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Nicaragua: 2001 Article IV Consultation—Staff Report; Statement by Staff Representative; Public Information Notice on the Executive Board Discussion; and Statement of the Nicaraguan Authorities

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2001 Article IV consultation with Nicaragua, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 27, 2001,** 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 August 27, 2001.** 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 **September 19, 2001** updating information on recent economic developments;

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the September 19, 2001, Executive Board discussion** of the staff report that concluded the Article IV consultation.

- a statement by the authorities of Nicaragua.

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

Statistical Appendix

*May also be included in Staff Report.

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NICARAGUA

Staff Report for the 2001 Article IV Consultation and the Staff-Monitored Program (SMP) for July–December 2001

Prepared by the Western Hemisphere Department

(In consultation with other departments)

Approved by Claudio M. Loser and Michael T. Hadjimichael

August 27, 2001

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EXECUTIVE SUMMARY

Economic performance deteriorated during the final months of 2000 and the first half of 2001, with economic growth decelerating as investment slowed from high post-Hurricane Mitch levels. The deficit of the combined public sector in 2000 turned out to be some 2 percent of GDP higher than anticipated at the time of the Board meeting in December, owing to substantial spending overruns in the fourth quarter of the year. During the first half of 2001, continued high spending and payments of domestic arrears (mainly to suppliers) resulted in central bank financing of the combined public sector of about 13 percent of the period's GDP and a decline in net international reserves (NIR) of close to US$120 million. As of end-June, gross reserves stood at about 50 percent of short-term public sector debt (on a remaining maturity basis).

Structural reforms advanced substantially in 2000 and so far in 2001. Four weak banks were intervened (including Banco Nicaraguense de Industria y Comercio, on August 4, 2001), banking supervision continued to be strengthened and legislation to reform the social security system was approved. At the same time, the ongoing bidding processes for the telecommunications and electricity generation companies is expected to be completed in August. In addition, efforts to improve the efficiency of the Comptroller's Office have continued and property rights have been strengthened with the establishment of mediation courts and the approval of a law on administrative procedures and dispute settlement.

The authorities have prepared an economic program for July–December 2001, aimed at improving fiscal performance by curbing spending and continuing the structural reform agenda. Discussions on the third annual Poverty Reduction and Growth Facility (PRGF), however, could not be completed because delays in addressing policy slippages made it unfeasible to bring the program back on track in 2001. Against this background, the authorities have requested the staff to monitor their program as a Staff-Monitored Program (SMP) to facilitate the transition to the new administration that will take office in January 2002 and to help build a track record for a possible new three-year PRGF arrangement in 2002. Under the SMP, the deficit of the combined public sector is targeted to decline during the second half of 2001. This would allow for an increase in NIR of US$50 million during 2001, on the basis of privatization proceeds and balance of payments support expected during the second half of the year. Structural actions include further steps to strengthen the financial system, privatization, the introduction of a private pension system, and improvements in governance.

The authorities' program contains an appropriate package of measures to improve economic performance and reduce vulnerabilities, but there are uncertainties regarding their implementation. In particular, a higher than envisaged use of central bank credit by the government, delays in privatization and/or the actions needed to release disbursements of balance of payment support, or the inability to roll over short-term central bank paper, could increase external vulnerabilities. The authorities have recently completed their Poverty Reduction Strategy Paper and the joint Fund/World Bank staff assessment has been submitted for Executive Board consideration together with this report.

I. Introduction

1. Discussions for the 2001 Article IV consultation and on the government's economic program for 2001 were held on three occasions in Managua and two occasions at headquarters in the period from February to June 2001.[1] The authorities' program for July–December 2001, which they have requested the staff to monitor as a Staff-Monitored Program (SMP), is outlined in this staff report for information, and in the attached Memorandum of Economic and Financial Policies (MEFP).[2] The SMP aims at strengthening macroeconomic policies and continuing structural reforms to facilitate the transition to the new administration that will take office in January 2002 and build a track record in preparation for a possible new three-year Poverty Reduction and Growth Facility (PRGF) arrangement next year. The authorities have also submitted a full Poverty Reduction Strategy Paper (PRSP) to the Boards of the Fund and the Bank for their consideration. The staffs of the Fund and the Bank have prepared a Joint Staff Assessment (JSA) of the PRSP, which is circulated together with this report.

2. In March 1998, the Executive Board approved a three-year PRGF arrangement in an amount equivalent to SDR 100.9 million (105 percent of quota) (EBM/98/30; EBS/98/7, Supp. 2), which was augmented by SDR 48 million in February 1999, in the aftermath of Hurricane Mitch (EBS/98/8) (Appendix I).[3] The second annual PRGF arrangement was approved in September 1999 (EBS/99/164). To date, loans in the amount of SDR 115.3 million have been disbursed. Nicaragua was declared eligible for assistance under the enhanced HIPC Initiative in September 1999, and reached the decision point in December 2000 (EBS/00/259).

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[1] The staff held discussions with the president of the central bank, the minister of finance, and other members of the cabinet; members of the national assembly and leaders of the main political parties; and representatives of labor unions, the business community, and NGOs. The mission also met with President Alemán. The staff team comprised at various times Messrs. Piñón (Head), Gudac, and Hilaire, and Ms. Mongrut (all WHD) and Ms. Baker and Mr. Rizavi (both PDR); and was assisted by Mr. Harnack, the Fund resident representative in Managua. Mr. Guzman headed the first mission and Mr. Di Tata participated in some of the final discussions with the authorities.

[2] The authorities intend to publish the MEFP.

[3] In December 2000, the arrangement's three-year commitment period was extended through mid-March 2002 (EBS/00/189 and Supp. 1). Currently there is no arrangement in place, as the second annual arrangement under the PRGF expired on March 17, 2001.

3. In concluding the 1999 Article IV consultation on September 15, 1999, Executive Directors emphasized the need to implement post-Hurricane Mitch reconstruction programs and improve social conditions, while making progress toward reducing Nicaragua's substantial fiscal and external imbalances, accelerating structural reforms, and improving governance. In completing the reviews under the second annual PRGF arrangement in December 2000, Directors noted that recent economic progress had been mixed, with persistent problems of governance and difficulties in the domestic banking system, and urged the authorities to redouble their efforts in these two areas. Nicaragua has accepted the obligations of Article VIII sections 2, 3, and 4 of the Fund Articles of Agreement and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

4. The quality of economic data in Nicaragua is subject to important limitations (Appendix IV), which complicate effective monitoring of economic performance. The staff believes that improvements in statistics, particularly in the areas of public finance and money and banking, will be necessary in the context of preparing a new three-year PRGF-supported program starting in 2002. The authorities are in the process of revising the national accounts data in consultation with staffs of the Fund and other international institutions.

II. Recent Economic Developments

A. Background

5. **Nicaragua's economic performance during 1998 and the first half of 1999 was in line with the program** supported by the three-year PRGF arrangement approved in March 1998, despite the adverse effects associated with Hurricane Mitch. Real GDP growth increased and unemployment and inflation declined, as investment rose significantly aided by strong inflows of private capital and official assistance related to the reconstruction effort. The fiscal position improved more than envisaged and credit policy was in line with the program.

6. **Policy implementation weakened in late 1999 and early 2000**. In particular, fiscal policy was more expansionary than anticipated, as the combined public sector deficit increased from 3.6 in percent of GDP in 1998 to 7 percent of GDP in 1999 and the current account deficit widened significantly. In addition, the accumulation of net international reserves (NIR) fell short of programmed levels. Further fiscal slippages occurred in early 2000, inflation accelerated, and the external position weakened. Against this background, a modified program for 2000 was agreed with the authorities,[4] including prior actions, aimed at establishing a track record of policy implementation that would permit the completion of the program review.

[4] The modified program was discussed between the staff and the authorities in April 2000 and presented to the Board in December 2000.

7. **On the structural front, during 1998 and 1999 progress was made** in preparing the legal frameworks for private investment and advancing the divestment of public enterprises, public employment was reduced, the resolution of property claims was accelerated, and trade tariffs were lowered. Moreover, the central bank charter and the banking and the superintendency laws were revised. However, delays were experienced regarding the privatization of the electricity and telephone companies, the approval of legislation to reform the pension system, and the implementation of steps to improve transparency in the use of public funds. Regarding governance, certain modifications to the constitution in early 2000 that affected nominations for the Supreme Court, the Electoral Council, and the Comptroller's Office (CO) generated concerns about the independence of these institutions from political interference. To address some of these concerns, the government undertook steps to strengthen the CO and a new law on government procurement was approved and began to be implemented.

B. Performance in 2000 and First Half of 2001

8. **Performance in 2000 under the second annual PRGF arrangement (approved in September 1999) was mixed.** Further progress was made on several structural reforms, but there were weaknesses in macroeconomic policies. Completion of the reviews and the decision point under the Enhanced Initiative for Heavily Indebted Poor Countries (HIPC) in December 2000 were accompanied by waivers for the nonobservance of performance criteria on public sector savings and domestic financing, central bank net domestic assets and NIR, and structural criteria regarding the social security reform law and privatization.

9. **Real GDP growth slowed to 4.3 percent in 2000**, from 7.4 percent in 1999, as construction activity tapered off from post-Hurricane Mitch highs and manufacturing slowed. Coffee production reached record levels in 2000, but profitability was severely affected by a sharp drop in international prices, while higher energy costs and domestic demand pressures contributed to **an increase in inflation to around 10 percent during 2000**, from about 7 percent in 1999. The unemployment rate declined to about 10 percent in 2000, from 10.7 percent in 1999. Monthly indicators suggest that real GDP growth has slowed further during the first half of 2001 to an annual rate slightly above 3 percent, with the 12-month rate of inflation declining to about 8 percent.

10. **The deficit of the combined public sector (after grants) reached 8.3 percent of GDP in 2000**, compared with 6.9 percent of GDP under the modified PRGF program and 6.4 percent estimated at the time of the Board meeting in December 2000 on the basis of information through September. This fiscal slippage reflected significant capital expenditure overruns and larger-than-anticipated current outlays related to municipal elections that took place in the fourth quarter. The overruns were financed, to a large extent, by an accumulation of domestic arrears (floating debt) of almost 2 percent of GDP.

11. **The fiscal stance remained weak during the first half of 2001**, with preliminary information pointing to a combined public sector deficit, after grants, of 7.2 percent of the

period's GDP, compared with 4.6 percent in the same period of the previous year. Expenditure remained high as a result of wage increases (for teachers, nurses, and police) granted at the beginning of the year, the cost of bank resolutions (equivalent to 2.5 percent of the period's GDP), the preparation of the national elections scheduled for November 2001, and a substantial increase in domestically financed capital outlays. The high deficit, the payment of domestic floating debt, and shortfalls in disbursements of balance of payments support (associated with delays in policy actions) contributed to a central bank financing of the combined public sector (including the central bank operating deficit) equivalent to 13 percent of the period's GDP during the first half of 2001.

12. **Weaknesses in the banking system intensified in 2000 but some improvement has been observed this year**. The financial condition of several banks deteriorated in 2000 due to fraud and mismanagement, with four banks being intervened since August 2000 (Box 1). The resolution process in each case involved the transfer of deposits and performing assets to other domestic banks, with the central bank providing the acquiring banks with bonds to make up for the difference between assets and deposit liabilities. The bonds associated with the first three interventions amounted to some US$240 million (or 9.5 percent of GDP); the cost of the recent intervention of a fourth bank has yet to be determined (see Box 1, Policy Discussions Section, and Appendix V).

Box 1. Recent Bank Resolutions

The resolution of the four weak banks since August 2000 consisted in their intervention, immediately followed by the absorption of their liabilities and performing assets by other private banks. The procedures comprised the following steps (1) writing off the shares of the original owners; (2) recapitalization of the intervened banks by exchanging their impaired assets for central bank paper in preparation for their resale; (3) auction of the banks' portfolios to other domestic private banks; (4) provision of contingent credit lines to the acquiring banks; (5) temporary exemption of acquired deposits from the legal reserve requirements; and (6) implementation of asset recovery plans. The authorities are also pursuing actions in the courts against those suspected of criminal responsibility for the banking problems, with some key players now in preventive custody. To date, all of the deposits of the intervened banks have been transferred to the acquiring banks, while loans are being evaluated prior to transfer (a six- to nine-month process). It is expected that by the end of 2001 all loans from the first three intervened banks, and by early to mid-2002 in the case of the fourth bank, will have been taken over by the acquiring banks or transferred to a special liquidating unit for asset disposal.

13. Demand deposits have been recovering in 2001, but **the banking system remains fragile**. Although loan loss provisioning and risk adjusted capital asset ratios have increased, the ratio of nonperforming loans to total loans has risen and profitability remains low (Table 10). There also has been a sharp deceleration in the growth of broad money during the last 12 months, with evidence of portfolio shifts toward liquid assets. Following a marked slowdown in 2000, the expansion of bank credit to the private sector slowed further in the first half of 2001.

14. Following a small decline in 2000, **NIR dropped by an additional US$120 million in the first half of 2001**, owing mostly to the large expansion of central bank credit to the government. As of end-June 2001, gross reserves stood at less than 50 percent of the short-term public sector debt (on remaining maturity basis). **Exchange rate policy continued to be based on a 6 percent annual rate of crawl vis-à-vis the U.S. dollar** during 2000 and the first six months of 2001. The real effective exchange rate appreciated by close to 11 percent in the 18-month period through June 2001, largely as a result of the appreciation of the U.S. dollar. So far, the currency appreciation does not appear to have affected significantly the competitiveness of noncoffee exports, including beef and seafood.

15. **Nicaragua's terms of trade deteriorated** by about 13 percent in 2000 owing to a significant drop in coffee prices and an increase in oil import prices; there was a further worsening in the first half of 2001 associated with a continued decline in coffee prices. Notwithstanding these developments, the current account deficit narrowed markedly in 2000, due to a higher coffee export volume and a drop in imports from the high post-Mitch levels. In the first five months of 2001, the current account deteriorated slightly relative to the same period in 2000.

16. As noted earlier, **structural reforms advanced in 2000 and the first part of 2001**. The national assembly approved legislation to (i) reform the social security system, including the establishment and supervision of private pension fund managers; (ii) improve government procurement; (iii) strengthen tax administration by restructuring the internal revenue and customs departments; and (iv) provide for more flexibility in payment options in the privatization of the Nicaraguan Telecommunications Company (ENITEL). In addition, the electricity distribution companies were privatized, a long-term lease for a major port facility was granted, and the treasury's consolidated cash management system for domestic resources was implemented. Privatization of ENITEL and the electricity generation plants, however, was further delayed and the resolution of Banco Nicaraguense de Industria y Comercio (BANIC) was delayed until August 4, 2001, when the bank was intervened and its assets auctioned off to another domestic bank.

17. **Recent improvements in governance** comprise: (i) improved efficiency of the CO in the reporting of cases of alleged corruption and pursuing administrative and judicial remedial actions; (ii) the establishment of property mediation centers and courts; (iii) approval of a law to protect private interests from wrongful actions by state institutions or officials; and (iv) the establishment of a public defenders' office to represent low income people. Delays have occurred in the approval of the new code on criminal proceedings and the civil service reform law, as well as in the introduction of the Integrated System for Financial Management and Auditing (SIGFA) in the ministries.

III. Policy Discussions

18. Discussions on the third annual PRGF arrangement could not be completed because of policy slippages during the first part of 2001 and delays in taking corrective actions, which

made it unfeasible to bring the program back on track in 2001. Moreover, the authorities indicated that they were not in a position to make policy commitments beyond 2001 because of the end of the current presidential term in January 2002. **The authorities requested an SMP for the period July–December 2001**, which is described in the MEFP, with the objective of facilitating the transition to the new administration and building a track record in preparation for a program that could be supported under a new three-year PRGF arrangement starting in 2002.

19. The authorities' program aims at advancing toward macroeconomic stability and implementing pending measures under the structural reform agenda. It is based on a real GDP growth of 3 percent in 2001 and targets an inflation rate of 8 percent. The rate of crawl of 6 percent of the exchange rate vis-à-vis the U.S. dollar will be maintained. During the discussions, **the authorities and the staff concurred on the need to adopt measures to restrain government expenditures during the second half of 2001, strengthen the banking system, and implement other actions related to public sector reform and good governance.**

20. In addition to the PRGF/SMP discussions, the Article IV discussions focused on (i) the review of current economic developments and prospects; (ii) the stance of financial policies; (iii) an assessment of the exchange rate policy and of external competitiveness; (iv) a review of vulnerability in the banking system; and (v) statistical issues.

A. Fiscal Policy

21. **The authorities' fiscal program for 2001 aims at reducing the combined public sector deficit** to 7.4 percent of GDP (8.3 percent of GDP in 2000). This target implies that the fiscal deficit during the second half of 2001 would be similar to that observed during the first half, notwithstanding the cost of a scheme to assist coffee growers facing difficulties in servicing their debts to the banking system, which is estimated at US$15 million (1.2 percent of the period's GDP). Moreover, excluding interest payments resulting from bank resolutions (estimated at 2.5 percent of GDP during 2001), the proposed reduction in the 2001 fiscal deficit is substantial.

22. **Central government expenditure are projected to decline to 35.5 percent of GDP in 2001**, after reaching a level equivalent to about 40 percent of GDP in 1999–2000 in the context of the reconstruction efforts associated with Hurricane Mitch; non Mitch-related social expenditures, however, would increase moderately from 12.4 percent of GDP in 2000 to 12.8 percent of GDP during 2001. To attain this expenditure level, central government outlays, excluding the expected support for the coffee sector, are targeted to decline by about 6 percent during the second half of 2001 relative to the same period in 2000 (expenditures rose by about 5 percent during the first half of 2001 on a year-to-year basis). The decline in expenditures will be more apparent on infrastructure, particularly on roads and transportation, where high Mitch-related expenditures were concentrated during 1999–2000 and, to a lesser extent, on current expenditure on goods and services.

23. **Savings of the combined public sector are expected to decline** to negative 0.1 percent of GDP in 2001, from 3.6 percent in GDP in 2000. The main factor behind this deterioration is the substantial increase in the interest bill (of about 3.6 percent of GDP), mostly as a result of the interest cost of bank resolutions[5] (2.5 percent of GDP). Excluding interest payments, however, savings would remain broadly constant in 2001, notwithstanding a higher budgetary cost of national elections (0.3 percent of GDP).[6]

24. For 2002, the new administration will face the challenge of putting in place quickly a fiscal program capable of addressing a further decline in tax revenues[7] and a reduction in privatization proceeds and balance of payments support. Against this background, **the staff stressed the need to implement a comprehensive tax reform package**, including measures equivalent to 2½ percent of GDP on an annual basis, with the objective of both increasing revenues and reducing distortions. Following previous recommendations by an FAD technical assistance mission, this could be achieved largely by eliminating exemptions and special regimes under the valued added tax (VAT) and by reducing import duty exemptions. The authorities agreed with the general thrust of the proposed reforms and indicated that specific measures would need to be discussed with the new administration.

B. Monetary and Financial Policies

25. The monetary program for 2001 is based on an increase in base money in line with nominal GDP growth and involves a contraction in the central bank's net domestic assets equivalent to 1.8 percent of GDP. **The program contemplates an increase in government deposits at the central bank** as a result of the expenditure restraint to be implemented during the second half of the year and the projected disbursements of balance of payments support and privatization proceeds. On this basis, **NIR are targeted to increase** by US$50 million during 2001, with gross reserves reaching a level equivalent to about 90 per-cent of public sector short-term debt on remaining maturity basis. The central bank's operating deficit is expected to rise due to a significant increase in the stock of central bank liabilities resulting from bank resolutions.

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[5] Bank resolutions were financed with central bank bonds maturing during 2002–04.

[6] On the revenue side, lower tax revenues resulting from reductions in excise taxes on petroleum products and the elimination of temporary import surcharges, are expected to be compensated by lower oil subsidies and higher social security contributions.

[7] In the absence of offsetting measures, tax receipts are expected to decline as pension contributions become tax deductible beginning in 2002 and excise tax rates are reduced according to a previously approved schedule.

26. **The staff cautioned the authorities about the increased vulnerability associated with the large volume of central bank paper** (mostly U.S. dollar indexed paper) that is falling due within the next 12 months (equivalent to about the level of gross foreign assets of the central bank or 10 percent of GDP) and, particularly, during July–December 2001. The staff stressed that these liabilities posed a major vulnerability risk in the event of a large exchange rate adjustment. The authorities agreed on the desirability of reducing the stock of these liabilities over the medium term. In the near term, to partially maintain tight monetary conditions, the authorities increased temporarily (through January 2002) the reserve requirement[8] by 2 percent effective in August and one additional percentage point in September 2001, but agreed that interest rates might need to increase to facilitate the rollover of the short-term debt. In addition, the authorities intend to take steps to improve open market operations in line with recommendations of a recent MAE technical assistance mission, including by introducing a system of repurchase agreements and by standardizing central bank paper to facilitate the development of a secondary market.

27. Regarding the financial system, during the remainder of the year **the superintendency of banks will complete the implementation of its plan of on-site inspections and take steps to strengthen banks where weaknesses are encountered**. It will also improve its prudential norms on asset risk classification and provisioning, fit and proper criteria, conflict of interest, and lending to related parties, in line with best international practices. The staff emphasized, however, that the superintendency should be further shielded from political pressures, which could impede its effectiveness. A recently established asset-liquidating unit has started to collect loans and dispose of assets taken over from the banks intervened in 2000–01, and the national assembly is expected to approve an amendment to the criminal code that defines financial crimes. The implementation of limits on deposit guarantees, established by the recently approved bank deposit insurance law, has been postponed to August 2002 because of concerns about a possible drop in bank deposits in the period preceding the elections.

28. An important part of the discussions with the authorities centered on the need to take immediate action to address the financial problems of BANIC, a bank identified as weak in the context of on-site inspections. Following several unsuccessful attempts to arrive at a private solution involving an injection of capital, on August 4, 2001 **BANIC was intervened** and its assets and liabilities auctioned off to another domestic bank (see Appendix V). While liabilities (deposits) to be absorbed are equivalent to about 8 percent of total banking system deposits, the fiscal cost of the operation will only be determined over the coming months, following the evaluation of the quality of the banks' assets. In light of this uncertainty, the authorities' program allows for an adjustment of the fiscal targets.

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[8] The additional reserve requirements, which will be remunerated and allowed to be held in the form of special central bank paper, are intended to ensure commercial bank holdings of central bank paper.

C. External Sector Policies

29. **The real appreciation experienced by the Cordoba over the last 18 months does not appear to have so far affected seriously the competitiveness of noncoffee exports** in key sectors, such as beef and seafood, but the performance of other nontraditional sectors is mixed. Against this background, the staff supported the continuation of the present crawl of 6 percent vis-à-vis the U.S. dollar, but stressed that this reinforced the need for prudent fiscal policy, particularly in view of the high degree of dollarization of the economy (84 percent of bank loans are denominated in U.S. dollars and 16 percent are indexed to the U.S. dollar). The authorities agreed with the staff's view.

30. **Key components of the external financing anticipated under the program for 2001 include privatization proceeds, balance of payments support, and HIPC-interim assistance**. Specifically, the program is based on privatization receipts of US$115 million (see the section on Structural and Policies and Governance); disbursements of the Inter-American Development Bank (IDB) balance of payments support, corresponding to the financial sector, electricity, and pension reform loans, of US$80 million; and World Bank and IDB interim HIPC assistance of US$34.4 million. The World Bank has already begun disbursing interim assistance, while the IDB has indicated that disbursements of both balance of payments support and interim assistance could start on the basis of the SMP.[9] In addition, the Central American Bank for Economic Integration (CABEI) is considering providing interim assistance. Given the uncertainties associated with the timing and amounts of HIPC-interim assistance, the authorities' program contains an adjustor for any shortfall/excess relative to the assumed level.

31. **The Nicaraguan trade system is relatively open**, with a rating of four out of ten on the Fund's trade restrictiveness index. There are no quantitative trade restrictions and the tariff regime is framed by the country's membership in the Central American Common Market (CACM). Recently, Nicaragua eliminated the temporary protection tariff of 5 percent levied on intermediate and capital goods not produced in Central America, and progress is being made on the implementation of the recently signed free trade agreements with Chile, the Dominican Republic, and Panama. However, a punitive 35 percent surcharge on all imports from Colombia and Honduras, which was imposed in December 1999 as a result of territorial sovereignty issues, remains in effect (no timetable has been set for its removal); in March 2000 Colombia filed a complaint with the World Trade Organization (WTO), which is currently under investigation. In addition, the authorities need to enforce compliance with recently passed legislation on intellectual property rights (Nicaragua is not a signatory of the Trade-Related Aspects of Intellectual Property Rights agreement) and to strengthen capacity to investigate invoice fraud so as to fully implement the WTO Customs Valuation Agreement.

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[9] IMF interim assistance under the HIPC initiative would be expected to begin after the approval of a new three-year PRGF arrangement.

32. Given the high level of debt, the staff underlined the need to limit external public sector financing to grants and concessional loans. It also urged the authorities to avoid the accumulation of external debt arrears and offer comparable treatment to all bilateral and commercial creditors. **The authorities emphasized that they would maintain prudent debt management policies and continue servicing all nonreschedulable obligations on a timely basis**. The staff welcomed recent progress in securing HIPC assistance from bilateral creditors, such as the recent swap of Nicaraguan debt between Guatemala and Spain, and urged the authorities to work toward securing agreements with other bilaterals.

D. Structural Policies and Governance

33. **Further actions in the structural area are envisaged under the SMP** (MEFP, Table 3). In particular, in addition to the steps to strengthen the financial system described above, the authorities intend to: (i) complete the privatization of the generating plants of the Nicaraguan Electricity Company (ENEL) in August; (ii) award to the private sector a management contract and a 40 percent stake in ENITEL in August; and (iii) begin the operations of a privately managed pension system by end-2001 (operating licenses will be issued to Fund managers in November).

34. **The authorities intend to improve governance**, with assistance from the World Bank, the IDB, and the donor community, by advancing judicial reforms, facilitating the resolution of property rights, and further improving transparency and monitoring of the budget process. To this end, the national assembly is expected to pass a code on criminal procedures by September and a law on decentralized real estate registries before the elections. Moreover, the 2002 budget is expected to incorporate the implementation of the SIGFA, including a mechanism for tracking poverty reducing expenditure and the use of HIPC debt relief funds in line with the PRSP.

E. Poverty Reduction Strategy Paper (PRSP)

35. **The staff supports the government's policy agenda described in the PRSP**, which rests on four pillars and three cross-cutting themes. The four pillars are: (i) broad-based economic growth; (ii) investment in human capital; (iii) better protection of vulnerable groups; and (iv) institutional strengthening and good governance. The three cross-cutting themes address the country's ecological vulnerability, social inequality, and the need for greater decentralization. The PRSP ranks broad-based economic growth as the most important pillar to reduce poverty.

F. Quantitative and Structural Benchmarks

36. The authorities' program includes indicative quantitative benchmarks for September and December 2001 on the net domestic financing and savings of the combined public sector, central bank net domestic assets, NIR, and no use of public sector borrowing on nonconcessional terms (MEFP, Table 1). To ensure the prompt identification of possible

deviations, the program incorporates monthly indicative ceilings on central government total expenditure (excluding interest and projects financed with tied foreign resources), current expenditure (excluding interest), total domestic financing, and central bank financing (MEFP, Table 2). Structural policy benchmarks are shown in Table 3 of the MEFP. The program envisages adjustment of the benchmarks for shortfalls in HIPC-interim assistance from multilateral institutions as well as the interest cost of BANIC's resolution, the latter with an upper limit of 0.2 percent of GDP.

G. Medium-Term Macroeconomic Outlook

37. **Nicaragua faces significant challenges over the medium term to achieve sustained growth and meaningful reductions in poverty levels**, while advancing toward fiscal and external sustainability. The staff and the authorities agreed that maintaining appropriate investment levels would require a substantial increase in both public and private national savings over the medium term so as to offset expected declines in external savings. To achieve these objectives, a stable macroeconomic environment based on a significantly improved fiscal stance, continued strengthening of the financial system, consolidation of pension system reforms, improvements in the judicial system, and civil service reform, will be critical. The authorities' medium-term strategy and macroeconomic projections presented in the PRSP are in line with the staff's recommendations and the adjustment scenario presented below[10] (Table 8).

38. On the fiscal front, increasing public savings in order to **advance toward a sustainable position requires the implementation of revenue measures**[11] and restraint on nonsocial current outlays. Under the scenario, savings of the combined public sector (excluding social security)[12] are projected to improve from a negative 2.8 percent of GDP in 2001 to a negative 0.7 percent of GDP by 2003, before shifting to a positive 1.5 percent of GDP by 2005. At the same time, capital expenditures and net lending would decline from 14.2 percent of GDP in 2001 to 12.1 percent by 2005, while social expenditures (excluding hurricane-related outlays) would increase moderately. The staff considers that the decline in

[10] While the scenarios are consistent, methodological differences in the measurement of investment are reflected in higher historical and projected levels of investment in the PRSP.

[11] The scenario assumes a tax reform, which yields 2.5 percent of GDP on an annual basis by 2003, resulting in an increase in total tax revenue of 1.0 percent of GDP.

[12] For comparability purposes, the scenario excludes social security revenue equivalent to 2.7 percent of GDP, which starting in 2002 (after the privatization of the pension system) is included in private savings. If these were included, public savings would be negative 0.1 percent of GDP in 2001 as indicated in paragraph 23.

capital expenditures is realistic, in view of the substantial reconstruction of the country's infrastructure carried out during the past few years.

39. **Private savings (including social security savings) are expected to increase through the consolidation of several ongoing structural reforms**, from 3.0 percent of GDP in 2001 to over 6.5 percent by 2005. These reforms include the privatization of the social security system and utility companies, and the strengthening of the financial sector. At the same time, private investment would increase from 14.3 percent in 2001 to about 18 percent in 2005, on the basis of an improved macroeconomic environment, the privatization of major utility companies, and the above-mentioned structural reforms.

40. The staff 's medium-term projections suggest that, **on the basis of a strong policy implementation, Nicaragua could advance significantly toward macroeconomic and external viability by 2005**. In particular, the economy could achieve a sustained real GDP growth of 5 percent, an inflation rate below 5 percent, and a substantially lower external current account deficit. This would establish an improved basis for a sustained long-term reduction in poverty.

41. **Risks over the medium term, however, are substantial.** Lack of fiscal restraint and/or the inability to carry out a meaningful tax reform could weaken public savings significantly, leading to lower investment and slower growth. Similarly, a weak implementation of key structural reforms, particularly in the financial sector and the pension system, and failure to improve governance, could have a detrimental effect on confidence and private sector savings. In addition, in the absence of a strong effort to correct financial imbalances, the government may face difficulties to roll over the substantial maturities associated with the debt issued to address problems in the banking system. These maturities begin falling due in 2002, but are particularly large in 2003 and 2004.

IV. Staff Appraisal

42. **Nicaragua's economic performance during 2000 and the first half of 2001 was disappointing**. Real GDP growth declined, owing largely to a deceleration in the construction sector as investment slowed from high post-Hurricane Mitch levels. Inflation edged up in 2000, partly because of higher oil import prices, but declined to single digit levels in early 2001. Despite a significant deterioration in the terms of trade, the external current account deficit narrowed in 2000 and widened only moderately in early 2001. Difficulties in the banking system resulted in the intervention of several banks since August 2000 and an increase in domestic public debt. Fiscal policy implementation weakened considerably during the final months of 2000 and the first half of 2001, because of large expenditure overruns, which led to a significant decline in NIR. In contrast, substantial progress was made in the structural area, including in social security and privatization.

43. Discussions on the third annual PRGF arrangement could not be completed because of delays in addressing policy slippages. However, **the authorities have adopted an economic**

program for July–December 2001 that constitutes a significant effort to address macroeconomic imbalances, and have requested a monitoring of its implementation by the Fund staff under an SMP. Full implementation of the SMP should result in an improved economic performance and facilitate the transition to a new three-year PRGF arrangement, which could be discussed with the new administration taking office in January 2002. The envisaged restraint in public spending during the second half of 2001, together with a strong implementation of structural reforms, will facilitate pending privatizations and the timely release of balance of payments loans, which are crucial to achieving the objectives of the program. Any delays in policy implementation would entail substantial risks of a significant deterioration in economic performance.

44. In addition to public expenditures restraint, **the achievement of medium-term fiscal and external sustainability would require a strong effort to increase public sector revenue and eliminate distortions**. In this connection, the incoming administration would need to implement a comprehensive tax reform in 2002, including by eliminating exemptions and special regimes under the VAT and import taxes.

45. **Implementation of a tight monetary policy would be crucial to protecting the international reserve position in the run-up to the presidential election**. Weakened demand for central bank paper and a recent shortening of maturities render the reserve position vulnerable, and the authorities should stand ready to increase interest rates, as needed, to encourage a rollover of maturing paper. Over the medium term, the implementation of a sound fiscal policy will be essential to reduce the stock of central bank debt and the associated vulnerabilities.

46. The staff commends the authorities on their actions to strengthen the banking system, including by the recent intervention of BANIC. Looking ahead, **it will be important to press forward with current plans to further strengthen banking supervision and prudential norms**.

47. Further action on other structural reforms would also have to be taken in the near future to build on the substantial progress achieved since the early 1990s in reforming the economic and institutional structure (described in Annex II of the PRSP). In this connection, the staff encourages the authorities to proceed vigorously with the implementation of public sector reforms, including the social security system, and measures to improve governance, especially with regard to the judicial system and transparency in the use of public funds. The staff supports the authorities' steps to deepen trade liberalization and the removal of the temporary protection tax. It recommends to fully implement pending measures on intellectual property rights and customs valuation and eliminate as soon as possible the punitive 35 percent tariff charged on imports from Colombia and Honduras.

48. The present crawling peg system has served Nicaragua well, contributing to a decline in inflation. Notwithstanding the recent real effective appreciation of the currency, owing largely to the appreciation of the U.S. dollar, competitiveness of the noncoffee export sector

appears to remain broadly appropriate. In this context, **the staff supports the authorities' plans to maintain the present exchange rate regime**, but stresses that its sustainability hinges on the implementation of sufficiently tight fiscal and credit policies to help protect the reserve position.

49. **While data are sufficient for surveillance purposes, deficiencies remain in several areas**. In particular, work is required to strengthen the quality and timeliness of fiscal and monetary statistics. The staff encourages the authorities to continue to advance in the revision of the national accounts and to adopt the revised accounts as soon as the technical work is complete.

50. **The PRSP presents a comprehensive and coherent strategy to reduce poverty in Nicaragua**; the outlined macroeconomic policies provide an appropriate medium-term framework and a solid basis for concessional assistance and debt relief. However, because of recent slippages in the implementation of macroeconomic and structural policies, the establishment of a satisfactory track record is needed before the resumption of Fund assistance under the PRGF.

51. It is recommended that the next Article IV consultation with Nicaragua be held on the standard 12-month cycle.

Table 1. Nicaragua: Selected Economic and Financial Indicators, 1995-2003

	Average 1995-97	Actual 1998	1999	2000 Modified Program	2000 Prel.	SMP 2001	Projections 2002	2003
	(Annual percentage change; unless otherwise indicated)							
National income, prices, and unemployment								
GDP at constant prices	4.7	4.1	7.4	5.5	4.3	3.0	3.7	4.5
Consumer prices (end of period)	10.2	18.5	7.2	10.0	9.9	8.0	6.0	5.0
Consumer prices (period average)	10.6	13.0	11.2	10.9	11.6	8.3	6.9	5.5
Unemployment rate (percent)	15.7	13.2	10.7	...	9.9	...	...	...
External sector								
Exports, f.o.b.	21.0	-0.6	-4.9	14.5	18.3	-6.1	12.5	13.1
Export volume	15.7	-2.3	9.3	11.9	20.9	-1.7	5.1	5.9
Imports, f.o.b.	20.7	0.9	23.1	1.0	-5.7	-4.5	2.3	4.8
Import volume	18.0	8.6	15.9	-3.3	-15.9	-5.2	2.9	5.4
Terms of trade (deterioration -)	3.1	7.7	-19.1	-1.8	-12.8	-3.7	7.7	7.4
Nominal effective exchange rate end of period (depreciation -)	-6.6	-11.9	-2.7	...	2.1	...	...	...
Real effective exchange rate end of period (depreciation -)	-1.0	2.0	1.6	...	8.8	...	...	...
Money and credit								
Net domestic assets of the central bank 1/	25.6	27.5	-39.3	-40.7	22.7	-35.5	-13.6	-12.7
Net credit to nonfinancial public sector 1/	84.4	-85.8	-75.6	-38.2	-36.2	-23.7	-37.5	-83.1
Net credit to financial institutions 1/	-40.7	-4.8	-2.6	-13.4	95.4	-45.0	-16.4	-6.1
Currency in circulation	17.3	22.2	29.5	12.0	1.2	4.0	9.7	9.5
Financial system liabilities to private sector	46.4	28.6	22.4	17.3	7.3	6.6	14.3	13.0
Financial system credit to private sector	11.1	45.3	40.0	17.1	14.2	4.4	10.5	10.1
Money income velocity (GDP/M3)	2.1	1.6	1.5	1.5	1.6	1.7	1.7	1.6
Interest rate on deposits (percent per annum) 2/	14.1	12.4	11.5	...	11.2	...	...	...
	(In percent of GDP)							
Public sector								
Combined public sector saving 3/	2.8	5.6	5.4	4.9	3.6	-0.1	-0.7	1.2
Combined public sector overall balance (before grants) 3/	-12.6	-7.4	-15.7	-13.6	-15.7	-14.9	-13.9	-12.3
Combined public sector overall balance (after grants) 3/	-6.0	-3.6	-7.0	-6.9	-8.3	-7.4	-4.1	-1.9
Nonfinancial public sector saving	3.0	8.9	7.1	6.2	5.2	3.6	2.9	4.5
Nonfinancial public sector overall balance (before grants)	-12.4	-4.1	-14.0	-12.3	-14.1	-11.2	-10.3	-9.0
Central bank operational results (deficit -) 4/	-0.2	-3.3	-1.7	-1.3	-1.6	-3.7	-3.6	-3.3
Savings and investment								
Gross domestic investment	27.3	33.8	43.3	36.9	34.4	28.5	28.5	29.5
Public	15.3	13.0	21.1	18.4	19.2	14.2	13.2	13.5
Private	11.9	20.8	22.2	18.5	15.2	14.3	15.3	16.0
National savings	-6.6	2.3	1.4	7.6	3.0	0.2	3.5	5.5
Public	2.8	5.6	5.4	4.9	3.6	-0.1	-0.7	1.2
Private	-6.3	-3.3	-4.0	2.7	-0.6	0.3	4.2	4.3
External savings 5/	33.8	31.5	41.9	29.3	31.4	28.3	25.0	24.0
External sector								
External current account balance	-36.2	-37.2	-47.9	-33.4	-37.3	-30.5	-25.6	-24.3
(Excluding interest obligations)	-21.5	-26.9	-37.7	-25.6	-27.0	-23.4	-17.8	-17.1
Trade balance (deficit -)	-25.9	-39.2	-52.3	-38.4	-40.1	-36.8	-33.3	-31.7
Outstanding external public debt (end of year)	382.9	296.0	289.0	271.5	278.0	...	...	...
	(In percent of exports of goods and nonfactor services)							
Contractual debt service	104.2	43.5	47.1	35.4	44.1	38.5	49.1	35.2
Gross international reserves (in months of imports)	1.7	2.3	3.3	4.0	3.2	3.6	3.6	3.6

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

1/ In relation to currency in circulation at the beginning of the year.
2/ Six-month deposits, end of period.
3/ Includes central bank operational losses.
4/ From 2001 onward, includes the cost of bank resolution on accrual basis.
5/ External current account deficit, excluding interest on debt to non-Paris Club bilateral creditors that is eligible for debt rescheduling and deferred interest to Paris Club.

Table 2. Nicaragua: Consolidated Operations of the Public Sector

(In percent of annual GDP)

	Actual		2000			2001 1/			Projections	
			Modified	Preliminary		Jan.-Jun.		Jan.-Dec.		
	1998	1999	Program	Jan.-Jun.	Jan.-Dec.	SMP	Prel.	SMP	2002 2/	2003
Combined public sector savings	**5.6**	**5.4**	**4.9**	**2.6**	**3.6**	**0.3**	**0.4**	**-0.1**	**-0.7**	**1.2**
Excluding interest payments	10.6	11.1	10.1	5.1	9.1	3.7	3.7	8.4	8.1	9.8
Combined public sector balance (before grants)	**-7.4**	**-15.7**	**-13.6**	**-6.1**	**-15.7**	**-6.9**	**-6.1**	**-14.9**	**-13.9**	**-12.3**
Total current revenues	**36.8**	**35.4**	**34.6**	**16.5**	**32.9**	**15.9**	**15.9**	**32.6**	**30.4**	**31.1**
Current revenue of the general government	34.2	33.0	33.1	15.7	32.3	15.7	15.6	32.0	29.7	30.4
Operational surplus of public utilities	2.6	2.4	1.5	0.8	0.6	0.3	0.3	0.6	0.7	0.7
Total current expenditure	**31.3**	**30.0**	**29.7**	**13.9**	**29.4**	**15.6**	**15.5**	**32.7**	**31.1**	**29.9**
Consumption and transfers	22.9	23.4	23.1	10.5	23.1	11.2	11.1	23.4	21.5	20.5
Nonfinancial public sector interest payments	5.1	4.9	5.3	2.5	4.6	2.5	2.5	5.7	5.9	6.1
Central bank operating deficit 3/	3.3	1.7	1.3	0.9	1.6	2.0	2.0	3.7	3.6	3.3
Capital expenditure and net lending (net of capital revenue)	**13.0**	**21.1**	**18.4**	**8.7**	**19.2**	**7.2**	**6.4**	**14.8**	**13.3**	**13.5**
Grants	3.8	8.7	6.6	3.8	7.3	2.7	2.5	7.5	9.9	10.4
Of which										
HIPC interim debt relief	0.0	0.0	0.0	0.0	0.0	0.4	0.4	2.8	5.3	6.1
Combined public sector balance (after grants)	-3.6	-7.0	-6.9	-2.3	-8.3	-4.2	-3.6	-7.4	-4.1	-1.9
Financing	**3.6**	**7.0**	**6.9**	**2.3**	**8.3**	**4.2**	**3.6**	7.4	**4.1**	**1.9**
External financing, net	7.8	10.8	8.4	2.8	6.5	1.4	1.4	5.0	1.9	1.9
Privatization receipts	0.0	0.0	3.4	0.0	4.8	0.0	0.0	4.5	0.5	0.4
Domestic financing, net	-4.1	-3.8	-4.9	-0.6	-3	2.9	2.2	-2.2	1.8	-0.4
Of which										
Central bank	-1.0	-2.2	-0.7	3.5	0.4	7.1	6.5	2.3	1.8	-0.7
Memorandum items:										
Total social expenditure 4/	10.4	12.1	12.4	...	12.4	...	...	12.8	13.0	13.5
GDP (in millions of cordobas)	21,881	26,126	30,995	30,409	30,409	33,904	33,904	33,904	37,584	41,416

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

1/ Assumes privatizations receipts of US$115 million.

2/ Assumes that private pension funds initiate operations in 2002.

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

4/ Excluding post-Mitch reconstruction expenditure.

Table 3. Nicaragua: Summary Operations of the Central Government

(In percent of annual GDP)

	Actual		2000			2001 1/			Projections	
			Modified	Preliminary		Jan.-Jun.		Jan.-Dec.		
	1998	1999	Program	Jan.-Jun.	Jan.-Dec.	SMP	Prel.	SMP	2002	2003
Total current revenue	**26.9**	**25.8**	**25.3**	**12.2**	**24.8**	**11.5**	**11.5**	**23.9**	**24.5**	**25.3**
Tax revenue	25.8	24.8	24.4	11.7	23.9	11.0	11.1	23.0	23.8	24.6
Nontax revenue and current transfers	1.1	0.9	0.9	0.5	0.9	0.5	0.4	0.9	0.7	0.7
Total current expenditures	**21.6**	**21.8**	**22.5**	**10.1**	**22.5**	**10.9**	**10.8**	**23.0**	**21.6**	**20.9**
Consumption and transfers	17.0	17.4	17.5	7.8	18.0	8.4	8.3	17.4	15.6	14.8
Of which										
Wages and salaries	6.0	6.4	6.0	2.7	6.2	2.8	2.8	6.3	5.8	5.5
Interest payments	4.6	4.4	5.0	2.3	4.4	2.5	2.4	5.6	5.9	6.1
Savings	**5.3**	**4.0**	**2.9**	**2.1**	**2.3**	**0.7**	**0.7**	**0.9**	**2.9**	**4.5**
Capital revenue	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure and net lending	10.5	17.9	14.6	7.1	16.8	6.0	5.4	12.5	10.6	11.3
Balance before grants	**-5.2**	**-13.9**	**-11.7**	**-5.0**	**-14.4**	**-5.3**	**-4.7**	**-11.6**	**-7.7**	**-6.8**
Grants	3.1	7.4	4.9	3.1	6.2	2.1	1.9	6.8	9.1	9.7
Of which										
HIPC interim relief	0.0	0.0	0.0	0.0	0.0	0.4	0.4	2.8	5.3	6.1
Balance after grants	**-2.1**	**-6.5**	**-6.8**	**-1.9**	**-8.3**	**-3.2**	**-2.8**	**-4.8**	**1.4**	**2.9**
Financing	**2.1**	**6.5**	**6.8**	**1.9**	**8.3**	**3.2**	**2.8**	**4.8**	**-1.4**	**-2.9**
External (net)	7.7	10.8	7.6	2.6	6.4	1.0	1.0	4.2	0.7	1.1
Privatization	0.0	0.0	3.4	0.0	4.8	0.0	0.0	4.5	0.5	0.4
Domestic (net)	-5.6	-4.4	-4.3	-0.7	-2.9	2.3	1.7	-3.9	-2.5	-4.4
Memorandum item:										
Military expenditure	2.8	2.8	2.5	1.3	2.8	...	...	2.4	...	...

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

1/ For 2001, assumes privatization receipts of US$115 million, of which US$22 million would be used to repay ENEL's short-term commercial debts and the rest would be deposited in the central bank.

Table 4. Nicaragua: Summary Accounts of the Central Bank

(Flows in millions of cordobas; unless otherwise stated)

	Actual		2000			2001			Projections	
			Modified	Preliminary		Jan.-Jun.		SMP		
	1998	1999	Program	Jan.-Jun.	Jan.-Dec.	SMP	Prel.	Jan.-Dec.	2002	2003
Exchange rate (cordobas/US$)	10.4	11.9	12.7	12.7	12.7	13.4	13.4	...	...	...
Net international reserves	**-58**	**922**	**881**	**-679**	**-374**	**-1,734**	**-1,574**	**693**	**426**	**444**
(In millions of US$)	-6	77	69	-53	-29	-129	-117	51	30	30
Net domestic assets	**301**	**-526**	**-680**	**410**	**393**	**1,601**	**1,460**	**-622**	**-249**	**-254**
Net credit to nonfinancial										
Public sector (NFPS) 1/	-941	-962	-638	734	-627	2,294	2,038	2,791	-685	-1,663
Public sector (NFPS) 2/	-941	-962	-638	734	-627	1,656	1,400	-416	-685	-1,663
Operational losses	673	438	414	281	461	370	369	642	1,214	1,732
Net credit to the financial system 3/	-52	-35	-224	-259	1,656	-452	-397	-790	-300	-123
CENIS and BOMEX	607	-45	-434	-438	-1,274	-800	-739	-3,510	-256	-41
Foreign liabilities										
(Medium- and long-term)	-50	33	152	97	161	118	127	170	116	236
Other 3/	64	44	50	-5	16	71	62	76	-338	-395
Currency	**243**	**395**	**201**	**-269**	**19**	**-133**	**-114**	**70**	**177**	**190**
Memorandum items:										
Currency (stock)	1,340	1,735	1,876	1,466	1,755	1,622	1,641	1,825	2,202	2,193
Currency (annual change; in percent)	22.2	29.5	8.1	13.0	1.2	10.7	11.9	4.0	9.7	9.5

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."

Table 5. Nicaragua: Operations of the Central Bank and the Financial System

Stocks at accounting exchange rates
(In millions of cordobas)

	December 31					
	C$10.4/US$	C$11.9/US$		C$12.7/US$		C$13.4/US$
	1998	1998	1999	1999	2000	2000
	I. Central Bank					
Net international reserves	**1,440**	**1,648**	**2,569**	**2,742**	**2,369**	**2,499**
(In millions of U.S. dollars)	139	139	216	216	187	187
Net domestic assets	**-101**	**-309**	**-834**	**-1,007**	**-614**	**-745**
Net credit to NFPS 1/	-753	-753	-1,715	-1,715	-2,343	-2,343
Operational losses	1,178	1,178	1,616	1,616	2,077	2,077
Net credit to the financial system	-818	-797	-832	-825	830	876
CENIS+BOMEX	-2,087	-2,388	-2,433	-2,597	-3,871	-4,084
Medium- and long-term foreign liabilities	-22,518	-25,766	-25,733	-27,463	-27,301	-28,806
Other 1/	24,898	28,217	28,262	29,977	29,993	31,534
Currency	**1,340**	**1,340**	**1,735**	**1,735**	**1,754**	**1,754**
	II. Consolidated Financial System					
Net international reserves	**3,858**	**4,415**	**4,151**	**4,430**	**4,017**	**4,238**
(In millions of U.S. dollars)	371	371	349	349	316	316
Net domestic assets	**10,377**	**11,287**	**13,378**	**14,068**	**14,718**	**15,298**
Net credit to nonfinancial public sector	-1,926	-1,926	-3,145	-3,145	-4,323	-4,323
Net credit to central government	-1,050	-1,050	-2,105	-2,105	-2,611	-2,611
Net credit to rest of public sector	-875	-875	-1,040	-1,040	-1,712	-1,712
Credit to the private sector	8,941	10,230	13,004	13,878	14,949	15,773
Medium- and long-term foreign liabilities	-22,640	-25,906	-25,958	-27,703	-27,713	-29,240
Central bank net losses	1,178	1,178	1,616	1,616	2,077	2,077
Other net assets	24,824	27,710	27,862	29,422	29,728	31,011
Liabilities to the private sector	**14,236**	**15,702**	**17,529**	**18,498**	**18,735**	**19,536**
Liabilities in local currency	5,680	6,077	7,058	7,323	6,969	7,121
Narrow money	2,505	2,505	3,127	3,128	3,327	3,279
Currency	1,340	1,340	1,735	1,735	1,754	1,754
Demand deposits	1,165	1,165	1,393	1,393	1,573	1,525
Quasi-money, including CENIS	3,176	3,573	3,931	4,195	3,642	3,842
Saving deposits	1,067	1,200	1,506	1,608	1,355	1,430
Time deposits	1,291	1,453	1,637	1,747	1,620	1,710
CENIS	817	919	788	841	666	703
Liabilities in foreign currency	8,555	9,625	10,471	11,174	11,766	12,415
	-10,377	-11,287	-13,378	-14,068	-14,718	-15,298
	(In percent of GDP)					
Memoradum items:						
Liabilities to the private sector	66		68		61	
Liabilities in local currency	27		27		22	
Narrow money (M1)	11		12		11	
Currency	6		7		6	
Quasi-money, including CENIS	5		5		5	
Liabilities in foreign currency	39		41		39	
Credit to the private sector 1/	41		50		49	

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

1/ Accounting adjustments with respect to exchange rate revaluations are included in "other."

Table 6. Nicaragua: Balance of Payments

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

	1996	1997	1998	1999	2000 Modif. Prog.	2000 Prel.
Current account	**-761**	**-784**	**-769**	**-1059**	**-817**	**-895**
Excluding interest obligations	-472	-573	-556	-835	-625	-647
Trade balance	-582	-795	-810	-1157	-940	-961
Exports, f.o.b.	467	577	573	545	618	645
Of which : coffee	116	116	173	135	...	171
Imports, f.o.b.	-1,050	-1,371	-1,384	-1,703	-1,559	-1,606
Nonfactor services (net)	-63	-15	-15	-42	-31	-22
Receipts	184	223	257	293	318	317
Payments	-247	-237	-272	-335	-349	-339
Official interest obligations	-289	-211	-213	-225	-191	-248
Other current transactions (net)	174	237	269	364	346	335
Factor services receipts	11	15	20	31	38	31
Other factor services payments	-46	-54	-61	-62	-73	-69
Private transfers	209	276	311	396	380	374
Capital account	**228**	**661**	**573**	**876**	**797**	**591**
Official (net)	11	163	293	415	402	288
Official transfers	247	192	189	307	272	286
Public sector consolidated	168	106	74	192	162	176
Other	79	86	115	115	110	110
Disbursements 1/	178	176	264	274	268	178
Amortization 1/	-426	-214	-148	-168	-139	-171
Other (net) 2/	13	9	-12	2	1	-5
Other Capital (private)	216	498	280	460	395	302
Overall balance	**-533**	**-123**	**-196**	**-184**	**-20**	**-304**
Change in net international reserves (- increase)	2	-58	6	-77	-69	29
Of which : IMF (net)	-11	0	22	104	35	21
Net change in arrears (decrease -)	-3,202	-177	62	151	-2,201	64
Exceptional financing	3,733	357	129	110	112	211
Paris Club rescheduling	51	24	79	91	112	183
Other rescheduling	3,682	333	50	19	0	16
Remaining financing gap	0	0	0	0	2,179	0
Memorandum items:						
Current account (in percent of GDP)	-40	-40	-37	-48	-33	-37
Excluding interest obligations (in percent of GDP)	-25	-29	-27	-38	-25	-27
Gross reserves (in millions of U.S. dollars)	214	312	357	513	668	497
Gross reserves (in months of imports)	2	2	2	3	4	3
Adjusted gross reserves (in millions of U.S. dollars) 3/	165	29	141	321	505	256
Net international reserves (in millions of U.S. dollars)	145	356	306	357	475	319
Debt service ratio	111	53	44	47	35	44
Debt service ratio, after restructuring	103	40	37	34	17	32
Debt service ratio, actual payments	40	31	28	20	...	20
Gross official grants and loans (in percent of GDP)	22	19	23	31	20	20
Net official grants and loans (in percent of GDP)	14	12	15	22	16	15
GDP (millions of US$)	1,921	1,968	2,068	2,212	2,441	2,397

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

1/ Medium and long term.
2/ Short-term debt, and private debt due to official creditors.
3/ Net of the stock of CENIs and in terms of the following year imports of goods and nonfactor services.

Table 7. Nicaragua: Medium-Term Balance of Payments

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

		SMP	Projections			
	2000	2001	2002	2003	2004	2005
Current account	**-895**	**-769**	**-717**	**-679**	**-685**	**-697**
Excluding interest obligations	-647	-590	-535	-508	-520	-535
Trade balance	-961	-929	-888	-876	-889	-903
Exports, f.o.b.	645	605	681	770	849	942
Imports, f.o.b.	-1,606	-1,534	-1,569	-1,646	-1,739	-1,845
Nonfactor services (net)	-22	7	6	4	-5	-16
Receipts	317	333	357	381	401	423
Payments	-339	-327	-351	-377	-405	-439
Official interest obligations	-248	-178	-181	-172	-165	-162
Other current transactions (net)	335	332	347	364	374	384
Capital account	**591**	**696**	**573**	**476**	**491**	**499**
Official (net)	288	324	227	158	158	134
Official transfers 1/	286	298	367	197	180	180
Disbursements 2/	178	204	186	182	176	180
Amortization 2/	-171	-178	-325	-221	-198	-226
Other (net) 3/	-5	0	0	0	0	0
Other Capital	302	372	345	318	334	365
Overall balance	**-304**	**-73**	**-144**	**-203**	**-194**	**-198**
Change in net international reserves (- increase)	29	-51	-30	-30	-40	-50
Of which : IMF (net)	21	-5	-5	-7	-15	-25
Net change in arrears (decrease -)	64	0	0	0	0	0
Exceptional financing	211	124	75	0	0	0
Financing gap 4/	0	0	99	233	234	248
Memorandum items:						
Current account (in percent of GDP)	-37.3	-30.5	-27.0	-24.3	-23.1	-22.2
Excluding interest obligations (in percent of GDP)	-27.0	-23.4	-20.2	-18.2	-17.6	-17.0
Gross reserves (in millions of U.S. dollars)	496.7	565.8	607.3	641.5	681.0	721.3
Gross reserves (in months of imports)	3.2	3.6	3.6	3.6	3.6	3.7
Adjusted gross reserves (in millions of U.S. dollars) 5/	255.8	338.7	394.1	439.3	487.6	533.5
Net international reserves (in millions of U.S. dollars)	319	394	440	482	537	602
Debt service ratio, accrual basis	44.1	38.5	49.3	34.8	30.3	30.3
Debt service ratio, after restructuring	32.2	24.2	24.9	20.0	18.1	17.9
Gross official grants and loans (in percent of GDP)	20.5	17.1	15.6	13.6	12.0	11.5
Net official grants and loans (in percent of GDP)	14.9	13.1	11.5	10.5	9.4	8.7
GDP (in millions of U.S. dollars)	2,397	2,522	2,649	2,794	2,961	3,139

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

1/ Figures for 2001 and 2002 include interim HIPC assistance in the amount of 71.2 and 140 million respectively.

2/ Medium and long term.

3/ Short-term debt, and private debt due to official creditors.

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

5/ Net of the stock of CENIs and in terms of the following year imports of goods and nonfactor services.

Table 8. Nicaragua: Medium-Term Macroeconomic Projections

	Actual			SMP	Projections			
	1998	1999	2000	2001	2002 1/	2003	2004	2005
	(Annual percentage change)							
	A. Economic Growth and Prices							
GDP at constant prices	4.1	7.4	4.3	3.0	3.7	4.5	5.0	5.0
Consumer prices (end of period)	18.5	7.2	9.9	8.0	6.0	5.0	4.0	4.0
Consumer prices (period average)	13.0	11.2	11.6	8.3	6.9	5.5	4.5	4.0
	(In percent of GDP)							
	B. Savings, Investment, and the Current Account							
External current account balance 2/	-31.5	-41.9	-31.4	-28.3	-25.0	-24.0	-22.9	-21.9
External current account, excluding interest obligations	-26.9	-37.7	-27.0	-23.4	-20.2	-18.2	-17.6	-17.0
Combined public sector balance before grants	-7.4	-15.7	-15.7	-14.9	-13.9	-12.3	-11.5	-10.6
Private sector S-I gap	-24.1	-26.2	-15.7	-13.4	-11.1	-11.7	-11.4	-11.3
	C. Savings and Investment							
Investment	**33.8**	**43.3**	**34.4**	**28.5**	**28.5**	**29.5**	**29.5**	**30.0**
Public sector	13.0	21.1	19.3	14.2	13.2	13.5	12.9	12.1
Private sector	20.8	22.2	15.1	14.3	15.3	16.0	16.6	17.9
National savings	**2.3**	**1.4**	**3.0**	**0.2**	**3.5**	**5.5**	**6.6**	**8.1**
Public sector	5.6	5.4	3.6	-0.1	-0.7	1.2	1.4	1.5
Private sector	-3.3	-4.0	-0.6	0.3	4.2	4.3	5.2	6.6
External savings	**31.5**	**41.9**	**31.4**	**28.3**	**25.0**	**24.0**	**22.9**	**21.9**
Memorandum items:								
Nominal GDP (in millions of cordobas)	22,499	26,126	30,409	33,904	37,584	41,416	45,422	49,601
ICOR	6.5	6.6	7.1	7.1	8.3	7.7	6.6	6.1

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

1/ Assumes that private pension funds initiate operations in 2002.
2/ Excluding interest on debt owed to non-Paris Club bilateral creditors that is eligible for debt rescheduling.

Table 9. Nicaragua: Public Sector External Debt and Debt Service

	1996	1997	1998	1999	Prel. 2000
(In millions of U.S. dollars, end of period)					
Total debt	6,094	6,001	6,287	6,549	6,660
Bilaterals	4,045	4,027	4,115	4,084	4,124
Multilaterals	1,682	1,657	1,897	2,170	2,260
Commercial banks	272	234	246	242	235
Other	95	83	29	53	41
(In percent of GDP)					
Total debt	317	305	304	296	278
Bilaterals	211	205	199	185	172
Multilaterals	88	84	92	98	94
Commercial banks	14	12	12	11	10
Other	5	4	1	2	2
(In millions of U.S. dollars)					
Total debt service obligations	724	425	362	396	424
Principal	436	214	148	171	176
Interest	289	211	213	225	248
Debt service paid	258	245	229	170	188
Principal	171	126	134	104	111
Interest	87	119	95	66	77
Debt service not paid	467	181	133	226	236
Principal	265	88	14	67	65
Interest	202	93	119	159	171
(In percent of GDP)					
Total debt service obligations	37.7	21.6	17.5	17.9	17.7
Principal	22.7	10.9	7.2	7.7	7.3
Interest	15.0	10.7	10.3	10.2	10.3
Debt service paid	13.4	12.4	11.1	7.7	7.8
Principal	8.9	6.4	6.5	4.7	4.6
Interest	4.5	6.0	4.6	3.0	3.2
Debt service not paid	24.3	9.2	6.4	10.2	9.8
Principal	13.8	4.5	0.7	3.0	2.7
Interest	10.5	4.7	5.8	7.2	7.1
(In percent of exports of goods and nonfactor services)					
Total debt service obligations	111.0	53.0	43.7	47.2	44.1
Principal	67.0	27.0	17.9	20.4	18.3
Interest	44.0	26.0	25.7	26.8	25.8
Debt service paid	40.0	31.0	27.6	20.3	19.5
Principal	26.0	16.0	16.2	12.4	11.5
Interest	13.0	15.0	11.5	7.9	8.0
Debt service not paid	72.0	23.0	16.0	26.9	24.5
Principal	41.0	11.0	1.7	8.0	6.8
Interest	31.0	12.0	14.4	19.0	17.8

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

Table 10. Nicaragua: Indicators of Financial Sector Vulnerability

	December					April	
	1996	1997	1998	1999	2000	2000	2001
Performance and profitability indicators							
Nonperforming loan ratio							
All banks	4.1	2.0	2.4	2.6	4.3	4.0	5.2
Top four banks	0.6	0.7	1.1	1.8	1.9	1.1	2.8
Last four banks	6.9	5.9	5.7	3.7	7.5	7.3	11.3
Accumulated loan loss provision/nonperforming loans	133.8	149.7	122.4	139.8	79.4	98.6	99.5
CAR (risk adjusted)	9.1	10.7	9.3	10.7	14.3	11.4	15.7
Required CAR	8.0	8.0	8.0	8.0	10.0	9.5	10.0
Financial income as a percentage of total assets							
All banks	10.3	9.3	11.0	11.4	10.7	4.2	4.0
Top four banks	13.9	11.9	14.3	13.3	13.0	5.5	4.5
Last four banks	9.4	6.8	9.7	8.6	9.5	3.5	3.4
After tax profits as a percentage of total assets							
All banks	0.3	0.8	0.8	1.5	1.4	0.6	0.5
Top four banks	1.3	1.4	1.4	2.1	2.4	1.1	0.9
Last four banks	1.6	0.6	0.4	1.3	0.3	1.2	0.5
Vulnerability indicators							
Average maturity of lending (in months)							
Short term	n.a.	n.a.	5.2	5.0	5.1	5.2	4.9
Long term (>12 months)	n.a.	n.a.	20.3	19.9	20.4	20.5	21.8
Average maturity of deposits	n.a.	n.a.	10.6	11.8	10.0	10.6	10.3
Rate of interest on deposits	8.0	7.9	7.5	8.2	7.2	8.7	8.2
Rate of interest on loans	16.6	16.8	18.2	17.7	14.9	17.8	16.6
Spread between lowest loans and deposit rates C$	5.6	8.1	8.4	7.8	8.7	8.0	5.5
Spread between lowest loans and deposit rates US$	9.4	10.2	9.6	8.7	8.1	8.3	7.0
Spread between highest loans and deposit rates C$	7.2	9.2	9.9	10.3	11.1	10.7	14.4
Spread between highest loans and deposit rates US$	10.4	11.0	9.8	9.1	8.2	8.7	6.8
Short-term foreign liabilities/total liabilities	3.5	3.3	2.9	5.8	4.0	3.8	2.5
Share of foreign exchange deposits in total deposits	62.1	64.3	67.9	67.8	70.3	65.8	68.8
Credit to coffee sector as percent of total credit	0.0	0.0	0.0	0.0	6.2	0.0	0.0

Table 10. Nicaragua: Indicators of Financial Sector Vulnerability

	December					April	
	1996	1997	1998	1999	2000	2000	2001
Memorandum items:							
Number of banks	13.0	12.0	12.0	12.0	8.0	12.0	7.0
Total loans as a percent of GDP	30.2	36.7	45.2	52.5	38.3	47.1	32.7
Concentration - four largest banks							
Assets as a percent of total assets	51.2	50.0	44.6	48.8	63.7	49.9	72.8
Deposits as a percent of total deposits	52.5	50.2	45.4	48.5	66.9	49.8	74.5
Loans as a percent of total loans	52.8	49.3	46.5	49.0	58.8	50.2	67.4
Loans - currency of denomination (percent of total)	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Dollars	52.0	73.0	81.0	83.0	83.0	84.0	84.0
Cordobas adjusted to maintain dollar value	46.0	27.0	19.0	17.0	17.0	16.0	16.0
Cordobas	2.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans - term structure	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Short-term loans as percent of total loans	66.3	59.2	55.1	53.5	49.2	54.4	41.9
Long-term loans as percent of total loans (18 months)	33.7	40.8	44.9	46.5	50.8	45.6	58.1
Average maturity on central bank paper							
Average interest rate on central bank paper							
Legal reserve requirement local currency	15.0	17.0	17.0	16.3	16.3	16.3	16.3
Legal reserve requirement foreign currency	25.0	17.0	17.0	16.3	16.3	16.3	16.3
GDP in nominal terms	16,203.7	18,601.0	21,881.4	26,125.9	30,395.1	30,395.1	33,903.7
Total Loans	4,890.2	6,823.6	9,886.1	13,711.4	11,644.3	14,308.4	11,076.6

Source: Central Bank.

Table 11. Nicaragua: Social Indicators 1/

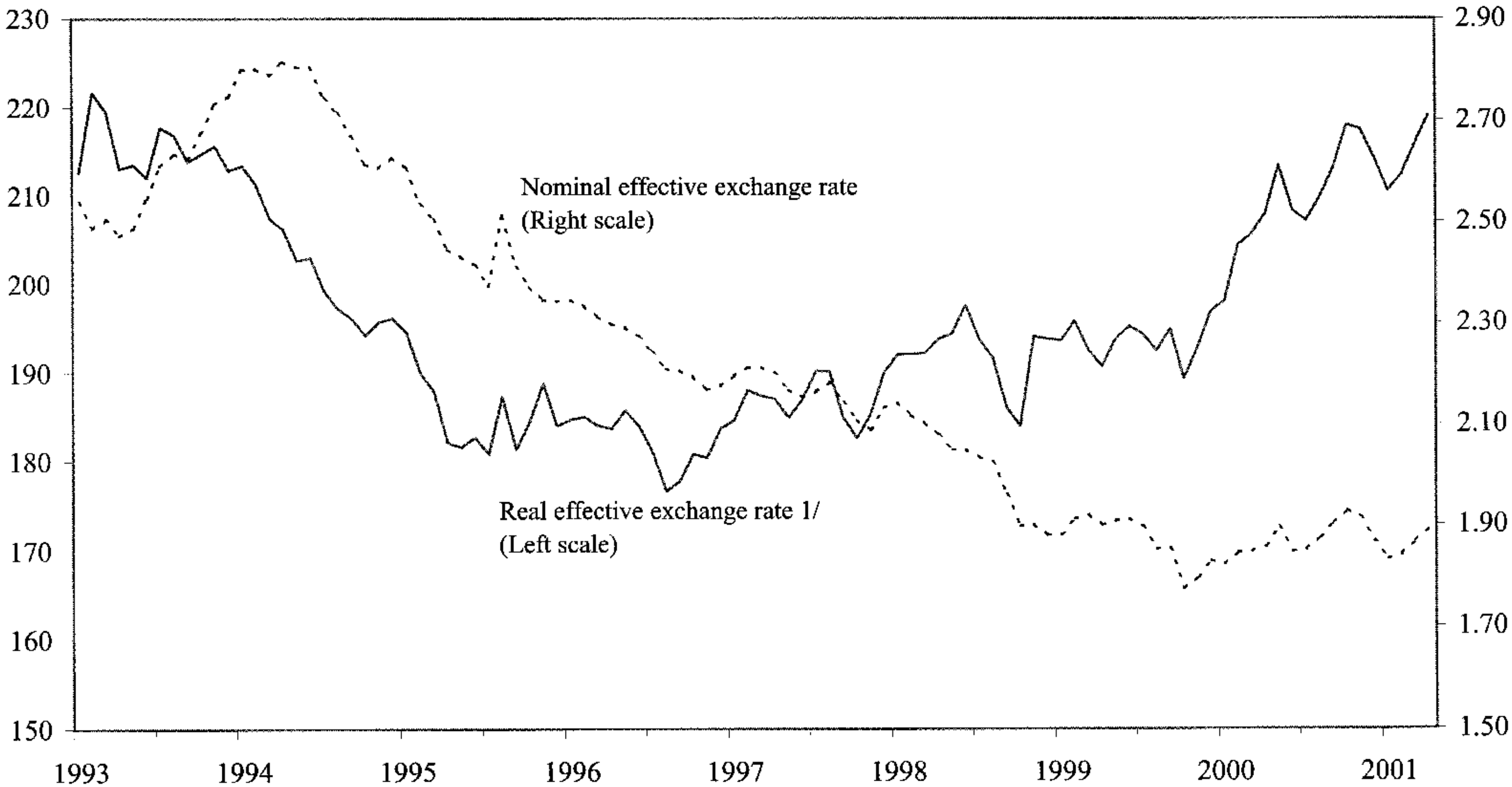
	Latest Observation				Same Region/Income Group	
	1970-75	1980-85	1993	1999	Latin America and the Caribbean	Low Income
Population						
Total population, mid-year (millions)	2.5	3.4	4.2	4.9	508.2	2,417.1
Growth rate (percent annual average for period)	3.3	3.1	...	2.7	1.6	1.9
Urban population (percent of population)	48.9	51.7	...	55.8	74.9	31.4
Total fertility rate (births per woman)	6.6	5.5	4.6	3.6	2.6	3.7
	(In percent of population)					
Poverty						
National headcount index	...	...	...	50.3	...	...
Urban headcount index	...	...	...	31.9	...	...
Rural headcount index	...	...	...	76.1	...	...
Income						
GNI per capita (U.S. dollar)	630	740	380	410	3,800	420
Income/consumption distribution						
Gini index	...	...	50.3	60.3	...	...
Lowest quintile (percent of income or consumption)	3.0	...	4.2	2.3	...	...
Highest quintile (percent of income or consumption)	65.0	...	55.2	63.6	...	...
Social indicators						
Public expenditure on:						
Health (percent of GDP)	...	...	...	8.3	3.3	1.2
Education (percent of GDP)	2.5	5.9	...	3.9	3.6	3.3
Social security and welfare (percent of GDP)	2.9	1.4	...	4.8	7.4	...
	(In percent of age group)					
Net primary school enrollment rate 1/						
Total	63	73	79	77	91	...
Male	...	71	...	77	...	...
Female	...	75	...	79	...	...
	(In percent of population)					
Access to an improved water source 2/						
Total	...	50	52	79	85	76
Urban	...	77	79	95	93	88
Rural	...	13	23	59	62	70
	(In percent under 12 months)					
Immunization rate						
Measles	...	49	81	97	90	64
DPT	...	35	78	83	87	70
Child malnutrition (percent under 5 years)	...	10	24	12	9	...
	(In years)					
Life expectancy at birth						
Total	57	61	67	69	70	59
Male	55	58	65	66	67	58
Female	59	64	70	71	73	60
Mortality						
Infant (per 1,000 live births)	93	71	58	34	30	77
Under 5 (per 1,000 live births)	168	143	72	43	38	116
Adult (15-59)						
Male (per 1,000 population)	348	277	...	200	207	288
Female (per 1,000 population)	283	189	...	137	122	258
Maternal (per 100,000 live births)	...	...	...	150	...	...
Births attended by skilled health staff (percent)	...	...	...	65	...	...

Source: 2001 World Development Indicators CD-ROM, World Bank.

1/ Net enrollment ratios exceeding 100 indicate discrepancies between the estimates of school-age population and reported enrollment data.

2/ Latest year for access to improve water source data is 2000.

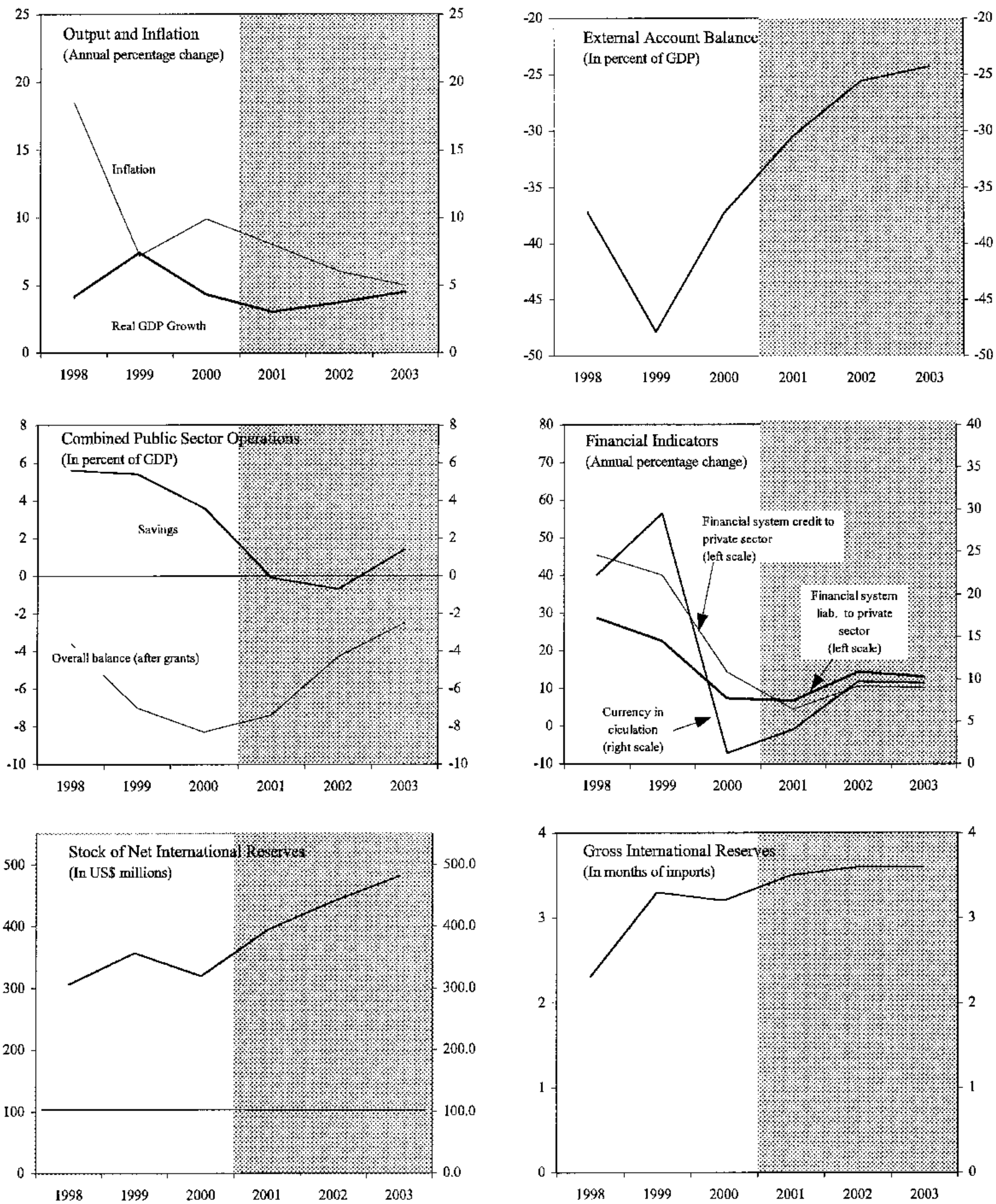
Figure 1. Nicaragua: Exchange Rate Developments
(1990=100)



Source: IMF Information Notice System.

1/ The real effective exchange rate is estimated as a trade-weighted index of nominal exchange rates deflated by seasonally adjusted relative consumer prices. An increase indicates an appreciation.

Figure 2. Nicaragua: Economic Performance in 1998-2000, and Projections for 2001-03



Sources: Ministry of Finance; Central Bank of Nicaragua; and Fund staff estimates and projections.
1/ Shaded areas represent estimates and projections.

Nicaragua: Fund Relations
(As of June 30, 2001)

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

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	130.00	100.0
Fund Holdings of Currency	130.01	100.0

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	19.48	100.0
Holdings	0.07	0.3

IV. **Outstanding Purchases and Loans**:	**SDR Million**	**Percent of Quota**
ESAF arrangements	127.33	97.9

V. **Financial Arrangements**:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
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):

	Overdue	**Forthcoming**				
	06/30/2001	**2001**	**2002**	**2003**	**2004**	**2005**
Principal	...	2.0	4.0	5.7	11.9	19.0
Charges/Interest	...	0.7	1.3	1.3	1.2	1.1
Total	...	2.7	5.3	7.0	13.1	20.1

VII. Implementation of HIPC Initiative:

	Enhanced Framework
Commitment of HIPC assistance	
Decision point date[1]	12/18/00
Assistance committed (2000 NPV terms)[2]	
Total assistance (US$ million)	3,267.0
Of which: Fund assistance (SDR million)[3]	63.0
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:

Under the Fund's safeguards assessment policy, Banco Central de Nicaragua is subject to a full Stage One safeguards assessment with respect to the ESAF/PRGF arrangement 03/18/1998, which is scheduled to expire on 03/17/2002.

A Stage One safeguards assessment of the Banco Central de Nicaragua is underway.

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.

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[1] Decision was approved in principle by the Fund.

[2] NPV terms at the completion point under the original framework; and NPV terms at the decision point under the enhance framework.

[3] Subject to satisfactory assurances regarding the exceptional assistance to be provided under the enhanced HIPC initiative by Nicaragua's other creditors.

As of June 30, 2001, the buying and selling rates in the official market were C$13.44 and C$13.57 per U.S. dollar, respectively.

X. Article IV Consultation:

Nicaragua is on the standard 12-month Article IV consultation cycle. The last consultation was completed by the Executive Board on September 15, 1999 (EBS/99/164 and SM/99/217).

XI. Technical Assistance:

Dept.	Purpose	Time of Delivery
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	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
STA	Mission on money and banking statistics.	June–July 1999

XII. Resident Representative:

Mr. Harnack assumed the position of Resident Representative in Nicaragua in March 1999.

Nicaragua—Relations with the World Bank Group
(As of June 30, 2001)

I. Financial Relations

A. Statement of Bank Loans and IDA Credits

(In millions of U.S. dollars)

Fiscal Year	Purpose	Bank	IDA	Undis-bursed
Thirty-one loans and 20 credits fully disbursed		**229.6**	**722.1**	
1995	Institutional Development Credit		23.0	0.2
1995	Basic Education[1]		47.2	1.1
1997	Rural Municipalities		30.0	0.4
1998	Road Rehabilitation and Maintenance II		47.4	18.3
1998	Health Sector Reform Project II		24.0	14.5
1999	Social Investment Fund III		45.0	10.6
1999	Forestry		9.0	5.4
2000	Telecommunications Reform		15.9	6.1
2000	Basic Education II		52.5	39.7
2000	Economic Management TAC		20.9	15.0
2000	Pension and Financial Markets		8.0	6.0
2000	Agricultural Technology and Rural Education		23.6	19.8
2001	Competitiveness LIL		5.0	5.0
2001	Road Rehabilitation and Maintenance		75.0	73.7
2001	Rural Municipalities II		28.7	27.6
2001	Natural Disaster Vulnerability		13.5	13.2
2001	Poverty Reduction and Local Development		60.0	58.5
	Sub-total		528.7	315.0
	Total	**229.6**	**1,250.8**	
	Of which: repaid	222.5	14.8	
	Borrower obligations	**2.3**	**646.1**	
	Amount sold	5.6		
	Of which: repaid	5.6		
	Total Undisbursed		**315.0**	**315.0**

Source: LCC2C staff estimates.

1/ Includes a supplementary emergency credit for US$13 million.

B. World Bank/IDA Loan Commitments and Disbursements

As of June 30, 2001, total loans/credits committed from the Bank/IDA amounted to US$1,292 million, of which US$315 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 1990s.

Since 1991, when IDA support was resumed, 26 credits, one supplementary emergency credit and six Fifth Dimension supplementary credits have been approved, totaling US$998 million. Nine 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, and finally a Road Rehabilitation and Maintenance Credit. The current portfolio consists of 17 projects aimed at: developing human capital (Health Sector Credit II and Basic Education Credit, including a Supplementary Emergency Credit); reviving agriculture and strengthening natural resource management (Rural Municipalities Credits I and II (PROTIERRA), Forestry Credit, and Agricultural Technology and Rural Education Credit); rehabilitating road infrastructure (Second and Third Road Rehabilitation Credits); institutional reform and strengthening of the public sector (Institutional Development Credit, and Economic Management TA); supporting the social safety net and combating rural poverty (Third Social Investment Fund Credit and Poverty Reduction and Local Development); 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); and improving disaster preparedness (Emergency Disaster Management Credit). In September 1997, a Global Environmental Facility Grant (GEF) of US$7 million was approved to fund the Atlantic Biodiversity Corridor Project. This project became effective following the submission to the Assembly on October 13, 1998 of the legislation to clarify communal property rights in the Atlantic region.

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$39.9 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.

In response to Hurricane Mitch, a Hurricane Emergency Project for US$50 million was approved on December 22, 1998 to provide balance of payments support for financing critical imports during the immediate reconstruction phase. Based on damage estimates, IDA has restructured seven ongoing operations within existing credit amounts to finance about US$63 million of hurricane-related expenditures. In addition, supplemental funding was approved on January 7, 1999 for the ongoing basic education project in the amount of US$13 million.

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 90 percent reduction on Nicaragua's debt service to IDA. As of June 30, 2001 Nicaragua had received US$2.8 million in IDA debt service relief.

II. Recent Nonlending IDA Assistance

IDA also provides a wide range of nonlending services to Nicaragua. IDA's Board of Directors discussed the Country Assistance Strategy for Nicaragua on April 9, 1998. A second Poverty Assessment: Challenges and Opportunities for Poverty Reduction has been completed (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. During FY 2000, the Bank also completed the Ex-Post Evaluation of the Emergency Social Investment Fund (December 7, 2000, Report No. 20400-NI) and a report on Nicaragua's Pension Reform (April 3, 2000, Report No. 19669-NI), providing the basis for recent pension reforms adopted by the government.

III. Plans for the Next 12 Months

Over the next few months, IDA will continue assisting the government in the PRSP process, including efforts to improve and strengthen the participatory process with civil society. In the first quarter of FY 2002, IDA will complete a Public Expenditure Review, which also aims to support the PRSP process. IDA is considering support for future projects including a Land Regularization Project, and Rural Electrification Project.

Nicaragua—Relations with the Inter-American Development Bank
(As of June 30, 2001)

I. Financial Relations

A. Statement of IDB Loans
(In millions of U.S. dollars)

Year	Purpose	Approved	Undisbursed
	Seventy loans fully disbursed	989.0	
1992	Nonconventional credit	23.6	0.7
1994	Agricultural service	16.1	0.7
	Pre-investment studies	9.0	1.2
1995	Roads	75.0	0.2
1996	Forestry resources conservation	15.3	1.2
	Lake Managua Basin management	15.0	13.7
1997	FISE III	50.0	1.7
	Rural development	40.0	15.6
1998	Electricity sector	76.1	48.4
	Financial sector reform	65.0	49.5
1999	Education reform	9.4	8.6
	Health modernization	48.6	43.7
	Roads	50.0	27.2
	Tax Administration	10.0	8.5
	Local Development	8.0	7.8
	Water supply modernization	13.9	13.8
2000	Social Protection Network	9.0	8.2
	Municipal support	5.7	5.5
	Lake Managua management	15.0	14.9
	FISE IV	50.0	49.5
	Support ERRP	10.0	9.9
	Transparency in Procurement	18.0	17.8
	Strengthening Family Ministry	1.0	1.0
	Educational Program	3.8	3.8
2001	Technology innovation program	6.8	6.7
	Strengthening of the judicial system	12.0	11.9
	Comprehensive child care program	25.0	25.0
Subtotal		**681.0**	
Total approved		**1,670.0**	
Total held by the IDB		**971.0**	

B. IDB Loan Commitments and Disbursements

In the November 1993–June 2001 period, 28 projects have been in execution totaling US$635.5 million (of which US$262.8 million has already been disbursed). The loan portfolio includes loans directed to the energy sector (US$76.1 million), water and sewerage (US$15.9 million), nonconventional credit (US$23.6 million), agricultural services (US$16.0 million), improvement of main roads (US$125.0 million), conservation and management of forestry resources (US$15.3 million), modernization of the tax administration (US$10.0 million), management of the Lake Managua Basin (US$60.9 million), local development (US$8.0 million), municipal support (US$5.7 million), and a program to aid children (US$3.5 million). These projects are proceeding normally. By 2000 several additional programs were approved (social protection network, municipal support, Lake Managua management, water supply modernization, strengthening Family Ministry, Support ERRP, Transparency in Procurement and an Education Program). In 2001 three projects were approved, Judicial System Program, Technology Innovation and a Comprehensive Child Care Program (Stage 2).

II. Recent Technical Assistance

In 2001, technical assistance also has been given for capacity building in poor communities, a national land use planning program and the strengthening of the Ministerio de la Familia. In 1999–2000 technical assistance for capital markets and privatization of electrical distribution were approved.

III. Recent Missions

In past months, several missions have visited Managua to finish the preparation of different projects considered in the 2001 pipeline, for a total of US$153 million, in the areas of improvement of roads, municipal development, poverty alleviation, technology innovation and management of forestry resources and social security reform.

IV. Plans for the Upcoming Months

A policy dialogue paper is being prepared to be presented and discussed with the next government, which will be the base for the Bank's country strategy for the 2002–04 period. In short the Board of Directors in going to considerate the intern relief within the HIPC initiative.

Nicaragua—Statistical Issues

The economic information for Nicaragua needs to be improved. The statistical problems are being addressed with the help of technical assistance from the Fund, IDA, the IDB, and the USAID. The authorities are fully cooperative in providing data to the Fund in a timely fashion, in some cases on a daily basis, directly by fax, e-mail, or through the resident representative. The Central Bank of Nicaragua (CBN) produces a monthly bulletin and an annual report covering developments in the monetary, fiscal, external, and real sectors. The CBN started providing statistical information to the general public through the Internet in 1996.

As to the coverage and timeliness of the reporting of data for the *IFS*, Nicaragua has reported data on monetary accounts regularly albeit with some lags, particularly on deposit money banks. The most recent complete data reported on national accounts refer to 1999. The GFS database includes annual data through 1995, except on expenditure by function, which are only through 1994. However, *IFS* covers budgetary central government data through February 2001.

Outstanding statistical issues

Among the major problems that affect the statistical information are the following:

Public sector finance

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 have made some progress in identifying the sources and reducing the size of the discrepancies.

External debt statistics

Data on the external debt of the government are in general good. Improvement of coverage is needed for external debt of public enterprises and of the private sector.

National accounts

Efforts are being made to improve national accounts data. The IDB is providing technical assistance on national accounts and trade price indices, via both a long-term consultant and short-term consultancies. The authorities have revised the methodology to prepare the national accounts data. This revision will be evaluated by an STA mission (September 2001).

Prices

Consumer price index (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.

Money and banking

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 money and banking statistics mission of June–July 1999 found that the CBN 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.

Balance of payments

The coverage of the Nicaraguan balance of payments statistics is somewhat incomplete, especially for the financial account. The balance of payments statistics mission that visited Nicaragua in August 1998 found that the balance of payments statistics compiled by the CBN have deteriorated since the end of the STA long-term technical assistance program in June 1994. 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 *2000 Balance of Payments Statistics Yearbook.*

Nicaragua—Core Statistical Indicators
(as of July 16, 2001)

	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	07/16/01	07/16/01	07/16/01	07/16/01	07/16/01	05/01	06/30/01	04/01	03/01	03/01	2000	05/01
Date Received	07/17/01	07/17/01	07/17/01	07/17/01	07/17/01	07/01/01	07/06/01	06/01	06/01	05/01	05/01	06/01
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: Bank Resolution Plans

Since August 2000, the Superintendency of Banks (SBIF) has intervened four banks accounting for about 40 percent of system deposits. To support orderly resolutions, the Central Bank of Nicaragua (BCN) provided liquidity support equivalent to US$130 million as of December 2000 to cover deposit withdrawals, and expanded open market operations by US$84 million in order to sterilize partially this liquidity injection. The fiscal cost of the first three interventions is estimated at around 9.5 percent of GDP in terms of the increase in the stock of public debt, and about 2.5 percent of GDP in terms of annual interest outlays. The cost of the most recent intervention is yet to be determined.

Interbank

On August 6, 2000, the SBIF intervened Interbank, the largest Nicaraguan bank, following the discovery of fraud associated with CONAGRA, an agricultural holding company. To stem the initial deposit flight, the BCN announced a full guarantee of all Interbank deposits. A *Junta Administradora*, which was changed to *Junta Liquidadora (JL)*, in October 2000, was set up to manage the intervened institution. Criminal charges were brought against board directors and managers of Interbank and CONAGRA. In addition, an embargo was put on CONAGRA's assets. However, the judicial process evaluating the criminal charges against the perpetrators of the Interbank fraud has been slow, and as of end-July 2001, the courts had not yet issued arrest warrants.

In October 2000, the authorities began implementing a two-step resolution plan involving participation by a domestic bank, Banpro. In the first step, Interbank's CONAGRA and other coffee-related assets were separated from the balance sheet and transferred to the JL. After evaluating the assets, the JL is to sell these assets and transfer the proceeds to the BCN in order to offset the credit provided.[1] In the second step, the remainder of the balance sheet was put under the administration of Banpro, which has been evaluating the assets and transferring impaired loans ("D" and "E") to the JL. This process is expected to be completed by August 30, 2001. The resulting deficit of assets over liabilities was covered by BCN paper (CENIS).

Bancafe

On November 17, 2000, following several months of unsuccessful attempts to improve the operations of Bancafe, the SBIF forcibly liquidated the bank. The government initially gave a limited guarantee to depositors, which was subsequently extended to a full guarantee. The portfolio of the bank was transferred to another domestic bank, Banco de Finanzas (BDF) along the lines of the Interbank/Banpro arrangement described above. BDF's

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[1] Until end-June 2001, only about US$1 million out of US$86 million extended in credit had been recovered by the BCN from assets sold.

credit portfolio vetting process ended on August 17, 2001. Judicial procedures have resulted in the jailing of several senior officials of Bancafe.

Bamer

In early 2001, as a result of detailed on-site inspections by the SBIF, Banco Mercantil (Bamer) with about 6 percent of banking deposits was found to be undercapitalized and suffering from cash flow problems. The authorities required the bank to increase its capital in the context of a normalization plan. However, due to a lack of action on the part of Bamer's shareholders, **the bank was intervened on March 5, 2001.** Bamer's portfolio and deposit liabilities were taken over by Bancentro under similar terms to the previous interventions.

Banic

In late 2000, the SBIF formally notified the shareholders of Banic of the bank's capital deficiency (US$10 million) and required them to place one third of the required additional capital by January 2001, with the rest to be subscribed by end-February. In March shareholders injected nearly US$4 million in new capital; this, in combination with a revaluation of fixed assets, resulted in the nominal compliance with the capital adequacy ratio. However, the bank continued to suffer from liquidity problems as evidenced by its failure to meet the reserve requirement, despite operating under a special reserve requirement regime granted by the SBIF (expired July 31, 2001). **On August 4, 2001 Banic was intervened** and the following day was auctioned off to Banpro, which had absorbed Interbank, in a similar operation to the previous interventions. The cost of the intervention will be known upon the completion of the asset valuation period lasting a maximum of nine months.

Statement by the IMF Staff Representative
September 19, 2001

1. The following information has become available since the "Staff Report for the 2001 Article IV Consultation and the Staff-Monitored Program (SMP)" (EBS/01/148) was issued. It does not change the thrust of the staff appraisal.

2. Through mid-September, however, net international reserves have continued to decline for a cumulative loss of US$200 million (compared with a targeted loss of US$43 million under the SMP for the period January–September 2001). The shortfall is mostly due to delays in completing privatizations (US$110 million) and disbursements of balance of payments support (US$35 million). The authorities now expect these resources to become available in October–November. As of September 11, gross reserves stood at US$325 million, or 2.0 months of imports of goods and services, compared with 3.2 months at end-2000.

3. Central bank financing to the government through end-August was below the levels envisaged under the SMP. However, although information is incomplete, there are indications that the government has accumulated new domestic arrears. The authorities have stated that they intend to eliminate all arrears before year-end, in line with the SMP.

4. The telecommunications company (ENITEL) was sold to a Swedish-led consortium on August 31 for US$83 million, with an initial payment of US$33 million that has not yet been made effective and five additional annual installments of US$10 million, in line with the SMP projections. The legality of the operation has been challenged in the courts by parties with claims on ENITEL and a ruling by the Supreme Court is expected within the next few weeks. The government had previously issued a decree guaranteeing payment of any court-approved liability. The privatization of the electricity generating plants, which was expected to take place in August and generate about US$90 million in 2001, has not been completed because potential investors declined to bid, citing legal concerns, including possible claims by third parties. The authorities have indicated that they are addressing the investors' concerns, including by providing, if necessary, government guarantees similar to those offered in the case of ENITEL. They expect to complete this privatization over the next month. Also, Nicaragua's request for the release of disbursements for US$35 million under the IDB financial and electricity loans is expected to be considered by the IDB Board by late September or early October.

5. The government is addressing the adverse effects of low international coffee prices and a drought in the North-Western region. As indicated in the staff report, the SMP envisages US$15 million in financial assistance from the government to coffee growers. While the authorities estimate that the effect of the drought on agricultural output would be limited, the impact at the regional level appears significant, with some 30,000 families losing more than 50 percent of their crops. Support is being provided by redirecting some US$3.7 million of previously committed IDB funds to fast disbursing assistance, and by emergency assistance from the World Food Program (WFP).

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 01/104
FOR IMMEDIATE RELEASE
October 2, 2001

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

IMF Concludes 2001 Article IV Consultation with Nicaragua

On September 19, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Nicaragua.[1]

Background

Economic performance during 1998 and the first half of 1999 was in line with the program supported by the three-year Poverty Reduction and Growth Facility (PRGF) arrangement approved in March 1998, despite the adverse effects associated with Hurricane Mitch. Policy implementation weakened in late 1999 and early 2000. In particular, fiscal policy was more expansionary than anticipated, as the combined public sector deficit increased and the external current account deficit widened significantly. In addition, the accumulation of net international reserves (NIR) fell short of programmed levels. Against this background, a modified program for 2000 was agreed with the authorities. However, economic performance deteriorated further during the final months of 2000 and the first half of 2001, with economic growth decelerating as investment tapered off from post-Hurricane Mitch highs. After increasing in 2000 as a result of higher energy costs, the 12-month rate of inflation declined to about 8 percent by mid-2001.

The deficit of the combined public sector in 2000, at 8.3 percent of GDP, was higher than anticipated, owing to substantial spending overruns in the fourth quarter of the year. These overruns were financed mainly by an accumulation of domestic arrears (mostly to suppliers). The fiscal stance remained weak during the first half of 2001 owing to the cost of bank resolutions, continued high spending, and payments of domestic arrears, which contributed to

[1] 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. This PIN summarizes the views of the Executive Board as expressed during the September 19, 2001 Executive Board discussion based on the staff report.

substantial central bank financing of the combined public sector and a decline in NIR of close to US$120 million.

While difficulties in the banking system intensified in 2000, the authorities took decisive actions to strengthen banking supervision. In addition, since August 2000 four banks, found to be weak through on-site inspections, were intervened and their performing assets sold to other private banks. The increase in central bank debt associated with the first three bank resolutions is estimated at about 10 percent of GDP, while the cost associated with the bank is still being evaluated. Demand deposit growth, after declining in late 2000, has been recovering in 2001. However, the growth of broad money has continued to decelerate, with evidence of portfolio shifts toward liquid assets. Similarly, after a marked slowdown in 2000, the expansion of bank credit to the private sector slowed further in the first half of 2001.

Exchange rate policy continued to be based on a 6 percent annual rate of crawl vis-à-vis the U.S. dollar. The real effective exchange rate appreciated by about 11 percent during the 18-month period ending on June 30, 2001, largely as a result of the appreciation of the U.S. dollar, while the terms of trade deteriorated owing to a significant drop in coffee prices and an increase in oil-import prices.

Structural reforms advanced during 2000 and so far in 2001. The national assembly approved legislation to reform the social security system and improve government procurement. In addition, the electricity distribution companies were privatized. As regards governance, efforts to improve the efficiency of the Comptroller's Office have continued and property rights have been strengthened with the establishment of mediation courts and the approval of a law on administrative procedures and dispute settlement.

Discussions on the third annual PRGF arrangement could not be completed because delays in addressing policy slippages during the first part of 2001 made it unfeasible to bring the program back on track in 2001. The authorities' program for July–December 2001, which they have requested the staff to monitor as a Staff-Monitored Program (SMP), aims at advancing toward macroeconomic stability and implementing pending structural measures. This will facilitate the transition to the new administration that will take office in January 2002, and help build a track record for a program that could be supported by a new three-year PRGF to be negotiated in 2002. The authorities' program assumes a GDP growth rate of 3 percent, the continuation of a 6 percent annual exchange rate crawl to the U.S. dollar, and targets an inflation rate of 8 percent by year-end.

The authorities' fiscal program aims at reducing the combined public sector deficit to 7.4 percent of GDP in 2001, by restraining expenditure growth during the second half of the year. The monetary program envisages an increase in base money in line with nominal GDP growth and a contraction in central bank net domestic assets. These policies in combination with the privatization of the electricity generating plants and a 40 percent stake in the telecommunications company and the release of balance of payments support would allow for an accumulation of NIR of US$50 million.

The authorities have prepared a Poverty Reduction Strategy Paper (PRSP) that presents a comprehensive and coherent strategy to reduce poverty in Nicaragua; the outlined macroeconomic policies provide an appropriate medium-term framework and a solid basis for concessional assistance and debt relief.

Executive Board Assessment

Directors observed that adverse terms of trade shocks, a decline in investment from high post-Hurricane Mitch levels, drought, and slippages in policy implementation, particularly in the fiscal and monetary areas, had contributed to the recent weak performance of the Nicaraguan economy. Economic activity slowed in 2000–01, the fiscal position has deteriorated, and international reserves have declined. Some Directors were disappointed that discussions on the third annual PRGF arrangement could not be completed because of delays in addressing policy slippages. Directors emphasized the importance of establishing a track record in policy implementation as a necessary element for continued support for HIPC and PRGF participation.

Against this background, Directors welcomed the authorities' intention to restore macroeconomic discipline in the context of an SMP for the period July–December 2001, although a few Directors would have preferred that it continue into 2002. Noting the risks associated with further slippages, Directors stressed that meeting all program targets for end-2001 is critical to maintaining the positive outlook envisaged in the PRSP, relieving pressures on the balance of payments, and building a track record in preparation for a possible new three-year PRGF arrangement, which could be discussed with the new administration taking office in January 2002.

In particular, Directors noted that an effective implementation of the fiscal program under the SMP, together with a stepped-up effort on the envisaged privatization and structural reforms, is crucial to maintaining macroeconomic stability, laying the basis for sustained growth, and strengthening the reserve position. In this context, Directors expressed concern about the continued decline in reserves experienced in recent weeks. They stressed that the authorities should stand ready to further restrain government expenditure and raise interest rates, as needed, to encourage the rollover of maturing central bank debt in order to protect the reserve position.

Directors noted that the achievement of medium-term fiscal and external sustainability requires a strong effort to increase the efficiency of public spending, focusing it on delivery of key social services, while increasing public savings by raising government revenue. In this regard, they stressed the importance of implementing a comprehensive tax reform in 2002, including by eliminating exemptions and special regimes under the value added tax and import taxes.

Directors welcomed recent steps to improve liquidity management and strengthen the banking system, including the intervention of Banco Nicaraguense de Industria y Comercio (BANIC). They urged the authorities to push ahead with current plans to improve prudential norms and reinforce bank supervision, noting that vulnerabilities remain.

Directors welcomed the progress made in improving the efficiency of the Comptroller's Office, implementing the new government procurement law, strengthening the institutions for the resolution of property rights, and approving legislation to reform the social security system. They stressed the need to proceed with the planned actions to further improve governance and transparency in the public sector.

Directors welcomed recent steps to deepen trade liberalization, including the removal of the temporary protection tariff. They urged the authorities to implement promptly pending measures on intellectual property rights and customs valuation, and to eliminate the punitive 35 percent tariff charged on imports from two countries in the region. Directors agreed that the crawling peg exchange rate system has served Nicaragua well, but stressed that its viability hinges on the implementation of prudent fiscal and credit policies. Some Directors indicated that there is also a need to assess the long-term impact of secular changes in coffee prices, and its implications for the external sector and exchange rate policy.

Directors were of the view that the PRSP prepared by the authorities constitutes a very comprehensive and coherent strategy to reduce poverty in Nicaragua, and that it could serve as a solid basis for concessional assistance and debt relief once the authorities have established a satisfactory track record of policy implementation. They noted, however, that the authorities should develop a structured action plan to ensure broad-based participation in the implementation of the poverty strategy, an integrated financial management system to monitor implementation and track poverty-related spending, and a set of economic indicators to complement social indicators in monitoring the progress in poverty reduction, with a focus on the poorest segments of society. Directors also encouraged the authorities to strengthen the institutions involved in implementing the strategy.

While statistical information was regarded as sufficient for surveillance purposes, Directors urged the authorities to strengthen both the quality and the timeliness of data, and stressed the importance of advancing in the revision of the national accounts.

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. A Staff Report for the 2001 Article IV Consultation with Nicaragua is also available.

Nicaragua: Selected Economic Indicators

	1997	1998	1999	2000	SMP 2001
(Annual percentage change; unless otherwise indicated)					
National income, prices, and unemployment					
GDP at constant prices	5.1	4.1	7.4	4.3	3.0
Consumer prices (end of period)	7.3	18.5	7.2	9.9	8.0
Consumer prices (period average)	9.2	13.0	11.2	11.6	8.3
Unemployment rate (percent)	14.3	13.2	10.7	9.9	...
External sector					
Exports, f.o.b.	-6.6	-0.6	-4.9	18.3	-6.1
Export volume	-7.2	-2.3	9.3	21.1	-1.7
Imports, f.o.b.	12.8	0.9	23.1	-5.7	-4.5
Import volume	19.7	8.6	15.9	-15.9	-5.2
Terms of trade (deterioration -)	6.8	7.7	19.1	-12.8	-3.7
Nominal effective exchange rate end of period (depreciation -)	-2.0	-11.9	-2.7	2.1	...
Real effective exchange rate end of period (depreciation -)	3.5	2.0	1.6	8.8	...
Money and credit					
Net domestic assets of the central bank 1/	-36.8	27.5	-39.3	22.7	-35.5
Net credit to nonfinancial public sector 1/	132.3	-85.8	-75.6	-36.2	-23.7
Net credit to financial institutions 1/	-22.3	-4.8	-2.6	95.4	-45.0
Currency in circulation	26.8	22.2	29.5	1.2	4.0
Financial system liabilities to private sector	65.6	28.6	22.4	7.3	6.6
Financial system credit to private sector	9.7	45.3	40.0	14.2	4.4
Money income velocity (GDP/M3)	1.6	1.6	1.5	1.6	1.7
Interest rate on deposits (percent per annum) 2/	11.5	12.4	11.5	11.2	...
(In percent of GDP)					
Public sector					
Combined public sector saving 3/	4.0	5.6	5.4	3.6	-0.1
Combined public sector overall balance (before grants) 3/	-9.7	-7.4	-15.7	-15.7	-14.9
Combined public sector overall balance (after grants) 3/	-4.5	-3.6	-7.0	-8.3	-7.4
Nonfinancial public sector saving	4.5	8.9	7.1	5.2	3.6
Nonfinancial public sector overall balance (before grants)	-9.2	-4.1	-14.0	-14.1	-11.2
Central bank operational results (deficit -) 4/	-0.5	-3.3	-1.7	-1.6	-3.7
Savings and investment					
Gross domestic investment	30.5	33.8	43.3	34.4	28.5
Public	13.7	13.0	21.1	19.2	14.2
Private	16.8	20.8	22.2	15.2	14.3
National savings	3.3	2.3	1.4	3.0	0.2
Public	4.0	5.6	5.4	3.6	-0.1
Private	-0.7	-3.3	-4.0	-0.6	0.3
External savings 5/	27.2	31.5	41.9	31.4	28.3
External sector					
External current account balance	-31.8	-37.2	-47.9	-37.3	-30.5
(Excluding interest obligations)	-21.3	-26.9	-37.7	-27.0	-22.3
Trade balance (deficit -)	-30.1	-39.2	-52.3	-40.1	-36.8
Outstanding external public debt (end of year)	296.7	296.0	289.0	278.0	...
(In percent of exports of goods and nonfactor services)					
Contractual debt service	50.2	43.5	47.1	44.1	38.5
Gross international reserves (in months of imports)	2.5	2.3	3.3	3.2	3.6

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

1/ In relation to currency in circulation at the beginning of the year.
2/ Six-month deposits, end of period.
3/ Includes central bank operational losses.
4/ For 2001, includes the cost of bank resolution on accrual basis.
5/ External current account deficit, excluding interest on debt to non-Paris Club bilateral creditors that is eligible for debt rescheduling and deferred interest to Paris Club.

Statement by Hernán Oyarzábal, Executive Director and Orlando Garner, Advisor to the Executive Director for Nicaragua
September 19, 2001

Introduction

On behalf of our Nicaraguan authorities, we would like to thank the staff for the candid report on the recent economic trends and financial developments in Nicaragua and for the support and helpful policy advise offered during the discussion related to the 2001 Article IV Consultation.

The staff appraisal clearly recognizes the effects of external shocks over a small open economy such as that of Nicaragua. The impact of the collapse of coffee prices—principal export item of Nicaragua—the increase in oil prices, and the culmination of the public investment program associated to post-hurricane Mitch reconstruction efforts are all correctly emphasized. Real GDP growth slowed in 2000 as a result of the reduction in construction activity with respect to post-hurricane Mitch level, the decrease in manufacturing, and the impact of the sharp drop in international coffee prices. Inflation rose to 10 percent during 2000, reflecting higher energy costs and domestic demand pressures. While inflation is expected to decline in 2001, GDP growth is envisaged to behave as in 2000. The deterioration of Nicaragua's terms of trade continued in 2001 and is still affecting adversely real income and transmitting recessive pressures to aggregate demand, therefore resulting in a negative impact on programmed public revenues.

Monetary and Financial Policies

During the second semester of 2001, the Nicaraguan authorities are committed to run a tight monetary policy and had expressed that they will conduct open-market operations only to carry out credit policy consistent with the program's inflation and balance of payment objectives. Government deposits are expected to increase during the second semester as a result of programs aimed to reduce fiscal expenditure, the resources coming from privatization, and the projected level of balance of payments disbursement. Even though Net International Reserves decreased in 2000 as a result of the effort to preserve financial and exchange rate stability, they are expected to rise by US$ 50 million at the end of 2001; representing an increase of about US$ 170 million during the second half of this year, and it assumes the elimination of domestic floating debt. These targets are to be achieved once the delays in the privatization process are resolved in the coming weeks. Also, conditions for IADB disbursements have been met, so it is expected than in October those disbursements will be effected.

In order to reduce inflationary pressures arising from excess liquidity in the banking system, reserve requirements were temporarily increased two percentage point in August and one additional point in September, and will continue to increase if the financial conditions require it.

The authorities concur with the staff's view related to the risk associated with the level of Central Bank paper in the market and the proximity of its maturity date. They have taken measures to reduce this stock in an amount of approximately US$ 25 millions and they have indicated that they are prepared to raise interest rates, if necessary, to allow for a rollover of the Central Bank short-term debt.

Regarding the financial system, authorities believe that, unfortunately, the negative effects of the external shocks have coincided with the intervention by the authorities of several banks due to fraudulent operations. The Nicaraguan authorities are committed to strengthen financial supervision and prudential norms with the support of IADB and WB.

The authorities' commitment to preserve the integrity of the financial system was demonstrated in August 4 of this year, when BANIC was intervened and liquidated after an intensive process of talks between the owners and the authorities, conducted with the purpose of increasing the level of capital of this institution, and afterward, looking for a market-led solution (merger or acquisition). The Bank's situation remained unstable as the owner was unable of bringing up the level of required capital. Finally the Bank was intervened and its assets and liabilities auctioned in an open bidding process.

The Nicaraguan authorities are in the process of establishing the legal basis for the building of a new entity that will manage effectively the non-performing assets from the intervened banks. The World Bank will assists them in this effort. By the same token, the authorities will comply with the objective of the liquidation of those assets in 2001.

Fiscal Policy

The staff report correctly presents the trend of public spending. An intensive program of public investment determined by the need for reconstruction after hurricane Mitch, and the impulses for higher current expenditures—in part stimulated by the coming electoral process, but also responding to the fragility of the social situation of the country—has not been able to achieve a sustained equilibrium between productive effort and the need for income redistribution.

With the purpose of getting the fiscal accounts back on track, the authorities are addressing the combined public sector deficit by cutting expenditures and setting monthly ceilings on government expenditures and domestic financing. There is also an agreement to report the performance of these targets every month and if cumulative deviations over the target occur, consultation with the Fund staff would have to take place. These actions will lead to a reduction of the combined public sector deficit from 8.3 percent in 2000 to 7.4 percent of GDP at the end of 2001, an important effort taking into consideration that this deficit includes: the bank resolution cost (equivalent to 2.5 percent of GDP), the election process cost (0.3 percent of GDP), and the cost of the mechanism to assist coffee growers (0.6 percent of GDP). In addition, the improvement in fiscal discipline in the second half of

2001 will facilitate the transition to the new administration that will take office in January 2002, and will pave the way for a new three-year PRGF.

The Nicaraguan authorities also renew their commitment to the objectives of the HIPC initiative through the execution of social programs to ensure broad-based economic growth, improved human capital, reinforced institutional development and also to provide a social safety net for the more vulnerable groups. While reducing expenditures, the government will focus its resources on programs related to poverty reduction. Non-Mitch related social expenditure is expected to increase from 12.4 percent of GDP in 2000 to 12.8 percent of GDP during 2001.

Moreover, these resources will be subject to more transparency and control, as they will be channeled through the new Law of Public Contract, and the System of Financial Management and Audits (SIGFA). Their prioritization will be according to the poverty map of the PRSP.

External Sector Policies

Our authorities share the staff's views regarding the exchange rate policy and concur that in order to maintain the crawling peg rate at 6 percent vis á vis the US dollar, they need to conduct sound economic policies and a financial program aimed at improving economic performance that will allow the country to achieve macroeconomic sustainability in the medium term.

In the field of debt management, the Nicaraguan authorities have expressed their willingness to maintain no arrears related to the non-rescheduled debt, and service has been made according to schedule. A rescheduling agreement has been reached with the Central American Integration Bank (CABEI) and Guatemala with the support of the Government of Spain. With regard to IADB, payments have been made using a policy of 15 to 30 days after the due date, which is accepted by this institution as no arrears. Moreover, the authorities have expressed their firm commitment to only obtain highly concessional loans and grants, according to the external debt capacity and the balance of payments of Nicaragua.

Structural Reforms

In terms of structural reforms, the Nicaraguan authorities have taken important steps. Privatization of two major enterprises, the Nicaraguan Electricity Company generating plants and the Telecommunication Company has advanced considerably. In August, the Telecommunications Company was sold for US$ 83 millions, more than anticipated in the program. In this case, the government issued a decree assuming any liability regarding problems associated with the legality of the operation, which was challenged in the courts. In addition, the Government stands ready to take similar or additional actions to ensure the privatization of the electricity generating plants, to be carried out within the next few weeks.

Additional reforms are envisaged in the public sector, such as the establishment of a privately-managed pension system that will have a supervisory agency and is expected to award operating licenses no latter than November 2001.

As regards to the financial system, in order to reinforce confidence in the system and to avoid further central bank liabilities, the authorities will complete two cycles of on-site assisted bank inspections. In the first one, measures will be taken to address weaknesses that might be found. In the second cycle, inspection will be conducted on the banks that absorbed the intervened financial institutions, and at the same time, once again, on banks where weaknesses were identified in the first cycle. In both cycles strengthening programs will be adapted if necessary. Moreover, modifications of prudential norms in compliance with the best international practices are expected to be implemented no later than this month, and it is anticipated that the national assembly will approve a revision of the criminal code defining financial crimes.

In the governance area, the authorities have indicated, as structural benchmarks, measures to increase transparency in the use of public funds by implementing the SIGFA. Although this system is expected to be in full use in three ministries by December of 2001, the 2002 budget is being prepared according to the norms and procedures of the SIGFA. Moreover, in the Judicial System two new instruments are expected to be approved by the National Assembly, the code on criminal proceedings and the law to strengthen decentralized real state registries.

Strengthened Growth and Poverty Reduction Strategy Paper (SGPRS)

The SGPRS is a revised version of the interim PRSP that was presented to the Board for discussion in December last year. Since then this document has been under the scrutiny and review of the most representative sectors of the Nicaraguan society, consultations have taken place within the government, civil society, donor countries, stockholders and beneficiaries of the strategy. A list of more than 140 meetings is provided in annex one of the SGPRS, including meetings with the Municipalities of Norte de Leon in February this year.

The join staff assessment clearly indicated that the SGPRS emerged from an intensive consultation process carried out by the authorities and the National Council for Social and Economic Planning (CONPES), that resulted in a document that contains not only a description of the consultation process but also provides a summary of comments and the recommendations received. This revised document will guide Nicaragua throughout the implementation of the strategy during the following five years. It also conveys our authorities' commitment to the goals of international development proposed by the OECD-DAC by the year 2015, especially the task of cutting poverty in half.

The poverty reduction strategy, as explained in the staff report, rests in four basic pillars: a) broad-based economic growth and structural reforms, b) greater and better investment in human capital, specially of the of the poor to enhance their productivity, income and welfare,

c) better protection of vulnerable groups and, d) good governance and institutional development, essential for stimulating economic growth and furthering poverty eradication. In addition the strategy addresses the issues of the country's ecological vulnerability, social inequality, and the need for greater decentralization.

In order to reduce poverty the strategy considers broad-based economic growth as a crucial factor and makes emphasis on policies to foster productive employment and to support rural development.

As recognized by staff, the macroeconomic and structural policies envisaged in the PRSP are consistent with the objectives of reaching macroeconomic stability and external viability as prerequisites for sustained growth in the long run. To support the strategy the Government is committed to: reallocate expenditures toward programs associated with poverty reduction; increase public saving; prioritize investment projects favoring those with higher social impact; and, increase the participation of civil society in the implementation of the strategy.

In regard to macroeconomic indicators, the authorities expect to reduce inflation from 10 percent in 2000 to 4 percent in 2005, and to speed up economic growth in 2002 to reach 5 percent by the year 2004-2005. Economic growth will be bolstered by the increase in exports and private investment associated with the rehabilitation of the agricultural sector, the completion of the privatization program and the establishment of private pension funds.

The stabilization effort will be supported by prudent fiscal policy that considers the implementation of a tax reform in 2002 and the reduction of capital expenditure to historical pre-Hurricane Mitch levels (10 percent of GDP). Also, there will be a reallocation of expenditures toward high-impact social programs.

The goals, targets and intermediate indicators of this PRSP are consistent with the IDGs and were selected on the basis of the poverty analysis, the participatory consultation process and the review of the country's commitments made in various international events. Targets like reducing external poverty by half by 2015; reducing child malnutrition to 7 percent; expanding coverage of sanitation services to 95 percent; and reducing illiteracy to 10 percent all by 2005, are consider feasible by Nicaraguan authorities, in light of the national consensus reached on the consultation process to elaborate the PRSP.

Recent Events

The vulnerability of Nicaragua has become even more evident in recent weeks as the impact of low international coffee prices and a drought affecting the northwestern region have hit the lives of susceptible groups. It is estimated that the effect of the drought on national agricultural output will be limited, but the impact on producers and employment is significant, with some 30,000 families (180,000 people) losing up to 50-90 of their planted areas. To deal with these problems, the government has established a US$ 15 million financial assistance program for the preparation of the next coffee crop. Additionally, the authorities are providing emergency assistance for US$7 million through job-for-food programs, which are funded by USAID and WFP and will cover some 50,000 families. A similar program is being implemented in the areas affected by low coffee prices, through the Secretary for Social Action, benefiting about 1,600 families. An additional production support program will be implemented to help some 20,000 producers in the next seed season with US$ 1 million, provided by FAO, PL–480 and Fondo de Crédito Rural; other assistance is being provided by redirecting some US$5 million of previously committed IDB funds to fast disbursing assistance. This assistance is benefiting about 28,000 families.

Finally, the authorities want to reassure their commitment toward sound macroeconomic policies, poverty reduction and economic growth. A full implementation of a Staff Monitored Program during the rest of the year, in compliance with the established quarterly benchmarks, will result in an improvement of the fiscal performance as well as an strengthening of the banking sector. In addition, these achievements will pave the way for a new three-year PRGF in the context of the SGPRS.