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CONFIDENTIAL

October 14, 1986

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 Salvadoran colón.

Mr. Sheehy (ext. 8672) is available to answer technical or factual questions relating to this paper.

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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 and Research Departments)

Approved by Eduardo Wiesner and Manuel Guitián

October 14, 1986

The recent evolution of El Salvador's real effective exchange rate, 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 1986 the Salvadoran colon had appreciated in real effective terms by more than 10 percent since the last occasion on which El Salvador's exchange rate developments were brought to the attention of the Executive Board, i.e. a notification of a change in El Salvador's exchange arrangements (EBD/86/67, 3/11/86) in March 1986. The appreciation is estimated to have amounted to 10.2 percent.

Recent developments in exchange rate policy were described in the document mentioned above which informed the Executive Board of changes in the exchange system on January 22, 1986 involving the unification of the exchange rate system at a new fixed rate of ₡ 5 per U.S. dollar and an intensification of exchange and trade restrictions. The unification of the exchange rate system completed the process of shifting transactions from the official to the parallel market which had been accelerated since late 1984. By June 1985, somewhat more than half of current account transactions were channeled through the parallel market. Compared with the weighted average value of the colon (₡ 3.8 per U.S. dollar) during the first half of January 1986, unification of the rates involved a depreciation of 24 percent vis-a-vis the U.S. dollar, bringing the total cumulative depreciation relative to the U.S. dollar since late 1984 to 44 percent and nearly restoring in real effective terms the value of the colon to its end-1980 level.

Since January 1986 the colon has appreciated in real effective terms mainly because of a continued high rate of inflation in El Salvador which resulted in a steady increase of domestic prices relative to those of its trading partners. In nominal effective terms, the colon has appreciated slightly since the end of January 1986. The consumer price index rose by 10 percent (seasonally adjusted) from March to July 1986, which was consistent with an annual rate of inflation of around 32 percent. This rate of domestic price increase can be attributed to

an expansionary credit policy, an intensification of restrictions and the lagged effect on some internal prices of the depreciation of the colon.

El Salvador's balance of payments position is expected to strengthen in 1986. Gains in terms of trade reflecting higher coffee prices and lower oil import prices are expected to make possible a reduction of the external current account deficit (excluding official transfers) by about half in 1986, to the equivalent of 2 1/2 percent of GDP. An overall balance of payments surplus of around US\$60 million is projected.

The staff recently held the 1986 Article IV consultation discussions with the Salvadoran authorities, including discussions on exchange rate policy. The staff report for the consultation will review and appraise recent developments in the exchange rate for the colon and in underlying policies.

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) |
|------------------------------|---|--|---|--|--|--|
| Quarterly | | | | | | |
| 1982 | | | | | | |
| I | 118.0 | 118.5 | 99.6 | 100.0 | 122.3 | 121.7 |
| II | 120.5 | 119.7 | 100.7 | 100.0 | 126.6 | 126.9 |
| III | 117.7 | 116.8 | 100.8 | 95.9 | 129.8 | 130.3 |
| IV | 118.3 | 114.7 | 103.2 | 93.3 | 134.4 | 134.1 |
| 1983 | | | | | | |
| I | 117.6 | 112.2 | 104.8 | 92.0 | 137.7 | 137.2 |
| II | 118.1 | 112.8 | 104.8 | 91.6 | 140.5 | 140.8 |
| III | 123.8 | 114.5 | 108.1 | 91.6 | 148.4 | 148.9 |
| IV | 129.4 | 115.2 | 112.3 | 91.6 | 154.8 | 154.5 |
| 1984 | | | | | | |
| I | 127.7 | 112.8 | 113.2 | 89.3 | 157.7 | 157.2 |
| II | 128.8 | 113.0 | 114.0 | 89.2 | 160.5 | 160.9 |
| III | 131.9 | 115.0 | 114.7 | 89.0 | 162.4 | 162.9 |
| IV | 134.9 | 116.6 | 115.7 | 87.1 | 167.6 | 167.2 |
| 1985 | | | | | | |
| I | 141.8 | 116.9 | 121.3 | 82.8 | 178.5 | 178.0 |
| II | 150.5 | 118.8 | 126.8 | 79.5 | 190.6 | 191.0 |
| III | 137.6 | 105.1 | 130.9 | 67.8 | 203.8 | 204.4 |
| IV | 139.8 | 101.6 | 137.5 | 66.1 | 220.2 | 219.6 |
| 1986 | | | | | | |
| I | 115.1 | 80.4 | 143.4 | 54.3 | 236.2 | 235.6 |
| II | 112.4 | 75.2 | 149.5 | 50.0 | 252.8 | 253.4 |
| Monthly | | | | | | |
| 1986 | | | | | | |
| March <u>3/</u> | 107.2 | 73.9 | 145.1 | 50.0 | 241.0 | 241.4 |
| April | 109.3 | 74.3 | 147.1 | 50.0 | 247.0 | 247.7 |
| May | 111.2 | 74.2 | 149.9 | 50.0 | 253.2 | 253.0 |
| June | 116.8 | 77.1 | 151.6 | 50.0 | 258.4 | 259.5 |
| July | 118.1 | 76.4 | 154.6 | 50.0 | 265.0 | 265.7 |
| Percentage change | | | | | | |
| March-July 1986 | 10.2 | 3.4 | 6.6 | 0.0 | 10.0 | 10.1 |

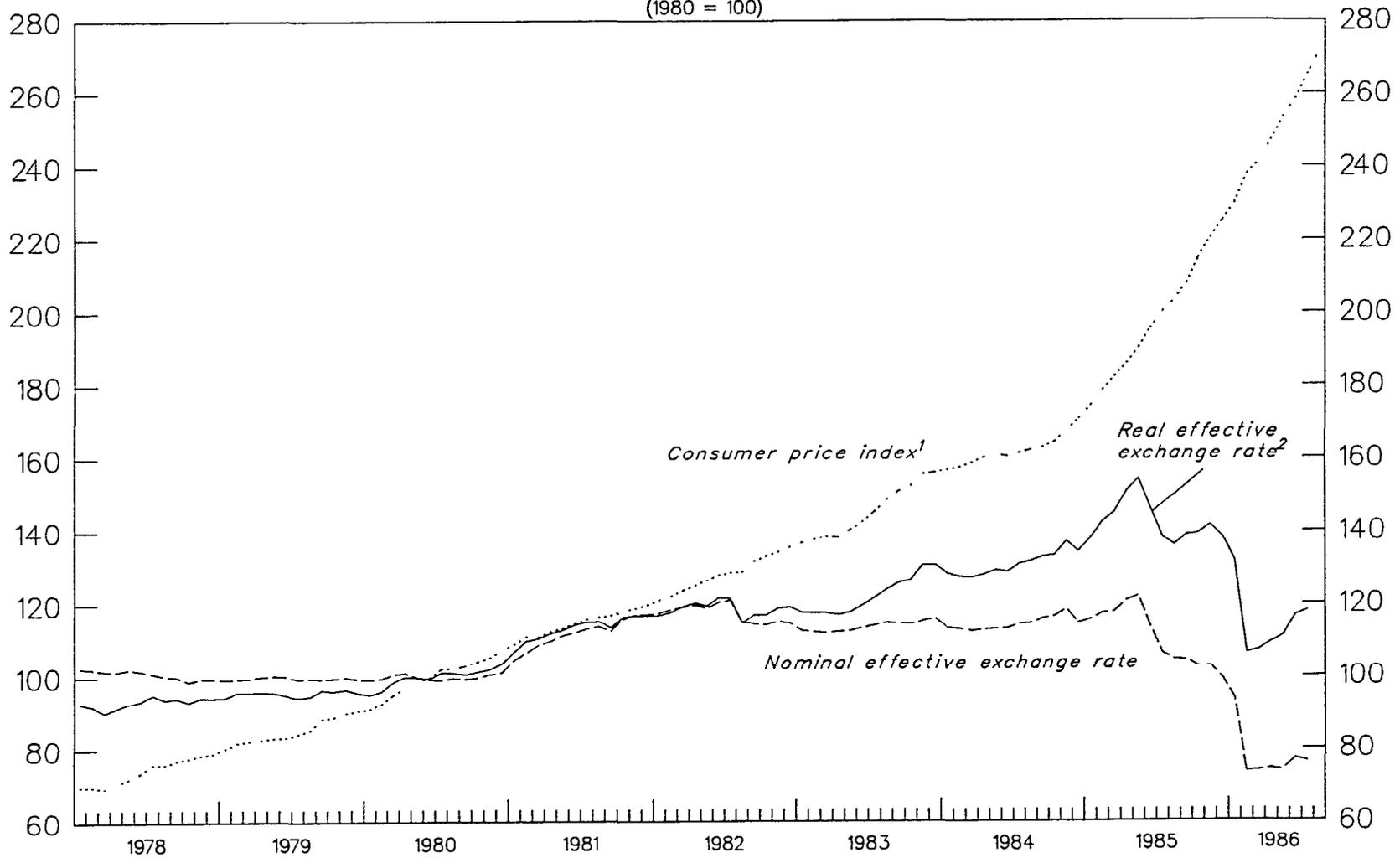
Source: Information Notice System.

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

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EL SALVADOR
 INFORMATION NOTICE SYSTEM INDEX OF REAL EFFECTIVE EXCHANGE RATE
 (1980 = 100)



Source: Information Notice System.

¹Seasonally adjusted.

²Trade-weighted index of nominal exchange rates deflated by seasonally adjusted relative consumer prices, increases mean appreciation.

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