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SM/88/39
Supplement 1
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

March 2, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Annual Review of the Implementation of Surveillance and
Biennial Review of the Document Entitled "Surveillance
over Exchange Rate Policies" - Background Material

The following correction has been made in SM/88/39,
Supplement 1 (2/12/88):

Page 35, 2nd full para., line 7: for "case (Ireland)"
read "case (Iceland)"

A corrected page is attached.

Att: (1)

Other Distribution:
Department Heads

currently calculated for 127 countries. ^{1/} For an additional 26 countries, price data are either not available or not considered to be sufficiently reliable or timely to be used for the calculation of real effective exchange rates. For these countries, real effective exchange rates are monitored on the basis of developments in nominal effective exchange rates and judgmental assessments of inflation relative to trading partners.

a. Information notices in 1987

There were 33 information notices in 1987, compared with 53 in 1986 (Table 20). This sharp reduction in the number of information notices reflected the greater stability of exchange rates in 1987 already discussed above. Three information notices were issued for industrial countries and 30 for developing countries.

The 33 information notices issued in 1987 were equally divided between real effective appreciations (16) and real effective depreciations (17) in marked contrast to the previous year when more than 80 percent of the notices had reported real effective depreciations. The three information notices issued for industrial countries all related to real effective appreciations of their currencies. In one case (Iceland), the appreciation in real effective terms reflected entirely a higher rate of inflation domestically than in trading partners while in the other two cases (Spain and the United Kingdom) the strengthening of their currencies, both relative to the U.S. dollar and in nominal effective terms, contributed significantly to the real appreciation. A similar appreciation of its currency relative to the U.S. dollar and in nominal effective terms, in this case reflecting mainly higher gold prices, also contributed significantly to the real appreciation of the South African rand. In the other 12 cases in which information notices reported appreciations in real effective terms of the currencies of developing countries (including three notices for Nicaragua), however, the appreciation was attributable mainly to domestic rates of inflation higher than in trading partners which were not offset, or only partly, by a depreciation of the exchange rate. Frequent causes of high rates of domestic inflation cited in these cases included excessive bank financing of fiscal deficits, and the effect on consumer prices of corrective price adjustments.

The cases in which information notices were issued relating to depreciations in real effective terms also reflected a variety of circumstances. In 12 cases, the depreciations reflected primarily action by the authorities to depreciate either a fixed or managed

^{1/} Effective exchange rates are not calculated for Democratic Kampuchea owing to the lack of sufficient information. Effective exchange rates are calculated for the currencies of two nonmembers (Hong Kong and Switzerland). Separate calculations are made for the currencies of the Netherlands and the Netherlands Antilles.

exchange rate as part of the implementation of policies to adjust to prevailing or emerging external imbalances. In contrast with the preceding year when depreciation of the reference currency (typically the U.S. dollar to which the subject currency was pegged) had been a frequent factor underlying reported depreciations, this was the case only for the Tongan pa'anga in 1987 (reflecting the depreciation of the Australian dollar). In three other cases, measured rates of domestic inflation markedly lower than those of the countries' trading partners were mainly responsible for the real effective depreciation, while, in the last case, the depreciation reflected primarily downward pressure on a market determined exchange rate which was ascribed to uncertainty about the maintenance of sufficiently restrictive financial policies.

b. Proposal to publish indicators of nominal and real effective exchange rates

For some years, the Fund has published in International Financial Statistics (IFS) a variety of measures of effective exchange rates for 16 industrialized member countries plus Switzerland on a quarterly basis, and MERM-weighted effective exchange rates on a monthly basis for the same countries (plus Australia). One of these measures of real effective exchange rates (that based on relative normalized unit labor costs) has also been used for these countries for the purposes of the Information Notice System (INS) after interpolation into a monthly series.

On the occasion of the last annual review of the implementation of surveillance, Executive Directors endorsed the proposal to publish in IFS the monthly indices of nominal and effective exchange rates monitored under the INS, subject to the agreement of member countries. For the 17 industrialized countries referred to above, this means that series of real effective exchange rates based on relative normalized unit labor costs will now be published on a monthly, rather than a quarterly, basis. In addition, a number of Executive Directors suggested that, for these countries, a monthly consumer price (CPI)-based real effective exchange rate index should also be published in IFS. For all other countries, monthly nominal and CPI-based real effective exchange rates would be published by the Fund for the first time as a result of the Executive Board's decision.

The staff has since been in communication with members' authorities to seek their approval in publishing these indices. As of February 1, 1988, responses had been received from 91 countries, of which 49 had given their approval to the publication of their indices.

Of the 17 countries for which ULC-based real effective exchange rates are currently being published in the IFS, 13 countries have agreed to the publication of their CPI-based indices. Final responses have not been received from three countries. Only one industrial country, Ireland, has decided against publication of its CPI-based index, citing reservations concerning the use of consumer prices as a measure of cost,