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EBS/86/206

CONFIDENTIAL

September 3, 1986

To: Members of the Executive Board
From: The Acting Secretary
Subject: Nicaragua - 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 Nicaraguan cordoba.

Mr. Bélanger (ext. 8671) or Mr. Elson (ext. 8500) is available to answer technical or factual questions relating to this paper.

Att: (1)

INTERNATIONAL MONETARY FUND

NICARAGUA

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 Eduardo Wiesner and W. A. Beveridge

September 2, 1986

The recent evolution of Nicaragua'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 June 1986 the Nicaraguan cordoba had appreciated in real effective terms by more than 10 percent since the last occasion on which the Executive Board had an opportunity to discuss Nicaragua's exchange rate policy--the Article IV consultation in May 1986. 1/ The real appreciation is estimated to have amounted to 41.3 percent.

Recent developments in exchange rate policy were described in detail in the staff reports for the 1986 Article IV consultation (SM/86/78 and SM/86/86). As noted in those documents, on February 1, 1986, Nicaragua depreciated the exchange rates vis-à-vis the U.S. dollar for most transactions and reestablished mixed exchange rates for certain export proceeds and invisible receipts. 2/ These changes entailed an implicit real effective depreciation of the cordoba of about 60 percent. 3/ Subsequently, in early March 1986 the exchange rate for petroleum imports was adjusted from C\$28 per U.S. dollar to C\$70 per U.S. dollar, which was the rate established on February 1 for most other imports. Since then, the various exchange rates for the cordoba relative to the U.S. dollar have remained unchanged.

1/ Chairman's summing up circulated as SUR/86/42 (5/20/86).

2/ The scope of the legal "free" market also was widened somewhat; transactions in that market, in which the value of the cordoba was quoted at C\$900 per U.S. dollar at end-June 1986, account for only around 3 percent of total foreign exchange transactions.

3/ The effective value of the cordoba for purposes of the information notice system is based on a composite rate, representing a weighted average of the multiple exchange rates.

The large appreciation of the cordoba in real effective terms in recent months accordingly has reflected entirely the high rate of domestic inflation, with prices increasing by 51.5 percent in June (not seasonally adjusted). The rapid increase in prices during 1986 reflects the continued effect of lax fiscal and monetary policies following large adjustments of the exchange rate, controlled prices and wages early in the year. The overall deficit of the Central Government is projected at around 24 percent of GDP in 1986 (unchanged from 1985) as increases in wages and other expenditures are expected to offset the growth of revenues. With the sizable domestic borrowing requirement of the public sector, overall bank credit has been expanding rapidly.

Staff Appraisal

In concluding the most recent Article IV consultation with Nicaragua, Directors welcomed the devaluation of the cordoba in February 1986 as a move in the right direction, but pointed out that this action would not be sufficient to restore competitiveness. Directors therefore encouraged the authorities to adjust the currency further, but underscored the critical importance of simultaneously implementing adequately restrained financial and wage policies.

Since February 1986, however, the cordoba has appreciated sharply in real effective terms because of the effects on the rate of domestic price increase of continued lax financial and wage policies. In real effective terms, the cordoba now is well above its level prior to the February devaluation. The adoption of a more flexible exchange rate policy (including a simplification of the complex exchange system) and appropriately restrained fiscal, monetary, and wage policies continue to be urgently needed to deal with Nicaragua's large internal and external imbalances.

Table 1. Nicaragua: 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	123.4	100.6	122.6	89.6	145.8	138.1
II	130.6	102.5	127.4	89.6	154.6	159.5
III	128.9	105.2	122.5	89.6	152.3	160.7
IV	139.9	106.7	131.2	89.6	165.4	160.0
1983						
I	145.6	102.8	141.7	86.2	181.0	169.7
II	155.7	105.4	147.8	86.2	192.5	199.5
III	170.4	108.2	157.5	86.2	209.7	223.8
IV	182.3	109.8	166.1	86.2	226.2	217.4
1984						
I	176.2	100.7	175.1	78.0	243.8	226.1
II	174.8	101.9	171.7	78.0	243.6	254.0
III	202.4	105.4	192.1	78.0	278.2	299.0
IV	243.7	107.9	225.8	78.0	334.0	318.6
1985						
I	207.0	74.1	287.2	52.0	434.0	398.8
II	253.0	55.6	455.0	38.9	702.0	742.9
III	353.4	54.8	645.0	38.9	1,010.1	1,089.4
IV	451.5	53.6	842.9	38.9	1,344.0	1,275.8
1986						
I	362.5	30.4	1,302.9	22.4	2,107.3	1,928.3
Monthly						
1986						
May <u>3/</u>	501.0	18.5	2,705.8	13.9	4,379.7	4,612.7
June	707.8	18.6	3,814.8	13.9	6,200.6	6,987.6
Percentage change						
May- June 1986	41.3	0.2	41.0	0.0	41.6	51.5

Source: Information Notice System.

1/ Increases mean appreciation. The effective value of the cordoba for purposes of the information notice system is based on a composite rate, representing a weighted average of the multiple exchange rates.

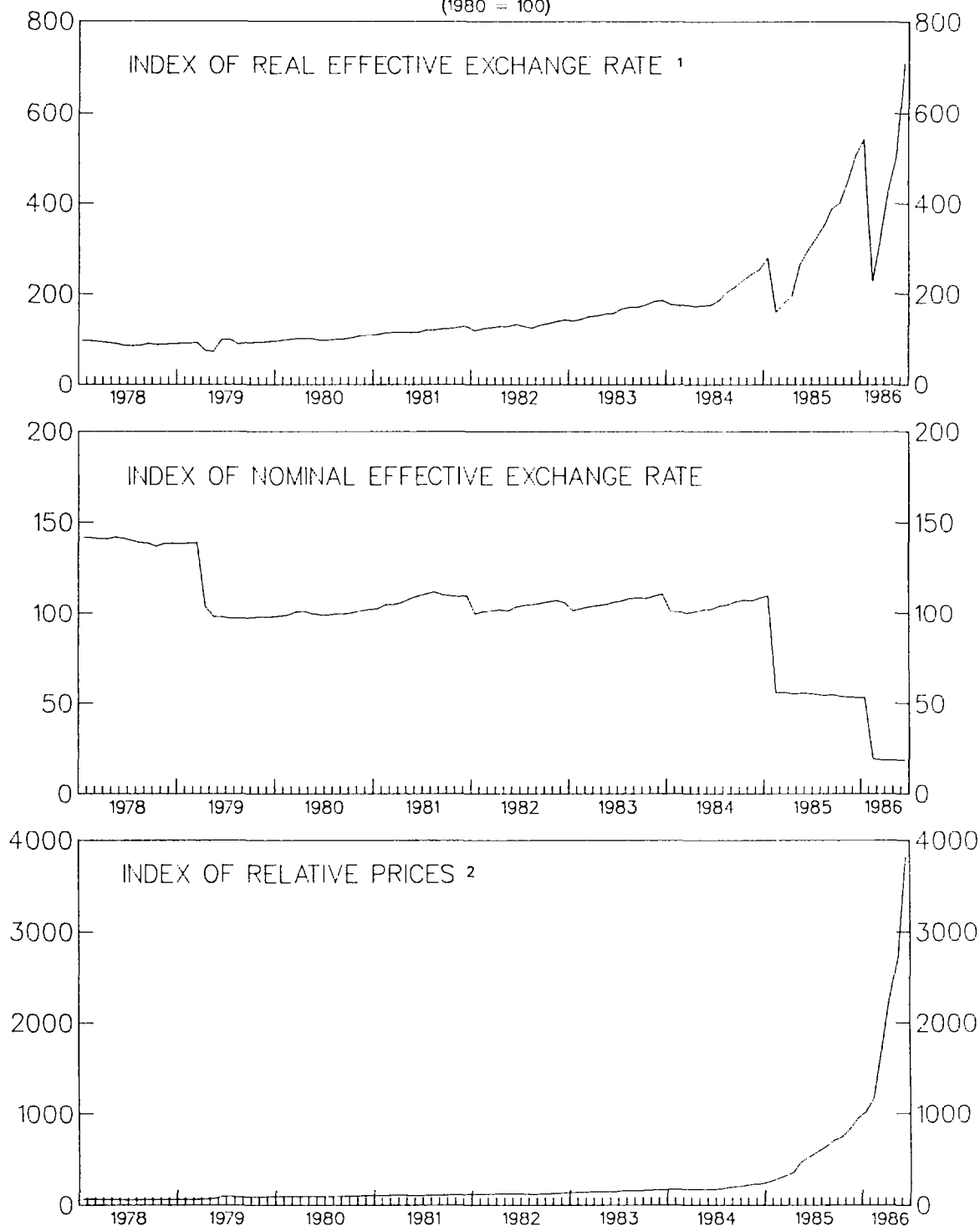
2/ Using seasonally adjusted price indices.

3/ Date of latest consideration by Executive Board.



CHART 1
NICARAGUA
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 Relative prices as measured by seasonally adjusted consumer price indices.