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Nicaragua: Letter of Intent, and Technical Memorandum of
Understanding

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Nicaragua—Letter of Intent



GOVERNMENT OF NICARAGUA

April 8, 2011

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C.

Dear Mr. Strauss-Kahn:

1. The Nicaraguan economy has continued to perform well. All quantitative performance criteria for December 2010 under the Extended Credit Facility (ECF) have been met; this has fostered macroeconomic stability, while further advancing fiscal consolidation, protecting social expenditure, and strengthening the international reserves position. The supplementary agenda also has made headway. For the remainder of 2011, the Government of Reconciliation and National Unity (GRUN) will continue implementing prudent macroeconomic policies, with particular attention to the potential impact of increases in international commodity prices on the economy.

Macroeconomic framework 2011

2. Following a decline of 1.5 percent in 2009, gross domestic product (GDP) recovered in 2010, growing at a rate of 4.5 percent, supported by increases in domestic and external demand. For 2011, the recovery in GDP is expected to continue, albeit at a slower pace (in the range of 3.5–4 percent), reflecting the impact of higher oil prices. Inflation in 2010 rose to 9.2 percent, due in part to the impact of heavy rain falls in September and October on the supply of foodstuffs in the basic consumption basket. In 2011, inflation is expected to hover around 8.5-9.5 percent, primarily reflecting the impact of increases in international agricultural and energy commodities. In line with the economic recovery, the external current account deficit in 2010 rose to around 14.8 percent of GDP. The decline in the terms of trade expected for this year will result in a further deterioration in the current account deficit, which may reach 18 percent of GDP by year end. It is expected that the current account deficit will continue to be financed with foreign direct investment and

official cooperation flows (to the public and private sectors), which will help to maintain a sound international reserves position.

Fiscal policy

3. The government will continue implementing a prudent fiscal policy during 2011. The government has sent to the National Assembly an amendment to the General Budget of the Republic that will lower the central government deficit after grants by approximately 0.4 percentage points of GDP relative to the program. Attaining this new target will be facilitated by the more favorable outlook for tax revenues, reflecting the higher level of economic activity, as well as changes in income tax withholding for commercial banks. The increased resources will be used primarily to lower government borrowing and increase the budgetary provisions required by the programs of electricity subsidies for pensioners and disadvantaged neighborhoods, and for food transfers. At the same time, the Nicaraguan Social Security Institute (INSS) will continue strengthening its management in order to achieve a surplus of at least 0.9 percent of GDP. These policies will help to ensure that the overall deficit of the consolidated public sector (CPS) does not exceed 1.8 percent of GDP during 2011 and that the monitorable wage bill as a share of GDP remains constant. In the event that tax revenue collection exceeds the new projected level, and in the absence of new shocks that alter the macroeconomic environment, the excess resources will be used to reduce domestic debt.

4. The government will continue its efforts to improve the effectiveness of public expenditure—in particular, expenditure on social programs. Accordingly, the authorities are preparing a report assessing the implementation of the National Human Development Plan during the period 2009–10 on the basis of surveys jointly financed by the World Bank (WB) and the Inter-American Development Bank (IDB); it is expected that this report (including publication of the surveys) will be completed in August 2011. With respect to the tax system, the government will continue exploring ways of reducing the number of exemptions, and of establishing a regulation on transfer prices. Tripartite discussions will continue among workers, the business community, and the government to study the range of options for improving the financial position of the pension system while gradually correcting its actuarial deficit. At the same time, the authorities will continue assessing INSS' investment regulations to ensure that its portfolio management is in line with international best practices.

Monetary and Financial Policy

5. Monetary policy will remain focused on protecting international reserves, containing inflation, and maintaining adequate levels of liquidity in the banking system in a context of rising international commodity prices. Following the increase of over US\$100 million observed in 2010, adjusted net international reserves (NIR-Adjusted, excluding SDR allocations) are expected to decline by US\$55 million in 2011. The decline will be the result of lower commercial banks' deposits at the central bank and placements of securities by the monetary authority. The rate of crawl of the exchange rate will be maintained at 5

percent during 2011. The Central Bank has published its audited financial statements for 2010, prepared in the context of its new Central Bank Charter.

6. The banking system is stable. Commercial banks continued restructuring their credit portfolios during 2010 and their profitability is expected to improve in 2011. The recent implementation of norms on the computation of minimum capital requirements is an appropriate macroprudential measure that will allow for balanced credit growth. The monetary and financial authorities will continue to implement measures to safeguard the soundness of the financial system including on-site supervision, to monitor the quality of credit portfolios and indicators of deposit concentration. In addition, the Superintendence of Banks and Other Financial Institutions plans to start implementing the stress test methodology on a pilot basis. The government will ensure that the legislative framework promotes the sound development of credit markets, including by keeping the policy of market-based determination of interest rates.

External Financing

7. Concessional resources will remain important for the financing of the government's economic program, and budgetary assistance flows are projected to reach to US\$45 million. Concessional resources will continue to be allocated to financing social programs and investment in infrastructure; nonconcessional borrowing will be strictly controlled, while efforts will be stepped-up to obtain increased access to concessional resources; and the management of public debt will continue to be strengthened, in cooperation with the IMF and the World Bank. In the context of the HIPC Initiative, further efforts will be made to restructure external debt pending relief.

Supplementary agenda

8. **Electric power sector.** The significant increase in oil prices will pose major challenges for the electricity sector during 2011. The average cost of electric power generation has outpaced the tariffs currently in effect. To forestall the impact that a sharp increase in electricity tariffs would have on economic activity and households, the government announced that aid resources from Venezuela will cover the gap between costs and tariffs. Use of these resources will not create public debt. The government will review the situation in the electric power sector in June, in order to establish, if necessary, a tariff adjustment timetable; the government will also assess options for more effective targeting of subsidies. To ensure the normal functioning of the sector, the central government will guarantee through the budget the payments of its electricity bill and of the energy consumption subsidies for customers paying social tariffs, pensioners, and disadvantaged neighborhoods.

9. **Water and sewerage.** In cooperation with the World Bank, the IDB, and the Spanish foreign aid authorities, the Nicaraguan Water and Sewerage Enterprise (ENACAL) will continue implementing its infrastructure investment program, which will enable ENACAL to improve its service and reduce the levels of unbilled water. At the same time,

ENACAL will continue its efforts to collect overdue bills, and the Nicaraguan Water Regulation Agency (INAA) will begin reviewing the need to adjust water tariffs.

10. **Strengthened monitoring of external aid flows.** The central bank has published the sixth report on cooperation, including detailed information on the uses of foreign aid in 2010. The government will continue to ensure that the use of foreign aid does not generate fiscal contingencies or sharp fluctuations in the level of bank deposits, and will consult with the Fund to ensure that the use of such aid is in line with the economic program.

11. **Strengthening of the public administration.** With financial and technical assistance from the World Bank and the IDB, specific steps are being taken in the following areas: (i) the terms of reference for a study to assess the budgeting for permanent and temporary positions in the central government have been completed; (ii) the Office of the Comptroller General of the Republic will publish an audit of the National Budget for the year 2009 by end-June 2011; the government will also take steps to ensure that public enterprises publish their audited financial statements; (iii) further progress has been made in strengthening tax and customs administration based on a work plan implemented with assistance from the Regional Technical Assistance Center (CAPTAC-DR); the government will also seek approval of a new Customs Law consistent with best practices; and (iv) further efforts will be made to strengthen liquidity management, in order to bring about a reduction in floating debt, while revising the coupon on new public debt issues to reflect the decline in market financing costs.

12. **Reform of the microfinance sector and strengthened monitoring of cooperatives.** The government remains committed to promoting the sound development of microcredit and of a payment-oriented culture in general. In this respect, before end-July 2011 the government will secure the approval of a Law providing a regulatory framework for entities operating in the microfinance sector with the aim of strengthening supervision, transparency, and efficiency in the sector (*new structural benchmark*). Also the monitoring of the activities of cooperatives will be stepped-up. Specifically, the oversight authority will issue rules to establish standard criteria to facilitate the publication of the audited financial statements of savings and credit cooperatives.

13. In view of the progress in implementing the ECF and the framework submitted for the remaining policies, we hereby request approval of the sixth review and seventh disbursement of the ECF in the amount of SDR 5.55 million. Performance under the remainder of the program will be evaluated on the basis of an additional review expected to occur in mid-October 2011, and in accordance with quantitative performance criteria for end-June 2011, which are included in Table 1. Prior actions and structural benchmarks through end-2011 are shown in Table 2. The government believes that the policies described in this letter are sufficient to meet the objectives of our economic program and we stand ready to take additional measures that may be needed for this purpose. In addition, we will consult with Fund staff regarding any measures that could have a potential impact on the program.

Sincerely yours,

/s/

Antenor Rosales Bolaños
President
Central Bank of Nicaragua

/s/

Alberto Guevara Obregón
Minister
Ministry of Finance and Public Credit

Table 1. Nicaragua: Quantitative Performance Criteria and Indicative Targets, 2010-11 1/

	2010		2011			
	Jan-Dec		Jan-Jun		Jan-Dec	
	Adj. Prog.	Prel.	Prog.	Prop. Prog.	Prog.	Prop. Prog.
Performance Criteria (Jan-Dec 2010, Jan-Jun 2011, indicative targets otherwise)						
	<i>(In millions of Córdoba)</i>					
1. Floor on combined public sector overall balance, after grants 2/	-3,418	-1,982	-1,844	-875	-3,314	-2,896
2. Floor on Social Security Institute (INSS) overall balance, after grants	1,415	1,492	1,016	982	1,495	1,400
3. Ceiling on change in net domestic assets of the central bank 3/ Cumulative flows from end-June 2010 4/	1,560	-182	680	230	1,573	2,348
	2,549	807	3,230	1,037	4,122	3,155
	<i>(In millions of US dollars)</i>					
4. Floor on change in net international reserves of the central bank 3/ Cumulative flows from end-June 2010 4/	-35	105	-70	-70	-40	-55
5. Continuous ceiling on nonconcessional external debt contracted or guaranteed by the consolidated public sector	-45	95	-115	25	-85	40
6. Continuous ceiling on the accumulation of new external arrears of the combined public sector	0	0	0	0	0	0
	0	0	0	0	0	0
Indicative targets						
	<i>(In millions of Córdoba)</i>					
1. Ceiling on central government primary expenditure 5/	29,953	30,439	16,802	16,747	34,370	35,460
2. Floor on poverty-related expenditures of the central government 6/	18,368	18,107	9,178	9,542	20,474	21,103
3. Ceiling on monitorable wage bill	11,288	11,301	5,901	6,088	12,599	12,850
Memorandum items						
Stock of NIR (adjusted, US\$ millions)	776	917	707	847	736	862

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

1/ Cumulative flows starting at the beginning of the calendar year. Definitions are specified in the TMU, including adjusters.

2/ Adjusted by any excess of project loans for up to US\$15 million in 2010 and US\$55 million in 2011. It is adjusted in 2011 by any use of US\$49.5 million of a grant to ENACAL received in 2009.

3/ Adjusted by shortfalls/excess in budget support external loans compared to programmed levels in both 2010 and 2011.

4/ The targets for NDA and NIR-Adjusted are defined as cumulative flows from June 2010.

5/ Adjusted by any shortfalls/excess in observed grants and project-loans with respect to programmed amounts.

6/ Adjusted for shortfalls/excess in external loans and grants as specified in TMU.

LOI Table 2. Nicaragua. Prior Actions and New Structural Benchmarks, 2011 1/

		Date	Status
Submission to National Assembly of a Supplementary Budget for 2011 consistent with program objectives	PA		Done
Publication of Aid Report with fuller disclosure on uses of aid flows	SB	End-March 2011	Done
Assembly approval of a regulatory framework for institutions operating in the microfinance industry 2/	SB	End-July 2011	
Complete study assessing the scope of productivity gains and rationalizing government employment practices 3/	SB	End-August 2011	

1/ SB=Structural Benchmark; PA=Prior Action

2/ Proposed new SB

3/ It is proposed that the completion date for this SB is moved to end-September 2011

Nicaragua—Changes to the Technical Memorandum of Understanding APRIL 8, 2011

All aspects of the Technical Memoranda of Understanding issued on September 4, 2007, August 28, 2008, October 21, 2009, and November 2, 2010, respectively, remain valid, except for new revision incorporated in the April 8 letter of intent and those indicated below.

A. Definitions

1. The monitorable wage bill for 2010-11 includes transfers of US\$31.3 million and US\$44.7 million (of which US\$20.6 million through June 2011) financed through a grant from the Venezuelan cooperation arrangement.¹

B. Quantitative Targets

2. The program targets for the quantitative performance criteria for end-June 2011, as well as the indicative targets for end-December 2011, are detailed in Table 1.

TMU Table 1. Nicaragua: Quantitative Performance Criteria and Indicative Targets, 2010-11 ^{1/}

	2010		2011			
	Jan-Dec		Jan-Jun		Jan-Dec	
	Adj.	Prog.	Prel.	Prog.	Prog.	Prog.
Performance Criteria (Jan-Dec 2010, Jan-Jun 2011, indicative targets otherwise)						
<i>(In millions of Córdoba)</i>						
1. Floor on combined public sector overall balance, after grants ^{2/}	-3,418	-1,982	-1,844	-875	-3,314	-2,896
2. Floor on Social Security Institute (INSS) overall balance, after grants	1,415	1,492	1,016	982	1,495	1,400
3. Ceiling on change in net domestic assets of the central bank ^{3/}	1,560	-182	680	230	1,573	2,348
Cumulative flows from end-June 2010 ^{4/}	2,549	807	3,230	1,037	4,122	3,155
<i>(In millions of US dollars)</i>						
4. Floor on change in net international reserves of the central bank ^{3/}	-35	105	-70	-70	-40	-55
Cumulative flows from end-June 2010 ^{4/}	-45	95	-115	25	-85	40
5. Continuous ceiling on nonconcessional external debt contracted or guaranteed by the consolidated public sector	0	0	0	0	0	0
6. Continuous ceiling on the accumulation of new external arrears of the combined public sector	0	0	0	0	0	0
Indicative targets						
<i>(In millions of Córdoba)</i>						
1. Ceiling on central government primary expenditure ^{5/}	29,953	30,439	16,802	16,747	34,370	35,460
2. Floor on poverty-related expenditures of the central government ^{6/}	18,368	18,107	9,178	9,542	20,474	21,103
3. Ceiling on monitorable wage bill	11,288	11,301	5,901	6,088	12,599	12,850
Memorandum items						
Stock of NIR (adjusted, US\$ millions)	776	917	707	847	736	862

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

^{1/} Cumulative flows starting at the beginning of the calendar year. Definitions are specified in the TMU, including adjusters.

^{2/} Adjusted by any excess of project loans for up to US\$15 million in 2010 and US\$55 million in 2011. It is adjusted in 2011 by any use of US\$49.5 million of a grant to ENACAL received in 2009.

^{3/} Adjusted by shortfalls/excess in budget support external loans compared to programmed levels in both 2010 and 2011.

^{4/} The targets for NDA and NIR-Adjusted are defined as cumulative flows from June 2010.

^{5/} Adjusted by any shortfalls/excess in observed grants and project-loans with respect to programmed amounts.

^{6/} Adjusted for shortfalls/excess in external loans and grants as specified in TMU.

¹ An analogous treatment will be given to the primary expenditure of the Central Government.

C. Adjustors

3. The target for the consolidated public sector (CPS) overall balance for 2011 will be adjusted *downwards* by up to the equivalent of US\$55 million (i.e., C\$1232 million at the program exchange rate) by the amount of any execution of investment projects above programmed levels financed with project-related external loans. This amount includes the use of a loan for US\$24 million disbursed in December 2010 by the IDB and the BCIE for the construction of hydroelectricity power stations for the Nicaraguan Electricity Corporation (ENEL).

4. The NIR-Adjusted target for 2011 will be adjusted *downwards* by up to US\$45 million in the event of shortfalls in external budget support loans compared to the programmed amounts. In that case, the target for net domestic assets will be adjusted *upwards* by up to US\$45 million.

5. The adjustors related to the external financing will be applied to the updated projections in Table 2.

TMU Table 2. Programmed External Financing 2010-11
(in millions of US\$)

External loans (a=b+c)	Budget support loans 1/ (b)	Project-related loans (c)	of which,		External grants 2/ (d=e+f)	of which,		Budget support grants (e)	Project-related grants (f)	Total financing (g=a+d)	Budget support (h=b+e)	Project-related (i=c+f)
			Project related loans to CG (c')	External grants 2/ (d')		Grants to CG (d')	Grants to CG (d')					
Cumulative from January 2010												
Q1-10	35	0	35	26	16	15	1	15	50	1	50	
Q2-10	94	0	94	74	44	40	1	44	138	1	137	
Q3-10	123	0	123	96	89	83	22	67	212	22	190	
Q4-10	266	43	223	162	142	134	22	120	408	65	343	
Cumulative from January 2011												
Q1-11	24	0	24	17	25	21	0	25	49	0	49	
Q2-11	63	0	63	51	69	60	0	69	132	0	132	
Q3-11	162	45	117	97	119	108	0	119	281	45	236	
Q4-11	225	45	180	150	174	160	0	174	399	45	354	

1/ Excludes IMF.

2/ Excludes extra-budgetary grants to finance wage bonus

6. The indicative target on poverty-reducing spending will be adjusted *downwards* for any shortfalls of external financing related to the poverty programs specified in Table 3. Similarly, the indicative target on poverty-reducing spending will be adjusted *upwards* for any excess of external financing related to the poverty programs specified in Table 3.

TMU Table 3. Nicaragua: Central Government Poverty Spending and Financing, 2010-11
(in C\$ millions)

	2010		2011			
	Jan.-Dec.		Jan.- Jun.		Jan.-Dec.	
	Prog.	Prel.	Prog.	Prop. Prog	Prog.	Prop. Prog
Poverty Spending	18,919	18,107	9,178	9,542	20,474	21,103
Domestic Financing	10,632	10,371	5,432	5,869	11,681	11,900
External Financing	8,287	7,737	3,746	3,673	8,793	9,203
Grants	2,563	2,294	1,085	853	2,898	2,976
Loans	2,898	2,642	1,105	1,030	2,667	3,000
Debt Relief	2,826	2,801	1,556	1,790	3,228	3,228

Source: Ministry of Finance and Public Credit.

D. Supplementary Agenda

7. **Study on Central Government employment.** The Ministry of Finance and Public Credit will provide to Fund staff a preliminary report in line with the terms of reference agreed on with the IDB, and broadly described in Country Report No. 10/376. The final report will be ready before end-September 2011, and its presentation to Fund staff will constitute a structural benchmark.

8. **Regulatory framework for the micro-finance sector.** In consultation with Fund staff and other multilateral organizations, the government will prepare a draft law to promote the development of micro credit. This draft law will establish, at the minimum, internal governance rules, internal and external controls, prudential rules, and mechanisms for the provision of data for the institutions that operate in the micro-finance sector. In addition, the law will define the mechanisms and institutions that will regulate and supervise micro financing entities. Approval of a law with these characteristics by the National Assembly before end-July 2011 will be a structural benchmark.

E. Provision of Information and Monitoring

9. **Continued production and publication of reports.** The information described in Section F of Annex II of Country Report No. 10/376 will continue to be provided according to the terms described therein. In particular, the reports described in paragraphs 18, 19, and 21 will start to be published electronically. The Report on External Aid flows will continue to be published biannually in electronic form.

10. **Analysis of the effectiveness of public social spending.** With the aim of measuring the quality of public spending, the Office of Economic Studies at the Ministry of Finance and Public Credit will produce a study on the redistributive impact of public expenditures. The study will also include aggregate indicators to measure the effectiveness and efficiency of public spending. The study will be used to support budget formulation, so that resources are assigned to priority social spending and to the best-performing programs. A draft will be available before end-June 2011, and the final version will be available before end-September 2011.

11. **Progress Report on the Implementation of the National Development Plan.** Using, among other sources, the results from the new surveys on poverty financed by the IDB, the government will produce a progress report on the attainment of the objectives established in the National Development Plan for 2009-10. The report will be available before end-August 2011, in time for the last review under the current ECF.

12. **Financial statements of the financial cooperatives.** In consultation with technical staff of the Central Bank, the Cooperatives' Regulatory and Supervisory Entity (INFOCOOP) will prepare regulations for the timely publication of the audited financial

statements by the financial cooperatives, on a standard, comparable basis. These regulations will be finalized and published before end-July 2011.

13. Financial assets of the Nicaraguan Social Security Institute (INSS). With the aim of continuing to strengthen the management of the financial assets of the INSS, the institute's annual statistical report for the year 2010 will include information on the composition of its financial assets, on changes in the composition of these assets over the last 12 months, and on the average actual return of the portfolio; the report also will include projections of the size and return of the portfolio for the following years. The statistical report for the year 2010 will be published before July 2011.