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CONFIDENTIAL

August 22, 1986

To: Members of the Executive Board

From: The Acting Secretary

Subject: Information Notice System - Extension of Monitoring to Countries Without Monthly or Quarterly Price Data and Information Notices for Djibouti and the United Arab Emirates

Attached for the information of the Executive Directors is a paper introducing an extension of the information notice system to countries without monthly or quarterly price data. Information notices for Djibouti and the United Arab Emirates are attached.

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

Att: (1)

INTERNATIONAL MONETARY FUND

Information Notice System:
Extension of Monitoring to Countries
Without Monthly or Quarterly Price Data
and Information Notices for
Djibouti and the United Arab Emirates

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(In consultation with the Research Department,
the Legal Department, and Area Departments)

Approved by C. David Finch

August 22, 1986

I. Introduction

The system to monitor developments in real effective exchange rates was established in July 1983. Under that system, significant changes in real effective exchange rates have been brought to the attention of Executive Directors both through quarterly reports and, in cases of changes in real effective exchange rates in excess of 10 percent since the last Board consideration of a member's exchange rate policy, through information notices which analyze and assess recent developments and policies. Six information notices were issued in 1983, 19 in 1984, 30 in 1985 and 37 so far in 1986.

At present, real effective exchange rates are monitored for 128 currencies, including the currencies of 83 percent of Fund members. 1/ Although Directors have noted on earlier occasions the importance of making the coverage of the system as comprehensive as possible, 2/ for 26 members, real effective exchange rates are still not available. For most of these countries, monthly or quarterly price data either are not available or are not considered sufficiently reliable or timely to be used for precise calculations of real effective exchange rates.

1/ Real effective exchange rates are also calculated for the currencies of Hong Kong and Switzerland, which are not members of the Fund. The real effective exchange rate is monitored separately for the currency of the Netherlands Antilles.

2/ See, for example, the "Chairman's Summing Up at the Conclusion of the Review of the Document "Surveillance Over Exchange Rate Policies" and Annual Review of the Implementation of Surveillance," SUR/84/32 (3/23/84).

II. Extension of Monitoring System to Countries Without Monthly or Quarterly Price Data

For most of the members for which real effective exchange rates are still not available, usable or up-to-date price indices or precise estimates are not thought likely to become available in the near future. Further improvements in the coverage of the monitoring of real effective exchange rates can nevertheless be achieved by modifying the current system to allow for less precise or exact monitoring. Although less precise, the extended monitoring described below will improve the Fund's monitoring of exchange rate developments, allowing for the monitoring to be applied more uniformly to all members, and help highlight for those members whose currencies are added to the system significant changes in their real effective exchange rates.

For those countries without appropriate price data, movements in real effective exchange rates for their currencies relative to the 10 percent appreciation/depreciation thresholds will be monitored on the basis of developments in nominal effective exchange rates and judgmental assessments of inflation relative to trading partners. The judgment concerning the likely range of inflation in each of these countries will be based, inter alia, on the past inflation performance of the country itself, the projected rate of inflation at the time of an earlier consultation, the evolution of money and credit aggregates, and other relevant information available to the staff.

The decision to issue an information notice in these cases will thus involve a greater element of uncertainty (which would be spelled out in the information notice) than is the case for countries with up-to-date price data. In order to avoid issuing information notices when, in retrospect, none would have been needed, it will also be necessary to delay issuing such notices until it is quite clear, on the basis of reasonable judgments concerning inflation, that the 10 percent appreciation/depreciation threshold has been exceeded. 1/

1/ In practice, for all currencies for which a nominal effective exchange rate is calculated at present, an implied rate of inflation can also be calculated which, given rates of inflation in trading partners, would keep the real effective exchange rate within the 10 percent threshold (see Annex). Monitoring will apply in the first instance to this implied rate of inflation. When this implied rate of inflation moves away from the judgmental assessment of the likely rate of inflation, a further review of this latter assessment will provide the basis to decide whether an information notice is warranted.

Also, in the absence of exact or precise estimates of inflation, the quarterly reports on "Indicators of Real Effective Exchange Rates" still will include only nominal effective exchange rate data for these countries.

Monitoring on this basis will expand the coverage of the information notice system to the currencies of 25 more members (listed in the Annex). Monitoring would still not apply to Democratic Kampuchea, for which the trade data necessary to calculate nominal effective exchange rates are not available.

The initial experience with the extended monitoring system will be examined in detail on the occasion of the next annual review of surveillance.

III. Information Notices for Djibouti and the United Arab Emirates

For two countries, Djibouti and the United Arab Emirates, developments in the nominal effective exchange rates for their currencies and rates of inflation in trading partners suggest that the real effective exchange rates for their currencies have changed by more than 10 percent since the date of the most recent Board discussion of exchange rate developments and policy in these countries. The Djibouti franc and U.A.E dirham have likely depreciated by more than 10 percent in real effective terms since the last Board discussion of their exchange rate policies. For these countries, the present paper constitutes an information notice.

Djibouti

The Djibouti franc is pegged to the U.S. dollar and has depreciated by 20.8 percent in nominal effective terms between June 1985 when the most recent Article IV consultation with Djibouti was concluded and May 1986. 1/ The impact of this depreciation on the real effective exchange rate, however, is likely to have been offset in part by the acceleration of inflation in 1985, which is estimated to have increased sharply to about 12 percent by the end of the year following several years of price stability. 2/ The rate of inflation from June 1985 through May 1986 nevertheless likely remained below the rate which would have prevented the real effective exchange rate from depreciating by more than 10 percent (see Annex). The depreciation of the franc since early 1985 has reversed about half of the appreciation in nominal effective terms (of nearly 90 percent) recorded since the late 1970s.

Growing domestic and external imbalances have been increasingly apparent in Djibouti in recent years. In particular, since 1982, growth has been negligible while both the fiscal position and balance of payments deteriorated sharply. In concluding the most recent Article IV consultation with Djibouti in June 1985, Executive Directors noted the significant appreciation of the franc, along with the U.S. dollar, relative to the currencies of trading partners. In acknowledging the special nature of Djibouti's exchange system, Directors stressed the

1/ Chairman's summing up circulated as SUR/85/67 (6/20/85).

2/ Based on the price index for expatriates living in Djibouti.

need for early and sustained efforts in implementing financial policies consistent with the maintenance of Djibouti's financial system and liberal exchange arrangements.

Developments in 1985, which reflected a further intensification of domestic and external imbalances, and the authorities' policy intentions, including exchange rate policy, are reviewed in detail and appraised in the recently issued staff report for the 1986 Article IV consultation (SM/86/159, 7/1/86). The Board discussion concluding the consultation has been tentatively scheduled for August 27, 1986.

United Arab Emirates

The U.A.E dirham is formally pegged to the SDR although, in practice, the dirham has maintained an unchanged relationship with the U.S. dollar since November 1980. The dirham has depreciated in nominal effective terms by 14.7 percent between July 1985 when the most recent Article IV consultation with the United Arab Emirates was concluded and May 1986. ^{1/} Prices in the United Arab Emirates have been declining in recent years (at an estimated average annual rate of 3-4 percent from 1983 to 1985). Unless this trend was reversed sharply in the last few months, the nominal effective depreciation of the dirham since mid-1985 resulted in a depreciation in real effective terms well above 10 percent.

Following a period of rapid expansion financed by rising oil revenues, since mid-1982 the authorities have directed their efforts to adjusting the economy to a steep decrease in oil receipts. In particular, total budgetary outlays were cut by approximately one fourth between 1981 and 1984; the resulting decrease in imports and capital outflows helped maintain the balance of payments in a comfortable position in 1984. In concluding the most recent Article IV consultation with the United Arab Emirates in July 1985, Executive Directors indicated that a restrained fiscal policy stance was appropriate and necessary. Directors, however, also noted that the slowdown in economic activity had highlighted the extent to which activity in the non-oil sector remained dependent on government expenditure and suggested that the authorities might wish to explore the role of exchange rate policy in encouraging autonomous development of private sector activity.

The policy of containing budgetary outlays was continued in 1985; however, the overall budget deficit rose because of the fall in oil revenues. For 1986, in light of the developments in the oil markets, the authorities have announced a further 15 percent reduction in government outlays. The policy of fiscal retrenchment has helped maintain the balance of payments in surplus in 1985 and a surplus is forecast in 1986 as well. However, private sector activity has remained subdued.

^{1/} Chairman's summing up circulated as SUR/85/82 (7/24/85).

The staff considers that the depreciation of the dirham in nominal effective terms since early 1985, which has reversed about half of the appreciation (of nearly 60 percent) recorded since the late 1970s, is appropriate as it will help restrain the demand for imports and promote a more efficient allocation of resources, thus promoting activity in the tradeable goods sector.

Calculation of Implied Rates of
Inflation Consistent with Movements in
Real Effective Exchange Rates of Less
Than 10 Percent

For each currency for which a nominal effective exchange rate is calculated at present, implied rates of inflation can be calculated which, given rates of inflation in trading partners, would keep the real effective exchange rate within the 10 percent appreciation/depreciation threshold. The relevant numerical information underlying the calculation of these implied rates of inflation is shown in Table 1 for the period through May 1986 for those countries for which only nominal effective exchange rates have been monitored so far under the Information Notice System.

For each country, the first two columns show the type and date of the latest Board consideration, column 3 shows the change in the nominal effective exchange rate for the country's currency from the date of the latest Board consideration through the most recent month for which information is available, and column 4 shows the rate of inflation in trading partners during the same period. Column 5 shows the annual rate of inflation below which the real effective depreciation would exceed 10 percent while column 6 shows the annual rate of inflation above which the real effective appreciation would exceed 10 percent. Thus, an estimated rate of inflation outside the range shown in the table would indicate the need for an information notice. The width of the range indicated in the table is determined by the length of time elapsed since the date of the latest Board consideration. The 10 percent real appreciation/depreciation margin is reflected, *pari passu*, in a 20 percentage point range between the lower and higher estimated price levels keeping the real effective exchange rate within the 10 percent appreciation/depreciation threshold. This 20 percentage point range between estimated price levels translates into a range of annualized rates of inflation of, for example, 20 percent in cases where a full year has elapsed since the latest Board consideration and 40 percent when only six months have elapsed.

Table 1. Countries for which Real Effective Exchange Rates are not Monitored

	Latest Board Consideration		Change From Latest Board Consideration Through May 1986		Range of Inflation Rates Keeping the Real Effective Exchange Rate Within the 10 Percent Threshold <u>2/</u>	
	Type <u>1/</u>	Date	Nominal Effective Exchange Rates	Trading Partner Prices		
<u>African Department</u>						
Algeria	C	9/85	-9.8	3.3	4.8	41.4
Benin	C	4/86	-0.5	0.2	-69.2	242.3
Cape Verde	C	3/85	-7.0	7.7	3.7	23.1
Chad	C	6/86	...	...	...	...
Comoros	C	6/86	...	...	...	...
* Djibouti	C	6/85	-20.8	2.2	17.7	46.4
Equatorial Guinea	R	6/86	...	...	...	...
Guinea	C,R	2/86	-2.3	0.5	-26.4	64.1
Guinea-Bissau	C	9/85	-26.3	4.7	44.8	95.5
Mozambique	C	7/85	-2.0	6.3	-2.9	23.7
Sao Tome & Principe	C	11/84	-5.5	9.0	2.6	17.2
<u>Asian Department</u>						
Bhutan	C	8/85	-1.9	2.7	-7.7	20.7
Kampuchea, Dem.	C	10/73	...	...	...	...
Lao, P.D. Rep.	C	1/86	-3.9	--	-18.0	49.9
Maldives	N	3/86	-4.1	0.1	-31.1	129.5
Viet Nam	C	7/86	...	...	...	...
<u>Middle Eastern Department</u>						
Afghanistan	C	1/86	-7.0	0.3	-8.8	66.7
Iraq	N	11/82	6.6	35.0	3.9	9.9
Lebanon	C	4/86	-17.3	0.2	186.0	3,052.6
Libya	N	5/86	...	...	...	...
Oman	C	6/86	...	...	...	...
Qatar	C	2/86	-4.2	0.3	-21.3	75.7
Syrian Arab Rep.	C	2/86	-3.2	0.7	-23.2	71.3
* United Arab Emirates	C	7/85	-14.7	2.0	9.2	38.9
Yemen Arab Rep.	N	1/86	-8.8	0.4	-2.4	78.1
Yemen P.D. Rep.	C	6/85	-18.8	2.8	15.3	43.5

1/ C: consultation; N: notification of change in exchange system; R: use of Fund resources.

2/ Annual rate, from date of latest Board consideration through May 1986. Lower end of range would keep the real effective depreciation less than 10 percent; higher end of range would keep the real effective appreciation less than 10 percent. A rate of inflation outside the range specified would indicate the need for an information notice.

* Indicates countries for which estimated rate of inflation would indicate a change of more than 10 percent in the real effective exchange rate.