

International Monetary Fund

[Nicaragua](#) and the
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Nicaragua: Letter of Intent, and Technical Memorandum of
Understanding

Press Release:
[IMF Executive Board
Completes Seventh
and Final Review of
Nicaragua's Extended
Credit Facility and
Approves US\\$8.74
Million Disbursement](#)
October 21, 2011

October 3, 2011

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GOVERNMENT OF NICARAGUA

October 3, 2011

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C.

Dear Ms. Lagarde:

1. The performance of the Nicaraguan economy has been satisfactory during 2011. All quantitative performance criteria for June 2011 under the Extended Credit Facility (ECF) have been met, and progress has been made in implementing the supplementary agenda, both of which have contributed to foster macroeconomic stability. For the remainder of the year, the Government of Reconciliation and National Unity (GRUN) will continue to implement prudent macroeconomic policies, with particular attention to the potential impact on the economy of the observed economic slowdown in the advanced economies and the continuing high level of international commodity prices.

Macroeconomic Framework for 2011-2012

2. After growing at a rate of 4.5 percent in 2010, gross domestic product (GDP) will continue to recover in 2011 at a projected rate of around 4 percent. Inflation is expected to hover at the lower end of the 8 to 9 percent range, primarily reflecting pressures on international prices for agricultural and energy products. In line with the decline in the terms of trade and a higher level of economic activity, the external current account deficit will increase in 2011, from 14.8 percent of GDP in 2010 to 15.7 percent of GDP this year. The revised growth outlook in the advanced economies suggests that GDP growth will slow in 2012, to a figure of between 3 and 3.5 percent, while inflation is also expected to decline to a range between 7 and 8 percent. It is expected that the external current account deficit will stand at around 18.4 percent of GDP in 2012.

Fiscal policy

3. The government will continue to implement a prudent and sustainable fiscal policy, and to that end will send to the National Assembly an amendment to the 2011 General Budget of the Republic (GBR) consistent with a central government deficit after grants of approximately 0.1 percent of GDP, which represents a 1 percentage-point improvement over the program agreed in the context of the sixth review of the ECF. This result will be achieved owing to improvements in tax revenues, reflecting the higher level of economic activity, and changes in income tax withholding for commercial banks, as well as a prudent execution of government expenditure. The increased resources will be used to pay down public debt, with priority being given to debt associated with the electricity sector. The payment of this debt will be included in a budget amendment to be approved by the National Assembly in 2011. In line with the improved central government deficit, the consolidated public sector deficit will also be smaller than expected in the last review and will reach about 1.1 percent of GDP in 2011. In addition, in mid-October the government will send to the National Assembly the GBR for 2012, which will be consistent with a deficit after grants of 0.4 percent of GDP. The monitorable wage bill as a share of GDP will remain broadly constant, while poverty-reducing expenditure will continue to be protected as a share of GDP. The surplus of the Nicaraguan social security institute (INSS) will stand at 0.5 percent of GDP, while the deficit of the consolidated public sector (CPS) will total around 2 percent of GDP.

4. In October 2011, the government published a report assessing the implementation of the National Human Development Plan during the period 2009–10 on the basis of poverty surveys financed jointly by the World Bank (WB) and the Inter-American Development Bank (IDB), that have been made available to both institutions. At the same time, the government is negotiating a new program with the IDB that will aim to strengthen the efficiency and effectiveness of social programs, particularly in the areas of health, education and family protection.

5. As part of its efforts to strengthen the tax system, the government has continued to explore ways of reducing the number of exemptions and deductions and establishing a regulation on transfer prices, for which it has received assistance from the IMF. In the area of pensions, the study containing a range of options for improving the financial position of the pension system has been presented to a tripartite forum including workers, employers and the government. Moreover, the INSS has published the composition of its financial assets in its 2010 Annual Report, a practice that it plans to continue in the future. Additionally, improvements to the investment rules are planned to ensure that portfolio management is in line with international best practices; specifically, a draft for new investment regulations will be prepared during the last quarter of 2011.

Monetary and financial policy

6. Monetary policy will remain focused on ensuring adequate international reserve coverage, containing inflation, and maintaining appropriate levels of liquidity in the money markets, in an international context characterized by the weaker economic situation of advanced countries. Net international reserves (NIR-adjusted) are expected to be higher than programmed, and to increase by approximately US\$20 million in 2011, as a result of the higher-than-expected increase in the demand for base money, which will be followed

by a slight decline next year. The rate of crawl of the exchange rate will be maintained at 5 percent in 2012. The Central Bank has continued its institutional strengthening. In this context, its capitalization will be continued and further steps will be taken toward its formalization. As well, and in line with IMF recommendations, a manual setting out the principles for the preparation of the Central Bank's financial statements in accordance with International Financial Reporting Standards (IFRS) has been adopted.

7. The banking system shows signs of improvement. Financial and solvency indicators for July 2011 suggest that progress has been made with the restructuring of their credit portfolios, which has led to an improvement in their profitability. It is expected that the improvement in the banks' balance sheets will result in a gradual increase in bank lending. The monetary and financial authorities will continue to monitor the quality of credit portfolios and deposit trends. At the same time, they will step up their efforts to cooperate with other supervisors in the region, to ensure timely information flows on the performance of financial groups with a presence in Nicaragua. As well, the Superintendence of Banks and Other Financial Institutions plans to start implementing the stress test methodology on a pilot basis in late 2011, with technical assistance from the IMF. The government will continue to ensure that the legislative framework promotes the sound development of credit markets, maintaining the current policy of market-based determination of interest rates.

External Financing

8. Concessional resources are important for the financing of the government's economic program. It is expected that the IDB will make disbursements of budgetary assistance in the amount of US\$45 million in 2011 and a similar amount in 2012. Concessional resources will continue to be allocated to financing social programs and investment in infrastructure, including the electrification of rural areas and disadvantaged neighborhoods. Nonconcessional borrowing will continue to be strictly controlled, while efforts will be made to obtain new concessional resources. To improve public debt management, the Central Bank and the Ministry of Finance will jointly prepare an annual Debt Sustainability Analysis that will enable them to assess the fiscal space in the medium-term. In the context of the Heavily Indebted Poor Countries (HIPC) Initiative, further efforts will be made to restructure the external debt pending relief.

Supplementary agenda

9. **Electricity sector.** The government recognizes the strategic importance of the energy sector and is committed to maintaining its financial viability. The difference between the average cost of electricity generation and the tariffs in effect in 2011 will result in a financing shortfall of approximately US\$100 million, which is being financed with concessional resources from Venezuela. These resources will be repaid as efforts to transform the country's energy matrix result in average generation costs that are lower than applicable tariffs. The government acknowledges that subsidies will have to be refocused and the parameters governing the electricity sector will need to be revised starting in 2012, and it is working with stakeholders to ensure the normal functioning of the sector. To this end, the government will work so that the electricity tariffs normalize payment flows, and

that investments in the sector help reduce technical and non-technical losses, while increasing service coverage. The central government will continue to guarantee through the budget the payment of its own electricity consumption, and the subsidies for customers paying social tariffs, pensioners, and disadvantaged neighborhoods, and will ensure that public companies that consume large amounts of electricity pay their electricity bills on a timely basis.

10. **Water and sewage.** Following some delays in the implementation of its investment program, the public water and sewage company (ENACAL) is investing in infrastructure in cooperation with the World Bank, the IDB, and the Spanish Cooperation Agency, which will enable it to improve its service and reduce the levels of unbilled water. To this end, ENACAL plans to install 20,000 new meters in the city of Managua by end-2011 with the twofold aim of improving billing and reducing technical losses. At the same time, ENACAL is devising a multiannual plan for the sector that will set targets for reducing unbilled water, among other objectives, with a view to improving the financial viability of providing this service.

11. **Enhanced monitoring of external aid flows.** The Central Bank will publish by mid-October the seventh report on foreign aid, including detailed information on the use of such aid in the first half of 2011. The government will continue to ensure that the use of foreign aid does not generate fiscal contingent liabilities 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.

12. **Strengthening of the public administration.** A series of steps is being taken to improve financial public management. Specifically, (i) with financial and technical assistance from the IDB, the government is conducting a study that will assess the budgeting of permanent and temporary positions in the central government and that will include options for its improvement (*structural benchmark*); the government has discussed preliminary findings of the study with the IMF technical team and expects to complete it by November 2011; (ii) 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); moreover, the IMF will provide technical assistance to support the efforts to modernize the General Directorate of Taxes (DGI); (iii) the Office of the Comptroller General of the Republic (CGR) published the audit of the 2009 GBR during the third quarter of 2011, and the draft budget for 2012 includes an allocation that will enable the CGR to do a similar audit of the 2010 GBR during the first half of 2012; the government will step up its efforts to ensure that public enterprises publish their audited financial statements; (iv) efforts have been ongoing to improve liquidity and public debt management; in this regard, the central government floating debt is expected to be reduced significantly in 2011, and the coupon on new public debt issuance will be adjusted to reflect market financing costs.

13. **Microfinance sector and cooperatives.** To strengthen supervision, transparency and efficiency in the microfinance sector, the National Assembly approved in June 2011 the Law for the Promotion and Regulation of Microfinance Institutions, which is applicable to entities operating in the sector (*structural benchmark*). The new oversight agency for the

microfinance sector (CONAMI) will begin operations in the first quarter of 2012, and the necessary financial resources for this will be included in the GBR. In addition, the oversight agency for cooperatives (INFOCOOP) issued regulations in August 2011 that set the standards for the preparation of the financial statements of savings and loan cooperatives, which will be published.

14. In view of the progress made in implementing the ECF and the framework presented for the remaining policies, we hereby request approval of the seventh review and the eighth disbursement of the ECF in the amount of SDR5.55 million. Table 1 shows quantitative performance criteria through June 2011 and projections for the remainder of the year. 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.	Prel.	Adj.	Prel.	Prog.	Proj.
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	-1,822	818	-2,896	-1,803
2. Floor on Social Security Institute (INSS) overall balance, after grants	1,415	1,492	982	1,040	1,400	1,431
3. Ceiling on change in net domestic assets of the central bank 3/ Cumulative flows from end-June 2010 4/	1,560	-182	230	-982	2,348	1,098
	2,549	807	1,037	-174	3,155	1,905
	<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	-5	-55	20
	-45	95	25	90	40	115
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	16,954	16,639	35,460	35,696
2. Floor on poverty-related expenditures of the central government 6/	18,368	18,107	9,645	9,839	21,103	21,064
3. Ceiling on monitorable wage bill	11,288	11,301	6,088	5,924	12,850	13,121
Memorandum items						
Stock of NIR (adjusted, US\$ millions)	776	916	847	911	862	937

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 adjustors.
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 financing as specified in TMU.

Table 2. Nicaragua. Structural Benchmarks, 2011 1/

		Date	Status
Assembly approval of a regulatory framework for institutions operating in the microfinance industry	SB	End-July 2011	Done
Complete study assessing the scope of productivity gains and rationalizing government employment practices	SB	End-September 2011	In Progress

1/ SB=Structural Benchmark.

*******Nicaragua—Changes to the Technical Memorandum of Understanding
October 3, 2011**

All aspects of the Technical Memoranda of Understanding (EBS/07/103, Supplement I; EBS/08/101, Supplement I; EBS/09/157, Supplement I; and EBS/10/198, Annex II; EBS/11/56, Annex II) issued on September 4, 2007, August 28, 2008, October 21, 2009, November 2, 2010, and April 8, 2011, respectively, remain valid, except for the revisions incorporated in the October 3, 2011 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 projections for end-December 2011, are detailed in Table 1.

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

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

	2010		2011			
	Jan-Dec		Jan-Jun		Jan-Dec	
	Adj.		Adj.			
	Prog.	Prel.	Prog.	Prel.	Prog.	Proj.
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	-1,822	818	-2,896	-1,803
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	2,549	807	1,037	-174	3,155	1,905
<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	-5	-55	20
	-45	95	25	90	40	115
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	16,954	16,639	35,460	35,696
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Memorandum items						
Stock of NIR (adjusted, US\$ millions)	776	916	847	911	862	937

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 adjustors.
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 financing as specified in TMU.

C. Adjustors

3. 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')		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	29	0	29	22	18	16	1	17	46	1	46
Q2-11	81	0	81	63	63	57	1	62	144	1	143
Q3-11	149	0	149	109	115	105	1	114	264	1	262
Q4-11	234	45	189	140	166	152	1	165	400	46	354

1/ Excludes IMF.

2/ Excludes extra-budgetary grants to finance wage bonus

4. 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.	Adj. Prog.	Prel.	Prog.	Proj.
Poverty Spending	18,919	18,107	9,645	9,839	21,103	21,064
Domestic Financing	10,632	10,371	5,869	6,063	11,900	12,203
External Financing	8,287	7,737	3,776	3,776	9,203	8,861
Grants	2,563	2,294	584	584	2,976	2,789
Loans	2,898	2,642	1,856	1,856	3,000	3,236
Debt Relief	2,826	2,801	1,336	1,336	3,228	2,835

Source: Ministry of Finance and Public Credit.

D. Supplementary Agenda

5. **Study on Central Government employment.** The Ministry of Finance and Public Credit discussed with Fund staff preliminary findings of the study in line with the terms broadly described in EBS/11/56. The final report will be ready before December 2011.

E. Provision of Information and Monitoring

6. **Continued production and publication of reports.** The information described in Section F of Annex II of EBS/10/198 will continue to be provided according to the terms described therein. In particular, the reports described in paragraphs 18, 19, and 21 will continue to be published electronically. The Report on External Aid flows will continue to be published semi-annually in electronic form.

7. **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 (MFPC) discussed with Fund staff preliminary results on a forthcoming report on the redistributive impact of public expenditures and of aggregate indicators to measure the effectiveness and efficiency of public spending, in line with EBS/11/56. The final version of the study will be available before December 2011.