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February 27, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Argentina - Real Effective Exchange Rate - Information Notice and Modification of Exchange System

Attached for the information of the Executive Directors is an information notice on the real effective exchange rate of the Argentine austral and the modification of its exchange system.

Mr. Acquah (ext. 8661) or Mr. Lachman (ext. 8648) is available to answer technical or factual questions relating to this paper.

Att: (1)

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INTERNATIONAL MONETARY FUND

ARGENTINA

Real Effective Exchange Rate - Information Notice and Modification of Exchange System

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 S.T. Beza and Eduard Brau

February 27, 1989

This paper describes recent developments in Argentina's real effective exchange rate under the information notice system, as well as changes introduced to the exchange system in February 1989.

I. Real Effective Exchange Rate Developments

Recent movements in the real effective value of the Argentine austral, as measured by the standard index developed for the information notice system, are set out in Table 1 and Chart 1. Based on this index, as of December 1988 the austral had appreciated by more than 10 percent since the last occasion on which Argentina's exchange rate developments were brought to the attention of the Board on March 18, 1988 in the context of a review under Argentina's stand-by arrangement. The increase in the real effective value of the Argentine austral between March 1988 and December 1988 is estimated at 11 1/4 percent. 1/

During the first half of 1988, there was a considerable reacceleration of inflation, but in real effective terms the official exchange rate was broadly maintained at around its end-1987 level through frequent exchange rate adjustments. As a result, the real effective exchange rate was maintained some 8 percent below its level in the third quarter of 1985, or at around its most competitive level in the period following the inception of the Austral Plan in mid-1985.

On August 3, 1988, as part of a package of stabilization measures (the Plan Primavera), the currency was devalued by 11 percent in the official market before being fixed against the U.S. dollar through

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1/ The increase in the real value of the austral over this period would be somewhat higher if measured by the combined consumer and wholesale price index as is generally presented by the Argentine authorities.

end-September. The package also included an agreement with leading industrial firms to restrict price increases, initially through a price freeze. 1/ In early October 1988, in the context of an extension of the price agreement with leading firms through February 1989, the authorities indicated that in November the austral would be depreciated by 4 percent in the official exchange market and that subsequently it would be depreciated by the greater of 4 percent a month or the previous month's rate of inflation less 2 percentage points.

A further element of the Plan Primavera was the substantial widening of the scope of the free exchange market that had been introduced in October 1987. Most import payments and 50 percent of industrial exports were transferred to the free market, while agricultural exports and the remaining 50 percent of industrial exports were maintained in the official market. The new exchange arrangements were intended to allow the Central Bank to earn the equivalent of around 1 1/4 percent of GDP on an annual basis from foreign exchange sales to the free market. These latter sales were to be effected through regular auctions by the Central Bank.

The austral appreciated in real effective terms during the last quarter of 1988 as inflation exceeded the price guideline and monetary policy was directed at maintaining the spread between the official and the free exchange rate at around 20 percent. In December 1988, the real effective exchange value of the austral on a trade-weighted basis was estimated to be about 13 percent higher than one year earlier. 2/ Notwithstanding this appreciation and the significant reduction in import tariffs effected in October 1988, the balance of payments was bolstered in the second half of 1988 by favorable export prices and by strong capital inflows attracted by domestic interest rates that were high relative to the announced guideline for the exchange rate. The current account deficit is estimated to have narrowed from US$4.2 billion, or 5 3/4 percent of GDP, in 1987 to US$2.3 billion, or 3 percent of GDP, in 1988, while the overall balance of payments deficit narrowed from US$4.1 billion to US$1.4 billion.

In January 1989, the earlier guideline for the adjustment of the official exchange rate was extended through June 1989 in the context of a further extension of the price agreement with leading industrial firms. It was also indicated that the unification of the exchange markets would begin in March 1989, according to a schedule that would provide for all industrial exports to be channeled through the free market by July 1989 and for all agricultural exports to be channeled through that market by end-1989.

1/ A fuller description of the Plan Primavera was presented in EBS/88/170 of August 17, 1988.

2/ The real effective exchange rate applicable to agricultural exports appreciated by about 25 percent over this period, while those applicable to industrial exports and to imports appreciated by about 13 and 3 percent, respectively.

II. Modification of the Exchange System

In early 1989, strong pressures began to emerge in the free exchange market that were initially met by substantial sales of foreign exchange by the Central Bank and by the raising of interest rates to very high levels in real terms. On February 6, 1989, the authorities announced that the Central Bank would no longer intervene in the free exchange market and that the dual exchange system hitherto in effect would be replaced by a new system comprising the following three exchange rates (Table 2):

(a) a commercial exchange rate applicable to agricultural exports and to the 50 percent of industrial exports that were previously transacted in the official exchange market, as well as to public sector debt and debt service transactions;

(b) a special exchange rate applicable to the remaining 50 percent of industrial exports and to imports that were formerly transacted in the free exchange market, as well as to transactions with the international organizations; and

(c) a free exchange market applicable to all other service and capital related transactions.

The authorities depreciated the austral in the commercial exchange market by 2 1/2 percent on February 7 and indicated that for February as a whole the depreciation would be 6 percent, which was broadly in accord with the earlier guideline of adjusting the official exchange rate by 2 percentage points less than the inflation rate of the preceding month. At the same time, the authorities indicated that the special rate would be maintained 25 percent above the commercial exchange rate and that there would be no central bank intervention in the free exchange market. Moreover, minimum import financing requirements, which had been eliminated in August 1988, were reintroduced with a general term of 90 days for most products.

In the two weeks following the introduction of the new exchange system, the exchange rate in the free market averaged ₳ 26 per U.S. dollar, representing a spread of around 80 percent over the commercial exchange rate and of 45 percent over the special rate, notwithstanding a sizable increase in domestic interest rates. Against this background, on February 21, further modifications in the exchange system were announced aimed at improving incentives for exporters and at reducing the spread between the free and the commercial exchange rates, as well as at facilitating a reduction in domestic interest rates.

The principal modification to the exchange system announced on February 21 included the immediate transfer of 20 percent of both agricultural and industrial exports to the free exchange market, which amounted to an effective depreciation for these two categories of exports of around 15 percent and 13 percent, respectively. Whereas all agricultural exports were formerly transacted at the commercial exchange rate, henceforth only 80 percent would be transacted at the commercial exchange rate, with the remaining 20 percent to pass through the free market. Similarly, industrial exports, which were formerly divided in a ratio of 50:50 in the commercial and special exchange markets, would now be transacted in the ratio of 30:50:20 in the commercial, the special, and the free exchange markets.

With a view to further relieving pressure on the free exchange market, the authorities indicated that henceforth private sector interest payments, dividends, profit remittances, and royalty payments could be effected through the purchase of BONEX from the Central Bank at the special exchange rate. At the same time, the authorities indicated that the commercial exchange rate would be adjusted by 7 percent in March, following the 6 percent adjustment that had earlier been announced for February. The staff estimates that at end-February 1989 the real effective trade weighted value of the austral was slightly more appreciated than its level at end-December 1988. This reflects a more rapid rate of inflation since end-1988 than the pace of depreciation of the official exchange rate which more than offset the effect of the shift of trade transactions from the commercial to the free exchange market.

The authorities also announced a new schedule for transferring exports from the commercial exchange market over the next four months that was to replace the previously announced scheme for the unification of the exchange market by end-1989. Beginning in April, 10 percentage points of exports each month would be shifted from the commercial market, initially to the special exchange market and then in June to the free exchange market. According to this schedule, whereas all agricultural exports were previously transacted in the commercial market, by June, 50 percent of these exports would be transacted in the commercial market, 20 percent in the special market, and the remaining 30 percent in the free market. Similarly, by June, 70 percent of industrial exports would be in the special exchange market and 30 percent would be in the free market.

The introduction of a third exchange rate complicates Argentina's multiple exchange rate system, while there is no schedule for the complete unification of the exchange markets. In the days immediately following the February 21 modifications to the exchange system, the spread between the free exchange rate and the commercial exchange rate showed little tendency to narrow, notwithstanding the shifting of additional export items to the free market and the maintenance of very high domestic interest rates. It would appear that a substantial narrowing in the current spread between the free market and the commercial market rates will be required if significant under- or over-invoicing of trade transactions is to be avoided.

Discussions between the staff and the Argentine authorities are still in progress within the context of the 1988 Article IV Consultation. In the interim, on February 8, 1989, a report was circulated to the Executive Board on Recent Economic Developments in Argentina (SM/89/30). The staff expects to examine further with the authorities the issue of exchange rate policy and the exchange system in the ongoing Article IV consultation discussions.

Table 1. Argentina: Real Effective Exchange Rate and Related Series

(Indices: 1980 = 100)

	Real Effective Exchange Rate 1/ 2/	Nominal Effective Exchange Rate 1/	Relative Consumer Prices (Local Currencies)	Exchange Rate in Terms of U.S. Dollars 1/	Consumer Price Index (Seasonally Adjusted)
Quarterly					
1982					
II	55.17	17.483	314.5	13.561	405.8
III	45.35	10.622	429.4	7.831	573.4
IV	39.58	6.576	605.5	4.694	830.0
1983					
I	39.72	4.610	861.1	3.208	1,216.9
II	40.89	3.571	1,143.8	2.352	1,674.2
III	44.80	2.748	1,638.1	1.720	2,499.3
IV	45.17	1.736	2,636.7	1.054	4,191.6
1984					
I	45.67	1.129	4,066.5	0.663	6,694.0
II	50.84	0.791	6,470.9	0.452	11,016.5
III	50.81	0.506	10,612.5	0.271	18,733.9
IV	49.44	0.279	17,993.8	0.142	33,046.4
1985					
I	50.27	0.158	32,345.9	0.076	61,663.3
II	45.32	0.074	63,463.5	0.035	125,252.4
III	39.60	0.048	82,055.1	0.022	167,088.4
IV	40.72	0.047	85,810.7	0.022	182,035.3
1986					
I	43.54	0.046	92,902.1	0.022	204,737.1
II	44.75	0.043	102,560.1	0.021	228,413.9
III	43.77	0.037	117,161.9	0.019	264,395.7
IV	44.36	0.031	140,618.2	0.016	323,656.3
1987					
I	43.77	0.025	171,279.8	0.013	407,997.3
II	42.91	0.022	197,396.2	0.011	471,887.3
III	41.03	0.018	226,884.0	0.009	596,971.8
IV	35.95	0.011	321,449.6	0.005	1,881,192.6
1988					
I	37.05	0.009	414,889.2	0.004	1,193,346.5
II	36.33	0.006	603,140.5	0.003	1,827,317.6
III	36.18	0.004	964,678.3	0.002	3,110,636.4
IV	39.91	0.003	1,226,744.1	0.001	4,248,569.1
Monthly					
1988					
March 3/	37.09	0.008	460,011.8	0.004	1,344,460.0
April	37.09	0.007	531,379.1	0.003	1,580,245.3
May	36.58	0.006	597,271.3	0.003	1,805,503.8
June	35.31	0.005	680,771.1	0.002	2,096,203.6
July	32.38	0.005	825,489.3	0.002	2,593,598.2
Aug.	33.95	0.003	988,012.9	0.001	3,175,706.0
Sept.	37.20	0.003	1,080,532.8	0.001	3,562,605.1
Oct.	38.95	0.003	1,159,338.0	0.001	3,916,303.9
Nov.	39.43	0.003	1,225,149.2	0.001	4,240,786.4
Dec.	41.32	0.003	1,296,745.1	0.001	4,598,617.1
Percentage change					
March-Dec. 1988	11.4	-60.5	181.9	-66.2	241.3

Source: Information Notice System.

1/ Increases mean appreciation.
2/ Using seasonally adjusted price indices.
3/ Date of latest consideration by Executive Board.

Table 2. Argentina: Modifications of Exchange System

System Before February 6, 1989		System After February 21, 1989		
Commercial Exchange Market	Financial Exchange Market	Commercial Exchange Market	Special Exchange Market	Free Exchange Market
		I. Merchandise Trade		
Exports Agricultural (100%) Industrial (50%) Regional 2/ (90%)	Exports Industrial (50%) Regional 2/ (10%)	Exports 1/: Agricultural (80%) Industrial (30%) Regional 2/ (70%)	Exports 1/: Industrial (50%) Regional 2/ (10%)	Exports 1/ Agricultural (20%) Industrial (20%) Regional 2/ (20%)
Imports of fuels and pharmaceuticals	Other imports	Imports of fuels and pharmaceuticals	Other imports 3/	
		II. Nonfactor Services		
Government services	Other public and private services	Government services	Royalties and technical services 4/	Other public and private services
		III. Net Factor Payments		
Public sector: Interest receipts Interest payments on rescheduled public debt and debt of Central Bank and Treasury	Public sector: Interest payments on other public debt	Public sector: Interest receipts Interest payments on rescheduled public debt and debt of Central Bank and Treasury	Public sector: Interest payments on other public debt	
	Private sector Interest receipts Interest payments Profits and dividends		Private sector Interest payments 4/ Profits and dividends 4/	Private sector: Interest receipts
		IV. Capital Flows		
Government paper	Direct investment	Government paper		Direct investment
Loans to Central Bank	Net private inflows	Loans to Central Bank		Net private inflows
	Loans from international organizations		Loans from international organizations	
Export financing 5/	Export financing 5/	Export financing 5/	Export financing 5/	Export financing 5/
	Import financing		Import financing 6/	

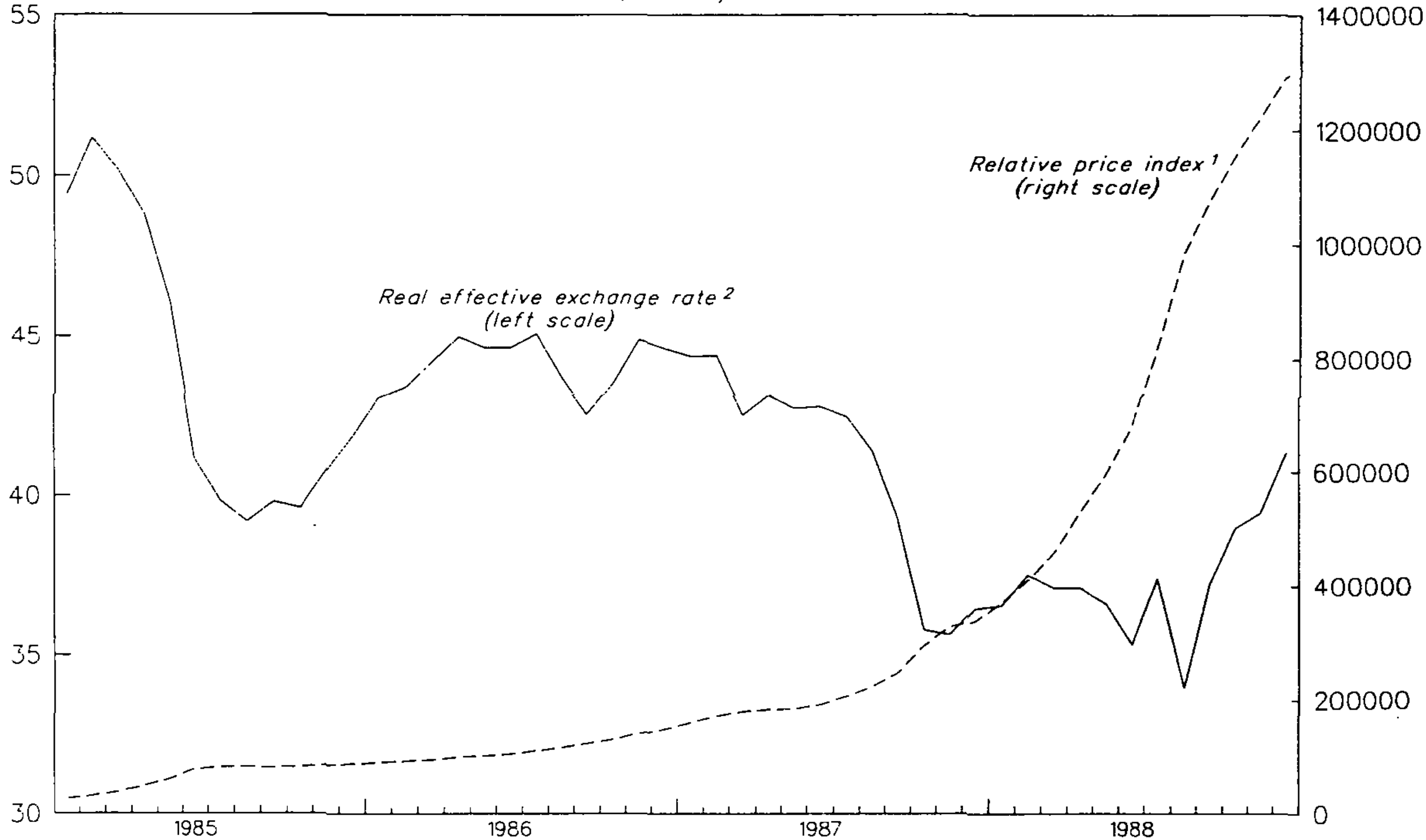
1/ According to a revised schedule to unify the exchange markets, 10 percentage points of exports will be transferred from the commercial to the special market in April and May, and 10 percentage points of exports will be transferred from the commercial to the free market in June 1989.
2/ Includes limited list of goods important in particular regional economies.
3/ Payments originally due before February 3, 1989, but that had been rescheduled, would be transacted through the free exchange market.
4/ Payments to be effected through the purchase of BONEX to be issued by the Central Bank.
5/ In general, export financing would be transacted through the same markets as the export operation being financed and in the same proportions.
6/ Minimum financing requirements for imports were reintroduced on February 7, 1989.

CHART

ARGENTINA

INFORMATION NOTICE SYSTEM INDEX OF REAL EFFECTIVE EXCHANGE RATE

(1980=100)



Source: Information Notice System.

1 Seasonally adjusted

2 Trade-weighted index of nominal exchange rates deflated by seasonally adjusted relative consumer prices, increases mean appreciation.