EBS/85/166

CONFIDENTIAL

July 9, 1985

To: Members of the Executive Board

From: The Secretary

Subject: El Salvador - Exchange System and Real Effective Exchange Rate Information Notice

There is attached for the information of the Executive Directors a paper on recent changes in the exchange system of El Salvador and on the real effective exchange rate of the Salvadoran colón.

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

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

EL SALVADOR

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 Legal and Research departments)

Approved by E. Wiesner and Manuel Guitián

July 8, 1985

In the attached document the authorities of El Salvador have informed the Fund that, with effect from June 17, 1985, El Salvador has introduced certain changes in its exchange system. In addition to reviewing these changes, this paper describes developments in El Salvador's real effective exchange rate under the Fund's information notice system.

I. Background

Since December 1981, El Salvador has had a multiple exchange rate system, comprising an official market in which the Salvadoran colón is pegged to the U.S. dollar at an exchange rate of C 2.50 = US$1, and a parallel market for authorized transactions and participants in which the exchange rate is, in principle, determined by market forces. The limited number of participants, (essentially banks) in this market has, however, resulted in the setting of rates that have not cleared the exchange market. 1/ In addition, there have been implicit exchange rates resulting from the mixing of the official and parallel market rates for certain exports, and import payments. There is a further, informal exchange market which handles transactions not eligible for the other exchange markets because of restrictions or administrative rationing. The value of the colón in the latter market fluctuates according to market forces and was about C 5.00 = US$1 in mid-May 1985.

As a result of a gradual shift of transactions from the official to the parallel market, the value of El Salvador's trade transactions in the parallel market rose from an estimated 7 percent of exports and 18 percent of imports at the end of 1982 to about 15 percent of exports

1/ The value of the colón in the parallel exchange market, which was about C 4.00 per US$1 at the end of December 1984, stood at C 4.08 per US$1 in mid-May 1985.

and 26 percent of imports by November 1984. In December 1984, the Salvadoran authorities made a further substantial shift of transactions from the official to the parallel exchange market which included: (a) 50 percent of receipts from nontraditional exports to Central America (except medicines, fertilizers, and insecticides and their inputs) and 30 percent of receipts from exports of medicines to Central America; 1/ (b) 100 percent of payments for imports of a number of consumer and investment goods; (c) 80 percent of payments for imports of several intermediate goods; and (d) 100 percent of payments for those services related to import transactions effected in the parallel exchange market. As a result of these changes, the staff estimates that the share of trade transactions in the parallel market rose to about 30 percent of exports and 40 percent of imports.

II. Real Effective Exchange Rate--Information Notice

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. 2/ Based on this index, as of April 1985, the Salvadoran colón has 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--during the Article IV consultation in December 1984. 3/ The appreciation is estimated to have amounted to 12.9 percent.

The colón depreciated in nominal effective terms between the middle of 1982 and the end of 1984, reflecting mainly the expansion in the scope of the parallel market; the exchange rate for the U.S. dollar in the official market remained unchanged. Nevertheless, the higher rate of inflation in El Salvador than in its trading partners resulted in a significant real effective appreciation of the colón over this period, raising the cumulative real appreciation since the end of 1980 to 32 percent. El Salvador's balance of payments has been weak since 1980, with an external current account (excluding official grants) in the range of 6 to 7 percent of GDP during the last four years.

Despite a small depreciation of the colón in the parallel market during the first four months of 1985 the effective depreciation of the

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1/ On March 1, 1985, the proportion of receipts from exports to the rest of Central America to be surrendered in the parallel exchange market was raised to 70 percent.

2/ The exchange rate used for the purposes of the information notice system is a composite rate, representing a weighted average of rates in the official and parallel markets.

3/ SM/84/246 and SM/84/247.

Guatemalan quetzal 1/ resulted in a nominal effective appreciation of the colón during this period. Inflation in El Salvador also continued to be higher than that of its trading partners. Reflecting these developments, the colón appreciated in real effective terms by 18 percent during the 12-month period ended April 1985 and the cumulative real appreciation since the end of 1980 rose to nearly 50 percent.

III. Modification of the Exchange System

The modification of the exchange system introduced on June 17, 1985 entails an effective depreciation of the colón resulting from the further transfer of transactions from the official to the parallel market, and the elimination of a number of implicit exchange rates resulting from mixing arrangements. 2/ In addition, the authorities have announced that the exchange rate in the parallel exchange market will reflect market forces, by a linking of exchange rate quotations in that market with the rates quoted in the informal market. Accordingly, the new regulations stipulate that the spread between the exchange rate in the parallel market (quoted by banks) and the rate in the informal market (referred to as the "national" market) should not differ by more than 20 percent.

As a result of the changes introduced on June 17, 1985 the parallel market now covers the majority of external transactions. On the receipts side it applies to:

(a) Coffee exports up to a maximum of US$90 million, and sugar exports to the U.S. quota market up to US$17.5 million for the crop year 1984/85;

(b) 100 percent of nontraditional exports outside the Central American region (the mixing of rates for such exports is thus eliminated);

(c) 100 percent of exports of shrimp and lobsters (previously 80 percent);

(d) 100 percent of exports to the Central American region (previously 70 percent) with the exception of exports of fertilizers, fungicides, insecticides, herbicides, medicines, and goods whose imported inputs are paid for through the official market;

1/ Trade with Guatemala in 1980, the base year for the weights used in El Salvador's effective exchange rate index, represented 26 percent of El Salvador's total trade transactions in that year.

2/ Monetary Board Resolution adopted at Meeting No. JM-11/85, June 12, 1985 (excerpts attached).

(e) 100 percent of receipts from exports of transportation, travel, insurance and reinsurance, investment income, government services, and other miscellaneous services with the exception of receipts for services rendered by Salvadorian embassies and consulates abroad, and interest income received by the public sector and the banking system;

(f) transfers and donations, except those received by the public sector and the banking system;

(g) the undisbursed balance of foreign loans totalling US$31.3 million for the Industrial Recovery Fund; and

(h) private capital inflows for direct and indirect investment, repatriation of capital registered beginning February 19, 1983, and loans registered beginning June 17, 1985.

In addition to the proceeds from the bulk of coffee and sugar exports, the official market handles all inflows of foreign loans to the public sector and the banking system.

On the payments side, the parallel market now includes:

(a) all imports (CIF) of intermediate goods;

(b) payments for imports of transportation, travel, investment income, insurance and reinsurance, government services, and other miscellaneous services with the exception of those assigned for the official market (see below);

(c) transfers and donations, except those made by the public sector and the banking system;

(d) private capital outflows of direct and indirect investment, repatriation of capital registered beginning February 19, 1983, and amortization of foreign debt registered beginning June 17, 1985;

The official exchange market applies to payments for imports (CIF) of medicines, certain agricultural inputs (fertilizers, fungicides, herbicides and insecticides); and certain food items when imported directly by producers or certain designated public entities. The official exchange market also applies to import payments for fuel (crude oil, gasoline, and LPG); medical-surgical equipment, and capital goods (listed in Resolution No. JM-III/21/84); and to payments for official travel; certain student expenses up to December 1985 for those authorized prior to November 30, 1981; public sector scholarships registered prior to June 17, 1985; remittances of profits and dividends authorized by Resolution No. JM-VIII/16/83 of October 26, 1983; interest payments by the private sector on loans registered before June 17, 1985; commissions and royalties accrued before 1982; interest payments of the public sector and the banking system; expenditures of Salvadoran Embassies and Consulates and other government expenditures; reinsurance payments valid up to December 1984; and outflows of public sector capital or that of the banking system.

According to the preliminary estimate made by the Central Reserve Bank of El Salvador, the parallel market now accounts for about 50 percent of exports and 63 percent of imports.

Staff Appraisal

At the conclusion of the 1984 Article IV consultation on December 5, 1984, Directors were of the view that action to widen the scope of the parallel market needed to be accelerated. They also noted that the exchange system had become exceedingly complex and urged the authorities to move more forcefully toward a reunification of the exchange rate. The steps that have been taken in transferring transactions to the more depreciated parallel market rate and in allowing market forces to play some role in determining the exchange rate in the parallel market, are in the right direction. However, the staff believes that the process towards unification should be accelerated in order to establish an exchange rate that fully reflects market forces.

During the forthcoming 1985 Article IV consultation discussions, the staff will accordingly urge the authorities to take further steps to increase the flexibility of exchange rate management with a view to establishing a unified exchange system without reliance on restrictions. In the meantime, no action by the Executive Board is proposed.

Attachments

INTERFUND,
WASHINGTON, D.C.

June 24, 1985

THE MONETARY AUTHORITIES OF EL SALVADOR IN ACCORDANCE WITH STABILIZATION AND ECONOMIC REACTIVATION PROGRAM CONTINUING ADJUSTMENT PROCESS THROUGH TRANSFER FROM OFFICIAL MARKET TO PARALLEL MARKET IN ORDER TO ARRIVE AT 60 PERCENT OF FOREIGN EXCHANGE REVENUE FROM EXPORTS AND 60 PERCENT OF OUTLAYS FOR IMPORTS, ADOPTING PRIORITIES FOR FOREIGN EXCHANGE ALLOCATION BASED ON EXTENT OF NEED, DOMESTIC PRODUCTION AND SUBSTITUTABILITY OF GOODS AND SERVICES.

THE MAIN EXCHANGE MEASURES REGARDING EXCHANGE INFLOWS WERE: AUTHORIZATIONS TO INCAFE AND INAZUCAR TO SELL IN THE PARALLEL MARKET EXCHANGE PROCEEDS OF COFFEE AND SUGAR EXPORTS UP TO US$90 MILLION AND US$17.5 MILLION, RESPECTIVELY AND 100 PERCENT EXCHANGE PROCEEDS OF EXPORTS OF PRAWN AND NONTRADITIONAL PRODUCTS, EXCEPT GOODS WHOSE IMPORTED INPUTS ARE PAID FOR 100 PERCENT THROUGH THE OFFICIAL MARKET.

TRANSFER OF 100 PERCENT OF FOREIGN EXCHANGE PROCEEDS OF EXPORTS OF TRANSPORTATION, TRAVEL, INVESTMENT, INSURANCE, REINSURANCE AND MISCELLANEOUS SERVICES AND PRIVATE CAPITAL INFLOWS FOR DIRECT AND INDIRECT INVESTMENT, REPATRIATIONS AND LOANS. MEASURES RESPECTING FOREIGN EXCHANGE OUTLAYS: TRANSFER TO PARALLEL MARKET OF 100 PERCENT OF PAYMENTS FOR TRANSPORTATION, TRAVEL, INVESTMENT, INSURANCE, REINSURANCE

AND MISCELLANEOUS SERVICES, PRIVATE TRANSFERS AND GIFTS, PRIVATE CAPITAL OUTFLOWS FOR DIRECT AND INDIRECT INVESTMENT, REPATRIATIONS, REPAYMENTS OF LOANS RECORDED AFTER THESE MEASURES GO INTO EFFECT. ALSO 100 PERCENT OF PAYMENTS FOR IMPORTS OF INTERMEDIATES C.I.F.

REGARDS

CHOUSSY

SECOND VICE-PRESIDENT, BACEN

Received in Cable Room June 24, 1985

Table. El Salvador: Real Effective Exchange Rate and Related Series

(Indexes: 1980 = 100)

	Real Effective Exchange Rate 1/ 2/	Nominal Effective Exchange Rate 1/	Relative Consumer Prices (Local Currencies) 2/	Exchange Rate in terms of U.S. Dollars 1/	Consumer Price Index (Seasonally Adjusted)	Consumer Price Index (Not Seasonally Adjusted)
Quarterly						
1979						
I	95.4	99.6	95.8	100.0	81.7	81.0
II	95.6	100.3	95.3	100.0	83.2	83.5
III	95.2	99.6	95.6	100.0	86.1	86.6
IV	96.1	99.7	96.4	100.0	89.9	89.7
1980						
I	96.7	99.9	96.7	100.0	93.0	92.4
II	99.9	100.1	99.8	100.0	98.6	98.9
III	101.0	99.5	101.6	100.0	102.6	103.1
IV	102.4	100.6	101.8	100.0	105.8	105.6
1981						
I	109.0	106.8	102.1	100.0	110.3	109.7
II	112.9	111.2	101.6	100.0	113.5	113.9
III	114.5	113.2	101.2	100.0	116.4	116.9
IV	116.5	116.8	99.8	100.0	118.9	118.7
1982						
I	117.9	118.5	99.5	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	118.0	114.7	102.9	93.3	134.3	134.1
1983						
I	117.4	112.3	104.6	92.0	137.6	137.2
II	118.2	112.8	104.8	91.6	140.5	140.8
III	123.5	114.5	108.1	91.6	148.5	148.9
IV	129.0	115.2	111.9	91.6	154.7	154.5
1984						
I	128.0	112.9	113.4	89.3	158.2	157.8
II	129.3	113.0	114.5	89.2	161.3	161.5
III	132.5	115.1	115.2	89.0	163.2	163.5
IV	134.9	116.7	115.6	87.1	168.1	167.9
1985						
I	142.5	117.2	121.5	83.1	179.1	178.7
Monthly						
1984						
Dec. 3/	134.1	114.7	116.9	83.3	171.3	171.1
1985						
Jan.	137.5	115.5	119.1	83.3	174.8	174.4
Feb.	142.6	117.1	121.8	83.1	179.4	178.3
March	145.4	117.6	123.7	82.0	183.2	183.3
April	151.4	120.9	125.3	82.0	186.4	186.5
Percentage change						
Dec. 1984-April 1985	12.9	5.4	7.2	-1.6	8.9	...

Source: Information Notice System.

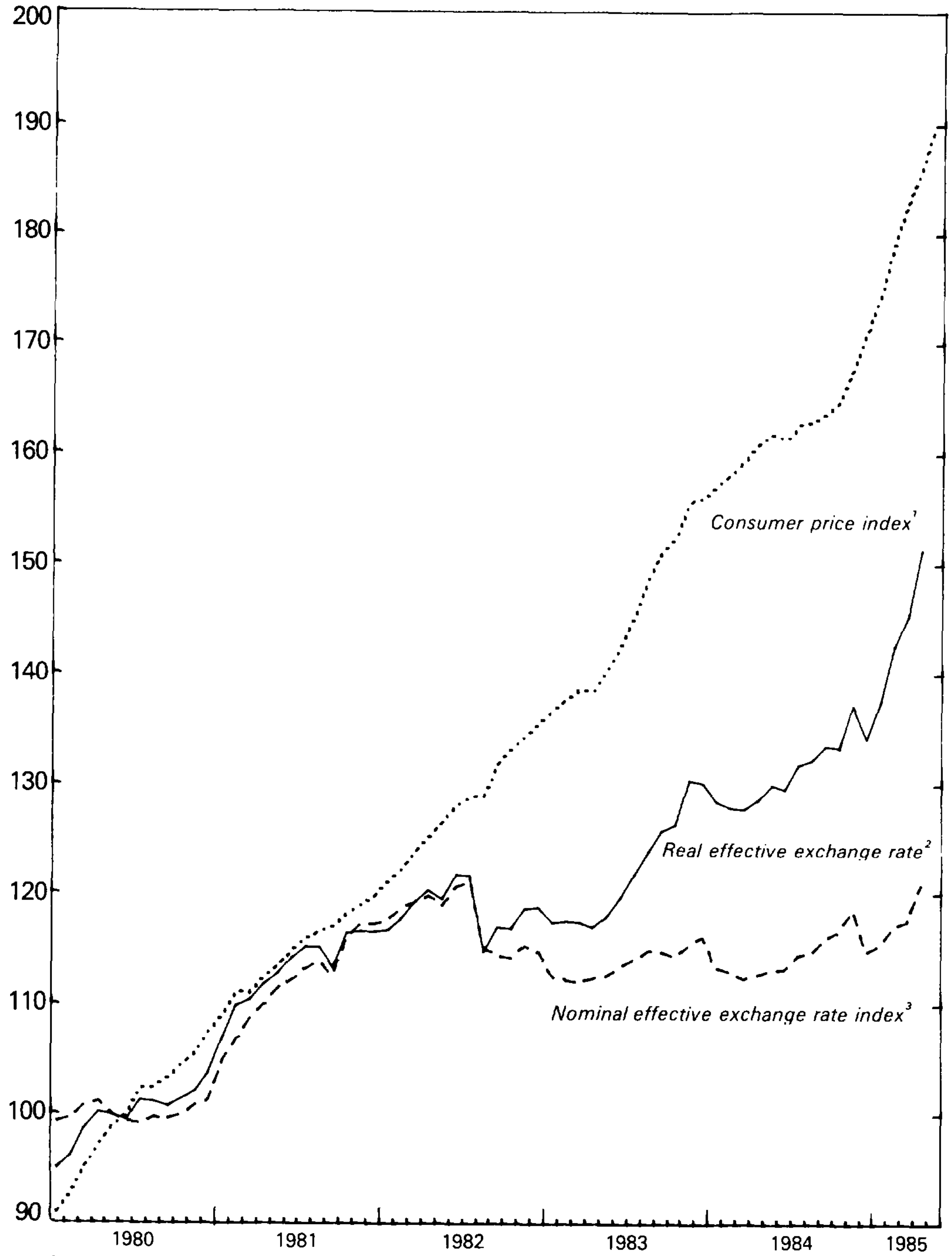
1/ Increase means appreciation.
2/ Using seasonally adjusted consumer price indexes.
3/ Date of latest consideration by the Executive Board.

CHART

EL SALVADOR

INFORMATION NOTICE SYSTEM INDEX OF REAL EFFECTIVE EXCHANGE RATE

(1980 = 100)



[1]Seasonally adjusted.

[2]Trade weighted index of nominal exchange rates deflated by seasonally adjusted consumer prices. increase indicates real appreciation

[3]Trade weighted index of nominal exchange rates.

ATTACHMENT IV

El Salvador: Excerpts from the Monetary Board Resolution Adopted at its Session No. JM-11/85 of June 12, 1985

The Monetary Board hereby resolves to adopt the following measures:

I. Exchange Measures

Receipts

1. To authorize the National Coffee Institute (INCAFE) to sell in the parallel foreign exchange market up to US$90 million of its proceeds from coffee exports, to both traditional and nontraditional markets, in accordance with needs to be determined jointly by the Central Reserve Bank and INCAFE in compliance with Resolution No. JM-7/85 of May 2, 1985.

2. To authorize the National Sugar Institute (INAZUCAR) to sell in the parallel market up to US$17.5 million of the proceeds from sugar exports from the 1984/85 harvest that are subject to quota.

3. To authorize the sale in the parallel market of 100 percent of the foreign exchange proceeds from exports of shrimp and prawns. This provision shall apply to exports carried out on or after June 17, 1985.

4. To authorize the sale in the parallel market of 100 percent of the foreign exchange proceeds from exports of nontraditional products dispatched from El Salvador to countries outside the Central American region on or after June 17, 1985.

5. To authorize the sale in the parallel market of 100 percent of the foreign exchange proceeds from exports dispatched from El Salvador to the Central American region on or after June 17, 1985. Excluded from this authorization are the foreign exchange proceeds from exports of fertilizers, fungicides, insecticides, herbicides, medicines and other goods involving imported inputs that are payable 100 percent through the official market, which must be sold in the latter market.

Before a foreign exchange sale is carried out, it is obligatory to present the corresponding export registration certificate.

6. To transfer to the parallel market 100 percent of the proceeds from all services involving transportation, international travel, international investment, government services, insurance, reinsurance and other service exports, with the exception of the following, which must be converted in the official market:

(a) Remittances received by the Government for services rendered by embassies and consulates accredited abroad; and

(b) Interest received by the public sector and the banking sector.

The date from which services receipts may be sold in the parallel market shall be the same as the date on which the corresponding expenditures are transferred to that market.

7. Transfers and grants shall be settled through the parallel market, with the exception of those received by the Central Government, autonomous official agencies and municipalities, which shall be sold through the official market.

8. The undrawn balances of the Industrial Recovery Fund, amounting to US$31.3 million, shall be transferred to the parallel market.

9. Refunds and surpluses in respect of goods and services shall be sold through the same exchange market as was the case for the corresponding payment.

10. Inflows of official and bank capital shall continue to be channeled through the official market; and

11. All private capital inflows shall be transferred to the parallel market:

(a) Direct and indirect international investment;

(b) Inflows pertaining to repatriated investments registered on or after February 19, 1983 in accordance with the provisions of Resolution No. JM-I/6/84 of April 11, 1984.

(c) Inflows from loans registered on or after June 17, 1985;

(d) Inflows of other foreign assets and liabilities registered on or after June 17, 1985.

Payments

1. The following payments shall remain in the official market:

(a) Medicines and raw materials used in their production;

(b) Fertilizers, fungicides, insecticides, herbicides and the raw materials used in their manufacture;

(c) Raw materials used for the production of edible oils and fats;

(d) Wheat and other raw materials used for the production of bakery goods;

(e) Animal fat for industrial use.

The goods listed above may be imported using foreign exchange from the official market for 100 percent of their value provided that the import operation is carried out directly by the producers and is solely for use in production or when the goods are imported by public sector agencies designated by the Government. Furthermore, when the Foreign Exchange Control Department so requires, the industrialist concerned must prove that there is no domestic production of the items or that existing stocks are inadequate.

2. To maintain in the official market the payment of 100 percent of the c.i.f. value of imported crude oil, gasoline and liquified petroleum gas (LPG), as well as medical and surgical instruments, whenever these goods are imported by public sector entities. In the case of gasoline and medical and surgical supplies, the importer must prove that the item in question is not produced domestically or that existing stocks are inadequate.

3. To maintain in the official foreign exchange market 100 percent of payments for capital goods under Resolution No. JM-III/21/84 that appear on the revised list of imported goods 100 percent of whose value is to be paid through the official market.

4. The following services shall continue to be paid for through the official market:

(a) Freight and insurance on goods which may be imported and paid for with foreign exchange from the official market;

(b) Travel expenses of official missions, within the ceilings established by the Monetary Board and the relevant decision;

(c) Expenses of university students who, as of November 30, 1981, were registered with the Exchange Control Department. This authorization shall remain in force until December 31, 1985;

(d) The expenses of holders of scholarships from the public sector whose awards were approved at June 17, 1985;

(e) Remittances of profits and dividends referred to in Resolution No. JM-VIII/16/83 of October 26, 1983;

(f) Private sector interest payments, when they correspond to foreign loans registered by June 17, 1985;

(g) Payments of commissions, royalties and expenses of head offices or of foreign branches or agencies which were incurred prior to 1982 (Resolution No. JM-XIV/1/83);

(h) Interest payments on the external debt of the public sector and the banking sector;

(i) Payments and per diems remitted by the Government to the diplomatic and consular corps accredited to foreign countries;

(j) Transactions with international and intergovernmental institutions and other government transactions (contributions to organizations such as the OAS, SIECA, etc.) and expenses of technical, cultural and military missions abroad, funded by the General Budget of the Nation or by the Special Budgets of autonomous official agencies or municipalities;

(k) Payments for reinsurance to cover risks through December 31, 1984 (Resolution No. JM-III/21/84).

One hundred percent of the payments for services involving international transportation, international travel, international investment, government services, insurance, reinsurance and miscellaneous services are transferred to the parallel market.

5. All transfers and grants shall be made through the parallel market with the exception of those made by the Government, autonomous government agencies and municipalities, which shall be processed through the official foreign exchange market.

6. Refunds or surpluses pertaining to goods and services shall be paid out through the same foreign exchange market through which payments were received in the country.

7. Outflows of official and bank capital shall remain in the official market.

8. All private capital outflows are transferred to the parallel market:

(a) Direct and indirect international investment.

(b) Payments to repatriate investments registered on or after February 19, 1983, in accordance with Resolution No. JM-XVII/12/83 of August 16, 1983.

(c) Repayments of loans registered on or after June 17, 1985. Repayments of the loans registered prior to that date shall remain in the official market.

(d) Outflows of other foreign assets and liabilities registered on or after June 17, 1985. Those registered prior to that date shall remain in the official market.

9. One hundred percent of the c.i.f. value of imports of intermediate goods clearing customs on or after June 17, 1985 and originating anywhere in the world is transferred to the parallel market.

10. Public sector institutions, banking sector institutions, the National Housing Bank and savings and loan associations must pay through the parallel market for imports of goods and services that have been transferred to that market, provided there is no indication to the contrary, in accordance with the provisions of Resolution No. JM-XI/10/85 of June 5, 1985.

11. The Office of the President of the Central Reserve Bank is empowered to draw up, in accordance with the NAUCA coding, the list of goods and services which must be paid for with foreign exchange from the

official market. It may also revise and update General List G of goods and services for which foreign exchange will be allocated only when the demands for more essential goods and services have been met. It is further authorized to issue the instructions necessary to resolve technical and operational problems that may arise in the implementation and administration of the above measures.

12. Any resolution, provision or instruction contrary to this resolution shall be null and void.

II. Control Measures and Other Complementary Measures Pertaining to Exchange Rates

1. To recommend to the Executive and the Judiciary, and submit to the Legislative Assembly, draft amendments to the Penal Code incorporating the following: persons falsifying documents for the specific purpose of obtaining authorization to purchase foreign exchange at the Central Reserve Bank of El Salvador or any other institution authorized to sell foreign exchange shall be punished by imprisonment for a period of one to eight years.

Persons submitting applications, documentation or any other type of certifications containing false data with a view to obtaining foreign exchange from the Central Reserve Bank of El Salvador or other institutions legally authorized to sell foreign exchange shall be punished by imprisonment for a period of six months to five years, even if the attempt is unsuccessful.

2. To stipulate that courier services must declare at customs the value of outward shipments of domestic or foreign currency (cash, checks, drafts, etc.) and present the corresponding authorization from the

Exchange Control Department of the Central Reserve Bank for the international transfer.

3. To determine whether the parallel market exchange rate being used by authorized banks is the rate resulting from the interplay of supply and demand for foreign exchange. The value of the colón in the parallel market must fluctuate within a band of roughly 20 percent of the effective exchange rate in the national market.

4. To stipulate that the differential between the buying and selling rates for foreign exchange offered by the banking system in the parallel market shall not exceed C 0.05 per US$1.

5. To instruct domestic banks to make arrangements for purchasing foreign exchange abroad by not later than December 31, 1985. Insofar as this measure is successfully implemented, member banks of the system shall be prohibited from contracting personal services for purchasing drafts abroad. The banking authorities of the United States will also be requested not to authorize this type of office for individuals.

6. To recommend that the Office of the President of the Central Reserve Bank examine the legal steps required for prosecution, under the laws already in force, of persons who traffic in foreign exchange (Law Controlling International Transfers, LICOA, Monetary System Law, Law on Sealed Paper and Stamp Duties, etc.).