

EBS/88/197

CONFIDENTIAL

October 12, 1988

To: Members of the Executive Board  
From: The Secretary  
Subject: El Salvador - Real Effective Exchange Rate - Information Notice

Attached for the information of the Executive Directors is an information notice on the real effective exchange rate of the Salvadorean colón.

Mr. Acquah (ext. 8661) is available to answer technical or factual questions relating to this paper.

Att: (1)



INTERNATIONAL MONETARY FUND

EL SALVADOR

Real Effective Exchange Rate--Information Notice

Prepared by the Western Hemisphere Department and the  
Exchange and Trade Relations Department

(In consultation with the Legal Department  
and the Research Department)

Approved by J. Ferrán and Eduard Brau

October 11, 1988

The recent evolution of the real effective exchange rate of the Salvadorean colon, as measured by the standard index developed in connection with the information notice system, is set out in the attached table and chart. Based on this index, as of July 1988 the colon had appreciated in real effective terms by more than 10 percent since the last occasion on which developments in El Salvador's exchange rate were brought to the attention of the Executive Board--in the Staff Report for the 1987 Article IV Consultation (SM/87/277, 11/24/87) considered by the Executive Board at EBM/88/9 on January 20, 1988. The real appreciation from January to July 1988 is estimated to have amounted to 12.7 percent.

The appreciation of the colon in real effective terms in 1988 stemmed mainly from a 10 percent increase in the nominal effective exchange rate, due to the strength of the U.S. dollar, to which the colon is pegged, relative to other major currencies. Also, the rate of inflation in El Salvador was somewhat higher than that in its trading partner countries as a group. The cumulative rate of inflation in the first seven months of 1988 rose to about 15 percent from 13 percent in the corresponding period of 1987, which can be attributed in part to a drought that has affected the availability of basic grains and to an increase in bank credit to the private sector.

Since early 1986, when the colon was last devalued, its real effective value has risen steadily, by a cumulative amount of around 35 percent. The adverse effects of the deterioration in competitiveness on the external accounts have been compounded by the weakness in world coffee prices and by a rise in imports related to earthquake reconstruction activity. As a consequence, the external current account deficit widened from less than 1 percent of GDP in 1986 to 4.5 percent in 1987 and is expected to rise to 5 percent in 1988. On the occasion of the Executive Board discussion of the 1987 Article IV consultation, Directors noted the determination of the authorities to maintain reasonable control over the domestic financial situation under unusually

difficult circumstances, but they also drew attention to policy shortcomings (SUR/88/5, 1/25/88). In particular, they noted the failure to support the devaluation of the colon in early 1986 with appropriate fiscal and monetary policies. Directors emphasized the importance of policies to reduce the overall fiscal deficit and to restrain bank credit, and advocated the pursuit of an exchange rate policy designed to restore external competitiveness.

A staff team visited San Salvador in August 1988 at the request of the authorities, to review economic developments and to discuss policies and prospects for 1988 and 1989. There was agreement with the authorities that credit policies needed to be tightened in order to prevent the acceleration in inflation from taking hold and to strengthen the balance of payments. In addition, the staff was of the view that it would be desirable to pursue more active interest rate and exchange rate policies. These issues will be examined in detail in the context of the next Article IV consultation discussions scheduled to take place in early 1989.

Table 1. El Salvador: Real Effective Exchange Rate and Related Series

(Indices: 1980 = 100)

	Real Effective Exchange Rate <u>1/</u> <u>2/</u>	Nominal Effective Exchange Rate <u>1/</u>	Relative Consumer Prices (Local Currencies)	Exchange Rate in Terms of U.S. Dollars <u>1/</u>	Consumer Price Index (Seasonally Adjusted)	Consumer Price Index (Not Seasonally Adjusted)
<b>Quarterly</b>						
<b>1982</b>						
II	123.6	132.7	93.2	100.0	126.5	126.9
III	121.9	132.6	91.9	95.9	129.8	130.3
IV	122.4	132.2	92.6	93.3	134.4	134.1
<b>1983</b>						
I	123.3	133.4	92.5	92.0	137.8	137.2
II	125.4	138.0	90.9	91.6	140.3	140.8
III	132.5	143.5	92.3	91.6	148.5	148.9
IV	138.2	147.7	93.5	91.6	154.9	154.5
<b>1984</b>						
I	137.0	147.6	92.8	89.3	157.8	157.2
II	138.2	150.7	91.7	89.2	160.4	160.9
III	142.5	157.4	90.5	89.0	162.5	162.9
IV	145.3	162.3	89.5	87.1	167.6	167.2
<b>1985</b>						
I	152.7	165.3	92.4	82.8	178.6	178.0
II	158.7	167.2	94.9	79.5	190.3	191.0
III	144.1	147.9	97.4	67.8	204.1	204.4
IV	145.6	145.1	100.4	66.1	220.1	219.6
<b>1986</b>						
I	121.3	117.8	103.1	54.3	236.4	235.6
II	118.0	110.4	106.9	50.0	252.0	253.4
III	124.3	111.1	111.9	50.0	270.3	270.4
IV	129.9	111.5	116.4	50.0	287.7	286.9
<b>1987</b>						
I	132.8	111.3	119.3	50.0	304.6	303.5
II	137.7	114.3	120.5	50.0	322.1	324.2
III	142.0	118.7	119.6	50.0	332.6	332.7
IV	141.9	118.3	119.9	50.0	347.1	346.1
<b>1988</b>						
I	145.8	121.6	119.9	50.0	364.2	362.8
II	153.6	125.9	122.0	50.0	387.3	389.8
<b>Monthly</b>						
<b>1988</b>						
Jan. <u>3/</u>	143.3	119.8	119.7	50.0	357.8	356.2
Feb.	146.3	122.3	119.7	50.0	363.9	361.1
Mar.	147.8	122.9	120.3	50.0	370.8	371.0
Apr.	149.9	123.8	121.1	50.0	379.4	381.4
May	153.4	125.6	122.2	50.0	387.1	389.0
Jun.	157.7	128.3	122.8	50.0	395.5	399.0
Jul.	161.5	132.0	122.3	50.0	400.6	401.8
<b>Percentage change</b>						
Jan. 1988- Jul. 1988	12.7	10.2	2.2	—	11.9	

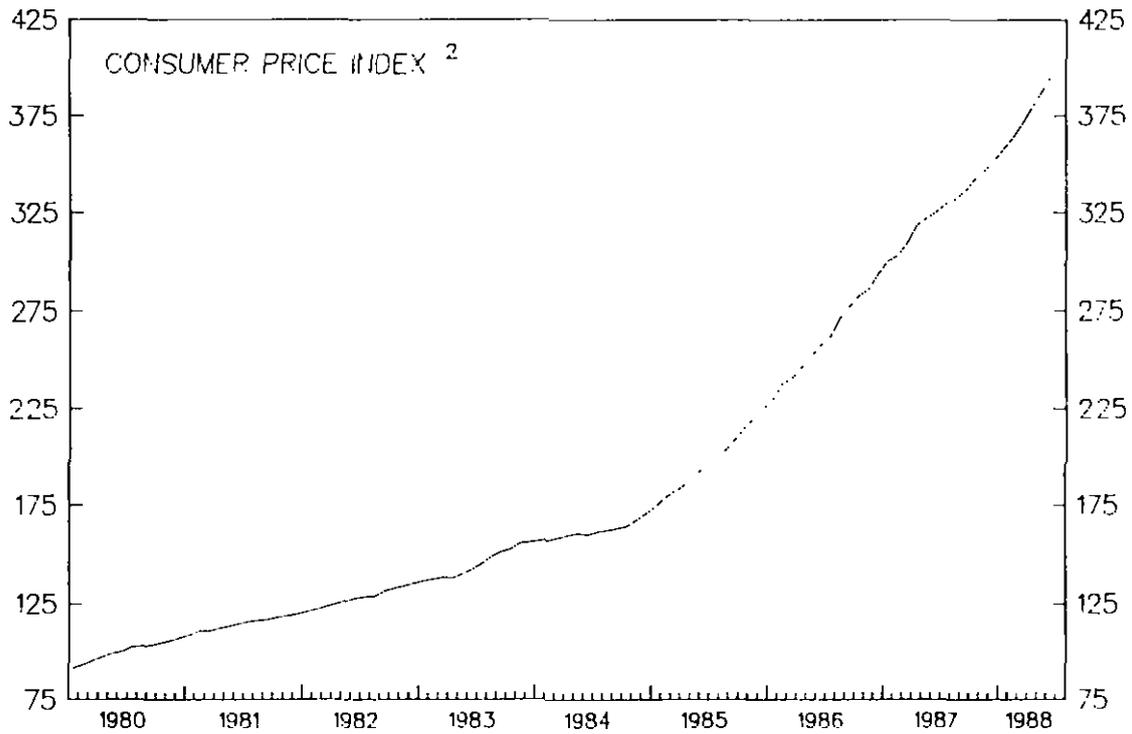
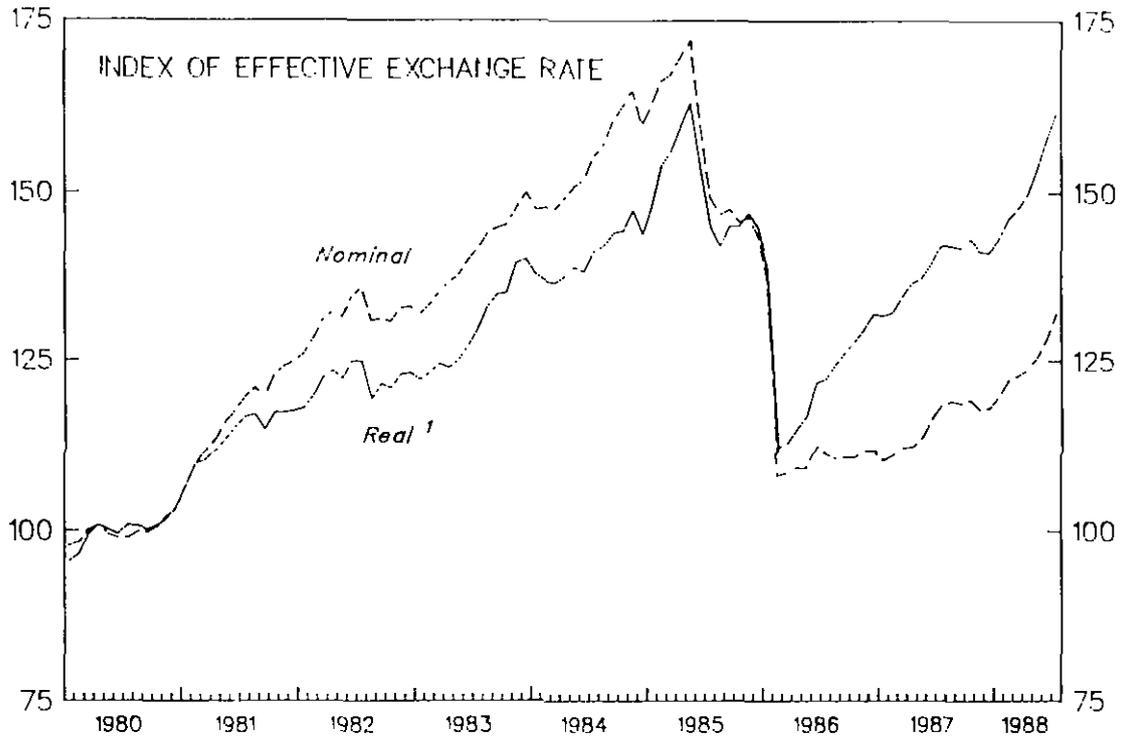
Source: Information Notice System.

1/ Increases mean appreciation.2/ Using seasonally adjusted price indices.3/ Date of latest consideration by Executive Board.



CHART  
EL SALVADOR  
INFORMATION NOTICE SYSTEM INDEX OF  
EFFECTIVE EXCHANGE RATE

(1980=100)



Source: Information Notice System.

<sup>1</sup> Trade weighted index of nominal exchange rates deflated by seasonally adjusted relative consumer prices; Increases mean appreciation.

<sup>2</sup> Seasonally adjusted.

