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CONFIDENTIAL

March 1, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Nicaragua - Exchange System and Real Effective Exchange Rate  
Information Notice

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The attached paper on recent changes in the exchange system of Nicaragua and an information notice on a change in the real effective exchange rate of the Nicaraguan córdoba is circulated for the information of Executive Directors as background for the discussion scheduled on Monday, March 4, 1985 of the staff report for the 1984 Article IV consultation with Nicaragua (SM/85/48, 2/11/85).

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Elson, ext. 8500.

Att: (1)

INTERNATIONAL MONETARY FUND

NICARAGUA

Exchange System and 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)

Approved by Eduardo Wiesner and Manuel Guitián

March 1, 1985

In the attached document received by the Fund on February 21, 1985, the Nicaraguan authorities have advised the Fund that Nicaragua has introduced certain changes in its exchange system with effect from February 8, 1985. In addition to reviewing these changes, this paper describes developments in Nicaragua's real effective exchange rate under the Fund's information notice system.

I. Background

As described in the staff report for the 1984 Article IV consultation with Nicaragua (SM/85/48, 2/11/85), at the end of 1984 the official exchange market comprised three basic exchange rates: (i) an official rate of C\$10 per U.S. dollar applying to a specified proportion of export proceeds and most imports; (ii) a special rate of C\$15 per U.S. dollar for imports of certain capital goods; and (iii) a "parallel" exchange rate of C\$28 per U.S. dollar for the remainder of export proceeds, imports of motor vehicles, and most invisible transactions. In addition, there were many implicit exchange rates resulting from the imposition of a 100 percent exchange tax on certain import payments and the mixing of exchange rates for various exports. Comprehensive licensing procedures have been required for all purchases of foreign exchange. An illegal black market has developed in which foreign exchange is sold at a large premium with respect to the official rates. As of end-1984, the value of the cordoba was reported to be about C\$300 per U.S. dollar in the black market.

II. Modification of the Exchange System

The modification of the exchange system announced on February 8, 1985 entails an effective depreciation of the cordoba, the elimination of mixing exchange rates for export proceeds, as well as the exchange

tax, and the introduction of new exchange rates, including a free exchange market for transactions either not included or not satisfied in the official markets. 1/ The new exchange system is as follows:

1. The existing official exchange rate of C\$10 per U.S. dollar will apply to interest and principal payments on external loans disbursed up to February 8, 1985. Debt service payments on external loans disbursed after February 8, 1985 will be settled at the exchange rates applicable to imports of goods and services (see below) for which the foreign loans will be used.

2. An exchange rate of C\$20 per U.S. dollar will apply to the provision of foreign exchange for imports of raw materials, spare parts, and certain essential consumer goods. 2/ Previously the applicable rate was C\$10 per U.S. dollar.

3. An exchange rate of C\$28 per U.S. dollar will be applicable to all export proceeds and to receipts from freight, insurance, port services, investment income, and expenditures by foreign embassies. It will apply to payments for imports of petroleum products 3/ and certain nonessential consumer goods, 2/ payments for other transport services, expenditures by Nicaraguan embassies and commercial offices abroad, payments for commissions, insurance, and expenses related to opening letters of credit and similar modes of payments. Previously, different mixed rates derived from a combination of C\$10 and C\$28 per U.S. dollar were used for exports of coffee, cotton, meat, sesame, and manufactured goods, while an exchange rate of C\$10 per U.S. dollar was applied to imports of petroleum products and one of C\$28 per U.S. dollar was applied to invisible transactions.

4. An exchange rate of C\$40 per U.S. dollar will be used for imports of many capital goods. 2/ Previously, the exchange rate for private motor vehicles was C\$28 per U.S. dollar and that of other capital goods was C\$15 per U.S. dollar.

5. An exchange rate of C\$50 per U.S. dollar will apply to exports of printed materials, international communication services, and foreign grants. On the payments side, this rate will be used for business and official travel, medical expenses, student expenditures abroad, foreign subscriptions, expenses for international communications, professional

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1/ This provision for the establishment of a free market has been approved, but has not yet been implemented.

2/ The lists of goods to which the particular rates apply were specified in Annexes to the attached resolution of the Central Bank of Nicaragua, but they have not yet been received by the Fund.

3/ The previous rate of C\$10 per U.S. dollar will apply for petroleum and petroleum products until further notice is issued to make the new rate effective.

fees for foreign experts, and transactions through foreign credit cards. Previously most of these transactions were settled at C\$28 per U.S. dollar.

6. The exchange rate that will be determined in the legal free exchange market to be established will be applied to receipts from tourism, private remittances, and other invisibles not subject to the fixed exchange rates. On the payments side, this rate will be applied to imports of all other goods and invisibles for which the fixed exchange rates will not apply, and the demand for foreign exchange that may not be satisfied in the official market.

On the basis of the trade-weighted shares of the various fixed rates just described, it is estimated that the above-mentioned changes entail an implicit devaluation of the cordoba of 45 percent on average (in foreign currency terms), partly offsetting the real effective appreciation that has occurred since 1979. Furthermore, the new system provides, to a limited extent, for market forces to play a role in determining the external value of the cordoba for certain transactions; the actual extent of this will depend on the implementation of the new market.

### III. Real Effective Exchange Rate--Information Notice

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 December 1984, the Nicaraguan cordoba had appreciated in real effective terms by more than 10 percent since the last occasion on which the Executive Board had had an opportunity to discuss Nicaragua's exchange rate policy in the context of the 1983 Article IV consultation in March 1984. The appreciation is estimated to have amounted to 43.6 percent. The appreciation in the real effective exchange rate of the Nicaraguan cordoba is largely attributable to the relatively high rates of domestic inflation. Over the period from March 1984 through December 1984, domestic inflation is estimated to have exceeded 50 percent on a seasonally adjusted annual basis. Over the same period, the nominal bilateral exchange rate was unchanged in terms of the U.S. dollar, while the nominal effective exchange rate rose by 8.8 percent.

### IV. Staff Appraisal

As discussed in the staff report for the 1984 Article IV consultation (SM/85/48), the Nicaraguan economy has been suffering from severe internal and external imbalances, including an overvaluation of the cordoba, that have been reflected in large overall balance of payments deficits and an accelerating domestic rate of inflation.

The new exchange system involves some simplification in that it represents a reduction in the number of rates as the mixing rates and the 100 percent exchange tax have been abolished, and it has resulted in an effective devaluation of the Nicaraguan cordoba. While the effective devaluation of the cordoba is a welcome development, the staff believes that the cordoba remains overvalued while the exchange system continues to be complex and restrictive. The newly announced floating exchange market should be effective in diverting exchange transactions from the illegal foreign exchange market if, as the staff understands, existing comprehensive licensing procedures for purchases of foreign exchange and their implementation in a restrictive manner will not apply to the new market.

The staff urges the Nicaraguan authorities to take early steps to adopt a unified and liberal exchange system; further significant adjustments in the exchange rate, accompanied by restrained demand management policies, will be needed to achieve an improvement in Nicaragua's balance of payments position and to permit settlement of the external payments arrears. The staff is of the view that further liberalization of the exchange system, including realistic and flexible exchange rate arrangements, will also be an important factor in assisting Nicaragua in discharging its overdue financial obligations to the Fund.

The Board of Directors of the Central Bank of Nicaragua, at its Session No. 107 on Friday, February 8, 1985, adopted a resolution worded as follows:

CD-BCN-CVII-1-85

FOREIGN EXCHANGE RULES

CHAPTER I

Legal Parity

Article 1. The legal parity of the cordoba vis-à-vis the United States dollar is hereby set at C\$28.00 per US\$1.00 (C\$28.00 = US\$1.00).

CHAPTER II

Exchange Rates for the Purchase and Sale of Foreign Exchange

Article 2. The following exchange rates for the cordoba against the United States dollar are hereby established:

A. PURCHASE

- (a) Foreign exchange proceeds of visible exports: C\$28.00 x US\$1.00
- (b) Foreign exchange generated by invisible exports, as follows:

1. Services

1.1 Freight charges. To be converted at the exchange rate of C\$28.00 x US\$1.00

1.2 Insurance and reinsurance. To be converted at C\$28.00 x US\$1.00, including:

- (i) insurance of goods
- (ii) premiums received by insurance companies for insurance and surety bonding
- (iii) premiums received by insurance companies for reinsurance and surety rebonding

- (iv) indemnification or compensation received from foreign insurance companies for losses covered by insurance or bonding
- (v) indemnification or compensation received from foreign companies for losses covered by reinsurance or rebonding
- (vi) other foreign exchange received by insurance companies for services relevant to their line of business

1.3 Communications. Foreign exchange received for services provided by radiotelegraph, postal, and similar communications companies, including foreign exchange received in transactions relating to such companies, shall be converted at C\$50.00 x US\$1.00.

1.4 Funds received by ports. The foreign exchange income of government institutions and private companies established in Nicaragua for port services such as the provision of fuel or food and port or airport fees for transportation companies shall be converted at the exchange rate of C\$28.00 x US\$1.00.

1.5 Return on investments. All foreign exchange income of individuals and institutions resident in Nicaragua from investments abroad shall be converted at C\$28.00 x US\$1.00, including:

- (i) profits
- (ii) dividends

(iii) miscellaneous interest

- 1.6 Consular income. Embassies, consulates, international missions, and representative offices of international organizations and institutions accredited in Nicaragua shall convert all foreign exchange they receive to meet their operating expenses at the exchange rate of C\$28.00 x US\$1.00.
- 1.7 Subscriptions. The foreign exchange income of companies resident in Nicaragua from newspaper, magazine, and similar subscriptions shall be converted at the exchange rate of C\$50.00 x US\$1.00.

Article 3. Foreign exchange proceeds of gifts and grants, as follows:

1. Cash gifts and grants. To be converted at C\$50.00 x US\$1.00; proof that the gift has been registered at the General Directorate of External Debt of the Central Bank, as stipulated in the Regulations Implementing Decree No. 838, is required.
2. Gifts in kind. To be converted at the exchange rate applicable to the import received, in accordance with the list in Article 4 of these Rules on imported goods.

B. SALE

Article 4. The exchange rates at which the foreign exchange required to pay for visible imports shall be sold shall depend on the category of the goods, as follows:



- (a) Essential consumer goods, C\$20.00 x US\$1.00 (in accordance with attached list A)
- (b) Nonessential consumer goods, C\$28.00 x US\$1.00 (in accordance with attached list B)
- (c) Raw materials and spare parts, C\$20.00 x US\$1.00 (in accordance with attached list D)
- (d) Petroleum and petroleum products, including fuel and lubricants, C\$28.00 x US\$1.00 (in accordance with attached list C)
- (e) Capital goods, C\$40.00 x US\$1.00 (in accordance with attached list E)

Article 5. The exchange rates for foreign exchange to be paid for invisible imports shall be as follows:

1. Services

- 1.1 Freight charges. The same exchange rate applicable to the imported good pursuant to Article 4 of these Rules
- 1.2 Travel. All foreign exchange paid out for official or business travel allowances shall be converted at the exchange rate of C\$50.00 x US\$1.00.
- 1.3 Students. To be converted at the exchange rate of C\$50.00 x US\$1.00. Includes the foreign exchange to cover living expenses, tuition, graduation expenses, books, insurance expenses, and moving and settlement costs for Nicaraguan students abroad.

- 1.4 Health. To be converted at the exchange rate of C\$50.00 x US\$1.00. Includes all foreign exchange which Nicaraguans must spend abroad for hospitalization, medical, and similar expenses.
- 1.5 Other transportation expenses. To be converted at the exchange rate of C\$28.00 x US\$1.00; includes all foreign exchange which Nicaraguan transportation companies must spend abroad for wharfage, cabotage, port services, etc.
- 1.6 Diplomatic payroll and other embassy expenses. To be converted at the exchange rate of C\$28.00 x US\$1.00; includes foreign exchange disbursements for the wages and salaries of diplomatic personnel abroad, diplomatic pouches, rentals, and other expenses of Nicaraguan embassies and consulates abroad.
- 1.7 Commercial office expenses. To be converted at the exchange rate of C\$28.00 x US\$1.00, and includes disbursements of foreign exchange for the maintenance of Nicaraguan commercial offices abroad.

- 1.8 Expenses for negotiation of letters of credit and payments for banking services. To be converted at the exchange rate of C\$28.00 x US\$1.00, and includes all disbursements of foreign exchange to cover the processing and negotiation of the opening and acceptance of letters of credit and banking commissions paid to correspondent banks abroad.
- 1.9 Subscriptions. To be converted at the exchange rate of C\$50.00 x US\$1.00, and includes subscriptions to foreign newspapers, magazines, and specialized technical publications.
- 1.10 Commissions. To be converted at the exchange rate of C\$28.00 x US\$1.00.
- 1.11 Reimbursements. To be converted at the exchange rate applicable to the imported good or service.
- 1.12 Essential expenses. To be converted at the exchange rate of C\$28.00 x US\$1.00.
- 1.13 Communication expenses. To be converted at the exchange rate of C\$50.00 x US\$1.00, and includes foreign exchange paid for international communications services.
- 1.14 Membership fees. To be converted at the exchange rate of C\$50.00 x US\$1.00, and includes foreign exchange disbursements for membership fees in international or regional organizations and institutions.

- 1.15 Professional fees. To be converted at the exchange rate of C\$50.00 x US\$1.00, and includes the payment of salaries and fees to foreign technicians and specialists.
- 1.16 Reinsurance payments. To be converted at the exchange rate of C\$28.00 x US\$1.00, and includes foreign exchange paid to foreign companies for reinsurance premiums and compensation paid by INISER for insurance taken out in dollars.
- 1.17 Credit cards. To be converted at the exchange rate of C\$50.00 x US\$1.00, and includes all payments for the use of international credit cards authorized by the Central Bank of Nicaragua.

C. EXTERNAL DEBT

Article 6. The exchange rate for contracted and disbursed foreign loans shall be, for recording purposes and for repayment of the loans and payment of the interest and charges and commissions on them, C\$10.00 x US\$1.00.

Article 7. The exchange rate for contracted but still undisbursed foreign loans and for foreign loans to be contracted in the future shall be, for recording purposes and for repayment of the loans and payment of the interest and charges and commissions on them, equal to the exchange rate applicable to the goods or services imported with the loaned funds.

Article 8. The exchange risk shall be assumed in accordance with the provisions of the foreign credit contracts concluded or to be concluded.

CHAPTER III

The Free Foreign Exchange Market

Article 9. All transactions not specified in the foregoing articles and attachments shall take place in the free foreign exchange market through exchange offices authorized as agents of the Central Bank at an exchange rate determined by the law of supply and demand. The exchange offices shall operate in accordance with the regulations to be issued by this Board of Directors.

CHAPTER IV

Miscellaneous

Article 10. The attachments referred to in this Resolution shall be published together with it and shall be deemed integral parts of it.

Article 11. The C\$28.00 x US\$1.00 exchange rate for petroleum and petroleum products specified in Article 4(d) of this Resolution shall not take effect until further notice. In the interim, pending a decision on the entry of that exchange rate into force, the previously applicable exchange rate, amended by this Resolution, shall be applied to these products.

Article 12. This Resolution has been adopted following agreement with the Executive Branch and shall take effect through its publication in any mass communications media.

Table. Nicaragua: Real Effective Exchange Rate and Related Series

(Indexes: 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)
<u>Quarterly</u>						
1979						
I	89.7	138.5	64.7	143.0	54.0	52.2
II	81.0	100.0	81.3	101.7	69.9	71.9
III	92.1	97.2	94.8	99.5	84.1	86.4
IV	92.2	97.8	94.2	99.5	86.5	85.2
1980						
I	97.1	99.3	97.9	100.0	93.4	89.9
II	99.1	99.9	99.2	100.0	97.9	100.4
III	98.4	99.4	99.0	100.0	100.1	103.1
IV	105.3	101.4	103.9	100.0	108.5	106.6
1981						
I	112.6	104.3	108.0	100.0	116.4	111.8
II	115.7	108.1	107.1	100.0	118.5	121.5
III	123.1	111.2	110.7	100.0	126.3	130.3
IV	126.4	109.8	115.1	100.0	134.5	131.9
1982						
I	112.3	93.0	120.8	82.8	143.7	138.1
II	121.3	94.7	128.1	82.8	155.5	159.5
III	121.5	97.2	125.0	82.8	155.3	160.7
IV	127.7	98.6	129.6	82.8	163.3	160.0
1983						
I	127.8	92.6	138.1	77.6	176.6	169.7
II	141.8	94.9	149.4	77.6	194.7	199.5
III	158.4	97.4	162.6	77.6	216.2	223.8
IV	161.2	98.9	163.0	77.6	221.9	217.4
1984						
I	143.7	85.2	168.6	66.0	235.2	226.1
II	150.5	86.3	174.5	66.0	248.0	254.0
III	178.5	89.2	200.1	66.0	289.3	299.0
IV	199.8	91.4	218.6	66.0	323.0	316.2 <u>4/</u>
<u>Monthly</u>						
March <u>3/</u>	143.5	84.7	169.5	66.0	238.2	228.8
April	145.1	85.3	170.1	66.0	240.5	236.0
May	150.1	86.6	173.4	66.0	246.4	253.3
June	156.4	86.9	180.0	66.0	256.9	272.7
July	164.7	88.4	186.4	66.0	267.6	289.8
August	184.7	88.9	207.7	66.0	300.3	307.3
Sept.	186.2	90.4	206.1	66.0	300.2	299.8
Oct.	194.7	91.2	213.6	66.0	313.4	310.6
Nov.	198.5	90.9	218.5	66.0	322.7	315.8 <u>4/</u>
Dec.	206.2	92.1	223.8	66.0	332.9	322.3 <u>4/</u>
<u>Percentage change</u>						
March 1984-						
Dec. 1984	43.6	8.8	32.0	0	39.7	

Source: Information Notice System.

1/ Increases mean appreciation.

2/ Using seasonally adjusted consumer price indexes.

3/ Date of latest consideration by Executive Board.

4/ Staff estimates.

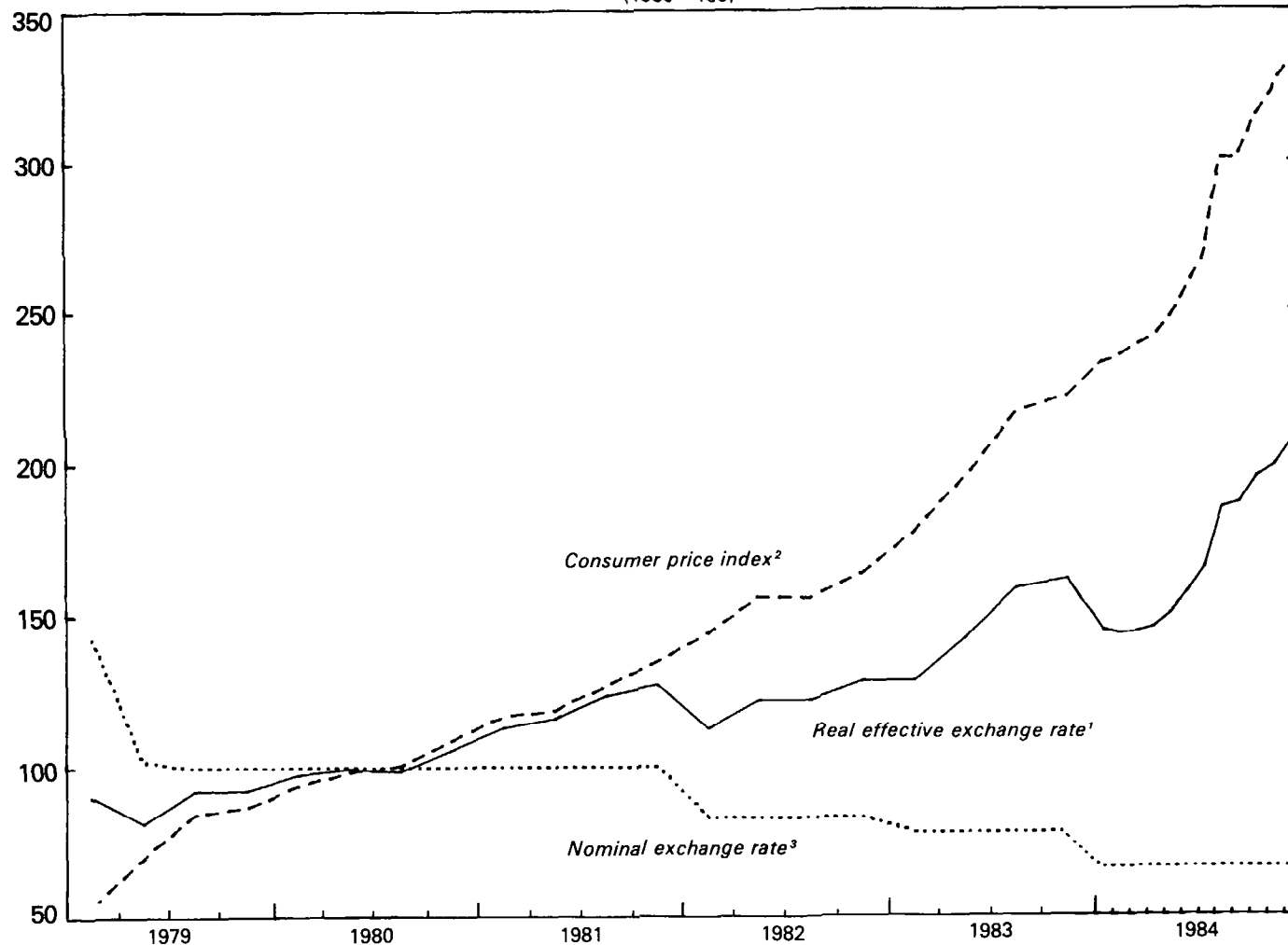
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CHART  
NICARAGUA  
REAL EFFECTIVE EXCHANGE RATE  
AND RELATED SERIES  
(1980 = 100)



Source: Information Notice System.

<sup>1</sup>Trade weighted index of nominal exchange rate deflated by seasonally adjusted consumer prices; increase means appreciation.

<sup>2</sup>Seasonally adjusted.

<sup>3</sup>U.S. dollars per Nicaragua cordoba (index).



