EBD/86/67

March 11, 1986

To: Members of the Executive Board

From: The Secretary

Subject: El Salvador - Exchange Arrangements and Exchange System

There is attached for the information of the Executive Directors a paper on a recent change in the exchange arrangements and exchange system of El Salvador

Ms. Jul (ext. 8524) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

El Salvador--Change in Exchange Arrangements and System

Prepared by the Western Hemisphere
and Exchange and Trade Relations Department

(In consultation with the Legal Department)

Approved by Eduardo Wiesner and W. A. Beveridge

March 10, 1986

In the attached communication dated January 22, 1986, the President of the Central Reserve Bank of El Salvador has informed the Fund of a devaluation of the colon in the official exchange market, with effect from January 22, 1986 (Attachment I). At the same time, the official exchange rate and the parallel (bank) exchange rate were unified, and import and exchange restrictions were intensified (Attachment II). 1/ The authorities also adopted a number of complementary measures in the fiscal, monetary and wage fields.

I. Background

In early 1982 El Salvador established a dual exchange market system comprising an official market in which the value of the colon continued to be pegged at ₡ 2.50 per U.S. dollar and a parallel (banking) market in which the value of the colon in principle fluctuated according to market forces, but which in practice was administered by the banks. In addition to the official and parallel exchange markets, there was a third (illegal) market which handled transactions not eligible for the other two exchange markets because of restrictions and administrative rationing. Through the end of 1984, the bulk of foreign exchange transactions were handled in the official market, and the parallel exchange rate remained virtually unchanged at around ₡ 4 per U.S. dollar. However, with the large shift of transactions to the parallel market in December 1984 and June 1985, more than one half of El Salvador's current account transactions were channeled through the parallel market where the exchange rate moved up gradually to ₡ 4.85 per U.S. dollar by the end of last year. During the four-year period ending December 1985, the average value of the colon in the two exchange markets depreciated in nominal effective terms by 13 percent, but appreciated in real effective terms by 19 percent.

1/ The implementing regulations of the exchange measures, which are not included in Attachment II to this memorandum, were received by the staff in late February 1986.

At the conclusion of the 1985 Article IV consultation by the Executive Board on December 27, 1985 (EBM/85/188), 1/ Executive Directors noted the efforts of El Salvador to maintain a growing economy and stable financial environment amidst the unsettled political situation of the country. At the same time, Directors emphasized the need for tighter credit policy and a stronger tax effort, and urged the authorities to reunify the exchange system at an exchange rate that would permit the elimination of exchange restrictions (including payments arrears) and would help to put the balance of payments on a solid footing. The Executive Board did not approve El Salvador's exchange restrictions.

II. Modification of the Exchange System

The main changes in the exchange system introduced on January 22, 1986 are as follows: (1) The official exchange rate of the colon was changed from ₡ 2.5 per U.S. dollar to ₡ 5.0 per U.S. dollar representing a devaluation of the colon of 50 percent against the U.S. dollar, the intervention currency. The commissions charged for sales of foreign exchange by the Central Reserve Bank to the government and commercial banks were lowered, while those charged to the public were more than doubled. The new commissions are as follows: (i) 0.5 percent (or ₡ 0.025 per US$1) on sales of banknotes to the Government and commercial banks; (ii) 1 percent (or ₡ 0.05 per US$1) on sales of checks and 1.5 percent (or ₡ 0.075 per US$1) on sales of banknotes to the public. (2) The authorities also unified the official exchange market and the parallel exchange market at the new official rate. The weighted average value of the colon during the first half of January was about ₡ 3.80 per U.S. dollar, and thus, the recent exchange rate adjustment involved a depreciation of about 24 percent in both nominal and real effective terms. In the recent Monetary Board resolution, the Central Reserve Bank was instructed to maintain the real effective exchange rate unchanged during 1986.

As a transitional arrangement, the following export proceeds will continue to be surrendered at the previous exchange rates: (i) export proceeds which were not surrendered to the Central Reserve Bank prior to January 1, 1986, as stipulated in the corresponding export permit; and (ii) proceeds of coffee exports from harvests prior to October 1, 1985. 2/ The previous official exchange rate also will continue to apply to the following payments: (i) external arrears on all payments with other Central American countries accumulated prior to January 21, 1986, external arrears on service payments outside Central America

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1/ The 1985 Article IV consultation discussions were held in September 1985, and recent economic developments and policies were reviewed in SM/85/315 (11/26/85) and SM/85/329 (12/10/85).

2/ The proceeds of coffee exports for the 1985/86 harvest will be surrendered at the new official rate, even if these exports were shipped prior to January 21, 1986.

accumulated up to December 31, 1985, and arrears on payments outside Central America related to confirmed or expired letters of credit up to January 21, 1986; (ii) payment obligations for approved imports of medicine financed by letters of credit or by cash payment and imports of capital goods which were cleared through customs prior to January 21, 1986; (iii) payments for all capital goods for which letters of credit were opened and authorized by the Central Reserve Bank prior to January 22, 1986, and that were funded from sources other than the Central Reserve Bank's foreign lines of credit; and (iv) payments for all other imports with letters of credit or by cash payment which were cleared through customs prior to November 1, 1985. The transitional arrangement described above represents a multiple currency practice.

Payments for invisibles of a personal nature (i.e., medical care, study abroad, foreign travel, and family assistance) will be subject to the following limits (previously any amount could be authorized to meet bona fide requirements): (a) up to US$5,000 a year to meet expenses for medical treatment, although additional amounts can be authorized in exceptional cases subject to verification; in addition, a guarantee deposit equivalent to 50 percent of the foreign exchange request must be placed with the Central Reserve Bank; (b) up to US$8,000 per year for educational expenses, plus US$400 per month for living expenses; (c) in the case of travel, the following limits were established: up to US$1,500 per year (or US$75 per day for a maximum of 20 days) for trips to countries in Central America (US$700 for children under 16 years); up to US$1,875 per year (or US$125 per day for a maximum of 15 days) for trips to countries outside Central America (US$900 for children under 16 years); 1/ up to a maximum of US$150 per day for business trips, subject to the approval of the Exchange Control Department of the Central Reserve Bank; (d) private remittances will only be authorized in the case of pension payments to retired Salvadoran diplomats living abroad with more than ten years of Government service. The measures just described represent exchange restrictions to the extent that they deny authority for bona fide requirements.

Import controls were intensified at the time of the recent devaluation. Import permits which exceed the equivalent of US$300 (previously US$2,000) must be authorized by the Central Reserve Bank and are subject to quotas set in accordance with a firm's average importsover the previous three years. Also, the so-called "G" list 2/ was divided into

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1/ In addition, a guarantee deposit of 20 percent was established for foreign exchange requests for nonbusiness travel outside Central America in excess of US$400; this deposit would be refunded upon certification that the duration of the trip corresponded with the number of days employed to calculate the amount of foreign exchange authorized.

2/ This list included low priority import items that were eligible for payment in the parallel exchange market. The banks were instructed to honor such requests only after the demand for the import of essential items through the parallel market had been satisfied.

two new lists as follows: (i) a prohibited list of imports of luxury items from outside Central America which is to be maintained for one year; and (ii) a list of nonessential goods that was made subject to a prior deposit requirement equivalent to 100 percent of the import value. The deposit must be made by the importer at the time an import permit is requested and is to be held by the Central Reserve Bank for a period of at least 90 days; no interest is paid on such deposits. In addition, imports from outside Central America in excess of US$5,000 can only be made by means of 90-day letter of credit financing. This provision discriminates against imports from outside Central America, and may give rise to an exchange restriction.

The Central Reserve Bank will continue to authorize foreign exchange and to issue import permits on the basis of the availability of foreign exchange in accordance with the following list of priorities: (i) basic foods, medicines, raw materials for the production of medicines, and oil products; (ii) raw materials and other intermediate goods needed for production, including machinery, equipment, and replacement parts; (iii) payments for medical expenses abroad, foreign study, travel and pensions; (iv) debt service; and (v) all other goods, services, transfers, and movements of capital. Specific monthly allocations of foreign exchange will be set for the import items listed in categories (i) and (ii) above and for the cash payment of certain imports of less than US$5,000; the other items listed above will be satisfied on the basis of available foreign exchange.

Special foreign currency accounts that were opened prior to January 21, 1986 may not be increased (except in the case of non-residents and industrial firms exporting to countries outside the Central American Common Market), but they may be maintained for a period of up to one year.

The Monetary Board instructed the Central Reserve Bank to set ceilings on the utilization of foreign credit by the commercial banks and the mortgage bank. Also, the Central Reserve Bank was authorized to establish a fund in U.S. dollars for servicing external public debt, which is to be supplied with receipts from export proceeds.

III. Other Economic Measures

At the time of the exchange rate unification, the Government of El Salvador also announced certain changes in fiscal, monetary, and wage policies. In the fiscal area, the Government introduced a 15 percent windfall profits tax on coffee exports and approximately doubled the rates of the selective consumption tax. In addition, the following tax measures were submitted for legislative approval: (i) an extension of the income tax withholding system; and (ii) an elimination of all tax exemptions for public sector institutions.

The monetary program of the Central Reserve Bank for 1986 also was announced. The program envisages an improvement in the net international reserve position of the Central Reserve Bank of US$75 million; a maximum increase in bank credit to the private sector of 13 percent (compared with 28 percent in 1985); and a maximum increase in bank credit to the nonfinancial public sector of ₡ 100 million (compared with about ₡ 160 million in 1985). At the same time, the Monetary Board raised interest rate ceilings in the banking system by up to 3 1/2 percentage points to a maximum of 21 percent for loans and 15 1/2 percent for deposits. (The annual rate of inflation targeted in this year's program is 20 percent, compared with 32 percent during 1985.) Also, the legal reserve requirements were changed to allow for a temporary increase from the existing level of 20 percent to 25 percent for the period from April 1 to July 31 to absorb excess liquidity of the banks, which is seasonally at a peak during this time of year; during the other eight months of the year the legal reserve requirements will remain unchanged at 20 percent.

Wages were increased in all sectors of the economy at the time of the devaluation. The minimum wage for rural workers was increased by amounts ranging from 52 to 74 percent depending on age and sex, and that for commercial and industrial workers was raised by 15 to 18 percent. For the private sector as a whole, average wage increases of 10 to 15 percent were authorized; in the public sector, an average increase of 17 percent was granted. Domestic gasoline prices were raised by about 50 percent, but the prices of certain "essential" goods and public services (including water, electricity, and telephones) were frozen for an indefinite period of time.

IV. Staff Appraisal

At the conclusion of the 1985 Article IV consultation with El Salvador in December 1985, Directors welcomed the action that had been taken to enlarge the scope of the parallel exchange market in 1985. However, in order to restore a relative price structure that would contribute to efficiency in resource allocation, they urged the authorities to reunify the exchange system at a rate that would permit the elimination of exchange restrictions (including payments arrears) and help restore balance of payments viability.

The unification of the exchange system on January 22, 1986 is, therefore, a step in the right direction, but the staff notes with concern that import and exchange restrictions have been intensified significantly. The other economic measures that were announced also address some of the concerns raised by Executive Directors at the conclusion of the 1985 Article IV consultation. However, the need to increase the restrictiveness of the exchange and trade system as evidenced by the action taken by El Salvador in January 1986 raises doubts about the adequacy of the supportive measures adopted in the fiscal, monetary, and wage fields. The staff recommends, therefore, that further policy actions be taken, including increased exchange rate flexibility, to eliminate these restrictions as soon as possible.

The staff is in close contact with the Salvadoran authorities. No action by the Executive Board is proposed at the present time.

ATTACHMENT I

Mr. J. de Larosiere
Managing Director
INTERFUND
Washington, D.C.

According to Article IV, Fund Agreement, we inform you the new official exchange rate of El Salvador as of this date January 22, 1986 is US$0.20 per colon.

Sincerely yours,

/s/
Alberto Benitez Bonilla
President
Central Reserve Bank

Received in cable room January 22, 1986

El Salvador--Monetary Board Resolution on Exchange Unification
(Session No. JM-2/86, January 21, 1986)

Whereas:

1. The purpose of exchange policy is to achieve a balance between the foreign and domestic sectors by means of an exchange rate which is realistic and consistent with the various macroeconomic and social interrelationships of the country;

2. The structural deficit of the balance of payments has increased in recent years owing to adverse domestic and external economic conditions;

3. It is necessary to reduce the size of the current account deficit and to take appropriate actions to correct the structural factors which produce deficits over the medium and long term;

4. It is necessary to reduce substantially the present dependence on foreign aid;

5. Inflation must be curbed before it becomes uncontrollable;

6. It is important to continue stimulating economic recovery in order to raise the levels of employment and income;

7. The real effective exchange rate is of fundamental importance to the Program of Stabilization and Development which the Government of the Republic will promote; however, given the present circumstances of the country, an equilibrium exchange rate can be achieved within a Stabilization Program at the lowest social cost only to the extent that the Program involves the support of a coherent set of economic policy measures which enable the productive system to adapt to the new economic conditions;

8. Given the shortage of foreign exchange, it is necessary to reduce imports of nonessential goods and services, for which purpose it is necessary to establish the mechanisms that make possible the rational use of foreign exchange;

9. With a view to rationalizing foreign exchange inflows and the use of foreign exchange, and to fulfilling appropriately the aim of exchange policy, it is advisable for the Central Reserve Bank of El Salvador to centralize all procedures relating to inflows and outflows of foreign exchange in accordance with the Law Controlling International Transfers;

10. It is fitting that individuals and firms which have opened Special Deposit Accounts in Foreign Currency in accordance with the regulations applicable heretofore not be affected, but that no new deposits should be added to such accounts.

The Monetary Board resolves that:

1. On the basis of Article 7(b)(1) of the Law on the Monetary System, to establish US$0.20 as the sole exchange rate for the colon. This exchange rate shall be applied to all international transactions entered into in the country by individuals or legal entities, whether residents or nonresidents, and the transactions in question must be carried out only through the banking system.

2. Any import permit for goods and services the value of which exceeds the equivalent of US$300.00, which does not result from the breakdown of a single operation, must be authorized by the Central Reserve Bank of El Salvador.

3. The Central Reserve Bank of El Salvador is authorized to establish a fund in dollars for payment of the public debt. This fund shall be supplied with foreign exchange proceeds from exports and shall be consistent with debt service payment requirements.

4. The Central Reserve Bank of El Salvador shall approve import permits and foreign exchange authorizations on the basis of the availability of foreign exchange and external lines of credit, in accordance with the following priorities:

(a) Basic foodstuffs, medicines, and fuels;

(b) Raw materials and other producer inputs, machinery, equipment and spare parts;

(c) Debt service; and

(d) Other goods, services, transfers and capital movements.

5. The Central Reserve Bank of El Salvador is authorized to determine ceilings on the allocation of foreign exchange for expenditure abroad for health, education and travel purposes, and to draw up the pertinent regulations. These ceilings and regulations shall be submitted to the Monetary Board for ratification.

6. The Central Reserve Bank of El Salvador shall establish prior deposits of 100 percent of the value of the imports listed in the Annex to this Resolution. These deposits must be made when Form F-10 is approved and shall be held for at least 90 calendar days.

7. The Central Reserve Bank of El Salvador, in accordance with exchange regulations and the Law Controlling International Transfers, shall take the measures necessary to ensure that foreign exchange is surrendered and used in the manner and amounts established in the corresponding export and import permits.

8. The Central Reserve Bank of El Salvador is authorized to buy and

sell foreign exchange through commercial banks, the Mortgage Bank, the Agricultural Development Bank, and the National Bank for Industrial Development.

9. All foreign exchange purchases and sales shall be effected in the banks at the rate of exchange established in item 1 of this resolution, notwithstanding the following:

(i) Foreign exchange proceeds from exports for which the term of 90 days, or a longer term as authorized by the Central Reserve Bank of El Salvador in accordance with the Law Controlling International Transfers, has expired before the date of this resolution shall be converted at ₡ 2.50 per US$1.00 or ₡ 4.85 per US$1.00 pursuant to what has been approved by this Board;

(ii) Foreign exchange proceeds from coffee exports from the 1985/86 harvest shall be paid at the new exchange rate of ₡ 5.00 per US$1.00 even if they were shipped prior to this resolution. Foreign exchange proceeds from harvests prior to 1985/86 shall continue to be paid at ₡ 2.50 per US$1.00; and

(iii) The following shall be paid at ₡ 2.50 per US$1.00: (a) letters of credit endorsed or expired up to January 21, 1986; (b) payment obligations for imports of raw materials for medicines financed by letters of credit or drafts, which merchandise has cleared Customs by the date of this resolution; (c) imports of capital goods that have cleared Customs by January 21, 1986; and all capital goods whose letters of credit have been opened and authorized by the Central Reserve Bank of El Salvador by January 21, 1986 using funds not arising from short-term lines of credit from foreign banks, even though the goods may arrive later; (d) all other goods imported under lines of credit or drafts which have cleared Customs before November 1, 1985; and (e) all services for which payment was due on or before December 31, 1985, in accordance with provisions of the Monetary Board. The Central Reserve Bank shall study the legal situation, the terms and the methods of such payment.

10. Foreign currency accounts in existence as of the date of this resolution may not receive new deposits but shall continue to operate for authorized uses until they have been liquidated, which shall occur in not more than one year.

11. The authorities concerned shall enforce the Law Controlling International Transfers as regards the obligation of individuals and legal entities to surrender foreign exchange with the banking system.

12. Any resolution, provision or order contrary to this resolution is without effect.

13. This resolution shall take effect one minute after midnight on Wednesday, January 22, 1986.