

**Nicaragua: 2002 Article IV Consultation and Requests for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility and for Interim Assistance Under the Enhanced Initiative for Heavily Indebted Poor Countries—Staff Report; Staff Statement; Public Information Notice, Press Release, and News Brief, on the Executive Board Discussion; and Statement by the Executive Director for Nicaragua**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2002 Article IV consultation with Nicaragua and requests for a Three-Year Arrangement under the Poverty Reduction and Growth Facility and for interim assistance under the Enhanced Initiative for Heavily Indebted Poor Countries, the following documents have been released and are included in this package:

- the staff report for the combined 2002 Article IV consultation and requests for a Three-Year Arrangement under the Poverty Reduction and Growth Facility and for interim assistance under the Enhanced Initiative for Heavily Indebted Poor Countries, prepared by a staff team of the IMF, following discussions that ended on **October 19, 2002**, with the officials of Nicaragua on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on November 19, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **December 4, 2002** updating information on recent economic developments.
- a Public Information Notice (PIN), Press Release, and News Brief **summarizing the views of the Executive Board as expressed during its December 4, 2002, discussion** of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.
- a statement by the Executive Director for Nicaragua.

The document(s) listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Nicaragua\*  
Memorandum of Economic and Financial Policies by the authorities of Nicaragua\*  
Technical Memorandum of Understanding\*  
Poverty Reduction Strategy Paper Annual Progress Report  
Joint Staff Assessment of the Poverty Reduction Strategy Paper Annual Progress Report  
Selected Issues Paper and Statistical Appendix  
\*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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NICARAGUA

**Staff Report for the 2002 Article IV Consultation and Requests for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility and for Interim Assistance Under the Enhanced Initiative for Heavily Indebted Poor Countries**

Prepared by the Western Hemisphere Department  
(In consultation with other departments)

Approved by Markus Rodlauer and Michael Hadjimichael

November 19, 2002

- Discussions for the 2002 Article IV consultation and a new three-year Poverty Reduction and Growth Facility (PRGF) Arrangement were held in Managua during March 11–26, July 10–23, and October 7–18, 2002, and at headquarters during August 21–30, 2002. The staff met with the Minister of Finance Mr. Montealegre; President of the Central Bank Mr. Alonso; Minister of Commerce and Industry Mr. Arana; Superintendent of Banks Mr. Sacasa; officials of the government and central bank; members of the National Assembly; the donor community; and NGOs. The staff closely coordinated its work with World Bank and IDB staff.
- In the attached letter to the Managing Director and the accompanying memorandum of economic and financial policies (MEFP), the government of Nicaragua requests a three-year arrangement under the PRGF for the period October 2002–September 2005, in an amount equivalent to SDR 97.5 million (75 percent of quota). The proposed disbursement schedule will raise Nicaragua's outstanding use of Fund resources to 140.2 percent of its quota by end-December 2005. It also requests interim HIPC assistance from the Fund in an amount equivalent to SDR 1.888 million.
- In concluding the 2001 Article IV consultation on September 19, 2001, the Executive Directors welcomed the authorities' intention to restore macroeconomic discipline in the context of a Staff-Monitored Program (SMP). They stressed that implementing the SMP was critical to maintaining the positive outlook envisaged in the Poverty Reduction Strategy Paper (PRSP) and building a track record in preparation for a possible new three-year PRGF arrangement.
- Nicaragua has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.
- Nicaragua reached the decision point under the HIPC Initiative in December 2000 (<http://www.IMF.org>) and is expected to reach the completion point by end-2003.
- The authorities report to the Fund on a regular basis core economic data used for surveillance but economic statistics need to be improved as indicated in Appendix IV.
- The authorities have agreed to the publication of the letter of intent, MEFP, and staff report.

	Page
Executive Summary .....	5
I. Background .....	6
A. Recent Developments .....	6
B. Outlook and Risks.....	12
II. Policy Discussions .....	15
A. Medium-Term Strategy .....	15
B. The Program for 2002–03 .....	24
C. Statistical Issues.....	27
D. Program Risks, Access, and Monitoring.....	27
III. Staff Appraisal .....	28
Text Boxes	
1. Performance under the Staff-Monitored Program (July–December 2001).....	8
2. Financial Sector .....	9
3. Tax Reform .....	10
4. Poverty-Reducing Spending and Tracking Mechanism.....	12
5. Reinvigorating Growth in Nicaragua.....	14
6. Pension System Reform.....	19
7. Structural Conditionality.....	23
Tables	
1. Selected Economic and Financial Indicators .....	31
2. Consolidated Operations of the Public Sector .....	32
3. Summary Operations of the Central Government.....	33
4. Consolidated Operations of the Public Sector-Quarterly.....	34
5. Summary Operations of the Central Government-Quarterly .....	35
6. Summary Accounts of the Central Bank.....	36
7. Summary Accounts of the Central Bank-Quarterly .....	37
8. Operations of the Central Bank and the Financial System .....	38
9. Social Indicators.....	39
10. Balance of Payments .....	40
11. Medium-Term Macroeconomic Framework.....	41
12. Status of Poverty Reduction and Structural Measures for Reaching the HIPC Floating Completion Point.....	42
13. Public Sector Domestic Debt.....	43
14. Public Sector External Debt and Debt Service .....	44
15. Phasing of IMF Disbursements and Reviews .....	45
16. Indicators of Financial Obligations to the Fund.....	46
17. External Financing Requirements and Sources .....	47

Figures

1.	Main Economic Indicators .....	7
2.	Fiscal Imbalances and Central Bank Financing .....	17
3.	Central Government Expenditure .....	18
4.	Exchange Rate Developments 1995-2002 .....	20
5.	Current Account Balance and Terms of Trade .....	21

Appendices

I.	Fund Relations .....	48
II.	Relations with the World Bank Group.....	52
III.	Relations with the Inter-American Development Bank .....	56
IV.	Statistical Issues .....	58
V.	Trade Regime and Regional Integration Process .....	61
VI.	Public Sector Debt Sustainability .....	64

Attachments

I.	Letter of Intent.....	70
II.	Memorandum of Economic and Financial Policies .....	72
III.	Technical Memorandum of Understanding .....	81

### Abbreviations and Acronyms

AN	National Assembly
BANIC	Nicaraguan Bank
BCN	Central Bank of Nicaragua
CABEI	Central American Bank for Economic Integration
CGR	Comptroller's Office
CONPES	National Council for Social and Economic Planning
CSE	Supreme Electoral Council
CSJ	Supreme Court of Justice
ENEL	Nicaraguan Electricity Company
ENITEL	Nicaraguan Telecommunications Company
ESAF	Enhance Structural Adjustment Facility
FISE	Emergency Social Investment Fund
FOGADE	Deposit Guarantee Fund
FSS	Supplementary Social Fund
GDP	Gross Domestic Product
HIPC	Enhanced Heavily Indebted Poor Countries Initiative
IDB	Interamerican Development Bank
IEC	Specific Consumption Tax
VAT	General Sales Tax
IMF	International Monetary Fund
INSS	Nicaraguan Social Security Institute
LSMS	Living Standards Measurement Survey
MEFP	Memorandum of Economic and Financial Policies
MHCP	Ministry of Finance
ODA	Overseas Development Agency
NGO	Non-Governmental Organization
PIP	Public Investment Program
PRGF	Poverty Reduction and Growth Facility
PSAC	Programmatic Structural Adjustment Loan
PSIA	Poverty and Social Impact Assessment
SGPRS	Strengthened Growth and Poverty Reduction Strategy
SB	Superintendency of Banks and Other Financial Institutions
SETEC	Technical Secretariat of the Presidency
SIGFA	Integrated System for Financial Management and Auditing
SMP	Staff-Monitored Program
SNIP	National System of Public Investment
SPNF	Non-Financial Public Sector
WB	World Bank
WTO	World Trade Organization

## EXECUTIVE SUMMARY

### Key Issues

- **Growth has decelerated sharply over the last three years, from over 7 percent in 1999 to an estimated 1 percent in 2002.** The deceleration is attributable to a marked weakening of fiscal policies, a banking crisis, and a deterioration in the external environment. Growth is also limited by structural and institutional constraints.
- **Large fiscal imbalances emerged in 2000–01,** reflecting unsustainable increases in spending as well as a weakening in tax revenues. This led to a substantial use of central bank financing and loss of official reserves.
- **A banking crisis in 2000–01 led to the closure of four banks and a jump in public debt of about 20 percent of GDP.** This debt is a major source of vulnerability, given its high interest rates and concentration of maturities in 2003–04.
- **The financial system remains vulnerable,** given the high degree of dollarization and weaknesses in the prudential framework (including significant past forbearance). Dollarization also acts as a constraint on exchange rate policy (crawling peg).
- **Structural and institutional barriers to growth** include weak governance and rule of law, an inefficient public sector, and inadequate protection of property rights—this is being addressed in the program, but will take time.

### Article IV Consultation and PRGF Discussions

- **The discussions centered on the policies needed to restore rapid growth, reduce poverty, and address vulnerabilities.** The new government has already established a track record of such policies since taking office in early 2002 and is attempting to widen ownership of the program across the political spectrum.
- **A key program objective is medium-term fiscal sustainability.** This will require a significant reduction of primary spending, while protecting poverty-reducing outlays, and an increase in tax revenues. Key program elements include a two-stage tax reform in 2002–03 and comprehensive tax administration reform.
- **The public domestic debt is to be reduced substantially** using resources from asset recoveries, privatization, and balance of payments support.
- **Strengthening the financial system is a priority,** including by ending forbearance, strictly enforcing prudential regulations, and revamping the regulatory framework. Stepped-up asset recovery efforts should also help improve the credit culture.
- **Key reforms to remove constraints on growth** include privatization, strengthening the judicial system, public sector restructuring, and increased budget transparency, although these will take time to take root.

## I. BACKGROUND

### A. Recent Developments

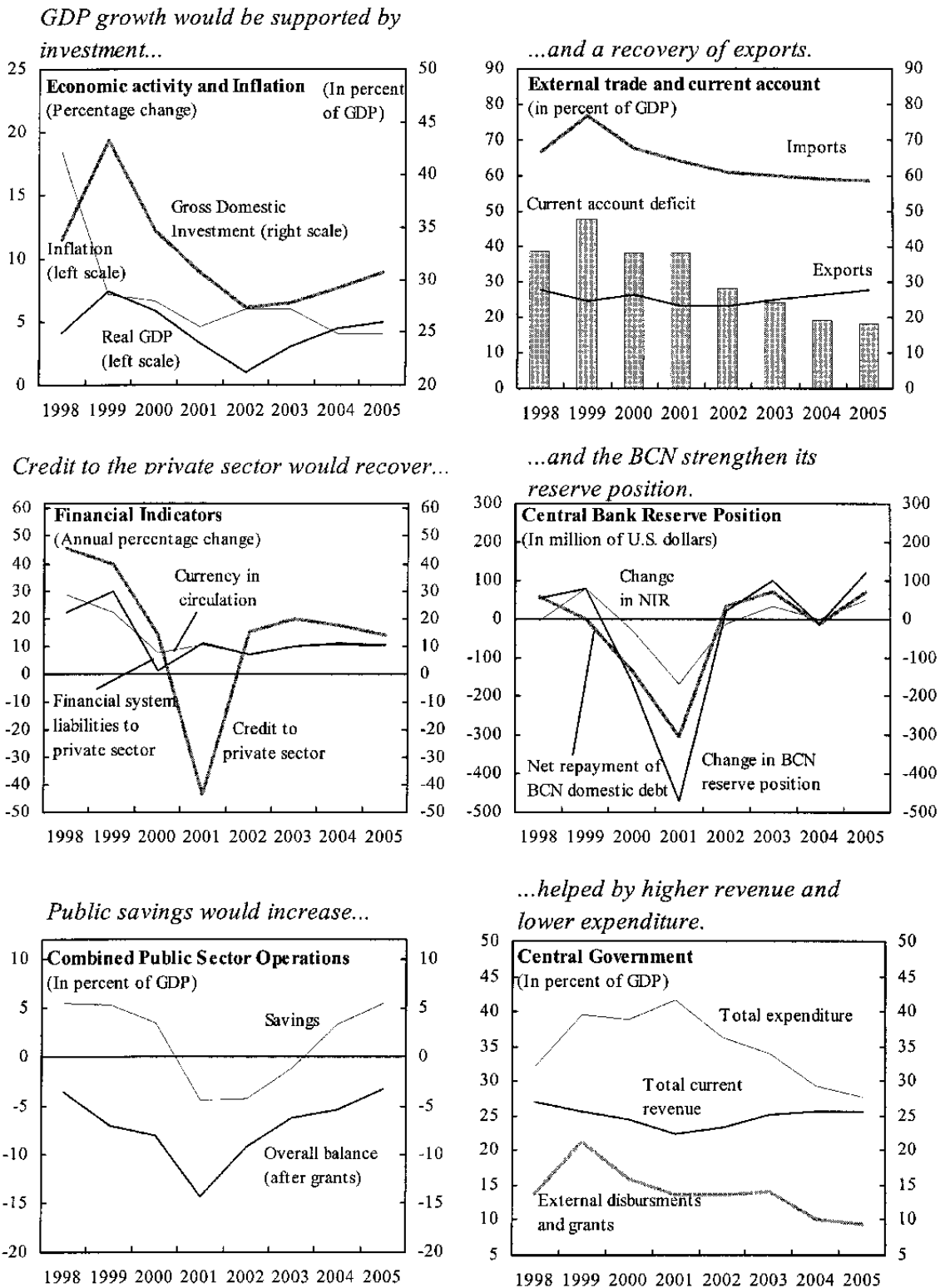
1. **Following a decade of economic decline, a generally peaceful transition to a democratic system and the adoption of market-based reforms in the early 1990s, generated a strong economic recovery since the mid-1990s.** Reforms accelerated with a change of government in 1997, supported by a three-year ESAF arrangement in early 1998. As a result of these efforts and the accompanying external assistance, real GDP grew at an annual average of about 5 percent during the second half of 1990s. Inflation was also brought under control, helped by a slowing crawl of the exchange rate. Substantial external assistance mitigated the adverse effect on growth of the 1998 Hurricane Mitch.

2. **Notwithstanding these improvements, the 1990s witnessed the emergence of serious underlying weaknesses, reflecting a difficult political environment and social tensions.** In particular, the difficult relations between the government and the opposition, pressures from vested interests and other groups, and widespread poverty and social needs heavily influenced economic and political decisions. As a result, government spending remained high and became inflexible, and the domestic debt of the public sector increased substantially as the government compensated former owners of properties confiscated during the Sandinista regime. Bank credit to the private sector was allowed to expand rapidly, under inadequate supervision. Political accommodations also resulted in the division of key institutions along party lines, including the Supreme Court of Justice, the Comptroller's Office (CGR), and the Supreme Electoral Council.

3. **In 2000–01, the economy deteriorated sharply as the underlying weaknesses were compounded by external shocks and a sharp widening of the fiscal deficit** (Table 1). After real GDP growth reached over 7 percent in 1999 (temporarily boosted by post-Hurricane Mitch reconstruction efforts), it slowed to an estimated 1 percent in 2002 as the external environment deteriorated, governance concerns intensified, and a banking crisis as well as expansionary fiscal policies stunted credit flows to the private sector. The deficit of the combined public sector (after grants) widened to over 14 percent of GDP in 2001, reflecting large expenditure overruns mainly related to municipal (2000) and presidential elections (2001). Together with a steep decline in the terms of trade, the financial developments resulted in a sharp weakening of the external position. Trend inflation has remained around 6 percent, reflecting the exchange rate crawl, with a decline in 2001 (to below 5 percent) attributable mainly to lower international oil prices (Figure 1).

4. **An effort to stabilize the economy under a Staff-Monitored Program (SMP) in 2001 was not successful (Box 1).** After discussions with the then authorities on a third annual PRGF supported program could not be completed, a SMP covering the second half of 2001 was designed to arrest the economic deterioration and establish a track record toward a new PRGF arrangement. The program focused on containing the fiscal deficit, which risked slipping out of control as a result of election-related spending. In the event, the deficit

Figure 1. Nicaragua: Main Economic Indicators



Sources: Central Bank of Nicaragua and Fund staff estimates.



widened sharply; monetary policy largely accommodated the fiscal expansion (Tables 2 and 3); and net international reserves (NIR) of the central bank declined significantly, instead of the moderate increase targeted under the SMP.

**Box 1. Performance Under the Staff-Monitored Program (July–December 2001)**

After discussions on a third annual PRGF could not be completed, a Staff-Monitored Program (SMP) covering July–December 2001 was presented to the Executive Board in the context of the 2001 Article IV consultation. The SMP was designed to contain the economic deterioration and build up a track record for a possible new three-year PRGF arrangement.

However, program implementation soon went off-track and macroeconomic performance deteriorated significantly:

- In particular, fiscal policy weakened sharply in the run-up to presidential elections in late 2001. The combined public sector deficit after grants reached 14.3 percent of GDP, exceeding the SMP target by about 6 percentage points, while public savings fell short of the program target by 4.3 percentage points of GDP.
- The higher fiscal deficit, combined with a shortfall in privatization proceeds, led to substantial central bank financing of the public sector (8.5 percent of GDP, compared with an expected contraction in the SMP).
- As a result, NIR declined by US\$170 million (compared with an increase of US\$50 million targeted in the SMP); by end-2001, gross reserves stood at 2.3 months of imports (3.6 in the SMP), while freely usable gross reserves fell to 1.1 month of imports.
- The external current account deficit reached 38 percent of GDP (compared with 30 percent of GDP in the SMP), reflecting higher imports and a sharp deterioration in the terms of trade that were only partly offset by higher than programmed export volume.
- While real GDP growth (3.3 percent) was about as programmed, the widening financial imbalances and continued problems in the banking system undermined the growth momentum in 2002 (which witnessed a further deceleration, to an estimated 1 percent, rather than a recovery as anticipated in the SMP).

5. **The financial position of the central bank also deteriorated sharply in 2000–01 (Table 6).** In addition to the large loss of reserves (with NIR declining by US\$200 million over the two-year period), the central bank's dollar-indexed domestic debt jumped by US\$520 million (21 percent of GDP) as it absorbed the cost of resolving four banks that failed in 2000–01 (Box 2). Gross international reserves at end-October 2002 stood at a relatively low US\$362 million; excluding reserve requirements on dollar deposits in the banking system, freely usable reserves were only US\$166 million (about one month of imports of goods and services).

## Box 2. Financial Sector

**Over the last decade, Nicaragua's financial sector experienced a major expansion followed by a crisis.** After the reintroduction of private banks in the early 1990s, credit to the private sector expanded rapidly, particularly during the late 1990s. Inadequate supervision, poor credit culture, and fraud led to a banking crisis and a major consolidation of the banking system in 2000–01. Between August 2000 and August 2001, four banks failed (representing close to 40 percent of total deposits), and their deposits and performing assets were absorbed by solvent banks through public auctions. To cover the difference between the value of assets and deposits, the central bank issued dollar-indexed bonds totaling about 20 percent of GDP.

**Despite this consolidation, the financial system remains weak.** As of June 2002, total assets of the financial sector were about 80 percent of GDP, mostly in banks. Banks' assets are highly concentrated in public sector debt instruments (40 percent), with loans to the private sector accounting for about one-third of assets. Key vulnerabilities relate to the high degree of dollarization in the system (about 90 percent of assets and 92 of liabilities are denominated in, or linked to, the U.S. dollar); significant exposure to government risk; maturity mismatches between assets and liabilities; a poor credit culture; and financial problems in key sectors of the economy. Inadequate prudential oversight has compounded those weaknesses, including explicit forbearance from early 2001 (when banks were no longer required to appropriately classify and provision their deteriorating coffee-related loans).

**Strengthening the financial system is a key element of the authorities' program.** During the first-year program the authorities will: (i) strengthen procedures for resolving distressed banks; (ii) strictly apply existing loan classification and loan-loss provisioning rules; (iii) approve prudential norms to contain maturity mismatches between assets and liabilities and enforce strictly prudential regulations; (iv) strengthen regular on-site inspections of banking institutions, and (v) amend legislation in line with Basle Core Principles. To achieve these goals the authorities will receive assistance from the World Bank, IDB, and MAE.

**The central bank has developed a banking crisis resolution strategy.** Its *short-term component* contains a recovery plan for assets received from previous banking resolutions. The total book value of the assets acquired as a result of the banking crisis is about US\$770 million (US\$400 million if fraudulent credit and overdue interest are deducted). An international bid to select a firm with international experience to carry out recoveries was launched in September 2002, and the firm selected was publicly announced in mid-November 2002. The contract with the selected firm is to be signed around year-end, and the asset recovery plan is to be completed by September 2003.

The *long-term component* of the strategy consists mainly of centralizing the management and liquidation of assets, in the event of bank interventions, in a new unit at the public deposit insurance fund (FOGADE).

6. **The new government that took office in January 2002 moved quickly to address economic imbalances.** Government spending was reined in, first through administrative means and then (in July) by a reduction in the budget (by about 1.5 percent of GDP). As a result, primary spending during the first three quarters of the year was contained at 26 percent of GDP, down from 28 percent during the same period of 2001. In preparation for a

comprehensive new program, the assembly approved the first round of a major tax reform package, yielding 2.1 percent of GDP on an annual basis (Box 3). While interest rates on central bank paper dropped significantly after the November 2001 presidential elections (to levels of about 12 percent by mid-2002, reflecting reduced political uncertainties), monetary policy has since been tightened and interest rates increased to about 15 percent by October. Despite the absence of balance of payments support, the net position of the central bank (change in NIR plus net repayment of domestic debt) has remained broadly stable in 2002 (Table 7).

### Box 3. Tax Reform

**Tax revenues in Nicaragua are low and have been declining in recent years.** The tax system is inefficient and inequitable, with widespread exemptions, exonerations, differential rates and special regimes. As a result, the system is difficult to administer, lacks transparency, and relies on few taxes and taxpayers.

**Strengthening the tax system is key to achieving fiscal sustainability.** FAD (2000), the IDB (2002), and other institutions have recommended comprehensive reform focusing on expanding the tax base; increasing efficiency of the system; and reducing the scope for fraud. An FAD mission estimated that the cost of exonerations on indirect taxation amounted to about 55 percent of actual revenue. Of particular concern is the general sales tax (VAT), which has a narrow tax base resulting from a long list of goods and economic activities with a zero-rate, widespread exemptions (including for nonprocessed food, petroleum and its derivatives, domestic transport, medical and educational services, and insurance), and preferential rates for cement and air tickets.

**Against this background, the authorities in early 2002 embarked on a two-stage reform of the tax system.** A first package, agreed with the staff in early 2002, was expected to achieve substantial improvements in efficiency, while raising tax revenue by about 3 percent of GDP on annual basis. It was to widen the tax base by eliminating the zero-VAT rate except for exports, limiting VAT exemptions to a short list of subsistence products, and eliminating the preferential VAT rates. In addition, it would incorporate administrative improvements, such as removing ad-hoc tax exemptions for the financial system, increasing tax withholdings on several activities, and enlarging the tax base for excise taxes on beverages. **A second stage of the tax reform**, for implementation in 2003, was originally expected to be broadly revenue-neutral and to focus on efficiency gains through: (i) including oil and its derivatives in the VAT base, compensated by a reduction in excise taxes; (ii) reducing considerably the number of products subject to excises; and (iii) expanding the income tax base.

**The government submitted a first package to the assembly in mid-2002.** Although the government proposal contained most of the measures previously agreed with the staff, it kept unchanged the zero-rated VAT list of 19 products of the subsistence basket. The assembly subsequently increased the zero-rated list to 53 products. As a result, the approved package fell short of the revenue target by 0.9 percent of GDP and lost an important measure to increase efficiency and transparency (a significant reduction of the list of zero-rated VAT products is needed to facilitate tax administration and reduce the scope for fraud).

**The authorities intend to submit a modified second stage of the reform to the assembly by March 2003.** The second stage is to yield about 1 percent of GDP and significant increases in efficiency. In particular, in addition to the previously contemplated measures, the plan is to reintroduce a significant reduction of zero-rated VAT products. The authorities intend to formulate well-targeted social programs to compensate the most vulnerable groups affected by this measure.

1/ Tax revenues of the central government represent some 22 percent of GDP. However, using the much higher GDP figures expected to be adopted in early 2003, this ratio drops to about 12 percent.

7. **While major weaknesses remain in the banking system, prudential oversight was stepped up in 2002.** The health of the banking system has been affected by sharp reductions in international coffee prices, weak enforcement of existing prudential norms, and widespread mismanagement and governance problems. Four banks (representing about 40 percent of total bank deposits) were intervened in 2000–01, with deposits and performing assets taken over by solvent banks. The nonperforming assets were assumed by the central bank in exchange for dollar-indexed bonds (equivalent to about 20 percent of GDP). Notwithstanding this resolution, the highly dollarized banking system remains vulnerable and, while most banks are well-capitalized according to official data, there is a significant risk that the quality of portfolios is weaker than reported. The superintendency of banks (SB) has taken a number of steps this year to strengthen bank supervision, including a strict requirement for all banks to comply with prudential norms (MEFP, paragraph 4).<sup>1</sup> Moreover, a new deposit insurance system (covering deposits up to US\$20,000) has been implemented in 2002.

8. **Nicaragua is the second-poorest country in Latin America although, since the mid-1990s, significant progress has been made in reducing poverty (Table 9).** Living Standards Measurement Surveys (LSMSs) show a decline in the share of the population living below the extreme poverty line from 19½ percent in 1993 to 15 percent in 2001. Most social indicators have also improved over this period; for example, primary school enrollment increased from 75 percent in 1993 to 81 percent in 2001; the number of years of education among the extreme poor has increased from 2.8 to 3.6 years; and chronic malnutrition has fallen from 24 to 18 percent. Nevertheless, progress has been uneven and, in some areas such as health indicators, there have been only moderate improvements.

9. **Nicaragua reached the decision point under the HIPC Initiative in December 2000 (EBS/00/259).** It is expected to reach the completion point by end-2003, provided the completion point conditions are met by then. In 2001–02, Nicaragua has benefited from interim assistance provided by the World Bank, the IDB, the Central American Bank for Economic Integration and the Organization of the Petroleum Exporting Countries Fund (since 2002), totaling about US\$115 million.<sup>2</sup> HIPC interim relief has been used to finance poverty-reducing expenditures in the health, education, and social safety net programs (Box 4). The debt service deferral granted by Paris Club creditors after Hurricane Mitch (1998) expired in March 2001 and, since then, Nicaragua has been servicing its post-

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<sup>1</sup> The MEFP is shown in Attachment II.

<sup>2</sup> The IMF has not been able to provide interim relief because of the lack of a PRGF-supported program since the decision point.

cut-off date debt.<sup>3</sup> During 2000–02 Nicaragua negotiated debt reduction agreements with Brazil, Bulgaria, Finland, Guatemala and Slovakia, which were in line with the debt relief to be provided by these creditors under the enhanced HIPC Initiative. At end-2001, Holland cancelled the stock of its ODA claims (US\$35 million).

#### **Box 4. Poverty-Reducing Spending and Tracking Mechanism**

**After increasing significantly in recent years, poverty-reducing spending is set to rise further under the proposed PRGF program.** Poverty-reducing expenditure has increased from 13 percent of GDP in 1998 to 15.5 percent of GDP in 2002, largely as a result of Hurricane Mitch related spending. Under the new PRGF program, poverty-reducing expenditure will increase further to 16¾ percent of GDP by 2005. This expenditure has been channeled toward priority programs identified in the PRSP, aiming to increase access to education, health, water and sewerage, and housing, as well as reducing mortality, malnutrition and illiteracy rates. This effort will be facilitated by the debt relief that Nicaragua is expected to receive under the HIPC Initiative, particularly after it reaches the completion point (expected for end-2003). In 2001–02, interim debt relief from multilateral institutions amounted to about US\$65 million (2½ percent of GDP); after the completion point, relief is expected to increase to 4–5 percent of GDP by 2004–05.

**The authorities have designed a mechanism to track and monitor the use of poverty-reducing public spending through the budget,** including the part financed with HIPC-related funds (Supplementary Social Fund-FSS). This will give both donors and aid recipients assurances that the resources made available through HIPC are being used effectively for alleviating poverty. The following new procedures were approved in September 2002: (i) The central bank calculates the amount of budgetary resources freed through HIPC relief, using a methodology agreed with the IMF and the World Bank; (ii) The FSS coordination council allocates resources for poverty capital expenditure in the National System of Public Investment (SNIP)), while the ministry of finance allocates resources for poverty-related current expenditure; (iii) the ministry of finance incorporates all poverty-reducing spending into the budget; (iv) the ministry of finance controls and tracks poverty expenditure using the Integrated Management Financial System (SIGFA); (v) SETEC monitors performance indicators of poverty reduction according to the targets and indicators defined in the PRSP; and (vi) the FSS prepares an annual report containing performance indicators on poverty reduction.

**The above mechanism is expected to be fully implemented in 2004.** During 2003, allocation of resources for poverty expenditure will continue under the responsibility of the Ministry of Finance for poverty current expenditure, and the National System of Public Investment for capital poverty expenditure. This will take into account ongoing projects and the poverty allocation criteria used for 2000 following the PRSP guidelines.

### **B. Outlook and Risks**

10. **The near-term outlook is for a moderate recovery of growth, in an environment of continued low inflation and an improvement in the external position.** This outlook is based on an expected gradual recovery in the external environment and further progress in restoring macroeconomic balance, mainly through continued fiscal adjustment and sizable

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<sup>3</sup> All pre-cutoff date debt would be eligible for treatment under Cologne terms once Nicaragua reaches an agreement on a new PRGF-supported program.

donor support. Reduced political tensions and greater domestic consensus will be essential in this effort. On this basis, real GDP is projected to grow by about 3 percent in 2003 (which would imply roughly unchanged real per-capita GDP). Inflation is projected to remain around 6 percent, while the external current account deficit (after grants) would narrow to 24 percent of GDP (down from 38 percent in 2001). The current account deficits are expected to be financed with privatizations proceeds, foreign direct investment, and official capital flows. Gross reserves are programmed to rise to about US\$410 million, or 2.5 months of imports (Table 10). There are substantial downside risks to this outlook, both from a possibly weaker external environment and from the substantial domestic vulnerabilities as discussed below.

**11. Over the medium term, the economy has the potential of resuming the 5 percent annual growth achieved during 1995–2000.** The medium-term outlook depends critically on policies to address the large economic imbalances and vulnerabilities, as well as political and economic reforms to ensure broad national ownership and continuity of policies, remove structural barriers to growth and assure greater legal certainty (Box 5). In particular, it will be necessary to increase substantially public savings, make room for the financing of private investment by gradually reducing the public sector's domestic debt with the financial system, and enhance the availability of credit for small enterprises and the rural areas. In addition, privatization and structural reforms to improve the business environment, focused on addressing corruption, strengthening the judicial system and enhancing property rights, will be needed for a sustained economic expansion. In such a scenario, real GDP growth would reach 5 percent by 2005, inflation would be contained around 4 percent, and the current account deficit would fall to below 20 percent of GDP.

Nicaragua: Medium-Term Economic Indicators, 2002–05

	Program			
	2002	2003	2004	2005
(Annual percentage change)				
GDP at constant prices	1.0	3.0	4.5	5.0
Consumer prices (end of period)	6.0	6.0	4.0	4.0
(In percent of GDP; unless otherwise indicated)				
Combined public sector savings	-4.2	-1.0	3.4	5.5
Combined public sector primary balance (before grants)	-5.3	-2.8	-3.2	-2.3
Combined public sector overall balance (before grants)	-16.5	-13.2	-9.4	-7.5
Combined public sector overall balance (after grants)	-9.2	-6.3	-5.3	-3.3
External current account balance	-28	-24	-19	-18
Gross international reserves (in months of imports)	2.2	2.5	2.7	3.0
Strengthening of central bank position (flows, US\$ million)	20.0	100.0	-15.0	120.0
Increase in NIR (+)	-13.0	30.0	0.0	50.0
Net repayment of central bank domestic debt (+) 1/	33.0	70.0	-15.0	70.0
Poverty-reducing spending 2/	15.6	15.8	16.3	16.8

1/ Includes debt denominated in and indexed to the U.S. dollar.

2/ Includes expenditures on programs identified in the PRSP aiming to increase access to education, health, housing, water and sewerage.

### **Box 5. Reinvigorating Growth in Nicaragua**

**During 1995–2000, Nicaragua grew at 5 percent per year (2 percent per-capita)**, mainly as result of progress in implementing market-oriented reforms and significant external assistance. Subsequently, however, GDP growth decelerated to about 1 percent in 2002, reflecting a deterioration of the terms of trade, loss of fiscal discipline, and governance and institutional weaknesses. In addition, a banking crisis during 2000–01 prompted a sharp reduction in credit to the private sector. With over 40 percent of bank assets held in government debt and credit to the private sector accounting for less than 35 percent of GDP, the financial sector has not been able to mobilize and intermediate savings for investment and economic growth.

**The program aims at restoring annual GDP growth of about 5 percent over the medium term and reducing poverty significantly.** There is considerable scope for growth in agriculture (where output is below historical levels), construction, tourism, and export processing. Other areas with high potential, particularly in the context of regional free trade agreements under negotiation, include textiles and light manufacturing. The authorities' strategy to achieve the growth objectives is based on (i) reducing macro-imbalances and addressing vulnerabilities, including through fiscal consolidation and a reduction of domestic public debt; (ii) strengthening the financial system; and (iii) implementing key structural reforms to improve the business environment.

**Fiscal consolidation.** The program envisages increasing public savings from negative 4 percent of GDP in 2002 to 5–6 percent of GDP by 2005 (the level of 1998–99), providing substantial resources for private investment. The composition of spending will shift toward poverty-reduction programs, focused on development of human and physical capital, facilitated by HIPC debt relief.

**Reduction of domestic debt.** Together with fiscal adjustment, proceeds from privatization, asset recovery and balance-of-payments support loans will allow for a gradual but steady reduction of the public domestic debt during 2002–05. This will release budgetary resources for investment and poverty-reducing expenditures (through lower interest payments), and increase the availability of credit to the private sector. As the financial intermediation process is restored, credit to the private sector is projected to increase from 41 percent of GDP in 2001 to over 50 percent of GDP by 2005.

**Strengthening the financial system.** The program aims to ensure sound banking by tightening prudential standards and correcting shortcomings in the regulatory and supervisory framework in line with Basel Core Principles. Given a history of fraud and a weak credit culture, successful implementation of the asset recovery plan should contribute to the health of the banking system, and lessen the moral hazard created by past implicit government guarantees.

**Good governance and institutional strengthening.** To restore investor confidence, the government has embarked on a comprehensive effort to fight corruption and promote transparency and accountability in the use of public resources. It is also committed to reforming the judicial system and the civil service, as well as strengthening property rights.

**Credit for Small Enterprises and the Rural Areas.** The World Bank and IDB are working on specific programs to support market-based credit to small enterprises and in rural areas. The World Bank's Rural Microfinance Development project will provide an IDA credit of US\$12 million to improve the efficiency of financial intermediaries that serve small productive units in rural areas, and to strengthen the legal framework in which they operate. A US\$40 million IDB loan is to be channeled (through financial institutions) to small enterprises and rural cooperatives.

12. **To ensure attainment of these objectives, Nicaragua needs to address its significant economic vulnerabilities, both domestic and external.** On the domestic side:

- *the large fiscal imbalance*, with high primary spending levels and pressures from vested interests and other groups, is a major source of fragility in the macroeconomic framework;
- *the large domestic debt of the public sector*, with high interest rates and large maturities in 2003–04, implies a heavy debt service burden and substantial rollover risk;
- *financial dollarization, weak prudential oversight, and problems in the important coffee sector*<sup>4</sup> make for significant vulnerabilities in the banking system, even after the resolution of four distressed banks in 2000–01.

On the external side:

- Nicaragua is *highly exposed to terms of trade shocks*,<sup>5</sup> given its dependence on a few basic export commodities, particularly coffee;
- *The crawling peg exchange rate* regime, although it has served Nicaragua well in containing inflation, is a source of vulnerability—particularly in the context of the highly dollarized banking system—and policies need to allow for progressively greater flexibility.

## II. POLICY DISCUSSIONS

### A. Medium-Term Strategy

13. **Discussions were held with the authorities, the national assembly, political parties, the private sector, civil society and NGOs.** The authorities are strongly committed to the strategy as updated in their PRSP progress report, as evidenced by their initiatives on governance (section V.D. of the PRSP), fiscal adjustment and tax reform. The population also appears supportive of the strategy as reflected by the government's strong approval ratings in major polls. However, while the government has initiated a major effort aimed at building consensus, the strategy remains to be embraced by many important parties to the

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<sup>4</sup> The sharp decrease in international coffee prices during 2000–02, as well as a decline in production in 2002, has significantly affected the coffee growers' repayment capacity.

<sup>5</sup> For example, Nicaragua's terms of trade deteriorated by 4 percent in 2000 and 11 percent in 2001.



political process, and the government continues to face significant political opposition, including within the ruling party.

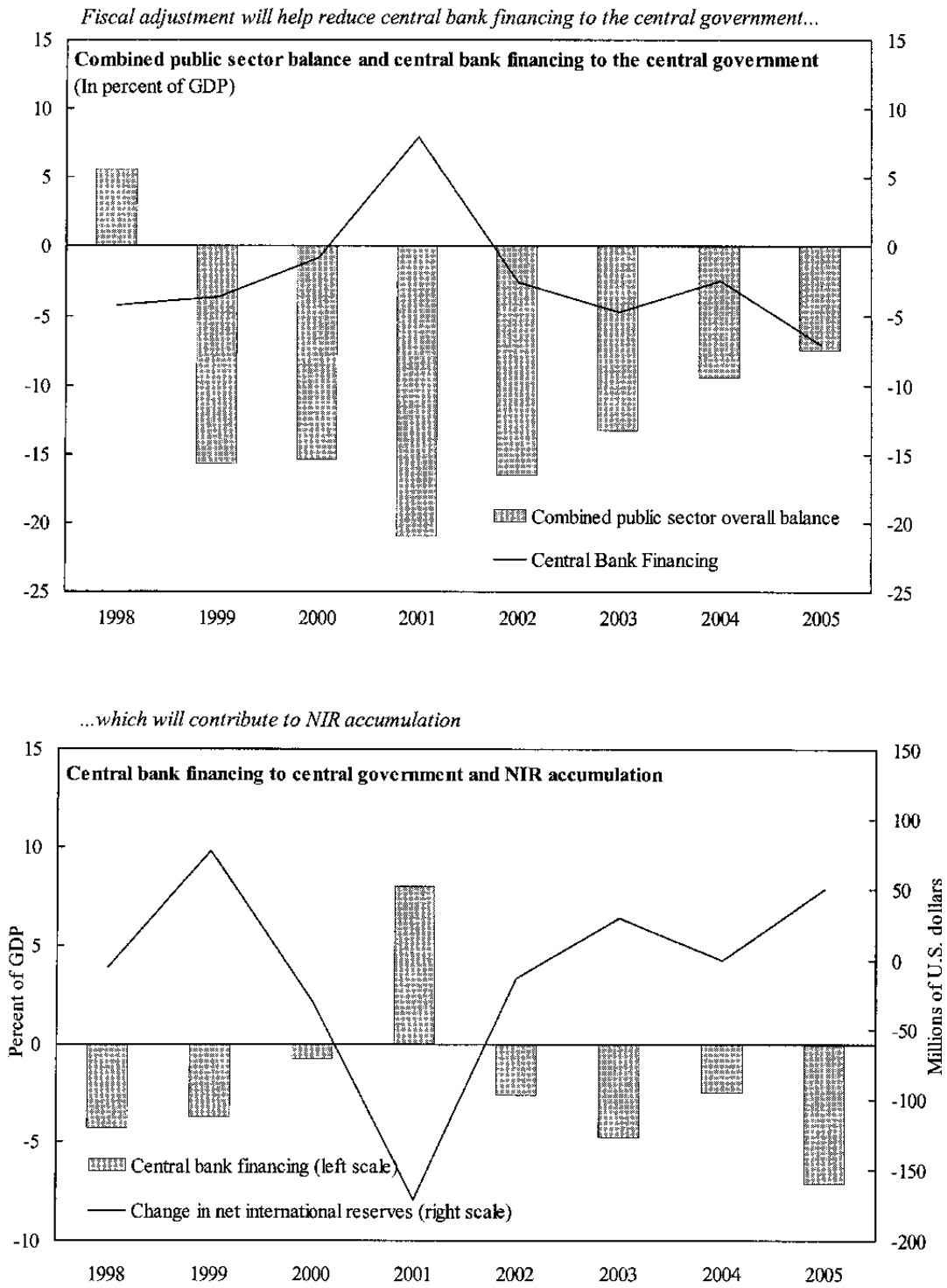
14. **The discussions focused on the policies needed to promote sustained growth and poverty reduction, in an environment of low inflation and fiscal sustainability (MEFP, paragraph 5) (see Figure 1).** The new authorities broadly shared the staff's assessment of the poor economic performance in recent years, particularly under the 2001 SMP, and agreed on the need to take decisive actions to redress the large imbalances, address key vulnerabilities, and implement reforms to remove the long-standing barriers to sustained growth. Key focal points of their strategy were to improve governance and accountability in the public and private sectors; rein in unsustainable government spending while raising the tax effort; and strengthen the banking sector, which had suffered badly from past mismanagement and forbearance. Continue trade liberalization and regional integration is to provide the basis for growth and efficiency gains in the tradeables sectors.

15. **The authorities' macroeconomic framework for 2002–05 centers on substantial improvements in the combined public sector balance and the reserve position of the central bank** (Table 11 and Figure 2). The authorities agreed with the staff that the large fiscal deficit and high domestic debt were major sources of vulnerability as well as a drag on growth. Addressing them, they noted, will require a sustained effort likely to reduce the importance of vested interest groups. Care would also need to be taken to protect the most vulnerable of the population in implementing the necessary measures. Nevertheless, they were confident that their recent election to government was a mandate for change, and pointed to the strong anti-corruption initiatives they had already taken and the satisfactory macroeconomic performance so far in 2002.

16. **The authorities reaffirmed their commitment to a growth-oriented poverty-reducing strategy, in line with the PRSP progress report (presented concurrently with this report).** The PRSP underscores the importance of promoting the private sector as the main engine of growth, based on: (i) broad-based economic growth with emphasis on productive employment generation and rural development; (ii) more and higher-quality investment in the human capital of the poor; (iii) better protection for vulnerable groups; and (iv) stronger institutions and good governance. In the PRSP progress report, the new government expresses its support of the strategy outlined in the PRSP, with particular emphasis of the first (employment and rural development) and fourth (institution building) pillars of the strategy. The PRSP progress report also notes the need to revise the criteria used for allocating poverty-reducing resources. The authorities intend to reach the HIPC completion point by end-2003, based on satisfactory implementation of the PRGF supported program and observance of completion point conditions (Table 12).

17. **The medium-term fiscal strategy is to combine deficit reduction with higher and more efficient poverty-related spending (MEFP, paragraph 8).** The combined public sector deficit, before grants, is to be reduced from 21 percent of GDP in 2001 to 7½ percent

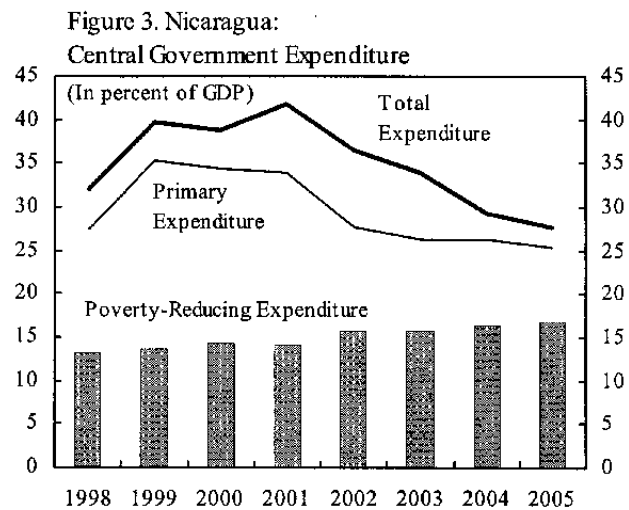
Figure 2. Nicaragua: Fiscal Imbalances and Central Bank Financing



of GDP by 2005, by raising tax revenue and reducing primary expenditure, while protecting poverty-reducing spending (see Table 2). Following the first round of tax reform in 2002, a second round focused on reducing exonerations, exemptions, and special regimes in both indirect and direct taxation, is essential. Tax collection is also expected to increase through a comprehensive tax administration reform, to be prepared with technical assistance from multilateral and bilateral institutions in 2003 (MEFP, paragraph 9) (see Table 3).

18. **A substantial reduction in overall primary spending should not affect poverty-reducing outlays as there is much scope for increasing efficiency.** The authorities agreed with the staff that overall expenditures need to be reduced, and are committed to lowering primary spending of the combined public sector to below 34 percent of GDP by 2005 (from 43 percent in 2001). Within that envelope, spending is to be redirected toward poverty-reducing programs, which will increase from 14.1 percent of GDP in 2001 to 16.8 percent of GDP in 2005 (see Box 4 and Figure 4). The World Bank has contributed to this effort through a recent Public Expenditure Review, and will assist the government in the preparation of a Poverty and Social Impact Analysis (scheduled for next year).

*Total spending will decline, while poverty-reducing expenditure increases.*



19. **The authorities intend to partially transfer pension administration to the private sector and comprehensively restructure the public sector.** The program incorporates a revenue loss equivalent to over 2 percentage points of GDP resulting from the pension reform, as pension contributions are taken over by private pension funds during 2003–04 (Box 6). The public sector restructuring plan, which will be prepared during 2003, is expected to consolidate government operations and enhance their efficiency, resulting in a reduction in current spending of at least ½ percent of GDP by 2005.

20. **Monetary policy will aim at strengthening the reserve position of the BCN in the context of low inflation (MEFP, paragraph 10).** Reducing the stock of the dollar-indexed and dollar-denominated domestic debt of the BCN is key to lowering vulnerabilities and spurring commercial bank lending to the private sector (Table 13). The debt is targeted to

decline during 2002–05 by over US\$300 million, to about US\$365 million at end-2005.<sup>6</sup> The targeted debt reduction will be financed mainly by exceptional privatization receipts, asset recoveries, and balance of payments support.

### **Box 6. Pension System Reform**

**Nicaragua's current pension system is unsustainable.** The system is funded through compulsory payroll contributions for all public and private sector workers and voluntary contributions for self-employed. Because (defined) benefits exceed the actuarial level of contributions, the system is accumulating unfunded liabilities (estimated at around 95 percent of GDP as of 2001). Even though Nicaraguan Social Security Institute (INSS) operations are in surplus on an overall basis, the pension component has had cash deficits since 1997. To limit the growing imbalances of the system, the authorities decided to reform the pension system by creating a self-financed alternative in 1998. Implementation of this reform, however, has been delayed, and the new pension system is now scheduled to become operational in 2003.

**Key elements of the pension reform are:** (i) the establishment of a mandatory, fully-funded defined contribution system administrated by privately managed funds for those younger than age 43; and (ii) strengthening of the existing pay-as-you-go system through adjusting system parameters (e.g., increasing contribution rates and age of retirement, as well as closing the system to new entrants). Based on affiliation data for 2002, approximately 280,000 active contributors will move to the new system, with annual contributions of about 2 percent on GDP. Those who migrate to the new system will receive a recognition bond for accrued pension rights, which will be inflation-indexed (but not interest-bearing) and paid out at retirement. Payment of these bonds is estimated to peak in 2025 at about 2 percent of GDP, and its discounted present value is estimated at around US\$400 million (assuming that the reform is implemented in 2003). From 2008 onward, the central government will finance the cost of pensions.

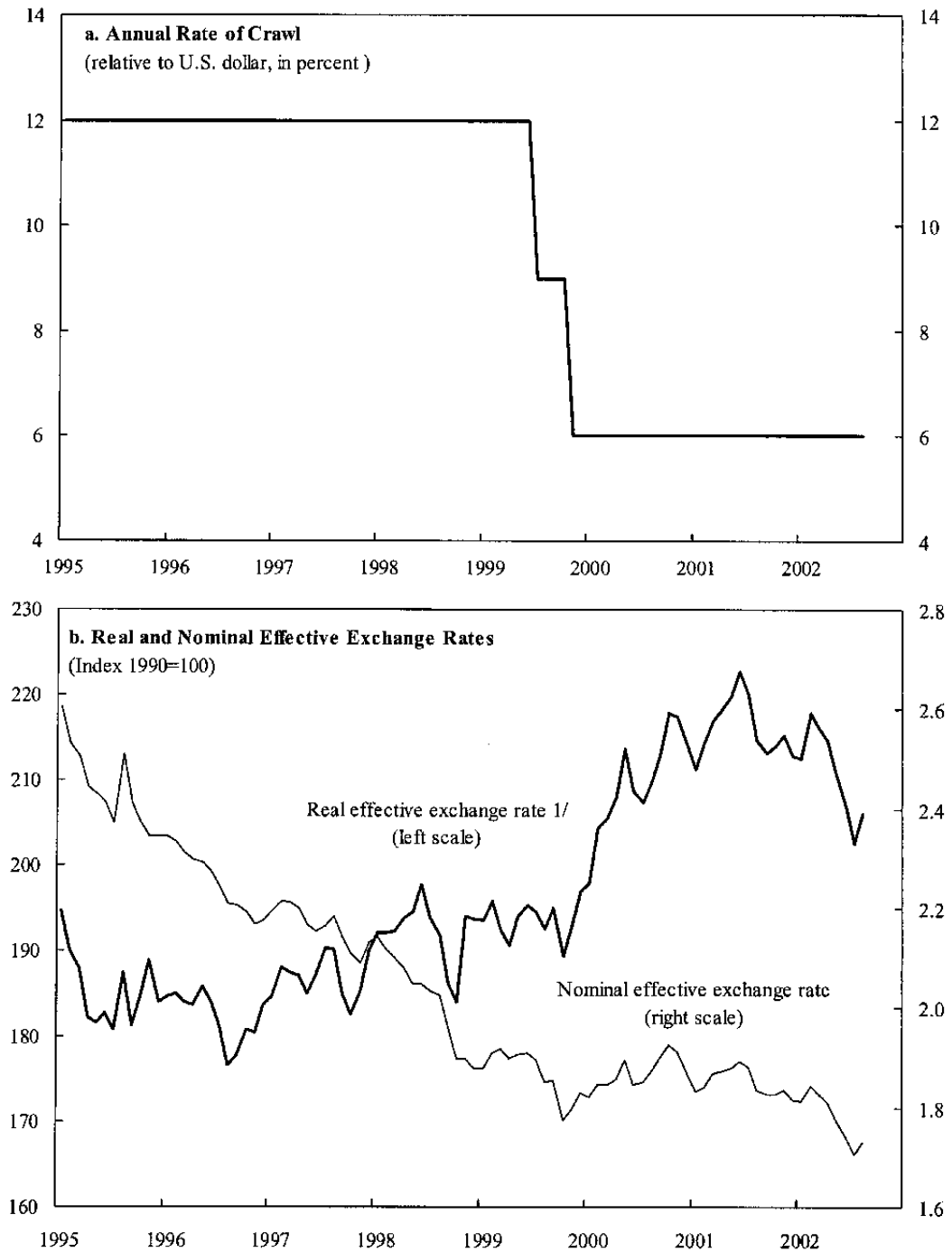
21. **The crawling peg exchange rate regime is a source of vulnerability.** The authorities emphasized that the crawling peg had been helpful in maintaining low inflation, and the staff broadly agreed with their assessment that the cordoba did not appear to be overvalued.<sup>7</sup> Nevertheless, while alternative policy options are limited in the near term given

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<sup>6</sup> The reduction in U.S. dollar terms includes net repayments of principal in local currency (equivalent to about US\$160 million) as well as the part of interest payments (in local currency) that effectively represents amortization (on account of indexation of principal to the U.S. dollar).

<sup>7</sup> Nontraditional export volume growth in recent years has outpaced foreign demand growth, and the real effective exchange rate—after appreciating in 2000–01—has fallen close to the level of the later 1990s (Figure 4).

Figure 4. Nicaragua: Exchange Rate Developments, 1995-2002



Sources: IMF Information Notice System; Fund staff estimates and Central Bank of Nicaragua.  
1/ Trade-weighted index of nominal effective exchange rates deflated by seasonally adjusted relative consumer prices. An increase (decrease) indicates appreciation (depreciation).

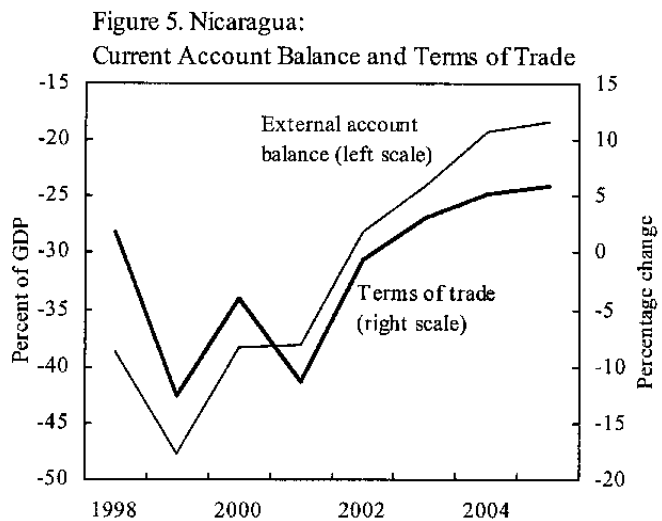
the high degree of dollarization, the staff argued that, in the longer run, greater flexibility would be beneficial for Nicaragua, given the risks and vulnerabilities associated with a peg. The authorities said they intended to carefully examine the effectiveness of the current exchange rate regime and its contribution to the objectives of low inflation and adequate external competitiveness. They agreed with the staff that it was important to continue taking steps to counter vulnerabilities, including through the pursuit of prudent macroeconomic policies and further strengthening the prudential framework.

22. **Strengthening the banking sector is key to Nicaragua's sustained growth.** The authorities are committed to strictly enforcing prudential regulations, improving the framework for bank resolutions (a new framework, elaborated with technical assistance from the Fund, is to be adopted in early 2003), and strengthening the superintendency of banks (MEFP, paragraph 21). The legal framework is to be changed to bring it in line with Basel Core Principles (MEFP, paragraph 11).

23. **The external current account deficit is projected to about halve over the program period** (from 38 percent of GDP in 2001 to 18 percent of GDP by 2005) (Figure 5).

About 5 percent of GDP of this improvement is derived from lower interest payments (particularly after the HIPC completion point), with the remainder reflecting mainly a significant improvement in the trade balance (see Table 10). Exports are projected to benefit from a gradual recovery in coffee and sugar prices and continued good performance of nontraditional exports; and moderate import growth is projected to resume, after a decline in 2002 from the unsustainably high levels of 2001 associated with expansionary fiscal policies. The services balance is projected to improve mainly owing to rapidly growing free-trade zone exports and tourism receipts, in addition to lower interest payments.

*Projected improvements in terms of trade will help reduce the current account deficit...*



24. **Significant private and official capital flows are expected to finance the current account deficit.** Foreign direct investment as well as privatization receipts are expected to be significant as private sector confidence is renewed under sound economic policies and improved governance conditions. Other private capital flows are likely to be less important initially as part of central bank debt repayments are deposited abroad, while credit to the private sector picks up gradually. Official capital flows will remain significant, and the program assumes a total of about US\$280 million of balance of payments support for the

period 2002–05, mainly from the World Bank and IDB. The remaining financing gaps are expected to be fully covered by debt relief under the enhanced HIPC Initiative (Appendix VI).

25. **The authorities have committed to prudent debt management.** The program foresees a significant reduction in the domestic debt of the combined public sector from 62 percent of GDP at end-2002 to about 42 percent of GDP by end-2005, about the level in 1998–99 before the banking crisis (Table 13). Consistent with this objective, the central bank's repayments of the domestic debt are targeted at US\$160 million during 2003–05 on a cash basis (US\$70 million in 2003). External borrowing by the public sector will continue to be limited to concessional loans (see Appendix VI), and the government will seek bilateral debt rescheduling agreements on Cologne terms. In addition, the authorities are aiming to harmonize the terms of BCN domestic debt with those of other Central American countries, so as to make it more attractive to investors.

26. **Further trade liberalization and regional integration are key to the authorities' mid-term growth strategy.** The authorities expect the ongoing process of regional integration in Central America to lead to implementation of a customs union with El Salvador, Guatemala, Costa Rica, and Honduras by early 2004. A free-trade agreement is currently being negotiated with Canada, and securing a similar agreement with the United States is high among the government's priorities. In response to the staff's recommendation to eliminate the temporary surcharge on imports from Colombia and Honduras, the authorities indicated that, for national security reasons, the surcharge would not be eliminated at this point but that it has been notified to the WTO. Nicaragua is rated as 4 on the Fund's restrictiveness index (a 10-point scale, with 1 indicating complete openness). Annex V discusses trade policy in greater detail.

27. **Improving governance and transparency are key objectives of the new government's agenda.** These are being pursued by prosecuting vigorously alleged corruption and fraud; strengthening the CGR; reforming the judicial system; extending the single-account reform to all government receipts, expenditures and financing; and through new legislation on real estate registries and on domestic and external public sector borrowing. Other areas of the structural reform agenda, covered by the World Bank and the IDB (Box 7), include the strengthening of the public procurement system, civil service reform, introduction of a private pension system, and continued progress with privatization (including the planned sale of the hydroelectric and thermal plants of the state electricity company (ENEL) during 2003–04, and of the remaining shares of the telecommunications company (ENITEL) by June 2003 (MEFP, paragraph 22).

## Box 7. Structural Conditionality

### 1. Structural conditionality in the proposed program

Structural conditionality under the first year of the PRGF Arrangement (2002–03) focuses on fiscal consolidation, financial system strengthening, and improving governance and transparency (Table 3, MEFP).

**Fiscal consolidation:** On the revenue side, a second stage of the tax reform seeks to improve efficiency and broaden the tax-base, and an action plan aims to strengthen tax administration. On the expenditure side, adoption of a public sector restructuring plan aims at increasing efficiency and a permanent reduction in current spending. Privatization process will continue and the remaining shares of the telecommunication company will be sold.

**Financial system:** Strengthening the prudential framework and enforcement of existing provisioning and capital requirements are key program elements. Implementation of a plan for regular on-site inspections as well as necessary legal amendments for effective bank supervision (in line with Basle Core Principles) are also envisaged during the first program year.

**Governance and transparency:** Successful implementation of a plan for asset recoveries will contribute to the health of the financial system, lessen moral hazard and reduce pressures on public finances. The approval of a law on domestic and external indebtedness will signal commitment to a sustainable debt position over the long term. Adoption of the revised national accounts as the official figures will allow a better assessment of economic policies and prospects.

### 2. Status of structural conditionality from earlier programs

A three-year ESAF arrangement was approved in March 1998. The first and second reviews under the second annual arrangement of the program were completed in December 2000, including waivers for nonobservance of structural performance criteria relating to the approval of the social security reform law and issuance of final bid documents for the public electricity company's generation and distribution units and for 40 percent of the public telecommunication company's assets. By end-2001, those structural reforms were implemented. Discussion on the third annual PRGF could not be completed because of significant policy slippages, particularly in the fiscal area.

### 3. Structural areas covered by World Bank and IDB lending

Disbursements of *World Bank* program loans are conditioned on strengthening the policy and regulatory environment in the telecommunications sector; pension reform to create a more equitable and sustainable system of old-age income security for workers; reforming the public sector management system and civil service; improving the efficiency and soundness of financial intermediaries that serve small productive units in rural areas; addressing constraints to private sector development; developing human capital; reviving agriculture and strengthening natural resource management; rehabilitating road infrastructure; supporting the social safety net and combating rural poverty; and improving protection from natural disasters. *IDB* lending operations support strengthening of the financial system, the General Comptroller and the judicial system; pension reform; credit to small enterprises and rural cooperatives; reform of the electricity sector; rural productive reactivation; social protection, focusing on child care; water supply modernization; health and education reforms; and improvement in transparency and control of government procurement.

### 4. Other relevant structural conditions

Seven floating HIPC completion point conditions are set out in Table 16. They refer to the preparation and implementation of the PRSP, implementation of a tracking mechanism for HIPC funds, maintenance of a stable macroeconomic framework supported by a PRGF arrangement, implementation of reforms to promote human capital development and social protection, implementation of governance strengthening measures, pension reform, and divestment of ENITEL and energy generating units of ENEL. Additionally, the new government has committed itself to reforming the judicial system. A special commission, in consultation with civil society, presented to the government a report in mid-2002 suggesting the needed reforms, including a new judicial career system, a new election system of magistrates of the Supreme Court, revision of existing legislation, and reorganization of the judicial system.



## **B. The Program for 2002–03**

28. **Since taking office in early 2002, the authorities have made good progress in building a track record of policy implementation.** Preliminary understandings were reached with Fund staff in March on key economic and financial targets for 2002–03. Based on the measures described above, fiscal and monetary performance during the first three quarters of 2002 has been in line with those targets. Although the tax package approved by the assembly in August (yielding about 2 percent of GDP on an annual basis) fell short of the initial goal of 3 percent of GDP, the authorities are committed to implementing a second round by mid-2003 to make up the shortfall.

29. **To reduce financial sector vulnerabilities, the authorities have ended regulatory forbearance and are about to implement a key recovery plan for assets of failed banks.** The SB has required all banks to comply with existing prudential norms, including provisioning and capital adequacy requirements for coffee-related loans. The BCN in late September initiated a public bidding process to select an experienced and reputable firm to manage the sale of nonperforming assets received from failed banks in 2000–01. Public announcement of the firm selected is a prior action for approval of the PRGF arrangement.

30. **The authorities have taken significant steps to improve governance and reduce corruption,** including adoption of a probity law for public employees and of changes to the penal code to define crimes of public servants. In addition, a broad-based commission on judicial reform (including civil society) prepared recommendations to strengthen the judicial system. Implementation of a public procurement reform program has started (with support from the IDB), and preparations for implementing a new penal procedures code are well advanced. The authorities expressed strong ownership of these reforms, although they acknowledged that it would take time for them to take root across the political spectrum.

31. **The first-year PRGF program (covering October 2002–September 2003) is designed to make further progress with fiscal consolidation, improve the reserve position of the BCN, and strengthen the financial sector.** The authorities underscored their commitment to fiscal adjustment, tightening prudential oversight, and fighting corruption, notwithstanding the depressed level of economic activity and the considerable social and political pressures against those policies. Given the difficult external environment, including weak prices for Nicaragua's main export commodity (coffee), real GDP growth is projected at 1 percent in 2002, followed by a gradual recovery during 2003 (with 3 percent growth for the year as a whole). Growth in 2003 is expected to be driven mainly by construction, agriculture and fishing, and tourism.

32. **The public sector deficit is to be reduced sharply from the unsustainably high level of 2001 (see Table 2).** The combined public sector deficit (after grants) is programmed at 6.3 percent of GDP in 2003, down from 14 percent of GDP in 2001. The primary public

sector deficit is to be reduced from 12 percent of GDP to 2.8 percent of GDP<sup>8</sup> over the same period despite the 1.1 percent of GDP reduction of social security contributions in 2003 associated with the introduction of a privately managed pension system. Consistent with these targets, the government recently submitted to the assembly a 2003 budget, which lowers primary current spending by 1½ percent of GDP (after it was cut by 2 percent of GDP in 2002). This reduction reflects mainly the commitment to maintain nominal wages at the 2002 level, while poverty-reducing spending is budgeted to increase by 0.2 percent of GDP. On the revenue side, the program for 2003 targets central government revenues to rise by 1¾ percent of GDP, reflecting the full-year effect of the first round of tax reform implemented in 2002 and the second round expected to be in place by end-June 2003 (see Box 3).

33. **A second round of tax reform to be implemented by mid-2003 is to yield at least 1 percent of GDP on an annual basis.** The authorities agreed with the staff on the importance of eliminating import tax exemptions and replacing the zero-rate VAT with direct and better-targeted programs to help the most vulnerable sectors of the population. However, also noted that their proposal in mid-2002 to reduce the list of zero-rated VAT products had been rejected by the assembly; they now intend to launch a broad-based effort, including with civil society, at reaching a national consensus on those measures (MEFP, paragraph 17). The authorities acknowledged that basing part of the adjustment on a future tax package carried some risks; however, a first round of tax reform was in place and they had contingency measures to ensure that the overall fiscal targets would be met (for example, through cuts in nonessential capital spending).

34. **Monetary policy will be geared toward strengthening the reserve position of the BCN in a low-inflation context (6 percent in 2003).** The authorities noted that fiscal adjustment and satisfactory implementation of the asset recovery plan were critical to achieving this goal. Monetary aggregates are expected to increase in line with nominal GDP growth (about 10 percent), while credit to the private sector is projected to increase at a somewhat faster pace (room for this increase is provided by the targeted reduction of government paper held by commercial banks). While the shift of resources to the private sector was important, the authorities agreed with the staff that this needed to be done while ensuring the quality of the new credit flows through close supervision. In this connection, the program allows the monetary authorities to manage domestic liquidity through lower reductions of the domestic debt with banks compensated by higher NIR accumulation. The annual crawl of the exchange rate will be maintained at 6 percent during 2003.

35. **The government is strongly committed to the recovery plan for the assets acquired by BCN from intervened banks (MEFP, paragraph 20).** The BCN will shortly

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<sup>8</sup> The targeted primary deficit in 2003 would still be higher than 1998, before the high Hurricane Mitch-related spending and the large election related overruns of 2000–01.

sign a contract with the selected firm to carry out the recoveries; the firm will then dispose of the assets by end-June, with proceeds to be received by the BCN by end-September 2003.

36. **Full compliance with prudential norms is a key objective of the program.** The SB has required all banks to comply with capital adequacy requirements by end-2002. It will start implementing regular on-site inspections for all banks (with technical assistance from the IMF, the World Bank, and IDB), and a new unit will be established in FOGADE, the deposits insurance agency, to manage and liquidate assets in the event of future bank interventions. There was agreement between the authorities and the staff on policies to react quickly in sign of weakness in financial institutions. Bank secrecy on assets will be removed, and new regulations will be prepared in 2003 to bring the prudential framework in line with Basel Core Principles (MEFP, paragraphs 11 and 21).

37. **The external current account deficit is expected to improve from 28 percent of GDP in 2002 to 24 percent of GDP in 2003.** This improvement is mainly due to higher exports as a result of an expected recovery in coffee and sugar prices and production, as well as better prospects for seafood exports, after a partial fishing ban in 2002. Imports are expected to register only modest growth, in part as a result of tight fiscal and monetary policies. The services balance is expected to continue improving due to higher receipts from tourism and free-trade zones. The main risks to this outlook relate to the possibility of higher oil import prices and a slower-than-anticipated recovery in coffee volumes and prices.

38. **The first-year program assumes balance of payments support of about US\$100 million.** The IDB and the World Bank would provide most of this financing under sectoral adjustment loans, and will continue to provide HIPC interim assistance; the authorities are also expected to request interim assistance from the IMF. Shortly after approval of the PRGF arrangement by the IMF, Nicaragua is expected to initiate discussions with Paris Club creditors on a flow rescheduling under Cologne terms. In addition, a new World Bank Programmatic Structural Adjustment Loan (PSAC) is expected to be approved by mid-December 2002, along with a new Country Assistance Strategy for Nicaragua. The PSAC is designed to support the implementation of the PRSP in three key areas: (i) improving the business climate to promote faster private sector-driven growth; (ii) social sector reforms to enhance the impact of social programs; and (iii) improving governance and strengthening institutions.

Nicaragua: External Financing  
(In millions of US dollars)

	Program						
	2002		2003				
	Q 4	Total	Q 1	Q 2	Q 3	Q 4	Total
<b>Disbursements of loans</b>	<b>84</b>	<b>194</b>	<b>71</b>	<b>39</b>	<b>53</b>	<b>63</b>	<b>226</b>
BOP support disbursements	43	43	40	0	15	20	75
Tied Loans	41	151	31	39	38	43	151
<b>Disbursements of grants</b>	<b>40</b>	<b>106</b>	<b>13</b>	<b>26</b>	<b>34</b>	<b>36</b>	<b>109</b>
Untied Grants	11	13	1	6	11	11	28
Tied Grants	30	93	12	20	23	25	81
<b>Total external financing</b>	<b>125</b>	<b>300</b>	<b>84</b>	<b>64</b>	<b>87</b>	<b>99</b>	<b>335</b>

Sources: Central Bank of Nicaragua and Fund Staff Estimates.

### C. Statistical Issues

39. **Although Nicaragua has taken significant steps to improve its economic statistics in recent years, important weaknesses remain (Appendix IV).** New national accounts for the period 1994–2000 were approved by the BCN’s Board in mid-2002 and will be adopted as the official figures in March 2003. Given that the new GDP series are expected to be significantly higher than the current estimates, the macroeconomic framework will need to be revised in the context of the second review, while preserving the underlying program objectives. Remaining weaknesses include sizable discrepancies between above-the-line fiscal data and financing items; sectoral monetary statistics (especially for the nonfinancial public sectors); and incomplete data for the financial account of the balance of payments. Work is ongoing on improving the sectorization of the financial sector accounts and shifting them to an accrual basis. The authorities have indicated their interest to participate in the General Data Dissemination System.

### D. Program Risks, Access, and Monitoring

40. **There are significant risks to the program, both domestic and from the difficult external environment.** Nicaragua’s track record of policy implementation in the 1990s is weak. Although the new government has shown strong commitment to the program, it has only been in office since January 2002, and still faces significant opposition from vested interests and other groups in carrying out its policy agenda. A further deterioration in the already difficult external environment is another serious risk. As noted, the economy is also vulnerable due to the large fiscal imbalance, a fragile banking system, and the large dollar-indexed and dollar-denominated domestic debt—while official reserves coverage is very low.

41. **Access under the PRGF arrangement is proposed at SDR 97.5 million (75 percent of quota), to be disbursed over the program period as shown in Table 15.** Access is justified by (i) the strength of the proposed program; (ii) the large external financing need (including because of weak commodity prices, in particular coffee); and (iii) Nicaragua's external vulnerabilities. In particular, despite considerable domestic adjustment envisaged during the program period, gross financing requirements will remain substantial over the medium term (see Table 10).

42. **Nicaragua's track record in servicing its obligations to the Fund is very strong.** The authorities have agreed to implement the recommendations of the Stage One Safeguard Assessment, which have been endorsed by Fund management. The main recommendations are that (i) the BCN strengthen financial reporting by either adopting International Accounting Standards (IAS) or disclosing any differences between the BCN's accounting principles and IAS in its financial statements; (ii) the BCN implement an action plan to collect overdue receivables from nonfinancial governmental agencies or to write them off as nonrecoverable; and (iii) the Internal Audit Department (IAD) review the process of reconciliation of reserves data, as reported to the Fund, to ensure that net reserves are properly valued and that they are consistent with the audited statements. The agreed implementation dates are shown in Table 2 of the Technical Memorandum of Understanding.

43. **Because of the high program risks, implementation of the first annual program will be monitored using quarterly performance criteria, benchmarks and reviews,** as set out in Tables 2 and 3 of the MEFP. If program implementation is satisfactory through December 2003, monitoring will be conducted semiannually during the remainder of the program.

### III. STAFF APPRAISAL

44. **After a period of rapid growth in the second half of the 1990s, economic performance deteriorated sharply in recent years as domestic problems were compounded by external shocks.** Despite the transition to democracy and peace, and greater emphasis on market-oriented reforms, economic policy making became increasingly politicized, governance problems festered, and widespread poverty and social tensions strained the social contract. In 2000–01, a sharp deterioration of the external environment combined with the loss of fiscal and monetary control in the run-up to presidential elections, produced a near-crisis with a huge increase in the fiscal deficit, a banking crisis, and a cut-off from balance of payments support.

45. **The new government that took office in early 2002 has moved quickly to address the economy's key vulnerabilities and create the basis for sustained rapid growth and poverty reduction.** The staff welcomes the authorities' keen awareness of the risks and challenges facing the Nicaraguan economy, and their strong commitment to policies designed to overcome them. Indicative of the authorities' determination is their expressed commitment

to and ownership of the updated PRSP, the satisfactory performance so far in 2002, and the strong anti-corruption initiatives they have taken. While this indicates strong government ownership of the program, it will take time to widen such ownership across the political spectrum, which in turn will depend on the program yielding early results.

46. **Fiscal consolidation is a key part of the authorities' medium-term strategy.** Their deficit reduction strategy appropriately aims at strengthening the tax effort and reducing nonpoverty-reducing primary expenditure, while raising the quantity and quality of poverty-reducing spending. The first stage of the tax reform approved in August was a valuable step in the direction of widening the tax base. It is particularly important to complete the tax reform, through a second round that includes elimination of exemptions and zero-rated VAT items (except exports), and to implement the envisaged comprehensive reform of the public sector. The staff also looks forward to the start of the transfer of part of pension administration to the private sector.

47. **While the crawling peg exchange rate regime has served Nicaragua well as an anchor of low inflation, the staff believes that greater flexibility is needed.** The staff agrees with the authorities that the level of competitiveness is broadly appropriate. Since the high degree of financial dollarization makes Nicaragua vulnerable to large exchange rate changes, the authorities consider the crawling peg to be the best option in the short run. However, given the well-known vulnerabilities associated with a peg, the staff believes that the authorities should work to put in place as soon as possible the conditions for moving toward greater flexibility, including appropriate fiscal, monetary, and financial sector policies.

48. **Against the background of significant forbearance in recent years, it is particularly important that financial institutions strictly observe prudential norms,** especially on provisioning and minimum capital requirements. It is essential for the SB to react promptly and forcefully to weaknesses in financial institutions. Regular on-site inspections and appropriate sanctions for noncompliance are key in this effort. The staff looks forward to the imminent selection of a firm to implement asset recoveries, as an important prior action, and encourages the authorities to allow speedy asset disposal without government interference. Successful asset recovery is crucial for the financing of the program, and will mark a milestone in the fight against corruption and moral hazard in the banking system.

49. **The staff welcomes the government's determination to combat corruption and encourages continued efforts to promote good governance in the public and private sectors.** Full and timely implementation of other structural reforms, including the privatization program, trade liberalization and integration, and the strengthening of property rights, will be essential to remove barriers to growth and promote the development of the private sector.

50. **The planned improvements in Nicaragua's statistics represent particular important steps, which will allow more effective economic monitoring and enhance transparency.** The improvements contemplated under the program to bring monetary statistics and national accounts in line with international standards are noteworthy. The staff encourages the authorities to follow-up soon on their expressed interest in joining the GDSS.

51. **There are important risks to the program, requiring vigilance on the part of the authorities and close monitoring under the PRGF arrangement.** The difficult economic and social situation, entrenched vested interests, and a strong political opposition will pose constant challenges to program implementation. An important first test will be the approval by the assembly of the 2003 budget submitted by the executive, with budget implementation, tax reform, and asset recoveries perhaps the most difficult—yet crucial—elements of the first-year program. In addition, an important source of risk is the weakness of the financial system, as official data may well overstate the soundness of the system. The difficult external environment, large dollar-indexed domestic debt, and a high degree of financial dollarization are additional vulnerabilities. In view of those risks, quarterly disbursements, conditioned on observance of performance criteria and reviews, are appropriate for the first program year.

52. **The staff recommends that the authorities' request for a new three-year PRGF arrangement and interim HIPC assistance be approved.** Notwithstanding the risks, the satisfactory track record established since early 2002 augurs well for implementation of the program, although strong efforts are needed to build broad ownership of the adjustment effort, including in the national assembly and the public at large.

53. It is expected that the next Article IV consultation with Nicaragua will be held on a standard 24-month cycle subject to the provisions of the decision on consultation cycles approved by the Board on July 15, 2002.

Table 1. Nicaragua: Selected Economic and Financial Indicators

	Actual		Prel.	Program			
	1999	2000	2001	2002	2003	2004	2005
(Annual percentage change; unless otherwise indicated)							
<b>National income, prices, and unemployment</b>							
GDP at constant prices	7.4	5.9	3.3	1.0	3.0	4.5	5.0
Consumer prices (end of period) 1/	7.2	6.6	4.7	6.0	6.0	4.0	4.0
Consumer prices (period average) 1/	11.2	7.4	7.4	4.4	6.0	4.8	4.0
Unemployment rate (percent)	10.7	9.9	10.5	...	...	...	...
<b>External sector</b>							
Exports, f.o.b.	-4.9	18.3	-8.1	1.0	10.8	11.5	12.6
Export volume	3.2	15.1	7.3	1.1	5.5	6.1	6.2
Imports, f.o.b.	21.6	-3.0	-1.1	-4.2	2.4	3.6	6.2
Import volume	18.3	-9.7	3.1	-4.7	1.0	3.4	6.1
Terms of trade (deterioration -)	-12.5	-4.0	-11.2	-0.6	3.0	5.2	5.9
Nominal effective exchange rate end of period (depreciation -)	-2.7	2.1	-2.9	...	...	...	...
Real effective exchange rate end of period (depreciation -)	1.6	8.8	-0.6	...	...	...	...
<b>Money and credit</b>							
Net domestic assets of the central bank 2/	-39.3	22.7	141.7	16.6	-12.0	10.7	-22.4
Net credit to nonfinancial public sector 2/	-75.6	-36.2	161.7	-40.7	-81.7	-47.8	-138.2
Net credit to financial institutions 2/	-2.6	95.4	-54.0	-19.8	-16.3	-16.8	-19.4
Currency in circulation	29.5	1.2	11.1	7.0	9.7	10.7	10.2
Financial system liabilities to private sector	22.4	7.3	10.3	7.1	9.8	10.3	9.8
Financial system credit to private sector 3/	40.0	14.2	-43.5	15.0	19.7	17.4	14.0
Money income velocity (GDP/M3)	1.5	1.6	1.7	1.7	1.7	1.7	1.7
Interest rate on deposits (percent per annum) 4/	11.5	11.2	10.5	...	...	...	...
(In percent of GDP)							
<b>Public sector 5/</b>							
Combined public sector saving 6/	5.4	3.6	-4.4	-4.2	-1.0	3.4	5.5
Combined public sector primary balance (before grants) 6/	-10.1	-10.0	-11.9	-5.3	-2.8	-3.2	-2.3
Combined public sector overall balance (before grants) 7/	-15.7	-15.4	-21.0	-16.5	-13.2	-9.4	-7.5
Combined public sector overall balance (after grants) 6/ 7/	-7.0	-8.1	-14.3	-9.2	-6.3	-5.3	-3.3
Nonfinancial public sector saving	7.1	5.1	-2.4	-1.1	2.2	7.0	8.9
Nonfinancial public sector overall balance (before grants)	-14.1	-13.9	-19.0	-13.5	-10.0	-5.9	-4.2
Central bank operational results (deficit -)	-1.7	-1.5	-2.0	-3.1	-3.2	-3.5	-3.3
Stock of combined public sector domestic debt	35.3	41.0	59.6	61.6	55.9	48.5	42.2
<b>Savings and investment</b>							
Gross domestic investment	43.3	34.7	30.8	27.3	27.8	29.1	30.7
Public	21.1	19.0	16.2	12.3	12.2	12.9	13.0
Private	22.2	15.8	14.6	15.0	15.6	16.3	17.7
National savings	1.4	2.6	-2.8	-1.2	3.0	9.1	11.7
Public	5.4	3.6	-4.4	-4.2	-1.0	3.4	5.5
Private	-4.0	-1.0	1.6	3.0	4.0	5.7	6.2
External savings 8/	41.9	32.1	33.6	28.5	24.8	20.0	19.0
<b>External sector</b>							
External current account balance	-47.7	-38.3	-38.1	-28.2	-24.0	-19.3	-18.3
(Excluding interest obligations)	-37.5	-27.7	-25.7	-26.0	-21.2	-16.0	-15.2
Trade balance (deficit -)	-52.1	-41.2	-40.7	-37.4	-35.1	-32.6	-31.0
Outstanding external public debt (end of year) 9/	289.0	278.0	250.3	184.5	128.8	128.0	124.5
(In percent of exports of goods and nonfactor services)							
Contractual interest obligations, before debt relief	47.1	45.3	38.5	43.4	33.1	27.5	26.4
Gross international reserves (in months of imports)	3.3	3.2	2.3	2.2	2.5	2.7	3.0

Sources: Central Bank of Nicaragua; Ministry of Finance; and Fund staff estimates.

1/ For 2000, staff estimates using the new consumer price index adopted in 2001.

2/ In relation to currency in circulation at the beginning of the year.

3/ Excludes credit held by liquidation boards.

4/ Six-month deposits, end of period.

5/ From 2001 onward, the interest cost of bank resolution on accrual basis is included in the central government operations.

6/ Includes central bank operational balance.

7/ For 2001-03, HIPC interim debt relief from multilaterals is recorded as grants, while the debt stock relief (assumed for end-2003) is implicit in lower interest payments and higher net external financing (from lower principal payments) for 2004-05.

8/ External current account deficit, excluding interest on debt to bilateral creditors that is eligible for debt rescheduling on conventional terms.

9/ For 2002-05, preliminary projections based on aggregate data.



Table 2. Nicaragua: Consolidated Operations of the Public Sector

(In percent of GDP)

	Actual		Prel.	Program			
	1999	2000	2001	2002	2003 1/	2004	2005
<b>Total current revenue</b>	<b>35.4</b>	<b>32.6</b>	<b>30.8</b>	<b>31.7</b>	<b>32.4</b>	<b>31.8</b>	<b>31.5</b>
Current revenue of the general government	33.0	32.0	30.3	31.3	32.0	31.4	31.0
Operational surplus of public utilities	2.4	0.6	0.5	0.4	0.4	0.4	0.4
<b>Total current expenditure</b>	<b>30.0</b>	<b>28.9</b>	<b>35.2</b>	<b>35.9</b>	<b>33.5</b>	<b>28.4</b>	<b>25.9</b>
Consumption and transfers	23.4	22.9	25.5	23.9	22.4	21.6	20.2
Nonfinancial public sector interest payments 2/	4.9	4.5	7.7	8.9	7.8	3.2	2.5
Central bank operating deficit	1.7	1.5	2.0	3.1	3.2	3.5	3.3
<b>Combined public sector savings</b>	<b>5.4</b>	<b>3.6</b>	<b>-4.4</b>	<b>-4.2</b>	<b>-1.0</b>	<b>3.4</b>	<b>5.5</b>
Excluding interest payments	11.1	9.0	4.6	7.0	9.4	9.6	10.8
<b>Capital expenditure and net lending (net of capital revenue)</b>	<b>21.1</b>	<b>19.0</b>	<b>16.6</b>	<b>12.3</b>	<b>12.2</b>	<b>12.9</b>	<b>13.0</b>
<b>Combined public sector primary balance (before grants)</b>	<b>-10.1</b>	<b>-10.0</b>	<b>-11.9</b>	<b>-5.3</b>	<b>-2.8</b>	<b>-3.2</b>	<b>-2.3</b>
<b>Combined public sector balance (before grants)</b>	<b>-15.7</b>	<b>-15.4</b>	<b>-21.0</b>	<b>-16.5</b>	<b>-13.2</b>	<b>-9.4</b>	<b>-7.5</b>
<b>Grants</b>	<b>8.7</b>	<b>7.3</b>	<b>6.7</b>	<b>7.3</b>	<b>7.0</b>	<b>4.1</b>	<b>4.2</b>
Interim debt relief: HIPC 3/	0.0	0.0	1.9	3.2	2.9	0.0	0.0
Other 4/	8.7	7.3	4.8	4.1	4.1	4.1	4.2
<b>Combined public sector balance (after grants)</b>	<b>-7.0</b>	<b>-8.1</b>	<b>-14.3</b>	<b>-9.2</b>	<b>-6.3</b>	<b>-5.3</b>	<b>-3.3</b>
<b>Financing</b>	<b>7.0</b>	<b>8.1</b>	<b>14.3</b>	<b>9.2</b>	<b>6.3</b>	<b>5.3</b>	<b>3.3</b>
Privatization and external financing, net 3/	10.8	11.2	7.4	7.3	9.0	7.8	6.9
Domestic financing, net	-3.8	-3.1	6.8	1.9	-2.7	-2.5	-3.6
Of which : central bank	-3.1	0.1	8.5	-2.7	-4.7	-2.5	-7.1
<b>Memorandum items:</b>							
Total expenditure of the combined public sector	51.1	48.0	51.8	48.2	45.7	41.2	39.0
Total interest of the combined public sector	5.7	5.4	9.0	11.2	10.5	6.2	5.2
Total primary expenditure	45.4	42.6	42.7	37.0	35.2	35.0	33.8
Total primary current expenditure	24.3	23.6	26.2	24.6	23.0	22.2	20.7
Total poverty-reducing expenditure 5/	13.6	14.4	14.1	15.6	15.8	16.3	16.8
Total HIPC debt relief	...	0.0	3.4	9.1	8.3	0.0	0.0
From multilaterals	...	0.0	1.9	3.2	2.9	0.0	0.0
From bilaterals	...	0.0	1.5	5.9	5.4	0.0	0.0
GDP (in millions of cordobas)	26,130	30,858	34,242	36,646	40,204	44,511	49,068

Sources: Ministry of Finance; Central Bank of Nicaragua; and Fund staff estimates.

1/ Assumes that private pension funds initiate operations in July.

2/ Includes the interest cost of bank resolution on accrual basis.

3/ For 2001–03, HIPC interim debt relief from multilaterals creditors is recorded as grants. Program projections assume that the HIPC stock of debt reduction takes place in 2003, which results in lower interest payments and higher net external financing (from lower principal payments) in 2004–05.

4/ Mainly project-related grants from bilateral donors.

5/ Excluding post-Hurricane Mitch reconstruction expenditure.

Table 3. Nicaragua: Summary Operations of the Central Government

(In percent of GDP)

	Actual	Prel.	Program			
	2000	2001	2002	2003	2004	2005
<b>Total current revenue</b>	<b>24.5</b>	<b>22.3</b>	<b>23.4</b>	<b>25.1</b>	<b>25.8</b>	<b>25.7</b>
Tax revenue	23.6	21.5	22.0	24.2	24.9	24.9
Nontax revenue and current transfers	0.9	0.9	1.4	1.0	0.8	0.8
<b>Total current expenditures</b>	<b>22.2</b>	<b>27.0</b>	<b>26.2</b>	<b>23.7</b>	<b>18.1</b>	<b>16.1</b>
Consumption and transfers	17.8	19.3	17.3	15.9	14.9	13.6
Of which: wages and salaries	6.1	6.2	6.8	6.3	5.7	5.5
Interest payments 1/	4.3	7.7	8.9	7.8	3.2	2.5
<b>Savings</b>	<b>2.4</b>	<b>-4.6</b>	<b>-2.8</b>	<b>1.4</b>	<b>7.6</b>	<b>9.6</b>
Capital expenditure and net lending (net of capital revenue)	16.6	14.7	10.2	10.2	11.2	11.6
<b>Primary balance before grants</b>	<b>-9.9</b>	<b>-11.7</b>	<b>-4.1</b>	<b>-1.0</b>	<b>-0.4</b>	<b>0.5</b>
<b>Balance before grants</b>	<b>-14.2</b>	<b>-19.4</b>	<b>-13.0</b>	<b>-8.8</b>	<b>-3.6</b>	<b>-2.0</b>
Grants	6.1	5.7	6.7	6.3	3.6	3.6
Of which: HIPC interim relief 2/	0.0	1.9	3.2	2.9	0.0	0.0
<b>Balance after grants</b>	<b>-8.1</b>	<b>-13.7</b>	<b>-6.3</b>	<b>-2.5</b>	<b>0.0</b>	<b>1.6</b>
<b>Financing</b>	<b>8.1</b>	<b>13.7</b>	<b>6.3</b>	<b>2.5</b>	<b>0.0</b>	<b>-1.6</b>
Privatization and external (net) 2/	11.0	6.8	6.5	8.3	7.3	6.6
Domestic (net)	-2.9	6.9	-0.2	-5.9	-7.3	-8.2
<b>Memorandum items:</b>						
Total expenditure	22.2	27.0	26.2	23.7	18.1	16.1
Total primary expenditure	17.8	19.3	17.3	15.9	14.9	13.6
Total primary current expenditure	17.8	19.3	17.3	15.9	14.9	13.6

Sources: Ministry of Finance; Central Bank of Nicaragua; and Fund staff estimates.

1/ Includes the interest cost of bank resolution on accrual basis.

2/ For 2001–03, HIPC interim debt relief from multilaterals is recorded as grants. Program projections assume that the HIPC stock of debt reduction takes place in 2003, which implies lower interest payments and higher net external financing.

Table 4. Nicaragua: Consolidated Operations of the Public Sector - Quarterly

(In millions of cordobas)

	2002					2003				
	Q-1	Q-2	Q-3	Q-4	Total	Q-1	Q-2	Q-3 1/	Q-4	Total
<b>Total current revenue</b>	<b>2,781.2</b>	<b>2,778.1</b>	<b>3,074.2</b>	<b>2,981.5</b>	<b>11,614.9</b>	<b>3,329.1</b>	<b>3,199.3</b>	<b>3,227.8</b>	<b>3,289.6</b>	<b>13,045.8</b>
Current revenue of the general government	2,735.7	2,747.0	3,029.6	2,955.7	11,468.0	3,295.4	3,159.4	3,175.5	3,252.8	12,883.1
Operational surplus of public utilities	45.5	31.1	44.6	25.7	146.9	33.7	39.9	52.2	36.8	162.7
<b>Total current expenditure</b>	<b>3,246.1</b>	<b>3,124.5</b>	<b>3,508.8</b>	<b>3,268.7</b>	<b>13,148.2</b>	<b>3,437.3</b>	<b>3,222.1</b>	<b>3,351.0</b>	<b>3,445.3</b>	<b>13,455.6</b>
Consumption and transfers	2,023.0	2,010.3	2,139.3	2,596.0	8,768.5	2,134.7	2,177.1	2,178.2	2,515.5	9,005.5
Nonfinancial public sector interest payments 2/	1,006.5	622.1	990.2	639.7	3,258.5	991.1	621.1	1,002.1	540.4	3,154.7
Central bank operating deficit	216.7	492.1	379.3	33.1	1,121.2	311.5	423.8	170.7	389.4	1,295.4
<b>Combined public sector savings</b>	<b>-464.9</b>	<b>-346.5</b>	<b>-434.6</b>	<b>-287.3</b>	<b>-1,533.3</b>	<b>-108.2</b>	<b>-22.8</b>	<b>-123.2</b>	<b>-155.7</b>	<b>-409.8</b>
Excluding interest payments	695.2	706.7	871.8	309.1	2,582.8	1,134.9	963.4	994.2	705.7	3,798.2
<b>Capital expenditure and net lending (net of capital revenue)</b>	<b>564.0</b>	<b>1,247.8</b>	<b>1,345.5</b>	<b>1,361.8</b>	<b>4,519.2</b>	<b>959.3</b>	<b>1,270.6</b>	<b>1,322.8</b>	<b>1,360.2</b>	<b>4,912.8</b>
<b>Combined public sector primary balance (before grants)</b>	<b>131.2</b>	<b>-541.1</b>	<b>-473.7</b>	<b>-1,052.7</b>	<b>-1,936.4</b>	<b>175.6</b>	<b>-307.2</b>	<b>-328.6</b>	<b>-654.5</b>	<b>-1,114.6</b>
<b>Combined public sector balance (before grants)</b>	<b>-1,029.0</b>	<b>-1,594.3</b>	<b>-1,780.1</b>	<b>-1,649.1</b>	<b>-6,052.5</b>	<b>-1,067.5</b>	<b>-1,293.4</b>	<b>-1,446.0</b>	<b>-1,515.9</b>	<b>-5,322.6</b>
<b>Grants</b>	<b>652.1</b>	<b>537.2</b>	<b>745.9</b>	<b>754.9</b>	<b>2,690.3</b>	<b>493.6</b>	<b>631.3</b>	<b>913.0</b>	<b>770.4</b>	<b>2,808.3</b>
Interim debt relief: HIPC 3/	479.3	201.0	317.1	178.0	1,175.3	293.5	242.4	399.3	226.4	1,161.7
Other	172.9	336.2	428.9	577.0	1,514.9	200.1	388.9	513.6	544.0	1,646.6
<b>Combined public sector balance (after grants)</b>	<b>-376.8</b>	<b>-1,057.0</b>	<b>-1,034.2</b>	<b>-894.2</b>	<b>-3,362.2</b>	<b>-573.9</b>	<b>-662.0</b>	<b>-533.0</b>	<b>-745.5</b>	<b>-2,514.4</b>
<b>Financing</b>	<b>376.8</b>	<b>1,057.0</b>	<b>1,034.2</b>	<b>894.2</b>	<b>3,362.2</b>	<b>573.9</b>	<b>662.0</b>	<b>533.0</b>	<b>745.5</b>	<b>2,514.4</b>
Privatization and external financing, net	356.8	586.7	519.5	1,194.8	2,657.8	1,090.6	414.9	1,173.6	934.7	3,613.8
Domestic financing, net	20.0	470.3	514.7	-300.6	704.4	-516.7	247.1	-640.6	-189.2	-1,099.4
<i>Of which</i> : central bank	-525.0	-102.0	-195.7	-169.1	-991.9	-560.5	-168.6	-769.4	-391.5	-1,890.1

Sources: Ministry of Finance; Central Bank of Nicaragua; and Fund staff estimates.

1/ Assumes that private pension funds initiate operations in July.

2/ Includes the interest cost of bank resolution on accrual basis.

3/ For 2002-03, HIPC interim debt relief from multilaterals creditors is recorded as grants.

Table 5. Nicaragua: Summary Operations of the Central Government - Quarterly

(In millions of cordobas)

	2002					2003				
	Q-1	Q-2	Q-3	Q-4	Total	Q-1	Q-2	Q-3	Q-4	Total
<b>Total current revenue</b>	<b>2,000.2</b>	<b>2,053.7</b>	<b>2,271.3</b>	<b>2,245.0</b>	<b>8,570.3</b>	<b>2,444.8</b>	<b>2,383.6</b>	<b>2,609.1</b>	<b>2,669.1</b>	<b>10,106.6</b>
Tax revenue	1,924.4	1,972.1	2,110.9	2,056.0	8,063.4	2,313.9	2,297.2	2,523.4	2,581.6	9,716.0
Nontax revenue and current transfers	75.8	81.7	160.4	188.9	506.9	130.9	86.4	85.7	87.5	390.5
<b>Total current expenditures</b>	<b>2,494.8</b>	<b>2,108.2</b>	<b>2,508.4</b>	<b>2,483.0</b>	<b>9,594.4</b>	<b>2,523.0</b>	<b>2,174.8</b>	<b>2,549.0</b>	<b>2,287.3</b>	<b>9,534.2</b>
Consumption and transfers	1,489.5	1,486.7	1,522.1	1,847.2	6,345.4	1,534.6	1,556.8	1,549.6	1,750.0	6,391.0
<i>Of which</i> : wages and salaries	537.6	577.0	573.3	819.3	2,507.2	583.0	581.4	581.4	793.7	2,539.4
Interest payments 1/	1,005.4	621.5	986.4	635.7	3,249.0	988.4	618.0	999.4	537.3	3,143.2
<b>Savings</b>	<b>-494.6</b>	<b>-54.4</b>	<b>-237.1</b>	<b>-238.0</b>	<b>-1,024.1</b>	<b>-78.2</b>	<b>208.7</b>	<b>60.1</b>	<b>381.7</b>	<b>572.4</b>
Capital expenditure and net lending (net of capital revenue)	425.4	1,064.3	1,099.2	1,141.0	3,729.9	783.2	1,008.5	1,108.2	1,213.3	4,113.2
<b>Primary balance before grants</b>	<b>85.4</b>	<b>-497.2</b>	<b>-349.9</b>	<b>-743.3</b>	<b>-1,505.0</b>	<b>127.0</b>	<b>-181.7</b>	<b>-48.6</b>	<b>-294.3</b>	<b>-397.6</b>
<b>Balance before grants</b>	<b>-920.0</b>	<b>-1,118.7</b>	<b>-1,336.3</b>	<b>-1,379.0</b>	<b>-4,754.0</b>	<b>-861.5</b>	<b>-799.7</b>	<b>-1,048.0</b>	<b>-831.6</b>	<b>-3,540.8</b>
Grants	592.2	464.5	680.4	712.5	2,449.6	430.1	565.9	827.6	725.2	2,548.8
<i>Of which</i> : HIPC interim relief 2/	479.3	201.0	317.1	178.0	1,175.3	293.5	242.4	399.3	226.4	1,161.7
<b>Balance after grants</b>	<b>-327.8</b>	<b>-654.2</b>	<b>-655.9</b>	<b>-666.5</b>	<b>-2,304.4</b>	<b>-431.3</b>	<b>-233.8</b>	<b>-220.4</b>	<b>-106.4</b>	<b>-992.0</b>
<b>Financing</b>	<b>327.8</b>	<b>654.2</b>	<b>655.9</b>	<b>666.5</b>	<b>2,304.4</b>	<b>431.3</b>	<b>233.8</b>	<b>220.4</b>	<b>106.4</b>	<b>992.0</b>
Privatization and external (net)	343.5	484.8	448.9	1,091.2	2,368.5	1,041.1	304.5	1,109.7	891.8	3,347.1
Domestic (net)	-15.7	169.5	206.9	-424.8	-64.0	-609.8	-70.7	-889.3	-785.4	-2,355.2

Sources: Ministry of Finance; Central Bank of Nicaragua; and Fund staff estimates.

1/ Includes the interest cost of bank resolution on accrual basis.

2/ For 2002-03, HIPC interim debt relief from multilaterals is recorded as grants.

Table 6. Nicaragua: Summary Accounts of the Central Bank

(Flows in millions of cordobas; unless otherwise stated)

	Actual	Prel.	Program			
	2000	2001	2002	2003	2004	2005
Exchange rate (cordobas/U.S. dollars)	12.7	13.4	...	....	....	....
<b>Net international reserves</b>	<b>-374</b>	<b>-2,290</b>	<b>-188</b>	<b>453</b>	<b>0</b>	<b>828</b>
(in millions of U.S. dollars)	<b>-29</b>	-171	-13	30	0	50
<b>Net domestic assets</b>	<b>393</b>	<b>2,485</b>	<b>324</b>	<b>-250</b>	<b>245</b>	<b>-568</b>
Net credit to nonfinancial						
Public sector (NFPS) 1/	-627	6,690	-794	-1,705	-1,095	-3,502
Public sector (NFPS) 2/	-627	2,837	-794	-1,705	-1,095	-3,502
Operational losses	461	680	1,121	1,296	1,534	1,602
Net credit to the financial system 3/	1,656	-947	-387	-340	-384	-492
CENIS, BOMEX, and TELs 4/	-1,274	-4,130	308	841	-199	1,149
Foreign liabilities						
(Medium- and long-term)	161	174	170	284	324	637
Other 3/	16	18	-93	-626	66	38
<b>Currency</b>	<b>19</b>	<b>195</b>	<b>137</b>	<b>203</b>	<b>245</b>	<b>259</b>
<b>Memorandum items:</b>						
Currency (stock)	1,754	1,949	2,086	2,289	2,534	2,793
Currency (annual change; in percent)	1.2	11.1	7.0	9.7	10.7	10.2
Strengthening of BCN reserve position						
(in millions of U.S. dollars) 5/	-163	-472	20	100	-13	120
Net repayment of BCN domestic debt (+)	-134	-301	33	70	-13	70
Increase in NIR (+)	-29	-171	-13	30	0	50

Sources: Central Bank of Nicaragua; and Fund staff estimates.

1/ Includes bonds issued to recapitalize weak banks.

2/ Excludes bonds issued to recapitalize weak banks.

3/ From 2002 onward, asset recovery of closed banks is included in "other."

4/ Certificados Negociables de Inversion (CENIS), Bonos en Moneda Extranjera (BOMEX), and Titulos Especiales de Liquidez (TELS).

5/ Defined as the sum of the net repayment of BCN domestic debt and the change in NIR.

Table 7. Nicaragua: Summary Accounts of the Central Bank-Quarterly

(Flows in millions of cordobas; unless otherwise stated)

	2002					2003				
	Q-1	Q-2	Q-3	Q-4	Total	Q-1	Q-2	Q-3	Q-4	Total
<b>Net international reserves</b>	<b>509</b>	<b>-247</b>	<b>-450</b>	<b>0</b>	<b>-188</b>	<b>159</b>	<b>130</b>	<b>169</b>	<b>-6</b>	<b>453</b>
(In millions of US\$)	36	-17	-32	0	-13	11	9	11	0	30
<b>Net domestic assets</b>	<b>-490</b>	<b>29</b>	<b>418</b>	<b>367</b>	<b>324</b>	<b>-233</b>	<b>-267</b>	<b>-220</b>	<b>470</b>	<b>-250</b>
Net credit to nonfinancial										
public sector (NFPS)	-497	-139	-95	-63	-794	-560	-31	-722	-392	-1,705
Net credit to the financial system	50	-332	-368	264	-387	-137	-106	-92	-5	-340
CENIS, BOMEX and TELs 1/	-255	96	421	46	308	88	82	233	438	841
Foreign liabilities										
(medium- and long-term)	50	0	84	36	170	53	27	174	30	284
Other	162	404	376	85	1,028	324	-240	187	398	670
<b>Currency</b>	<b>19</b>	<b>-219</b>	<b>-31</b>	<b>367</b>	<b>137</b>	<b>-73</b>	<b>-137</b>	<b>-51</b>	<b>464</b>	<b>203</b>
<b>Memorandum items:</b>										
Currency (stock)	1,969	1,750	1,719	2,086	2,086	2,013	1,876	1,825	2,289	2,289
Currency (annual change; in percent)	12.3	4.1	3.1	7.0	7.0	2.3	7.2	6.2	9.7	9.7
Change in BCN reserve position (in millions of U.S. dollars)	20	-13	3	11	20	16	25	30	29	100
Net repayment of BCN domestic debt	-16	4	34	11	33	6	17	19	29	70
Change in NIR	36	-17	-32	0	-13	11	9	11	0	30

Sources: Central Bank of Nicaragua; and Fund staff estimates.

1/ *Certificados Negociables de Inversion (CENIS)*, *Bonos en Moneda Extranjera (BOMEX)*, and *Titulos Especiales de Liquidez (TELs)*.

Table 8. Nicaragua: Operations of the Central Bank and the Financial System

(Stocks in millions of cordobas)

	2001 1/	2002 2/	2003	2004	2005
<b>I. Central Bank</b>					
<b>Net international reserves</b>	<b>213</b>	<b>39</b>	<b>494</b>	<b>519</b>	<b>1,365</b>
(In millions of U.S. dollars)	16	3	33	33	83
<b>Net domestic assets</b>	<b>1,737</b>	<b>2,048</b>	<b>1,795</b>	<b>2,015</b>	<b>1,429</b>
Net credit to NFPS	35,216	34,798	33,421	32,529	29,139
Net credit to the financial system	201	-82	-354	-689	-1,152
CENIs, BOMEX and TELs 3/	-7,436	-7,603	-7,219	-7,776	-6,899
Medium- and long-term foreign liabilities	-23,727	-25,073	-26,295	-27,279	-27,595
Other	-2,518	8	2,241	5,229	7,936
<b>Currency</b>	<b>1,949</b>	<b>2,086</b>	<b>2,289</b>	<b>2,534</b>	<b>2,793</b>
<b>II. Consolidated Financial System</b>					
<b>Net international reserves</b>	<b>3,004</b>	<b>2,917</b>	<b>4,088</b>	<b>5,509</b>	<b>6,979</b>
(In millions of U.S. dollars)	224	205	271	347	425
<b>Net domestic assets</b>	<b>9,597</b>	<b>18,667</b>	<b>19,607</b>	<b>20,824</b>	<b>22,041</b>
Net credit to nonfinancial public sector	31,182	34,077	32,273	31,742	28,745
Credit to the private sector	13,544	10,894	13,042	15,451	17,703
Medium- and long-term foreign liabilities	-24,394	-25,950	-27,074	-27,858	-27,866
Other net assets	-10,735	-353	1,366	1,489	3,460
<b>Liabilities to the private sector</b>	<b>12,601</b>	<b>21,584</b>	<b>23,695</b>	<b>26,332</b>	<b>29,020</b>

Sources: Central Bank of Nicaragua; and Fund staff estimates.

1/ From 2001 onward, monetary accounts are prepared using a better sectorization and classification.

2/ In 2002, credit held by the liquidation boards is assumed to be sold to the private sector or written off.

3/ Certificados Negociables de Inversion (CENIS), Bonos en Moneda Extranjera (BOMEX), and Titulos Especiales de Liquidez (TELs).

Table 9. Nicaragua: Social Indicators

	Latest Single Year			Same Region/Income Group	
	1970-75	1980-85	1994-2000	Latin America & Caribbean	Low-Income
<b>Population</b>					
Total population, mid-year (millions)	2.5	3.4	5.1	515.7	2,459.8
Growth rate (percent annual average for period)	3.3	3.1	2.7	1.6	2.0
Urban population (percent of population)	50.3	56.4	64.7	75.4	31.9
Total fertility rate (births per woman)	6.6	5.5	3.6	2.6	3.6
<b>Poverty</b> (percent of population)					
National headcount index	..	..	47.9	..	..
Urban headcount index	..	..	30.5	..	..
Rural headcount index	..	..	68.5	..	..
<b>Income/consumption distribution</b>					
GNI per capita (U.S. dollars)	640	750	410	3,670	410
<b>Income/consumption distribution</b>					
Gini index	..	..	60.3	..	..
Lowest quintile (percent of income or consumption)	..	..	2.3	..	..
Highest quintile (percent of income or consumption)	..	..	63.6	..	..
<b>Social indicators</b>					
<b>Public expenditure</b>					
Health (percent of GDP)	..	..	5.7	2.8	1.2
Education (percent of GDP)	..	..	6.3	3.3	3.4
Social security and welfare (percent of GDP)	2.9	1.4	4.9	7.4	..
<b>Net primary school enrollment rate</b> (percent of age group)					
Total	63	73	80	97	..
Male	..	71	78	99	..
Female	..	75	81	98	..
<b>Access to an improved water source</b> (percent of population)					
Total	..	..	84	85	76
Urban	..	..	92	93	88
Rural	..	..	72	62	70
<b>Immunization rate</b> (percent under 12 months)					
Measles	..	49	99	93	57
DPT	..	35	82	87	57
Child malnutrition (percent under 5 years)	..	10	11	9	..
<b>Life expectancy at birth</b> (years)					
Total	57	61	68	70	59
Male	55	58	67	67	58
Female	59	64	71	74	60
<b>Mortality</b>					
Infant (per 1,000 live births)	93	71	40	29	76
Under 5 (per 1,000 live births)	168	143	50	37	115
<b>Adult (15-59)</b>					
Male (per 1,000 population)	348	277	220	208	294
Female (per 1,000 population)	283	189	223	121	261
Maternal (per 100,000 live births)	..	..	148	..	..
Births attended by skilled health staff (percent)	..	..	70	..	..

Source: 2002 World Development Indicators CD-ROM, World Bank.

Note: 0 or 0.0 means zero or less than half the unit shown. Net enrollment ratios exceeding 100 indicate discrepancies between the estimates of school-age population and reported enrollment data.



Table 10. Nicaragua: Balance of Payments

(In millions of U.S. dollars; unless otherwise indicated)

	Actual		Prel. 2001	Program				Projected	
	1999	2000		2002	2003	2004	2005	2006	2007
<b>Current account</b>	<b>-1059</b>	<b>-931</b>	<b>-970</b>	<b>-726</b>	<b>-640</b>	<b>-541</b>	<b>-548</b>	<b>-553</b>	<b>-581</b>
Excluding interest obligations	-835	-674	-723	-593	-499	-404	-412	-422	-451
Trade balance	-1,157	-1,003	-1,036	-963	-935	-916	-926	-940	-982
Exports, f.o.b.	545	645	592	598	663	739	833	938	1031
<i>Of which: coffee</i>	135	171	105	73	80	81	96	116	126
Imports, f.o.b.	-1,703	-1,648	-1,629	-1,561	-1,598	-1,656	-1,758	-1,878	-2,013
Nonfactor services (net)	-42	-32	-26	-6	17	32	38	44	51
Receipts	293	311	328	339	371	407	435	464	504
Payments	-335	-343	-354	-345	-354	-376	-397	-420	-453
Official interest obligations	-225	-257	-247	-133	-141	-137	-136	-131	-131
Other current transactions (net)	364	361	339	376	420	480	476	474	480
Factor services receipts	31	31	15	8	13	26	26	29	31
Other factor services payments	-62	-69	-77	-85	-89	-87	-93	-109	-118
Private transfers	396	400	402	453	496	541	543	554	567
<b>Capital account</b>	<b>876</b>	<b>627</b>	<b>558</b>	<b>532</b>	<b>523</b>	<b>317</b>	<b>363</b>	<b>411</b>	<b>434</b>
Official (net)	415	346	366	254	299	208	195	204	164
Official transfers	307	308	346	329	266	174	186	180	170
Public sector consolidated	192	176	125	106	109	114	126	120	110
Other	115	132	173	150	80	60	60	60	60
HIPC grants 1/	0	0	49	73	77	0	0	0	0
Disbursements 2/	274	220	217	194	226	197	184	180	170
Amortization 2/	-168	-171	-177	-269	-193	-163	-174	-156	-176
Other (net) 3/	2	-11	-20	0	0	0	0	0	0
Other capital (private)	460	282	193	278	224	109	168	206	271
Foreign direct investment	300	265	132	201	256	251	241	232	289
Commercial banks	110	17	-85	18	-46	-92	-47	-37	-30
Other (net)	221	-13	166	59	14	-50	-25	12	12
Errors and omissions	-175	12	-20	0	0	0	0	0	0
<b>Overall balance</b>	<b>-184</b>	<b>-304</b>	<b>-412</b>	<b>-194</b>	<b>-117</b>	<b>-224</b>	<b>-184</b>	<b>-142</b>	<b>-147</b>
Change in net international reserves (- increase)	-77	29	171	13	-30	0	-50	-50	-50
<i>Of which: IMF (net)</i>	104	21	-5	4	20	40	12	-6	-6
Net change in arrears (decrease -) 4/	151	64	-285	-1944	0	0	0	0	0
Exceptional financing	110	211	526	1945	0	0	0	0	0
Remaining financing gap 5/	0	0	0	179	147	224	234	192	197
<b>Memorandum items:</b>									
Current account (in percent of GDP)	-47.7	-38.3	-38.1	-28.2	-24.0	-19.3	-18.3	-17.4	-17.3
Excluding interest obligations (in percent of GDP)	-38	-28	-28	-23	-19	-14	-14	-13	-13
Gross reserves (in millions of U.S. dollars)	513	497	383	355	417	477	576	620	664
Gross reserves (in months of imports)	3.3	3.2	2.3	2.2	2.5	2.7	3.0	3.0	3.0
Net international reserves (in millions of U.S. dollars)	357	187	16	3	33	33	83	139	189
Debt service ratio 6/	47	45	38	43	33	28	26	21	20
Debt service ratio, after debt relief 6/	34	33	24	17	11	8	8	9	9
Debt service ratio, actual payments 6/	20	20	22	17	11	8	8	9	9
Gross official grants and loans (in percent of GDP)	31	23	20	21	20	15	14	11	10
Net official grants and loans (in percent of GDP)	22	17	17	16	15	10	9	9	3
GDP (millions of U.S. dollars)	2,213	2,433	2,547	2,571	2,661	2,806	2,989	3,185	3,360

Sources: Central Bank of Nicaragua; and Fund staff estimates.

1/ Include interim HIPC assistance from multilaterals.

2/ Medium and long term.

3/ Short-term debt, and private debt due to official creditors. As of 2002, short-term debt is included in total interest and amortization payments.

4/ In 2002 this represents the stock of arrears to non-Paris Club creditors that will have to be rescheduled under terms comparable to those granted by the Paris Club.

5/ The financing gaps could be filled with debt relief to be granted under the enhanced HIPC Initiative.

6/ In percent of exports of goods and nonfactor services.

Table 11. Nicaragua: Medium-Term Macroeconomic Framework

	Actual		Prel. 2001	Program				Projections	
	1999	2000		2002	2003 1/	2004	2005	2006	2007
(Annual percentage change)									
GDP at constant prices	7.4	5.9	3.3	1.0	3.0	4.5	5.0	5.5	5.5
Consumer prices (end of period) 2/	7.2	6.6	4.7	6.0	6.0	4.0	4.0	4.0	4.0
Consumer prices (period average) 2/	11.2	7.4	7.4	4.4	6.0	4.8	4.0	4.0	4.0
(In percent of GDP)									
External current account balance	-47.7	-38.3	-38.1	-28.2	-24.0	-19.3	-18.3	-17.4	-17.3
External current account, excluding interest obligations	-37.5	-27.7	-28.4	-23.1	-18.7	-14.4	-13.8	-13.2	-13.4
Combined public sector balance before grants	-15.7	-15.4	-21.0	-16.5	-13.2	-9.4	-7.5	-7.1	-5.5
Private sector S-I gap	-26.2	-16.8	-13.0	-11.9	-11.6	-10.6	-11.5	-11.0	-11.0
Investment	43.3	34.7	30.8	27.3	27.8	29.1	30.7	31.0	31.0
Public sector	21.1	19.0	16.6	12.3	12.2	12.9	13.0	13.0	13.0
Private sector	22.2	15.8	14.6	15.0	15.6	16.3	17.7	18.0	18.0
National savings	1.4	2.6	-2.8	-1.2	3.0	9.1	11.7	13.0	13.0
Public sector	5.4	3.6	-4.4	-4.2	-1.0	3.4	5.5	6.0	6.0
Private sector	-4.0	-1.0	1.6	3.0	4.0	5.7	6.2	7.0	7.0
External savings	41.9	32.1	33.6	28.5	24.8	20.0	19.0	18.1	18.0
<b>Memorandum items:</b>									
Nominal GDP (in millions of cordobas)	26,130	30,858	34,242	36,646	40,204	44,511	49,068	53,837	59,070

Sources: Central Bank of Nicaragua; Ministry of Finance; and Fund staff estimates.

1/ Assumes that private pension funds initiate operations in July 2003.

2/ For 2000, staff estimates using the new consumer price index adopted in 2001.

Table 12. Nicaragua: Status of Poverty Reduction and Structural Measures for Reaching the HIPC Floating Completion Point

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1. **Nicaragua's annual PRSP progress report.** The full PRSP was submitted to the Board of the Fund in September 2001 and a report of the first year of its implementation is presented with this staff report.
  2. **Use of budgetary savings resulting from the interim relief under the HIPC Initiative.** A reliable tracking mechanism of poverty reducing expenditures was approved. The mechanism is already operating and it was consulted with the NGOs, donors and civil society.
  3. **Stable macroeconomic framework and satisfactory performance under a program supported by a PRGF arrangement.** A request for a new three-year PRGF arrangement is presented for Board approval.
  4. **Human capital development and social protection**
    - a. **Approval of a satisfactory school autonomy law and its implementation.** A law considered satisfactory by the World Bank was approved in February 2002. Implementing regulations are pending.
    - b. **Approval of a satisfactory general health law and its implementation.** A law deemed satisfactory by the World Bank was approved in March 2002. Implementing regulations are pending.
    - c. **Introduce an effective system of social protection.** A pilot program was concluded in 2002. Design and adoption of an effective social protection program based on the findings of the pilot program is in process.
  5. **Governance**
    - a. **Approval and advance in implementation of a satisfactory civil service law.** A draft of the law was submitted to the Assembly in December 1999. Approval is pending.
    - b. **Introduction of a satisfactory system of management and inspection of public sector procurement.** Implementation of the program agreed with the IDB started in October 2002.
    - c. **Satisfactory progress in implementation of a plan to strengthen and improve the efficiency of the Comptroller's Office.** Program agreed with the IDB is expected to begin by end-2002.
    - d. **Approval of the law on penal procedures and initiation of training programs and technical preparations for its implementation.** A law on penal procedures (Law nr. 411) was approved and published in December 2001. Implementation of the law is expected to start at the end of 2002. Training programs and technical preparations are advanced.
    - e. **Approval of the law on public prosecutors and initiation of training programs and technical preparations for its implementation.** A law on public prosecutor (Law nr. 342) was approved in May 2000 and published in October 2000. Implementing regulations are pending.
  6. **Pension system. Restructuring of the social security institute and introduction of a satisfactory private pension system.** A new Pension Law and the Pension Superintendence Law were approved in 2000. New law on the social security institute including pending parametric reforms is expected to be approved by end 2002. Award of licenses to private fund managers and transfer of all eligible social contributors to the new pension system are expected in 2003.
  7. **Divestment of (a) ENITEL:** 40 percent of ENITEL's share and its management were awarded in August 2001. 1 percent of the shares were donated to workers, and 10 percent offered for sale to workers. The sale of the government's share is expected to be completed in the second semester of 2003; and (b) **all electricity generating units of ENEL.** In January 2002 one of the thermal plants (GEOSA) was sold. The sale of the hydroelectric (Hidrogcsa) and one thermal plant (Gecsa) is pending.
-

Table 13. Nicaragua: Public Sector Domestic Debt (stocks; accrual basis)

(In millions of US dollars)

	1998	1999	2000	Prel. 2001	Projections			
					2002	2003	2004	2005
<b>BCN liabilities</b>	<b>183</b>	<b>175</b>	<b>289</b>	<b>695</b>	<b>671</b>	<b>578</b>	<b>448</b>	<b>363</b>
Certificados Negociables de Inversiones (CENIs)	182	175	205	608	585	578	448	363
Auctioned	182	175	205	188	178	280	440	355
Coffee-related	0	0	0	10	9	8	8	8
Bank resolution (from Interbank onward)	0	0	0	410	398	290	0	0
Bonos en Moneda Extranjera (BOMEX)	0	0	48	21	24	0	0	0
Titulos Especiales de Inversion (TEIs)	0	0	36	27	16	0	0	0
Titulos Especiales de Liquidez (TEIs)	0	0	0	39	46	0	0	0
<b>MHCP liabilities</b>	<b>711</b>	<b>606</b>	<b>707</b>	<b>829</b>	<b>913</b>	<b>909</b>	<b>913</b>	<b>899</b>
Indemnization bonds (BPIs) 1/	677	565	639	763	850	850	840	808
Other paper	34	41	68	66	62	59	74	90
Bonds (held by the Social Security Institute)	14	15	15	19	18	17	17	16
Other	20	26	53	47	44	42	57	74
<b>Combined Public Sector Domestic Debt</b>	<b>894</b>	<b>781</b>	<b>996</b>	<b>1,524</b>	<b>1,583</b>	<b>1,487</b>	<b>1,361</b>	<b>1,261</b>
In percent of GDP	42.5	35.3	41.0	59.6	61.6	55.9	48.5	42.2
<b>Memorandum Items:</b>								
<b>Debt reduction on accrual basis (+)</b>	<b>-32</b>	<b>113</b>	<b>-215</b>	<b>-528</b>	<b>-59</b>	<b>96</b>	<b>126</b>	<b>100</b>
Central Bank	162	8	-114	-406	24	93	130	85
Central government	-194	105	-102	-122	-83	4	-4	15
<b>Net Repayment of BCN Domestic Debt (+)</b>	<b>...</b>	<b>...</b>	<b>...</b>	<b>...</b>	<b>52</b>	<b>81</b>	<b>8</b>	<b>106</b>
Central bank	...	...	...	...	33	70	-13	70
Central government	...	...	...	...	19	11	20	36

Sources: Central Bank of Nicaragua; and Ministry of Finance.

1/ Increase in 2002 reflects previously awarded court claims on properties confiscated during the Sandinista government.

Table 14. Nicaragua: Public Sector External Debt and Debt Service 1/

	1996	1997	1998	1999	2000	Prel. 2001
(In millions of U.S. dollars; end of period)						
Total debt	6,094	6,001	6,287	6,549	6,660	6,374
Bilaterals	4,045	4,027	4,115	4,084	4,124	3,740
Multilaterals	1,682	1,657	1,897	2,170	2,260	2,343
Commercial banks	272	234	246	242	235	243
Other	95	83	29	53	41	48
(In percent of GDP)						
Total debt	317	305	304	296	274	250
Bilaterals	211	205	199	185	170	147
Multilaterals	88	84	92	98	93	92
Commercial banks	14	12	12	11	10	10
Other	5	4	1	2	2	2
(In millions of U.S. dollars)						
Total debt service obligations	724	425	361	398	422	429
Principal	436	214	148	173	164	182
Interest	289	211	213	225	257	248
Debt service paid	258	287	229	170	188	257
Principal	171	159	134	104	111	127
Interest	87	128	95	66	77	130
Debt service not paid	467	138	132	228	234	173
Principal	265	55	14	69	53	55
Interest	202	83	118	159	180	118
(In percent of GDP)						
Total debt service obligations	38	22	17	18	17	18
Principal	23	11	7	8	7	7
Interest	15	11	10	10	11	10
Debt service paid	13	15	11	8	8	11
Principal	9	8	6	5	5	5
Interest	5	6	5	3	3	5
Debt service not paid	24	7	6	10	10	7
Principal	14	3	1	3	2	2
Interest	11	4	6	7	7	5
(In percent of exports of goods and nonfactor services)						
Total debt service obligations	111	53	43	47	44	45
Principal	67	27	18	21	17	19
Interest	44	26	26	27	27	26
Debt service paid	40	31	28	20	20	27
Principal	26	16	16	12	12	13
Interest	13	15	11	8	8	14
Debt service not paid	72	23	16	27	24	18
Principal	41	11	2	8	6	6
Interest	31	12	14	19	19	12

Sources: Central Bank of Nicaragua; Ministry of External Cooperation; and Fund staff estimates.

1/ As compared to the 2001 Article IV Consultation, there have been revisions to the split between debt service paid and not paid in 1997, revisions to debt service obligations in 1999, and adjustments in 2000 to take into account the impact of debt rescheduling agreements.

Table 15. Nicaragua: Phasing of IMF Disbursements and Reviews

Date of Disbursement	Amount (Millions of SDRs)	Conditions
December 2002	6.965	Executive Board approval of PRGF arrangement and first-year program.
March 2003	6.965	Completion of first review and observance of end-December 2002 performance criteria.
June 2003	6.965	Completion of second review and observance of end-March 2003 performance criteria.
September 2003	6.965	Completion of third review, observance of end-June 2003 performance criteria.
January 2004	13.93	Completion of fourth review and observance of end-September 2003 performance criteria and approval of second-year program.
March 2004	13.93	Completion of fifth review and observance of end-December 2003 performance criteria.
September 2004	13.93	Completion of sixth review and observance of end-June 2004 performance criteria and approval of the third-year program.
March 2005	13.93	Completion of seventh review and observance of end-December 2004 performance criteria.
September, 2005	13.92	Completion of eighth review and observance of end-June 2005 performance criteria.
<b>Total</b>	<b>97.50</b>	

Source: IMF, Treasurer's Department.

Table 16. Nicaragua: Indicators of Financial Obligations to the Fund (as of September 30, 2002)

(In millions of SDRs; unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Outstanding Fund credit (end of period)	118.6	128.3	143.5	173.4	182.2	159.1	136.0	111.8	88.8	69.4	49.9
Poverty Reduction and Growth Facility (PRGF) disbursements	0.0	7.0	20.9	41.8	27.9	0.0	0.0	0.0	0.0	0.0	0.0
Total debt service to the Fund	5.1	2.5	6.8	13.1	20.3	24.4	24.3	25.3	23.9	20.2	20.2
Principal	4.0	2.0	5.7	11.9	19.0	23.1	23.1	24.2	23.0	19.4	19.5
Charges and interest	1.1	0.5	1.1	1.2	1.3	1.3	1.2	1.1	0.9	0.8	0.7
Total debt service to the Fund after HIPC assistance 1/	5.1	0.6	3.7	4.5	2.4	9.5	10.0	12.3	17.6	20.2	20.2
Outstanding Fund credit (end of period)											
In percent of quota	91.2	98.7	110.4	133.3	140.2	122.4	104.6	86.0	68.3	53.4	38.4
Debt service to the Fund (in percent of total debt service due after rescheduling) 1/	4.2	2.1	7.6	18.9	27.0	26.3	23.4	22.1	22.6	17.5	17.1
Total debt-service ratio (after rescheduling) 1/	16.3	16.5	11.4	8.0	7.9	8.8	9.0	9.1	7.6	7.5	7.1
Of which: IMF	0.7	0.3	0.9	1.5	2.1	2.3	2.1	2.0	1.7	1.3	1.2
Repayment to IMF/reserves (in percent)	1.3	0.7	1.8	3.5	4.6	5.2	4.6	4.5	4.0	3.1	2.9

Source: IMF, Treasurer's Department.

1/ IMF delivery of HIPC assistance based on indicative drawdown schedule specified in the decision point document (Table 11 of EBS/00/259).

Table 17. External Financing Requirements and Sources

(In millions of U.S. dollars)

	Actual	Prel.	Program			
	2000	2001	2002	2003	2004	2005
<b>Gross financing requirements</b>	<b>-1,099.4</b>	<b>-976.4</b>	<b>-990.7</b>	<b>-890.9</b>	<b>-760.2</b>	<b>-809.2</b>
External current account deficit (excluding Official transfers)	-931.0	-970.4	-725.9	-639.9	-541.4	-547.6
Debt amortization	-170.8	-176.9	-269.0	-193.3	-163.4	-174.2
Gross reserves accumulation	7.9	176.1	9.3	-50.1	-39.7	-62.2
IMF repurchases and repayments	-5.5	-5.2	-5.2	-7.5	-15.8	-25.3
<b>Available financing</b>	<b>1,099.4</b>	<b>976.4</b>	<b>990.7</b>	<b>890.9</b>	<b>760.2</b>	<b>809.2</b>
Foreign direct investment (net)	265.4	132.3	201.0	256.0	251.2	240.7
Debt financing from private creditors	3.9	80.9	77.0	-31.9	-141.7	-72.4
Trade pre-financing	-99.8	69.7	20.0	0.0	-50.0	-25.0
Commercial banks' reserves	16.6	-84.8	18.4	-45.9	-91.7	-47.4
Official transfers	308.3	346.0	329.4	266.0	174.3	185.5
Disbursements (medium- and long-term loans)	219.6	216.6	193.6	226.3	196.9	183.6
<i>Of which:</i> balance of payments financing	26.1	35.0	43.0	75.0	50.0	35.0
<i>Of which:</i> expected new commitments	...	...	15.0	30.0	50.0	50.0
IMF disbursements	26.6	0.0	9.0	27.7	55.5	37.1
Net change in arrears	63.9	-284.6	-1943.6	0.0	0.0	0.0
Other flows 1/	0.9	-40.4	0.0	0.0	0.0	0.0
Exceptional financing 2/	210.8	525.7	1945.0	0.0	0.0	0.0
Financing gap 3/	0.0	0.0	179.2	146.8	224.1	234.3

Sources: Central Bank of Nicaragua; and Fund staff estimates.

1/ Includes all other net financial flows, and errors and omissions.

2/ Includes only traditional debt rescheduling.

3/ Could be covered by debt relief under the enhanced HIPC Initiative.



**NICARAGUA—FUND RELATIONS**  
(As of October 31, 2002)

**I. Membership Status:** Joined: 03/14/1946; Article VIII since 7/30/1964.

**II. General Resources Account:**

	<b>SDR Million</b>	<b>Percent of Quota</b>
Quota	130.00	100.00
Fund Holdings of Currency	130.01	100.01

**III. SDR Department:**

	<b>SDR Million</b>	<b>Percent of Allocation</b>
Net cumulative allocation	19.48	100.00
Holdings	0.13	0.68

**IV. Outstanding Purchases and Loans:**

	<b>SDR Million</b>	<b>Percent of Quota</b>
ESAF/PRGF arrangements	123.33	94.87

**V. Financial Arrangements:**

<b>Type</b>	<b>Approval Date</b>	<b>Expiration Date</b>	<b>Amount Approved (SDR Million)</b>	<b>Amount Drawn (SDR Million)</b>
ESAF/PRGF	03/18/1998	03/17/2002	148.96	115.32
ESAF	06/24/1994	06/23/1997	120.12	20.02
Stand-by	09/18/1991	03/17/1993	40.86	17.03

**VI. Projected Obligations to Fund:** (SDR million; based on existing use of resources and present holdings of SDRs)

	<b>Overdue</b>	<b>Forthcoming</b>				
	<b>06/30/2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Principal	...	2.00	5.69	11.85	19.03	23.06
Charges/Interest	...	<u>0.42</u>	<u>1.03</u>	<u>0.99</u>	<u>0.90</u>	<u>0.80</u>
Total	...	2.42	6.72	12.84	19.92	23.86

**VII. Implementation of HIPC Initiative:**

	<b>Enhanced Framework</b>
Commitment of HIPC assistance	
Decision point date	December 2000
Assistance committed (2000 NPV terms) <sup>1</sup>	
Total assistance (US\$ million)	3,267.00
<i>Of which:</i> Fund assistance (SDR million) <sup>2</sup>	62.98
Completion point date	Floating
 Delivery of Fund assistance (SDR million)	
Amount disbursed	0
Interim assistance	0
Completion point	0
Amount applied against member's obligations (cumulative)	0

**VIII. Safeguards Assessments:**

The overall findings of the Stage One safeguards assessment of the Central Bank of Nicaragua (BCN) indicated that the safeguards at the BCN appear generally adequate and a Stage Two (on-site) assessment was not considered necessary at this juncture. However, certain weaknesses were identified, in the financial reporting framework and internal controls systems as follows: (i) accounting principles used by the BCN fall short of certain key International Accounting Standards (IAS), including with regard to disclosure requirements, and (ii) outstanding loans to government agencies that were long overdue without evidence of adequate follow-up. The staff recommended that (i) the BCN strengthen financial reporting by either adopting IAS, or disclosing any differences between the BCN's accounting principles and IAS in its financial statements; (ii) the BCN implement an action plan to collect the overdue receivables or to write them off as nonrecoverable; and (iii) the Internal Audit Department (IAD) should review the process of reconciliation of reserves data to ensure that net reserves are properly valued, that there are no encumbrances, and that they are consistent with the audited financial statements.

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<sup>1</sup> NPV terms at the completion point under the original framework; and PNV terms at the decision point under the enhance framework.

<sup>2</sup> Subject to satisfactory assurances regarding the exceptional assistance to be provided under the enhanced HIPC initiative by Nicaragua's other creditors.

**IX. Exchange Rate Arrangements:**

In December 1995, the Monetary Board of the central bank approved the **unification of the exchange rate system** effective January 1, 1996. With the unification of the exchange rate, all previous exchange restrictions on payments and transfers for current international transactions and multiple currency practices were eliminated. The central bank buys/sells any amount of foreign currency from/to financial institutions at the official exchange rate, and implements a crawling peg system. In November 1999, the monthly crawl was reduced from an annual rate of 9 percent to 6 percent.

As of October 31, 2002, the buying and selling rates in the official market were C\$14.18 and C\$14.32 per U.S. dollar, respectively.

**X. Article IV Consultation:**

It is expected that the next Article IV consultation with Nicaragua will be held on a standard 24-month cycle subject to the provisions of the decision on consultation cycles approved by the Board on July 15, 2002. The last consultation was completed by the Executive Board on September 19, 2001 (EBS/01/148 and SM/01/275).

**XI. Technical Assistance:**

<b>Dept.</b>	<b>Purpose</b>	<b>Time of Delivery</b>
FAD	ROSC Fiscal Transparency Module	November 2001
FAD	Mission to review energy taxation and advise on the system of exemptions, exonerations, tax holidays, and other incentives with regard to the major indirect taxes	January 2000
MAE	Bank Supervision	October 2002
MAE	Bank Restructuring	November 2001
MAE	Assessing CBN's debt sustainability and streamline its open market operations, with special focus on providing liquidity to CBN's securities and increase their marketability.	July 2001
MAE	Workshop on payments system.	January 27–29, 1999
MAE	Consultancy on introducing an exchange rate band.	October 1999
OIA	Mission to assess the management, organizational structure, and internal control systems and procedures of the Superintendency of Banks and Other Financial Institutions.	February 2000

<b>Dept.</b>	<b>Purpose</b>	<b>Time of Delivery</b>
STA	National accounts	November 2001
STA	Monetary and finance statistics	November 2001
STA	Monetary and finance statistics	September 2001
STA	Mission on money and banking statistics.	June–July 1999

**XII. Resident Representative:**

Mr. Breuer assumed the position of Resident Representative in Nicaragua in August 2002.

**NICARAGUA—RELATIONS WITH THE WORLD BANK GROUP**  
(As of August 31, 2002)

**I. FINANCIAL RELATIONS**

**A. Statement of Bank Loans and IDA Credits**  
(In millions of U.S. dollars)

<b>Fiscal Year</b>	<b>Purpose</b>	<b>Bank</b>	<b>IDA</b>	<b>Undis- bursed</b>
<b>Thirty-one loans and 23 credits fully disbursed</b>		<b>229.6</b>	<b>814.3</b>	
1998	Health Sector Reform Project II		24.0	8.2
1998	Road Rehabilitation and Maintenance II		47.4	7.0
1999	Social Investment Fund III		45.0	5.9
1999	Forestry		9.0	3.0
2000	Basic Education II		52.5	22.6
2000	Telecommunications Reform		15.9	2.6
2000	Economic Management TAC		20.9	7.5
2000	Pension and Financial Markets		8.0	3.4
2000	Agricultural Technology and Rural Education		23.6	13.2
2001	Competitiveness LIL		5.0	4.6
2001	Road Rehabilitation and Maintenance III		75.0	67.6
2001	Rural Municipalities II		28.7	21.8
2001	Natural Disaster Vulnerability		13.5	12.7
2001	Poverty Reduction and Local Development		60.0	55.6
2002	Land Administration		32.6	34.7
	Sub-total		461.1	270.3
	<b>Total</b>	<b>229.6</b>	<b>1,275.4</b>	
	<i>Of which:</i>			
	Repaid	224.1	19.2	
	<b>Borrower obligations</b>	<b>0.0</b>	<b>770.9</b>	
	Amount sold	5.6		
	<i>Of which:</i>			
	Repaid	5.6		
	<b>Total Undisbursed</b>			<b>270.3</b>

## **B. World Bank/IDA Loan Commitments and Disbursements**

1. As of August 31, 2002, total loans/credits disbursed and currently committed from the Bank/IDA amounted to US\$1,505 million, of which US\$270 million remain to be disbursed. In view of its low income and high indebtedness, Nicaragua has been an IDA-only country since lending resumed in the early 1990s. The evolution of IDA gross disbursements exhibits a progressive decline since 1999. This pattern reflects the return to a normal lending program following the exceptional financing induced by emergency reconstruction needs in the aftermath of hurricane Mitch in October 1998. These needs triggered a rapid response on the part of IDA, which more than doubled gross disbursements from US\$51 million in 1997 to US\$120 million in 1999. The decline of gross disbursements since then mirrors the winding down of reconstruction activities.
2. Since 1991, when IDA support was resumed, 27 credits, one supplementary emergency credit and six Fifth Dimension supplementary credits have been approved, for a total of US\$1,031 million. Twelve operations have been fully disbursed: three adjustment credits (ERCI, ERCII, and FSAC) with their respective Fifth Dimension supplementary credits, the first and second Social Investment Fund Credits, a Health Sector Reform Credit, a Hurricane Emergency Credit, a Technology and Land Management Credit, a Road Rehabilitation and Maintenance Credit, a Basic Education including a Supplementary Emergency Credit, an Institutional Development Credit and the first Rural Municipalities Credit.
3. The current portfolio consists of 15 projects aimed at: developing human capital (Health Sector Credit II and Basic Education Credit II); reviving agriculture and strengthening natural resource management (Second Rural Municipalities Credit (PROTIERRA), Forestry Credit, Agricultural Technology and Rural Education Credit, and Land Administration Credit); rehabilitating road infrastructure (Second and Third Road Rehabilitation Credits); strengthening the public sector (Economic Management TA); supporting the social safety net and combating rural poverty (Third Social Investment Fund Credit, and Poverty Reduction and Local Development Credit); strengthening the policy and regulatory environment in the telecommunications sector (Telecommunications Sector Reform Credit); reforming Nicaragua's pension structure to create a more equitable and sustainable system of old-age income security for workers (Pension and Financial Market Reform Credit); addressing constraints to private sector development (Competitiveness Credit); and improving disaster preparedness (Natural Disaster Vulnerability Credit). In addition, a Global Environmental Facility Grant (GEF) of US\$7 million was approved in September 1997 to fund the Atlantic Biodiversity Corridor Project.
4. As an IDA-only country, Nicaragua has benefited from additional balance of payments support through the: Fifth Dimension Program, which provides supplementary IDA credits attached to ongoing adjustment operations to help countries service their IBRD debt. Nicaragua has received six Fifth Dimension supplementary credits for a total of US\$40 million. In 1995, IDA contributed US\$40 million in grant funds to a US\$88 million commercial debt buyback operation; this operation purchased over 80 percent of Nicaragua's outstanding commercial debt at a steep discount.

5. Nicaragua reached the HIPC Decision Point on December 21, 2000, qualifying for IDA debt relief assistance equal to US\$379 million. Since January 1, 2001, IDA has provided Interim HIPC assistance equivalent to a 90 percent reduction on Nicaragua's debt service to IDA. As of August 31, 2002, Nicaragua had received close to US\$12 million in IDA debt service relief.

## II. RECENT NONLENDING IDA ASSISTANCE

6. IDA has provided a wide range of nonlending services to Nicaragua. The main products delivered over the last two years include:

- *A Public Expenditure Review* (December 7, 2001, Report No. 23095-NI), which aims to support the PRSP process and its implementation.
- A Joint IDA-IMF Staff assessment (August 21, 2001, Report No. 22627-NI) of the Poverty Reduction Strategy Paper (PRSP) prepared by the government in July 2001
- A second *Poverty Assessment: Challenges and Opportunities for Poverty Reduction* (February 21, 2001, Report No.20488-NI). This assessment was based on the second *Living Standards Measurement Survey* (LSMS) carried out in 1998, and also includes the results of the *Qualitative Poverty and Exclusion Study*, which included consultations with 22 poor communities in three regions of the country.
- *An Ex-Post Evaluation of the Emergency Social Investment Fund* (December 7, 2000, Report No.20400-NI)
- A report titled *Nicaragua Pension Reform Proposal* (April 3, 2000, Report No.19669-NI), which provides the basis for recent pension reforms adopted by the government.

## III. PLANS FOR THE NEXT TWELVE MONTHS

7. Over the next few months, IDA will finalize a new Country Assistance Strategy (CAS), now scheduled for Board presentation in FY 2003. Future projects being considered for IDA support include a Land Administration Project, an Off-grid Rural Electrification Project, a Rural Micro finance Development Project and a fast disbursing adjustment operation, possibly in the form of a Poverty Reduction Support Credit (PRSC).

Contact Person: Ulrich Lachler, (202) 528-8886

## STRUCTURAL MEASURES SPONSORED BY THE WORLD BANK AND IDB

	Structural Measures	Progress Indicators
<b>Public Sector</b>	<ul style="list-style-type: none"> <li>• Complete the privatization of the telecom sector</li> <li>• Complete the privatization of the power sector</li> <li>• Improve performance of water/sewerage services</li> </ul>	<ul style="list-style-type: none"> <li>• Sell the remaining shares of ENITEL to the private sector (2002–03)—IDA</li> <li>• Sell remaining public electricity generating plants to the private sector (2002–04)—IDB</li> <li>• Adjust water and sewerage tariffs until marginal costs are fully recovered (2002–03)—IDB</li> </ul>
<b>Governance and Transparency</b>	<ul style="list-style-type: none"> <li>• Develop a professional and efficient civil service</li> <li>• Improve public financial management</li> </ul>	<ul style="list-style-type: none"> <li>• Approve and implement a satisfactory civil service reform law or issue a presidential decree establishing a new merit based system for civil servants (2002–03)—IDA</li> <li>• Implement SIGFA &amp; Single Treasury Account—IDA</li> </ul>
<b>Financial Sector</b>	<ul style="list-style-type: none"> <li>• Strengthen the financial system</li> </ul>	<ul style="list-style-type: none"> <li>• Complete the full cycle of on-site assisted inspections (with adequately trained SBIF staff) in the banks that absorbed the intervened banks and those banks where weaknesses were identified in the first cycle. Implement strengthening programs for Banks where weaknesses were found (2002–04)—IDA and IDB</li> <li>• Ensure that prudential norms on asset-risk classification and provisioning fully comply with the Basel core principles (2003)—IDA, IMF and IDB</li> <li>• Complete the sale of assets from intervened banks (2002–03)—IDA, IMF, and IDB</li> <li>• Reform the FOGADE law (2003)—IDA, IMF and IDB</li> </ul>
<b>Social Security</b>	<ul style="list-style-type: none"> <li>• Complete social security system reform program</li> <li>• Develop domestic capital markets and modernize commercial code</li> </ul>	<ul style="list-style-type: none"> <li>• Award contracts to private pension fund managers (2002–03)—IDA and IDB</li> <li>• Introduce system of individual funded accounts (2003)—IDA and IDB</li> <li>• Pension fund supervision agency operating satisfactory (2003–04)—IDA and IDB</li> <li>• Introduce a new capital markets law and a new commercial code (2002–03)—IDB</li> </ul>
<b>Transport Sector</b>	<ul style="list-style-type: none"> <li>• Develop efficient road maintenance system</li> </ul>	<ul style="list-style-type: none"> <li>• Launch a road maintenance fund and rationalize state owned construction companies in transport ministry (2003–04)—IDA</li> </ul>
<b>Social Sector Reform</b>	<ul style="list-style-type: none"> <li>• Institutional Reform in Education Sector</li> <li>• Institutional Reform in Health Sector</li> <li>• Develop and Implement a Social Protection Mechanism</li> </ul>	<ul style="list-style-type: none"> <li>• Implementation of School Autonomy Program to strengthen quality and coverage of primary education (2003–04)—IDA</li> <li>• Implementation of Health Modernization Program (2003–04)—IDA and IDB</li> <li>• Design and implement a comprehensive social protection mechanism (2003–04)—IDA and IDB</li> </ul>



**NICARAGUA—RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK**  
(As of October 3, 2002)

**I. FINANCIAL RELATIONS**  
**A. Statement of IDB Loans**  
(In millions of U.S. dollars)

Year	Purpose	Approved	Available
<b>Seventy-four loans fully disbursed</b>		<b>1,187.1</b>	
1996	Forestry resources conservation	15.3	0.1
	Lake Managua basin management	15.0	10.6
1997	Rural development	40.0	4.3
1998	Electricity sector	46.1	18.5
	Health modernization	48.6	34.1
	Financial sector reform	65.0	24.8
1999	Education reform	9.4	7.2
	TC social policy reform	2.1	0.6
	Roads	50.0	2.3
	Tax administration	10.0	7.2
	Local development	8.0	7.6
	Water supply modernization	13.9	12.8
2000	Social protection network	9.0	0.4
	Municipal support	5.7	4.4
	Lake Managua management	15.0	14.5
	FISE IV	50.0	47.0
	Support ERRP	10.0	8.7
	Transparency in procurement	18.0	15.9
	Strengthening family ministry	1.0	0.8
	Educational program	3.8	3.3
2001	Technology innovation program	6.8	6.3
	Strengthening of the judicial system	12.0	11.7
	Comprehensive child care program	25.0	21.5
	Municipal development	12.0	11.1
	Forestry development	32.7	29.9
	Road rehabilitation	35.0	34.7
	Electric inter system	25.0	24.8
2002	Pension system reform	30.0	29.7
	Strengthening general comptroller	5.4	5.3
	Social protection network	20.0	19.8
	Rural productive re-activation	60.0	59.4
	Low income housing	22.5	22.3
<b>Subtotal</b>		<b>722.4</b>	
<b>Total approved</b>		<b>1909.5</b>	
<b>Total held by the IDB</b>		<b>501.5</b>	

## **B. IDB Loan Commitments and Disbursements**

As of October 1, 2002, there are 32 projects in the Bank's portfolio for a total amount of US\$722.4 million, and an available balance of US\$501.5 million. As of this date, nine operations remain to be eligible (a total of US\$217.9 million). As of June 30, 2002, Nicaragua had received US\$29.5 million in IDB debt service relief, and it is expected that the total for the year would be US\$45.5 million.

## **II. RECENT TECHNICAL ASSISTANCE**

The Bank's program also includes 17-new nonreimbursable technical cooperation for a total of US\$3.5 million.

## **III. RECENT MISSIONS**

A Bank mission recently visited Managua to have consultations with the government, the International Community, and Civil Society to finish the preparation of its Country Strategy for years 2002–05. It is expected to have it approved by the Board in the last quarter of 2002.

## **IV. PLANS FOR THE UPCOMING MONTHS**

The Bank is in the process of preparing the Consultative Group for Nicaragua, to be held in Managua on February 6 and 7, 2003.

## NICARAGUA—STATISTICAL ISSUES

Nicaragua's economic data reported to the Fund are generally adequate for surveillance purposes. There are some statistical shortcomings in all sectors, which are being addressed with technical assistance from the Fund, IDA, IDB, and U.S. AID. The authorities are cooperative in providing data to the Fund in a timely fashion, and in some cases, on a daily basis. The Central Bank of Nicaragua (BCN) produces a monthly bulletin and an annual report covering developments in the monetary, fiscal, external, and real sectors. The BCN provides statistical information to the general public through the Internet.

### A. Real Sector

Current National Accounts show a number of shortcomings, including the use of outdated methodology and base year for constant prices (1980) and the absence of quarterly features. At the request of the Central Bank of Nicaragua, an STA's mission visited Managua in November 2001. The mission assessed positively the quality of the exercise. A more realistic GDP estimate for the base year was 70–80 percent above the current official GDP data. The new national account figures entail a broader coverage of industries, supply and use tables, and an expansion of data sources for the compilation of the 1994 new benchmark and base year. The executive board of the CBN approved in August 2002 the revised national accounts series for the period 1994–1999, which are compatible with current international standards (1993 SNA). The new national accounts series for the period 1994–2000 will be adopted by March 2003. The adoption of the revised series will allow a better assessment of economic developments and prospects.

The consumer price index (CPI) is reported on a regular and timely basis. CPI with new weights referencing 1999 was introduced in 2001. The weights used rely on data from a household expenditure survey (1998/99). The CPI covers Managua and eight other cities.

### B. Public Sector

Large discrepancies have been found in reconciling financing items (from domestic and external sources) with the balance based on revenue and expenditure. The discrepancies have large variations from month to month, and are observed in the accounts of the central government and of the overall nonfinancial public sector. In recent missions, the staff working with officials from the ministry of finance and the central bank has made some progress in identifying the sources and reducing the size of the discrepancies.

Data reported for 1991–2000 published in the *GFSY 2001* do not accurately reflect the 1986 *GFS* methodology for consolidating transactions between the budgetary central government and social security funds. Therefore, pending the review of these data by Nicaraguan authorities, STA did not publish the financing data for budgetary central government and social security funds. The breakdown of these data by debt holder and by type of instrument, and for the consolidated central government by type of instrument have

not yet been reported to STA. Detailed data for a central government outstanding debt, domestic and foreign for 1991–2000 are not yet available. The authorities did report Nicaraguan GFS data for publication in the *GSFY 2002*.

### **C. Monetary and Financial Sector**

The sectorization in the commercial banks' plan of accounts, mainly for the data on claims and deposits of the nonfinancial public sector, should be improved in order to assess the net credit to the central government and the rest of the nonfinancial public sector. Currently, data provided by the commercial banks differ substantially from data supplied by the ministry of finance. The monetary and financial statistics mission of June–July 1999 and November 2001 found that the BCN had significantly improved the timeliness of the analytical accounts for the central bank and the Nicaraguan Investment Fund. However, the difficulties in properly sectorizing the accounts of the deposit money banks (in central government, nonfinancial public enterprises, and local governments) hinder the quality of the monetary statistics. A recent monetary and financial statistics mission from the BCN to the IMF headquarters (July–August 2002), provided better sectorized monetary accounts to STA and WHD departments, in accordance with previous IMF's technical assistance missions. It is envisaged that these better sectorized monetary statistics for program and publication purposes will be published in *IFS* beginning in January 2003.

### **D. External Sector**

Starting in 1995, data are compiled in accordance with methodology of the Fifth Edition of the *Balance of Payments Manual (BPM5)*, within the limits set by the availability of information sources. The coverage of the Nicaraguan balance of payments statistics is somewhat incomplete, especially for the financial account. There is no information on portfolio investment transactions, other than the monetary authorities' transactions, and the coverage of direct investment data is incomplete due to a discontinuation of enterprise surveys. As for the current account, details for some services and income items are not available. The quality of trade statistics has been affected by changes in the recording and valuation of import trade data by customs. Nicaragua sent methodology notes describing the compiling methods for balance of payments statistics which were included in Part 3 of the *2002 Balance of Payments Statistics Yearbook*.

Data on the external debt of the government are in general good. Improvement of coverage is needed for external debt of public enterprises, of banks, and of the private sector. Nicaragua does not compile the International Investment Position.

**NICARAGUA—CORE STATISTICAL INDICATORS**  
(As of November 7, 2002)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	11/01/02	11/01/02	11/01/02	11/01/02	11/01/02	10/18/02	09/02	09/02	06/02	09/02	2001	09/02
Date Received	11/04/02	11/04/02	11/04/02	11/04/02	11/04/02	11/01/02	10/02	10/02	10/02	10/31/02	10/02	10/02
Frequency Of Data 1/	D	D	D	D	W	M	W	M	Q	M	A	M
Frequency of Reporting 1/	D	D	D	D	W	M	W	M	Q	M	A	M
Source of Update 2/	A	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting 3/	E	E	E	E	E	E	E	E	E	E	V	E
Confidentiality 4/	C	D	D	D	D	C	C	C	C	C	C	C
Frequency of Publication 1/	M	M	M	M	M	M	M	M	M	M	A	M

1/ D= Daily; M= Monthly; W= Weekly; A=Annual.

2/ A= Central Bank of Nicaragua.

3/ E= Electronic data transfer; V= Staff visits.

4/ C= Unrestricted use; D= Embargoed for a specified period.

**NICARAGUA—TRADE REGIME AND REGIONAL INTEGRATION PROCESS**

**Import tariffs**

Owing to its membership to the Central American Free-Trade Area, Nicaragua has been harmonizing its tariff structure with that of the other members (El Salvador, Honduras, Guatemala, and Costa Rica) around four main bands:

Category	Tariff	Number of Items
Primary, intermediate and capital goods not produced in Central America	0	2,991
Primary and capital goods produced in Central America	5	1,698
Intermediate goods produced in Central America	10	340
Final goods	15	1,270

Currently about 78 percent of the tariff lines have been harmonized, and the objective is to move to a customs union by January 1, 2004, which would imply a zero tariff among members and the unified tariff structure described above. However, at present intra-regional tariff remain high in the agricultural sector, with tariffs greater than 15 percent on some agricultural products such as dairy, poultry, and cereals.

Special safeguards (temporary higher tariffs and tariff quotas) are being applied on rice, dairy products, and sorghum, for a total of 33 items, with the highest rate being 170 percent for chicken legs. These are consistent with WTO agreements, as they are duly notified and temporary, and justified by a sudden fall in internal prices or a sudden increase in imports.

The temporary tariff surcharge of 5 percent on intermediate and capital goods not produced in Central America was eliminated as of May 27, 2001.

The 35 percent surcharge on imports from Honduras and Colombia was introduced in 1999, because of territorial disputes with these countries. It is within the maximum consolidated amounts agreed to under WTO agreements.

Nicaragua implements a liberal and open policy regarding trade in services, and respects the GATS agreement. Their initial offer in the WTO covered the services to enterprises, communication services, tourism and transportation and financial services.

**Tariff exemptions and special regimes**

There are four broad categories of goods exempted from tariffs:

1. Goods exempted through international agreements, such as the ICRC, international missions.

2. Goods exempted in the Constitution, such as medicines, vaccines and serums, orthopedic instruments and prostheses, school and scientific equipment, books, magazines and other publications, paper, equipment for the media.
3. Some temporary exemptions expiring at the end of 2002 on goods related to the agricultural sector, fisheries, small crafts industry.
4. Goods destined to the firefighters, churches and religious associations, NGOs, and grants received by NGOs or charities.

Special regimes include the following:

1. *Free trade zone*: all enterprises, as well as industrial park installations benefit from widespread exemptions from tariffs and all other taxes.
2. *Temporary admission regime for re-exports* (law on temporary admission for re-exporting): imports either get free admission with a guarantee from the importer, which is returned if the goods are re-exported after 6 months, or the importer pays the tariff at entry and then gets a drawback. Local sales to enterprises in the free-trade zone can also be considered as exports and benefit from this regime.
3. *Law of investment promotion* (Law No 74-2000, August 2000): benefits all new registered investments with widespread exemptions on import tariffs and local taxes. The law promotes foreign investment and greatly simplifies registration procedures.
4. *Tourism Law*: establishes a special regime for the tourism sector. New investments in the tourism sector benefit from widespread exemptions on tariffs and local taxes.

**Customs valuation code:** The law has been approved in June, and the regulations were approved in August 2002 and code will become effective as of September 2003.

**Government procurement:** Nicaragua is not a member of the WTO agreement on government procurement.

**Intellectual property protection:** Nicaragua is implementing the TRIPs agreement and passed in 2000 the remaining necessary legislation. Compliance appears low however, and there are reports of widespread breaches, such as piracy of sound and video recordings and the illegal use of satellite signals and broadcasts.

### **Export taxes**

There are no taxes on exports. A very small number of goods are prohibited from export, such as, for example, unprocessed timber thicker than 6 inches, caoba and cedar which has not been transformed to category 2, shrimp and lobster in the reproductive stages and live cattle under 350 kg. and certain types of hide.

### **Regional trade agreements**

There has been recent progress in strengthening the Central American Free-Trade Area (CAFTA), notably with the integration of Costa Rica (now comprising El Salvador, Honduras, Guatemala, Nicaragua, and Costa Rica). The objective is to deepen the process and move to a customs union by January 1, 2004, as described above.

Nicaragua signed a free-trade agreement with Mexico in December 1997, and has negotiated—as part of the CAFTA—free-trade agreements with Chile, Panama, and the Dominican Republic that have still not been ratified. The authorities also hope to negotiate a free-trade agreement (FTA) with the United States, and with Canada.



### NICARAGUA—PUBLIC SECTOR DEBT SUSTAINABILITY

This appendix examines the origins and medium-term dynamics of the public sector debt, and presents a number of stress tests to illustrate the effects of alternative assumptions on debt sustainability.

**Although external debt has traditionally been at the center of attention, it is the size and cost of domestic debt that now represent the largest threat to short and medium-term fiscal sustainability.** At end-2001, Nicaragua's total public debt in nominal terms amounted to about US\$7.9 billion (about 310 percent of GDP), of which US\$6.4 billion was external debt (250 percent of GDP), and US\$1.5 billion domestic debt (60 percent of GDP). In net present value terms the stock of debt was US\$5.8 billion (229 percent of GDP—Table 1). Total interest payments (external and domestic) represented about 15 percent of central government expenditures and 22 percent of revenue in 2001 (Table 2).

Table 1. Nicaragua: Public Sector Debt

	2001	2002	2003	2004	2005	2006	2007
<b>Stock of public debt</b>							
In millions of US\$ 1/	7,898.0	6,328.0	4,916.2	4,951.9	4,981.9	5,040.4	5,056.0
As percent of GDP 1/	310.1	246.1	184.7	176.4	166.7	158.3	149.1
In millions of US\$ 2/	5,832.9	4,445.6	3,172.2	3,165.7	3,186.3	3,225.7	3,219.8
As percent of GDP 2/	229.0	172.9	119.2	112.8	106.6	101.3	94.9
<b>Stock of external debt 3/</b>							
In millions of US\$ 1/	6,374.0	4,745.0	3,429.2	3,590.9	3,720.9	3,846.4	3,966.0
As percent of GDP 1/	250.3	184.5	128.8	128.0	124.5	120.0	116.3
In millions of US\$ 2/	4,308.9	2,862.6	1,685.2	1,804.7	1,925.3	2,031.7	2,129.8
As percent of GDP 2/	169.2	111.3	63.3	64.3	64.4	63.8	62.8
<b>Stock of domestic debt (accruals)</b>							
In millions of US\$	1,524	1,583.0	1,487.0	1,361.0	1,261.0	1,194.0	1,090.0
As percent of GDP	59.8	61.6	55.9	48.5	42.2	37.5	32.1
<b>Exports of goods and nonfinancial services</b>							
	938.4	937.1	1,034.1	1,146.7	1,267.6	1,402.2	1,535.1
<b>GDP</b>	<b>2,546.9</b>	<b>2,571.4</b>	<b>2,661.4</b>	<b>2,806.4</b>	<b>2,989.3</b>	<b>3,184.2</b>	<b>3,391.9</b>

Source: Central Bank of Nicaragua, Ministry of Finance and staff projections.

1/ External debt in nominal terms

2/ External debt in NPV terms. Preliminary projections based on revised aggregate data, not strictly comparable to decision point projections.

3/ External debt stock presented after debt relief, assuming a Cologne flow rescheduling after approval of a new PRGF arrangement, and a stock operation at end-2003.

**The public debt buildup is the result of large fiscal imbalances and institutional and governance weaknesses.** Nicaragua's external debt problem arose as borrowing grew much faster than the repayment capacity during the late 1970s and 1980s, due to unsustainably high government spending. On the domestic side, there are two main debt instruments, BPIs and

CENIs. BPIs were issued by the central government to compensate previous owners of properties confiscated during the Sandinista regime, with maturities of 15 years and interest rates between 3 to 5 percent. This debt of about US\$0.8 billion starts maturing in 2004, and maturities become significant starting in 2007. CENIs are central bank instruments originally intended for monetary control purposes, and typically placed through regular auctions at market interest rates, with maturities of up to three years. However, during 2000–01 these instruments were also issued to cover the difference between performing assets and liabilities of failed banks that were taken over by other banks (about 20 percent of GDP).

**As regards external debt, Nicaragua is participating in the enhanced HIPC initiative.** Relief during the interim period (2001–2003) is being provided by multilateral creditors through grants, and at the completion point the stock of debt will be reduced by 72.2 percent in NPV terms (EBS/00/259).<sup>1</sup> External debt service is projected to decline from 16 percent of exports and 27 percent of government revenues in 2001 to 8 and 13 percent, respectively, by 2005. In addition, to ensure long-term sustainability beyond the HIPC completion point, the authorities' strategy focuses on sound fiscal policies as well as prudent borrowing policy, based on highly-concessional financing, and keeping new borrowing in line with expected repayment capacity.

**To reduce the domestic debt, the authorities' strategy aims to** (i) gradually reduce the fiscal deficit (the combined public sector deficit before grants is to decline from 16.5 percent of GDP in 2002 to 7.5 percent in 2005); (ii) use exceptional proceeds resulting from privatization, asset recovery, and balance of payments support to retire debt of about US\$100 million in 2002–2003 (US\$160 million over the program period); (iii) harmonize the terms of new issues of CENIs with other Central American countries in order to facilitate the roll-over of maturities; (iv) address financial sector weaknesses by strengthening the prudential and regulatory framework; and (v) strengthen the credit culture through implementation of the asset recovery plan and enforcement of the rule of law, in particular as regards property rights.

**On this basis, the stock of public debt would decline from 230 to 107 percent of GDP between 2001 and 2005.** Debt service would peak at 25 percent of GDP in 2004 and fall to 14 percent of GDP by 2005; but interest payments would still amount to 23 percent of central government revenue and 14 percent of exports (Table 2). Although these ratios remain high, the continuous reduction in the stock and the pursuit of a sound fiscal policy with a return to primary surpluses by 2005 should help build private sector confidence and facilitate rollovers at longer maturities and more favorable interest rates.

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<sup>1</sup> EBS/00/259, December 7, 2000.

Table 2. Nicaragua: Public Sector Debt Service (Cash basis) 1/

(In millions of US dollars)

	2001	2002	2003	2004	2005	2006	2007
Total public sector debt service	412.9	474.0	546.2	717.9	422.1	359.5	381.0
Principal	289.9	316.9	343.2	411.0	250.3	210.0	234.7
Interest	123.0	157.1	203.0	306.9	171.8	149.5	146.3
Public sector external debt service	153.3	154.9	118.2	91.9	100.1	123.4	138.6
Principal	106.2	113.9	54.2	33.0	34.3	50.8	61.2
Interest	47.1	41.0	64.0	58.9	65.8	72.6	77.4
Public sector domestic debt service	259.6	283.4	428.0	626.0	322.0	236.1	242.4
Principal	183.7	203.0	289.0	378.0	216.0	159.2	173.5
Interest	75.9	80.4	139.0	248.0	106.0	76.9	68.9
<b>Memorandum Items:</b>							
Total public debt service:							
As percent of exports of goods and non-financial services	44.0	46.8	52.8	62.6	33.3	25.6	24.8
As percent of central government revenue	72.4	72.7	81.4	99.1	54.8	42.2	42.6
As percent of GDP	16.2	17.0	20.5	25.6	14.1	11.3	11.2
External debt service:							
As percent of exports of goods and non-financial services	16.3	16.5	11.4	8.0	7.9	8.8	9.0
As percent of central government revenue	26.9	25.7	17.6	12.7	13.0	14.5	15.5
As percent of GDP	6.0	6.0	4.4	3.3	3.3	3.9	4.1
Domestic debt service:							
As percent of central government revenue	45.5	47.0	63.8	86.4	41.8	27.7	27.1
As percent of GDP	10.2	11.0	16.1	22.3	10.8	7.4	7.1

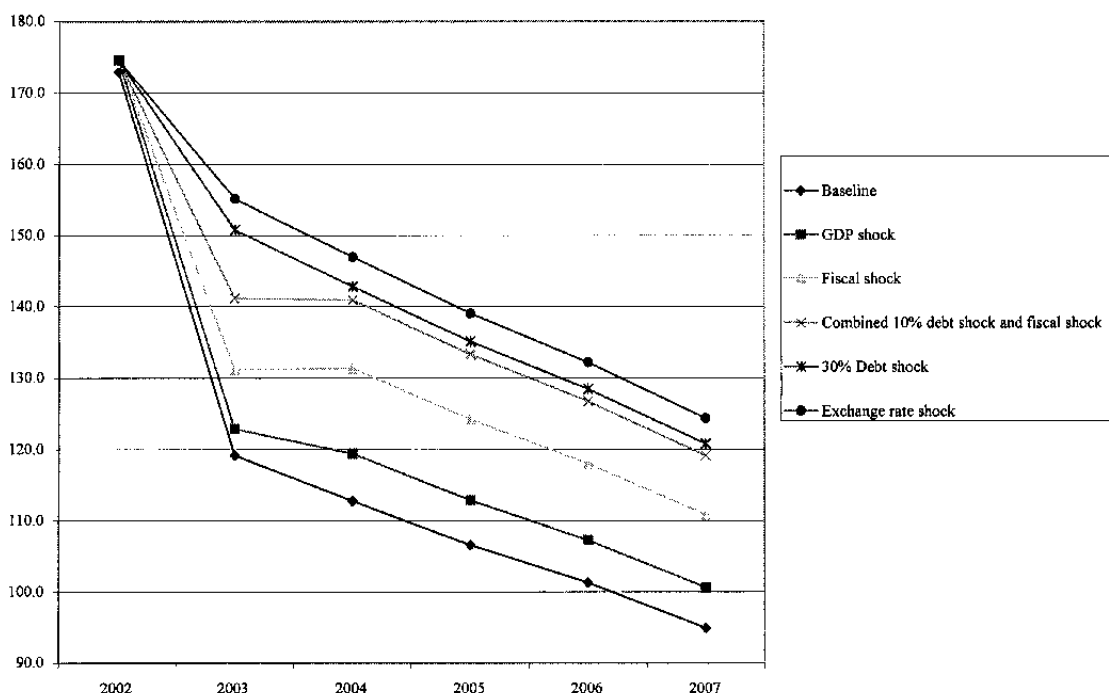
Sources: Central Bank of Nicaragua; Ministry of Finance; and Fund staff estimates.

1/ External debt service presented after debt relief. The high amount of interest on domestic debt interest in 2004 reflects, zero-coupon-type bonds includes coupon-type bonds falling due in that year.

**The sensitivity of the projections to a number of shocks has been tested using a methodology in line with the analytical framework developed in a recent Board paper on assessing sustainability (SM/02/166).** While in the alternative scenarios the stock of debt is still expected to decline significantly (mainly as a result of HIPC), the reduction would be considerably less. Three types of shocks would each result in a stock of total debt roughly 25–30 percent higher by 2007 than in the baseline (Figure 1 and Table 3):

- A 30 percent sustained real depreciation of the exchange rate in 2003, reflecting the fact that public debt is mostly denominated in, or indexed to, foreign currency;
- A 30 percent higher stock of debt at end-2003 (due, for example, to delays in implementation of the HIPC initiative, and/or another large issue of domestic debt in response to banking sector problems); and
- A higher combined public sector deficit in 2003 and 2004 (by two standard deviations of the past five-year average, or 6.5 percent of GDP) and lower “exceptional” proceeds from asset recoveries, privatization, and balance of payments support (by about 10 percent of GDP).

**Figure 1. Sensitivity Tests on the Public Debt Stock**



Other scenarios examined include a higher fiscal deficit, but with “exceptional” proceeds as programmed, which would lead to a debt/GDP ratio of about 110 percent by 2007, compared with about 95 percent in the baseline; and lower GDP growth in 2003–04 (1.7 percent compared with 3–4.5 percent in the baseline) resulting in a moderately higher debt ratio (100 percent).

**The dynamics of external debt including stress tests are shown in Table 4.** In the baseline, mainly because of the impact of the enhanced HIPC initiative, the ratio of external debt to exports falls from 306 percent to about 140 percent between 2002 and 2007 and the debt/GDP ratio also falls steadily from 111 percent to 63 percent. The sensitivity analysis shows that if key variables were at their average level for the past 5 years, the ratio of external debt to GDP would be substantially higher in 2007 than in 2002 (by 80 percentage points of GDP—reflecting the unsustainable path the current account deficit between 1997 and 2001). Results also indicate that the projection is most sensitive to a devaluation or to a deterioration in the external environment in 2003 and 2004, reflected in higher oil prices as well as lower commodity prices and private remittances (negative terms of trade shock combined with lower growth in the United States). Under the latter scenario, the financing need increases by about US\$140 and US\$70 million in 2003 and 2004, respectively, leading to a debt ratio about 10 percent higher at the end of the period than under the baseline scenario. However, as mentioned earlier, in all scenarios the impact of HIPC clearly dominates and leads to a steadily declining external debt to GDP ratio.

Table 3. Nicaragua: Public Sector Debt Sustainability Framework, 1997–2007

	Actual				Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
<b>I. Baseline Medium-Term Projections</b>										
Public debt/revenues 1/	731.9	614.9	691.9	676.1	475.8	331.6	348.2	329.3	320.8	300.8
Public debt/GDP 1/	297.1	274.9	233.5	229.0	172.9	119.2	112.8	106.6	101.3	94.9
Change in public debt/GDP	-9.8	-22.2	-41.4	-4.5	-56.1	-53.7	-6.4	-6.2	-5.3	-6.4
Net debt-creating flows/GDP (5+6)	-42.3	-41.2	-35.1	-9.5	-7.4	-9.7	-6.8	-7.5	-6.2	-5.7
Overall deficit, excluding net interest payments/GDP (=primary deficit)	-1.3	1.4	2.3	4.7	-1.9	-3.8	-0.8	-1.8	-1.1	-1.0
$((r - \pi) - g(1 + \pi)) / (1 + g + \pi + g\pi)$ debt/GDP (8/7) 2/	-41.0	-42.5	-37.4	-14.3	-5.5	-5.9	-6.0	-5.8	-5.1	-4.7
Adjustment factor: $1 + g + \pi + g\pi$	1.2	1.2	1.2	1.1	1.1	1.1	1.1	1.1	1.1	1.1
$((r - \pi) - g(1 + \pi))$ debt/GDP (9+10)	-48.2	-50.8	-44.2	-15.8	-5.9	-6.4	-6.7	-6.3	-5.6	-5.2
(r - $\pi$ ) times debt/GDP	-34.1	-26.4	-26.4	-8.2	-2.5	-0.9	-1.0	-0.4	0.5	0.6
minus g (1 + $\pi$ ) times debt/GDP	-14.1	-24.3	-17.8	-7.5	-3.5	-5.5	-5.7	-5.9	-6.1	-5.8
Residual, incl. asset changes, privatization receipts (negative), and valuation changes in external debt/GDP (3-4)	32.6	18.9	-6.3	5.0	-48.7	-44.0	0.4	1.3	0.9	-0.7
<b>Memorandum Items: Key macro and external assumptions</b>										
Nominal GDP (in millions of cordobas)	22	26	31	34	37	40	45	49	54	59
Real GDP growth (annual change)	4.1	7.4	5.8	3.0	1.4	3.0	4.5	5.0	5.5	5.5
Exchange rate (cordobas per U.S. dollar)	10.6	11.8	12.7	13.4	14.3	15.1	15.9	16.4	16.9	17.4
Nominal appreciation of local currency against U.S. dollar	-10.7	-10.4	-6.9	-5.7	-5.7	-5.7	-4.8	-3.4	-2.9	-2.9
GDP deflator (change, in percent per year)	13.0	11.2	11.6	7.4	5.9	6.5	6.0	5.0	4.0	4.0
Average interest rate on public debt (percent per year)	1.9	2.3	2.0	3.9	4.8	6.0	5.1	4.6	4.5	4.6
Average real interest rate (nominal rate minus change in GDP deflator, percent)	-11.1	-8.9	-9.6	-3.5	-1.1	-0.5	-0.9	-0.4	0.5	0.6
Growth of revenues (deflated by GDP deflator, in percent per year)	6.2	18.2	-20.1	3.4	8.8	1.9	-5.8	4.9	2.9	5.4
Growth of noninterest expenditure (deflated by GDP deflator, in percent per year)	7.6	25.9	-17.1	10.2	-9.6	-4.0	2.9	1.6	4.8	5.9
<b>II. Stress Tests</b>										
1. If real GDP growth rate in 2003 and 2004 is average minus two standard deviations, others at baseline					172.9	122.9	119.4	112.9	107.3	100.6
2. If public sector primary balance (in percent of GDP) in 2003 and 2004 is average minus two standard deviations, others at baseline					172.9	131.1	131.3	124.2	118.0	110.9
3. If (2) and lower proceeds from privatization and asset recovery equivalent to 10% of GDP					172.9	141.2	140.9	133.3	126.7	119.1
4. If one time 30 percent real depreciation in 2003, others at baseline 3/					172.9	155.2	147.0	139.0	132.2	124.3
<b>Memorandum items:</b>										
Primary deficit (percent of GDP, average of past 5 years)					1.1	1.1	1.1	1.1	1.1	1.1
Primary deficit (percent of GDP, standard deviation of past 5 years)					2.7	2.7	2.7	2.7	2.7	2.7
Real interest rate (nominal rate minus change in GDP deflator, average of past 4 years)					-8.3	-8.3	-8.3	-8.3	-8.3	-8.3
Real interest rate (nominal rate minus change in GDP deflator, standard deviation of past 4 years)					3.3	3.3	3.3	3.3	3.3	3.3
Nominal interest rate (average of past 5 years)					2.5	2.5	2.5	2.5	2.5	2.5
Nominal interest rate (standard deviation of past 5 years)					0.9	0.9	0.9	0.9	0.9	0.9
Real GDP growth rate (average of past 5 years)					5.1	5.1	5.1	5.1	5.1	5.1
Real GDP growth rate (standard deviation of past 5 years)					1.7	1.7	1.7	1.7	1.7	1.7
GDP deflator (average of past 5 years)					10.5	10.5	10.5	10.5	10.5	10.5
GDP deflator (standard deviation of past 5 years)					2.2	2.2	2.2	2.2	2.2	2.2

Sources: Central Bank of Nicaragua; Ministry of Finance; and staff projections.

1/ Combined public sector.

2/ Defined as:  $r$  = interest rate;  $\pi$  = GDP deflator, growth rate;  $g$  = real GDP growth rate.

3/ Real appreciation is approximated by nominal appreciation against U.S. dollar plus increase in domestic GDP deflator.

Table 4. Nicaragua: External Sustainability Framework, 1997-2007

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
<b>I. Baseline Medium-Term Projections</b>											
External debt/Exports of G&S 1/	641.9	626.2	628.2	485.5	459.1	305.5	163.0	157.4	151.9	144.9	138.7
External debt/GDP 1/	260.6	251.4	238.1	191.3	169.2	111.3	63.3	64.3	64.4	63.8	62.8
Change in external debt/GDP	-30.9	-9.2	-13.3	-46.8	-22.1	-57.9	-48.0	1.0	0.1	-0.6	-1.0
Net debt-creating external flows/GDP (5+9+12)	24.0	15.7	31.7	3.6	17.0	18.1	10.7	7.1	8.0	7.3	4.3
Current account deficit, excluding interest payments/GDP	33.8	32.6	44.9	35.3	36.4	26.6	21.6	17.2	16.1	15.1	15.0
Deficit in balance of G&S/GDP			54.2	42.5	36.4	37.7	34.5	31.5	29.7	28.1	27.7
Exports of G&S/GDP	40.6	40.2	37.9	39.4	37.0	36.4	38.9	40.9	42.4	44.0	45.7
Imports of G&S/GDP	81.7	80.1	92.1	81.9	73.4	74.1	73.4	72.4	72.1	72.2	73.4
Minus net non-debt creating capital inflows/GDP	-8.8	-8.9	-13.6	-10.9	-5.2	-7.8	-9.6	-9.0	-6.3	-6.1	-9.7
Net foreign direct investment, equity/GDP	8.8	8.9	13.6	10.9	5.2	7.8	9.6	9.0	6.3	6.1	9.7
Net portfolio investment, equity/GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(r-g-(p+gp))/(1+g+p+gp)debt/GDP (14/13)	-1.0	-8.0	0.4	-20.8	-14.2	-0.7	-1.4	-1.2	-1.7	-1.7	-1.0
Adjustment factor: 1+g+p+gp	1.0	1.1	1.0	1.1	1.1	1.0	1.0	1.1	1.1	1.1	1.1
(r-g-(p+gp))debt/GDP (15+16+17)	-1.0	-8.4	0.4	-23.2	-15.5	-0.7	-1.4	-1.2	-1.8	-1.8	-1.1
r (interest rate) times debt/GDP	6.2	4.8	3.2	3.5	1.9	1.6	2.5	2.2	2.3	2.4	2.4
minus g (real GDP growth rate) times debt/GDP	-14.9	-10.6	-3.7	-16.8	-14.7	-2.4	-3.3	-2.8	-3.2	-3.5	-3.5
minus (p + gp) (p = US dollar value of GDP deflator, growth rate) times debt/GI	7.7	-2.6	0.9	-9.8	-2.7	0.1	-0.6	-0.6	-1.0	-0.7	0.0
Residual, incl. change in gross foreign assets/GDP (3-4)	-54.9	-24.9	-45.0	-50.4	-39.1	-76.0	-58.7	-6.1	-8.0	-7.9	-5.3
<b>Memorandum Items: Key macro and external assumptions</b>											
Nominal GDP (local currency)	18.6	21.9	26.1	30.9	34.2	36.6	40.2	44.5	49.1	53.8	59.1
Nominal GDP (US dollars)	2.0	2.1	2.2	2.4	2.5	2.6	2.7	2.8	3.0	3.2	3.4
Real GDP growth (in percent per year)	5.1	4.1	1.5	7.1	7.7	1.4	3.0	4.5	5.0	5.5	5.5
Nominal GDP deflator (in US dollars, change in percent per year)	-2.5	1.0	-0.4	3.9	1.3	-0.1	0.5	0.9	1.5	1.0	0.0
External interest rate (percent per year)	2.1	1.8	1.3	1.5	1.0	1.0	2.2	3.5	3.6	3.8	3.8
Growth of exports of G&S (US dollar terms, in percent per year)	22.7	3.9	1.0	14.2	-2.0	-0.1	10.3	10.9	10.5	10.6	9.5
Growth of imports of G&S (US dollar terms, in percent per year)	24.0	2.9	23.1	-2.3	-6.5	2.4	2.4	4.0	6.1	6.6	7.3
<b>II. Sensitivity Analysis for External Debt-to-GDP Ratio</b>											
1. If interest rate, real GDP growth rate, US\$ GDP deflator growth, non-interest current account, and non-debt flows (in percent of GDP) are at average of past 5 years						<b>113.6</b>	<b>77.5</b>	<b>95.4</b>	<b>110.8</b>	<b>125.6</b>	<b>143.0</b>
2. If real GDP growth rate in 2003 and 2004 is average minus two standard deviations, others at baseline						<b>111.3</b>	<b>66.5</b>	<b>70.3</b>	<b>70.2</b>	<b>69.5</b>	<b>69.0</b>
3. If US\$ GDP deflator in 2003 is average minus two standard deviations, others at baseline						<b>111.3</b>	<b>68.5</b>	<b>69.4</b>	<b>69.3</b>	<b>68.6</b>	<b>68.1</b>
4. If terms of trade shock in 2003-04 (higher oil price, lower remittances and exports)						<b>111.3</b>	<b>69.7</b>	<b>74.7</b>	<b>74.5</b>	<b>73.7</b>	<b>73.1</b>
5. One time 30 percent depreciation in year 2003 (-30% GDP deflator shock), others at baseline.						<b>111.3</b>	<b>111.2</b>	<b>111.4</b>	<b>110.2</b>	<b>108.4</b>	<b>107.2</b>
<b>Memorandum Items:</b>											
Current account deficit, excluding interest payments (percent of GDP, average of past 5 years)						36.6	36.6	36.6	36.6	36.6	36.6
Current account deficit, excluding interest payments (percent of GDP, standard deviation of past 5 years)						4.9	4.9	4.9	4.9	4.9	4.9
Net non-debt creating capital inflows (percent of GDP, average of past 5 years)						9.5	9.5	9.5	9.5	9.5	9.5
Interest rate (average of past 5 years)						1.5	1.5	1.5	1.5	1.5	1.5
Interest rate (standard deviation of past 5 years)						0.4	0.4	0.4	0.4	0.4	0.4
Real GDP growth rate (average of past 5 years)						5.1	5.1	5.1	5.1	5.1	5.1
Real GDP growth rate (standard deviation of past 5 years)						2.5	2.5	2.5	2.5	2.5	2.5
GDP deflator, US dollar terms (average of past 5 years)						0.7	0.7	0.7	0.7	0.7	0.7
GDP deflator, US dollar terms (standard deviation of past 5 years)						2.3	2.3	2.3	2.3	2.3	2.3

Sources: Central Bank of Nicaragua; Ministry of Finance; and staff projections.

1/ External debt in NPV terms.



REPUBLICA DE NICARAGUA

Mr. Horst Köhler  
Managing Director  
International Monetary Fund  
Washington, D.C., 20431  
U.S.A

Managua, Nicaragua  
November 19, 2002

Dear Mr. Köhler:

1. We are enclosing with this letter the Memorandum of Economic and Financial Policies (MEFP) that underpins our economic program and poverty reduction strategy during 2002–05, and sets out specific objectives and quarterly targets for December 2002–September 2003.
2. In order to permanently eradicate extreme poverty from our country we must provide a proper stable macroeconomic framework to foster rapid growth in a context of low inflation and expand job opportunities to all Nicaraguans, mainly through private sector investment, production and exports. A sustained increase in output and employment generation will be the only way our people, particularly the poor, will have access to better food, health, shelter, and living standards.
3. President Enrique Bolaños' strong determination to make the program succeed and his decisive battle against corruption, makes this program different from others.

Specifically,

- **Our poverty reduction strategy provides a safety net for the poorest and increased public sector expenditures in social sectors**, but the ultimate solution in the combat against poverty is sustainable economic growth and a steady and adequately remunerated employment. We want Nicaraguans to feel pride and dignity, and that they are able to provide for themselves and their families with their own efforts.
- **A reduction of the public sector deficit that will promote price stability and stimulate job creation in the private sector, not in the public sector.** We want our tax system to be more equitable so as to reduce the burden on the working people. We are reducing wasteful public spending while ensuring that outlays to benefit the poor are increased and better targeted.

- **Development and strengthening of the financial markets** will also be addressed, including activities to ensure that banks are sound and properly supervised and regulated. The hard working public must be confident that their financial savings are secure and channeled to sound productive investments.
- **Reducing the high level of external and domestic debt is a key element of our program.** Reaching the HIPC completion point will be essential to obtain external debt relief and release needed resources to fight poverty. However, we need concessionary financing while fiscal reform and expenditure rationalization allow our public sector to reach a sustainable position. We also need technical and financial support to reduce our domestic debt overhang.

4. To support these objectives and policies, Nicaragua hereby requests a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) in a total amount equivalent to SDR 97.5 million (75 percent of the quota). The Government of Nicaragua also requests interim assistance under the HIPC Initiative in an amount equivalent to SDR 1.888 million, which will cover 33.2 percent of principal obligations falling due to the Fund between the date of the approval of the new PRGF arrangement and September 30, 2003.

5. The Government of Nicaragua stands ready to take additional measures that maybe appropriate for the achievement of the program's objectives. We will continue consulting with the Fund on its economic and financial policies, and will provide the Fund all necessary data on a timely basis for monitoring purposes. During the program period, the government will not introduce or intensify any exchange restrictions, introduce or modify any multiple currency practices, conclude any bilateral payments agreements that are inconsistent with Article VIII of the Fund's Articles of Agreement, or introduce or intensify import restrictions for balance of payments purposes. Consistent with its intention to keep the public informed about its policies and objectives, the government will publish the MEFP and will report periodically on progress under the program.

6. We propose that the IMF carry out reviews under the program in March 2003, June 2003, September 2003 and January 2004 based on the observance, respectively, of end-December 2002, end-March 2003, end-June 2003, and end-September 2003, quantitative and structural performance criteria established in Tables 2 and 3 of the attached memorandum.

7. We are confident that all the above actions will earn us the trust of the multilateral and bilateral community, but most importantly that it will reestablish the credibility of our own people in their country and in their government.

Sincerely yours,

\_\_\_\_\_  
/s/  
Mario B. Alonso I.  
President  
Central Bank of Nicaragua

\_\_\_\_\_  
/s/  
Eduardo Montealegre  
Minister of Finance



## MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

### I. BACKGROUND

1. The new government that took office in early 2002 inherited a situation of rapidly declining growth and increasing vulnerabilities. In 2001, real GDP growth slowed to about 3 percent, from almost 6 percent in 2000. The combined public sector deficit before grants was above 21 percent of GDP in 2001, while after grants it exceeded 14 percent of GDP, almost 6 percent of GDP higher than in 2000. As a result, net international reserves (NIR) fell by US\$170 million in 2001, lowering gross international reserves to about 2.3 months of imports. In addition, the central bank issued dollar-indexed domestic debt equivalent to almost 20 percent of GDP to resolve problems in the banking system.
2. Against this background, the new government moved decisively to address economic imbalances. In particular, the authorities restrained public expenditures and, in July 2002, the National Assembly (NA) reduced the 2002 budget by 1.5 percent of GDP (about 3 percent of GDP on an annual basis). In addition, at the initiative of the executive, a tax package was approved by the NA in August 2002, which contained a significant reduction of import tariff exemptions; a reduction of income tax exonerations; an increase in the corporate income tax rate; and increases in retention rates. Although new zero-rated VAT products were added to the subsistence basket by the NA, the package is expected to yield some 2.1 percent of GDP in revenues on an annual basis.
3. As a result of these measures, the combined public sector deficit (after grants) has fallen in 2002. During January–September 2002 the deficit declined to 6.7 percent of annual GDP, compared with 8.8 percent of GDP in 2001, while total primary expenditures fell to 26.0 percent of GDP, from 28.2 percent of GDP during the same period of last year. In addition, the level of NIR and the domestic debt of the central bank have remained broadly constant during the first three quarters of 2002, despite the absence of balance of payments support.
4. As part of the efforts to strengthen the financial sector, all banks are required to comply with existing prudential norms and the Superintendency of Banks (SB) has concluded a second round of on-site assisted inspections. In particular, all banks are now required to comply with provisioning requirements (including for coffee-related loans) and capital adequacy requirements. In addition, new norms on fit and proper criteria for bank managers and main shareholders, as well as on conflict of interest, have been approved, in line with international best practices. Moreover, based on an international bidding process, the central bank has selected and publicly announced the firm that will carry out recoveries of assets received from intervened banks.

## II. MEDIUM-TERM POLICIES

5. The main objective of the government's economic program for 2002–05 is to resume sustained rapid growth in a context of low inflation, while significantly reducing poverty. The authorities remain committed to the strategy presented in the PRSP, as updated in the PRSP progress report. This strategy aims at restoring fiscal and external sustainability; increasing spending on poverty-reducing programs in line with HIPC relief; accelerating the implementation of structural reforms directed at higher efficiency of public spending; and boosting foreign and domestic private investment.

6. An important goal of the new government is to improve governance and fight corruption. Several concrete steps to this effect have already been taken, including the approval of a new probity law for public functionaries; changes to the penal code to define crimes of public servants; and an anti-corruption initiative that has already achieved tangible and internationally recognized results. Also, a commission on judicial reform, with civil society participation, has prepared recommendations to strengthen the judicial system. Along these lines, a public procurement reform program has been launched and a new criminal procedures code is being implemented.

7. The government's main medium-term economic objectives are as follows:

Table 1. Nicaragua: Medium-Term Economic Indicators, 2002–05

	Projected			
	2002	2003	2004	2005
(Annual percentage change)				
GDP at constant prices	1.0	3.0	4.5	5.0
Consumer prices (end of period)	6.0	6.0	4.0	4.0
(In percent of GDP; unless otherwise indicated)				
Combined public sector savings	-4.2	-1.0	3.4	5.5
Combined public sector primary balance (before grants)	-5.3	-2.8	-3.2	-2.3
Combined public sector overall balance (before grants)	-16.5	-13.2	-9.4	-7.5
Combined public sector overall balance (after grants)	-9.2	-6.3	-5.3	-3.3
External current account balance	-28	-24	-19	-18
Gross international reserves (in months of imports)	2.2	2.5	2.7	3.0
Strengthening of central bank position (flows, US\$ million)	20.0	100.0	-15.0	120.0
Increase in NIR (+)	-13.0	30.0	0.0	50.0
Reduction of central bank domestic debt (+) 1/	33.0	70.0	-15.0	70.0
Poverty-reducing spending	15.6	15.8	16.3	16.8

1/ Includes debt denominated in and indexed to the U.S. dollar; reduction = (+).

8. The fiscal program envisages a reduction of the combined public sector (CPS) deficit (after grants), accompanied by an increase in poverty-reducing expenditures. The CPS deficit (after grants) is projected to fall from 9.2 percent of GDP in 2002 to 3–4 percent of GDP in 2005, an amount that is consistent with a sustainable level of concessional loans. Fiscal consolidation will be the result of raising revenue from 30.8 percent of GDP to 31½ percent of GDP between 2001 and 2005, while reducing primary expenditures from 43 percent of GDP to about 34 percent of GDP over the same period. The revenue increase will take place despite the loss of over 2 percent of GDP of revenues in 2003–04 due to the partial transfer of pension administration to the private sector. Under the program, poverty-related expenditures will reach about 17 percent of GDP by 2005, 4 percent of GDP higher than in 1998 (before the exceptional and unsustainable increase in spending associated with the Hurricane Mitch reconstruction efforts). Tracking mechanisms for poverty-reducing spending have been developed, and reports on the use of HIPC relief are being prepared.

9. The fiscal position is to be strengthened at both the revenue and expenditure sides. On the revenue side, a second stage of the tax reform will be implemented by mid-2003, which is expected to generate about 1.0 percent of GDP on an annual basis, and tax administration will be strengthened with the assistance of multilateral organizations to increase revenues by 0.6 percent of GDP by 2005. On the expenditure side, restraint, increases in efficiency and transparency, and a permanent reduction in current primary spending will add over 5.0 percent of GDP to public savings by 2005. To assist in this effort, a comprehensive public sector restructuring plan will be prepared in 2003, enhancing the efficiency of government while also improving public savings (by about 0.6 percent of GDP by 2005).

10. Monetary policy will be geared toward improving the financial position of the central bank in the context of low inflation. A gradual reduction of the central bank's domestic debt is a key objective of the program, in order to lower vulnerabilities and support higher economic growth over the medium term by providing the basis for increased commercial banks lending to the private sector. To achieve such reduction, the program envisages the recoveries of assets received from intervened banks and the increase of central government deposits at the central bank as a result of privatization proceeds, balance of payments support loans, and fiscal adjustment.

11. To strengthen the financial sector, the authorities are committed to enforcing strictly the existing prudential framework, and strengthening that framework further where necessary. In particular, the SB will implement a new norm to address banks' maturity mismatches, and is working to improve supervisory practices with technical assistance from multilateral organizations. By September 2003, the government will submit to the NA necessary amendments to bring the legal framework in line with the Basel Core Principles for effective bank supervision and to remove secrecy on banking assets.

12. Other key elements of the structural reform agenda are aimed at removing constraints to growth and achieving a sustainable external position. Trade liberalization and efforts to lower trade barriers with key commercial partners, including through a free trade agreement

with the United States, and a customs union with the other Central American countries, are among the government's priorities. Programs to bolster market-based credit to small enterprises and the rural areas are being implemented with World Bank and IDB assistance. The government also plans to implement a new system of privately managed pension funds, and to reform the judicial system and the civil service.

13. In the context of the enhanced HIPC Initiative, the authorities will seek bilateral debt rescheduling agreements on Cologne terms and will strictly limit all new external assistance to grants and concessional loans, as prudent debt management is key to fiscal and external sustainability. As noted above, the government will seek to substantially reduce the nonconcessional dollar-indexed and dollar-denominated domestic debt of the public sector (including the central bank). To improve debt management the government is aiming to standardize the terms of domestically issued dollar-indexed or dollar denominated debt so as to make it more attractive to investors.

14. The crawling exchange rate peg has served Nicaragua well as an anchor to maintain low inflation. The authorities will aim at lowering inflation further in the medium term, supported by appropriate monetary, exchange rate, and fiscal policies. For the longer run, the authorities will continually reassess the effectiveness of the current exchange rate regime and its contribution to the objectives of low inflation and adequate external competitiveness.

### **III. THE PROGRAM FOR 2002–03**

15. To foster sustained rapid growth in a low-inflation environment, the program aims at maintaining macroeconomic stability by pursuing a prudent and transparent fiscal policy, gradually reducing the stock of domestic debt, strengthening the official reserves of the central bank, and increasing poverty-related spending. Real GDP growth is projected to increase from 1 percent in 2002 to 3 percent in 2003.

16. The program targets a reduction of the combined public sector deficit (after grants) from over 14 percent of GDP in 2001 to 9.2 percent of GDP in 2002, and to 6.3 percent of GDP in 2003. At the same time, the program aims at an increase in poverty-reducing spending to 15.8 percent of GDP by 2003, compared with 14.1 percent of GDP in 2001. In addition, the poverty spending profile will be strengthened by replacing measures that are not well targeted to the poor with well-focused programs.

17. In order to achieve the fiscal objectives laid out in the program and to strengthen the poverty-reducing strategy, draft legislation for the second stage of the tax reform will be submitted to the NA by March 2003. The package will be designed to significantly increase efficiency, equity and fairness of the tax system, while generating revenues of at least 1 percent of GDP on an annual basis. The government considers that in order to achieve these objectives, it is necessary to consider reducing the number of products subject to excises, eliminating import exonerations, and replacing zero-rated and exempted VAT products-which are costly and not well targeted to the poor-with direct and better-

focused support programs to help the most vulnerable groups. In this connection, the government will work with the NA to facilitate a consensus on these issues. The authorities will reach detailed understandings with the staff on the tax reform package prior to its submission to the assembly. In addition, the structural benchmarks on the submission to the national assembly (March 2003) and approval by the national assembly of a tax package yielding 1 percent of GDP on an annual basis (June 2003), will be converted into performance criteria at the first review of the program.

18. On the expenditure side, the 2003 budget submitted to the NA contains primary outlays of 35 percent of GDP, compared with the unsustainable level of 43 percent of GDP in 2001. Should revenue collections during the year fall short of the indicative targets set out in Table 2, the government stands ready to implement offsetting measures, while protecting poverty-reducing spending.

19. Monetary policy will be guided by the objective of strengthening the position of the central bank in a low-inflation context (6 percent during 2003). During 2003, the authorities intend to maintain the crawling peg of the exchange rate at an annual rate of 6 percent. In addition, the program targets an increase of NIR (US\$30 million), together with a reduction in the dollar-indexed and dollar-denominated domestic debt of the central bank (US\$70 million). These targets are to be achieved mainly by the envisaged fiscal adjustment, decisive implementation of the recovery plan for assets received from intervened banks, the privatization program, and balance of payments support—together expected to yield about US\$185 million during 2003.

20. The government is firmly committed to the implementation of the recovery plan for the assets received by the central bank from intervened banks, which is crucial for the success of the program. The central bank has recently selected, on the basis of a competitive bidding process, a firm with international experience in asset management to carry out these recoveries. Signature of the contract with the selected firm will take place in December 2002, and the implementation of the asset recovery plan will be completed by September 2003.

21. Strengthening the banking system is high on the government's agenda. As a critical step, full compliance with capital requirements by end-2002 is a central objective of the program. By mid-2003, draft legislation to remove bank secrecy on assets will be introduced, and new prudential norms to limit risks derived from maturity mismatches between assets and liabilities will be approved. Also by mid-2003, the SB will begin implementing regular on-site inspections for all banks and a new unit will be set up at FOGADE, the public deposit insurance agency, to manage and liquidate assets in the event of bank interventions.

22. Additional elements of the structural reform program include the sale of the remaining government stake in the telephone company; the start of an action plan to strengthen the judicial system (based on the recommendations made by the Judicial Reform Commission in 2002); modernization of the Comptroller's office (with technical assistance and financial support from the IDB); beginning the operation of the new pension system based on private pension fund managers; approval by the NA of laws on public sector

borrowing; strengthening decentralized real estate registries (with World Bank assistance); and extending the coverage of the central government's single account to include all receipts, expenditures and financing. Also, the authorities are committed to the implementation of the recommendations of the Fund's Stage One safeguards assessment of the BCN.

23. Efforts are continuing to improve the statistical database with technical assistance from the Fund, IDA, the IDB, and U.S. AID. The BCN has prepared revised national accounts estimates in constant 1994 prices, which include more accurate data sources and will be adopted by March 2003 as the official figures. Work is ongoing (with technical assistance from the IMF) to improve the database and sectorization of banking sector accounts. This will result in a major improvement in the consistency between the monetary and fiscal sector statistics, and in the quality of data on credit for the private sector.

#### **IV. PROGRAM MONITORING AND IMPLEMENTATION CAPACITY**

24. Implementation of the first annual program supported under the PRGF arrangement (October 2002–September 2003) will be monitored through reviews based on the observance of quarterly performance criteria and benchmarks (end-December 2002, and end-March, end-June and end-September 2003). Quantitative and structural performance criteria are presented in Tables 2 and 3, and defined in the attached Technical Memorandum of Understanding. Prior actions will be implemented at least five business days before Executive Board Discussion of the authorities' request for the PRGF arrangement. Completion of the first review under the PRGF arrangement in early 2003 will be conditional on reaching detailed understandings on an appropriate tax reform package. The second review will focus inter alia on the asset recovery plan. The third review will focus on the adequacy of the tax reform package approved by the assembly. The authorities will also transmit to Fund staff all the necessary documentation required under the Fund's safeguard rules, prior to the Executive Board discussion.

Table 2. Nicaragua: Quantitative Performance Criteria for  
2002-03 PRGF-Supported Program 1/

	Cumulative Flows from January 1, 2002				
	Est.	Programmed			
	Sep. 30 2002	Dec. 31 2002	Mar. 31 2003	Jun. 30 2003	Sep. 30 2003
(In millions of cordobas)					
Net domestic financing of the combined public sector (ceilings)	1,005	704	188	435	-206
Savings of the combined public sector (floors)	-1,246	-1,533	-1,641	-1,664	-1,787
Net domestic assets of the central bank (ceilings)	-43	325	92	-176	-395.4
(In millions of U.S. dollars)					
Net international reserves of the central bank (floors)	-13	-13	-3	6	17
Net repayment of the domestic debt of the central bank (+) (floors) 2/	23	33	39	56	74
Contracting or guaranteeing nonconcessional public sector external debt (ceilings) 3/	0	0	0	0	0
Stock of external payments arrears (ceilings) 3/	0	0	0	0	0
(In millions of cordobas)					
<b>Memorandum items:</b>					
Indicative targets					
Tax revenue of the central government (floors)	6,007	8,063	10,377	12,674	15,198
Total primary expenditure of the central government (ceilings)	7,105	10,098	12,420	14,986	17,648
Deficit of the combined public sector, before grants (ceilings)	-4,403	-6,052	-7,120	-8,413	-9,859
Net domestic financing of the non-financial public sector (ceilings) 4/	-869	-1,144	-2,208	-2,624	-3,356

Sources: Central Bank of Nicaragua; Ministry of Finance; and Fund staff estimates.

1/ The program targets for December 2002, and March, June and September 2003, will be adjusted for the difference between the actual data for September 30, 2002 and the estimates for September 30, 2002 shown in the table.

2/ Dollar-denominated or dollar-indexed.

3/ Measured on a continuous basis.

4/ On a cash basis.

Table 3. Nicaragua: Prior Actions, Structural Performance Criteria, and Benchmarks 1/

Measures	Expected Date of Implementation
<b>I. Prior Actions for Board Consideration of a PRGF Arrangement</b>	
<p>1. <b>Submission to the national assembly of a 2003 budget</b> for the central government, which together with the estimated yield of the 2003 tax package, is consistent with a combined public sector deficit (after grants) target equal or less than 6.3 of GDP.</p>	End-October 2002
<p>2. <b>Confirmation by the authorities of compliance by all commercial banks with prudential norms, including on coffee sector loans.</b></p>	End-October 2002
<p>3. <b>Public announcement of the selection of a reputable firm with international experience in asset management to implement asset recovery.</b></p>	End-November 2002
<b>II. Performance Criteria</b>	
<p>1. <b>Confirmation by the authorities of compliance by all banks with existing capital adequacy requirements.</b></p>	End-December 2002
<p>2. <b>Asset Recovery Plan</b></p>	
<p>(i) <b>Signature of a contract with an international firm to implement asset recoveries.</b></p>	End-December 2002
<p>(ii) <b>End of the asset recovery process.</b></p>	End-June 2003
<p>(iii) <b>Conclude implementation of asset recovery plan for assets received from intervened banks.</b></p>	End-September 2003
<p>3. <b>Approval by the national assembly of a 2003 budget</b> for the central government, which with the projected yield of the 2003 tax package, is consistent with a combined public sector deficit (after grants) target equal or less than 6.3 of GDP.</p>	End-December 2002
<b>III. Benchmarks</b>	
<p>1. <b>Submission to the national assembly of the law on domestic and external indebtedness of the public sector.</b></p>	End-December 2002
<p>2. <b>Submission to the national assembly of an appropriate 2003 tax reform package,</b> in line with paragraph 17 of the MEFP, yielding 1.0 percent of GDP on an annual basis.</p>	End-March 2003



Table 3. Nicaragua: Prior Actions, Structural Performance Criteria, and Benchmarks 1/

Measures	Expected Date of Implementation
3. <b>Approval of prudential norms to limit risks derived from maturity mismatches between assets and liabilities.</b>	End-March 2003
4. <b>Publication and official adoption by the central bank of revised national accounts for 1994–2000.</b>	End-March 2003
5. <b>Approval by the national assembly of an appropriate 2003 tax reform package,</b> in line with paragraph 17 of the MEFP, yielding 1.0 percent of GDP on an annual basis.	End-June 2003
6. <b>Adoption by the general directorates of customs and revenue of an action plan to strengthen tax administration</b> during the period 2003–2005.	End-June 2003
7. <b>Start implementing a plan for regular on-site bank inspections,</b> in line with recommendations of MAE 2001 mission.	End-June 2003
8. <b>Submission to the national assembly of necessary legal amendments in line with Basle Core Principles for effective bank supervision.</b>	End-September 2003
9. <b>Divest the remaining government stake in ENITEL.</b>	End-September 2003

1/ The specific requirements for the implementation of these measures are specified in the Technical Memorandum of Understanding.

NICARAGUA—TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This technical memorandum sets out the understandings between the Nicaraguan authorities and the Fund relating to the monitoring of the first-year program (October 2002–September 2003) of the Poverty Reduction Growth Facility (PRGF) arrangement. It defines the concepts used to assess compliance with quantitative and structural performance criteria and benchmarks specified in the Memorandum of Economic and Financial Policies (MEFP). It also sets the frequency of the data to be provided to the Fund for monitoring the program.

**A. Fiscal Targets**

2. **Coverage of fiscal accounts**

(i) **Nonfinancial public sector (NFPS)** includes the central government, the Nicaraguan social security institute, the municipality of Managua, and two public sector enterprises: the electricity company (operations of ENTRESA only) and the water and sewerage company (ENACAL).

(ii) **Savings of the combined public sector (CPS)** include the savings of the NFPS and the operating result (quasi-fiscal balance) of the Central Bank of Nicaragua (BCN).

(iii) **The deficit of the CPS** includes the deficit of the NFPS and the operating result (quasi-fiscal balance) of the BCN.

3. **Interest on the domestic debt** includes interest on a due basis, except for the cost of CENIS issued for bank resolution, which are shown on accrual basis (see Table 1).

Table 1. Financial Cost of Bank Resolution 1/  
(In millions of cordobas)

	Accrual	Due	Adjustment
2001	720	0	720
2002	1,026	299	727
2003	910	849	61
2004	357	2,299	-1,942

1/ Corresponds to the interest and dollar-indexation cost associated with the issuance of CENIS due to the bank resolution implemented in 2000–01.

4. **Interest on the external debt** is presented on a due basis before HIPC debt relief.

5. **Total primary expenditure of the central government** is defined as the sum of wages and salaries, other goods and services, current transfers, and capital expenditure.

6. **Savings of the CPS** are defined as the difference between current revenue and current expenditure of the nonfinancial public sector, plus the operating result of the BCN.
7. **Adjuster:** The floor of the combined public sector savings will be adjusted upwards by the amount of additional revenues associated with delays in the implementation of the privately managed pension funds, assumed to take place at end-June 2003.
8. **Net Domestic financing (NDF) of the CPS** comprises the operating result of the central bank, the adjustment of the cost of the bank resolution from cash to accrual, and the change from their respective stocks at the end of the previous year of the sum of (i) outstanding stock of indebtedness of the nonfinancial public sector to the domestic financial system (central bank, commercial banks, and FNI) net of deposits (including arrears that correspond to obligations considered eligible for refinancing or rescheduling, or other debt reduction mechanism) with the foreign currency part of the net debt to the banking system converted into cordobas at the program exchange rate (of C\$14.3 per U.S. dollar for 2002 and C\$15.1 per U.S. dollar for 2003); (ii) outstanding stock of domestically-issued public sector debt held by resident and nonresident private sector with the foreign currency part converted into cordobas at the program exchange rate (of C\$14.3 per U.S. dollar for 2002 and C\$15.1 per U.S. dollar for 2003); (iii) outstanding stock of supplier credits; and (iv) outstanding stock of floating debt.
9. **Adjusters:** The ceiling on the cumulative NDF of the combined public sector will be adjusted: (i) upwards/downwards by up to US\$25 million in the event of lower/higher privatization receipts and/or lower/higher disbursements of balance of payments support than the amounts shown in Table 3; and (ii) downwards (unlimited) in the event of additional revenues associated with delays in the implementation of the privately managed pension funds, assumed to take place at end-June 2003.
10. **Deficit of the CPS (before grants).** Defined as the savings of the combined public sector (as given in paragraph 6) plus capital revenue less capital expenditure and net lending of the nonfinancial public sector.
11. **Reporting:** The BCN will send to the IMF monthly electronic information on the detailed operations of the CPS. The monthly information will be provided within four weeks of the end of each month.
12. **Calculation of HIPC relief for poverty-reducing expenditure.** For program purposes, the amount of budgetary resources freed by HIPC debt relief for additional poverty spending will be calculated as the difference between the annual average of debt service paid between 1992 and 1998 and debt service after HIPC on a cash basis. This amount cannot be lower than the amount of HIPC relief delivered as grants.

#### **B. Monetary Targets**

13. **Net international reserves (NIR) of the central bank.** For program purposes, NIR is defined as the difference between the (i) gross foreign assets of the central bank that are

readily available; and (ii) central bank's short-term reserve liabilities (including purchases and credits from the IMF), plus arrears on foreign debt service, plus foreign currency reserve requirement deposits of commercial banks at the central bank.

14. Readily available **foreign assets of the central bank** exclude those that are pledged or otherwise encumbered, including but not limited to reserve assets used as collateral or guarantee for a third-party external liability.

15. **Net repayment of the domestic debt of the central bank.** For program purposes, it is defined as the difference between new placements and redemptions of CENIs, TELs, TELs, BOMEX, standardized *letras* and any other central bank paper held by institutions outside the central government, net of new issuance of central government paper. It also includes all domestically placed paper held by residents and nonresidents. This amount will be converted into U.S. dollar at the program exchange rate.

16. **Adjusters:** The net repayment of the domestic debt of the central bank will be adjusted: (i) upwards/downwards by up to US\$25 million in the event of higher/lower privatization receipts and/or disbursements of balance of payments support for all quarters; (ii) upwards (unlimited) if proceeds from asset recovery are received during the first quarter of 2003; (iii) upwards/downwards by US\$30 million in the second quarter of 2003 in the event of higher/lower than programmed asset recovery receipts; and (iv) upward/downward by US\$15 million in the third quarter of 2003 in the event of higher/lower than programmed asset recovery proceeds. In addition, to the extent that the NIR target is exceeded, the domestic debt target will be adjusted downwards.

17. **Net domestic assets (NDA) of the central bank** are defined as the difference between the change in the stock of currency issued and net international reserves (as defined in point B.1) valued at the program exchange rate of C\$14.3 per U.S. dollar for 2002 and C\$15.1 per U.S. dollar for 2003.

18. **Reporting:** The BCN will send to the IMF (i) daily electronic mail containing information of actual daily accounts of the BCN (stocks and flows) at the beginning of the next working day; (ii) monthly electronic mail with information of actual monthly accounts of the BCN, commercial banks and FNI (stocks and flows), within four weeks of the end of the month; and (iii) actual quarterly accounts of the central bank, commercial banks, and FNI (stocks and flows) within five weeks of the end of the quarter.

### C. Structural Measures

19. **Confirmation by the authorities of compliance by all commercial banks with prudential norms, including on coffee sector loans** requires that the authorities confirm in writing that all banks classify and provision their loans according to the current regulatory framework.

20. **Confirmation by the authorities of compliance by all banks with existing capital adequacy requirements** requires that the authorities confirm in writing that all banks and finance companies meet the Capital Adequacy Ratio (CAR) of 10 percent or that they are implementing a normalization plan, in line with existing regulations, to reach a 10 percent CAR within 90 days.

21. **The plan for regular supervision of banking institutions** should ensure an effective supervision, in line with recommendations of the 2001 MAE mission. It should include (i) the undertaking of a peer review of compliance with Basel Core Principles; (ii) the application of consolidated supervision procedures; (iii) the review of the on-site technical and administrative procedures, including the inspection manual, to bring them up to full compliance with best international practices; and (iv) the application of a framework for intensifying supervisory action, penalties, and regulatory actions for noncompliance with regulatory norms.

22. **The requirement of a public announcement of the firm selected** to manage the asset recovery will be considered met after the BCN makes a public announcement of a firm that has a proven track record in international asset management, and that has been selected following the terms of reference of the international public bidding process and in line with the procurement law.

23. **The requirement to sign the contract with an international firm to implement asset recoveries** will be considered met after the signature of a contract containing the following elements (i) provide incentives conducive to the sale of all assets at market-determined prices within the timeframe of the contract; (ii) put all assets received by the BCN at the disposal of the firm, with the only exceptions of claims that have been previously verified as fraudulent (assets or debtors that do not exist, or cases of identity fraud), assets sold or credits paid before the start of operations of the firm; (iii) allow the final sale decisions to be taken by the outsourcing firm; and (iv) provide contractual assurances for the firm to make decisions independently from any government agency.

24. **End of the asset recovery process** is understood as the full completion by the outsourcing firm of the tasks assigned in the contract.

25. **Implementation of the recovery plan for assets received from intervened banks** will be considered as concluded when the firm hired for assets liquidation has fully completed all the tasks assigned in the contract, and the BCN has received the payments for all sold assets. Additionally, all assets managed by the firm should have been sold, or transferred to the ministry of finance and taken out of the BCN accounts.

26. **The public sector restructuring plan** will aim at increasing efficiency and at a permanent reduction in current primary spending contributing on a cumulative basis to at least 0.5 percent of GDP in 2004, and 0.6 percent of GDP in 2005.

27. **The action plan to strengthen tax administration** will aim at increasing revenues on a cumulative basis by at least 0.1 percent of GDP in 2003, 0.5 percent of GDP in 2004 and 0.6 percent of GDP in 2005.

28. **Publication of revised national accounts** will be considered in compliance after the authorities adopt the revised GDP series for 1994–2000 as the official figures.

29. **The changes to the legal framework in line with Basle’s Core Principles of effective banking supervision** will (i) introduce legal protection for supervisors (Principle 1); (ii) give supervisors the authority to review and reject any proposals to transfer significant ownership in existing banks to other parties (Principle 4); (iii) grant supervisors the ability to do supervision on a consolidated basis (Principle 20); and, (iv) grant supervisors adequate supervisory measures to bring about timely corrective action when, among other reasons, banks fail to meet prudential requirement (Principle 22). In addition, the revised legal framework will eliminate the Superintendency of Banks’ restrictions on sharing information with similar institutions in other countries; and remove secrecy on bank assets.

30. To address weaknesses identified during the stage one safeguards assessment of the CBN, the authorities proposed the following timetable for the implementation of Fund’s Treasurer’s Department (TRE) recommendation during the first year of the program:

Table 2. Nicaragua: Safeguard Assessment–Timetable for the Implementation of Treasurer’s Department Recommendations

Measures	Expected Date of Implementation
1. Disclose the differences between International Accounting Standards (IAS) and the BCN reporting standards.	July 2003
2. Internal Audit Department of the BCN reviews the process of reconciliation of the international reserves data on a quarterly basis.	December 2002
3. Write off outstanding loans to central government agencies, which are long overdue or implement an action plan to recover these loans.	March 2003
4. Submit amendment of the BCN Law to the National Assembly to enhance the specificity of existing provisions for the removal of BCN Board members from office.	September 2003

**D. External Sector Targets**

31. **Borrowing on nonconcessional terms.** For the purpose of the ceiling on the contracting of nonconcesional external debt of the NFPS and the BCN, external debt limits

apply to the contracting or guaranteeing of nonconcessional external debt by the public sector<sup>1</sup> and the BCN or any other agencies on their behalf. This limit applies not only to debt as defined in Point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted by the IMF on August 24, 2000 (see Appendix) but also to commitments contracted or guaranteed for which value has not been received. External debt includes all current liabilities with a nonresident party, which are created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, at some future point(s) in time to discharge the principal and/or interest liabilities under the contract. This definition includes loans, suppliers' credits, and leases (operational and financial leases). The ceiling on contracting of nonconcessional external debt applies both to medium- and long-term debt defined as debt with maturity of one year or longer, as well as to short-term debt, defined as debt with maturity of less than one year. For program purposes, central bank instruments placed in the domestic market held by nonresidents, will be excluded from the ceiling on the contracting of nonconcessional external debt and included in the net repayment of the domestic debt of the central bank target.

32. **Excluded** from the ceiling on debt with a maturity of less than one year are import-related credits and central bank reserve liabilities. Borrowing from the Fund is excluded from the ceiling (maturities up to one year).

33. **Concessionality** will be based on a currency-specific discount rate based on the 10-year average of the OECD's commercial interest reference rates CIRR for loans or leases with maturities greater than 15 years and on the 6-month average CIRR for loans or leases maturing in less than 15 years. Maturity will be determined on the basis of the original loan contract. Under this definition of concessionality, only debt with a grant element equivalent to 35 percent or more will be excluded from the debt limits.

34. **Reporting:** A loan-by-loan accounting of all new loans contracted or guaranteed by the public sector, including detailed information on the amounts, currencies, and terms and conditions, as well as relevant supporting materials, will be transmitted on a quarterly basis within four weeks of the end of each quarter by the BCN.

35. **External payments arrears.** External debt-service arrears are defined as overdue debt service arising in respect of obligations incurred directly or guaranteed by the public sector, except on debt subject to rescheduling or restructuring.

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<sup>1</sup> As regards external sector targets, the public sector comprises the nonfinancial public sector as defined under fiscal targets, as well as all other public sector entities and enterprises including ENITEL (as long as the government stake is at least 50 percent), the airport, the lottery, CORNAP, and ENAP.

36. **Reporting:** The accounting of nonreschedulable external arrears by creditor (if any), with detailed explanations, will be transmitted by the BCN on a monthly basis within four weeks of the end of each month.

**E. Other Definitions**

37. **Privatization receipts** are defined as payments received by the government in connection with the sale of state assets net of any fee. Privatization revenues in foreign exchange are those recorded as such in the balance of payments.

38. **Balance of payments support.** Official external untied financial assistance is defined as loans provided by foreign official entities that are received by the budget, excluding project/tied loans. The amounts assumed in the program consistent with this definition are shown in Table 3 attached.

39. **Accounting of HIPC assistance.** Interim HIPC assistance from multilateral creditors is identified as grants and shown in the public sector operations under grant revenues, and in the balance of payments table under current transfers. Interim HIPC debt relief from bilateral creditors is presented as exceptional financing in the public sector and in the balance of payments' tables.

Table 3. Nicaragua: Cumulative Program Financing  
(In millions U.S. dollars)

BOP Support	
<b>2002</b>	
Q4	43
<b>2003</b>	
Q1	83
Q2	83
Q3	98

Sources: Fund staff estimates and projections.



**Statement by the IMF Staff Representative on Nicaragua  
December 4, 2002**

1. This statement provides additional information that has become available since the issuance of the staff report (EBS/02/194) on November 20, 2002. This information does not alter the thrust of the staff appraisal.
2. **All prior actions proposed for Board consideration of Nicaragua's request for a new three-year PRGF Arrangement have been implemented** (see Table 3 of the Memorandum of Economic and Financial Policies—MEFP).
  - The 2003 budget was submitted to the Assembly on October 15, 2002 and it is consistent with the program.
  - The authorities have confirmed as of November 25, 2002 that all commercial banks have classified and provisioned their loans, including those related to the coffee sector, in accordance with the existing regulatory framework.
  - On November 17, 2002 the central bank of Nicaragua announced publicly the firm selected by the bidding committee to manage the asset recovery plan. The authorities have confirmed that the selected (foreign) firm has experience in international asset management and that the selection followed the provisions of the procurement law as well as the terms of reference of the international bidding process.
3. **Recent data indicate that economic developments continue in line with the program.** The 12-month inflation rate was 4 percent in October, below the annual target of 6 percent. Revised fiscal data for the first nine months show a combined public sector deficit below of 6.4 percent of annual GDP, below the estimate of 6.7 percent presented in the staff report. The reserve position of the central bank has remained stable in November, with freely usable reserves at US\$163 million, or one month of imports of goods and services as of end-November. The index of economic activity fell by 1 percent during January–August, compared with the same period in 2001, in line with the projected 1 percent real GDP growth for the year as a whole.
4. **The domestic political environment remains difficult and will pose continuous challenges to program implementation.** Specifically, a recent legislative proposal submitted by two opposition members of the assembly could, if accepted, derail the implementation of the asset recovery plan. The proposal would allow debtors of failed banks to purchase their nonperforming loans, financed with new loans at a below-market interest rate and 15-years maturity. The authorities have expressed their strong opposition to the initiative and are confident that it will not be accepted by the assembly.



INTERNATIONAL MONETARY FUND

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December 12, 2002

International Monetary Fund  
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Washington, D. C. 20431 USA

## **IMF Concludes 2002 Article IV Consultation with Nicaragua**

On December 4, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Nicaragua.<sup>1</sup>

### **Background**

After a decade of economic decline, the peaceful transition to a democratic system and adoption of market-based reforms in the early 1990s generated a strong economic recovery. Real GDP grew at an annual average of about 5 percent during the second half of 1990s and inflation was brought under control, helped by a slowing crawl of the exchange rate. Substantial external assistance mitigated the adverse effect on growth caused by the 1998 Hurricane Mitch. Notwithstanding these improvements, this period also saw the emergence of new vulnerabilities, reflecting a difficult political environment and social tensions. Government spending remained high and became inflexible, and the domestic debt of the public sector increased substantially. Meanwhile, bank credit to the private sector was allowed to expand rapidly, under inadequate supervision.

In 2000–01, the economy deteriorated sharply as the vulnerabilities were compounded by external shocks (including a steep decline in the terms of trade) and a widening fiscal deficit. Efforts to arrest the economic deterioration under a staff-monitored program (SMP), covering the second half of 2001, were not successful. The combined public sector deficit (after grants) increased to over 14 percent of GDP in 2001, reflecting large expenditure overruns; governance

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

concerns intensified; and a banking crisis stunted credit flows to the private sector. As a result, real GDP growth, after reaching over 7 percent in 1999 (boosted by Hurricane Mitch-related spending), slowed to an estimated 1 percent in 2002. Exchange rate policy continued to follow a "crawling peg" to the U.S. dollar, and trend inflation remained around 6 percent, reflecting the exchange rate crawl.

The financial position of the central bank deteriorated sharply in 2000–01. In addition to a large loss of reserves (with NIR declining by US\$200 million over the two-year period), the central bank's dollar-indexed domestic debt jumped by US\$520 million (21 percent of GDP) as it absorbed the cost of resolving four banks that failed in 2000–01. Gross official reserves at end-October 2002 stood at US\$362 million (2.7 months of imports of goods and services); excluding reserve requirements on dollar deposits with domestic banks, gross reserves were US\$166 million (one month of imports of goods and services).

The new government that took office in January 2002 has moved quickly to address economic imbalances. Government spending was reined in, first through administrative means and then (in July) by a reduction in the budget (by about 1.5 percent of GDP). The assembly also approved the first round of a major tax reform package, yielding about 2.1 percent of GDP. As a result, the combined public sector deficit after grants is projected to narrow significantly in 2002 (to 9.2 percent of GDP). Reflecting improved confidence, interest rates on central bank paper dropped significantly after the November 2001 presidential elections, to about 12 percent by mid-2002; since then, monetary policy has been tightened and interest rates have increased to about 15 percent by October. Despite the absence of balance of payments support, the net position of the central bank (NIR plus the central bank's domestic debt) has remained broadly stable during the first 10 months of the year. Prudential oversight of banks has been stepped up, and all banks have been required to comply with relevant provisioning and capital adequacy rules.

Nicaragua reached the decision point under the HIPC Initiative in December 2000, and it is expected to reach the completion point by end-2003 assuming relevant conditions are met. In 2001–02, Nicaragua received about US\$110 million of interim assistance from various multilateral organizations, which has been used to finance poverty-reducing expenditures in the health, education, and social safety net programs. The debt service deferral granted by Paris Club creditors after Hurricane Mitch (1998) expired in March 2001, and since then Nicaragua has been servicing its post-cut-off debt. During 2000–02 Nicaragua negotiated debt reduction agreements with Brazil, Bulgaria, Finland, Guatemala, and Slovakia, in line with the enhanced HIPC Initiative. At end-2001, Holland cancelled its ODA claims on Nicaragua.

### **Executive Board Assessment**

Executive Directors noted with concern that economic performance in Nicaragua had deteriorated significantly in recent years as domestic problems were compounded by external shocks. In particular, a deterioration of the external environment, combined with expansionary fiscal and monetary policies in the run-up to presidential elections and a banking crisis, had resulted in large increases in the fiscal deficit and domestic debt, and a significant decline in official international reserves.

Against this backdrop, Directors welcomed the new government's commitment to correct the economy's key vulnerabilities and create the basis for sustained growth and poverty reduction by addressing the structural rigidities confronting the economy. They were encouraged by the authorities' efforts to date to address the macroeconomic imbalances, strengthen prudential oversight in the banking sector, and undertake strong anti-corruption initiatives, but stressed that further decisive actions in these areas will be needed over the medium-term. Building on the government's strong ownership of the program, it will therefore be important that the authorities continue their efforts to widen ownership and support for reform across the political spectrum and among the population at large.

Directors agreed that sustained fiscal consolidation will be key to the authorities' medium-term strategy and, in particular, their objective of attaining public debt sustainability. Early passage and strict implementation of the 2003 budget, in line with the program, will be an important milestone in this regard. Following the helpful first stage of tax reform, which fell however short of initial objectives, Directors underscored the need for timely adoption of a second round of reforms to achieve the targeted increase in revenues while also making the tax system more equitable, efficient, and transparent. They stressed that eliminating tax exemptions and reducing the list of zero-rated VAT items will be critical to this end. They also looked forward to the planned comprehensive reform of tax administration and partial transfer of pension administration to the private sector, while encouraging careful monitoring of any budgetary implications of pension reform. On the expenditure side, Directors supported the authorities' plan to reduce non-priority primary spending while raising the quality and quantity of poverty-reducing spending. They highlighted, in this context, the importance of carrying on with the implementation of the new mechanism to track and monitor the use of poverty-reducing spending, and also looked forward to the forthcoming Poverty and Social Impact Analysis to help target social programs.

Directors supported the authorities' monetary policy strategy of strengthening international reserves while maintaining low inflation, noting that fiscal adjustment and implementation of the asset recovery plan will be key to helping achieve these objectives. The authorities were also encouraged to further strengthen the independence of the central bank. Directors noted that the crawling peg exchange regime has helped to keep inflation low, and that the current level of external competitiveness is broadly appropriate. While Directors saw no need to consider abandoning the crawling peg in the near future, many Directors considered that over the medium term greater flexibility would help reduce vulnerabilities and facilitate adjustment to shocks and structural change. These Directors, therefore, recommended that the authorities put in place the conditions for moving toward greater flexibility, including appropriate fiscal, monetary and financial sector policies, while carefully taking into account the high degree of dollarization of the economy.

Directors stressed the crucial importance of strengthening bank supervision and strict enforcement of prudential rules, especially on provisioning and minimum capital requirements. They urged the supervisory authorities to react promptly and forcefully to any weaknesses in financial institutions. Directors welcomed the recent selection of a firm to implement asset recoveries, and encouraged the authorities to allow speedy asset disposal without government interference—noting the importance of successful asset recovery for program financing, improving governance, and strengthening the credit culture. Directors commended the

authorities' commitment to combat money laundering and the financing of terrorism, and encouraged them to continue their efforts in this area. They also looked forward to the implementation of the recommendations of the safeguard assessment.

Directors were encouraged by the steps taken by the authorities toward achieving public debt sustainability, including their efforts aimed at lowering the stock of nonconcessional domestic debt. They also stressed that long-term debt sustainability beyond debt relief will depend on continued prudent external borrowing based on highly-concessional financing.

Directors welcomed the high priority which the authorities are giving to structural reforms aimed at addressing economic vulnerabilities and removing long-standing barriers to growth. They looked forward to continued efforts to fight corruption and improve accountability in the public and private sectors, and urged the authorities to press ahead with their plans for reforming the judicial system, restructuring the public sector, and continuing the privatization program. Further trade liberalization and regional integration will also be important to underpin growth and external viability.

Directors supported the planned improvements in Nicaragua's economic statistics, including steps to bring monetary statistics and national accounts in line with international standards, and encouraged the authorities to follow up on their intention to join the General Data Dissemination System.

**Public Information Notices (PINs)** are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Nicaragua: Selected Economic and Financial Indicators

	1997	1998	1999	2000	Prel. 2001
(Annual percentage change; unless otherwise indicated)					
<b>National income, prices, and unemployment</b>					
GDP at constant prices	5.1	4.1	7.4	5.9	3.3
Consumer prices (end of period) 1/	7.3	18.5	7.2	6.6	4.7
Consumer prices (period average) 1/	9.2	13.0	11.2	7.4	7.4
Unemployment rate (percent)	14.3	13.2	10.7	9.9	10.5
<b>External sector</b>					
Exports, f.o.b.	23.4	-0.6	-4.9	18.3	-8.1
Export volume	18.9	2.5	3.2	15.1	7.3
Imports, f.o.b.	30.6	1.9	21.6	-3.0	-1.1
Import volume	32.2	8.2	18.3	-9.7	3.1
Terms of trade (deterioration -)	9.8	1.9	-12.5	-4.0	-11.2
Nominal effective exchange rate end of period (depreciation -)	-2.0	-11.9	-2.7	2.1	-2.9
Real effective exchange rate end of period (depreciation -)	3.5	2.0	1.6	8.8	-0.6
<b>Money and credit</b>					
Net domestic assets of the central bank 2/	-36.8	27.5	-39.3	22.7	141.7
Net credit to nonfinancial public sector 2/	132.3	-85.8	-75.6	-36.2	161.7
Net credit to financial institutions 2/	-22.3	-4.8	-2.6	95.4	-54.0
Currency in circulation	26.8	22.2	29.5	1.2	11.1
Financial system liabilities to private sector	65.6	28.6	22.4	7.3	10.3
Financial system credit to private sector 3/	9.7	45.3	40.0	14.2	-43.5
Money income velocity (GDP/M3)	1.6	1.6	1.5	1.6	1.7
Interest rate on deposits (percent per annum) 4/	11.5	12.4	11.5	11.2	10.5
(In percent of GDP)					
<b>Public sector 5/</b>					
Combined public sector saving 6/	4.0	5.6	5.4	3.6	-4.4
Combined public sector primary balance (before grants) 6/	-4.2	-0.1	-10.1	-10.0	-11.9
Combined public sector overall balance (before grants) 7/	-9.7	-7.4	-15.7	-15.4	-21.0
Combined public sector overall balance (after grants) 6/ 7/	-4.5	-3.6	-7.0	-8.1	-14.3
Nonfinancial public sector saving	4.5	8.9	7.1	5.1	-2.4
Nonfinancial public sector overall balance (before grants)	-9.2	-4.1	-14.1	-13.9	-19.0
Central bank operational results (deficit -)	-0.5	-3.3	-1.7	-1.5	-2.0
Stock of combined public sector domestic debt	44.0	42.5	35.3	41.0	59.6
<b>Savings and investment</b>					
Gross domestic investment	30.5	33.8	43.3	34.7	30.8
Public	13.7	13.0	21.1	19.0	16.2
Private	16.8	20.8	22.2	15.8	14.6
National savings	3.3	2.3	1.4	2.6	-2.8
Public	4.0	5.6	5.4	3.6	-4.4
Private	-0.7	-3.3	-4.0	-1.0	1.6
External savings 8/	35.3	33.0	41.7	32.1	33.4
<b>External sector</b>					
External current account balance	-40.0	-38.7	-47.7	-38.3	-38.1
(Excluding interest obligations)	-29.3	-28.4	-37.5	-27.7	-25.7
Trade balance (deficit -)	-40.4	-39.9	-52.1	-41.2	-40.7
Outstanding external public debt (end of year)	296.7	296.0	289.0	278.0	250.3
(In percent of exports of goods and nonfactor services)					
Contractual interest obligations, before debt relief	53.4	43.5	47.1	45.3	38.5
Gross international reserves (in months of imports)	2.2	2.3	3.3	3.2	2.3

Sources: Central Bank of Nicaragua; Ministry of Finance; and IMF staff estimates.

1/ For 2000, staff estimates using the new consumer price index adopted in 2001.

2/ In relation to currency in circulation at the beginning of the year.

3/ Excludes credit held by liquidation boards.

4/ Six-month deposits, end of period.

5/ For 2001 the interest cost of bank resolution on accrual basis is included in the central government operations.

6/ Includes central bank operational balance.

7/ For 2001 HIPC interim debt relief from multilaterals is recorded as grants.

8/ External current account deficit, excluding interest on debt to bilateral creditors that is eligible for debt rescheduling on terms.



Press Release No. 02/53  
FOR IMMEDIATE RELEASE  
December 4, 2002

International Monetary Fund  
Washington, D.C. 20431 USA

**IMF Approves In Principle a Three-Year, US\$129 Million PRGF and US\$2.5 Million in Interim HIPC Assistance for Nicaragua**

The International Monetary Fund (IMF) today approved in principle a three-year arrangement for Nicaragua under the Poverty Reduction and Growth Facility (PRGF) in the amount of SDR 97.50 million (about US\$129 million) to support the government's 2002-05 economic program. The decision entitles Nicaragua to the release of SDR 6.97 million (about US\$9 million). The IMF Board's decision will become effective after the World Bank Executive Board's review of Nicaragua's Poverty Reduction Strategy Paper (PRSP) progress report, which is scheduled for December 10, 2002.

The PRGF is the IMF's concessional facility for low-income countries. It is intended that PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a PRSP. This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent, and are repayable over 10 years with a 5 ½-year grace period on principal payments.

Nicaragua was also granted in principle SDR 1.88 million (about US\$2.5 million) in additional interim assistance under the Heavily Indebted Poor Countries (HIPC) Initiative. The additional interim assistance will also become effective after the World Bank Board's review of Nicaragua. Nicaragua reached the decision point under the HIPC Initiative in December 2000 and is expected to reach the completion point by the end of 2003.

In commenting on the Executive Board's discussion, Eduardo Aninat, Deputy Managing Director and Acting Chairman of the Board, said:

“Following a sharp deterioration of economic performance in recent years, the new government of Nicaragua has embarked on a three-year program, to be supported by a new PRGF arrangement, that addresses key economic vulnerabilities and barriers to growth and poverty reduction. The authorities have already demonstrated a strong commitment to appropriate policies through the important measures they have put in place, and their ownership of the program augurs well for its implementation. Given the considerable challenges that lie ahead,

however, they need to work toward further broadening program ownership across the political spectrum and be forceful and vigilant in implementing their policy agenda.

“Key components of the program include the targeted reduction of the fiscal deficit while protecting poverty-related outlays, stepped-up bank supervision and tight enforcement of prudential rules, and the central bank asset recovery plan. The structural reform agenda focuses on removing constraints to growth, including through privatization, increasing budget transparency, public sector restructuring, judicial system reform, and further trade liberalization and regional integration. The government’s strong anti-corruption agenda and its efforts to enhance governance and accountability in the public and private sectors is a key overarching goal of the strategy. Crucial priorities for the immediate future include early approval of the 2003 budget in line with the program, a second round of tax reform including substantial reduction of zero-rated VAT items, strict enforcement of prudential rules, and full implementation of the asset recovery plan.

“The government is to be commended for completing the PRSP Annual Progress Report, which has been prepared in a participatory process including civil society and the donor community, and provides a sound basis for Fund concessional assistance. While progress has been made in implementing the PRSP, the sizable deviations from the macroeconomic framework in 2001 did not allow the government to fully implement its poverty reduction strategy. Thus, a satisfactory track record of implementation of the PRSP still needs to be established for Nicaragua to reach the HIPC completion point.

“The Executive Board’s approval of the authorities’ request for a new three-year PRGF arrangement as well as for interim debt relief under the enhanced HIPC Initiative will become effective following the World Bank’s endorsement of the PRSP progress report, which is expected shortly,” Mr. Aninat stated.

### **Program Summary**

Nicaragua’s economic growth decelerated in the last three years from over 7 percent in 1999 to an estimated 1 percent in 2002, due to a marked weakening of the fiscal policies, a banking crisis, and a deterioration in the external environment.

The fiscal imbalances that emerged in 2000-01, as a consequence of increases in spending and weakening in tax revenues, were addressed by the government that took office in January 2002. Government spending was reined in through administrative means and a reduction in the budget. As a result, primary spending during the first three quarters of the year was contained at 26 percent of GDP, down from 28 percent during the same period of 2001. Nicaragua’s assembly also approved the first round of a tax reform package, and, to reduce financial sector vulnerabilities, the authorities are about to implement a recovery plan for assets of failed banks. For 2002, real GDP growth is projected at 1 percent, followed by a gradual recovery during 2003 to 3 percent. Growth in 2003 is expected to be driven mainly by construction, agriculture and livestock activities.



The objective of the approved PRGF-supported program for 2002-05 is to promote sustained growth and poverty reduction, in an environment of low inflation and fiscal sustainability. The authorities' strategy for the next three years is to combine deficit reduction with higher and more efficient poverty-related spending.

During the first year of the program, Nicaragua will focus on making further progress in fiscal consolidation, improving the reserve position of the central bank and strengthening the financial sector. As part of the **fiscal** effort, the authorities intend to reduce primary spending, while protecting poverty-reducing outlays, and an increase in tax revenues. The public sector deficit is expected to be reduced to 6.3 percent of GDP in 2003, down from 14 percent in 2001. The program also targets government revenues to rise by 1¾ percent of GDP in 2003, reflecting the effects of the tax reform initiated in 2002 and the partial effects of the second stage of the tax reform to be implemented in 2003.

The **monetary** policy will aim to strengthen the position of the central bank in a low-inflation context. The authorities have noted that fiscal adjustment and satisfactory implementation of the asset recovery plan are critical to achieving this goal, and intend to sign shortly a contract with the selected firm to carry out the recoveries.

The **external** current account deficit is expected to be reduced from 28 percent of GDP in 2002 to 24 percent in 2003. This improvement is mainly due to higher exports as a result of an expected recovery in coffee and sugar prices and production, as well as better prospects for seafood exports.

Nicaragua joined the IMF on March 14, 1946; its quota is SDR 130 million (about US\$172 million). Its outstanding use of IMF financing currently totals SDR 123 million (about US\$163 million).

## Nicaragua: Selected Economic and Financial Indicators

	1997	1998	1999	2000	Prel. 2001
(Annual percentage change; unless otherwise indicated)					
<b>National income, prices, and unemployment</b>					
GDP at constant prices	5.1	4.1	7.4	5.9	3.3
Consumer prices (end of period) 1/	7.3	18.5	7.2	6.6	4.7
Consumer prices (period average) 1/	9.2	13.0	11.2	7.4	7.4
Unemployment rate (percent)	14.3	13.2	10.7	9.9	10.5
<b>External sector</b>					
Exports, f.o.b.	23.4	-0.6	-4.9	18.3	-8.1
Export volume	18.9	2.5	3.2	15.1	7.3
Imports, f.o.b.	30.6	1.9	21.6	-3.0	-1.1
Import volume	32.2	8.2	18.3	-9.7	3.1
Terms of trade (deterioration -)	9.8	1.9	-12.5	-4.0	-11.2
Nominal effective exchange rate end of period (depreciation -)	-2.0	-11.9	-2.7	2.1	-2.9
Real effective exchange rate end of period (depreciation -)	3.5	2.0	1.6	8.8	-0.6
<b>Money and credit</b>					
Net domestic assets of the central bank 2/	-36.8	27.5	-39.3	22.7	141.7
Net credit to nonfinancial public sector 2/	132.3	-85.8	-75.6	-36.2	161.7
Net credit to financial institutions 2/	-22.3	-4.8	-2.6	95.4	-54.0
Currency in circulation	26.8	22.2	29.5	1.2	11.1
Financial system liabilities to private sector	65.6	28.6	22.4	7.3	10.3
Financial system credit to private sector 3/	9.7	45.3	40.0	14.2	-43.5
Money income velocity (GDP/M3)	1.6	1.6	1.5	1.6	1.7
Interest rate on deposits (percent per annum) 4/	11.5	12.4	11.5	11.2	10.5
(In percent of GDP)					
<b>Public sector 5/</b>					
Combined public sector saving 6/	4.0	5.6	5.4	3.6	-4.4
Combined public sector primary balance (before grants) 6/	-4.2	-0.1	-10.1	-10.0	-11.9
Combined public sector overall balance (before grants) 7/	-9.7	-7.4	-15.7	-15.4	-21.0
Combined public sector overall balance (after grants) 6/ 7/	-4.5	-3.6	-7.0	-8.1	-14.3
Nonfinancial public sector saving	4.5	8.9	7.1	5.1	-2.4
Nonfinancial public sector overall balance (before grants)	-9.2	-4.1	-14.1	-13.9	-19.0
Central bank operational results (deficit -)	-0.5	-3.3	-1.7	-1.5	-2.0
Stock of combined public sector domestic debt	44.0	42.5	35.3	41.0	59.6
<b>Savings and investment</b>					
Gross domestic investment	30.5	33.8	43.3	34.7	30.8
Public	13.7	13.0	21.1	19.0	16.2
Private	16.8	20.8	22.2	15.8	14.6
National savings	3.3	2.3	1.4	2.6	-2.8
Public	4.0	5.6	5.4	3.6	-4.4
Private	-0.7	-3.3	-4.0	-1.0	1.6
External savings 8/	35.3	33.0	41.7	32.1	33.4
<b>External sector</b>					
External current account balance	-40.0	-38.7	-47.7	-38.3	-38.1
(Excluding interest obligations)	-29.3	-28.4	-37.5	-27.7	-25.7
Trade balance (deficit -)	-40.4	-39.9	-52.1	-41.2	-40.7
Outstanding external public debt (end of year)	296.7	296.0	289.0	278.0	250.3
(In percent of exports of goods and nonfactor services)					
Contractual interest obligations, before debt relief	53.4	43.5	47.1	45.3	38.5
Gross international reserves (in months of imports)	2.2	2.3	3.3	3.2	2.3

Sources: Central Bank of Nicaragua; Ministry of Finance; and IMF staff estimates.

1/ For 2000, staff estimates using the new consumer price index adopted in 2001.

2/ In relation to currency in circulation at the beginning of the year.

3/ Excludes credit held by liquidation boards.

4/ Six-month deposits, end of period.

5/ For 2001 the interest cost of bank resolution on accrual basis is included in the central government operations.

6/ Includes central bank operational balance.

7/ For 2001 HIPC interim debt relief from multilaterals is recorded as grants.

interest payments and higher net external financing (from lower principal payments) for 2004–05.

8/ External current account deficit, excluding interest on debt to bilateral creditors that is eligible for debt rescheduling on terms.



FOR IMMEDIATE RELEASE

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News Brief No. 02/125  
FOR IMMEDIATE RELEASE  
December 13, 2002

International Monetary Fund  
700 19th Street, NW  
Washington, D. C. 20431 USA

**IMF Gives Final Approval of PRGF Arrangement and Interim Assistance for Nicaragua**

The Executive Board of the International Monetary Fund (IMF) has given its final approval of a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) for Nicaragua for SDR 97.50 million (about US\$129 million) to support the government's 2002-05 economic program. The Executive Board also gave its final approval of Nicaragua's request for SDR 1.88 million (about US\$2.5 million) in interim assistance under the Heavily Indebted Poor Countries (HIPC) Initiative (see Press Release No. 02/53).

The final decisions by the IMF Executive Board were contingent on a decision by the Executive Board of the World Bank on December 11, 2002. That decision concluded that Nicaragua's Poverty Reduction Strategy Paper (PRSP) provided a sound basis for World Bank concessional assistance.

These decisions entitle Nicaragua to the release of SDR 6.97 million (about US\$9 million) under the PRGF arrangement, and of SDR 1.88 million (about US\$2.5 million) in interim assistance under the HIPC Initiative.

**Statement by Hernán Oyarzábal, Executive Director and  
Orlando Garner, Advisor to Executive Director for Nicaragua  
December 4, 2002**

On behalf of our Nicaraguan authorities, we would like to thank the Staff for the ongoing policy dialogue, valuable advice and assistance offered during the mission and for their hard work in preparing the excellent set of papers on the country's recent economic and financial developments for today's discussion.

The new government of President Enrique Bolaños that took office in January has made a strong determination to fight against corruption and to improve governance and accountability. In this sense, the government is promoting the public discussion of the main economic policies through the National Economic and Social Council (CONPES) in order to establish a strong ownership of its economic program. This will ensure the enforcement of the policies that has been taken, and all the future required actions toward the fulfillment of the objectives established on this new Poverty Reduction and Growth Facility submitted to the Executive Board.

**Background**

Nicaragua's macroeconomic situation has improved dramatically during the 90's after all the instability that prevailed during the 80's. However, the transition steps during the 1990's left the country with a US\$ 817 millions of domestic debt consequence of a bond issuance (Property Indemnization Bonds) made to indemnified the rightful owners of properties that were expropriated during the Sandinistas socialist revolution. Add to this the constant presence of major natural disasters such as droughts, hurricanes, earthquakes and floods that contributed to lessen the results of the government's economic policy. Nevertheless, the country's efforts toward stability resulted in the necessary economic conditions to obtain the Board consideration for the HIPC's decision point in December 2000.

**Recent Economic Performance**

The beginning of the new decade (2001) was not as expected. The country struggled to comply with the Program but many factors adversely affected the Nicaraguan Economy among them; the global economic slowdown, the continuing domestic banking crisis, the falling of Nicaragua's main commodity prices, the rise in oil prices during the first half of the year and the uncertainty of investors with relation to the outcome of the electoral process. To top these negative conditions as election approached, fiscal policy became lax, and a corruption emerged in the public administration. Consequently, in 2001 real GDP growth slowed to about 3 percent, from almost 6 percent in 2000, and the combined public sector deficit before grants rose to around 21 percent of GDP in 2001, while after grants it exceeded 14 percent of GDP, almost 6 percent of GDP higher than in 2000.

The new authorities inherited a situation of rapidly declining growth and increasing vulnerabilities. However, they moved decisively to address the economic imbalances and soon after taking office, our authorities adopted bold measures toward controlling public expenditure, the 2002 budget was reduced by 1.5 percent of GDP (about 3 percent of GDP on an annual basis), and a tax package was approved by the National Assembly (NA) in August 2002. This package contained a significant reduction of import tariff exemptions; a reduction of income tax exonerations; an increase in the corporate income tax rate; and increases in retention rates, these measures are expected to produce revenues equivalent to approximately 2.1 percent of GDP on annual basis.

### **The Economic Program**

During his first address to the nation, the newly elected President of Nicaragua explained the negative repercussion produced by the deviation of the previous administration from the goals that were agreed under the IMF Monitored Program, at the same time, he indicated his firm decision to take corrective actions. Our authorities have designed a program to foster sustained rapid growth of about 5 percent over the medium term, while keeping inflation low, creating the necessary macroeconomic conditions to secure that the aspirations stated in the poverty reduction strategy become a reality. The program aims to restore fiscal as well as external sustainability while protecting poverty related expenditures, and at the same time, our authorities have developed a structural agenda that seeks to improve governance, to establish the rule of law, combat corruption and set accountability in all government actions.

### **Fiscal Policy**

Our authorities consider that fiscal policy is the cornerstone of the program, for that reason the Government plans to reduce the combined public sector deficit before grants from 21 percent of GDP in 2001 to 7.5 percent of GDP at the end of the program (2005). To accomplish this goal, our authorities plan to address the deficit from both the expenditure and revenue sides. During the course of the program, primary spending of the combined public sector will be reduced from 43 percent of GDP in 2001 to 34 percent of GDP by 2005. It is of especial significance to mention that during the adjustment process, poverty related expenditures will be protected and will reach 16.8 percent of GDP the highest level since the extraordinary spending occurred during the reconstruction of the damages after Hurricane Mitch.

On the revenue side, a second phase of the tax reform will be implemented during the first semester of 2003, this measure is expected to generate 1.0 percent of GDP on an annual basis, and with the assistance of the Interamerican Development Bank (IADB) customs and tax administration will be enhanced resulting in an additional 0.6 percent of GDP by the end of 2005. Our authorities believe that these actions will also contribute to increase the efficiency, equity, and fairness of the tax system. Revenues are expected to climb from 30.8 percent of GDP to 31.5 percent of GDP, notwithstanding the public revenue loss of 2 percent of GDP in 2002 and 2003 associated with the partial privatization of the pension administration.

## **Monetary Policy and the Financial Sector**

As indicated before the program aims at resuming sustained rapid growth in an environment of low inflation thus, the role of monetary policy is essential for the success of the government's agenda. Knowing this, our authorities are taking bold measures to enhance the financial position of the Central Bank. With this purpose, they are conducting a gradual reduction of the bank's domestic debt, which is expected to decline in approximately US\$ 300 million to approximately US\$ 365 million at the end of the program. The financing of this effort is supported by fiscal adjustment, balance of payment support, privatization receipts, and the proceeds from the liquidation of assets of intervened banks. This last measure is being implemented with the assistance of USAID, in order to maximize the proceeds from the auction of the assets that the Central Bank had received from the intervened banks and assure the transparency of the process.

Our authorities consider that the crawling peg exchange rate regime has served Nicaragua well and will continue using it as anchor to control inflation. Also, the regime is considered appropriate given the high degree of financial dollarization that makes Nicaragua susceptible to large exchange rate changes. In response to the staff concern about the risk and vulnerabilities associated with a peg, the authorities have indicated that they plan to evaluate its suitability in a timely basis and will be ready to reconsider exchange rate policy in the medium term.

The soundness of the financial sector is also a high priority in the government's agenda. Evidence of such commitment is the authorities' determination to require in full the observance of the existing regulatory and prudential legislation to all financial institutions. They will introduce the necessary legal changes to ensure that banking supervision will perform according to Basel Core Principles. This reform is expected to be submitted to the National Assembly not later than September 2003 and will be strengthened with the continuation of regular on-site inspections in the financial system by the Superintendency of Banks.

In addition to the above measures, starting 2002 a new deposit insurance system (FOGADE) is covering deposits up to US\$ 20,000 and by mid 2003, the institution's structure will be enhanced with the establishment of a unit that will manage and liquidate assets resulting from future bank interventions, if necessary.

## **External Sector**

Nicaragua has a relatively open trade regime that has been strengthened by the country's incorporation to the Central America Free Trade Agreement (CAFTA). In compliance with the agreement Nicaragua will harmonize the tariff structure with the other Central American countries (Honduras, El Salvador, Guatemala, and Costa Rica). Up to now, 78 percent of the tariffs have been harmonized in line with the objective of creating a Custom Union by January 2004, which will imply zero tariffs among members and a unified tariff structure. Nicaragua also has a free-trade agreement with Mexico, and is in the process of ratifying free-trade agreements with Chile, Panama, and Dominican Republic. In addition, our

authorities are negotiating a free-trade agreement with Canada and together with the rest of the Central American countries another one with the United States. Our authorities want to stress that these treaties are in accordance with WTO guidelines.

The alleviation of the external debt's burden is a key element in the country's program; to this end, our Nicaraguan authorities reiterate its commitment to comply with all the necessary requirements and to meet the programs quantitative and structural criteria to reach the HIPC's completion point during 2003. In addition to this commitment, our authorities would like to ensure their determination to conduct a prudent borrowing policy based only in highly concessional loans and to maintain the borrowing level in accordance with the country's repayment capacity.

Nicaragua is grateful for the assistance received from the international community, nonetheless while the adjustment process gets underway, the country will continue in need of further assistance in the form of concessional loans, grants and technical support. Following today's Board discussion, the Nicaraguan Government will request Paris Club assistance under Cologne Terms for its bilateral debt, and the World Bank approval of a Programmatic Structural Adjustment Loan in support of the country's PRSP implementation. In the meantime, Nicaragua is honoring all post-cut-off-date debt service.

### **Structural Reforms**

Since reaching its decision point, Nicaragua has made important advances in its structural agenda. For example by December 2001, all the conditions that required waivers for nonobservance of structural performance criteria have been implemented. The incumbent authorities have moved even further in this area approving important regulations for human capital development and social protection namely the School Autonomy Law and the General Health Law. These legislations along with the System of Social Protection which pilot program concluded with success in February 2002 are in the process of being implemented.

Additionally, the authorities are also implementing programs that have been designed to enhance the country's governance, among them: a system of management and inspection of public sector procurement that begun in October 2002 and a program to strengthen the Comptroller's office that is anticipated to begin at the end of this year. At the same time, they are developing the appropriate conditions to enact the Law on Public Prosecutors, and the Law on Penal Procedures, which are in an advance stage of formulation.

The Nicaraguan Government considers they have gathered enough political support in the National Assembly to continue with the modernization of the pension system thus, in addition to the previously approved Pension Law and the Pension Superintendence Law they expect to pass the Law of the Social Security Institute in the coming month. With these set of laws in place, our authorities estimate that by 2003, licenses to private funds managers will be already awarded, and all eligible social contributors will be in the new pension system.



Finally, the stage is being prepared for the auction of the government's remaining shares in the telecommunication company (ENITEL) and the sale of last two electric generating plants. Both events are expected to take place next year.

## **SGPRS**

Nicaragua's new government has endorsed the Strengthened Growth and Poverty Reduction Strategy (SGPRS) that was presented to the Board on September 25, 2001, and have conducted an evaluation of the results achieved so far. The progress achieved is better than expected, especially if we take into consideration the policy slippages of the past. According to the 2001 Living Standard Measurement Survey (LSMS) urban and rural poverty, as well as extreme urban and rural poverty have decreased in comparison to 1998 and 1993. Staff calls our attention to the fact that in the case of the rural area this accomplishment is worth mentioning given the fact that this area has the highest concentration of poverty.

Important advances have also been achieved, especially in the areas of human capital, protection to vulnerable groups, good governance, and social equity and in crosscutting themes, such as environment and decentralization. Examples of such progresses are the recently approved, Nicaraguan Environmental Plan, the Policy for Land Use Planning and the National Policy for Decentralization and Local Development.

As indicated before, during 2002 alone progress was made in modernizing the educational sector with the approval of the Educational Participation Law that has permitted the increases in teachers' salaries and the increase in preschool and primary school enrollment. The government's review of the indicative targets shows that in education, from the nine indicators that were set, five were accomplished and in some cases exceed. Progress was also achieved in the health sector with the approval of the General Law for Health. The results in the health sector were also positive, from the thirteen proposed indicators, eight were met, among them some that were envisaged to be met in the year 2005. The four indicators related to water and sanitation, were also met.

Our authorities are fully aware that even with the above accomplishments, the first pillar of the SGPRS remains broad-based economic growth. In this sense, the Government has revised the strategy's macroeconomic framework so it can be more realistic and related with the medium-term SGPRS objectives. They firmly believe that sound macroeconomic policy will create the necessary environment for the appropriate use of the external resources, private sector investment, efficient government social spending, and other conditions necessary to achieve growth. The strategy inserted in this revised macroeconomic framework gives enough assurance for the proper use of the Fund and Bank concessional assistance.

The success of the SGPRS will require donors assistance; for that reason with the support of the IADB, a consultative group is being prepared for early next year, that will among other aspects, try to restore donors' confidence in Nicaragua and improve coordination among them. Nicaragua has developed a strong campaign to combat corruption; the Office of Public Ethics was created assuming activities related to control, integrity, transparency, and efficiency. A Code of Ethic and a Basic Manual for Civil Servants were published and

training is being conducted, and the Law of Probity was passed under this Government. On top of these actions, the Office of the Attorney General is investigating serious irregularities in some government institutions and has presented charges against top officials of the previous administration, some of them have already been sentenced and other are on trial. A recent survey shows that this action has the support of 95 percent of the population.

Besides the above actions that are considered instrumental in strengthening credibility and accountability, the Government has implemented a modern management public spending system, that allows for a more transparent formulation of the budget, creating public awareness, and better accounting of the sources of financing. This system is divided in the following instruments: i) The Supplementary Social Fund that establish norms and procedures for the resources coming from the HIPC debt relief, and from donations directed to poverty reduction; ii) the National System for Public Investment that follows project implementation; iii) the Integrated System for Financial Management and auditing that is a fully automated system designed for the administration of public funds; iv) the Debt Management System that has been developed and put into action with the assistance of UNDP, and v) the National System for Monitoring of Poverty Indicators.

The Government is also working with the World Bank in the creation of a system dedicated to empirical analyses, and Poverty and Social Impact Analysis (PSIA). They expect that the first PSIA will be ready for the upcoming consultative group.

Finally, our authorities wants to reiterate their firm commitment to sound macroeconomic policies and to the objectives of the poverty reduction strategy, especially with its first pillar of broad-based economic growth. Furthermore, they would like to acknowledge the assistance given by Mr. Piñon and his team. They have done an excellent job and have taken the extra step by promoting strong ownership in assisting the new Government in the design of its economic program.