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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/36

10:00 a.m., March 5, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	
	H. G. Schneider
	X. Blandin
	J. Delgadillo, Temporary
	M. K. Bush
	M. Z. M. Qureshi, Temporary
T. Hirao	T. Yamashita
J. E. Ismael	
R. K. Joyce	
	C. Robalino
G. Laske	
G. Lovato	C. P. Caranicas
	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	
	K. G. Morrell
	O. Kabbaj
	E. I. M. Mtei
M. A. Senior	
	A. Lindø
N. Wicks	
	Wang E.

L. Van Houtven, Secretary
J. A. Kay, Assistant

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Also Present

Asian Department: S. Kimura. Exchange and Trade Relations Department: M. Guitian, P. A. Molajoni. Legal Department: G. P. Nicoletopoulos, Director; J. K. Oh, S. A. Silard. Treasurer's Department: D. Williams, Deputy Treasurer; M. N. Bhuiyan, D. Gupta, M. A. Lumsden, G. Wittich. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. Caiola, C. Cha, C. M. de Rosa, M. R. Figuerola, M. T. Hernandez, G. Oliveros. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, C. J. Batliwalla, S. E. Conrado, L. Ionescu, W. Moerke, G. E. L. Nguyen, Y. Okubo. Assistants to Executive Directors: R. Bernardo, J. Bulloch, I. Fridriksson, V. Govindarajan, N. U. Haque, J. M. Jones, H. Kobayashi, M. J. Kooymans, G. W. K. Pickering, E. Portas, D. J. Robinson, S. Sornyanyontr, J. C. Williams.

1. ST. CHRISTOPHER AND NEVIS - MEMBERSHIP - REPORT OF COMMITTEE

The Executive Directors considered the report by the Committee on Membership for St. Christopher and Nevis (EBD/84/49, 2/16/84).

Without discussion, the Executive Board approved the draft decision requesting the Secretary to send the Board's report and a draft Resolution on Membership for St. Christopher and Nevis to the Governors for a vote by mail.

The decision was:

MEMBERSHIP FOR ST. CHRISTOPHER AND NEVIS

1. The Board of Governors is requested to vote without meeting pursuant to Section 13 of the By-Laws of the Fund upon the attached draft Resolution.

2. The Secretary is directed to send the attached report and draft Resolution on Membership for St. Christopher and Nevis to each member of the Fund by rapid means of communication on or before March 7, 1984.

3. To be valid, votes must be cast by Governors or Alternate Governors and must be received at the seat of the Fund before 6:00 p.m., April 4, 1984. Votes received after that time will not be counted.

4. The effective date of the Resolution of the Board of Governors shall be the last day allowed for voting.

5. All votes cast pursuant to this decision shall be held in the custody of the Secretary until counted, and all proceedings with respect thereto shall be confidential until the Executive Board determines the result of the vote.

6. The Secretary is authorized to take such further action as he shall deem appropriate in order to carry out the purposes of this decision.

Decision No. 7641-(84/36), adopted
March 5, 1984

REPORT BY THE EXECUTIVE BOARD

MEMBERSHIP FOR ST. CHRISTOPHER AND NEVIS

St. Christopher and Nevis applied on July 26, 1983 for admission to membership in the International Monetary Fund in accordance with Section 2 of Article II of the Articles of Agreement of the Fund; and, pursuant to Section 21 of the By-Laws, the Executive Board had consulted with the representative of that Government and has agreed upon the terms and conditions which, in the opinion of the Executive Board, the Board of Governors may wish to prescribe for admitting St. Christopher and Nevis to membership in the Fund.

The Executive Board has therefore approved the attached Resolution for submission to the Board of Governors for a vote without meeting pursuant to Section 13 of the By-Laws.

DRAFT RESOLUTION

MEMBERSHIP FOR ST. CHRISTOPHER AND NEVIS

WHEREAS, St. Christopher and Nevis on August 2, 1983 requested admission to membership in the International Monetary Fund in accordance with Section 2 of Article II of the Articles of Agreement of the Fund;

WHEREAS, pursuant to Section 21 of the By-Laws of the Fund, the Executive Board has consulted with the representative of St. Christopher and Nevis and has agreed upon the terms and conditions which, in the opinion of the Executive Board, the Board of Governors may wish to prescribe for admitting St. Christopher and Nevis to membership in the Fund;

NOW, THEREFORE, the Board of Governors, having considered the recommendations of the Executive Board, hereby resolves that the terms and conditions upon which St. Christopher and Nevis shall be admitted to membership in the Fund shall be as follows:

1. Definitions: As used in this Resolution:

   (a) The term "Fund" means the International Monetary Fund;

   (b) The term "Articles" means the Articles of Agreement of the International Monetary Fund, as amended;

   (c) The term "SDR" means the special drawing right.

2. Quota: The quota of St. Christopher and Nevis shall be SDR 4.5 million.

3. Payment of Subscription: The subscription of St. Christopher and Nevis shall be equal to its quota. St. Christopher and Nevis shall pay 21.7 percent of its subscription in SDRs or in the currencies of other members selected by the Managing Director from those currencies that the Fund would receive in accordance with the operational budget in effect at the time of payment. The balance of the subscription shall be paid in the currency of St. Christopher and Nevis.

4. Timing of Payment of Subscription: St. Christopher and Nevis shall pay its subscription within six months after accepting membership in the Fund.

5. Exchange Transactions with the Fund and Remuneration: St. Christopher and Nevis may not engage in transactions under Article V, Section 3, or receive remuneration under Article V, Section 9, until its subscription has been paid in full.

6. Exchange Arrangements: Within 30 days after accepting membership in the Fund, St. Christopher and Nevis shall notify the Fund of the exchange arrangements that it intends to apply in fulfillment of its obligations under Article IV, Section 1 of the Articles.

7. Representation and Information: Before accepting membership in the Fund, St. Christopher and Nevis shall represent to the Fund that it has taken all action necessary to sign and deposit the Instrument of Acceptance and sign the Articles as contemplated by paragraph 8(a) and 8(b) of this Resolution, and St. Christopher and Nevis shall furnish to the Fund such information in respect of such action as the Fund may request.

8. Effective Date of Membership: After the Fund shall have informed the Government of the United States of America that St. Christopher and Nevis has complied with the conditions set forth in paragraph 7 of this Resolution, St. Christopher and Nevis shall become a member of the Fund on the date when St. Christopher and Nevis shall have complied with the following requirements:

   (a) St. Christopher and Nevis shall deposit with the Government of the United States of America an instrument stating that it accepts in accordance with its law the Articles and all the terms and conditions prescribed in this Resolution, and that it has taken all steps necessary to enable it to carry out all its obligations under the Articles and this Resolution; and

   (b) St. Christopher and Nevis shall sign the original copy of the Articles held in the Archives of the Government of the United States of America.

9. Period for Acceptance of Membership: St. Christopher and Nevis may accept membership in the Fund pursuant to this Resolution not later than six months after the effective date of this Resolution, which date shall be the date of its adoption by the Board of Governors; provided, however,

that, if the circumstances of St. Christopher and Nevis are deemed by the Executive Board to warrant an extension of the period during which St. Christopher and Nevis may accept membership pursuant to this Resolution, the Executive Board may extend such period until such later date as it may determine.

2. NICARAGUA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Nicaragua (SM/84/26, 1/24/84). They also had before them a staff report on recent economic developments in Nicaragua (SM/84/50, 2/21/84; and Cor. 1, 2/27/84).

Mr. Senior made the following statement:

It has been a little more than two years since the previous consultation with Nicaragua in December 1981--for reasons that were mainly not related to the authorities' willingness to receive Fund missions--and in that time significant changes--institutional and otherwise--have occurred that practically made it necessary for the staff to study from scratch the statistical base and the institutional framework of the country. In the relatively short time of the mission, the staff has done an excellent job, not only in preparing the documents for our discussion, but perhaps more importantly in re-establishing a fruitful and serious dialogue with the authorities involving the comprehensive analysis of economic policy in Nicaragua. I am sure that this consultation will lead to a continuing process of analysis of the Nicaraguan economy and the initiation of more frequent interchanges in the future.

Rather as in the previous consultation, my authorities are in agreement with the thrust of the staff papers regarding economic developments in Nicaragua during 1983, although they would suggest a substantial difference in emphasis as regards the causal factors that have most heavily influenced economic activity. The Central American countries have been individually discussed by the Board on several occasions during the past three years, not only in regard to Article IV consultations but also in regard to requests for the use of Fund resources. In practically all these discussions, this chair has mentioned that in order to understand fully the recent evolution of these economies, Directors must view them in the broader perspective of international and regional developments and the effects that they have had on the small, relatively open, and quite vulnerable economies of the Central American countries. Even at the risk of being repetitive, I should once again emphasize this point, more particularly for Nicaragua, a country that in the last five years has been severely affected in succession by external economic factors; a protracted revolutionary struggle caused heavy physical destruction of infrastructure, economic installations, and productive plants, disrupting economic activity; more recently, external aggression has seriously affected the country's security and limited even more severely the scope for the formulation of economic policy.

Beginning in 1978, the Central American economies were affected by adverse external and internal circumstances, which weakened those factors that had underpinned the dynamic economic growth that these economies had shown in the previous ten years. A slackening in world economic activity induced a weakening of demand for the principal export commodities of these countries, lowered their world prices, and significantly limited exports. Large increases in oil prices and in other imports greatly worsened their terms of trade; high interest rates in the international markets aggravated their balance of payments. Political uncertainties in the region further constrained the access of Central American countries to international capital markets and led to massive capital flight, and the structural difficulties faced by the Central American Common Market virtually halted growth in the industrial sector. As a consequence, during 1978-80 real GDP in the region grew by an average of less than 1 percent, after average growth rates of over 6 percent in 1976 and 1977, and has declined to negative rates in the last three years. This has, of course, resulted in a significant and steady deterioration in the living standards of the Central American people, especially if account is taken of the relatively high rates of population growth that these countries have.

Within this regional context, which in itself would have been sufficient to affect severely any Central American country--as it effectively did--even under "normal" circumstances, the Nicaraguan economy was further affected by the specific circumstances of the country. Following the first significant armed confrontations in late 1977, the widespread struggle of 1979 severely damaged the country's productive capacity and led to huge financial losses. I do not want to dwell on these well-publicized facts; suffice it to say that a study prepared by the IBRD in October 1981 estimated that the income forgone by Nicaragua during 1978-80 surpassed US$2 billion, a figure substantially larger than the country's 1980 GDP; and also indicated that even under favorable assumptions the country's per capita income of 1977 would not be recovered until the end of the present decade. The difficult challenge posed by the formidable task of economic recovery just mentioned has lately been made even more difficult by the external aggression that Nicaragua is confronting. Not only does this situation effectively disrupt production in certain areas; it is also distracting and diverting resources--financial and human--to the task of defense.

In the staff papers, developments during 1983 are well explained, and I would not want to be repetitive. I should emphasize, however, that the results mentioned by the staff, whether in fiscal, monetary, or external policies, differ very markedly from what was initially planned by the authorities at the beginning of that year, or at the end of the previous one. While it is true that--after the significant decline of GDP in 1982--economic policy was formulated mainly to promote recovery, the authorities were clearly conscious that such an effort would have to be framed within sound financial policies that would also promote adjustment and set the basis for a sustainable external balance in the medium term. Thus, for example, in the fiscal area, the budget approved at the beginning of the year implied a lowering of the deficit, as a percentage of GDP, in comparison with the previous year. In the event, as the staff has patently made clear, there were large differences between actual expenditures and budgetary appropriations that resulted in a large increase in the deficit as a percentage of GDP. The largest overruns were in military spending and transfers, basically as a response to increased external aggression, thus increasing defense needs. Under "normal" circumstances, the authorities have indicated that they would be prepared to implement a comprehensive set of stabilization measures, such as those envisaged in the economic development strategy that they prepared for the medium term and presented in Brussels at the Meeting of the Program for the Economic Development of the Central American Isthmus. With defense expenditures--which are increasing because of external aggression--representing such a high proportion of total expenditures, however, the adjustment effort based on traditional financial policies has been waning. That is the basis for my assertion that the scope for policy formulation in these circumstances is rather limited. Indeed, during 1983 the economic policy that was eventually followed was mostly a response to external adverse circumstances, rather than a programmed exercise based on ex ante considerations solely of an economic nature.

Even with these limitations, conscious of the need for adjustment, the authorities have formulated a set of economic and financial policies that are mainly directed to redressing the most serious imbalances. In the fiscal area--utilizing the latest Nicaraguan figures available--the budget just approved would reduce the fiscal deficit of the Central Government from the equivalent of 23 percent of GDP in 1983 to 11 percent of GDP in 1984. A summary of the 1983 and 1984 budgets can be seen in the following table:

Nicaragua: Central Government Budgetary Operations

(In millions of córdobas)

	1983	1984	Percent Changes 83/82	84/83
I. Total revenue	9,983.6	14,676.7	37.8	47.0
II. Total expenditure	20,414.1	19,076.3	52.9	-6.6
Current expenditure	13,027.9	14,705.4	32.1	12.9
Capital expenditure	7,386.2	4,370.9	111.4	-40.8
III. Overall deficit	10,430.5	4,399.6	70.7	-57.8
As percent of GDP	23	11		
IV. Financing				
External	1,693.6	1,084.5	9.8	-36.0
Internal	8,736.9	3,315.1	91.3	-62.1
Central Bank	(8,213.5)	(3,181.8)	(140.3)	(-61.3)
Other	(523.4)	(133.3)	(-54.4)	(-74.5)

Source: Central Bank of Nicaragua.

Estimated revenue for 1984 takes into account certain modifications in the tax system, new tax rates, improved tax administration, and nominal increases in economic activity. Some of the most important new measures have already been in effect since October 1983, and thus will have a large impact in 1984. The major modifications to the tax system include the introduction of a Net Wealth Tax, which is a substitute for a real estate tax and other property taxes, and a rise in the income tax rates from 40 percent to 45 percent for commercial activities, 40 percent for manufacturing, 37.5 percent for agribusiness, and 35 percent for agriculture. At the same time, imports made with owned resources will be liquidated at the rate of C$28 = US$1. Excise taxes were increased for petroleum products and beer and alcoholic beverages. Most important, the current tax of C$5 per US$1 on sales of foreign exchange for certain imports has been increased to C$10.

On the expenditure side, I would only underscore the substantial reduction in capital expenditures, of the order of 41 percent in relation to 1983, and a reduction of 9 percent in current subsidies after a growth of 33 percent in 1982 and 43 percent in 1983. While the Government considers that subsidies are necessary to maintain real wages within tolerable limits, as well as to support some enterprises that were left in a weak financial condition after the revolutionary war, it has the firm intention of rationalizing these transfers in the future.

Monetary policy in 1984 will also be congruent with the adjustment effort embodied in the fiscal program. The summary account of the consolidated financial systems in 1983 and 1984 is set out below:

Nicaragua: Summary Account of Consolidated Financial Systems

(In millions of córdobas)

	Dec. 1983	Dec. 1984	Percentage Changes 83/82	84/83
I. Liabilities, private sector	16,227.4	20,957.6	52.3	29.1
II. Foreign liabilities	20,603.4	23,683.4	48.6	14.9
III. Domestic credit	34,953.2	43,992.4	36.2	25.9
Central Government (net)	14,332.8	17,514.6	128.2	22.2
Rest of public sector	331.8	331.8	(3.7)	--
Foreign trade ent.	904.8	1,000.0	(34.4)	10.5
APP* and private sector	18,401.0	24,163.2	10.1	31.3
Investments	982.8	982.8	3.1	--
IV. Other net assets	(559.9)	(559.9)	--	--
V. Gross international reserves	2,437.5	1,208.5	21.0	(50.4)

Source: Central Bank of Nicaragua.

* People's Property Area.

As can be seen in the above table, for 1984 domestic credit is to grow somewhat less than the liabilities to the private sector, and more or less in line with deposits. At the same time, the financial program for 1984 calls for a substantially lower growth in credit than in 1983, mainly because of significantly lower credit requirements from the Central Government. On the other hand, credit to the APP and to the private sector is to increase substantially, especially if compared with the low growth observed in 1983.

Underlying the above figures, nominal deposit interest rates are being increased by about 2 percentage points for passbook savings and certificates of deposit, even though such deposits have not shown a high elasticity to interest rate changes in the recent past. This is not surprising under conditions of uncertainty. Lending rates and the legal reserve coefficient will remain more or less the same, but the interest rate paid by the Central Bank for deposits to the liquidity fund is being lowered, although always maintaining a differential in favor of the commercial banks. In general, all this represents a more moderate stance of monetary policy.

Since 1982 the exchange system used in Nicaragua has become increasingly complex. In general, it has been used to accomplish simultaneously a number of different purposes, such as affording incentives to exports and restricting nonessential imports, while maintaining the price of essentials in order not to affect lower income groups unduly, thus easing the pressure for disproportionate wage increases. Progressively, however, the system has become more cumbersome and difficult to manage. The authorities regard this system as temporary and would move toward its rationalization as normalcy is restored in the region and the current scarcity of foreign exchange is eased substantially. In this regard, the authorities are well aware that a successful adjustment in exchange rate policy can be achieved only through a concerted effort in the main areas of economic policy, so that fiscal and monetary policies would be compatible with the desired results. The scope for such policy action is still quite limited in current circumstances.

As I mentioned before, Nicaragua is facing an acute shortage of foreign exchange, and it has accumulated arrears with some creditors and with the Fund. Most arrears have been eliminated through rescheduling, but such an arrangement has not been possible with the Fund. The Nicaraguan authorities are making efforts to try to regularize the situation with the Fund in the near future, as foreign exchange availability will allow. As mentioned in the staff paper, this issue will be considered in a separate report, and the authorities would hope to have a more formal resolution by that time.

Mr. Robalino stated that he agreed with the staff appraisal and supported its main conclusions. In recent years, Nicaragua's economic activity had been affected by internal political problems, while international factors had seriously interfered with the balance of payments. Even though the ratio of the current account deficit to GDP had been reduced in 1983, owing mainly to the control of imports, government expenditure had been far in excess of the increase in revenue. Transfers to the public sector had been recognized by the Nicaraguan authorities as one of the factors contributing to economic maladjustment, while current price and subsidy policies had not been as successful as had been hoped in stimulating exports. On the contrary, they had led to a deterioration in the public finances. There was therefore a clear need to strengthen the fiscal situation in Nicaragua.

As to monetary policy, Mr. Robalino remarked that the staff had clearly explained the inconsistency between the growth of bank credit and the limitation of resources. The authorities would do well to conduct a review of their monetary policy in order to bring about a better allocation of resources.

If the authorities continued to enforce their present exchange rate policy, Mr. Robalino considered, it would be difficult to achieve a manageable economic and financial situation. As the staff had shown, what was needed was the implementation of consistent economic policies in the future.

Mr. Laske observed that the economic situation in Nicaragua was not good. Damage caused by the civil war was one of the main reasons, but the difficulties had been increased by the adoption of policies that had intensified, rather than corrected the maladjustments, imbalances, and distortions that the authorities had inherited when they had assumed control in 1979. The staff had clearly indicated the fields in which the authorities' policies were inappropriate; he fully agreed with the judgment of the staff and supported its recommendations.

Taking up a specific aspect of Nicaragua's relations with the Fund, Mr. Laske recalled that in recent months the Chairman had reported to the members of the Executive Board on several occasions regarding Nicaragua's overdue obligations. The oldest outstanding debt had been overdue since May 16, 1983. The amount would soon have been outstanding for five years, the limit for Fund lending to members when the lending was not related to an extended arrangement or to the enlarged access policy. No other country had been in arrears to the Fund for so long, and the Fund had not previously failed to take the appropriate steps set out in the Articles. He assumed that the arrears owed by Nicaragua had been discussed by the Fund mission at the time of the consultation. Indeed, the staff report (SM/84/26) began by drawing the attention of Executive Directors to the arrears, on which a separate paper was shortly to be issued. He assumed from the language that the authorities had so far made no acceptable proposals for settling the overdue obligations.

The Fund's effectiveness and its credibility, Mr. Laske observed, depended on members' adhering scrupulously to the provisions of the Articles of Agreement and fulfilling the obligations connected with them. One of the most important of obligations of members was to make repurchases and to pay charges and interest when they fell due. The Fund should not and could not allow undischarged obligations to extend over long periods. Flexibility should only be exercised in those cases where the authorities concerned had obviously made every effort to pay the Fund without excessive delay. The case of Nicaragua did not seem to fall into that category, and he would therefore expect the report on the arrears to be issued shortly.

He had heard Mr. Senior express the hope that the Nicaraguan authorities would try to regularize the situation in the near future, Mr. Laske remarked. While Mr. Senior's statement was encouraging, in the absence of concrete proposals he did not believe that it offered sufficient grounds to delay action on the part of the Fund. Nevertheless, he strongly hoped that the authorities would see fit to settle their overdue obligations before the report was issued, thus sparing both themselves and the Fund an action that would be unnecessary.

Mr. Delgadillo stated that he was in agreement with the main thrust of the staff appraisal. Despite an improvement in the economic performance of Nicaragua in the two years following the civil war, economic activity was sluggish, the external position was weak, and the rate of inflation was increasing. Undoubtedly, the unfavorable external conditions did constitute a major constraint on the achievement of more satisfactory results. A decline in the external demand for local products and reduced prices for exports had certainly had unsatisfactory repercussions. At the same time, the adoption of short-term domestic policies when dealing with medium-range economic and social objectives was bound to have a noticeable impact on economic performance. The continuation of present price and subsidy policies could lead to further unfavorable effects on the supply of goods, to an increase in aggregate demand, to a misallocation of resources, and to a widening of the fiscal deficit; ultimately, it was bound to create additional internal and external imbalances.

While the substantial increase in government revenues and the application of tight income policies were welcome, Mr. Delgadillo observed, the authorities needed to take action to correct the increase in the overall fiscal deficit, mainly by making a change in expenditure policies.

The adoption of appropriate interest rates and the strengthening of the control of credit would certainly help to improve the efficiency of monetary policy, Mr. Delgadillo stated. Although the changes in the original 1984 monetary program were encouraging, much remained to be done to bring about appropriate interest rates and legal reserve requirements.

The weak performance of the external sector had been caused mainly by adverse developments abroad, Mr. Delgadillo remarked. The fall in the terms of trade had been particularly noticeable. Nevertheless, he agreed with the staff that the present system of exchange rates would not contribute to restoring external balance.

He had been encouraged by Mr. Senior's statement that the recovery effort was to be based on sound financial policies aimed at achieving a sustainable external balance, Mr. Delgadillo said. The measures adopted by the authorities in connection with public finance, monetary policy, and the exchange rate system could be seen as an indication of the authorities' awareness of their present difficulties, and of the need for adjustment.

In brief, Mr. Delgadillo remarked, Nicaragua was facing serious economic and financial difficulties. Political conditions in the area were certainly having a direct impact on the economies of several countries, including that of Nicaragua. He hoped that the authorities would be able to put in place a medium-term economic plan, of the type submitted in Brussels in September 1983. As to Nicaragua's arrears to the Fund, he hoped that the authorities would soon be able to resolve the matter.

Mr. Hirao expressed broad agreement with the staff appraisal. Nicaragua's economy had been badly affected for the past few years by both external and internal circumstances. The staff and Mr. Senior had described the developments thoroughly. Productive capacity had been severely damaged, and even under the most favorable assumptions the country's per capita income would not be restored to the 1977 level until the end of the decade, as the World Bank had indicated. Inflation had been high, and the external position had remained weak. No doubt the authorities were faced with a difficult task in trying to bring the economy back onto a suitable track.

While a number of factors had made it difficult for the authorities to achieve their objectives, Mr. Hirao went on, the policies that they had been following also seemed to have had an important impact on economic performance. Among them, as the staff had noted, the degree of subsidization was having substantial adverse effects on efficiency. The subsidies seemed to be primarily responsible for both internal and external imbalances, and pressures to resort to unofficial markets and speculation had arisen. The use of subsidies had always had a deleterious effect on public finances.

He agreed with the staff that the mechanism for controlling credit ought to be strengthened, Mr. Hirao remarked. The practice of having the Central Government assume responsibility for the unpaid debts of public enterprises would have to be curbed. Flexible management of interest rates would also be important as a means of improving the performance of the economy.

As to external policy, Mr. Hirao commented, the present subsidy and rationing schemes seemed to have been hampering the revival of exports while causing excessive use of the limited foreign exchange. The existence of arrears in servicing the country's obligations had curtailed Nicaragua's access to new borrowing. The exchange system had become increasingly complex, as the authorities had wished to use it to achieve a variety of goals at the same time. Indeed, it seemed to have become not only cumbersome but difficult to manage. The authorities were clearly aware that the successful adjustment of exchange rate policy would be achieved only through a concerted effort in the other main areas of economic policy.

Like other Directors, Mr. Hirao mentioned, he had noted with concern that Nicaragua was overdue in meeting a number of payments both to the Fund's General Resources Department and to its SDR Department. Being overdue in payments to the Fund was contrary to the purposes of the institution and would impair both its operations and its credibility. He had noted from Mr. Senior's remarks that the authorities were making efforts to try to regularize the situation in the near future. He understood that a separate report would be issued shortly, but he hoped that the authorities would have settled their obligations before it appeared.

Mr. Joyce commented that the Nicaraguan economy faced serious difficulties and--what was worse--that there were no signs that the major economic imbalances were being reduced. Although it was clear that the consequences of the civil war and continuing exogenous constraints were part of the problem, Nicaragua's problems also flowed from overexpansionary demand management practices and from policies that had accentuated the serious structural problems in the economy. In the absence of significant reductions in fiscal expenditure, together with changes in the price, interest rate, and exchange rate systems, the economy was likely to continue to deteriorate.

The dramatic rise in the fiscal deficit despite large increases in revenue was a matter of particular concern, Mr. Joyce went on. The deficit constituted a growing financial burden on the economy. Moreover, in view of the measures already taken to generate revenue, he doubted whether much more could be done in that direction. A more profitable course would be to concentrate on controlling the increases in government expenditures. That was a field in which technical assistance from the Fund would be useful. Significant savings in expenditure would, however, be possible only with a realignment of spending priorities. He did of course realize that, as the authorities had stated, they had been obliged to make major expenditures on defense. Nevertheless, he viewed with concern the role played by the subsidies and the expenditures incurred to cover the deficits of the state enterprises in increasing the fiscal deficit. He welcomed the stated intention of the authorities to reduce substantially such transfers, and more generally to consider reducing the number of products eligible for subsidy. He regretted, however, that no details had been provided of the price reforms needed to make the reductions in transfers possible.

Regarding monetary policy, Mr. Joyce said, he supported the staff position on the importance of strengthening the mechanisms for controlling credit and for reducing unpaid debts currently being assumed by the Central Government. He would moreover urge the authorities to move toward eliminating negative real interest rates both for savings and for loans.

On the structural side, Mr. Joyce went on, he viewed with deep concern the building-up of substantial export subsidies, which had reached 50 percent of the world price for goods like cotton. The practice could not be expected to lead to a sustained improvement in exports. Rather, the system served only to isolate producers from developments in world markets and to reduce the incentive to contain production costs. Domestically, consumer price subsidies had contributed to a substantial increase in demand for grains, which could now be filled only through imports, using foreign exchange that would otherwise have been used to help reduce external arrears or to purchase necessary factors of production. The situation would appear particularly deplorable once it was considered that much of the effort to reduce the current account deficit had been concentrated on maintaining strict control over the level of imports. While he sympathized with the authorities in their desire to minimize wage pressures, he questioned their view that the subsidies were necessary to avoid a general escalation in wages.

Taking up the topic of exchange rate policy, Mr. Joyce said that he strongly supported the staff recommendation that the Executive Board should not approve the current exchange rate restrictions and practices. The rationing mechanism for allocating foreign exchange was excessively cumbersome. Moreover, the exchange rate system had effectively isolated the domestic economy from foreign markets and contributed to declining export market shares.

Notwithstanding the serious economic difficulties faced by Nicaragua, Mr. Joyce observed, the elimination of external payments arrears was essential if the country were to have access to adequate foreign financing in the near future to help overcome the current account deficit. Like Mr. Laske, he was deeply concerned about Nicaragua's continuing arrears to the Fund; the authorities should make every effort to eliminate them at the earliest possible opportunity.

Mr. Qureshi stated that Nicaragua faced a difficult economic situation, characterized by large financial imbalances both in the domestic economy and abroad. As noted by others, the situation ought to be seen against the background of developments in recent years and of several adverse exogenous influences. The civil war of 1978-79 had caused economic destruction and dislocation on a large scale; it was only over a period of time that the economy could fully recover. Some improvement in output had taken place in 1980 and 1981, but it had died down later, partly because the security situation had deteriorated once again. The external economic environment had not been favorable, marked as it was by sluggish demand for Nicaragua's exports and a deterioration in its terms of trade.

Nevertheless, Mr. Qureshi went on, some of the policies adopted by the authorities also appeared to have played a role in the weakening of the economic situation. The staff had usefully drawn attention to the policy areas where adjustment was needed to reduce the domestic and external disequilibria. Foremost among those was the need to reverse the deterioration in the fiscal situation. Containment of the growth in public expenditure and a rationalization of the system of prices, subsidies, and transfers were of particular importance. Greater attention also needed to be given to improving the structure of incentives so as to promote savings, raise the efficiency of public sector enterprises, and strengthen the supply responses, especially in the external sector.

It was encouraging that, as mentioned by the staff and Mr. Senior, the authorities were aware that they needed to make adjustments, Mr. Qureshi considered. The measures that the authorities expected to take to improve their financial policies in 1984 were also commendable. The medium-term strategy described in Part II, Section 7 of SM/84/26 placed due emphasis on efforts to achieve stabilization and to bring about recovery. It was true that, in view of the structural nature of many of the problems facing the authorities--including weaknesses on the supply side caused by war-related disruptions--and the significant institutional changes being introduced, their policies ought to be not only formulated but also evaluated in a medium-term context. Moreover, some of the policies that appeared open to question seemed to be in the nature of specific responses to problems that had arisen in the especially pressing circumstances of recent years; they were therefore considered temporary by the authorities. Nevertheless, the increasing severity of the financial imbalances--particularly the weak external position and the difficulties of debt servicing--meant that some of the intended policy adjustments ought to be accelerated. Naturally, any improvement in the economic situation and any increase in the scope for adjustment policies would also depend on improvements in the security situation.

Finally, as to the question of outstanding arrears, Mr. Qureshi noted the statement by Mr. Senior that the authorities were making efforts to settle them in the near future.

Mr. Wicks remarked that the economy of Nicaragua had been subject to great pressures over the past few years. It had been affected by the civil war and its aftermath, by the consequences of the world recession, and by military activity. Mr. Senior had described the situation very clearly. Nevertheless, it was impossible to escape the conclusion that the Nicaraguan authorities had adopted policies that had made matters rather worse. The plan presented to the September 1983 meeting in Brussels of the Inter-American Development Bank suggested to him that the authorities were well aware of the changes in economic policy that were needed. But he found it difficult to agree with the authorities that the introduction of economic adjustment could await the return of more normal conditions. Meanwhile, negative adjustment was taking place; unless the authorities were careful, the economy would continue on a downward path.

On the fiscal side, Mr. Wicks continued, widespread subsidies contributed to making the deficit unsustainable. His understanding was that the fiscal deficit had reached 26.5 percent of GDP in 1983, including writing off the debts of parastatals. Although tax revenue had risen fast, it had not risen nearly fast enough to justify the expansion of public expenditure in 1983. Yet capital expenditure had risen substantially, having almost doubled in real terms. The 1984 budget seemed a step in the right direction, but he doubted whether it would be implemented as drafted. Mr. Senior had stated that the authorities intended to rationalize subsidies in the future. He hoped that rationalization meant that they would be reduced very substantially. Despite guaranteed prices, the area under cotton cultivation had dropped sharply, and producers had failed to repay bank credits. He wondered whether those developments were attributable to the disturbances, or whether there was some other reason. Second, the staff seemed to suggest that producer subsidies were depressing supply, again a point on which information would be useful.

On the monetary front, Mr. Wicks stated, substantially negative real interest rates were highly undesirable as they could only exacerbate the misallocation of resources. Indeed, monetary policy as a whole needed radical overhaul.

The exchange system was complex, Mr. Wicks observed. The multiple currency practices reflected deficiencies in domestic policies. Some of those practices had added to the balance of payments difficulties and to delays in servicing external obligations, including those to the Fund. It was regrettable that there was such a lack of information about nontrade transfers, since net investment income and other transfers represented nearly 50 percent of merchandise exports. He was sure that the staff was correct in recommending nonapproval of the exchange system, as it had done on the occasion of the previous Article IV consultation.

The authorities acknowledged that the exchange system required modification, but again they seemed to feel that the change could await the restoration of normalcy, Mr. Wicks commented. In view of the serious losses of foreign exchange that were the consequence of the present arrangements, he doubted whether the authorities ought to delay reform of the exchange rate system.

Commenting on the arrears owed to the Fund by the Nicaraguan authorities, Mr. Wicks observed that Appendix I to SM/84/26 suggested that on January 24, 1983 overdue repurchases and charges together had amounted to SDR 7.5 million. He did not know whether the amounts had increased since then. Some of those amounts had been overdue for almost ten months. The matter was extremely serious, not only for the member concerned, but also for the entire membership of the Fund. The Nicaraguan authorities surely knew of the likely consequences if they did not settle their account. The Articles of Agreement and the Rules and Regulations were clear about the procedures that the Fund would have to follow. It was however also a very serious matter for the membership as a whole, particularly for borrowing members. If purchases and charges were not repaid, the resources would not be available for new purchases by members. But the position was even more serious than that. If a member failed to pay its obligations even for what might seem a relatively small amount, the financial trust that was the foundation of the Fund would be undermined, and with it the Fund's authority. If such episodes were to continue, it would become even harder to raise borrowed resources than it was at present. Such a change would be a real blow to the interests of borrowing members.

He therefore hoped that his colleagues would join him in asking Mr. Senior to convey a strong message to his Nicaraguan authorities that they should forthwith repay all overdue purchases and charges, Mr. Wicks stated. Like Mr. Laske, he welcomed the expression of hope in Mr. Senior's statement that the arrears would soon be paid. He recognized that the Nicaraguan economy was suffering from grievous balance of payments problems, but he had noted that merchandise exports amounted to some US$400 million a year. The top priority for the Nicaraguan authorities should be to use some of the foreign currency earnings to repay the Fund straight away.

Mr. Suraisry remarked that the staff had analyzed the Nicaraguan economy quite thoroughly. He endorsed the main points of the staff appraisal and emphasized the seriousness of the external and internal imbalances in the Nicaraguan economy. Determined efforts were needed if those imbalances were to be corrected.

Regarding Nicaragua's external arrears, Mr. Suraisry stated that it was disappointing to see that Nicaragua had still not made any repayments to the Fund. The matter was serious: first, it undermined the revolving character of the Fund's resources. Without them, the Fund could not help all its members to overcome their economic problems. Second, it undermined the Fund's liquidity and credit standing. He agreed with Mr. Laske that the hope expressed by Mr. Senior was encouraging but insufficient. Like Mr. Wicks, he strongly urged Nicaragua, and others in a similar position, to make every effort to repay the Fund promptly. To do so would not only be in the best interests of the Fund and the other members; it would also be in the best interests of Nicaragua itself.

Ms. Bush remarked that the Nicaraguan authorities clearly faced a difficult economic situation aggravated by the aftermath of civil war and an external economic environment that was less than ideal. Despite such influences, however, most of Nicaragua's poor economic performance was attributable to inappropriate economic policies. The most damaging were the pricing policies and the system of subsidies. Subsidies had contributed significantly to the high level of transfers from the Central Government--equal to 14 percent of GDP in 1983--which in turn underlay the rising public sector deficit, amounting to over 20 percent of GDP. Furthermore, the subsidy system had had the effect of increasing basic food imports, because the artificially low prices for those products had added to the pressure on the balance of payments. As Mr. Wicks had mentioned, producers had in many cases not responded to production subsidies by increasing their output. The staff had noted that the authorities were considering reforming the subsidy system. She urged that in so doing they should improve the pricing signals and reduce the strain of transfers on the budget.

Interest rates of between 8 percent and 10 percent were very negative in real terms, Ms. Bush considered. She disagreed with the authorities' view that bank deposits would not respond to more appropriate interest rates. Furthermore, she believed that bank profitability could be better ensured by improving loan recovery than by maintaining low deposit rates.

The Nicaraguan exchange rate policy was, as the authorities conceded, complex and cumbersome, Ms. Bush observed. It involved multiple currency practices subject to Fund approval. She urged that, in concert with the elimination of subsidies, the exchange rate should be unified and allowed to attain an appropriate level. She also urged that the system of exchange permits and other restrictions should be eliminated in the interest of increasing producer confidence that foreign exchange would be obtainable when required. The distortions and disincentives introduced by the existing exchange regime were so severe that she agreed with the staff recommendation that it should not be approved.

A number of policies and actions, inconsistent with the authorities' objective of maintaining a mixed economy with an important role for the private sector, had engendered widespread uncertainty, Ms. Bush remarked. In particular, subsidies to various sectors--including interest rate subsidies--foreign exchange rationing, cumbersome administrative procedures and multiple rates of exchange, an increase in the public sector's share of production and credit, and public sector expenditures in excess of appropriated amounts all contributed to creating an economic environment not conducive to private sector activity. Mr. Senior had stated that credit to the private sector was to be increased in 1984, and such a move would be a step in the right direction. Private sector confidence was essential for the eventual economic recovery of Nicaragua, and she urged that the impact of new policies and reforms on the private sector be given careful consideration.

Finally, Ms. Bush observed, Nicaragua had incurred arrears to various creditors, including the Fund. Mr. Senior and the staff had both mentioned that arrears to some creditors had been eliminated through rescheduling. She was however very disturbed to learn that no arrangements had been made to repay arrears to the Fund. She hoped to receive the report promised by the staff forthwith; in any event, the authorities should take immediate steps to fulfill Nicaragua's obligations to the Fund. She agreed with those speakers who had pointed out the seriousness of the situation both for the Fund's credibility and for other borrowers.

The staff representative from the Western Hemisphere Department commented first on Mr. Wicks's point that cotton production had apparently failed to respond to incentives offered by the authorities. There were three causes for the apparent anomaly. First, there had been a change in the structure of land ownership in Nicaragua. Before 1979, cotton production had been carried on mainly on large properties, using spraying equipment and machinery that could not profitably be used on small properties. As a result of the agrarian reform of 1980-81, the large properties had been divided into smaller ones, where cotton was difficult to produce. Second, there had been a shift from production of cotton to basic grains. On the fertile areas near the Pacific coast, much of the land had been shifted from cotton to basic grains, mainly corn and rice, because of the incentives offered to growers of basic grains, designed to provide sufficient quantities to meet the needs of the people. Third, there had been a lack of imported inputs, mainly fertilizers and insecticides, which Nicaragua had been unable to import because of the lack of foreign exchange. As a result, the productivity of the land under cultivation had dropped quite substantially. It seemed unlikely that there would be much of an increase in cotton production in the near future; even more land on the Pacific littoral would be shifted into basic grains owing to the large deficit in domestic grain production.

The more general point raised by Mr. Wicks referred to the system of incentives employed by the authorities, the staff representative recalled. He would agree that the system did not lead to an improvement in productivity as the subsidies were intended to cover not only production costs but also a certain profit margin. In general, the incentives had been less effective than they had been expected to be; producers had few outlets for investing their profits in view of the restrictions on imported goods, the rationing of foreign exchange, the very negative real interest rates paid on deposits, and the small scope for private investment. The staff had intended to say that, because of inconsistencies with other policies, the incentives seemed to discourage production to some extent. The staff was preparing a report on overdue repurchases from the Fund that would be distributed as soon as it was ready.

The Chairman confirmed that he had seen the report; he had asked for a few changes to be made, and it would be placed on the agenda shortly.

Mr. Senior said that he would convey the frank and varying comments of the Executive Directors to his Nicaraguan authorities.

The Nicaraguan economy was passing through a critical period, Mr. Senior observed. To a great extent, the situation was the result of external factors that had severely affected the country's capacity to produce and export since 1978, thus especially affecting its external financial position. Internal factors had in some instances compounded the problems. Expansionary policies adopted as a means of reducing unemployment and maintaining consumption at levels prevailing before the revolutionary war had further affected the external balance. The authorities themselves recognized the drawbacks of their policies; but it would be only fair to say that the limitations faced by the Government that had come into power in the late 1970s had made it almost impossible to bring about any much more rapid or more stable economic recovery.

Without describing in detail the exogenous factors that had severely limited production in Nicaragua, Mr. Senior stated, he agreed with the authorities that insufficient attention had been given to those factors, thus contributing to a rather sanguine perception of the possibilities for short-term recovery in the country.

In SM/84/50, the staff had described in some detail the developments in the real sector of the Nicaraguan economy, Mr. Senior noted. There, significant progress had been achieved in some key fields, like agriculture. The current financial difficulties, which were certainly very severe, had been allowed to overshadow those achievements. While it was certainly true that the external sector had become the main impediment to sustained economic growth in Nicaragua--the external position would have to be restored before the authorities could put their growth policies into place--in the particular circumstances of the country, many of the expansionary policies adopted by the authorities had produced benefits that were tangible, albeit limited in certain cases. Since 1979, the authorities had been quite successful in sharply increasing the output of certain meats. For instance, hog production had increased by about 30 percent, while the production of poultry had more than tripled in the same time. Although beef production had responded less satisfactorily, the cause had been the substantial depletion of the herds of cattle during the civil war. Increasing the supply of beef in the short term would require substantial investments that were far beyond the country's capacity. Previous production levels could be regained only in the longer term, even if a determined effort were made.

There were many other examples of the limitations created by the present situation, Mr. Senior went on. Cotton production, for instance, was very sensitive to political circumstances, as was manufacturing output. There had been a significant increase in the area planted for cotton since the civil war. It was expected that there would be another large increase in the area planted for cotton in 1984, although the authorities did not wish to return to the output of the past, not only because of the high import content of cotton but also because of the agricultural drawbacks to cotton growing. Realistically, however, until new, commercially viable alternatives were found, the country would still have to make a determined effort to increase cotton production. As to manufacturing output, the destruction caused by the civil war and the disruption of the Central American Common Market made it difficult to believe that there would be any short-term recovery in that sector.

On the fiscal situation in Nicaragua, Mr. Senior stated, the unsatisfactory figures for 1983 should not be taken as representative of the authorities' fiscal policy. The 1983 figures had been brought about by the abnormal circumstances related to defense needs at a time when the security situation had been deteriorating. Expenditure had also been required in preparation for certain unforeseen developments that he would not describe further. At the same time, it had reflected increased transfers to a number of enterprises that had been facing a difficult financial situation since the civil war. It was to be hoped that there would be no need to repeat those extraordinary expenditures, and that outlays by the Government could be maintained within the approved budget limits. As to the adjustment effort being undertaken in the fiscal area, the major effort was being concentrated on the expenditure side, even though it was expected that there would be a substantial increase in revenues. Total expenditures were expected to fall in nominal terms, representing a substantial decline in real terms, largely as a result of a cut in capital expenditure, which was expected to grow by much less than the inflation rate.

Many speakers had referred to Nicaragua's arrears with the Fund, Mr. Senior noted. The authorities were aware of the critical situation and were making efforts to eliminate or reduce the debt as soon as possible. Nevertheless, the country was facing a very serious, or even critical, liquidity situation. It was true that while arrears with other creditors had been rescheduled, it had not been possible to reach the same conclusion with the Fund. While he could not offer any stronger commitment by the authorities, he was certain from recent conversations that they were making determined efforts to resolve the issue as soon as possible.

The Chairman made the following summing up:

Executive Directors were in general agreement with the staff appraisal in the report for the 1983 Article IV consultation with Nicaragua.

Directors recognized that the Government that had come into power in mid-1979 had inherited very difficult problems resulting from the civil war. Directors also noted that the authorities' attempt to cope with their economic problems was hampered by the uncertainties in the region, the worsening terms of trade, the sluggish external demand for Nicaragua's leading exports, and a decline in intra-Central American trade.

However, Directors observed with much concern that the policies followed by the authorities had powerful effects on economic performance that aggravated, in their view, the country's problems. In particular, Directors noted that policies with respect to prices and subsidies, a key element of the authorities' strategy, were having substantial adverse effects on efficiency and that they had contributed considerably to the widening internal and external imbalances. Directors commented that the subsidies had led to a major fiscal deficit and increases in bank credit, thus giving rise to unsustainable inflationary and balance of payments pressures.

Directors stressed that the improvement of the fiscal situation would require the urgent implementation of effective controls over expenditures. The authorities should recognize that budget expenditures were threatening to become out of hand and that the scope for increasing public sector revenues was limited, Directors observed. A re-examination of priorities by the authorities was very much needed, given the sizable burden imposed on the public finances by the system of subsidies and transfers and by the assumption by the public sector of the large debts incurred by public enterprises. Directors urged the authorities to introduce a major overhaul of monetary and credit policy in order to stimulate domestic savings and to improve the allocation of resources. Directors stressed that the role of interest rates in credit allocation should promptly be enhanced and that negative real interest rates should be eliminated.

Directors recognized that Nicaragua's balance of payments difficulties were to some extent the consequence of external factors, but they considered that they were mainly traceable to deficiencies in domestic policy. The reformulation of policies could not await the return of "normal" conditions in Nicaragua and in the region, as the authorities hoped. The reformulation should take place without delay and should be placed in a comprehensive medium-term framework.

Directors noted that Nicaragua maintained a comprehensive system of exchange controls, and they observed that such exchange practices were not conducive to adjustment. Directors remarked that the system of exchange controls was extremely complex and that it had become increasingly difficult to administer; they urged the authorities to pursue policies that would allow for prompt liberalization of the exchange system, the gradual elimination of arrears, and the adoption of a realistic and unified exchange rate. In the absence of a change in policies that would offer the prospect that the reliance on exchange restrictions would be temporary, it was not possible to approve the restrictions.

Directors expressed very strong views on the overdue obligations of Nicaragua to the Fund, one of which had been outstanding for almost ten months, while the drawing was approaching the statutory limit of five years. Unless Nicaragua were able forthwith to make immediate arrangements to repay the Fund, Directors considered, the Fund should take appropriate urgent action to protect its interests. Directors were of the view that action on this matter was critical for ensuring the credibility and financial soundness of the Fund itself, and thus its continued capacity to support the adjustment programs of its members.

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

The Executive Directors concluded the 1983 Article IV consultation with Nicaragua.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/35 (3/2/84) and EBM/84/36 (3/5/84).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 83/128 through 83/131 are approved. (EBD/84/58, 2/27/84).

Adopted March 2, 1984

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/41 (3/1/84) is approved.

APPROVED: August 20, 1984

LEO VAN HOUTVEN
Secretary