

## International Monetary Fund

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**Nicaragua:** Letter of Intent, Memorandum of Economic and Financial  
Policies, and Technical Memorandum of Understanding

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The following item is a Letter of Intent of the government of Nicaragua, which describes the policies that Nicaragua intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Nicaragua, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

Managua, Nicaragua  
August 24, 2007

Mr. Rodrigo de Rato  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431  
U.S.A.

Dear Mr. de Rato:

We enclose herewith the Memorandum on Economic and Financial Policies (MEFP), which describes the economic and financial program to be implemented by the Government of Reconciliation and National Unity in 2007–10, and establishes the policies that the government proposes for the first year of the program and for the medium term. Also attached is the Technical Memorandum of Understandings (TMU).

The key aim of our program is to create the conditions for a significant reduction in poverty and sustained economic growth in a context of macroeconomic stability, and fiscal and external sustainability. The program also proposes implementation of a structural reform agenda intended to strengthen the energy sector, the institutional framework of the public sector, the social security system, and the financial system. At the same time, the government has developed a new social policy focus (set out in the progress report on the National Development Plan) to achieve effective poverty reduction in the medium and long term, and help attain the Millennium Development Goals (MDGs).

In support of these important objectives, policies, and actions, Nicaragua is requesting a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) in an amount equivalent to SDR 71.5 million (55 percent of quota). We propose that the IMF carry out program reviews in March and September 2008, based on the observance of end-December 2007 and end-June 2008 performance criteria, respectively, shown in Tables 1 and 2 in the attached MEFP. To that end, all data needed to monitor progress made in implementing the program will be provided.

The government considers the policies and actions set out in the MEFP to be sufficient to achieve the program objectives, and stands ready to take the necessary measures to that end. Nicaragua will consult with the IMF on the adoption of measures that might require the revision of policies contained in the MEFP and provide the necessary data on a timely basis for monitoring purposes, in accordance with IMF policy. Consistent with its intention of keeping the public informed of its objectives, policies, and actions, the government will

publish this letter of intent and the MEFP and will inform the public periodically on progress under the program.

We are confident that the policies included in our economic program and the central focus on poverty reduction will give new impetus to Nicaragua's sustained development and the improvement of the quality of life of its people. We hope that we will count on the continued support of the international community for the government's policy agenda.

Sincerely yours,

/s/

Antenor Rosales Bolaños  
President  
Central Bank of Nicaragua

/s/

Alberto Guevara Obregón  
Minister  
Ministry of Finance and Public Credit

## MEMORANDUM ON ECONOMIC AND FINANCIAL POLICIES

### I. BACKGROUND

1. The aim of the program of the Government of Reconciliation and National Unity is to create the conditions for a substantial reduction in poverty and for sustained economic growth in a context of macroeconomic stability and sustainable public finances and external accounts. In addition, the institutional framework will be strengthened so as to maintain a private and public investment climate that will support growth and productivity, create quality jobs, and make it possible to efficiently provide basic services that improve human capital. In turn, this is expected to create new opportunities for increasing wealth as a means of reducing poverty.

2. The government's program will be geared towards achieving an effective reduction in poverty in the medium and long term while ensuring favorable macroeconomic performance. The program is made up of a package of policies and actions in the social, fiscal, monetary, and trade areas, as well as the pursuit of a significant institutional policy agenda. In this context, the national priorities have been redefined to include: economic revitalization, combating hunger, and reducing malnutrition and poverty; rights to health and social protection; literacy training and education; improved water, sanitation, and the environment; electricity supply; and decentralization, citizenship, and governance.

### II. SOCIAL FRAMEWORK OF THE PROGRAM

3. The government has developed a new approach to social policy. This approach encompasses: (i) providing capital to the poor to help them realize their potential as producers, and so moving beyond the previous approach that was more assistance oriented; (ii) implementing policies on free access to and direct subsidies for the main services provided by the government to the most vulnerable sectors; (iii) promoting financial mechanisms and instruments that favor small producers in rural areas; (iv) aligning external cooperation toward priority sectors, and reducing the fragmentation of external support; (v) formulating programs and projects that ensure that the MDGs are met; and (vi) actively involving the poor in solving the problems affecting them.

4. The macroeconomic policies developed by the government are consistent with the progress report on the National Development Plan, and in particular with the chapter on the priorities of the Government of Reconciliation and National Unity. To this end, the following actions have been taken in designing the macro framework: (i) carrying out a detailed analysis of social expenditure, giving priority both to urgent needs and to the implementation of policies in a medium-term context; (ii) incorporating the main MDGs and the policies needed to narrow the gap between the existing situation and these goals; (iii) introducing a performance-based approach to public financial management; and (iv) integrating financial programming with budgeting and programming in the main agencies in charge of public service delivery, in order to strengthen public expenditure management. Finally, as part of

the government's participatory and national consensus-building policy, this effort entailed a consultation process with social and civic organizations.

5. Given the financial constraints facing Nicaragua with regards investing out of its own resources in the infrastructure and services needed to achieve the MDGs, the continued support of the international community for the government's economic and social policies will be key. Moreover, further progress will need to be made on efforts to achieve full donor harmonization and alignment with the government's objectives and priorities. Public expenditure will be prioritized in terms of improvements in the quality of services and the investments necessary for increasing their efficiency and effectiveness.

6. The social policy agenda centers on ensuring that the poorer segments of the population have access to goods and services in the areas of health, education, water, sanitation, food security and sovereignty, social protection, housing, and training. To this end, the government will seek to eradicate hunger among the poorest, expand access to schooling, reduce illiteracy, increase the supply of medicines, and improve access to higher quality water and sanitation services. Starting in June 2008, the government will publish on a bi-annual basis the key social indicators in the health, education, water, and sanitation sectors (*structural benchmark*).

- **Food security and sovereignty.** The objective of the food security and sovereignty policy is the eradication of hunger among the poorest, prioritizing children. To achieve this objective, a productive, agro-ecological, agro-industrial, participatory, and gender approach will be implemented (Zero Hunger Program) to promote capacity building and facilitate production for self-consumption and commercial sale by impoverished families. The main policies and actions included in this program are to: (i) offer support to 75,000 rural families over the next five years to produce food for themselves and for sale, by providing a credit of US\$1,500 to each family; (ii) promote nutrition for children under 6 and school-age children through micronutrient, breast-feeding, school lunch, and other programs; and (iii) provide food assistance to rural families in extreme poverty. In addition, producers in the poorest communities will be provided with a packet of improved seeds, urea, technical assistance, financing, and other inputs.
- **Education.** Education policy is aimed at guaranteeing free, universal, quality education and reducing illiteracy. Five key education policies have been prepared to achieve these objectives: (i) *more* education, to reduce illiteracy and increase coverage in the provision of preschool, primary, and secondary school education; (ii) *better* education, to improve the school curriculum and teacher training; (iii) *other* education, to transform the values of the education system; (iv) *participatory and decentralized* education management, to promote the involvement of local and national stakeholders in education; and (v) *all-encompassing* education, to integrate the various components of the education system. To reintroduce free education and remove the distortions created by budget transfers to autonomous centers, the

government has eliminated the autonomous school model that resulted in heads of households having to pay for their children to gain access to education.

- **Health.** The objective of the health policy is to enhance quality and coverage and guarantee the free provision of the services rendered by the public health system to the population. In support of these policies, all charges to the population for the provision of these services have been eliminated, and the supply of drugs and medical materials will be increased to satisfy the demand for outpatient and hospital care. In addition, it is planned to: (i) implement a family preventive care model, which will initiate a process of decentralization toward Local Integral Healthcare Systems; (ii) make adjustments to the existing system whereby private companies provide health care services for members of the social security system by updating the regulatory framework for these companies; and (iii) increase the medical benefits of social security beneficiaries by making full use of contributions paid in for this purpose.
- **Water.** The objectives of the water supply and sanitation policy are to ensure the maintenance of existing systems and networks, increase coverage and improve service quality, and promote the rational use of these resources. To achieve these objectives, the government will: (i) implement a plan for maintaining and expanding potable water and sewerage services; (ii) promote the development and monitoring of water quality in rural aqueducts, (iii) encourage the sound management of water resources; and (iv) reduce the high levels of water losses (including water delivered but not billed), and repair and replace pumping equipment.

### III. MEDIUM-TERM MACROECONOMIC FRAMEWORK

7. The program envisages an increase in real economic growth over the medium term to about 5 percent per annum, with inflation moderating to 7 percent, in line with maintaining the crawling peg regime and the inflation differential in relation to the country's major trading partners. Improved productivity will constitute a critical underpinning for increased growth. This requires, in particular, reforms in the energy sector (¶27), improved rates of return on public investment (¶28), and a strengthened business climate (¶34). In this connection, it is projected that growth will be supported by a significant increase in public investment, and by an acceleration of exports. Increased productivity will be facilitated by public investment in infrastructure and by the government's commitment to macroeconomic stability. It is anticipated that improved access to international markets and greater diversification of productive capacity will facilitate export growth.

8. The deficit in the current account of the balance of payments is expected to narrow gradually over the medium term. The external imbalance reflects especially the private sector savings-investment gap, which is projected to decline over the medium term. Higher productivity resulting from the implementation of the institutional policy agenda will support

some increase in private sector savings. The reduction in the current account deficit will also be predicated on improvements in export performance, and the incorporation of new investments in the free trade zones, while large inflows of family remittances will continue to support the balance of payments. Overall, a slight increase in external debt as a percentage of GDP is expected in the next 2–3 years, followed by reduction over the medium term. The balance of payments will be financed mainly by the inflow of net external resources to the public sector in the form of grants, concessional loans, and external debt relief. Moreover, it is expected that private capital flows will gradually increase as a result of greater foreign direct investment and net contributions from the domestic financial system to the economy.

Nicaragua: Macroeconomic Indicators

	2005	2006	Program			
			2007	2008	2009	2010
Real GDP growth (in percent)	4.3	3.7	4.2	4.7	5.0	5.0
Inflation (end of period, in percent)	9.6	9.5	7.3	7.0	7.0	7.0
Inflation (period average, in percent)	9.6	9.1	8.2	7.3	7.0	7.0
Overall balance of Combined Public Sector after grants (in percent of GDP)	-1.6	0.2	-1.0	-1.8	-1.0	-1.0
External current account balance (in percent of GDP)	-14.9	-15.8	-15.8	-16.3	-15.3	-14.6
Gross International Reserves (US\$ million)	730	924	925	1,043	1,183	1,317
in months of imports of goods (excl. maquilas)	3.1	3.4	3.1	3.2	3.4	3.5
Net international reserves (program definition, US\$ million)	282	535	595	665	745	835

## Fiscal Policy

9. The government's fiscal policy will seek to ensure the sustainable financing of programs and projects to reduce poverty, increase investment in productive infrastructure, and develop human capital. The program seeks to strike a balance between creating fiscal space for priority spending and reducing indebtedness over the next decade. This reduction in debt is consistent with the social and poverty reduction objectives, while at the same time maintaining a stable macroeconomic situation. To this end, all spending increases will have identified sources of financing, while also ensuring that recurrent expenditure is financed with permanent sources.

10. The government will continue to strengthen revenue mobilization and administration. Implementation of the revenue administration modernization strategy (¶30) will be carried forward, contributing to the projected increase in public sector revenue from 18.8 percent of GDP in 2006 to 19.9 percent in 2010. In addition, the planned introduction of a tax reform in 2007 will generate additional resources, while improving the equity and efficiency of the system (¶20). These additional resources will be used to finance higher pro-poor expenditure.

11. Poverty reducing spending (at the consolidated public sector level) is envisaged to increase as a share of GDP, from 13.4 percent in 2006 to at least 17.8 percent in 2010, consistent with achieving the social objectives discussed earlier in paragraph 6. The government will also work towards improving the focus, quality, and efficiency of social expenditure, efforts which will be a key aspect of the institutional policy agenda. In this context, there will be close monitoring of the transparent use of the resources derived from external debt relief.

12. Growth in the public sector wage bill will be managed consistent with preserving macroeconomic stability and external competitiveness. In this regard, a medium-term wage policy will be developed to eliminate the existing inequalities and distortions, while correcting wage gaps in priority sectors. This plan will be finalized by June 2008 (¶21).

### **Monetary and Exchange Policy**

13. Monetary policy will continue to be focused on guaranteeing the stability of the currency and normal operations of the payment system. Meeting these objectives will help keep inflation low and stable, to which end the current exchange rate regime will be maintained and the free convertibility of the currency guaranteed. Open market operations will rely on short-term financial instruments in order to improve liquidity management. Net credit to the nonfinancial public sector will be contractionary in order to support the objectives of the monetary program, which allows for an increase in international reserve coverage.

14. Exchange rate policy will maintain the crawling peg exchange rate system during the program period. This regime, in force since 1993, has proved effective in anchoring inflationary expectations and reducing market uncertainties. The government will conduct studies on exchange rate systems to determine the suitability of adopting an alternative arrangement for the Nicaraguan economy in the future.

### **External Financing and Trade Policy**

15. The program hinges on the continued support from multilateral financial institutions and the international community to finance public sector operations and the balance of payments. This financial support is estimated at an annual average of about US\$694 million during the program period, including US\$61 million in budgetary support from bilateral sources. Nicaragua will continue to benefit from debt relief initiatives. This past March, under the Multilateral Debt Relief Initiative (MDRI), the IADB granted relief in the amount of US\$790 million. This adds to the relief granted in 2006 by the IMF (US\$133 million) and the World Bank (US\$694 million). As regards the HIPC Initiative, agreements have been formalized on over 60 percent of the debt relief contemplated in the Completion Point document, and best efforts continue with non-Paris Club bilateral creditors with the objective of receiving relief on comparable terms. In addition, the government continues its good faith efforts to reach a collaborative agreement with its private creditors and has prepared a



strategy for reducing its external commercial debt through a buy-back operation. This operation is expected to be concluded during the fourth quarter of 2007 with support from the World Bank through its Debt Reduction Facility (DRF).

16. The Government of Nicaragua and the Government of the Bolivarian Republic of Venezuela have signed cooperation agreements in various areas, such as: energy, health, education, housing, water, financial and technical assistance, and investments relating to projects with private sector participation. Agreements have also been reached under ALBA (¶17) where oil deliveries from Venezuela could potentially meet all of Nicaragua's needs. Under the current terms and conditions of the ALBA cooperation, oil supply transactions conducted through the state-owned petroleum company PETRONIC will not generate public debt, as the total oil invoice will be paid in full, with a portion of such payments being channeled to ALBA development institutions. Consistent with the commitment on transparency, the flow of funds invested in Nicaragua under the ALBA cooperation will be monitored. Any financing of the public sector from such cooperation will be incorporated into the deficit target monitored under the program, with the possibility of the upward adjustment of this target by a maximum of 2 percentage points of GDP a year in order to ensure public debt sustainability.

17. The aim of trade policy is to increase and diversify exports, leverage the potential of existing markets, and facilitate access to new markets. To achieve these objectives, the government will continue to create conditions that encourage export production, without negatively affecting the domestic market, through enforcement, administration, and trade negotiation. In addition, ties with major trading partners will continue to be strengthened and the negotiation of new trade treaties and agreements will pursue. In March 2007, the National Assembly ratified Nicaragua's accession to the Bolivarian Alternative for Latin America and the Caribbean (ALBA). There are also plans to move ahead with regional and bilateral trade negotiations with CARICOM, the European Union, Brazil, Canada, Chile, and Panama. Finally, the complimentary agenda of the Free Trade Agreement with the United States (US-CAFTA-DR) will be pushed forward and negotiations towards establishing the Central American Customs Union will be continued.

#### **IV. MACROECONOMIC PROGRAM FOR 2007–2008**

##### **Fiscal Policy**

18. The deficit of the consolidated public sector (CPS) after grants is projected to reach 1 percent of GDP in 2007, reflecting an increase in social and infrastructure expenditure necessary following lags in expenditure execution in 2006. Given that this target is greater than the CPS deficit consistent with the General Budget approved for 2007, the government will submit a supplementary budget to the National Assembly during the fourth quarter of 2007. This supplementary budget will include, among others, additional funding for the Zero Hunger Program, increases in capital expenditure, wage adjustments for teachers, and transfers to public enterprises, which are expected to be financed in part by the debt relief

granted by the IADB, higher external disbursements, and improved tax collection. In addition, treasury bills will be issued for the equivalent of 0.1 percentage points of GDP to subsidize Managua public transport fares.

**Nicaragua- Consolidated Public Sector Fiscal Accounts**  
(in percent of GDP)

	2006	2007	2008
Overall balance of CPS (a+b+c+d)	0.2	-1.0	-1.8
Primary balance	2.2	0.8	-0.1
Interest	2.0	1.8	1.7
a. Central government	0.1	-0.9	-1.2
Revenue	18.8	19.6	19.7
Tax	17.5	18.2	18.3
Other	1.3	1.4	1.4
Expenditure	22.7	24.7	25.1
Current	15.4	15.7	15.9
Capital	7.3	9.0	9.2
Grants	4.0	4.2	4.2
b. INSS and ALMA	1.3	1.5	1.5
c. Public enterprises	-0.8	-1.2	-1.5
d. Central bank	-0.4	-0.4	-0.6

19. The 2008 fiscal program envisages a temporary increase in the CPS deficit (of 0.8 percent of GDP), primarily reflecting the urgent investment needs in the energy and water sectors (2.1 percent of GDP) as well as the administrative costs of the municipal elections (0.4 percent of GDP). By mid-October 2007, the government will submit to the National Assembly a 2008 Draft Budget consistent with a deficit of the consolidated public sector of 1.8 percent of GDP, and will seek its approval by end-2007 (*structural performance criterion*).

20. The projected increase in expenditure of the consolidated public sector during 2008 will be financed by additional resources from external cooperation and a slight improvement in tax collections. In addition, the government plans to submit to the National Assembly, during the fourth quarter of 2007, a tax reform aimed at improving the equity of the system, with the intent of using the additional resources to finance poverty spending. This reform will aim at reducing and streamlining tax exemptions and exonerations, introducing regulations for transfer pricing, streamlining the personal income tax, and eliminating ambiguities in the tax law. Simultaneously, efforts will continue to strengthen tax administration (¶ 30).

21. The comprehensive public sector wage bill is projected to increase in line with nominal GDP during 2007–08. Moreover, steps will be taken to redress built up lags in the adjustment of real wages in priority sectors such as education, health, and security. In this regard the government this year granted important increases in the wages of teachers (17.7 percent) and health care professionals (14.2 percent). At the same time, 910 new teachers and 613 new health sector personnel were hired.

22. The financial imbalances in the electricity sector will be addressed through policies that attenuate their fiscal and social impact. The government will ensure that the regulator adjusts electricity tariffs in line with costs so as to eliminate tariff deviations that have a financial impact on the sector. The National Assembly has amended the Energy Stability Law to postpone adjustments in the tariff schedule for the private electricity distributor until June 2008 (¶27). This law will lead to bridge financing of 0.2 percent of GDP between mid-2007 and mid-2008 from the state-owned electricity generator (ENEL) to the distribution company. The financing will be temporary and repayment by the distributor will begin in the second half of 2008, in line with the adjustment in the tariff schedule (in addition to a temporary markup) that will enter into force in July 2008 in conformity with the law.

23. The public enterprise for water and sanitation (ENACAL) is in a difficult financial position. To begin correcting this critical situation, while at the same time increasing provision of water and sanitation services, the following actions will be adopted: (i) implementation of an emergency plan to achieve savings in ENACAL; and (ii) increased revenues through a differential adjustment in water tariffs which simultaneously protects poorer households. The cost of protecting these consumers will be financed by annual budgetary transfers of 0.1 percent of GDP in 2008–09.

### **Monetary Policy**

24. The main objective of monetary policy is to maintain the stability of the currency and the normal conduct of domestic and external payments. To anchor inflationary expectations the program retains the crawling peg arrangement with an unchanged annual 5 percent rate of crawl in 2007–08. In addition, the program contemplates an annual accumulation of adjusted net international reserves of US\$60 million in 2007 and US\$70 million in 2008, and establishes a ceiling for the net domestic assets of the central bank. This policy will allow an increase of the main indicators for international reserves coverage.

25. To deepen financial intermediation, the central bank has decided to reverse last year's temporary increase in the reserve requirement. Accordingly, the monetary program contemplates a reduction in the reserve requirement for the fourth quarter of this year from 19¼ percent to the previous level of 16¼ percent of liabilities subject to reserve requirements. This reduction will be implemented taking into account avoiding undesirable monetary pressures. The central bank will undertake open market operations deemed necessary, consistent with its policy to use short-term financial instruments for liquidity management purposes.

## **V. INSTITUTIONAL POLICY AGENDA**

26. The government will implement an institutional policy agenda that complements the macroeconomic policies aimed at ensuring sustainable economic growth and poverty reduction. The objectives of the agenda are to strengthen: (i) the energy sector, by expanding capacity mainly from renewable energy sources and reducing losses in the distribution

system; (ii) the institutional framework of the public sector, including the public financial administration system; (iii) the pension system; and (iv) the financial system. To guarantee the orderly implementation of the institutional policy agenda, an action plan has been developed that is carefully sequenced in the various areas of concern, as delineated in the paragraphs which follow.

27. **Strengthening the energy sector reform.** The electricity sector is in an unprecedented crisis, making it necessary to adopt palliative measures to partially cover the power generation shortfall. The increase in international oil prices and the lack of investment in power generation have put into stark relief the sectors structural and financial problems, creating blackouts and a risk of a collapse in electricity services. Although installed energy generating capacity (554 MW in 2006) is slightly higher than the demand estimated for 2007 (530 MW), restrictions in hydroelectricity and the forced exit of several thermal plants (for their maintenance and repair) have given rise to rationing. Owing to fraudulent behavior by consumers and the lack of investment in distribution, the level of distribution losses rose to 27 percent in 2006, as compared to the 14 percent of technical distribution losses recognized by the regulator in setting tariffs. The government has developed a strategy aimed at expanding power generation supply, while reducing dependency on hydrocarbons and improving the performance of the distribution sector through measures aimed at reducing fraud in the usage of electricity services and creating a stable regulatory framework.

- *Expanded generation.* The government will take steps to broaden and diversify the supply of electrical energy (roughly 75 percent of electricity generation uses fossil fuels) with a view to addressing power generation shortfalls and reducing blackouts. To this end, ENEL is drawing up plans to increase the capacity of bunker- and diesel-based plants by 270 MW in 2007-08, of which Venezuela is granting the right-to-use of plants with capacity of about 120 MW, without generating public debt. For 2008-2011, actions needed to support new renewable energy projects providing a total of 210 MW will be adopted, and the transmission system will be expanded and strengthened. These new projects will be financed by private and/or public resources. Moreover, rural electrification projects will be promoted to help combat poverty, as about half of the rural population has no access to electricity services.
- *Loss reduction.* The government is fully aware that for an effective solution to the problems of the sector the high levels of technical and non-technical losses will need to be reduced. To reduce non-technical losses, measures will be introduced establishing criminal penalties to discourage fraudulent consumption of public services, including electricity by end- 2007 (*structural performance criterion*). In addition, in 2008 the government will support the distributor in the implementation of a pilot program to improve electricity metering and service in low-income urban neighborhoods. Moreover, by end-April 2008 a diagnostic assessment will be conducted to determine the causes of the technical and non-technical distribution losses, and will include recommendations to reduce them (*structural benchmark*).

- *Regulatory framework.* The energy regulator will continue to authorize monthly adjustments in tariffs, when justified by cost changes, by applying a formula that takes such changes into account and avoids the accumulation of additional losses. To continue bolstering transparency in the sector, by end-2007, the regulator will publish the formula and methodology used to calculate tariff changes (*structural benchmark*). Owing to the drastic reduction in energy supplies that has affected the cost of power generation, by Law the implementation of the new distribution tariff structure approved by the regulator has been temporarily suspended until end-June 2008. To compensate for the financial impact of this measure, temporary financing will be provided to the distributor during the 2007–08 period (¶22).

28. **Strengthening the public financial administration system.** One key objective of the government in the context of the planned increase in public spending is to improve the efficiency, transparency, and accountability of public sector operations. To this end, the Office of the Comptroller General recently completed an audit of the execution of the 2005 Budget, and the Law on Access to Public Information was approved. To guarantee the implementation of a program for strengthening public financial administration, the government will develop an action plan in this regard by end-June 2008 (*structural performance criterion*) to be put in place during the 2008–10 period. In the short term, the government will seek to: (i) centralize the formulation and execution of investment expenditure within the Ministry of Finance and Public Credit (MHCP); and (ii) finalize, by end-April 2008, the revision of the Budget Classification Manual and the Chart of Accounts, in order to ensure their consistency with the budget classification standards set forth in the *Government Finance Statistics Manual 2001 (structural benchmark)*.

29. **Strengthening of the pension system.** An inter-institutional commission has been established to analyze alternative mechanisms for strengthening the pension system. A plan for strengthening the pension system will be designed and agreed with employees and employers. As a first step, and given the uncertainties about the size of pension liabilities, by end-June 2008 the government will complete an actuarial study on the current system (*structural benchmark*). Once the study has been finalized, the inter-institutional commission will, by end-2008, propose alternatives for improving the financial position of the system and restoring the balance between contributions and benefits. Among other actions to be evaluated are increases in coverage, the recovery of debts, and the diversification of investments, while strengthening risk management, in order to improve yields. Finally, taking current legislation into account and in order to avoid additional pressures on the financial and actuarial position of the INSS and the finances of the consolidated public sector, the government will not make any changes in contributions or benefits without first identifying how they are to be financed.

30. **Strengthening tax and customs administration.** The government will continue to strengthen tax and customs administration. With regard to tax administration (DGI), it will take the following actions: (i) complete the implementation of the collection (tax payments) system through the bank system; (ii) finalize the introduction of the new taxpayer

identification system (re-registration) with a view to improving the auditing system; and (iii) develop a comprehensive human resources policy that supports the professionalization of DGI staff. These actions will be completed by end-March 2008 (*structural benchmark*). At the same time, a strategic plan has been prepared with the objective of strengthening the structure of customs administration (DGA).

31. **Strengthening the Central Bank.** The government will strengthen the mandate and functions of the Central Bank (BCN) to improve the design and implementation of monetary and exchange rate policy, and enhance the credibility of macroeconomic policies and support the development of the capital market. As a first step, a study will be conducted to evaluate the existing legal framework of the Central Bank, including: (i) the definition of the main objective of the monetary authority; (ii) the period, election, and requirements of the President and Board of Directors of the BCN; (iii) the participation by government authorities and political representatives on the Board of Directors of the BCN; (iv) the existing restrictions on the use of monetary policy instruments; and (v) financial relations between the BCN and the government. At the same time, by end-June 2008 an assessment of the financial situation of the BCN will be completed (*structural benchmark*). In addition, the audit and control mechanisms of the BCN will be strengthened.

32. **Strengthening of the financial system.** The government will continue to strengthen the banking system in order to deepen and ensure sound financial intermediation. The government has embarked on further strengthening the regulatory framework of the financial system through the preparation of laws to combat money laundering and the financing of terrorism, as well as other laws modernizing the capital market, including with regards trusts, insurance, and the warehousing framework. To facilitate financing for small and medium-scale producers who lack access to credit, initial steps have been taken toward the creation of a development bank. The government's intention is for this bank to merge the various public lending and transfer programs already in existence in Nicaragua, while ensuring it receives a small initial capitalization, and does not accept deposits from the public.

33. **Ensuring an orderly decentralization process.** The existing fiscal decentralization framework will be implemented, including the transfer to municipalities of 10 percent of national budget revenues by 2010. The overall fiscal position will be protected in the program, and the responsibilities of the municipalities will be revised by mid-2009 so as to prevent duplications. It is also necessary to strengthen control by the municipalities as well as the monitoring of their expenditures to ensure efficiency. In the short term, the monitoring and control of transfers to the municipalities will be improved. To this end, the following actions will be taken: (i) finalizing the electronic accounting framework for municipalities, to enable the Ministry of Finance to conduct timely monitoring of their expenditure execution; (ii) increasing the number of municipalities that provide information on their budget execution to the Office of the Comptroller General; and (iii) merging the various central government institutions that implement investment projects in the municipalities, so as to ensure adequate coordination and efficiency.

34. **Strengthening of other institutions.** The government will implement additional measures aimed at stimulating and promoting private investment, improving the investment climate, enhancing competitiveness, and favoring an export orientation. Details on these measures will be set forth in the new National Development Plan currently under preparation.

## **VI. PROGRAM MONITORING**

35. The program will cover the period from 2007 to 2010. Half-yearly reviews will be conducted, to assess implementation of the relevant performance criteria, with test dates at end-December and end-June of each year, so as to align the program monitoring with the budget year. The performance criteria and indicative targets used for program monitoring are indicated in Tables 1 and 2, based on the definitions set forth in the attached Technical Memorandum of Understanding (TMU).

Table 1. Nicaragua: Quantitative Performance Criteria and Indicative Targets, 2007–10 1/

	2007					2008				2009 Proj.	2010 Proj.
	2006	Jan.- Mar. Est.	Jan.- Jun. Est.	Jan.- Sep. Proj.	Jan.-Dec. Prog.	Jan.- Mar. Prog.	Jan.- Jun. Prog.	Jan.- Sep. Prog.	Jan.-Dec. Prog.		
<b>Performance Criteria</b> (for end-Dec. 2007 and end-Jun. 2008, indicative targets otherwise)											
	(In millions of cordobas)										
1. Floor on combined public sector overall balance, after grants	207	1,201	1,949	937	-1,064	-59	-1,036	-1,391	-2,141	-1,360	-1,430
2. Ceiling on change in net domestic assets of the central bank 2/	-3,855	-287	-2,510	-2,036	-560	-179	-849	-1,320	-630	-819	-977
	(In millions of US dollars)										
3. Floor on change in net international reserves of the central bank		7	109	82	60	0	22	44	70	80	90
4. Continuous ceiling on nonconcessional external debt contracted or guaranteed by the combined public sector		0	0	0	0	0	0	0	0	0	0
5. Continuous ceiling on the accumulation of new external arrears of the combined public sector		0	0	0	0	0	0	0	0	0	0
<b>Indicative targets</b>											
	(In millions of cordobas)										
1. Ceiling on central government primary expenditure 3/	19,459	4,535	9,054	15,975	24,181	6,328	13,552	20,528	27,965	30,726	34,593
2. Floor on poverty-related expenditures of the central government	11,381	2,649	5,341	9,843	15,349	3,749	8,061	11,776	17,743	20,509	23,378

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.

2/ Defined as the difference between Currency and Net International Reserves at an accounting exchange rate specified in the TMU.

3/ Defined as the difference between expenditures and interest.



Table 2. Nicaragua: Structural Performance Criteria and Benchmarks, 2007–08

	Date	Type
<b>Energy</b>		
1. Introduce measures establishing criminal penalties to discourage fraud in the consumption of electricity (MEFP ¶27, TMU ¶28).	End-Dec. 2007	PC
2. Preparation of a diagnostic assessment of the causes for the technical and nontechnical distribution losses, including recommendations for reducing them (MEFP ¶27, TMU ¶30).	End-Apr. 2008	SB
3. Publish the formula for adjusting electricity tariffs in response to changes in costs (MEFP ¶27, TMU ¶31).	End-Dec. 2007	SB
4. Ensure that the tariff schedule covers the costs of generating and distributing electricity as required by law (MEFP ¶27, TMU ¶32).	End-Jul. 2008	SB
<b>Fiscal</b>		
5. Approval of the 2008 budget consistent with a combined public sector deficit of 1.8 percentage point of GDP (MEFP ¶19).	End-Dec. 2007	PC
6. Prepare an action plan for strengthening the public sector financial administration system (MEFP ¶28, TMU ¶29).	End-Jun. 2008	PC
7. Finalize the revision of the Budget Classification system and the chart of accounts (MEFP ¶28).	End-Apr. 2008	SB
8. Complete the study on the actuarial status of the pension system (MEFP ¶29, TMU ¶33).	End-Jun. 2008	SB
9. Adopt measures to strengthen tax administration (MEFP ¶30, TMU ¶34).	End-Mar. 2008	SB
<b>Monetary</b>		
10. Complete an assessment of the financial position of the central bank and make recommendations to strengthen its finances (MEFP ¶31, TMU ¶35).	End-Jun. 2008	SB
<b>Social</b>		
11. Initiate the bi-annual publication of the principal social indicators for the health, education, and water and sanitation sectors (MEFP ¶6).	End-Jun. 2008	SB

1/ PC= Performance criterion; SB= Structural benchmark.

## TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This technical memorandum summarizes the understanding between the Nicaraguan authorities and the International Monetary Fund relating to the monitoring of the Poverty Reduction and Growth Facility (PRGF) arrangement.

### A. Program Definitions

2. For program purposes, all quantitative performance criteria and indicative targets will be defined as cumulative annual flows (from January 1 to December 31) for 2007 and separately for 2008.

### Fiscal Definitions

3. **Coverage of the fiscal accounts:**

- a. The Nonfinancial Public Sector (NFPS) includes the central government (CG), the Nicaraguan Social Security Institute (INSS), the Municipality of Managua (ALMA), and a subgroup of public enterprises—the electricity distribution company (ENATREL), the water and sewerage company (ENACAL), the energy company (ENEL), the national ports company (EPN), and the postal and telecommunications company (TELCOR).
- b. The Combined Public Sector (CPS) includes the NFPS and the Central Bank of Nicaragua (BCN).

4. The Central Government Overall Balance is defined as the total revenues of the Central Government minus total expenditures of the Central Government.

- a. Total revenues of the Central Government are defined on a cash basis as the sum of tax revenues, nontax revenues, capital revenues, and current transfers.
- b. Total expenditures of the Central Government are defined on a cash basis as the sum of wages and salaries, goods and services, interest, current and capital transfers, capital expenditure, and net lending.
- c. Interest on domestic and external debt is recorded on a cash basis for program purposes.

5. Primary Expenditure of the Central Government is defined as the total expenditure of the Central Government minus interest charges of the Central Government.

6. Foreign Grants to the Central Government are equal, for program purposes, to tied and untied grants to the Central Government.

7. Overall Balance of the Central Government after grants is equal to the overall balance of the Central Government plus foreign grants to the Central Government.
8. CPS Overall Balance after Grants is equal to the (i) Central Government overall balance, plus (ii) the overall balance of the INSS, (iii) the overall balance of ALMA, plus (iv) the overall balance of the subgroup of public enterprises included in the definition of the CPS given above in 3a, (v) the quasi-fiscal balance of the BCN, plus (vi) CPS foreign grants.
9. Net Domestic Financing of the CPS comprises the operating balance of the BCN, and the sum of the changes in the following balances during the corresponding period:
  - (a) outstanding nonfinancial public sector debt to the domestic financial system (BCN, commercial banks, and the Financiera Nicaragüense de Inversiones-FNI) net of deposits (including arrears corresponding to obligations eligible for refinancing, rescheduling, or any other debt reduction mechanism), with the foreign currency portion of the net debt to the banking sector converted into Córdobas at the program exchange rate; (b) the outstanding stock of domestically issued public sector debt held by the resident or nonresident private sector, with the foreign currency portion of the debt converted into Córdobas at the program exchange rate; (c) the outstanding stock of suppliers' credits; and (d) the outstanding stock of floating debt.
10. The definition of poverty-reducing spending of the central government. For the purposes of the program, poverty-reducing spending consists of all spending defined as such in the Central Government's Budget under the poverty-tracking instrument of the Integrated Financial Management and Administrative System (SIGFA). Thus defined, total poverty-reducing expenditure was 12.2 percent of GDP (11,381 million Córdobas) in 2006. This definition will be complemented with another spending definition that measures the direct incidence of spending on poverty.

### **Monetary Definitions**

11. Adjusted Net International Reserves (NIR-Adjusted) of the BCN are defined as:
  - a. Gross foreign assets, defined as those readily-available and under effective control of the BCN (excluding those that are encumbered, such as reserve assets used as collateral or guarantees for third-party external liabilities);
  - b. *Minus* the BCN's short-term reserve liabilities, including purchases and credits from the IMF;
  - c. *Minus* foreign currency deposits of commercial banks in the BCN (foreign currency reserve requirements).
12. The Net Domestic Assets (NDA) of the BCN are defined as the difference between the cash balance and the NIR-Adjusted, assessed at the program exchange rate.

13. The program exchange rate will be 18.4 Córdobas per US\$ for 2007, and 19.4 Córdobas per US\$ for 2008.

### **External Sector Definitions**

14. Nonconcessional debt of the CPS will be defined as: (i) the contracting of nonconcessional external debt of the CPS, or by any other agency acting on behalf of the CPS; or (ii) the provision of guarantees on nonconcessional debt.

- External debt includes all current (i.e. not contingent) liabilities with a nonresident party created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some point(s) in time; these payments will discharge the principal and/or interest liabilities under the contract. This definition includes loans, suppliers' credits, and leases.

15. **Concessional**: The concessional of external loans or financial leasing contracts will be based on a currency-specific discount rate according to the currency of the contract and the maturity date of the operation. For loans with maturities equal to or greater than 15 years, the 10-year average of the OECD's commercial interest reference rate (CIRR) will be used. The six-month average CIRR rate will be applied to loans with maturities of less than 15 years. In all cases, the CIRR rates will be adjusted by the relevant margins specified in concessional spreadsheets prepared by the IMF to account for the maturity dates of the operation. Maturity will be determined on the basis of the original loan contract. Under this definition of concessional, only debt with a grant element of 35 percent or more will be excluded from the debt limits.

16. External Payments Arrears are defined for program purposes as debt service obligations arising from external debt contracted or guaranteed by the CPS overdue by more than 30 days, except on external debt subject to relief, rescheduling, or restructuring.

17. Budget Support Financing is defined as external untied financial assistance in the form of loans and grants provided by foreign official entities and received by the CPS for unrestricted budgetary use.

## **B. Program Targets**

### **Fiscal Targets**

18. The quantitative performance criterion includes a floor on the overall balance of the CPS after grants, as defined above.

19. The indicative targets of the program include:

- a. A ceiling on central government primary expenditure, as defined above.
- b. A floor on poverty-reducing spending, as defined above.

### **Monetary Targets**

20. Quantitative performance criteria include (i) a floor on the cumulative annual flows of NIR-Adjusted of the BCN; (ii) a ceiling on the cumulative annual flows of NDA of the BCN, as defined above.

### **External Sector Targets**

21. Continuous performance criteria for the external sector apply to:

- a. A ceiling of nonconcessional external debt of the CPS, as defined above, subject to the following caveats:
  - This limit applies not only to debt as defined in point (9) of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted by the International Monetary Fund on August 24, 2000, but also to commitments contracted or guaranteed by these agencies for which value has not been received.
  - The ceiling on contracting of nonconcessional external debt applies both to short-term debt (maturity of one year or less) and to medium- and long-term debt (maturity of more than one year).
  - The ceiling excludes: (i) BCN instruments placed on the domestic market and held by nonresidents; (ii) short-term, import-related credits; (iii) BCN liabilities with maturities of less than one year; and (iv) liabilities to the IMF.
- b. A ceiling on external payments arrears of the CPS, as defined above.

### **C. Program Adjustors**

22. The NIR-Adjusted target will be adjusted *downwards*, up to a maximum total of US\$30 million in both 2007 and 2008, by the cumulative amount of any *shortfall* in external budget support financing (untied loans and grants) relative to the programmed amounts specified in Table 1, column H.

23. The NDA target will be adjusted *upwards*, up to a maximum total of US\$30 million in both 2007 and 2008, by the cumulative amount of any *shortfall* in external budget support financing (untied loans and grants) relative to the programmed amounts specified in Table 1, column H.

24. The target on the overall balance of the CPS after grants will be adjusted *downwards*, up to a maximum total of US\$30 million in both 2007 and 2008, by the cumulative amount

of any *shortfall* in external budget support grants relative to the programmed amounts specified in Table 1, column E.

25. The indicative target on the primary expenditure of the central government will be adjusted *upwards* by the cumulative amount of any *excess* in external budget support grants relative to the programmed amounts specified in Table 1, column E.

**Table 1. Programmed External Financing, 2007-08**  
(en millions de US\$)

	<b>External loans</b>	Budget support loans 1/	Project- related loans	<b>External Grants</b>	Budget support grants	Project- related grants	<b>Total financing</b>	Budget support	Project- related
	(a=b+c)	(b)	(c)	(d=e+f)	(e)	(f)	(g=a+d)	(h=b+e)	(i=c+f)
<b>Cumulative from January 2007</b>									
Q4-07	317	55	261	270	60	211	587	115	472
<b>Cumulative from January 2008</b>									
Q1-08	89	4	85	47	8	39	136	12	124
Q2-08	177	4	173	133	24	109	310	28	282
Q3-08	281	24	258	201	34	167	482	58	424
Q4-08	371	39	332	280	60	221	651	99	553

1/ Excludes al IMF.

26. In the case of external loans to the CPS associated with the ALBA cooperation (MEFP ¶ 16), the target on the overall balance of the CPS after grants will be adjusted *downwards*, up to a maximum total of US\$115 million in 2007 and US\$120 million in 2008 less the external loans from ALBA directed to public entities not included in the program's definition of the CPS. In addition, the indicative target on the primary expenditure of the central government will be adjusted *upwards* by the external loans under ALBA directed to the central government.

27. The indicative target on poverty-reducing spending will be adjusted *downwards* by the amount by which external financing (grants, loans, debt relief) linked to the poverty-reducing spending is below the programmed amounts specified in Table 2.

**Table 2. Nicaragua: Central Government Poverty Spending and Financing Sources, 2006-08**  
(in C\$ millions)

	2007					2008				
	2006	Jan-Mar. Prel.	Jan-Jun. Prel.	Jan-Sep. Proj.	Jan-Dec. Prog.	Jan-Mar. Prog.	Jan-Jun. Prog.	Jan-Sep. Prog.	Jan-Dec. Prog.	
<b>Poverty spending</b>	<b>11,381</b>	<b>2,649</b>	<b>5,341</b>	<b>9,843</b>	<b>15,349</b>	<b>3,749</b>	<b>8,061</b>	<b>11,776</b>	<b>17,743</b>	
Domestic financing	5,892	1,802	3,224	4,893	7,570	2,072	3,867	4,942	8,440	
<b>External financing</b>	<b>5,489</b>	<b>847</b>	<b>2,117</b>	<b>4,950</b>	<b>7,779</b>	<b>1,677</b>	<b>4,194</b>	<b>6,834</b>	<b>9,303</b>	
Grants	1,936	176	625	1,617	2,440	362	946	1,949	2,784	
Loans	1,881	271	657	1,791	3,140	811	2,138	3,060	3,687	
Debt relief	1,672	401	835	1,542	2,199	504	1,109	1,825	2,832	

Source: Ministry of Finance and Public Credit.

## D. Institutional Policy Agenda

### Structural Performance Criteria

28. **Enhance mechanisms to discourage fraud in electricity consumption.** This will involve introducing measures by end-2007 establishing criminal penalties to be imposed by a judicial authority on businesses and individuals found guilty of fraudulently consuming electricity. The same will be established for other public utilities (water and telecommunications). Fraud is defined as cases of (i) unduly benefiting from an illegal connection or tampering with metering and control systems; (ii) alteration of utility bills, including for electricity; (iii) destruction or illegal seizure of properties forming part of the system for distributing and installing public utilities.

29. **Prepare an action plan to reinforce public sector fiscal management.** This action plan will be prepared by the MHCP and presented to economic cabinet by end-June 2008 and will include the following key elements: (i) improving the budget recording system, including information on floating debt; (ii) assessing the coverage of the Treasury Single Account (TSA); and (iii) improving cash management. The plan will also include recommendations for enhancing audits and internal controls, improving sectoral assessments of public expenditure; and strengthening the medium-term expenditure framework.

### Structural Benchmarks

30. The study on the causes of losses in electricity distribution, including recommendations to reduce these losses, will be carried out by an independent, internationally recognized firm in the sector.

31. **Publish the formula for adjusting electricity tariffs as a result of cost variations.** Both the formula and the tariff calculated under the formula will be published by the regulator as changes are made.

32. **Ensure the new tariff structure covers the costs of electricity.** Amendments to the Energy Stability Law establishes that the current tariff structure will be valid for 12 months (July 2007 to June 2008), but will not be applied to final consumers. The deviations that result from the non-application of the current tariff will be financed by ENEL and repaid by the distribution firms during the period July 2008 to June 2009 through the implementation of a new tariff structure, which at the same time will cover electricity costs.

33. **Complete the actuarial study of the pension system.** The actuarial study will present conclusions on the size of the actuarial gap and the main factors explaining it. The study will be presented to the INSS Board and the economic cabinet.

34. **Initiatives to enhance tax administration include:** (i) completing the process by which all taxpayers are allowed to pay taxes through the banking system; (ii) revamping the taxpayer registry, through the introduction of a new taxpayer identification numbering system; and (iii) developing a comprehensive human resources policy in the DGI—approved by the MHCP—identifying, among other things, initiatives and the corresponding financing for training auditors and computerizing key departments.

35. **Assessment of the financial situation of the BCN and recommendations to improve its finances.** This involves conducting a special study on the bank's balance sheet and profit and loss statements, to assess the financial situation of the BCN, including the valuation of its assets and liabilities, and the causes of financial losses. The study will contain recommendations to address past losses, avoid future losses, and reconcile the BCN's financial position with the MHCP. The analysis and recommendations will be submitted to the BCN Board of Directors and recommendations relating to the reconciliation will be submitted to the MHCP.

## E. Reporting

36. **The BCN will publish the following documents on its web page:**

- a. Daily report containing information on the daily accounts of the BCN (stocks and flows) with a two-day lag;
- b. A monthly report with information (stocks and flows) on (i) the monthly accounts of the BCN within four weeks of the end of each month; and (ii) the monthly accounts of commercial banks and the FNI within six weeks of the end of each month;
- c. Quarterly accounts (stocks and flows) of (i) the BCN, within four weeks of the end of each quarter; and (ii) commercial banks and the FNI, within six weeks of the end of each quarter;



- d. Monthly information on the detailed operations of the CPS no later than five weeks after the end of each month; and
- e. Monthly information on the accounting of non-reschedulable external arrears by creditor, with detailed explanations, within four weeks of the end of each month.
- f. The BCN's annual financial statements and accompanying audit opinion within one month of the finalization of the audit, that will include the official approval of the Comptroller's Office.

**37. The Ministry of Finance and Public Credit (MHCP) will publish the following documents on its web page:**

- a. Contracts for external loans contracted or guaranteed by the combined public sector (CPS), approved by the General Assembly and published in the Official Gazette, including information on the corresponding amounts, currencies, and terms and conditions, as well as relevant supporting materials;
- b. Quarterly information on the issuance and redemption of domestic debt obligations (BPIs, bonds and bills) within four weeks of the end of each quarter; and
- c. Quarterly information on the operations of the national oil company (PETRONIC) and its affiliates within four weeks of the end of each quarter; and
- d. Quarterly information (stocks and flows) of the CPS debt within four weeks of the end of each quarter. The data will contain a detailed breakdown by creditor and debtor institution (central government, public enterprises, and other public entities excluded from the program's definition of the CPS).

**38. Monitoring of private external debt.** Given the large external current account deficit and the need to increase knowledge of private sector activities, the BCN will endeavor to improve its monitoring of private external debt. In this regard, we expect to develop and introduce a new private external debt survey by March 2008, and to obtain preliminary results by December 2008.

## **F. Safeguards**

39. The financial reporting, audit and control mechanisms of the BCN will be strengthened through the implementation of the safeguards recommendations of July 2007. Key measures and timetable are detailed in the table below. Other measures contained in the safeguards report will be monitored on an ongoing basis.

**Table 3. Safeguards Recommendations and Implementation Timetable, 2007-09**

Measure	Implementation Date	Status
1. Approval by the BCN's Board of Directors of the calendar and procedures for appointment of external auditors, and completion of annual audits.	Sep.-07	...
2. Implementation of the International Financial Reporting Standards (IFRS):		
(i) Approval by the BCN Board of Directors official implementation plan;	Oct.-07	...
(ii) presentation of semi-annual status reports;	Jul.-08; Jan.-09 and Jul.-09.	...
(iii) publication in the annual financial statements of key differences from IFRS and their quantification.	Feb.-08	...
3. Approval by the BCN's Board of Directors of the charter of the internal audit unit.	Oct.-07	...