DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

SM/84/26

CONTAINS CONFIDENTIAL INFORMATION

January 24, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Nicaragua - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1982 Article IV consultation with Nicaragua, which will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Caiola, ext. (5)8634.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL
INFORMATION

INTERNATIONAL MONETARY FUND

NICARAGUA

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the
1983 Consultation with Nicaragua

Approved by Eduardo Wiesner and Manuel Guitian

January 23, 1984

The 1983 Article IV consultation discussions with Nicaragua were conducted in Managua from October 24 to November 9, 1983.1/ The representatives of Nicaragua included the Ministers of Planning, Finance, Agriculture, Internal Trade, Industry, and Labor; the undersecretaries of External Trade and Planning; the President of the Central Bank; and officials of the Central Bank, ministries, nationalized commercial banks, and various government agencies and enterprises. The staff representatives were Messrs. Caiola (Head), de Rosa, Hernandez (all WHD), Molajoni (ETR), and Mrs. Rodriguez (secretary, WHD). Mr. Conrado, Advisor to the Executive Director for Nicaragua, attended the policy meetings.

Nicaragua is overdue in meeting a number of payments, the first of which fell due May 16, 1983, both to the Fund's General Resources Department and the SDR Department.2/ A separate report on these overdue payments and proposals to deal with the matter will be issued shortly.

I. Recent Economic Developments

In 1978-79 Nicaragua was ravaged by a civil war that seriously disrupted economic activity. In those two years, real GDP dropped by more than 32 percent, with the decline widespread among all the sectors. Infrastructure was heavily damaged, and the rates of growth of both domestic savings and fixed capital formation turned negative.

The Government that came into power in mid-1979 introduced an "Economic Rehabilitation and Reconstruction Plan" aimed at transforming the socioeconomic structure of the country, within the framework of a mixed economy. On the institutional front, new ministries and public entities were created, banks and insurance companies were nationalized, and the State assumed control of the export trade of the traditional agricultural commodities. Properties of officials of the former regime and of private individuals who had left the country were expropriated and organized into the People's Property Area (APP). An agrarian

1/ Nicaragua has accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Articles of Agreement.
2/ EBS/83/71, April 1, 1983; EBS/83/108, May 25, 1983; EBS/83/144, July 11, 1983; EBS/83/199, September 13, 1983; and EBS/84/5, January 5, 1984.

reform law (approved in 1981) expropriated land that was judged to be worked inadequately and gave the Government considerable discretionary power to regulate land tenure, resource utilization, as well as the determination of crops to be produced. As a result of these changes, the share of the public sector (including APP) in aggregate production rose from 14 percent in 1978 to 37 percent in 1980. The recovery program emphasized expansionary fiscal and monetary policies; to contain the balance of payments effects of these policies, trade restrictions and exchange controls were intensified.

In 1980-81 the economy recorded rapid recovery, and real GDP grew at a rate of more than 9 percent a year (Table 1). Outlays for fixed capital formation rose strongly, spurred by large public investment, while private investment was sluggish. But the recovery was shortlived, and in 1982 real GDP declined by some 1 1/2 percent to a level that was still below 80 percent of that attained in 1977, the year prior to the start of the civil war. After falling sharply from 1979 to 1981, unemployment rose again in 1982, although it remained below the 1979 level. Also, the rate of domestic inflation, as measured by the consumer price index, remained at levels well above Nicaragua's historical standards (28 percent a year in 1980-82 compared with 6 percent a year in 1976-78).

Table 1. Nicaragua: Selected Economic Indicators

(In annual percentage changes)

	1976-77 1/	1978	1979	1980	1981	1982	Est. 1983
Real GDP	6.8	-7.8	-26.4	10.0	8.5	-1.4	2.9
Cost of living							
Average	7.0	4.6	48.2	35.3	23.9	24.6	28.5
End of year	8.6	4.4	70.3	24.8	33.4	22.2	38.8

Source: Ministry of Planning.

1/ Average.

For 1983 the authorities were forecasting a recovery in economic activity. Real GDP had been expected to increase by 3 percent, on the strength of a sharp upturn in agricultural production together with some improvement in manufacturing output. However, the agricultural sector seems to have been affected by the escalation in guerrilla warfare that has been experienced during the year, and manufacturing output has been hampered by the shortage of imported inputs due to the lack of foreign exchange. Thus, it is likely that real GDP changed little in 1983. Domestic prices are estimated to have risen by 39 percent from December 1982 to December 1983.

The balance of payments during the last five years has been weak, reflecting the adverse effects of internal and external factors.1/ The output of Nicaragua's leading export products has declined, while imports increased sharply in 1980-81. A deterioration in the terms of trade also contributed to the widening of the current account deficit of the balance of payments from 8 percent of GDP in 1977 to about 23 percent of GDP in 1981. Mainly because of strict control over imports, the current account deficit declined to 18 percent of GDP in 1982 and to 14 percent in 1983. Notwithstanding a rapid rise in the external debt, net capital inflows have not been sufficient to finance the current account deficits, and Nicaragua has recorded large overall balance of payments deficits (defined to include renegotiation of external debts, accumulation of arrears, capitalization of interest, and changes in the banking system's net international reserves) in each year of the period 1980-83.2/ Notwithstanding the renegotiation of external debts and the shift of short-term debts into medium-term credits, the country's net international reserves have declined markedly since 1978 (Table 2).

To a large extent, the price and balance of payments developments reflected the expansionary fiscal and monetary policy pursued by the authorities under their recovery plan. In the fiscal field, the central government finances have been weak, even though the authorities made substantial efforts to increase revenues. Central government budgetary revenues rose from 12 percent of GDP in 1976-78 to 28 percent in 1983; however, over the same period, central government budgetary expenditures increased from about 18 1/2 percent of GDP to 49 percent of GDP,3/ reflecting the rise in outlays in the social area (particularly for health and education), transfers to the rest of the public sector and, more recently, the growing military budget. The overall budget deficit of the Central Government widened from 6 1/2 percent of GDP in 1976-78 to 21 percent in 1983, with financing coming increasingly from the Central Bank (Table 3). The total deficit was considerably higher because the budget does not cover certain expenditures financed by foreign loans, the capitalization of external interest payments, and the assumption by the Central Government of certain debts of nationalized banks and public enterprises.

1/ Balance of payments statistics have been adjusted by the staff to reconcile them with data derived from other fiscal, monetary, and external debt statistics. In the period under review, data so arranged show large outflows as a residual item.

2/ During 1979 there was an accumulation of external arrears for an unspecified amount.

3/ In addition in 1983 the Central Government took over debts of the APP and of government agencies with the domestic banking system, estimated at about 5 1/2 percent of GDP. In previous years, similar operations were carried out outside the budget.

Table 2. Nicaragua: Balance of Payments

(In millions of U.S. dollars)

	1979	1980	1981	1982	Est. 1983
Goods, services and transfers	180	-451	-593	-537	-496
Exports, f.o.b.	616	450	500	408	406
Imports, f.o.b.	-389	-803	-922	-724	-725
Interest payments	-78	-180	-199	-217	-180
Other services, net	-61	-42	-42	-56	-83
Transfers, net	92	124	70	52	86
Capital movements, n.i.e.	-183	-69	231	251	258
Public sector, net	14	25	80	313	318
Rescheduled amortizations	(...)	(-137)	(-74)	(-11)	(-23)
Other, net	(14)	(162)	(154)	(324)	(341)
Central Bank	88	64	118	54)	76
Rest of financial system	-7	18	82	20)	
Other 1/	-278	-176	-49	-136	-136
Allocations of SDRs and monetary gold	5	9	25	3	33
Overall balance	2	-511	-337	-283	-205
Debt rescheduling/arrears	-	314 2/	395	184	205 3/
Interest	(--)	(72)	(116)	(93)	(104)
Principal	(--)	(242)	(279)	(91)	(101)
Net international reserves (inc -)	-2	197	-58	99	...

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

1/ Including net errors and omissions.
2/ Excluding rescheduling of US$252 million debts in arrears.
3/ Excluding a rollover of US$107.5 million of short-term liabilities and the rescheduling of US$684.4 million of principal payments on medium- and long-term debt in arrears.

Table 3 : Nicaragua: Central Government Budgetary Operations

(As percent of GDP)

	1976-78 1/	1979 2/	1980 2/	1981	1982	Est. 1983
Total revenues	11.9	13.0	22.4	23.9	25.8	28.0
Tax revenue	10.7	10.2	17.2	17.9	20.1	23.1
Other	1.2	2.8	5.2	6.0	5.7	4.9
Total expenditures	18.5	19.7	28.3	31.3	36.5	49.1
Current expenditure	12.3	17.8	22.9	26.9	30.7	35.5
Capital expenditure	5.1	1.3	5.1	4.3	5.7	13.6 3/
Net lending	1.1	0.6	0.3	0.1	0.1	...
Overall surplus or deficit (-)	-6.6	-6.7	-5.9	-7.4	-10.7	-21.1
External financing (net)	3.9	1.4	4.3	1.6	0.3	8.1
Internal financing (net)	2.7	5.3	1.6	5.8	10.4	13.0 3/

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

1/ Average.
2/ Data for 1979 and 1980 are not fully comparable with data for subsequent years.
3/ Excluding assumption of EMABAS and APP debts with the domestic banking system (5.4 percent of GDP).

In the monetary area, total domestic credit expanded at more than twice the rate of increase of money and quasi-money during the four years 1980-83. The result has been the weak balance of payments position and high inflation referred to above.

II. Summary of Discussions

1. Main objectives of the Government's program

The authorities said that these objectives were to deal with internal and external imbalances while consolidating the process of structural reforms that had been initiated in mid-1979. These reforms were geared to the broadening of the scope of the public sector to enable it to control key sectors (marketing of leading export products, domestic distribution of basic commodities, banking activities) and to take a leading role in fostering certain activities. Investment in social areas (health and education) was to be given high priority in the Goverment's plans. The private sector had a role, provided that its contribution was consistent with the general objectives of the Government.

The authorities said that, even in normal circumstances, their objectives had to be viewed in a medium-term context, because of the far-reaching structural changes that were envisaged and the considerable damage caused by the 1978-79 civil war. Their task had been complicated by a combination of economic factors (deterioration of trade terms and sluggish demand for Nicaraguan products) and deterioration in the security situation. An acute scarcity of foreign exchange was perceived by the authorities as a serious bottleneck in the implementation of government plans.

The consultation discussions focused on price and wage policies, fiscal policy, monetary policy, and external policies.

2. Price and wage policies

Pricing policies are a key ingredient of the Government's economic program and have far-reaching effects on the Nicaraguan economy; in particular, they involve a system of subsidies that affect the government budget, the credit program, and the management of the exchange rate.

The authorities indicated that their price policy was aimed at (a) providing financial incentives to producers of the chief export products and the main staples for domestic consumption, and (b) ensuring an adequate supply of basic goods at reasonable prices. Production incentives were aimed particularly at the agricultural sector on the expectation that quick results were feasible, both in terms of exports and import substitution. In their view, the high protection that had been afforded the industrial sector had given rise to great inefficiencies and had adverse effects on domestic value added. Moreover, the industrial sector had been geared primarily to the Central American market which currently was in disarray and with little expectation of recovery in the short run.

The authorities have established a stabilization and marketing organization (ENABAS) for staples for domestic consumption, and have created eight foreign trade enterprises to handle the exportation of various products (coffee, cotton, meat, sugar, bananas, and some non-traditional exports) and the importation of certain inputs (agricultural inputs and imports of some specific commodities). In addition, they have opened a chain of retail outlets to handle the distribution of certain commodities in the domestic market.

Incentives to producers consist of (a) a minimum price that is set with a view to covering production costs and providing a reasonable profit margin; (b) assurances that output will be purchased at these minimum prices by the state marketing boards; and (c) bank credit at preferential rates. Exporters are entitled to receive export prices if they are higher than the price guarantee, and the costs of subsidies of export schemes are covered by the Central Bank through a mix of exchange rates. In some cases the subsidy is substantial. For the crop year 1982-83, the minimum price for cotton was more than 50 percent above the world market price and for coffee it was 12 percent above the world price. The authorities said that major incentives to producers had been necessary in order to revitalize economic activity.

To assure the supply of some basic goods for domestic consumption, a rationing system had been introduced for rice, beans, corn, sugar, cooking oil, soap, and gasoline, most of which are sold by state-owned retailers at subsidized prices. Consumers may purchase these products in amounts above the allotted quotas at private retail outlets, where prices are well above the official ones. The controlled retail prices of basic grains are well below the sum of the guaranteed producer price and ENABAS' operational costs. The difference between the minimum price paid to producers and that paid by local consumers is financed by the Central Government in the form of transfers to ENABAS. The subsidy on basic grains alone was estimated at more than 1 percent of GDP in 1982.

In reviewing the results of these policies, the authorities recognized the shortcomings of the price arrangements and the sizable costs that were involved. The highly subsidized prices of some basic grains had fueled demand far in excess of domestic production. The gap had been filled in part by imports covered by foreign donations, but large imports of basic grains had had to be paid out of foreign exchange holdings. Difficulties in distribution, together with the large differential between buying and selling prices, had fostered speculation and a black market in certain products. Also, notwithstanding the price incentives that had been furnished, the area under cotton cultivation had dropped considerably. Finally, even though the guaranteed prices were expected to cover all production costs, bank credits had not been repaid by many producers, thus implicitly increasing the cost of the subsidization program.

The authorities had been giving consideration to the possibility of increasing domestic sales prices of basic grains to the levels of prices paid to producers, or of reducing the number of products qualifying for subsidies. However, they feared that such changes could trigger requests for wage adjustments that would be disruptive. Nonetheless, sales of gasoline outside the rationing scheme have been authorized, at prices two-and-one-half times the official price.

The authorities said that their pricing and subsidy policies had had the effect of moderating the demands for wage increases. In general, wage policy had sought a temporary fall in real wages in order to stimulate employment and economic recovery. Consistent with these objectives, after a large increase granted in 1979, wages had been increased relatively little and had lagged behind inflation. Minimum wages had not been revised since May 1981, ceilings on public sector salaries had been strictly enforced, and the intervention of the Ministry of Labor had effectively limited the size of wage increases in the private sector and had prevented the breaking of collective agreements before their expiry. In the Central Government, increases in the wage bill had reflected mainly a rise in the labor and military forces rather than salary adjustments.

3. Fiscal policy

In reviewing developments in the fiscal area, the authorities emphasized the efforts made to raise revenues. Central government revenues have increased by 14 percentage points of GDP from 1976-78 to 1982, and are estimated to have risen by another 2 percentage points (to 28 percent of GDP) in 1983 (see Table 3). About 3 percentage points of this increase was attributable to the inclusion in the budget of operations that were previously carried out outside the budget, or to foreign grants. However, the increase in revenue was very large even after allowing for the difference in coverage.

The increase in revenue resulted from a combination of new or revised taxes and a drive to curtail tax evasion. The most important tax measures included a C$5 per U.S. dollar tax on sales of foreign exchange for nonessential imports (introduced in 1982); a surcharge on direct taxes (applicable for the fiscal year 1982/83); a broadening of the coverage and an increase in the rates of income taxes; and higher rates for excise and sales taxes, combined with increases in controlled prices of some of the commodities on which such taxes are levied, e.g., petroleum products, beer, and soft drinks. The yield from import taxes also rose sharply as a result of the depreciation of the cordoba in 1979, which partly offset the effects of a decline in imports in general and of imports subject to duty in particular. For 1983 the revenue increase in relation to GDP was entirely attributable to increases in the domestic prices of petroleum products and to higher proceeds from the tax on sales of foreign exchange.

Notwithstanding the effort to raise revenues, the overall deficit of the Central Government has widened in relation to GDP because of a rapid increase in expenditures in social fields (health and education), defense, and transfers to the rest of the public sector (including expropriated enterprises) and to the private sector. Interest payments also have risen strongly.

The sharp rise in transfers has been in large measure the result of the pricing and subsidy policies of the authorities discussed above. Apart from covering directly the differences between costs and prices for certain products, government transfers have financed also the rising operating deficits incurred by state enterprises and other public agencies because of a freeze of their prices. Total transfers from the Central Government are estimated to have reached 14 percent of GDP in 1983; in addition, in 1983 the Central Government took over a part of the outstanding indebtedness of ENABAS and of APP with the banking system, with the debt in question estimated at about 5 1/2 percent of GDP. The authorities acknowledged that the heavy pressures on the public finances could be alleviated only if their pricing and subsidy policies were revised.

There have been large differences between actual expenditures and budgetary appropriations in recent years (Table 4). The largest overruns have been in military spending and transfers. The authorities attributed the overruns in transfers to the difficulties in projecting operational losses of government agencies and the full impact of subsidies. They added that the start of guerrilla warfare in their country had affected budgetary control. Nonetheless, all efforts were being made to contain salaries, delay low priority investments, and rationalize expenditure in general.

The budget for 1984 was still in preparation at the time of the mission. The authorities said they would be seeking to limit the overall deficit in order to reduce inflationary pressures. To this end, revenues would be increased through administrative improvements and selective tax increases. Expenditures would be concentrated on certain priority sectors (defense, health, education, supply and distribution of basic commodities, and incentives to agricultural production), while other categories, particularly wages and salary, would continue to be restricted. Transfers to the rest of the public sector were to be reduced drastically, except for basic grain subsidies. Investment outlays were to be directed to complete projects in progress. Even with success in these efforts, the authorities doubted that the central government deficit to be financed domestically could be brought below 10 percent of GDP in 1984, compared with a deficit of about 13 percent of GDP in 1983.

Table 4. Nicaragua: Central Government Operations

(In millions of cordobas)

	1979 1/	1980 1/		1981			1982			1983	
	Budget Actual	Budget Actual	Extra Budget	Budget	Budget Actual	Extra Budget	Budget	Budget Actual	Extra Budget	Budget	Budget Proj.
Revenues, including grants	1,892	4,901	--	5,779	6,200	--	6,958	7,619	--	9,377	9,726
Current expenditures	2,587	5,008	--	6,724	6,986	1,652	7,983	9,090	2,625	10,792	12,340
Wages and salaries	1,006	1,585	--	1,963	1,904	--	2,333	2,189	--	2,822	2,843
Goods and services	1,013	2,173	--	2,929	3,016	835	3,341	3,899	1,788	4,464	6,296
Interest	331	488	...	936	847	817 2/	1,116	1,384	837 2/	1,687	890
Transfers	237	762	--	896	1,219	--	1,193	1,618	--	1,819	2,311
Current account	-695	-107	--	-945	-786	-1,652	-1,025	-1,471	-2,625	-1,415	-2,614
Capital expenditures	280	1,179	609	1,596	1,130	1,429	2,283	1,702	1,540	2,832	4,712
Fixed capital formation	148	817	136	1,306	883	233	2,078	1,135	506	1,915	2,135
Transfers, including lending	132	362	473	290	247	1,196	205	567	1,034	917	2,577 3/
Overall deficit	-975	-1,286	-609	-2,541	-1,916	-3,081	-3,308	-3,173	-4,165	-4,247	-7,326
External financing	210	938	432	1,017	424	3,645	913	78	4,310	1,130	2,809
Drawings of loans)		1,038	136	1,214	617	1,068	1,106	277	2,294	1,519	3,022
Capitalization of interest)	210	--	--	--	--	710	--	--	680	--	--
Assumption of external debt)		--	473	--	--	1,917	--	--	1,392	--	--
Amortization)		-100	-177	-197	-193	-50	-193	-199	-56	-389	-213
Internal financing	765	348	177	1,524	1,492	-564	2,395	3,095	-145	3,217	4,517
Financial system 4/	898	1,056	-360	1,506	2,015	-1,570	2,432	3,108	-506	2,969	
Other 5/	-133	-708	537	18	-523	1,006	-37	-13	361	248	4,517
Memorandum item											
External debt renegotiations 6/	...		5,663			2,687			567		

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

1/ Data for 1979 and 1980 are not fully comparable with data for subsequent years.
2/ Including capitalized interest.
3/ Excluding assumption of ENABAS and APP debts with domestic banking system (C$1,884 million).
4/ Including transactions related to assumption by the Central Government of external debts of commercial banks.
5/ Including timing differences between Treasury and banks' records.
6/ Excluding capitalization of interest.

4. Monetary policy

When the present Government came into power in mid-1979, it introduced changes in the banking system in order to assure that credit would be allocated on the basis of priorities established by the state. The locally-owned banking system was nationalized and reorganized into five commercial banks.1/ One of the new banks (the National Development Bank), besides carrying on normal credit operations, was to be specialized in the financing of the agricultural sector. One bank was to finance housing construction, and the other three banks (one of which is very small) were to follow the traditional pattern of commercial banking. To deal with the problem of the weak loan portfolio that was a legacy of the civil war, the Government authorized a restructuring of bank credits by spreading the maturity over periods ranging from six to ten years at preferential interest rates, depending on the activities and importance of the enterprises requesting relief. Since the commercial banks had large external debts that could not be repaid for lack of foreign exchange, the Central Government assumed these obligations and made capital contributions to the banks.

In implementing monetary and credit policies the authorities have been making use of selective credit controls, legal reserve requirements, and interest rates. These instruments have been used within the framework of annual credit programs that are subject to review every six months.

The credit programs include limits on gross credit expansion as well as estimates on credit recoveries. The limits on credit are distributed monthly by economic activities and lending institutions. A review of monetary developments showed that while gross credit had expanded according to plans, recoveries had fallen short of estimates, with the result that bank credit in arrears (excluding the restructured credit referred to above) had risen from 15 percent of outstanding credit to the private sector (including APP) at the end of 1980 to 31 percent at the end of June 1983. The increase in credit in arrears was in both the agricultural and industrial sectors, particularly to APP enterprises. Arrears also had emerged in credits for the production of commodities for which the Government had guaranteed minimum prices that had been expected to cover all costs of production.

In reviewing the experience of the past few years, the authorities acknowledged that credit expansion had been too large relative to the accrual of bank resources. They noted that the task of credit management had been difficult on a number of points. Apart from the problem of individual enterprises not being in a position to repay bank loans on time, there had been the pressures to extend credit for certain specific activities in order to avoid bankruptcy and unemployment, for the capitalization of state marketing boards and expropriated enterprises, and for the purpose of covering the widening fiscal deficit.

1/ Branches of foreign banks were allowed to continue to operate, but they could no longer receive local deposits.

At the beginning of 1983, the structure of legal reserve requirements was revised, with such requirements unified at 10 percent, compared with an average of 16 1/2 percent previously. Because of the seasonality of bank deposits and credit operations, two of the commercial banks can be expected to have excess reserves for several months of the year. These excess reserves are to be deposited with the Central Bank in a special account (the Liquidity Fund) that pays an interest of 12 percent. This Fund is used to extend credit to the National Development Bank. According to the scheme, the National Development Bank is expected to repay these credits on a schedule that would enable the lending banks to implement their own credit programs without difficulties. Although it is still too early to assess the full impact of the new legal reserve arrangement, it might be noted that excess reserves dropped from 5 percent of liabilities subject to requirement in June 1982 to 1 percent in June 1983, and there are certain questions whether the National Development Bank will be in a position to repay borrowings from the Liquidity Fund.

Regarding interest rates, the authorities have followed a policy of subsidizing loans for housing and for what are viewed as productive purposes. Interest rates charged on loans have ranged between a minimum of 8 percent for credits to agricultural cooperatives and a maximum of 24 percent for commercial credits (excluding credits to ENABAS), but bank credits generally carry interest rates in the range of 12 percent to 18 percent. Interest rates paid on deposits are 8 percent for savings deposits, 9 percent for time deposits of up to six months, and 10 percent for time deposits of up to one year; the rate increases by 1 percentage point for each additional year of maturity up to a maximum of 16 percent.

The Nicaraguan authorities acknowledged that the rate of growth of liabilities of the banking system had been below the rate of price increase in the last few years, and that the rise of such liabilities had not covered the expansion of bank credit. Nevertheless, they had decided against an upward adjustment of deposit rates because of a view that the accrual of bank deposits was fairly inelastic to changes in the rate of return, and because of concerns about the repercussions on bank profitability.

The review of monetary policy in the recent past had led the authorities to the conclusion that certain modifications should be introduced in the 1984 monetary program. The modifications would include a change in credit allocations to give priority to the production of agricultural products for export and for domestic consumption, closer scrutiny of credit requests to ensure that the more pressing credit needs were satisfied, administrative improvements to assure a better recovery of credits, and a closer balance between credit expansion and accrual of resources to the financial system. The authorities did not expect to make major changes in legal reserve requirements or in the structure of interest rates.

5. External policies

The Nicaraguan authorities said their weak balance of payments situation reflected sluggish world demand for Nicaraguan exports and the deterioration in the terms of trade, as well as difficulties in negotiating new foreign credits. The shortage of foreign exchange had been aggravated by the need to import basic grains to satisfy rising domestic demand. In these circumstances, imports of capital goods and other basic inputs had to be cancelled or postponed. Efforts that had been made to increase exports generally had not been successful. In the case of agricultural products, production had not responded to the incentives provided, while international prices had stayed rather low. Exports of manufactured goods had been depressed by the shrinkage of the Central American Common Market.

As regards the management of the exchange system, all external transactions must take place in the official exchange market. Purchases of foreign exchange may be effected only if they are explicitly authorized by the Central Bank in the form of an exchange permit. Foreign exchange is rationed on the basis of priorities, which are periodically reviewed by the Government. The rationing mechanism involves decisions by at least three different committees. The list of transactions currently permitted is severely limited.

In the official exchange market, transactions take place at either C$10 per U.S. dollar or C$28 per U.S. dollar. Proceeds from most exports are liquidated at exchange rates resulting from different combinations of the two rates just mentioned. At present, more than 90 percent of total export proceeds are liquidated at mixed rates that range from C$12.53 per U.S. dollar to C$17.20 per U.S. dollar; these rates are set and reviewed periodically by the Central Bank. The exchange rate for imports is C$10 per U.S. dollar, but nonessential imports are subject to a C$5 per U.S. dollar exchange tax (which is credited to the Central Government). All import duties and taxes are liquidated at the C$10 per U.S. dollar exchange rate.

Full details on the value of transactions taking place at various exchange rates are not available except for trade. The share of exports liquidated at C$28 per U.S. dollar increased from 12 percent of total exports in 1982 to 30 percent in the first six months of 1983. During the same period, the share of imports subject to the C$5 per U.S. dollar exchange tax increased from about 13 1/2 percent of total imports to nearly 25 percent. The average exchange rate of the cordoba for exports moved from C$10 per U.S. dollar in 1981 to C$15.33 per U.S. dollar in the first semester of 1983, and that for imports moved from C$10 per U.S. dollar to C$11.22 per U.S. dollar over the same period. (If import taxes and duties are included, the average exchange rate for imports depreciated from C$10.68 per U.S. dollar in 1981 to C$12.11 per U.S. dollar in the first semester of 1983.)

These exchange arrangements have given rise to net losses, which amounted to C$331 million in 1982 and C$887 million in the first semester of 1983. Taking into account the seasonality of exports, the staff has estimated tentatively that net exchange losses for 1983 as a whole may have amounted to about C$750 million (2.2 percent of GDP).

Nicaragua has received external assistance in the form of donations and loans from governments, but these inflows have not covered the current account deficit and scheduled debt repayments. As a result, Nicaragua has accumulated arrears and has renegotiated amortization and interest payments due to many of its creditors. In the case of foreign commercial banks, since 1981 Nicaragua has not been current in the payment of interest under the terms of the rescheduling agreement, and the unpaid interest has been capitalized.1/ As a result, the availability of foreign credits from commercial sources (other than through renegotiation) has been dwindling. Also, Nicaragua has not settled its net debit balances in the Central American Clearing House, and its access to this regional arrangement has been restricted.

The net international reserves of the Central Bank (defined as the difference between gross foreign assets and short-term liabilities, including liabilities to the Fund) have weakened from a net liability position of US$26 million at the end of 1979 to a net liability position of US$435 million at the end of June 1983, notwithstanding the elimination of US$94 million of short-term liabilities through a rescheduling operation. Over the same period, the gross foreign assets of the Central Bank have risen from US$122 million to US$281 million, but this increase reflected mostly a revaluation of gold holdings (which are pledged as collateral for foreign loans), subscriptions to regional monetary organizations, and credits under clearing arrangements which are more than offset by debits under the same arrangements. At the end of June 1983, Nicaragua's liquid foreign exchange reserves were estimated to be about US$20 million, some of which had been deposited abroad as a guarantee for the opening of letters of credit.

In a general discussion of the exchange system, the authorities noted that the arrangements adopted had sought to meet a number of aims, including the reactivation of specific export sectors, the discouragement of nonessential imports, control over the prices of basic commodities, the blockage of capital flight, and the allocation of foreign exchange in accordance with planned priorities. The authorities said that they were aware that the exchange system, as it had developed, was very complex and cumbersome to manage. In part this was the consequence of responses to the problems that arose in the aftermath of the civil war, the difficulties experienced in obtaining economic reactivation and growth in a situation of severe internal and external pressures. They stated that although the current system was viewed as temporary, its simplification could only be undertaken once political and economic normalcy had been re-established in the region.

1/ Nicaragua is also in arrears to the Fund.

6. Practices subject to Fund approval

The exchange system of Nicaragua gives rise to a number of practices which are subject to Fund approval under Article VIII. These involve restrictions on payments and transfers for current international transactions and multiple currency practices.

All requests for foreign exchange in Nicaragua are subject to a rationing mechanism, and at present requests relating to low priority imports and certain invisible transactions are routinely rejected in view of the scarcity of foreign exchange. This practice constitutes a restriction subject to Fund approval under Article VIII, Section 2(a). In addition, the existence of arrears on current external payments obligations constitutes another restriction subject to Fund approval under Article VIII, Section 2(a).

At the same time, the exchange system involves a number of multiple currency practices. These arise from the existence of two officially recognized exchange rates, from the liquidation of the proceeds from certain exports at rates resulting from different combinations of the two exchange rates, and from a tax of C$5 per U.S. dollar on the purchase of foreign exchange for nonessential imports. These practices are subject to Fund approval under Article VIII, Section 3.

7. Medium-term outlook

In connection with a Meeting of the Program for the Economic Development of the Central American Isthmus, sponsored by the Inter-American Development Bank in Brussels in September 1983, the Nicaraguan Government prepared a document outlining the main elements of the economic policy it intended to follow during the period 1983-88. The plan envisaged the implementation of stabilization measures, and it described an economic development strategy that called for investment of the order of 20 percent of GDP. This investment effort would require a substantial mobilization of domestic savings as well as large capital inflows from abroad. To achieve these objectives, the document stressed the need to reduce fiscal deficits, restrict monetary expansion, and increase the efficiency of public enterprises. In addition, reference was made to the need for export promotion and greater flexibility in interest rates and exchange rates.

In the consultation discussions the authorities informed the mission that the medium-term plan had been drafted on the assumption that the political situation in the Central American region would return to normal, thereby permitting a substantial reduction of defense expenditures. They also had assumed that Nicaragua would have access to external sources of financing in the amount and terms specified in the plan, and that external demand for Nicaraguan products would revive. Since these basic assumptions were not being met, the authorities said that their policies would have to continue to focus on the short term.

III. Staff Appraisal

Nicaragua has been experiencing serious economic and financial difficulties. The economic recovery in the first two years following the end of the 1978-79 civil war gave way to a decline in economic activity in 1982. Real GDP in 1982 was probably no more than 80 percent of the level attained in 1977, the year prior to the start of the civil war, and it appears to have remained at about that level in 1983. At the same time, the external position is very weak and the rate of inflation continues to be high by Nicaraguan standards.

The inability of the authorities to achieve their objectives in respect of stabilization and the revitalization of the economy has reflected a number of factors. The Government that took over in mid-1979 was confronted with a very difficult situation as it inherited a badly deteriorating economic apparatus, decapitalized enterprises, and damaged infrastructure. Its attempts to cope with economic problems were hampered by a worsening of terms of trade, sluggish external demand for Nicaragua's leading exports, and a decline in Central American regional trade. However, the policies followed by the authorities also had an important impact on economic performance, and the consultation discussions focused on whether these policies have been appropriate to the achievement of a stronger economy and a sustainable external position.

A key element of the authorities' strategy has been its price and subsidy policy, which encompasses a wide range of commodities and services. The degree of subsidization, whether provided directly or indirectly, is such that it is having substantial effects on efficiency and is an important factor behind the internal and external imbalances that exist. At their present levels, subsidies to producers are reducing their incentives to hold down production costs and thus are affecting supply adversely, while the subsidies to domestic consumers are stimulating demand unduly. With production unable to satisfy demand at the prevailing prices, there are pressures to resort to unofficial markets and speculation is fostered.

As already mentioned, the increased use of subsidies has not only affected the efficiency of resource use but it also has affected the handling of macroeconomic policies. It has resulted in a widening of the fiscal deficit, increase in bank credit, and a weakening of the capital position of the banking system and of the state marketing boards, and thus it has given rise to inflationary and balance of payments pressures.

Even though the authorities have raised government revenues at an impressive rate, through a combination of new tax measures and tightening of tax evasion, the Central Government's overall deficit has increased markedly notwithstanding the fact that Nicaragua has not been servicing in full its external debt. The deterioration of fiscal performance is mostly attributable to transfers to the rest of the public sector required to cover the subsidies referred to above and, more recently, rising military expenditures. In recent years the fiscal results have differed greatly from the budget plans because of cost overruns and of other expenditures not contemplated in the original presentation. The margin to increase public sector revenues further is likely to be somewhat limited, and to deal with the fiscal problem that is being faced the authorities will need to act to a large extent on the side of expenditures. Improvements in expenditure control could make a significant contribution in this regard, but also will be necessary to seek savings through a re-examination of priorities. As already stated, the system of subsidies and transfers has come to constitute a sizable burden on the public finances.

The conduct of monetary policy requires major revisions to bring the growth of total credit into line with resources, to achieve a more efficient allocation of credit, and to spur savings. It is clear that the mechanism for controlling credit will have to be strengthened, to limit the growth of credit in default and to curb the practice of having the Central Government assume responsibility for unpaid debts. Besides adding to the pressures on scarce fiscal resources, thus rendering fiscal management even more difficult, this practice is counterproductive since it diminishes the incentives for an appropriate scrutiny of credit demands and weakens the determination to collect credits at their maturity. Increasing the role of interest rates in allocating credit would help Nicaragua deal with some of the difficulties in credit accounts management confronted and would contribute to an improvement in economic performance. Furthermore, the present interest rate policy, which results in negative real interest rates for most transactions, is not consistent with the stated objective of the authorities to increase Nicaragua's savings, and is likely to result in a misallocation of resources.

Nicaragua is facing serious balance of payments difficulties, partly because of factors outside of its control but also because of deficiencies in domestic policies. Incentives to exporters have not resulted in a revival of exports partly because other policies (i.e., domestic interest rates and import schemes) run counter to these incentives. The limited foreign exchange is made even more scarce by the need to import basic grains generated by the present subsidy and rationing scheme. Nicaragua has so far received substantial assistance from foreign governments, but it has fallen in arrears in the servicing of its obligations and has not been able to adhere to the terms of the renegotiation schedules. As a result, Nicaragua's access to new foreign borrowing is likely to be severely curtailed. Nicaragua's foreign exchange holdings are practically exhausted and balance of payments difficulties are likely to persist in the absence of adjustments in basic policies. As regards the exchange and trade system itself, the current arrangements are unduly complex and to the extent they help protect the balance of payments they do it in an inefficient manner. There is a need for increased use of the price mechanisms in this field.

At present, Nicaragua maintains a comprehensive system of exchange controls, rations foreign exchange and has accumulated external payments arrears, giving rise to restrictions subject to Fund approval. The dual exchange rate system, together with the associated mixing rates and an exchange tax constitute multiple currency practices subject to Article VIII, Section 3. These restrictions and practices have been intensified and in view of present prospects and the policies being implemented by the authorities, the staff does not recommend Fund approval for these restrictions and practices, and urges the Nicaraguan authorities to pursue policies to enable them to liberalize the exchange system as soon as possible.

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

Fund Relations with Nicaragua
(December 30, 1983)

Date of membership: March 14, 1946.

Status: Article VIII.

Quota: SDR 51.0 million. (Nicaragua has not consented to the proposed maximum quota of SDR 68.2 million under the Eighth General Review.)

Fund holdings of cordobas:

	Millions of SDRs	Percent of Quota
Total	64.3	126.1
Of which: credit tranches	2.7	5.2
compensatory financing	10.6	20.8
oil facility	0.01	0.01

Overdue Repurchases: Four scheduled repurchases, for which original due dates were May 16, August 16, November 16, and November 30, 1983 are overdue. These repurchases are related to the compensatory financing facility purchase (SDR 6.375 million) and to the credit tranches purchase (SDR 0.543 million).

Overdue charges: Periodic charges totaling SDR 0.221 million due November 4, 1983 are overdue. In addition, net interest of SDR 0.409 million on use of SDRs due November 1, 1983 remains unsettled.

SDR Department:

	Millions of SDRs	Percent of Allocation
Net cumulative allocation	19.5	100.0
Holdings	--	--

Direct distribution of profits from gold sales (July 1, 1976-July 31, 1980): US$4.3 million.

Gold distribution: 23,106 fine ounces (four distributions).

Exchange system: Official system exchanging at two rates--of C$10 per U.S. dollar and C$28 per U.S. dollar--or a combination of the two rates, according to transactions.

Last Article IV consultation: August-September 1981, completed by the Executive Board on December 23, 1981.

Nicaragua--Basic Data

Area and population			
Area			148,000 sq. kilometers
Population (mid-1983)			3.01 million
Annual rate of population increase (1979-83)			3.3 percent
GDP (1983)			SDR 3,235 million
GDP per capita (1983)			SDR 1,073
Origin of GDP (1983)			(percent)
Agriculture			25.8
Manufacturing			23.5
Construction			2.0
Transport and communications			5.8
Commercial services			19.2
Government			8.6
Other			15.1
Ratios to GDP (1983)			
Exports of goods and nonfactor services			15.3
Imports of goods and nonfactor services			21.9
Central government revenue			28.0
Central government expenditure			49.1
External public debt (end of June)			93.1
Saving			1.0
Investment			15.3
Money and quasi-money (end of year)			39.4
Annual changes in selected economic indicators	1981	1982	Est. 1983
Real GDP	8.5	-1.4	2.9
Real GDP per capita	5.0	-4.6	-0.4
GDP at current prices	18.5	14.0	17.5
Domestic expenditures (at current prices)	18.2	7.2	13.0
Investment	(82.2)	(-10.7)	(-2.9)
Consumption	(8.6)	(11.7)	(16.2)
GDP deflator	9.2	15.7	14.3
Cost of living (annual averages)	23.9	24.6	28.5
Central government revenues	26.5	22.9	27.7
Central government expenditures	31.2	33.0	58.0
Money and quasi-money	15.1	22.0	39.8
Money	(24.5)	(27.3)	(48.0)
Quasi-money	(2.8)	(13.6)	(25.1)
Net domestic assets of the financial system 1/	34.2	46.7	54.0
Credit to public sector	(5.1)	(20.5)	(42.7) 2/
Credit to private sector	(44.7)	(32.1)	(30.2) 2/
Merchandise exports (f.o.b., in U.S. dollars)	11.0	-18.4	-0.3
Merchandise imports (f.o.b., in U.S. dollars)	14.9	-21.6	0.2

Central government budget	1981	1982	Est. 1983
	(millions of cordobas)		
Revenue	6,200	7,619	9,726
Expenditure	8,116	10,792	17,052
Current account surplus or deficit (-)	-786	-1,471	-2,614
Overall deficit (-)	-1,916	-3,173	-7,326
External financing (net)	424	78	2,809
Internal financing (net)	1,492	3,095	4,517
Balance of payments	(millions of U.S. dollars)		
Merchandise exports (f.o.b.)	500	408	406
Merchandise imports (f.o.b.)	-922	-724	-725
Investment income (net)	-171	-208	-175
Other services and transfers (net)	--	-13	-2
Balance on current and transfer accounts	-593	-537	-496
Official capital (net) 3/	80	313	318
Financial system medium- and long-term capital (net) 3/	200	74	76
Other	-24	-133	-103
Change in net reserves of banking system (increase -)	-58	99	...
Debt rescheduling	395	184	205

International reserve position	June 30 1982	Dec. 31 1982	June 30 1983
	(millions of SDRs)		
Central Bank (gross)	103.9	129.3	162.8
Central Bank (net)	-439.9	-378.8	-406.4
Rest of financial system (net)	-72.8	-11.6	-0.5

1/ In relation to the stock of money and quasi-money at the beginning of the period. Excludes contra-entry of SDR allocations.
2/ Excluding Central Government's assumption of APP debts.
3/ Excluding debt rescheduling.