foreign investment flows, etc.).

In order to calculate underinvoicing of exports, the records of imports of the rest of the world (ROW) from Surinam (as reported in Directions of Trade Statistics, IMF) adjusted for cif/fob factors are compared with export statistics of Surinam. The assumption is that these trade records of the ROW are quite accurate and not faked, which is plausible especially for the developed countries. Since Surinam has the developed countries as its major trading partners, this method can be considered reliable assuming no other asymmetries in trade reporting exist.

The practice during the crisis years has been a massive withholding of export revenues abroad, so that actual cash receipts by the Central Bank of Surinam (balance of payments on a cash basis) have been even less than reported transaction values (balance of payments on a transaction basis).

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<sup>10</sup> 'Supply' on the 'market' extends beyond geographical boundaries; i.e. it is exerted on the 'market' within the home country, as well as on that abroad. For example, parallel market swap arrangements in real estate located in Surinam may not involve actual cash transfers of foreign currencies on Surinamese soil. The foreign exchange component of the purchase (made by non-residents) could be kept abroad for the beneficiary, the Surinamese resident. The same may hold for unrecorded unrequited transfers from abroad, such as family remittances, on behalf of Surinamese residents. Instrumental in these transfers are the informal so-called 'foreign exchange bureaus' holding office in the main capital flight recipient countries, for instance The Netherlands. These mediate in parallel market transactions by having agents in Surinam delivering or collecting the Surinamese Guilders counterpart, while foreign currency transfers remain conducted abroad.

Table 3.1 'Export-Leakage' and as percentage of imports-fob ROW  
1975-88 (US\$ million)

	75-79	%	80-82	%	83-88	%	80-88	%
receipts	1762		1414		1962			
imp.fob ROW	1816		1444		2155			
'leakage'	54	3	30	2	193	9	223	6

Derived from Appendix 3A1

Thus, an illegal private transfer to abroad of export revenues took place, which is the difference between recorded imports-fob-ROW and actual remitted export earnings, and is estimated at **US\$ 223 million** for the period 1980-88 - see Table 3.1 and Appendix 3A1.

It is shown that the 'leakage-percentage', the ratio of the illegally non-remitted earnings over real earnings (fob payments ROW), was higher during the crisis years than during the early 1980s and before (2-3% during 1975-82 as against 9% during 1983-88). This shows that the incentive to divert foreign exchange illegally to abroad has increased during the latter half of the 1980s.

For the estimation of overinvoicing of imports a similar method and assumption (about the reliability of ROW statistics) is adopted. Actual payments for the import of goods (including payment of freight and insurance), with exports cif ROW (also reported in Directions of Trade Statistics) are compared. Here also the cif/fob factor for Surinam as calculated by the IMF (International Financial Statistics, IMF) is assumed correct, and subsequently used in the transformation of fob exports ROW to cif values.

Because no official payment is made for 'Own-Funds' imports, the values of these (which are recorded by the Central Bank) are subtracted, to give an account of what has been paid in excess of what was due.

In fact, this method gives figures of net import misinvoicing, since there can also be a contra-incentive for underinvoicing the goods, in the case, for example, when import taxes are high. It is found, however, that there has been a net import overinvoicing during 1980-88, of a total value of **US\$ 178 million** - see Table 3.2 below and Appendix 3A2.

Table 3.2 Import Overinvoicing (net) and as percentage of declared value, 1980-88 (US\$ million)

	80-82	x	83-88	x	80-88	x
payments	1648		1933			
exp.cif ROW	1529		2134			
'OF'-imports	---		259			
Overinvoice(net)	119	7	59	3	178	5

Derived from Appendix 3A2

Import overinvoicing (net) as a percentage of declared value was 5% on average during 1980-88, though lower during the latter part of the 1980s (3%), presumably because it has been easier to enforce stricter control over the smaller amounts of foreign exchange available for official imports.

We have now calculated supply of foreign exchange onto the 'parallel market' from trade misinvoicing and other leakages through trade, except for the share of foreign exchange that has been officially acquired and subsequently shifted onto the parallel market. This amount is unknown, but we have arrived at an indicative figure of total estimated value for foreign exchange supplied to the parallel market for the trade balance, of **US\$ 401 million** during the 1980s.

Other sources of supply of foreign exchange to the parallel market consist of other unrecorded current account transfers from abroad, such as unrecorded primary factor incomes, unrecorded family remittances, and, as is suggested, 'service payments' to individuals allegedly involved in the illicit drugs transportation through Surinam. Another supply could be unrecorded capital transactions, like 'direct (productive) investment', investment in real estate and tenure in Surinam, and others. All these 'flows' are by their very nature extremely difficult to measure. As far as the author knows there are no estimates available. Moreover, the time available for this study did not allow the development of suitable methods of collecting and processing data with the aim of providing at least some indicative figures.

As a matter of illustration, in Appendix 3A3 the trend of officially received foreign factor incomes (primary factor incomes and unrequited transfers (including family remittances)) from 1975 up to 1988 is presented. Official foreign factor inflows (primary factor income and transfers) amounted to an accumulated total of US\$ 212 million during the six-year period of 1977-82. After 1982, during the six years between 1983 and 1988, official receipts had dropped to US\$ 56 million; **US\$ 156 million or 73% less.**

It is plausible to believe that foreign factor incomes have continued to be transferred to Surinam, through the parallel circuit instead, and that there is a substantial incidence of family gifts from overseas of both foreign currencies and goods in kind through unofficial or

unrecorded channels. This foreign exchange is assumed to be bought up by third parties, the so-called 'foreign exchange dealers', for purposes of capital flight, foreign consumption, future 'rent-seeking' through parallel market imports or other speculative activities.

It is also suspected that non-residents are investing in land and real estate in Surinam<sup>11</sup> via the parallel market, i.e. without acquiring an official licence, thus circumventing the obligation of surrender of the purchase money in foreign exchange to the monetary authorities, but instead laundering it through the parallel market at the discounted rate<sup>12</sup>.

### 3.2.1.2 Demand

We will now consider the components of demand for foreign exchange on the parallel market. As argued in Chapter 2 these encompass:

- a transaction demand; in the case of Surinam presumably consisting of the financing of 'Own-Fund' imports and other unrecorded current account transactions such as tourism, study abroad, transfers to dependents living abroad, etc.; and
- a portfolio or assets demand; associated with unrecorded private capital and financial investments abroad, and probably also connected to the inertial foreign consumption pattern of the rich<sup>13</sup>.

Parallel market imports through the so-called 'Own-Fund' licences system<sup>14</sup> have been allowed since 1984 and have effectively supplemented diminishing official imports. 'Own-Fund' imports are recorded by the Central Bank of Surinam. The figures for 1984-88 are in table 3.3, below:

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<sup>11</sup> Investment in real estate in Suriname can also constitute demand for foreign exchange, i.e. constitute an 'end-use' of foreign exchange 'supplied' to the parallel market- see also footnote 1.

<sup>12</sup> An investigation performed at the Registry of Mortgage to find evidence and possible incidence of illegal and/or unrecorded real estate conveyance by non-residents, although unsuccessful in specifying quantitative evidence, nevertheless has pointed out various factors indicating a substantial evasion of the foreign exchange regulations and other procedures in this regard, with the obvious motive to conceal the 'foreign' nature of the transaction and the subsequent obligation of applying for a foreign exchange licence with the implication of surrendering the purchase money to the monetary authorities against the official exchange rate. Instead 'foreigners' have been acquiring real estate, buildings and tenure at a discounted rate on the parallel market; the foreign currency countervalue allegedly being held abroad or used for consumptive purposes.

<sup>13</sup> In some instances this can also constitute a direct transactions demand.

<sup>14</sup> Private individuals obtain licenses to import goods for which no payment from official reserves and official foreign exchange receipts are made.

Table 3.3 Parallel Market Imports and share in Total Imports  
1984-88 (US\$ mln)

	1984	1985	1986	1987	1988	84-88
Total	391	327	263	325	386	1692
Off. Imp.	381	305	220	241	286	1433
Par.Mkt.Imp.	10	22	43	84	100	259
(% of total)	3	7	16	26	26	15

Derived from Appendix 3A2

Between 1984 and 1988 approximately US\$ 260 million was imported through the parallel market, i.e. at dollar value: 15% of total imports during that period. The share increased from 3% in 1984 to 26% in 1988 (see also Appendix 3A2). These imports are then assumed to have been financed out of the illegal external capital movements due to trade misinvoicing, which we have estimated at US\$ 401 million in 1980-88. In other words, it is suggested that there has been a 'gross capital flight' via the trade account of approximately US\$ 140 million (US\$ 400 million minus US\$ 260 million) during 1980-88, or 50% of parallel market imports. Alternatively stated: of the estimated illegal capital 'outflow' on the basis of falsified trade accounts during the 1980s, almost two-thirds could have been returning in the form of parallel market imports of goods through the 'OF'-licences system during the latter part of the decade.

Other factors of transaction or current account demand for foreign exchange on the parallel market, such as tourism abroad, study abroad and in some instances transfers to dependents living overseas, could not be estimated.

With regard to the portfolio or asset demand, we will next consider a particular 'end-use' (of this demand component) of foreign exchange, namely the private acquisition of foreign bank assets held abroad by Surinamese residents. In this case we refer to the change in stock variable, increased on balance by net private capital outflows. As an indication the records on all Surinamese non-bank residents' deposits in banks abroad is looked at. The International Monetary Fund reports in its International Financial Statistics Yearbook the item 'Cross-Border Bank Deposits of Nonbanks by Residence of Depositor'. From this source (Yearbook 1989) we read that the stock increased from US\$ 70 million as of end 1981 to US\$ 150 million as of end 1988, an accumulation of private foreign bank assets of US\$ 80 million during the period.

It is in fact assumed that all accumulated foreign assets of individuals, companies and other non-bank institutions that have Surinam as their residence can be considered flight capital. Again this includes only the recorded amounts, so that to the extent the recorded transactions are biased or that residence is misreported, this measure is also biased<sup>15</sup>. However, not all external asset acquisition necessarily takes the form of bank deposits; moreover, capital flight from Surinam acquired abroad by non-residents and/or non-nationals is also excluded. Finally, from this statistic it cannot be discerned whether interest-earnings are added to the stock and

<sup>15</sup> See also Vos (1990; 4) on this question.



whether on balance the stock increases or decreases due to capital flight in itself, i.e. exclusive of accumulation of interest.

Nevertheless, this stock variable can be associated with a particular demand on behalf of the wealthier classes of the country, i.e. their demand for foreign exchange income in the form of the interest bearings of the deposits. These people whose life-styles include some vacation abroad during part of the year, can then easily live on and consume the interest-earnings on these stocks.

### 3.2.2 Capital Flight and Unrecorded Remittances

One of the empirical findings of the previous analysis was the estimate of a 'gross capital flight' due to trade, of approximately US\$ 140 million during the 1980s, consisting of the illegal private capital outflow on behalf of trade misinvoicing of US\$ 400 million (US\$ 223 million due to non-transfer of export earnings plus US\$ 178 million due to net import overinvoicing), minus parallel market imports ('OF'-imports) of the order of magnitude of US\$ 260 million.

We will now compare this finding with another (traditional) method of calculation of capital flight, namely the method of the World Bank, which we will adjust for specific items in the case of Surinam. The World Bank measure is the 'broadest' one based on the country's official external account transactions (Cumby & Levich, 1987; 33). In effect, unrecorded private capital outflows are calculated as a residual item equalling the sum of net (short-term) foreign asset acquisition by the banking sector and the private non-bank sector plus errors and omissions<sup>16</sup> (Vos, 1990; 5).

However, since officially recorded figures are used and notwithstanding that their discrepancy is considered to constitute the measure of capital flight, this measure still could be biased to the extent that the statistical records of its component parts are inaccurate. But even more importantly, certain unrecorded transactions with the external economy are totally omitted. These consist of, as we explained earlier, unrecorded current and capital account transactions. We will therefore adjust this measure with some of the results we obtained in the previous section. This could bring us somewhat closer to an indicative figure of capital flight on the basis of the World Bank's method. This is done as follows:

$$\text{WB-method: } CF = dD + dF^* - CAD^* - dR + VA^*$$

where dD is change in stock of external debt; dF are non-debt capital inflows; CAD is current account deficit; dR is change in monetary reserves; VA is valuation differences; \* Surinam adjustment: dF includes direct foreign investment (DFI) and grants; CAD is corrected for 'OF'-imports; VA-valuation differences are added.

On the basis of this method, for 1980-88 capital flight is estimated at:

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<sup>16</sup> This method includes the external assets held by the resident banking sector, which are excluded in other methods, for example Cuddington (1986), Morgan Guarantee (1986) and Vos (1990).

dD = D88 - D79 = 102 - 22	=	US\$	79	million (OECD, CBoS)
plus				
DFI + grants 1) = -138 + 291	=	'	153	' (IMF-BoP)
minus				
CAD* = CAD + 'OFI' = 498 + 258	=	'	756	' (CBoS)
minus				
dR	=	'	-181	' (CBoS)
plus				
VA	=	'	17	' (CBoS)
plus				
trade misinvoicing	=	'	<u>401</u>	' (Appendices)
CF	=	US\$	75	million

1) grants 1980/1/2 : Dutch Aid of a total of US\$ 266 million for those years (91% of the period's total)

Yet, so far this study has not been able to find a reliable estimate for one important supply of foreign exchange on the parallel market, namely the unrecorded foreign remittances to Surinamese residents received from their family and acquaintances living abroad. This foreign exchange presumably is used by other actors for purposes of capital flight. Who these third parties are and by which means they generate the Surinamese Guilders countervalue to pay for this will be studied in a following section of this paper.

For now, the implication is that the above calculations of capital flight, both on basis of trade misinvoicing and the adjusted World Bank method, must be considered to be understated for that part of the unreported remittances that is assumed to be re-exported abroad.

We have to make two qualifications. Firstly, we have found a range, rather than an absolute figure, for capital flight; of between US\$ 75 million and US\$ 140 million. Which, of course, is reliable to the extent that the methods of calculations and the data used are accurate. This figure constitutes 2-4% of total exports (ROW records); or 2-4% of total imports (ROW records) as well; or 1-2% of domestic output (officially recorded value added) between 1980-88, which would appear not to be excessive, but we maintain it is understated for unrecorded unrequited transfers from abroad.

Secondly, we have not found an overall estimate for unrecorded current and capital account transfers to Surinam. From empirical observations it is very obvious that within this category, one important unrecorded 'flow' being channelled through the parallel market is family remittances from abroad to residents in Surinam. It is unmistakably believed that these constitute a major source of support in the maintenance of costs of life of many families within Surinam, who in the face of the economic crisis have become increasingly dependent on additional transfers of (foreign) incomes and savings, received from relatives and others, in the form of consumer goods from abroad and foreign money. These effectively supplement incomes and savings available to the 'private sector' (i.e. households) in Surinam. Yet, as was suggested on the pattern of capital flight, part of these resources are subsequently acquired by certain classes

in society and shifted abroad again. This aspect of the parallel market points to a particular process of mobilization, accumulation and redistribution of external and internal resources. The following sections of the paper will try to establish the link with the process of investment, output and savings of the formal economy on the one hand, and with the fiscal and monetary sphere on the other hand.

Finally, the following indicators could be surveyed in future research:

1. parallel factor income and -unrequited transfers (parallel net foreign factor income), including family and migrants' remittances;
2. residents' stocks and bonds ownership abroad;
3. non-residents' capital flight from Surinam;
4. illicit drugs trade earnings.

### 3.2.3 Savings, Output and Sectoral Distribution

We will now incorporate some of the previous findings on hidden and unrecorded flows and variables of the parallel market in the macro-economic accounting framework. Implications of the parallel market for national savings, the GDP, GNP and the sectoral distribution will be analysed. The aim will be to shed some light on the relationship between the parallel market and the formal economy in the process of economic accumulation and distribution, and the articulation of the national economy as a whole with the external economy.

We will, however, instead of considering the whole of the period of the 1980s, confine the analysis to the years between 1984 and 1988 when the parallel market actually started growing. As a result the magnitudes of adjustment will not be the same as the figures on unrecorded foreign exchange earnings and capital flight found in the previous section.

In line with national accounting conventions the following relationships hold ex-post: imports of goods and services (cif) minus exports of goods and (non-factor) services (fob) equal gross national investments minus domestic savings (which is the domestic savings-gap).

$$Mg\&s - Xg\&s = I - S \text{ (domestic)}$$

Deducting net factor incomes from abroad (NFFI) from the domestic savings-gap gives the national savings-gap; i.e. gross investment minus national savings, which equals the current account of the balance of payments. This is financed by net foreign borrowing and the change in monetary reserves (including SDRs, valuation differences, etc.), which materializes in a change in net foreign assets of the banking system.

$$M - X - NFFI = I - S \text{ (national)} = F + R = NFA$$

Disaggregation is on the basis of the distinction between the public sector and the private sector. The government savings-gap equals the government budget deficit (GBD, before financing). government investment and savings are given (reported by Ministry of Finance). National private savings are accordingly calculated as residuals.

$$(I_g - S_g) + (I_p - S_p) = (NFA_g + NFA_p)$$

The gross domestic product against market prices (GDPmp) can subsequently be calculated according to the 'expenditure approach', by adding national consumption and domestic savings. The national product is GDP plus net foreign factor income (NFFI), or, national consumption plus national savings.

$$\text{GDPmp} = C + S(\text{domestic})$$

$$\text{GNPmp} = \text{GDPmp} + \text{NFFI} = C + S(\text{national})$$

This means that if net factor incomes from abroad (net primary factor income and unrequited transfers) is positive, the national income of the country is greater than its domestic product. Similarly, private savings are increased.

$$\text{NI} = \text{GNPmp} = C + I + X - M = C + S$$

We will now look at the behaviour of these variables in the case of Surinam and at the presumed effect of parallel market activities.

### 3.2.3.1 External Account, Savings-gap, Domestic and National Product

In Appendix 3B1 the national savings-gap, private and public savings and GDPmp are derived on a 'cash basis'. This method is used by the General Bureau for Statistics, basing itself on Central Bank figures of the Balance of Payments on a cash-basis, official figures from the Ministry of Finance on the public sector, and collected figures on investment and consumption, net indirect taxes and depreciation. National savings and the component private savings are accordingly calculated as residuals<sup>17</sup>.

In Appendix 3B2 the adjustment for the parallel market is done for the trade account. To official payments of imports of goods and services are added the value of 'Own-Fund'-imports, while the estimated overinvoicing of imports is subtracted. Export earnings are supplemented by the 'leakage'-value. Thus a re-estimated gross savings-gap is achieved. The net savings-gap should be adjusted for parallel market net factor inflows, but since these are not known, the adjustment of the national savings-gap is only partial. Finally, the GDPmp and GNPmp are re-calculated.

Considering the impact of the parallel market, the adjustment, per definition, is as follows:  
adding 'OF'-imports:

- adds to savings-gap;
- reduces private savings (with given public savings);

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<sup>17</sup> Budget surveys also produce estimates of consumption, investment and savings. However, discrepancies between the two methods have been considerable, due to not yet solved problems of data sources, data-gathering techniques, and the like.

- lowers GDP/GNP;
- subtracting import-overinvoicement:
- the opposite effect;
- adding 'export-leakage':
- reduces savings-gap;
  - increases private savings;
  - increases GDP/GNP;
- parallel market foreign factor inflows:
- reduce national savings-gap;
  - increase national private savings;
  - increase GNP;
- parallel market foreign factor outflows:
- the opposite effect to inflows.

The adjustment falls on private savings, since government savings, public and private investment and public and private consumption are given. The result is presented in table 3.4 on the next page.

The adjustment for imports is plus US\$ 227 million, offsetting the positive adjustment for exports of US\$ 171 million. The official trade surplus is turned into an adjusted trade-gap of US\$ 16 million; i.e. there is an actual domestic savings-gap of the same amount. However, unrecorded net foreign factor incomes are not known; the national savings-gap therefore is only partially adjusted. The calculated gap could well be an actual surplus due to these foreign transfers. Then, actual private savings would be increased instead of being reduced, as would GNPmp. GDPmp, however, adjusts downwards with an accumulated value of US\$ 56 million over 1984-88.

Both Appendix 3B1 and 3B2 are expressed in US-dollars. But as imports and exports are domestically valued through a de-facto dual (or say: multiple) exchange rate system, official trade priced at the official exchange rate and parallel trade at the parallel exchange rate, it is interesting to see what happens to macro-economic aggregates expressed in Surinamese currency values. The relevance is to get an indication of the influence of the parallel market exchange rate. This is shown in Appendix 3B3 and Table 3.5 provides a summary.

Table 3.4 Macro Balance: Official and Adjusted Parameters,  
accumulated value US\$ million, 1984-88

	official	adjusted	change	(%)
Imports	1784	2011	+227	+13
'OF'-imports			+259	
Overinvoice			-32	
Exports	1824	1995	+171	+9
'Leakage'			+171	
M-X=I-S(gross)	-40	16	+56	+140
NFFI	-41	n.k	n.k	
I-S(net)*	1	57	+56	+5600
G't Savings	1060	1060	0	0
Priv. Savings*	1696	1640	-56	-3
GDPmp	5276	5220	-56	-1
GNPmp*	5235	5179	-56	-1

\* partially adjusted

n.k. = not known

Derived from Appendix 3B1 and 3B2

Table 3.5 Savings-Gap converted at dual exchange rates,  
accumulated over 1984-88 (Sf million)

	official	adjusted	change**	(%)
M-X=I-S(gross)	-72	282	+354	+492
I-S(net) *	2	356(-U)	+354	+17700
Priv. Savings*	3035	2690(+U)	-345	+11
GDPmp	9436	9085	-351	+4
GNPmp *	9363	9012(+U)	-351	+4

\* adjustment for net foreign factor income = X

\*\* rounding errors

Derived from Appendix 3B3

The adjusted figures are rough estimates, since it is assumed that all parallel market transactions are conducted at the prevailing parallel market exchange rates<sup>18</sup>. What is invariably clear, however, is that the adjustment assumes larger proportions under the influence of the parallel exchange rates. The domestic savings-gap is increased with 492% in Surinamese Guilders value (table 3.5) as compared to 13% of the US-dollar value (table 3.4). The national savings-gap is increased with 17700% in SG against 5600% in US\$; however, these variables should be adjusted downwards, i.e. reduced, on account of unrecorded net foreign factor incomes.

<sup>18</sup> These rates are calculated as the year-averages of observed parallel market rates.

The main observation from the macro-economic picture is that there seems to be a substantial excess of domestic spending over domestic output and savings, i.e. an 'excess demand' for goods and services, which could only have been met with increased savings accruing to the private sector due to unrecorded transfer of foreign savings, the unrecorded remittances from abroad.

The interpretation of the trade deficit is that imports have been in excess of exports, meaning that domestic savings were insufficient in meeting domestic investments. With a net inflow of foreign factor incomes the national savings-gap is reduced (by U), however, and serves to 'finance' the increased imports (increasing due to parallel market imports) for one, while also leading to a larger GNP. Total private savings available to the private sector are in fact increased by U.

But the following questions still need to be answered.

1. What has been the pattern of parallel market imports in terms of its composition in consumer versus producer (investment) goods? This question focuses on repercussions of the present apparent 'overconsumption' (in the form of the trade deficit) on future growth prospects. Related to this we will distinguish between private and public sector savings and investments (see paragraph 3.2.3.2).
2. With what means have parallel market imports been paid for? This question relates to the 'origin' of the Surinamese Guilders counter-value of these transactions, that could also offer a partial explanation of the level of the parallel market exchange rate (this issue concerns the channel through fiscal and monetary developments - the issue in section 3.2.4).

### 3.2.3.2 Sectoral Accumulation and Distribution

The next issue to be examined is the distribution of parallel market imports among the different economic sectors and the shares of institutional sectors (public and private).

As the data processing of 'OF' imports lags behind somewhat, only figures for 1988 until the second quarter of 1989 can be presented. According to this information, presented in Table 3.6 (see also Appendix 3B4), consumer goods, comprising essential food stuffs, household equipment, clothing and shoes, constituted 12% of parallel market imports during 1988-89II; luxury consumption goods on average 5% (increasing share), and medicines only 1%. Transport, including also many imported cars for private use, accounted for 12-15%, whereas raw materials, spare-parts and construction inputs together averaged 28%. The category 'others' poses a problem for analysis; it is very large and unspecified.

Table 3.6 Composition of Parallel Market Imports,  
percentages of totals, 1988-89II

	Cons. goods	Prod. inputs			Others	Total
		Priv. Transp.	& spare parts	Constr. Mat.		
1988	15	21	12	7	45	100
1989II	19	20	15	9	37	100

Derived from Appendix 3B4

To see whether this picture is similar or diverges from official import figures, it is compared to total import data on a transaction basis, registered by the General Bureau for Statistics<sup>19</sup>. In first instance, shares of different categories of goods of total imports seem not to have changed significantly from 1980 onwards (Appendix 3B5). Raw materials, spare-parts and investment goods increased their shares somewhat - as a result of priority schemes designed to deal with foreign exchange shortage - though not their absolute levels. Whereas the share of essential consumer goods is the same within parallel imports as within total imports, that of luxury goods (alcoholic drinks, tobacco, and the like) is higher within parallel market imports. Raw materials and spare-parts are a smaller proportion of parallel market imports than in the case of total imports, while transportation, including private cars, constitute a much higher percentage. Although in total imports construction materials are not specified, they are presumed to fall under the category 'investment' goods, which is not specified for parallel imports.

These figures suggest that the economy has not been supplied with a sufficient amount of necessary investment goods either through the official imports nor through the parallel market. Foreign inputs and raw materials can be assumed to have served only the maintenance of some already existing production activities and the construction of housing. It can be hypothesized that some of the imported production inputs are destined for those sectors, mainly the agricultural export sector, that generate the foreign exchange earnings which are illegally privately appropriated and supplied to the parallel market.

Moreover, an important part of imports consists of consumer items, which in the case of parallel imports involve an even larger share of luxury consumer goods. Parallel imports are thus invariably of a commercial nature; and, as we will discuss later on, yield quick and high returns necessary for the 'financing' of the buying up of foreign exchange on the parallel market, for purposes of capital flight and others.

<sup>19</sup> On the basis of the available statistics, the author has tried to make both sets of data as compatible as possible.



The repercussions for investment are obvious<sup>20</sup>. From Table 3.7 it can be seen that investment levels are low for both official and adjusted estimates. Investment by the private sector tripled during 1986-87, but dropped again in 1988 to US\$ 103 million, or almost 70% of the 1987 level. As a percentage of GDP<sub>mp</sub> in 1988, investment comprised 8.4% according to official estimates and 12.5% on the basis of adjusted estimates.

Table 3.7 Private investment levels, 1984-88

	1984	1985	1986	1987	1988
Priv. Investm. (US\$)	66	46	146	140	103
% of GDP <sub>mp</sub>					
- official	7.0	4.7	14.8	13.2	8.4
- adjusted	7.2	4.7	12.9	12.0	12.5

Based on Appendices 3B1 and 3B2

The conclusion from the above is that 'OF'-imports that have 'added' to the National Savings-Gap are, however, not used in a way that could narrow this gap in the future, i.e. they are not geared towards productive investment to enhance domestic output and growth, which would ultimately result in the generation of sufficient domestic savings to facilitate further productive investment and the maintenance of a sustainable external account.

Another distinction can be made between the 'public' and the 'private' sector. Within the latter, different economic sectors and the household sector are grouped together.

It can be observed from Appendix 3B6 that during the years 1985 until September 1989, parallel market imports have predominantly been on behalf of the private sector, with a share of between 75% to 85%, against the share of the public sector of 15% to 25%.

This means that the 'private sector', or rather commercial entrepreneurs and illegal exporters of foreign exchange earnings and capital, accumulates private or personal wealth, while the government accumulates a budget deficit and, to the extent it had to rely on foreign loans, its external debt as well.

Finally, we should also say something about real consumption levels, rather than nominal consumption. In Table 3.8 real private consumption indices are presented; the top line shows real levels of consumption; the two bottom lines show the consumption percentage of GDP, for both official estimates and parallel market adjusted estimates. Consumption levels fell by almost one-third between 1984-86, declined further in 1987 and recovered to the 1986-level in 1988.

<sup>20</sup> A disadvantage for the present analysis is that data on investment per category of economic activity are not at hand.

As a percentage of GDP, the trend for both the official and the adjusted figures is the same and the difference is marginal. The share of consumption in GDP decreased until 1986 and increased thereafter. But overall, real consumption has declined since 1983 and in 1988 stood at 48% of the level of a decade earlier (1978) and at 35% of the level of 1981<sup>21</sup>.

Table 3.8 Real Private Consumption 1984-88

	1984	1985	1986	1987	1988
Real Cons. (US\$m ln)	622	581	425	358	455
Perc. of real GDP					
- official estim.	64	66	55	67	80
- adjusted estim.	66	67	54	66	82

Source: General Bureau for Statistics and App. 387

In other words, there has not been a real increase in consumption levels. 'Overconsumption' invariably has been the result of stagnating production and output, while accelerating inflation has been reducing people's purchasing power.

Moreover, it appears that, notwithstanding the supply of imports through the parallel market, which has meant some alleviation of the constrained official market, total imports have been decreasing in both nominal and real terms.

In Table 3.9, the current and constant price indices of imports (ROW statistics) for 1983-88 are given (derived from Appendix 3A4). It is shown that nominal as well as real levels of imports fell from 1983 until 1986, to increase again thereafter. In 1988, real import levels had recovered and stood slightly above the 1983-level. The year 1988 experienced an increase of imports under the Dutch Emergency Assistance Scheme<sup>22</sup>.

<sup>21</sup> We would have to investigate the impact of the so-called foodparcels and other gifts in kind sent by family living abroad to Surinamese residents. The 1990 Annual Report of De Surinaamsche Bank states that in 1989 these parcels increased by 22% from the number in 1988, i.e. to a total of 102,809 parcels, which is on average 1 (one) parcel for every household.

<sup>22</sup> In 1988: Nf 20 million (De Surinaamsche Bank, 1990 Annual Report).

Table 3.9 Imports, 1983-88, indices

	1983	1984	1985	1986	1987	1988
curr. P-index	100	89	74	59	73	87
const. P-index	100	83	70	67	87	104

Derived from Appendix 3A4

In spite of parallel market imports, many scarcities of various kinds of consumer and producer goods on both the official and the parallel market have been widely felt throughout society, affecting both consumers and certain categories of domestic producers.

To lend further support to some of these propositions, follow-up research could entail, for example, more detailed analysis of investment per economic sector. Also, a study of the income (re-)distribution among various groups and classes could reveal more of the interaction of the parallel market with the socio-economic system.

### 3.2.4 Supply of and Demand for Money, Inflation, Parallel Market Exchange Rate and Real Exchange Rate

In the previous section an 'excess demand' in the economy was mentioned; there is a domestic savings-gap materializing in excess of imports over exports, while additional imports through the parallel market have served consumption purposes and only marginal investment activities. Parallel market exchange rates, that have been rising throughout the period from 1984 up to now, have applied to these imports, which result in the high prices of goods and services available in the parallel economy. However, these have gradually affected the formal economy as well. That is to say, there has been an inflationary process associated with the parallel market spreading to the formal economy (both public and private sectors).

The question is often asked, what accounts for the huge Surinamese Guilders countervalue that is involved; there is a tendency to explain inflation and the increase in the level of the parallel exchange rate in terms of the existing 'excess liquidity' and to look for the origin in the fiscal and monetary developments of the past years<sup>23</sup>.

In this section we will link the previous discussion on parallel market trade, the current account deficit and the savings-gap with the analysis of domestic credit creation, the fiscal budget deficit and private sector demand for money, while also looking at inflation. We investigate whether there is 'excess money supply'; the 'causes' of the growth of the money stock or the sources of demand for money; the causes of inflation; and the possible relationship with

<sup>23</sup> Both the Surinamese authorities (see Central Bank of Surinam and Ministry of Finance) and the International Monetary Fund (IMF) have expressed such views.

the parallel market exchange rate.

These relationships can be expressed by the following equations:

$$CA = M - X = I - S \text{ (national)} = \Delta F + \nabla R = \nabla NFA = \Delta DC - \Delta M_2;$$

where  $CA = M - X$  is the current account of the balance of payments,  $I - S$  (net) is the national savings-gap,  $\Delta F + \nabla R$  is net foreign borrowing plus change in official monetary reserves,  $\nabla NFA$  is change in net foreign assets of the economy,  $DC$  is domestic credit creation, and  $M_2$  is the change in the domestic money stock.  $\Delta DC - \Delta M_2$  is 'excess money supply/demand'.

The change in domestic money stock  $M_2$  can be disaggregated into liquidity 'creation' on behalf of the public sector and the private sector (domestic 'liquidity creation') and on account of foreign transactions:

$$\begin{aligned} \Delta M_2 = \Delta DC + \Delta NFA &= \Delta(DC_g + DC_p) + \Delta(NFA_g + NFA_p) \\ &= \Delta(DC + NFA)_g + \Delta(DC + NFA)_p \end{aligned}$$

### 3.2.4.1 Money Supply and Demand for Money

#### Money supply: change in M2

$M_2$  is defined as Money-M1 (currency on circulation plus demand deposits) plus Quasi-Money, consisting of 'secondary' liquidity, i.e. 'ungenuine savings' (10% of Savings) and short-term (less than one year of remaining maturity) Savings- & Time deposits<sup>24</sup>.

In Table 3.10 the components of  $M_2$  and the liquidity ratio, the percentage of  $M_2$  over GDPmp, are presented for 1983-88.  $M_1$  increased fourfold and  $M_2$  a little over three and a half times during 1983-88! The liquidity ratio increased from 31% in 1983 to 93% in 1988.

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<sup>24</sup> This is in accordance with the Dutch statistical system; the IMF (as well as CEMLA), however, defines Quasi-Money as including long-term Savings- & Time deposits, i.e. adopting a broader measure of  $M_2$ .

Table 3.10 Domestic Money Stock and Liquidity Ratio, 1983-88 (Sf mln)

	1983	1984	1985	1986	1987	1988
	end of period					
M1	455	577	880	1230	1562	1945
second. liq.	101	91	75	120	98	89
M2	556	668	955	1350	1660	2034
GDPmp(VA-curr.P)	1787	1745	1741	1791	1923	2186
liq.ratio(M2/GDP)	31	38	55	92	86	93

Source: Central Bank of Surinam

Money demand: 'causes' of change in M2

We will now look at the demand for money of both the public and the private sector. In Table 3.11 the 'causes' for the increase in the money stock are demonstrated. Obviously, the government is a net 'creator' and the private sector a net 'absorber' of liquidity (see also Appendix 3C1).

Table 3.11 'Causes' of Liquidity Creation, 1983-88 (Sf mln)

	1984	1985	1986	1987	1988
change in M2	112	287	395	310	374
- government	279	352	456	481	481
- private sect.	-61	-48	2	-163	-53
- foreign sect.	-106	-17	-63	-9	-54

Source: Central Bank of Surinam

The government's demand for money results from its need to finance its budget deficit. In Table 3.12, various components making up the government budget deficit are presented<sup>25</sup>. In explaining the trend, it must first be remarked that from 1975 until 1982 government expenditure on development projects had been financed with Dutch Development Aid. After the suspension of this aid agreement by the Dutch government, the Surinamese government gradually reduced its development expenditure due to the lack of external financial resources. The increase in government expenditure during the second half of the 1980s was mainly accounted for by personnel and materials. Material costs increased by 85% in 1983-88. However, almost 40% of the increase in expenditure has been the result of price increases (see deflator change). During this period the increase in government employment was an average of

<sup>25</sup> Based on Ministry of Finance: 'Financial Nota 1990'.

5% of total employment; public sector jobs increased by 4,731 compared with 6,803 lay-offs for the economy as a whole. By end-88, government employment was more than 45% of the total employed population<sup>26</sup>. government subsidies and transfers however, showed some decrease during this period.

On the revenue side, government income in the form of taxes (direct and indirect) increased more slowly (28% increase during 1983-88), while income from the traditionally important bauxite sector declined. The bauxite levy was lifted under pressure from the bauxite companies from 1986 on. Foreign finance was insignificant and only small loans and grants were received from abroad.

Thus, for the financing of its deficit, the government relied mainly on Central Bank credits (on average 95% of the total deficit).

Table 3.12 Government Budget Deficit, Revenue and Expenditure Indices  
1983-88

	1983	1984	1985	1986	1987	1988
Budg. Def. (Sfmln)	313	312	372	462	485	511
Fin. Capital Mkt.	1	32	20	6	4	30
Liq. Creat.	312	280	352	456	481	481
Index Revenues		100	96	95	101	126
Index Expendit.		100	107	116	124	141
Deflator		100	101	108	139	140
Gov.'t-Employment (end of period)	100	101	104	105	109	116

Source: Ministry of Finance, General Bureau for Statistics

Table 3.13 presents some variables related to liquidity creation and absorption by the private sector during 1983-88. It can be seen that the private sector in recent years has been demanding increasingly more credits from the commercial banks. In the four years between 1985 and 1988, commercial bank loans to the private sector increased more than fivefold. In 1988 these constituted almost 10% of GDP and approximately 37% of Central Bank loans to the government.

<sup>26</sup> Central Bank of Surinam, 1988 Annual Report (preliminary).

Table 3.13 Liquidity Creation for the Private Sector, major components  
1984-88

	1984	1985	1986	1987	1988
credits to priv.sect	-1	33	39	52	178
minus					
- capital investments	-31	-24	2	8	3
- fin.investm.& others	91	105	35	207	228
(ow. Sav.Dep.Scheme)	--	--	7	230	124
Total	-61	-48	2	-163	-53

Source: Central Bank of Surinam

Data on bank loans to the private sector - see Table 3.14 - shows that loans from the banking system (excluding the Central Bank) predominantly have served to finance tertiary economic sector activities, rather than primary and secondary production. There has, moreover, been an upsurge in personal bank credit connected to 'pay-offs', housing construction and mortgage financing. These are sectors and activities that have invariably been growing simultaneously with and as a result of the parallel economy. On average, during 1983-88, the tertiary sector obtained over 60% of commercial bank loans; commerce and housing construction have been the dominant recipients, with respectively 20% and 14% of total credit on average. Within the productive sector, agriculture received on average 20% of total credit. Other productive sectors have received very small amounts of bank loans over the past years.

Table 3.14 Bank credit per economic sector, percentages  
1985-88

	1985	1986	1987	1988
Total (SG mln.)	812.7	869.1	895.4	1051.1
(%)	100	100	100	100
Prim.& Second. (agriculture)	38 (19)	37 (20)	39 (20)	38 (22)
Tertiary (commerce)	62 (19)	63 (18)	61 (20)	62 (21)
(housing)	(15)	(15)	(14)	(13)

Derived from Appendix 3C2

The high percentage of bank credit to commerce and trade suggests that these form part of the domestic finance initially needed for imports and trade of parallel market goods. Finance of the agricultural sector through bank loans has remained at a fairly constant percentage, presumably to a great extent also connected to the need of continuing production for parallel exports of agricultural products.

At the same time, the private sector has also absorbed some of the existing liquidity which is represented by the second and third rows of the table. From end-86 on the Central Bank of Surinam, in cooperation with the commercial banks, has operated a Savings Deposits Scheme in order to attract savings from the public so as to monetize excess money balances. The rate of increase, however, is on the decline. It is therefore foreseen that, in addition to the present rush for bank loans for the private sector, the maturing of these savings deposits, inter alia, will not be followed by financial re-investment, thus giving rise to a potential of extra purchasing power demand and possible increase in inflation in the coming years.

Moreover, if these facts are related to the extension of commercial bank credit per institutional sector, which is - as shown in Appendix 3C3 - predominantly on behalf of the private sector at the virtual exclusion of the public sector, the following may be concluded. Traditionally, the private sector, rather than the public sector has relied on commercial bank credits. In recent years this has increasingly served to finance parallel market imports and related commercial activities by traders, and to sustain agricultural exports that are a source of illegal transfer of foreign exchange on the parallel market, while households exert a demand for credit to finance rising costs of living.

From the data discussed above, the conclusion can finally be drawn that, although the government has been the predominant source of increase of the money supply, there is a growing demand for money on the side of the private sector as well. Demand for money by the 'private sector' is distinguished, on the one hand, by a high demand from commercial activities presumably connected to co-financing of parallel market imports and parallel market trade by the merchants involved. On the other hand, households confronted with inflation have relied on certain types of bank credit to finance their expenditure in face of rising costs of living and their falling real incomes. But the crisis and inflationary impact of the growing parallel market has also affected revenue and spending of the government. For example, the government has been increasing its functions in the administration and 'control' of the crisis. Secondly, it has been absorbing unemployment in the face of declining output and lay-offs in the private sector, although it may be advanced that at times the employment of more civil servants in the apparatus has also the political motive of nurturing goodwill among the electorate or as part of the patronage system. Thirdly, government revenue has been declining under the crisis of the formal economy while the informal sector has been expanding. The formal tax basis is diminishing, and import duties<sup>27</sup> are decreasing. Fourthly, under pressure of the foreign bauxite companies, the levy was lifted. Fifthly, government expenditure has also been affected

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<sup>27</sup> The government has failed to modify the import duty system by incorporating de facto parallel market prices in basis calculations for collecting excise duty. The duty is levied in Surinamese currency as a fixed proportion of the dollar-value, converted, however, at the official exchange rate.



on the parallel market.

### 'Excess Liquidity'

'Excess Liquidity' or 'Liquidity Overhang' is defined as the difference between actual money supply and the level pertaining to a historically observed constant velocity of circulation of money (V) that would be valid under 'normal' inflation rates.

According to the quantity theory of money the following equation holds:

$$PY = VM;$$

where Y is real goods and services, P is the general price level, V is velocity of circulation of money, M is the domestic money stock (M2).

The implicit money demand function, such as that of the IMF financial programming model, is expressed as follows:

$$M^* = (P^e \times Y^e) / V;$$

where the superscripts e indicate 'expected' values.

'Excess liquidity' would then be M(actual) minus M\*.

Since the following changes induce an increase in the level of P:

1. decrease of Y, inter alia; or
2. increase in M, inter alia; or
3. increase in V, inter alia; or
4. a combination of these, for prices to be kept stable, the money supply should only be increased proportionally to both the increase in real supply of goods and services and the increase in the velocity of circulation of money.

In Appendix 3C4 a linear regression analysis has been carried out to estimate (constant) velocity, V, for the years 1975-81, when inflation indeed was more or less stable. The forecasts for M2 for 1982-88 on the basis of this V and nominal GDPmp are called 'transaction money at M2'. 'Excess Liquidity' is then actual M2 minus transaction money.

'Excess Liquidity' at the end of 1988 is thus calculated to be Sf 1,535 million - see Table 3.15.

It has been argued that 'excess liquidity' has been available for price increases<sup>28</sup>. However, actual inflation does not only depend on the additional influx of money in the economy, but also on its increased velocity of circulation. This velocity of circulation can be seen in Table 3.10, to be the inverse of the liquidity ratio. The figures indicate that the velocity has come down to virtually 1 during 1986 to 1988, compared with 3 in 1983.

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<sup>28</sup> See, for example, Central Bank of Surinam, 1988 Annual Report.

Table 3.15 'Excess Liquidity' 1983-88 (\$f mln)

	1983	1984	1985	1986	1987	1988
M2	556	668	955	1350	1660	2034
transaction money at constant velocity	396	385	384	397	431	499
'Excess Liquidity'	160	283	571	953	1229	1535

Abstracted from App. 304

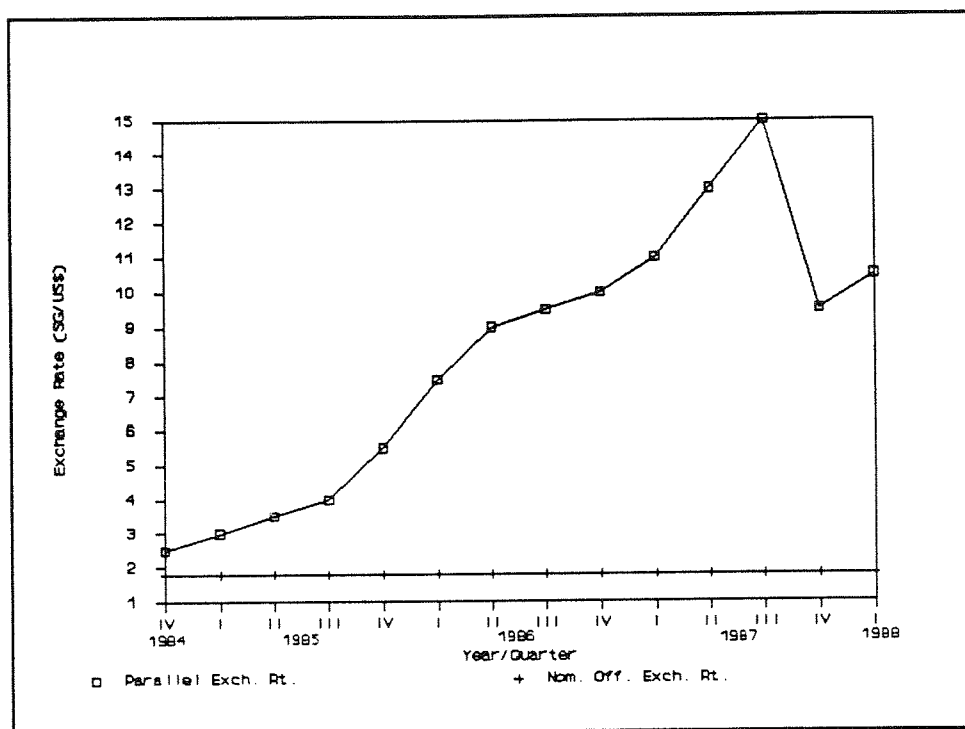
However, the influence, in practice, of the parallel market exchange rate on the increase in the 'general price level', the CPI, and its component parts (price indices of tradables and non-tradables) needs closer attention. This is the focus of the next section, where both 'external' (import prices, exchange rates) and 'internal' (local cost price) factors relevant for inflation, are studied.

### 3.2.4.2 Inflation and Parallel Market Exchange Rate

#### Trend of the parallel market exchange rate

In the following graph the movement of the parallel market exchange rate is illustrated<sup>29</sup>. The trend is a steadily increasing one. However, fluctuations in the level of the parallel market exchange rate are also influenced by political developments, as shown by the sudden drop after the General Elections in November 1987.

<sup>29</sup> Based on quarterly and monthly averages of periodical observations of the buying and selling rates of exchange on the parallel market (which has as a physical location, amongst others, the Central Market place in the capital city) - source: Ministry of Economic Affairs, Bureau for Foreign Exchange Control, Export and Import Licenses.



Graph 1. Parallel market exchange rate

The parallel market exchange rate is said to apply also to parallel market imports through the so-called 'Own-Fund' licences. On the basis of year-averages of monthly observed PMERs, the Surinamese Guilder countervalue of these imports between 1984 and 1988 can be calculated - see Table 3.16 and Appendix 3A5.

As such, parallel market imports would have been valued at approximately SG 2,670 million, which constitutes a little over 47% of total imports (parallel and official), or slightly more than 30% of accumulated value added of domestic production (GDP<sub>fc</sub>) during that period<sup>30</sup>

Table 3.16 Observed PMERs (Sf/\$) and Surinamese Guilder Value of Parallel Market Imports 1983-88

	1984	1985	1986	1987	1988	84-88
Observed PMERs	2.5	4	9	14	10	
Sur.Guild.Value(mln)	24.0	88.0	386.0	1,175.0	999.0	2,672.0

Abstracted from Appendix 3A5

plus allowing for a profit margin. Hence, it can be expected that price rises or inflation reflect the rise in the level of the parallel market exchange rate plus a mark-up for profits. Although the latter will be only implicitly analysed, in the following we look at the share of the foreign price component compared with that of the local price component of the Consumer Price Index (CPI). Thereafter we will examine the price indices of tradables and non-tradables in order to discern the influence of the parallel market exchange rate as compared with the influence of other price increases.

#### 'Foreign component' of the consumer basket

In Table 3.17 the 'foreign price component' compared with the 'local price component' of the 'consumer basket', the basis of the CPI, is presented<sup>31</sup> - see also Appendix 3D1. The foreign component captures the foreign currency price change of imported goods (foreign inflation and real exchange rate changes of major trading partners) and the change in the nominal exchange rate of conversion to domestic currency; the local component refers to local cost components, including wages.

The share of the foreign component increased for all categories of goods during the period 1983-88, except for 'food and beverages'. For 'housing, construction and equipment' the increase was from 51% to 63%; for 'clothing and shoes' from 53% to 65%; and for 'others' from 41% to 56%. Since the import tax increased between 1983 and 1987 (in 1988 it was the same as in 1987) the gross import content<sup>32</sup> increased from 57% in 1983 to 73% in 1988 for all goods incorporated in the CPI. The share of the local component in the CPI decreased from 43% in 1983 to 27% in 1988.

From this we can conclude that increases in labour costs, the dominant item of local costs, have had a minor influence on the domestic price level. In other words, a so-called wage-price spiral cannot be held responsible for inflation in the Surinamese context<sup>33</sup>. Rather inflation

<sup>31</sup> General Bureau for Statistics: 'Devaluation and the short-term effects on costs of living in Surinam', May 1990.

<sup>32</sup> Gross Import Content equals Net Import Content plus Import Tax; Local Component equals Total Value minus GIC.

<sup>33</sup> In fact real wages have been falling during most of the period for the public sector (where nominal wage increases have been marginal and with substantial lags) as well as for the private sector, where the degree of unionization and union pressures have been low, due to prevailing high formal sector unemployment.

has been increasing due to so-called 'external' factors, of which the rise of the parallel market exchange rate is the most significant. This is considered from a different angle in the following by looking at the trend of price indices of tradables and non-tradables which influence both the CPI and the GDP-deflator.

Table 3.17 : Import- and Local component of goods-categories within CPI

	food & beverages			housing- constr.& -equipm.			clothing & shoes			others			total	
	FC	tax	LC	FC	tax	LC	FC	tax	LC	FC	tax	LC	6IC	LC
1983	51.4	4.2	44.4	51.1	11.6	37.3	53.1	12.8	34.1	40.6	9.9	49.5	57.4	42.6
1987	43.7	12.5	43.8	52.5	16.9	30.6	64.7	18.5	16.8	51.3	14.7	34.0	64.4	35.6
1988	50.5	14.4	35.1	62.7	20.2	17.1	64.8	18.5	16.7	55.5	15.9	28.6	72.6	27.4

Abstracted from Appendix 3D1

### Influence of PMER on Tradables and Non-Tradables

The CPI captures price increases of both domestically produced consumer goods (belonging to home-goods or non-traded goods), and imported consumer goods (belonging to tradables). The GDP-deflator also incorporates non-tradables' and tradables' (exports and imports) price increases.

The following relationships exist and we will analyze these variables:

$$\text{CPI} = w_{nt} \text{PINT} + w_t \text{PIT}, \quad \begin{array}{l} w_{nt} = \text{share of non-trad. in consumer-package and} \\ w_t = \text{share of tradables in consumer-package;} \end{array}$$

$$\text{PIT} = \text{ID} * \text{SERI}/100$$

$$\text{SER} = m_o \text{OER} + m_p \text{PMER}, \quad m_o = \text{OM/TM} \quad \text{and} \quad m_p = \text{PMM/TM}.$$

In Table 3.18 the impact of these variables for 1983-88 is shown. We will refer to the influence on the 'domestic price level' which incorporates the domestic prices faced by both domestic consumers (CPI) and domestic producers (GDP-deflator). Up to 1985 the increase in the CPI was partially 'imported' by the increase in foreign prices of imported goods, through both foreign price indices and the RERs of major trading partners (see increase of Import Deflator (ID)--Appendix 3A4). The increase of prices of imported goods after 1985 has been mainly the effect of the rise in the shadow exchange rate (SER -index: SERI), which is the weighted average of the official exchange rate (OER) and the parallel exchange rate (PMER) - calculated in Appendix 3D3 where the weights are the shares of official and parallel imports in total imports - the import deflator shows a decline after this year. The influence of the parallel market exchange rate (PMER) increases as parallel market imports (PMM) make up a greater share of total imports (see Append. 3A2). Hence the steady

(PMM) make up a greater share of total imports (see Append. 3A2). Hence the steady increase of the Price Index of Tradables (PIT).

Table 3.18 Influence of the parallel market exchange rate on different price indices 1983-88

	1983	1984	1985	1986	1987	1988
CPI	100	103.7	114.9	136.6	209.5	224.4
GDP-deflator	100	105.5	106.4	110.9	130.9	141.8
ID	100	106.4	106.1	88.1	84.4	84.3
SERI	100	101.0	108.3	165.9	276.5	218.9
PIT	100	107.5	114.9	146.2	233.4	184.5
PINT	100	102.5	110.1	128.4	175.3	266.7
PMER(SG/\$)	--	2.5	4	9	14	10

Based on App. 3A4, 3A5, 3D2 and 3D3

However, it can be held that the rise of the PMER and the higher share of parallel imports indirectly affects the non-tradables price index via the price rise of imported intermediate inputs. Hence in Table 3.18 there is also a rapid increase in the Price Index of Non-Tradables (PINT), which is calculated in Appendix 3D2.

### 3.2.4.3 Real Exchange Rate and 'Incentive Structure'

After considering the development of domestic prices, the next issue to be looked at is the real exchange rate (RER). The RER gives some insight in the overall 'incentive structure'. It shows how in general the export sector, the import sector and the non-traded goods sector will be expected to respond to the nominal exchange rate on the basis of the relative cost structure of the sector compared with that of foreign producers<sup>34</sup> (see theoretical discussion of Chapter 2). In the analysis we will try to compare expected behaviour with actual responses and developments.

With the widespread presence of the parallel market and the de facto dual exchange rate system, the question can be asked whether the RER has not already been depreciated. Given the duality of the foreign exchange regime, in which increasingly fewer goods are fully priced

<sup>34</sup> Two qualifications need to be made here. Firstly, within sectors, as probably among them as well, different price and cost structures are faced, so that in fact a disaggregated analysis of each specific sector or product is needed to draw conclusions about profitability and presumed allocation of resources on basis of the real exchange rate as a relative price signal. Moreover, to the extent discriminatory taxes and tariffs are effective, these would also play a role. We would thus have to calculate the 'effective Rate of Protection' for different traded goods categories. Officially, an uniform import duty (tax) prevails in Surinam, but in practice it is applied in a modified way. However, since no data are available, we adhere to the uniform import tax. There are no taxes on exports. These issues can be taken up in further research; we will consider here in a very general sense the influence of the RER as the competitive and allocative price incentive in external trade. Secondly, it must be noted that this is still different from analyzing the effects of 'exogenous' factors like terms of trade, protectionism, etc.

according to the official nominal exchange rate and an increasing share according to a mix of the official and the 'free' (parallel market) rate, we will consider two sets of real exchange rates for the period 1980-88:

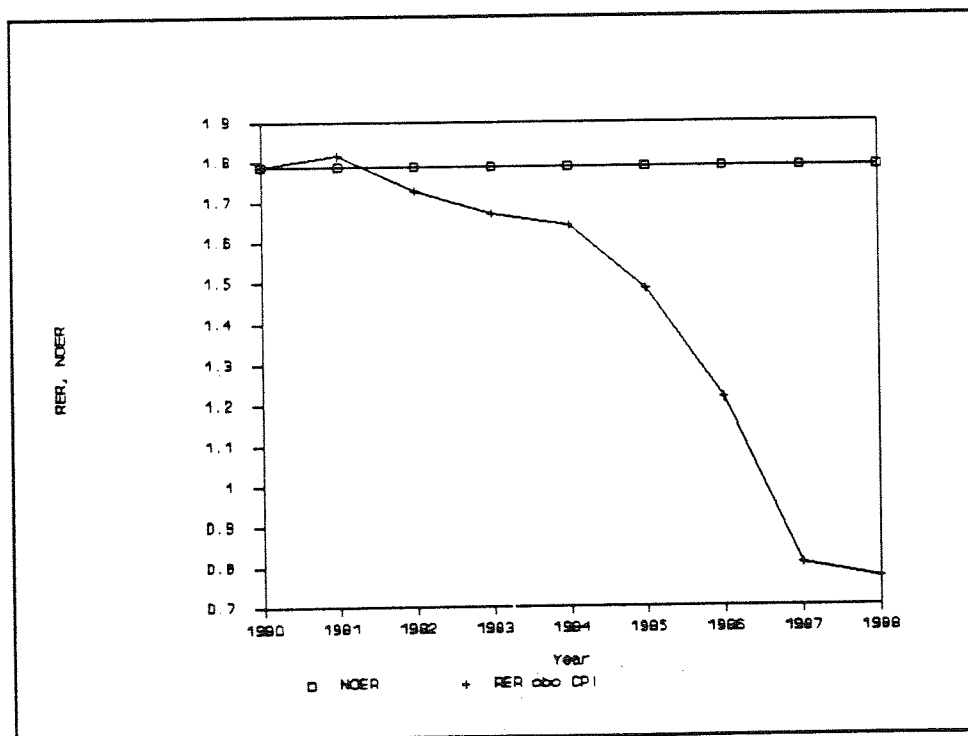
1. the RER based on the nominal official exchange rate;  $RER = NER * P_t^f / CPI^d$
2. the RER based on the shadow exchange rate, which is the weighted average of the official exchange rate (OER) and the parallel market exchange rate (PMER);  
 $RER = SER * P_t^f / CPI^d$

As foreign price level we use weighted major trading partners' producer price indices, while using the CPIs as domestic comparative price indices. It is assumed that the latter is representative of price increases faced by both domestic producers and consumers, incorporating the influence of the parallel market exchange rate as well. In fact, this is examined in a two-fold way; firstly, as the parallel rate is incorporated in the domestic price structure, and secondly, since use will be made of the shadow exchange rate.

As reference year we choose 1980 when RER was influenced by massive aid inflows from abroad, with the implication that subsequent appreciation of the real exchange rate under not so 'favourable' external conditions, constitutes a serious misalignment. All calculations are done in Appendix 3D4.

ad 1:

- a.  $RER = NER * PPI^f / CPI^d$



Graph 2. Real exchange rate 1 of nominal official exchange rate

From **Graph 2** it follows that the nominal official exchange rate is increasingly becoming overvalued; the real exchange rate is rapidly appreciating. (Note the exchange rate is expressed as Surinamese Guilders per US-dollar; when the line goes down there is an appreciation: less SG per US\$, the official value of a guilder per unit of a dollar increasing). Thus, given the domestic cost structure - expressed by the CPI - exporters who surrender foreign exchange earnings at the OER are paying an implicit tax, whereas importers and others that acquire foreign exchange at the official market receive an implicit subsidy.

We can also draw some conclusions about the productivity of home production versus that of foreign production. The foreign price index increased relative to that of output from domestic output until 1982. This means that even under the nominal official exchange rate it would have been still more profitable to produce at home than to import these goods from abroad. Given exogenous prices for exports (small country assumption) exporters are assumed to be still recovering domestic production costs<sup>35</sup> when converting at the official exchange rate. After 1982 this changes; at the official exchange rate imports effectively substitute non-tradables, for production of the latter becomes more expensive and the rent (implicit subsidy) of importing at the official exchange rate increases. Similarly, it is no longer profitable for exporters to exchange at the official rate.

However, as producers of non-tradables and those who produce for export buy their inputs on both the official and parallel market the actual exchange rate that prevails for them is the shadow exchange rate.

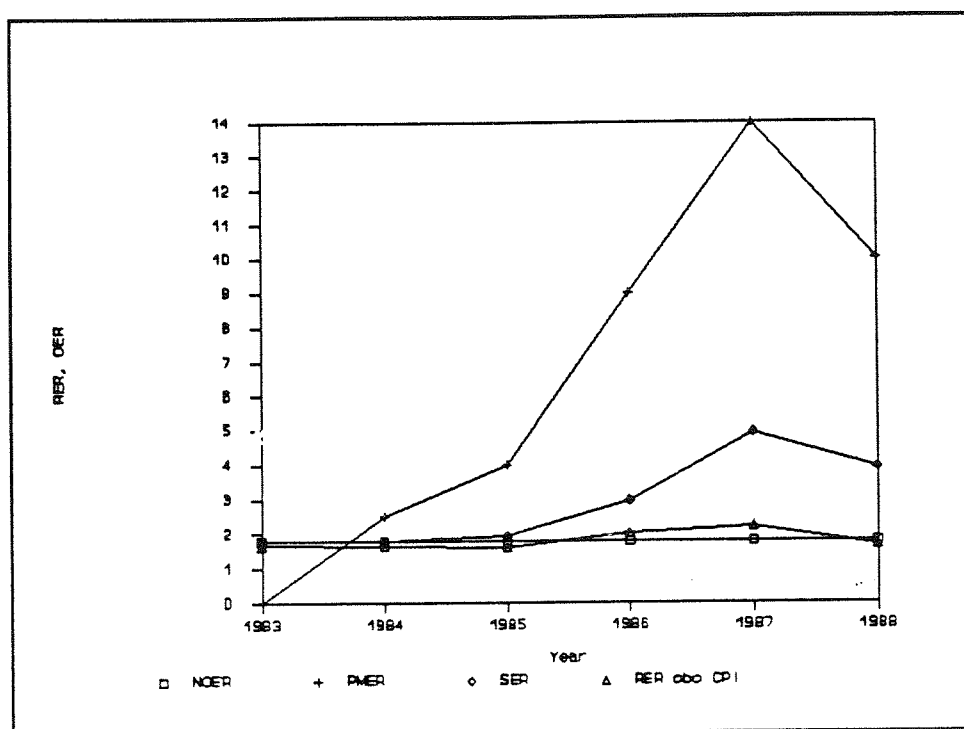
ad 2:

a. 
$$\text{RER} = \text{SER} * \text{PPI}^f / \text{CPI}^d$$

---

<sup>35</sup> 'Normally' the exporter would want to recover both costs of production and obtain a reasonable profit.





Graph 3. Real exchange rate 2 of shadow exchange rate

From Graph 3 it can be seen that the shadow real exchange rate hardly differs from the real exchange rate. This may suggest that the parallel market rate closely follows the purchasing power path of the domestic country in relation to that of its major trading partners. We might expect more incentive on the part of entrepreneurs to produce at home rather than to import. It suggests therefore a shift away from importables to the non-traded goods sector during 1983-88. The prospects for exporters would be based on the real exchange rate calculated from the shadow rate on one hand and prices of both home goods and of imported intermediate inputs on the other hand. These latter price changes are presumably incorporated by the CPI (see earlier, pg 12).

From the graph it can be seen that there was a slight appreciation of this real exchange rate until 1986. This would suggest that costs of importing inputs at the parallel market offset the returns of exchanging the export earnings on this same parallel market. This is not surprising if it is kept in mind that exporters and foreign exchange dealers operating on the parallel market are not necessarily the same people. But the analysis implies that the alternative for exporters during that time must have been to divert foreign currency abroad, i.e. capital flight, rather than to exchange it for local currency on either the official or the parallel market. This would conform the findings on 'leakage' of export revenues in Appendix 3A1 (except for the year 1984).

After 1985, the Shadow Exchange Rate shoots up, because increasingly more goods are being imported through the parallel market as against the share of official imports, while the parallel exchange rate also increased. From the graph we would expect during 1986-87 a

slight incentive to exchange foreign currency earnings for Surinamese currency on the parallel market at home as this would cover internal costs of production plus presumably a profit. And as was seen in section 3.2.1, trade misinvoicing increased substantially during those years. However, the incentives to divert foreign exchange onto the parallel market are strong not just from a real exchange rate depreciation point of view, but rather from a 'capital flight' viewpoint.

In the previous analysis (sections 3.2.1 and 3.2.2) we discussed various motives for this capital flight (foreign consumption, foreign assets accumulation, parallel market imports). Furthermore, in studying the composition of parallel market imports and investment behaviour (sections 3.2.3 and 3.2.4) it was suggested that privately appropriated foreign exchange earnings will not necessarily be automatically geared towards productive purposes.

But we have now reached a point where we can advance some final conclusions about the empirical work and relate these to Chapter 2's theoretical expositions on policies.

<p style="text-align: center;"><b>CHAPTER 4</b> <b>CONCLUSIONS</b></p>
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#### **4.1 THE DYNAMICS OF THE PARALLEL MARKET, SOCIO-ECONOMIC EFFECTS AND GROWTH IMPLICATIONS**

In Chapter 3 it was stated that traditional exports, bauxite and its derivatives and agricultural exports, face structural constraints in expanding. The potential for foreign exchange earnings from the bauxite industry has depended on demand stemming from industrial production in the industrialized countries, which has been on the decline from a long term perspective, while in the short-run, Surinam's export revenue from this net foreign exchange earning sector has been negative during the 1980s. Traditional primary agricultural exports, in the case of rice, are conditioned by LOME/ACP conventions in which respect the country is a price-taker while at the same time having to meet a certain minimum export-quota. Since there is increased competition from low-cost producers from other developing countries, enhancing the prospects for this export product would require a structural transformation by shifting away from the high quality long-grain varieties for which demand is slack, to less luxurious types for which consumer demand is growing. Other traditional primary exports, such as timber, have been adversely affected by the internal war and the 'feedback' of foreign exchange 'scarcity' via non-availability of imported inputs for production.

The structural and external constraints faced by traditional exports can only be overcome by a longer-term investment programme and enhancing and diversifying the export base. Moreover, the overall dependency of the economy on imports of consumption and producer goods should be reduced. In other words, the structural or potential foreign exchange 'scarcity', the external balance constraint, should be resolved along structural lines.

This strategy has to be accompanied, however, by proper commercial and exchange rate policies, while the domestic savings and expenditure balance also have to be seriously revised. These aspects, their actual dynamics and interconnection in the presence of the parallel market as a particular institutional and behavioural set of these relationships, have been the main study subject of this paper.

One first finding was that although there is a structural foreign exchange constraint inherent in the production basis of the Surinamese economy as a whole, actual foreign exchange earnings of the official economy are seriously understated for hidden and unrecorded foreign exchange flows and transfers on the parallel market. The visible foreign exchange scarcity is, moreover, a problem of the particular institutionally determined process of accumulation, appropriation and distribution. The study has analysed the 'private response' to the economic and foreign exchange crisis, which evades the formal, and often legal, framework of the economy and government policies in the pursuit of 'individual' gains and

as a means of 'individual' or 'group' survival. At the same time, it is demonstrated and argued that this process is neither economically nor socially optimal, in both the short-run and the long-run, with self-evident implications for growth.

The short-term effects are obvious when looking at incomes, consumption and standards of living among different classes and groups within society. Rather than perceiving of 'the' private sector, the process of economic growth and redistribution should be seen as taking place among these groups and classes in a particular way which determines the future or longer-term trends in this process.

In this regard the parallel economy and informal sector cannot be idealized. In both absolute and relative senses it has given rise to an increasing gap between poor and rich; not only because the latter have had better opportunities and have become wealthier accordingly, but essentially because the parallel market has served as their medium for prospering to the detriment of the poor. There has been growing poverty, despite involvement of the poor in various informal sector activities that has the obvious function of meeting some of their basic needs in the face of formal sector unemployment. As newspaper reports state ('De Ware Tijd', 1 Sept. 1990), a significant part of primary school age youth does not attend school at present, for reasons that are invariably connected to poverty and the involvement of kids from poor families in the so-called 'hustle' (informal employment) for daily survival. A recent investigation of malnutrition amongst 1-4 year olds attending crèches in the capital found that for almost half of the sample group there was a 3% and more incidence of malnutrition, which was even over 10% for one-seventh of the crèches surveyed ('De Ware Tijd', 28 Aug. 1990). Many scarcities of essential foodstuffs or high prices are the order of the day, affecting poor and middle-income class people, while decent housing, water and electricity are not available to many poor families; public transportation on which mainly the poor rely is in a very deplorable state, health care has become almost inaccessible, and education in most cases is too expensive to afford.

In contrast with diminishing standards of living, falling real incomes and purchasing power of the poor and middle-income people, there has been a curious 'overnight' enrichment of a limited group of 'privileged' people. Luxurious villas, expensive cars, and lavish parties are enjoyed by the rich in the midst of the economic crisis. Whereas inflation taxes the poor and middle-class, the rich invariably have escape routes to protect their wealth and are actually accumulating it at home and abroad. Investment in real estate and housing, which under the present circumstances is extremely expensive, and capital flight have been the major outlets for the appropriator classes and a limited group of the well-to-do.

The implications of this adverse income distribution for long-term growth are evident. Falling real incomes and consumption lead to lower productivity of labour power and to lower educational standards. The typical 'hustle' informal sector activities themselves are often only marginally productive.

The other side of the coin is whether the rich do or do not put their wealth at the service of enhancing production and investment, so as to contribute to growth, greater social welfare and alleviation of poverty in the long run.

The parallel market system of imports and the private accumulation of foreign exchange by the wealthy has itself longer-term consequences. This has firstly been analysed as the

process of private appropriation of foreign revenue and exchange, illegally or not, by certain entrepreneurs and big parallel market traders. The illegal shifting of export revenue to the parallel market and the overinvoicing of imports for similar purposes deprives the formal economy of scarce and much-needed resources. This would not be bad in itself, if for some reason or the other the formal sector (government) were incapable of creating the right incentives or was not pursuing suitable policies, and the private sector were to act in its place by eliminating imbalances and stimulating growth, i.e. if the privately appropriated resources are indeed put to productive uses. However, our empirical evidence proves this does not occur. Rather, scarce foreign exchange earnings privately appropriated through the parallel market, have not been put at the service of productive forces, but have served as a mechanism to further enrich a limited group of already wealthy people at the expense of formal sector employees and informal sector workers alike.

One of the mechanisms through which this is achieved is the discretionary power exerted by the merchant class over the system of 'Own-Fund' imports. Another channel, and connected to the above is the buying-up of unofficial family remittances by so-called 'foreign exchange dealers'. In fact, it has meant that relatives and acquaintances of Surinamese families living abroad subsidize a particular form of capital export by this group of merchants and speculators. Using part of illegally acquired or otherwise privately appropriated foreign exchange for parallel market imports in still insufficient amounts and for mainly consumption purposes enables the 'entrepreneurs' operating on the parallel market to generate the domestic finance needed for subsequently buying-up foreign exchange unrequited remittances on the informal market. This is done by holding levels of imports below necessary requirements of consumption and investment so as to be able to sell the goods at prices which represent a substantial profit margin. And again, productive imports are 'crowded out', and also concentrated more on foreign inputs and raw materials needed for the continuation of exports that form the basis of illegal appropriation of revenue.

However, although inflation is partially a result of insufficient supply of goods to the market, the monetary accommodation that took place in the form of credit creation on behalf of the private sector and through monetary financing of the public budget deficit, should be added to the picture. Yet, as our analysis shows, this has been an almost self-fulfilling mechanism in which the direction of causality is virtually circular. The study demonstrated that inflationary pressures from the parallel market engender a typical demand for certain bank loans, namely for consumption purposes that can no longer be met from current (in real terms falling) incomes, such as consumer durables, transportation, and even for school uniforms, enrolment fees and school-books and for investments in real assets. On the other hand a significant share of total commercial bank credits did go to commerce and trade, compared with a minimum to the important productive sectors. This pattern conforms the overall emphasis of parallel economy activities on consumption, commerce, and trade rather than on 'risky' productive investments.

In the meantime, the government is facing an increasing discrepancy between its revenue and its expenditure, as a result of the adverse effect of the parallel market. But it can be said that in the end the government deficit and debt accumulation have a counterpart in

wealth accumulation by the few in society with discretionary power over scarce goods and services enabling them to absorb the purchasing power of formal sector employees and others dependent on them, like the informal economy 'hustlers' who effectively share in the salaried workers' incomes. In this respect it can also be said that by financing its budget the government subsidizes the already rich.

The government should not be seen as a helpless victim of, nor passive spectator to, the striving for personal gains by foreign exchange dealers and parallel market merchants. Of course, its policies to date have not been effective in bringing both the external and the internal imbalances to more sustainable levels. Indeed, these policies and some of the measures taken have been instrumental in shaping the institutional settings and arrangements for the influence of the parallel economy on the process of accumulation, reproduction and distribution. For example, although the government has enacted a foreign exchange priority allocation scheme, in practice many licences for parallel imports of non-essentials and luxury consumer goods have been issued on a different basis to that of preferential treatment due to established priorities. At the same time there has been no compensation for the budget, which could have been achieved by appropriate taxes on profits and/or tariffs on luxury imports. Giving in to pressure for privilege exerted by certain individuals or groups, puts the government in the position of acting in a contradictory role, in which the general interest might be sacrificed for private interests. And as was found in the case-study, these latter interests, geared towards maximization of personal gains, have undermined a strategy of productive investment leading to future growth and increased social welfare.

Furthermore, the maintenance of an overvalued nominal official exchange rate in a situation where export producers face de facto parallel market prices for their imported inputs as well as for many local supplies, means that they will be unable to recover costs when they have to surrender foreign exchange receipts to the monetary authorities at official exchange rates. Moreover, continued subsidization of buyers of foreign exchange through the official market is not sustainable, as this fuels demand for foreign exchange to be officially acquired and which is subsequently used for speculation on the parallel market. At the same time, important government revenue is thus forgone.

It can be asked what effects a devaluation would have, in combination with other policies, and what could be attained in terms of reducing capital flight abroad, and redirecting and promoting productive investment in the home economy instead. In the final part of this chapter this question is considered and some conclusions in the light of the theoretical framework of Chapter 2 are presented.

#### **4.2 POLICY IMPLICATIONS: DEVALUATION AND UNIFICATION OF THE FOREIGN EXCHANGE MARKET: A FEASIBLE OPTION?**

On the basis of the previous analysis some basic policy conclusions can be reached. These will be basic indeed, because as has been emphasized on many occasions, this study of the parallel market and its interaction with the formal economy has not been exhaustive. An integrated policy proposal can therefore not be made at this stage. This would require much

more detailed analysis (at the level of economic sectors, productive units, etc.) of the economic process, with due regard at the same time for the redistributive implications of various policy options. Nevertheless, this study constitutes a first step in revealing and understanding the parallel economy in Surinam. We will discuss some policy considerations relating to devaluation: the instrument often hailed as the solution to the crisis.

In the first place, devaluation is traditionally advanced as an instrument to correct the trade deficit. In the context of Surinam, it can be argued that given its position as a price-taker for its main export products, the effect of devaluation will be an increase in domestic currency earnings to exporters and an increase of domestic currency costs for importers. In other words, in the short-run the 'domestic currency' balance would be changed rather than the 'foreign currency' balance of the trade account. Theoretically, devaluation would have implications for resource allocation: a shift towards exports and a shift away from imports, and after a while eventually correcting the trade balance by increasing foreign exchange earnings from increased exports and through saving on foreign exchange demand for imports. In practice, however, the effects are dynamic, and this is what we saw in the previous analysis. The parallel market provides the example of a de facto devaluation accompanied by inflation. Exchanging export revenue on the parallel market gives a higher return in domestic currency. What has not been obvious, however, is whether these funds have been reinvested to expand export production. Much would also depend on the availability to exporters of the foreign exchange component of these investments, which, though, have become more expensive (de facto devaluation on the parallel market). That is to say, if exporters are not assured of a continuous, regular and sufficient supply through the official market of the needed foreign exchange with which to purchase foreign inputs for production, regardless of an official devaluation, they would still prefer to retain a certain amount of foreign exchange illegally abroad for these purposes. And yet, this would be ideal; for the empirical evidence on Surinam has shown that a significant part of foreign exchange privately appropriated and held abroad by certain sections of the present 'entrepreneurial' class is used for immediate or future consumption (abroad, or at home via 'Own-Fund' imports), instead of being invested in production at home. By the same token, imports didn't or won't necessarily automatically provide the needed productive inputs.

Secondly, there is a potential source of foreign exchange available to Surinamese nationals in the form of unrequited transfers from abroad by family and acquaintances, and also from tourists and visitors. It could be asked under what conditions these people would be willing to exchange foreign currency with the monetary authorities (or authorized commercial banks) at a devalued rate, instead of on the parallel market. Obviously, the government would have to compete with the regular parallel market foreign exchange dealers and set the rate near to the prevailing parallel market rate, unless these dealers could be successfully excluded from participation. This policy would significantly increase government expenditure which would have to be met by some means of financing that are sound from the macroeconomic point of view and compatible with manageable inflation. Experiments with these kinds of so-called 'second-window' foreign exchange operations by the monetary authorities in other Third World countries, for example Guyana, have shown, however, that it has been extremely difficult to achieve an effective unification of the foreign exchange

market through these means. In fact, the moment the authorities devalue the second administered exchange rate, the 'free market' rate devalues significantly. In other words, it has at no time been possible to reduce the premium on the parallel market to zero. This is a matter for serious consideration in assessing the usefulness of devaluation, for it concerns an important dimension of the parallel market for foreign exchange, namely the demand for capital flight.

So, thirdly, the existence of the demand for foreign exchange for capital flight purposes implies that it is not guaranteed that devaluation will reduce the exchange rate premium on the parallel market. Even with capital controls and official schemes of allocation of foreign exchange, under certain conditions, there will always be an 'excess' demand for foreign exchange not satisfied by the official market, but by the parallel market. This demand, as has been shown for Surinam, has become an intrinsic part of wealth appropriation, reproduction and spending of a certain section of the 'entrepreneurial' and merchant class. This class clearly sees its business interests and future not lying within the country but rather abroad.

Historically, this may have been a manifestation of the alienation of part of the local capitalist class and its close affinity to bourgeois lifestyles in rich Western countries. However, during the 1980s up to 1987, the political dimension of this class' power, the State, was taken away from them by the military. Losing such a historically solid power base to support their economic goals has made them look for ways beyond the formal, government apparatus, i.e. the alternative parallel market, to continue their personal wealth accumulation, partially within the country, but increasingly more abroad. This demonstrates that the problem at stake is not a question of the 'State' versus the 'free market' as alternative mechanisms of regulation of the economy. Rather it is the way in which, and on behalf of which classes and socio-economic groups in society, the State acts. The State is not inseparable from the market, but in fact 'penetrated' by it, in that it represents specific socio-economic groups' interests. The economic problem of allocation and distribution is therefore also a political one. Any long lasting solution to the economic crisis obviously needs a stable political environment. And also one that has a reliable and trusted political leadership which rests on broad political support and that feels affiliated with the national economy and its people. So there is a role for the State to play; it should desirably align with the working class, the middle-class and professionals, and those sectors of the local capitalist class that are positioned to work on the basis of a common political platform and economic programme that aspires to growth and increased output, simultaneously with more equitable distribution and social welfare.

However, as long as the State doesn't represent all economic interests, which it can't in a class society, there will continue to be a discrepancy between some of its own economic objectives and priorities, and those of some sectors of the economy. In other words, tax evasion, smuggling, and parallel market activities will be the 'natural' reaction of these 'market' segments to State regulation.

Fourthly, from the preceding points it is clear that devaluation alone will not be sufficient in solving the domestic savings-gap or the foreign exchange 'scarcity', nor in



eliminating the incentives for parallel market smuggling and capital flight. Devaluation also has the disadvantage of an 'across-the-border-effect' in not differentiating between sectors nor products, which is required for diversification of the export base and for selectivity in importing. The policy alternative, therefore, should be a carefully studied blend of different policies, including the following:

- (a) foreign exchange retention schemes for exporters;
- (b) allocation of foreign exchange for imports according to a priority scheme, with close regulation to prevent it from being re-directed towards other than the stated purpose;
- (c) differential tariffs on imports, whereby luxury items should receive a high tax;
- (d) capital controls be maintained;
- (e) if the above measures are successful in counteracting the spread of the parallel market, inflation is kept low, and confidence in government aims and policies is gradually restored, it will be more probable that unrequited foreign transfers that previously found their way through the parallel market could now be mobilized through the official channels by offering a small discount. To prevent the unleashing of inflationary pressures from any increase in purchasing power, the government could opt for issuing bonds to absorb and freeze these funds.
- (f) appropriate and sufficient guarantees to holders of private foreign bank accounts could also facilitate the success of cooperation between the Surinamese authorities and governments of the major capital flight recipient countries (The Netherlands and the USA) in an attempt to mobilize idle resources lying abroad for productive use at home.
- (g) production incentives through bank loans to the productive sectors at reasonable interest rates and concessional foreign borrowing;
- (h) improving the government budget position by reducing and shifting some of its commitments without weakening its management and continuing to provide the necessary public works and infrastructure, education and relief schemes for the very poor.

Finally, what major lessons from a general theoretical perspective and in relation to similar kinds of problems in other Third World countries can be learned?

A first conclusion is that every specific country situation warrants its own study of the phenomena before reaching policy conclusion that are relevant to that particular case. Nevertheless, it has been demonstrated by the present analysis that proceeding from a structuralist point of departure allows more for reaching some understanding of the functioning of the economy and the parallel market in foreign exchange. This involves looking at the role of institutions, sectors and classes in the process of (re)production and redistribution. The parallel market is not a problem caused by the government disrupting 'equilibrium' instead of allowing equilibrium to be established automatically through market forces. The parallel market is a specific form of ex post balancing of sectoral and institutional surpluses and deficits at the aggregate level, yet according to a certain pattern that either perpetuates or levels out such imbalances at the sectoral and institutional level. It is suggested that the greater the discrepancies engendered, the more detrimental the effects for future growth. Therefore growth and equity should also go together.

In a similar vein of reasoning and relevant to the topic, it can be posited that there is also an alternative role for money and finance. The problem of the parallel market (and for

development economics in general) is not the absolute level of the money supply, but rather the type of finance, to what economic sector and institutions it goes, and to what extent it supports and facilitates the preferred pattern of growth and redistribution. This again warrants some specific regulation of and guidelines for the financial system, and complementary monetary measures in order to facilitate filling the savings-gaps of strategic sectors through mobilization of additional resources available elsewhere.

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