**FOR AGENDA**

EBS/00/189
Supplement 1

CONFIDENTIAL

December 14, 2000

To: Members of the Executive Board

From: The Secretary

Subject: **Nicaragua—First and Second Reviews Under the Second Annual Arrangement Under the Poverty Reduction and Growth Facility and Requests for Waiver of Performance Criteria and for Extension of Commitment Period**

The attached supplement to the paper on the first and second reviews under the second annual arrangement for Nicaragua under the Poverty Reduction and Growth Facility and Nicaragua's requests for a waiver of performance criteria and for an extension of the commitment period (EBS/00/189, 8/31/00), is tentatively scheduled for discussion on Monday, December 18, 2000. A revised draft decision appears on pages 7-9. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Nicaragua indicating their preference to publish it.

Questions may be referred to Mr. Gudac (ext. 38619).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat; and to the European Commission, the European Investment Bank, and the Inter-American Development Bank, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

NICARAGUA

# First and Second Reviews Under the Second Annual Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria and for Extension of Commitment Period Supplementary Information

Prepared by the Western Hemisphere Department

(In consultation with other departments)

Approved by Claudio M. Loser and Anthony R. Boote

December 13, 2000

This supplement provides information on recent economic developments and policies since the issuance of the staff report (EBS/00/189). In the accompanying letter to the Managing Director, the authorities report on recent progress under the Poverty Reduction and Growth Facility (PRGF)-supported program and their intentions in the fiscal, credit, and financial areas in the remainder of 2000 and in early 2001. They also request that the commitment period under the three-year PRGF arrangement be extended until March 17, 2002 in order for it to cover the authorities' program for 2001 under the third annual arrangement.

1. **Nicaragua's financial situation weakened during the period August–November 2000, but began to improve in late November/early December as a result of the authorities' determined actions.** Following a sharp deterioration in the quality of the portfolios of two banks owing to fraud and mismanagement, confidence in the banking system weakened, resulting in deposit withdrawals, some capital flight, and a cumulative loss of some US$40 million in official net international reserves during August–November. To deal with the situation, the authorities intervened two commercial banks, provided a framework for guaranteeing their deposits, and implemented resolution plans in line with recommendations of the Fund, the World Bank, and the Inter-American Development Bank (IDB) (Box 1). At the same time, the central bank sterilized part of the liquidity injections through open market operations. As a result of these actions, **the situation of the financial system stabilized toward the end of November and early December with interest rates on U.S. dollar-denominated central bank paper rising slightly to around 15 percent and official net international reserves starting to recover**.

## Box 1. Nicaragua: Bank Resolution Plans

Toward the end of 2000, the deteriorating financial condition of three banks, which together accounted for about 30 percent of system deposits, was a cause of great preoccupation for the Nicaraguan authorities. By the end of November, two of the banks had been intervened and a private recapitalization of the other is being required. To support orderly resolutions during August–November, the central bank (BCN) provided liquidity support equivalent to US$125 million to cover deposit withdrawals, and placed US$82 million of its own paper, primarily with banks and public sector entities, to sterilize this liquidity injection. The cost to the public sector of the bank resolutions is projected to be equivalent to around 7 percent of GDP in terms of the increase in the stock of public debt, and about ¾ percent to 1 percent of GDP in terms of annual interest outlays.

**Interbank**

**On August 7, 2000, the Superintendency of Banks (SBIF) intervened Interbank**, the largest Nicaraguan bank, following reports of fraud associated with CONAGRA, an agricultural holding company. A *Junta Administradora* was set up to manage the intervened institution, criminal charges were laid against board directors and managers of Interbank and an embargo was put on CONAGRA's assets. To stem the initial deposit flight, the BCN announced a full guarantee of all Interbank deposits.

In October, the authorities started to implement a two-step resolution plan involving participation by another domestic bank, Banpro. In the first step, **Interbank's CONAGRA assets were separated out of the balance sheet and transferred to the central bank (BCN) in "payment" for liabilities to the BCN, i.e., the liquidity support that the BCN had provided**, as discussed above. The rest of the balance sheet will be put under the administration of Banpro; by the end of November almost all the deposits and assets were under Banpro management. In the second step, this "clean" balance sheet is being evaluated, and **impaired loans classified as "D" and "E" will be transferred to BCN within a six- to nine-month period**. Any ensuing deficit of assets over liabilities will be covered by BCN paper (CENIS).

The authorities also have taken **steps to formally extinguish Interbank's capital**.

With respect to **asset recovery** and minimization of the cost to the public sector, a special commission, chaired by the BCN general manager and including prominent qualified domestic persons, was set up to manage the CONAGRA portfolio, while Banpro was commissioned to recover the "D" and "E" loans. It was decided that the Interbank license would be retained during the early stage of the asset recovery process in order to facilitate the execution of legal claims.

**Bancafe**

**On November 17, following several months in which attempts to improve the operations of Bancafe proved unsuccessful, the SBIF intervened the bank, and started liquidation proceedings.** The BCN initially gave a limited guarantee to depositors (for sums up to the equivalent of US$775), which was subsequently extended to a full guarantee. The portfolio of the bank was transferred to another domestic bank, Banco de Finanzas (BDF) along the lines of the Interbank/Banpro arrangement described above.

**Other weak bank**

The SBIF formally notified this bank of its capital deficiency and the need for additional capital. **The SBIF is requiring that private shareholders place one third of the required additional capital by January 2001**, with the rest to be subscribed by end-February.

2. **In the context of the recent serious banking problems and the authorities' efforts to resolve them, there have been slippages with respect to certain benchmarks under the modified program, while performance in other areas has been satisfactory (Tables 1–3).** Largely reflecting private capital flight, delays in the programmed disbursements for balance of payment support from the IDB associated with lags in financial and electricity sector reforms, and unprogrammed withdrawals of nonfinancial public sector deposits from the central bank, official net international reserves fell by US$82 million during January–November, compared with a targeted increase through end-December under the modified program of US$240 million, after adjustments.[1] Also, the program's September benchmark on the central bank's net domestic assets was not observed. These deviations took place notwithstanding the placement of large amounts of central bank paper. In the first nine months of the year, public sector saving fell short of the program benchmark by 0.2 percentage point of annual GDP, as a substantial shortfall in revenue (owing mainly to lower than expected VAT collections and operating surplus of the electricity company (ENEL)) was nearly offset by lower current spending. The combined public sector deficit (after grants and excluding the cost of bank resolutions) was equivalent to 4.3 percent of annual GDP (5.3 percent in the program) as the implementation of capital projects and the disbursement of external project loans fell short of programmed levels owing to continued institutional weaknesses. As a result, the program benchmark on the net domestic financing of the nonfinancial public sector was met. The 12-month rate of inflation fell from a peak of 15 percent in April to around 9 percent in October–November (10 percent in December 2000 under the modified program). Output growth is now expected to be around 5 percent in 2000 (5.5 percent under the modified program).

3. **The authorities maintained the momentum of reforms in key structural and governance areas (Box 2).** Specifically, the pending prior actions for completion of the PRGF review were implemented: the Treasury's consolidated cash management system for resources from internal sources was completed; the authorities are implementing satisfactorily plans for the resolution of the two weak banks (as indicated above); they are acting on a plan for the private recapitalization of a formerly state-owned bank by early next year; and are taking steps to tighten credit policy (as indicated below). In addition, actions have been taken to strengthen the efficacy of the Comptroller's Office, while considerable progress has been made in the areas of privatization, social security reform, and judicial reforms. Progress also is continuing in the preparation of a participatory poverty reduction strategy. The municipal elections held in November were carried out in a free and transparent manner.

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[1] The modified program's NIR target (US$33 million) has been adjusted: *upward* for higher-than-envisaged (1) privatization proceeds (projected at around US$80 million, net of certain additional debt service payments and allowed spending), and (2) net placements of domestic public debt (projected at around US$135 million owing to the bank resolutions); and *downward* for certain higher-than-envisaged external debt payments (US$7 million).

## Box 2. Nicaragua: Structural and Governance Measures Taken in Recent Months

The following structural and governance improving measures have been taken since August 2000:

**Privatization**

- **ENITEL:** The single offer received in September was below the reservation price. The government's new strategy, developed in consultation with the World Bank involves opening of the sector to private competition and sale of enterprise units. One unit has been offered for sale in **January 2001**, and the modifications of the law needed to proceed with the sale of the other units are expected to be submitted to the Assembly in the **first quarter of 2001.**

- **ENEL:** Two electricity distribution enterprises were sold in September. No bid was received for the thermal generating plants. The Supreme Court ruling removing legal challenges to sale is expected soon, and invitation of bids, including for the hydroelectric plant, is expected in February 2001.

- **Leasing of port facilities:** For Puerto Cabezas a 25-year lease concluded, and preparation to offer Corinto in the first quarter of 2001 are at an advanced stage.

- **Private management of water supply facilities:** For the Leon-Chinandega subsystem prequalification completed; invitation of final bids from the prequalified investors is expected in January 2001.

**Governance**

- **Municipal elections:** in November were conducted in a transparent and free manner.

- **Comptroller's Office (CO):**

  - The Assembly has approved a CO law, and is expected to vote in December 2000 on several articles vetoed by the President. The IDB and World Bank staff consider that the approved legislation is satisfactory irrespective of the outcome of the voting.

  - The CO council approved internal regulations to improve its organization and functioning.

  - The CO council approved a comprehensive action plan for the strengthening of CO, prepared with assistance of the IDB, and set implementation priorities for 2001.

  - Put in place an office for accepting and processing citizens' allegations of the misuse of public funds.

- **Judicial reform:** The new law on public prosecutors was approved by the Assembly in October. The new penal code has been approved in the first stage, and final approval is expected in the first quarter of 2001. A draft new law on penal procedures is being consulted, and is expected to be submitted to the Assembly in January 2001.

- **Transparency of government operations:** All domestic receipts (revenue and transfers) are being recorded in the new consolidated cash management system (*cuenta única*) of the treasury since September 2000.

**Poverty Reduction Strategy**

The government has started a series of local consultations of the Interim PRSP and the 2001 investment plans, and is making progress with the costing of the PRSP programs and projects.

4. The **authorities intend to continue implementing prudent financial policies with the aim of rebuilding the official reserve cushion and further strengthening the banking system.** In the closing weeks of 2000, they are acting to mop up excess liquidity in the banking system by shifting public sector deposits at the commercial banks to the central bank, by introducing a temporary 65 percent marginal liquidity requirement on banks, and through open market operations. It is expected that these measures would increase official net international reserves by around US$40 million during December. Actions to tighten credit policy further are constrained by the fragility of the banking system. Looking to 2001, in order to raise the official reserve cushion further, the authorities intend to sterilize the net proceeds from the anticipated privatization of the electricity generating facilities (possibly around US$30 million) and take the pending actions in financial and electricity sector reforms to secure the disbursements of delayed balance of payment support from the IDB (US$60 million). On the basis of a satisfactory privatization and the disbursements from the IDB, official net international reserves are expected to increase by a further US$70 million during the first half of 2001. In view of the adverse effects that exchange rate instability might have on Nicaragua's highly dollarized and still somewhat fragile financial system, the authorities are committed to maintaining the current crawling peg exchange rate system.

5. **To support the international reserve build up and reduce pressures on interest rates, the authorities intend to continue implementing prudent fiscal policies.** Specifically, the authorities are restraining expenditures with the aim of complying with the end-December 2000 benchmarks on public sector saving and net domestic financing.[2] Furthermore, until a comprehensive macroeconomic framework is in place in the first half of 2001, the authorities intend to continue to restrain as necessary domestically financed outlays to avoid recourse by the nonfinancial public sector to net domestic financing.[3] Consistent with this approach, the authorities have indicated that they will refrain from granting across-the-board wage increases and grant wage increases only selectively for teachers, health workers, and police personnel.

6. **The authorities are committed to policies aimed at improving the health and efficiency of domestic financial intermediation.** To that effect, they will implement an action plan that has been developed with the support of Fund, World Bank, and IDB staffs (Attachment I of the letter). The authorities will (1) continue to act on the bank resolution plans that are underway; (2) act to strengthen the remaining weak bank; (3) review the legal, regulatory, and supervisory framework in line with international best practices; and

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[2] Adjusted for delays in balance of payments support and the unanticipated costs of bank resolutions.

[3] Before taking into account the additional resources stemming from the privatization of the electricity generation facilities and the IDB balance of payments support that had been programmed to be disbursed in 2000.

(4) strengthen legal efforts aimed at punishing those responsible for fraud in the intervened banks.

7. In the authorities' view, the support of the Fund is critical to restoring confidence, mobilizing urgently needed financial support from official creditors and donors, including in the context of the HIPC Initiative, and improving the prospects for continued economic growth and poverty alleviation. In this context, **the authorities have requested that discussions be conducted as soon as possible on a program for 2001 that could be supported by a third annual PRGF arrangement**. A mission is scheduled for January 2001, which would also conduct the Article IV consultation.

8. **Appraisal.** While it was originally intended that this review be completed in September 2000, it had to be postponed when serious banking sector difficulties emerged and prior actions were delayed. Ideally, it would have been preferable to have an agreed macroeconomic framework for 2001 with the completion of this review, as it would have given stronger assurances of the implementation of policies to attain the program objectives. However, the authorities' attention in recent months has focused appropriately on very near term banking and macroeconomic policies to ensure that the unforeseen difficulties in these areas were successfully contained. At the same time, the authorities also had to help ensure that the municipal elections were carried out in a satisfactory manner.

9. The staff is encouraged by the authorities' recent policy actions and firm determination to implement financial sector reforms and address the banking problems. The policies and specific steps in these areas have been endorsed by the staffs of the IDB and the World Bank. The staff also is encouraged by the actions being taken to correct slippages relative to the macroeconomic, structural, and governance policies contemplated in the modified program. In the period ahead, the authorities should vigorously implement their specific action plan on financial sector reforms. They should also continue to implement prudent fiscal, credit, and wage policies in preparation of a comprehensive economic framework for 2001 that could be supported by a third annual PRGF arrangement. While there remain important risks, the staff considers that the actions taken, together with the understandings already reached with the authorities on key policies for 2001, are, in the circumstances, sufficient to merit completion of the review. The actions being taken, together with financial support under the PRGF and the HIPC Initiative and the positive signal that such support would provide, are expected to strengthen confidence and minimize the adverse impact of banking problems on output and employment growth.

**Revised Proposed Decision**

The following revised draft decision, which may be adopted by a majority of the votes cast, is proposed for adoption by the Executive Board:

1. Nicaragua has consulted with the Fund in accordance with paragraph 2(d) of the second annual arrangement for Nicaragua under the Poverty Reduction Growth Facility (PRGF) (EBS/99/164, Supplement 1) and paragraph 4 of the letter dated August 19, 1999 from the Minister of Finance and the President of the Central Bank of Nicaragua in order to review program implementation.

2. The letter from the Minister of Finance and the President of the Central Bank of Nicaragua dated August 30, 2000, together with its Memorandum of Economic and Social Policies (the "Memorandum"), and the letter from the Minister of Finance and the President of the Central Bank of Nicaragua dated December 13, 2000, shall be attached to the second annual PRGF arrangement for Nicaragua, and the letter dated August 19, 1999 from the Minister of Finance and the President of the Central Bank of Nicaragua, together with its attached Memorandum of Economic and Financial Policies, shall be read as supplemented and modified by the letters dated August 30, 2000, and its attached Memorandum, and December 13, 2000, respectively.

3. Subject to paragraph 4 below, the Fund decides that:

(a) The first and second reviews contemplated in paragraph 2(d) of the second annual PRGF arrangement for Nicaragua are completed upon the condition that the information provided by Nicaragua regarding the implementation of the prior actions specified in Box 1 of the Memorandum attached to the letter dated August 30, 2000 is accurate;

(b) Nicaragua may request the disbursement of the second and third loans specified in paragraphs 1(b) and (c), respectively, of the second annual arrangement, notwithstanding the non-observance, with regard to the second loan, of the quantitative performance criteria for December 31, 1999 referred to in paragraph 2(a)(i), (ii), (iii), and (iv) of the second annual arrangement and the structural performance criteria relating to the approval of the social security reform law, the invitation for final bids for ENITEL, and on the issuance of final bid documents for ENEL's generation and distribution units, referred to in paragraph 2(b) of the arrangement, and, with regard to the third loan, of the quantitative performance criteria for June 30, 2000 referred to in paragraph 2(a)(i), (ii), (iii), and (iv) of the second annual arrangement, on the condition that the information provided by Nicaragua to assess the observance of these performance criteria is accurate; and

(c) The commitment period of the three-year arrangement under the PRGF for Nicaragua approved on March 18, 1998 (EBS/98/7, Supplement 2) is extended to March 17, 2002.

4. This decision is adopted in principle and shall become effective on the date in which the Fund decides that the World Bank has concluded that the Interim Poverty Reduction Strategy Paper for Nicaragua (I-PRSP) provides a sound basis for a fully participatory PRSP and for World Bank concessional financial assistance.

Table 1. Nicaragua: Consolidated Operations of the Public Sector

(In percent of annual GDP)

| | 1999 | | 2000 | | | |
|---|---|---|---|---|---|---|
| | | | Jan.-Jun. 2000 | | Jan.-Sep. 2000 | |
| | Adj. Prog. | Actual | Adj. Mod. Prog. | Prel. | Adj. Mod. Prog. | Prel. |
| **Combined public sector savings** | **4.8** | **5.3** | **2.6** | **2.6** | **3.9** | **3.7** |
| Excluding interest payments | 10.2 | 10.0 | 5.1 | 5.0 | 8.2 | 7.5 |
| **Combined public sector balance (before grants)** | **-13.6** | **-15.4** | **-7.7** | **-5.9** | **-11.0** | **-9.4** |
| **Total current revenue** | **33.6** | **34.5** | **16.9** | **16.2** | **25.8** | **24.6** |
| Current revenue of the general government | 31.3 | 32.2 | 16.0 | 15.4 | 24.4 | 23.6 |
| Operational surplus of public utilities | 2.3 | 2.3 | 0.9 | 0.8 | 1.4 | 1.0 |
| **Total current expenditure** | **28.8** | **29.3** | **14.3** | **13.5** | **21.9** | **20.9** |
| Consumption and transfers | 21.8 | 22.9 | 10.8 | 10.3 | 16.4 | 15.8 |
| Nonfinancial public sector interest payments | 5.4 | 4.8 | 2.5 | 2.4 | 4.4 | 3.8 |
| Central bank operating deficit | 1.6 | 1.6 | 0.9 | 0.9 | 1.1 | 1.3 |
| **Capital expenditure and net lending (net of capital revenue)** | **18.4** | **20.6** | **10.3** | **8.5** | **14.9** | **13.1** |
| Grants | 8.0 | 8.5 | 3.7 | 3.8 | 5.7 | 5.1 |
| **Combined public sector balance (after grants)** | **-5.6** | **-6.9** | **-4.0** | **-2.1** | **-5.3** | **-4.3** |
| **Financing** | **5.6** | **6.9** | **4.0** | **2.1** | **5.3** | **4.3** |
| External financing, net | 10.0 | 10.5 | 3.7 | 2.8 | 7.0 | 5.0 |
| Privatization receipts | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Domestic financing, net 1/ 2/ 3/ | -4.4 | -3.7 | 0.3 | -0.6 | -1.7 | -0.7 |
| *Of which:* Central bank | -4.4 | -2.6 | 3.3 | 3.4 | 2.2 | 4.1 |
| **Memorandum items:** | | | | | | |
| Total social expenditures (in percent of GDP) 4/ | 14.3 | 15.2 | 7.3 | 6.5 | 11.0 | 10.4 |
| GDP (in millions of cordobas) | 27,188 | 26,782 | 30,995 | 30,995 | 30,995 | 30,995 |

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

1/ For 1999, the program target was adjusted upward by US$15 million because of lower-than-envisaged disbursements of balance of payments support from the IDB and World Bank.

2/ The January-June 2000 target was adjusted upward by (i) US$10.5 million because of lower-than-programmed disbursements of balance of payments support from the IDB, and (ii) US$5.0 million because of larger-than-envisaged interest payments, associated with the privatization of ENITEL and agreements with bilateral creditors.

3/ The January-September 2000 target was adjusted upward by US$6.2 million because of larger-than-envisaged interest payments, associated with the privatization of ENITEL and agreements with bilateral creditors.

4/ Program definition has been modified to exclude expenditures of the Rural Development Institute.

Table 2. Nicaragua: Quantitative Benchmarks of the Modified 2000 Program

| | Cumulative Flows from January 1, 2000 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | June 30, 2000 | | | September 30, 2000 | | | December 31, 2000 | | |
| | Adj. Modif. Prog. | Outcome | Margin (+) Deviation (-) | Adj. Modif. Prog. | Outcome | Margin (+) Deviation (-) | Adj. Modif. Prog. | Projection | Margin (+) Deviation (-) |
| | (In millions of cordobas) | | | | | | | | |
| Net domestic financing of the nonfinancial public sector 1/ | -178 | -446 | 268 | -841 | -614 | -227 | -2,385 | -206 | -2,179 |
| Savings of the combined public sector | 790 | 808 | 18 | 1,165 | 1,149 | -15 | 1,475 | 1,437 | -38 |
| Net domestic assets of the central bank 1/ 2/ | 642 | 469 | 173 | -806 | 806 | -1,612 | -2,838 | 509 | -3,347 |
| | (In millions of U.S. dollars) | | | | | | | | |
| Net international reserves of the central bank 1/ 2/ | -67 | -53 | 14 | 45 | -81 | -126 | 240 | -40 | -280 |
| Disbursements of nonconcessional external loans contracted or guaranteed by the public sector 3/ | | | | | | | | | |
| Maturity of more than one year 4/ | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Maturity of one year or less 5/ | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Stock of external payments arrears limit 6/ | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | (In millions of cordobas) | | | | | | | | |
| **Memorandum items**: 7/ | | | | | | | | | |
| Deficit of the combined public sector | -2,420 | -1,827 | 593 | -3,445 | -2,915 | 530 | -4242 | -4,045 | 197 |
| Total expenditures of the central government | 5,660 | 5,223 | 437 | 8,625 | 8,157 | 469 | 11,542 | 11,176 | 366 |

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

1/ The January-June 2000 targets were adjusted by (i) US$10.5 million because of lower-than-programmed disbursements, and (ii) US$6.2 million because of larger-than-envisaged associated with the privatization of ENITEL and agreements with bilateral creditors. The January-September 2000 targets were adjusted by (i) US$7.4 million because of larger-than-e interest payments, associated with the privatization of ENITEL and agreements with bilateral creditors. The January-December targets were adjusted by (i) US$115 million, represent from the privatization of ENEL; (ii) US$10 million for poverty-related expenditure; (iii) US$26 million for external debt payments of ENEL; and (iv) US$7.4 million for debt service

2/ The January-September targets were adjusted by US$82.7 million because of the higher-that-envisaged net issue of central bank or government paper. The January-December targ by US$135 million, representing the projected higher-than-envisaged net issue of central bank or government paper.

3/ Loans of a grant element of less than 35 percent on the basis of currency specific CIRR discount rates.

4/ Excludes Paris Club resources resulting from the deferral of Nicaragua's debt service.

5/ Excluding normal import related credits.

6/ Excluding reschedulable arrears, measured on a continuous basis.

7/ Indicative ceilings.

Table 3. Nicaragua: Selected Macroeconomic Indicators, 1999-2000

| | 1999 Actual | 2000 Modified Prog. With Priv. 1/ | 2000 Revised Proj. 2/ |
|---|---|---|---|
| (Annual percentage change; unless otherwise indicated) | | | |
| **National income and prices** | | | |
| GDP at constant prices | 7.0 | 5.5 | 5.0 |
| Consumer prices (end of period) | 7.2 | 10.0 | 9.0 |
| **Financial sector** | | | |
| Financial system liabilities to private sector | 21.9 | 17.3 | 9.9 |
| Financial system credit to private sector | 40.0 | 17.1 | 14.5 |
| (In percent of GDP) | | | |
| **Combined public sector 3/** | | | |
| Saving | 5.3 | 4.9 | 4.6 |
| Overall balance (before grants) | -15.4 | -13.6 | -12.9 |
| Overall balance (after grants) | -6.9 | -6.9 | -6.4 |
| Domestic financing | -3.7 | -4.9 | -3.8 |
| **External sector** | | | |
| External current account balance | -37.0 | -33.4 | -31.8 |
| (In percent; unless otherwise indicated) | | | |
| Gross international reserves | | | |
| In months of imports | 3.9 | 4.0 | 3.1 |
| In percent of short-term debt | 203.0 | 257.5 | 203.8 |

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

1/ Assumes net privatization receipts of US$37 million.
2/ Assumes net privatization receipts of US$79 million.
3/ Includes quasi-fiscal losses.

Mr. Horst Köhler
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, DC 20431

Managua, Nicaragua
December 13, 2000

Dear Mr. Köhler:

1. This letter describes recent performance under the government's modified economic program for 2000, which was set out in the Memorandum of Economic and Social Policies (MESP) of August 30, 2000, relating to the second annual arrangement under the Poverty Reduction and Growth Facility (PRGF) that was approved on September 15, 1999. It also describes certain policies in the financial and macroeconomic areas that the government has started to implement in the wake of recent difficulties in the banking sector and while discussions are under way in early 2001 on a macroeconomic framework that could be supported by the third annual PRGF arrangement. In order to complete the discussions on a program that could be supported by the third annual arrangement, we request that the commitment period under the three year PRGF arrangement be extended until March 17, 2002.

2. Since the MESP was prepared, and despite the adverse effects of recent banking difficulties (see below), progress has continued to be made in the macroeconomic, structural, and governance areas. Reflecting a tightening of fiscal and credit policies starting in the second quarter of 2000, as envisaged under the modified program, 12-month inflation fell to around 9 percent in October–November, from a peak of 15 percent in April. In the first nine months of 2000, the combined public sector deficit (after grants) was held to the equivalent of 4.3 percent of annual GDP, compared with 5.3 percent under the program, as externally financed capital outlays fell short of programmed levels. Credit to the private sector expanded by 23 percent in the year to August 2000, compared with over 40 percent during 1999. The benchmark on the net international reserve target for September could not be met, however, because of the serious difficulties experienced by two large banks beginning in August.

3. In the structural area, the electricity distribution companies have been sold and a long-term lease of a port has been granted. The thermal electricity plants have not yet been divested, however, because potential investors are awaiting the outcome of a Supreme Court judgment on existing legal challenges, and the telecommunications company has not been privatized because a single bid that was received in October 2000 was below the reservation price. Legislation on the supervision of private pension funds was submitted in October to the National Assembly. In the governance area, the Treasury's cash management system has been completed and actions aimed at strengthening the Comptroller's Office have been undertaken. Also, new legislation modernizing the functions of public prosecutors has been passed and a new penal code is expected to be approved by the National Assembly shortly. In

addition, the November municipal elections were carried out in a free and transparent manner.

4. The government has made further important progress in preparing its strengthened poverty reduction strategy (SPRS). The SPRS is being consulted at the local level to seek grass roots reaction; comments from civil society and the donor community are being incorporated; and the costing of programs and projects has begun. The government is receiving substantial technical and financial support from the Inter-American Development Bank (IDB) and UNDP to strengthen the institutions involved in the preparation of Nicaragua's poverty alleviation strategy, as well as in the monitoring and evaluation of its implementation.

5. Despite the progress being made in all these areas, Nicaragua's economic and financial situation was unsettled in August–November. Confidence in the banking system weakened, and banking system deposits fell sharply during that period, contributing to a cumulative loss of US$90 million in net official international reserves during January–November 27, 2000. The weakening of confidence reflected a marked deterioration in the quality of the portfolios of two commercial banks related to fraud and mismanagement. To deal with this situation, the government acted decisively by intervening these banks, providing liquidity assistance in the context of guaranteeing their deposits and, subsequently, by implementing resolution plans for these institutions. At the same time, open market operations were stepped up to sterilize part of the liquidity injection by the central bank. The resolution plans involve: (1) writing off the shares of the original owners; (2) recapitalization of the intervened banks (by exchanging their impaired assets for central bank paper) in preparation for their resale; (3) resale of the intervened banks to other domestic banks; and (4) implementation of asset recovery plans. Also, the government is pursuing legal action against those involved in fraudulent activities.

6. As a result of these actions, the financial situation has now stabilized and the government is taking steps to rebuild the official international reserve cushion and further improve the health of the banking system.

7. In particular, the government is committed to increase public sector deposits at the central bank by US$36 million during November 28–December 31, 2000 (consistent with the underlying programmed flow of central bank net credit to the nonfinancial public sector, adjusted for certain delayed external flows) to rebuild official international reserves by around US$50 million in that period. Credit conditions also will be tightened through the implementation until end-January, 2001 of a marginal liquidity requirement on bank's deposits and through open market operations. The official reserve cushion would increase further in 2001, as the government will carry out pending reforms in the financial and electricity sectors that will secure the disbursement of US$60 million of delayed balance of payments support from the IDB. Also, in early 2001 the government will offer for sale the electricity generation facilities, sterilizing the net proceeds in the central bank.

8. To support the international reserve build-up and reduce pressures on interest rates, the government will continue to undertake actions necessary to comply with the modified program's end-December benchmarks on public sector saving and net domestic financing, adjusted for delays in the disbursement of balance of payments support from the IDB and the fiscal cost of bank resolutions. In early 2001, the government will hold comprehensive discussions of fiscal policy options with IMF staff in the context of the formulation of a program that could be supported by a new PRGF arrangement. Until then, domestically financed spending by the nonfinancial public sector will be contained as necessary to avoid recourse to net domestic financing, before taking into account resources stemming from the privatization of the electricity generating plants (net of debt service payments connected with the privatization of the electricity company) and the disbursement of the delayed balance of payments support from the IDB. To that end, the government will continue to refrain from granting across-the-board wage increases and will limit wage increases to selective adjustments for teachers, health workers and police personnel.

9. To improve the health of the banking system, in the next few months the government will review and modify, as necessary, the legal, regulatory and supervisory framework of the financial system. For that purpose, a specific action plan to be implemented with IMF, World Bank, and IDB technical support has been developed (Attachment I). As part of this plan, the government will enact by the end of this year a law on deposit insurance to provide appropriate guarantees to small depositors and limit the fiscal costs of bank restructuring. The government will consult with the IMF, the World Bank, and the IDB staffs any modifications that might be required to bring this legislation in line with international best practices and will submit the required modifications to the National Assembly by March 2001.

10. The government is committed to implementing vigorously the actions described in this letter to support its economic program, which aim at reducing the country's high poverty levels. In particular, special care will be taken to monitor developments in the banking system to strengthen its situation through appropriate policy actions. The government reaffirms its intention to use HIPC Initiative assistance solely for poverty spending. The government feels that the implementation of the strategy laid out in this letter is essential to resolve the difficulties in the banking sector and ensure continued macroeconomic stability and economic growth. The government stands ready to take any further measures that might be required to deal with unexpected difficulties in complying with its economic program.

11. The government appreciates the continuing support of the IMF, which is critical to maintaining confidence and improving Nicaragua's economic prospects.

Sincerely,

/s/
Noel Ramírez Sánchez
President of the Central Bank

/s/
Esteban Duque Estrada
Minister of Finance

Attachment

## NICARAGUA: FINANCIAL SECTOR REFORMS[1]

| Objective | Action | Date of Implementation |
|---|---|---|
| I. Strengthen the **institutional framework for banking crisis resolution.** | a. Create appropriate institutional arrangements to coordinate all institutions involved in the banking crisis resolution process (CBN, Ministry of Finance, SBIF), and assign clear responsibility. | End-January 2001 |
| II. Establish the **legal basis** for bank restructuring. | a. Ensure that the deposit insurance law that will be enacted shortly is consistent with international best practices, containing flexible provisions for prompt bank resolution. The law should contain provisions to prevent undue suspension of bank resolution procedures due to legal claims, legal protection, and conflict of interest clauses for all staff and contractors involved in the bank resolution process. Changes necessary to the law, in order to bring it into line with the above considerations, will be submitted to the National Assembly after consultation with the IMF, IDB, and World Bank. | Approve deposit insurance law according to international best practices by end-March 2001. |
| | b. Modify the financial legislation to enhance superintendency's capabilities for bank resolution and to adapt deadlines for intervention and recapitalization according to international best practices. Include legal protection and conflict of interest clauses for the superintendent of banks, the president of the CBN, and staff of the superintendency of banks and CBN. | End-March 2001 |
| | c. Modify the criminal code to update the definition of financial crimes. | End-June 2001 |
| | d. Review of the legal and institutional framework for establishing, registering and enforcing property rights, including catastral and collateral registration systems, and develop a time-bound action plan to address any deficiency found. | End-December 2001 |
| III. Strengthen **solvency of banks**. | a. Finalize current cycle of on-site assisted inspections and officially communicate required adjustments | End-March 2001 |
| | b. Complete a second cycle of on-site assisted inspections including a review of all remaining categories of assets, liabilities and capital accounts not included in the first cycle. Also, a full diagnosis of contingent accounts would be performed and adequate samples of small credits would be taken and the results extrapolated to the remaining small credits portfolio. Revised rules as described in III.c and VI.a will be applied. | End-September 2001 |
| | c. Design and implement strengthening programs for banks where capital weaknesses have been found during the assisted inspections. | Start implementation by end-January 2001 |
| IV. **Strengthen banks' liquidity management.** | a. Design and implement a repo facility at the CBN. | End-March 2001 |
| | b. Develop and implement a plan to improve the CBN's ability to place bonds at market terms, including strengthening the financial profile (debt sustainability) of the CBN. | Develop the plan by end-February 2001<br>Implementation by end-May 2001 |
| | c. Reserve requirements (RR) will not be increased. The recently introduced liquidity requirement (LR) (that banks whose deposits increased between August 5 and December 5, 2000 invest 65 percent of this increase in BOMEX) will be rescinded. | As regard the RR, continuous<br>As regards the LR, end-January 2001 |

[1] All measures contained in this matrix will be implemented in manners satisfactory to the Fund and World Bank staffs.

| Objective | Action | Date of Implementation |
|---|---|---|
| V. **Resolve intervened banks.** Manage and recover impaired assets of Interbank and Bancafe. | a. Formally write off the value of the shares of Interbank's shareholders. For banks falling below 2.5 percent CAR and failing to recapitalize the bank within the legal timeframe of intervention, the intervention board should be constituted as general shareholders' meeting and formally write off the value of the shares of the bank. | Immediately |
| | b. Prepare an inventory of all assets of both intervened banks, which have not been transferred to other institutions, including valuation. | End-March 2001 |
| | c. Establish a time-bound program for the disposal of the assets which will include an asset management strategy covering institutional arrangements, information and transparency, and private sector outsourcing. | End-April 2001 |
| | d. Prepare a litigation strategy after assessing all possible legal actions to pursue in the courts those allegedly involved in criminal activities and misconduct in intervened banks. | End-January 2001 |
| VI. **Strengthen prudential regulations.** | a. Tighten the rules for classification and provisioning of restructured loans and review classification criteria for all loans. | End-February 2001 |
| | b. Review current norms to make sure they are still adequate given Nicaragua's needs. Among others, banks should be required to publish audited accounts, and sanctions should be introduced to punish the publication of erroneous information. | Norms reviewed by end-April 2001<br>Changes approved by end-May 2001 |
| | c. Conduct a diagnostic of the operating procedures of the *central de riesgos* and implement a time-bound action plan to correct any deficiencies found. | Diagnostic completed by end-June 2001. Action plan implemented by end-December 2001 |
| | d. Approve and strengthen fit and proper regulations for main shareholders and managers of banks, including restrictions on former owners and managers of failed banks that have caused losses to the State to subsequently own or manage banks. | End-January 2001 |
| | e. Amend accounting standards to bring them into conformity with GAAP (Generally Accepted Accounting Principles), including with respect to proper asset valuation (mark-to-market valuation of securities—except held to maturity—and real estate assets) and accounting of restructured loans. | End-December 2001 |
| | f. Complete satisfactory review of supervisory practices and undertake, with the assistance of the IFIs and foreign supervisors, compliance assessments of the Basle Core Principles. | End-January 2002 |
| | g. Develop time-specific action plan to address any deficiencies found in (f). | End-March 2002 |
| VII. Strengthen **prudential supervision.** | a. Implement the strengthening strategy and the integrated support program for the superintendency of banks, as established in the technical assistance matrix of the World Bank, and implement the training actions to be determined in the IDB program. | Beginning January 2001. Shall be completed by end-June 2002. |
| | b. Introduce a ladder of intensified supervisory action and penalties for noncompliance with regulatory norms. The Superintendency of Banks will apply penalties and disciplinary measures on a uniform and nondiscretional basis. The authorities will review the level and uniformity of penalties and of supervisory actions. | End-March 2001 |
| | c. Strictly enforce fit and proper, conflict of interest, and related party lending regulations. Create public registries of main shareholders and managers of banks and related party databases. | End-December 2001 |