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EBS/86/170

CONFIDENTIAL

July 31, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Tanzania - Exchange Arrangements and Real Effective
Exchange Rate Information Notice

Attached for the information of the Executive Directors is a paper on a recent depreciation of the Tanzanian shilling, and of its real effective exchange rate.

Mr. Belanger (ext. 8671) is available to answer technical or factual questions relating to this paper.

Att: (1)

INTERNATIONAL MONETARY FUND

TANZANIA

Exchange Arrangements and
Real Effective Exchange Rate Information Notice

Prepared by the African Department and
the Exchange and Trade Relations Department

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

Approved by A. D. Ouattara and W. A. Beveridge

July 31, 1986

In the attached communication dated June 26, 1986, the Central Bank of Tanzania has notified the Fund that, with effect from June 20, 1986, the midpoint exchange rate of the Tanzanian shilling against the U.S. dollar, the intervention currency, was adjusted to T Sh 40 = US\$1. This adjustment represents a 25 percent devaluation against the U.S. dollar, bringing the total cumulative depreciation since end-March 1986 to 60 percent.

The Tanzania shilling has been pegged to a composite of the currencies of Tanzania's main trading partners since January 20, 1979, when the shilling was devalued by 10 percent and its peg to the SDR was discontinued. Subsequently the shilling remained approximately unchanged in terms of the U.S. dollar until March 8, 1982, when the rate was depreciated by 10 percent. Further depreciations followed on June 6, 1983 of 20 percent, and on June 14, 1984 of 26 percent, resulting in an exchange rate of T Sh 17 per U.S. dollar. These depreciations were, however, well below that required to offset the sharp deterioration in relative price performance that had taken place over the same period, with the result that as of July 1984 despite the June depreciation, the Tanzania shilling had appreciated in real effective terms by about 70 percent since 1978.

Subsequently, through early 1986, the exchange rate of the shilling against the U.S. dollar remained relatively stable despite a continued deterioration in relative price performance. This resulted, by March 1986, in a cumulative real effective appreciation of the shilling of 113 percent since 1978. As the real effective exchange rate index is calculated on the basis of the official consumer price index, which has been influenced by price controls and by consumer subsidies and may not be an adequate measure of actual cost developments, the extent of the real appreciation could be even higher. These developments, combined with an extensive system of exchange controls, led to the emergence of a parallel market where the exchange rate was reportedly about five times more depreciated than the official exchange rate.

In recognition of the importance of establishing an appropriate exchange rate, the Tanzanian authorities began to depreciate the shilling in April 1986. The exchange rate against the U.S. dollar was depreciated gradually from T Sh 16.0 = US\$1 at the end of March to T Sh 19.95 = US\$1 by the end of April, T Sh 26.0 = US\$1 by the end of May, and T Sh 30.0 = US\$1 by June 19. As noted earlier, the shilling was depreciated further to T Sh 40.0 = US\$1 on June 20, concurrent with the announcement of the budget for fiscal year 1986/87 (July-June).

The evolution of Tanzania's real effective exchange rate through May 1986, as measured by the standard index developed in connection with the information notice system, is set out in the attached table and chart. 1/ Based on this index, the Tanzania shilling had depreciated in real effective terms by 29.6 percent by May 1986 from the level prevailing in March 1986, when the most recent Article IV consultation with Tanzania was concluded. 2/ The further depreciation of the shilling since May, by 43 percent against the U.S. dollar, will result in a further substantial depreciation in real effective terms.

Staff Appraisal

The recent depreciation of the shilling is an important step in the direction of the more active use of exchange rate policy that has been advocated by Executive Directors on recent occasions when Tanzania's economic policies were brought to the attention of the Executive Board. In their consideration of the staff papers for the Article IV consultation with Tanzania on March 20, 1986, Executive Directors expressed deep concern about the severe economic difficulties facing Tanzania and the continued reluctance of the authorities to take significant adjustment policy actions. 3/ Directors urged the authorities to adopt a comprehensive policy package aimed at providing appropriate incentives to the economy through large shifts in relative prices. In this context, Directors stressed that a substantial initial depreciation of the currency was indispensable and that thereafter exchange rate policy must remain adequately flexible, with a view to establishing an equilibrium exchange rate within a short period. Directors urged that the initial

1/ The consumer price index in Tanzania is available on a quarterly basis only. For the purpose of the information notice system, monthly data are derived by interpolation of the seasonally adjusted quarterly series.

2/ Chairman's summing up circulated as SUR/86/27 (3/26/86).

3/ Similar considerations were stressed by Executive Directors at the time of their third consideration of Tanzania's overdue obligations to the Fund (Tanzania--Overdue Financial Obligations to the Fund--Further Review of Decision on Complaint Under Rule K-1 and Notice of Failure to Settle Trust Fund Obligations (EBS/86/85, 4/21/86).

exchange rate adjustment reverse most, if not all, of the real effective appreciation of the currency since the late 1970s. The recent depreciation has more than offset this appreciation.

Subsequent to the Board conclusion of the 1985 Article IV consultation, staff teams visited Dar-Es-Salaam in early April and in May to discuss economic and financial policies that could constitute the main elements of an adjustment program that could eventually form the basis for a stand-by arrangement from the Fund, once Tanzania's overdue obligations to the Fund have been cleared. Discussions were also held with the Tanzanian authorities during a recent Consultative Group meeting in Paris on June 10-11.

Table 1. Tanzania: 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)
Quarterly <u>3/</u>						
1981						
III	141.1	122.2	115.5	98.1	128.8	129.6
IV	141.6	119.8	118.3	98.6	135.2	137.2
1982						
I	147.9	119.8	123.5	92.9	143.7	143.3
II	148.1	116.0	127.7	86.9	152.4	149.4
III	166.9	118.0	141.5	85.3	172.2	173.5
IV	172.0	118.8	144.8	85.2	179.2	181.8
1983						
I	179.4	121.1	148.2	83.9	186.3	186.1
II	180.0	112.7	159.8	75.9	204.8	200.3
III	160.2	102.7	156.0	66.2	205.2	206.9
IV	177.8	105.7	168.3	65.9	226.6	230.0
1984						
I	186.1	104.3	178.4	66.4	245.0	245.0
II	170.1	89.7	189.7	54.2	265.7	259.9
III	172.6	83.5	206.8	46.3	295.6	297.6
IV	183.4	85.4	214.9	45.5	313.9	318.3
1985						
I	198.7	89.0	223.4	44.4	334.4	335.1
II	202.1	87.7	230.5	46.5	352.3	344.5
III	198.3	86.2	230.2	47.7	356.7	358.7
IV	199.3	83.5	238.8	49.8	376.7	382.0
1986						
I	202.0	81.3	248.5	51.3	395.7	396.9
Monthly						
1986						
March <u>4/</u>	202.0	81.3	248.5	51.3	395.7 <u>5/</u>	
April	178.5	70.7	252.4	44.8	402.6	
May	142.3	55.5	256.3	35.7	409.7	
Percentage change						
March- May 1986	-29.6	-31.7	3.2	-30.4	3.5	

Source: Information Notice System.

1/ Increases mean appreciation.

2/ Using seasonally adjusted price indices.

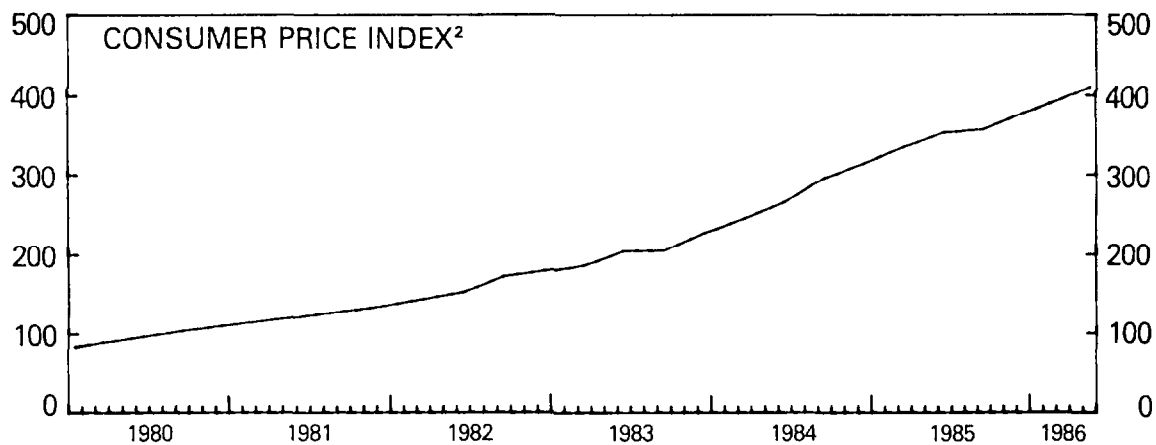
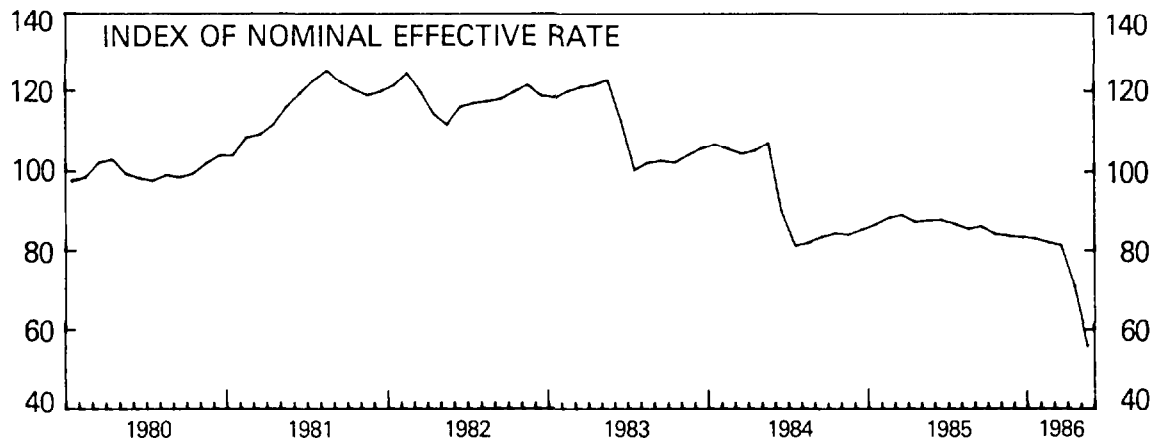
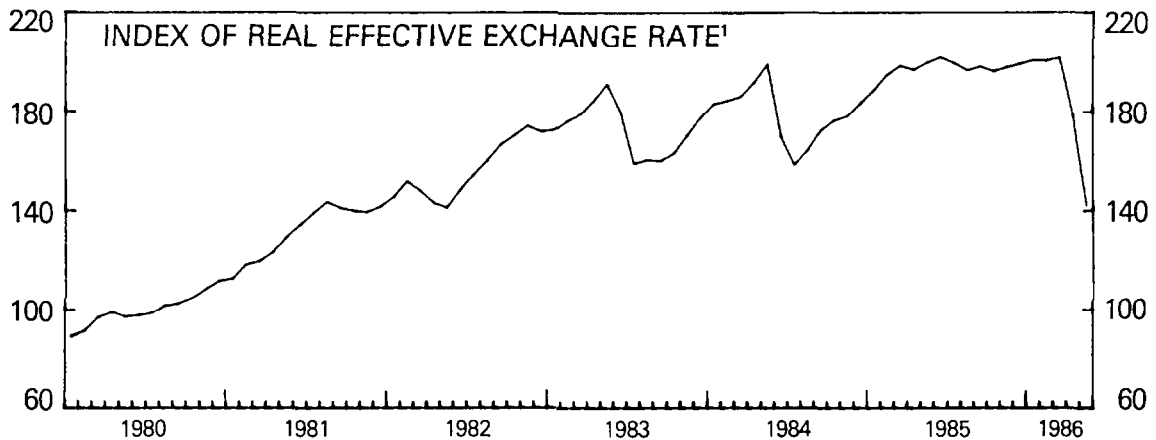
3/ End of quarter

4/ Date of latest consideration by Executive Board.

5/ Monthly data derived by interpolation of seasonally adjusted quarterly series.

CHART 1
TANZANIA
INFORMATION NOTICE SYSTEM INDEX OF
EFFECTIVE EXCHANGE RATE

(1980 = 100)



Source: Information Notice System.

¹ Trade-weighted index of nominal effective exchange rate deflated by seasonally adjusted consumer prices; a rise(fall) in the index reflects an appreciation(depreciation).

² Seasonally adjusted.