FOR AGENDA

SM/07/59

February 9, 2007

To: Members of the Executive Board

From: The Secretary

Subject: **Nicaragua—Ex Post Assessment of Longer-Term Program Engagement**

Attached for consideration by the Executive Directors is a paper on the ex post assessment of the Fund's longer-term program engagement with Nicaragua, which is tentatively scheduled for discussion on **Friday, February 23, 2007**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Nicaragua indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Lall, RES (ext. 36113), Mr. Prat, WHD (ext. 39333), Ms. Yackovlev, FAD (ext. 34335) and Mr. Zhan, PDR (ext. 34854).

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 on Tuesday, February 20, 2007; and to the European Commission, the European Investment Bank, and the Islamic Development Bank, following its consideration by the Executive Board.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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INTERNATIONAL MONETARY FUND

NICARAGUA

Ex Post Assessment of Longer-Term Program Engagement

Prepared by a staff team from the Fiscal Affairs, Policy Development and Review, Research, and Western Hemisphere Departments[1]

Authorized for Distribution by the Policy Development and Review Department and Western Hemisphere Department

February 8, 2007

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[1] The team comprised Mr. Lall (head, RES), Mr. Prat (WHD), Ms. Yackovlev (FAD), and Mr. Zhan (PDR). Ms. Guerra Bradford (WHD) provided research assistance.

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EXECUTIVE SUMMARY

The recent economic history of Nicaragua reflects the convergence of several important factors:

- **The economy has been exposed to a number of exogenous shocks, including agricultural commodity price cycles and natural disasters.** The resulting high volatility of output is a key source of vulnerability to large segments of the population, given the legacy of a highly uneven distribution of income and widespread poverty.

- **The economy was characterized by poor initial conditions when program engagement began in the early 1990s**. The economic collapse of the 1980s had left Nicaragua with large external and fiscal imbalances, high inflation, a crushing burden of external debt and a reduction in per capita income to levels not seen since the 1920s.

- **A broad-based constituency for reform to deal with the above problems has been slow to materialize**. The complex political history and disparities in income distribution have led to significant divisions in the polity and society, and powerful interest groups have exercised significant influence on the policy process.

Nicaragua has been engaged in a succession of Fund-supported programs beginning with a Stand-By Arrangement in 1991. This assessment focuses on the three ESAF-PRGF arrangements since 1994.

- **Success in achieving the programs has to be assessed against both program objectives and broader macroeconomic outcomes.** Successive programs sought to establish the foundations for medium-term growth of around 5 percent, inflation of around 4-5 percent and reserve coverage of 3-3½ month of imports. Growth objectives were met in the 1990s but have fallen short subsequently—in part due to the banking crisis of 2000—and average inflation has been above 8 percent over the period. However, successive Fund-supported programs helped avoid serious macroeconomic instability despite the numerous shocks the economy has faced since the mid-1990s.

- **Poor implementation of reforms and the focus of program conditionality on relatively short-term measures were the main factors leading to the mixed program performance.** The Fund responded to a mixed implementation record by developing and prioritizing corrective policy measures aimed at ensuring achievement of short-term macroeconomic objectives. Where compliance was delayed by political or institutional constraints, the Fund responded with a significant amount of flexibility. As a result, progress on some policy measures aimed at addressing key medium term challenges was slow to materialize.

Looking ahead, while there is an unfinished reform agenda which could serve as the basis for Nicaragua's continued engagement in the context of a Fund-supported program, important lessons from past experience need to be considered.

- **Success in establishing the foundations for high and stable growth and a sustained reduction of poverty require comprehensive reforms, only some of which are in the core areas of Fund expertise.** There is significant scope for the hardening of budget constraints at several levels of the economy, including at the municipal level, autonomous enterprises, and the energy sector. Key fiscal institutions need to be further strengthened, particularly in the areas of budgeting (earmarked transfers are of particular concern) and intergovernmental relations (between local and central government, and between the central government and autonomous institutions). Improving governance is also essential to raising the efficiency of the public sector, and fostering a robust private sector.

- **Economic reforms need to be considered as a sequence and within a medium term framework.** During past program engagement, the structural reform program has at times been held hostage by short-term impediments. Going forward, the structural reform program must stay focused on removing impediments to long-term growth, by identifying medium-term priorities and translating them into short-term policy actions.

- **Ownership of the reforms and strong implementation will be crucial to the success of a future Fund-supported program.** The still substantial vulnerabilities facing the economy and the need for external financing suggest that the Fund can play an important role in maintaining macroeconomic stability and continuity in the reform agenda. One key finding is that the authorities' willingness to commit to reforms often outpaced their ability to deliver on those commitments in a timely fashion. Going forward, the credibility of reform commitments would be enhanced by demonstrated up-front actions rooted in consensus, and would serve to increase the chances of success of a Fund-supported program.

I. Introduction

1. This ex-post assessment (EPA) report examines Nicaragua's reform efforts and the role of the Fund over the course of the three ESAF and PRGF arrangements since 1994. It aims to address the following interrelated questions: were the key economic challenges facing Nicaragua correctly identified; were the Fund's policy advice and related conditionality appropriate to address these challenges; and, was the implementation of reforms adequate? Based on these questions, the paper aims to distil the lessons from Nicaragua's past engagement under Fund-supported programs and discusses its implications for the future.

2. The report is structured as follows. Section II provides a brief overview of the economic context and the main features of Fund-supported programs since 1994. Section III analyzes key aspects of the Nicaraguan economy that must be addressed in efforts aimed at establishing stable long-term growth, alleviating poverty and reducing macroeconomic vulnerabilities. This discussion provides a framework for Section IV, which assesses the role of Fund-supported programs and outlines the key policy priorities going forward. Section V discusses strategies for the Fund's future engagement with Nicaragua.

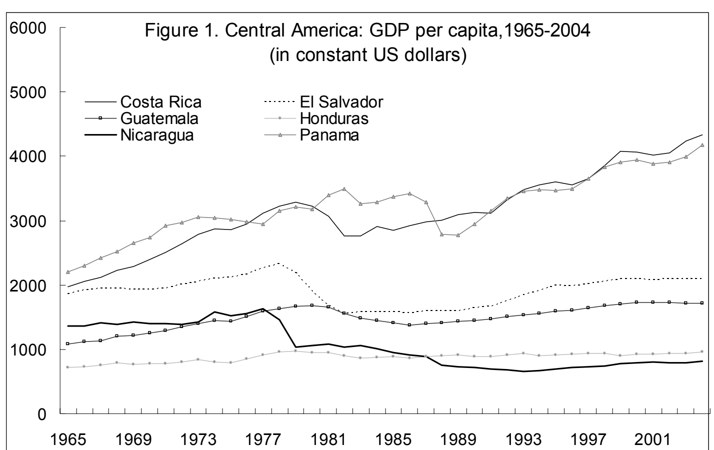
II. Economic Context and the History of Fund-supported Programs

A. Basic Economic Characteristics

3. Three important and inter-related features of Nicaragua provide the context for understanding the Nicaraguan economy, the challenges to policymaking, and the priorities for reform going forward:

- The economy is vulnerable to a number of exogenous shocks, including agricultural commodity price cycles and natural disasters. These shocks have contributed to the high output volatility in Nicaragua, underscoring the need for a savings cushion for both the public sector and households.

- The economy is characterized by highly uneven income distribution and widespread poverty, exacerbated by the economic collapse of the 1980s which reduced real per capita income to the level of the 1920s (Figure 1).



Source: World Bank, *World Development Indicators*.

- The complex political

history of the country and the disparities in income distribution have led to significant divisions in the polity and society. Powerful interest groups have been effective in exercising veto power over several key reforms, and therefore, a broad-based constituency for comprehensive reforms has been slow to materialize.

4. In this context, the priorities for economic reforms center around the need to expand economic opportunity across the population and reduce economic vulnerabilities, which affect the poor disproportionately. Reforms, therefore, need to focus on producing high and stable growth, ensuring the effective use of resources for poverty alleviation, maintaining low levels of debt, and increasing economic flexibility to respond to shocks.

B. Main Features of IMF-Supported Programs 1994–2006

5. During the period under review, Nicaragua entered into three Fund-supported programs (in 1994, 1998, and 2002). Against the backdrop of the economic collapse of the 1980s, the main challenges facing the economy in the early 1990s revolved around establishing macroeconomic stability and the reduction of vulnerabilities arising from large fiscal and external imbalances and a high level of public debt. Successive Fund-supported programs sought to address these challenges through the combination of macroeconomic stabilization measures and structural reforms (Tables 1 and 2).

Table 1. Nicaragua: Selected Economic and Social Indicators

I. Social and Demographic Indicators

Population (2005 estimates, millions)	5.8	Percent of population below the poverty line (2001)	47.9
GDP per capita (2005, U.S. dollars)	850	Gini index (2001)	43.1
Unemployment (2005)	11.5	Life expectancy at birth in years (2004)	70.1
Oil imports (2005, millions of U.S. dollars)	615	Adult literacy rate (2004)	76.7

II. Economic Indicators, 1994–2007

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006 Est.	2007 Proj.
(Annual percentage changes; unless otherwise indicated)														
National income and prices														
Real GDP	...	5.9	6.3	4.0	3.7	7.0	4.1	3.0	0.8	2.5	5.1	4.0	3.7	4.2
GDP per capita in US$	670	721	731	727	746	760	779	788	753	748	799	850	908	942
Consumer price index (end of period)	...	11.1	12.1	7.3	18.5	4.8	6.5	4.8	3.9	6.5	9.3	9.6	8.6	6.4
Consumer price index (average)	...	11.2	11.6	9.2	13.0	11.2	7.1	6.0	3.8	5.3	8.4	9.6	9.2	7.0
Money and credit														
Liabilities to the private sector (M3)	...	...	41.7	53.4	28.0	23.7	4.5	12.1	14.0	14.6	17.5	9.6	17.8	...
Net credit to the private sector	...	...	-3.3	40.7	44.5	36.8	-14.9	-17.3	14.4	26.6	27.5	31.8	32.1	...
(In millions of US$; unless otherwise indicated)														
External Sector														
Current account balance	-911.5	-722.5	-826.3	-842.5	-688.3	-930.3	-791.7	-796.6	-767.2	-749.1	-695.7	-779.2	-765.0	-775.4
(in percent of GDP)	-30.6	-22.6	-24.9	-24.9	-19.3	-24.9	-20.1	-19.4	-19.1	-18.3	-15.5	-15.9	-14.2	-13.7
Trade balance (deficit -)	-429	-385	-527	-728	-749	-1,071	-921	-910	-918	-972	-1,075	-1,314	-1,363	-1,398
Exports	376	545	595	745	761	749	881	895	917	1,050	1,365	1,552	1,940	2,155
Imports	804	930	1,122	1,473	1,510	1,820	1,802	1,805	1,834	2,021	2,440	2,865	3,303	3,554
Income, services and transfers	-483	-338	-299.8	-114.2	60.3	140.9	129.2	113	150	222	380	535	597	623
Foreign direct investment	40	75	97	172	195	300	267	150	204	201	186	230	285	300
International reserve position														
NIR (stock, adjusted)	...	...	...	...	139	216	187	16	64	83	211	282	528	628
GIR (stock)	...	...	...	...	357	513	497	383	454	504	670	730	896	986
(in months of imports of G & NFS)	...	...	...	...	2.4	2.9	2.8	2.1	2.5	2.1	2.8	2.7	2.9	2.9

Table 1. Nicaragua: Selected Economic and Social Indicators (concluded)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006 Est.	2007 Proj.
						(Ratios to GDP)								
Public finances														
Primary balance (after grants)	-0.4	-0.7	-1.7	1.1	0.9	-1.2	-2.3	-2.8	-0.3	0.1	0.4	0.7	2.0	1.8
Overall balance (after grants)	-3.7	-3.7	-4.2	-2.7	-2.0	-4.1	-5.1	-9.0	-5.4	-4.3	-2.8	-1.5	-0.3	-0.3
Stock of debt (at face value)	407.7	331.9	198.6	208.8	212.5	207.2	204.1	193.5	197.7	215.8	93.5	90.3	69.8	65.1
Domestic 1/	14.8	10.8	15.0	31.4	24.2	18.5	20.2	22.1	21.3	34.7	29.4	27.3	21.4	15.1
External 2/	393.0	321.1	183.5	177.4	188.3	188.7	183.8	171.4	176.4	181.1	64.1	63.0	48.4	49.9
Combined public sector debt	407.7	331.9	198.6	208.8	212.5	207.2	204.1	193.5	197.7	215.8	93.5	90.3	68.9	65.6
Domestic debt	14.8	10.8	15.0	31.4	24.2	18.5	20.2	22.1	21.3	34.7	29.4	27.3	21.4	16.4
External debt 2/	393.0	321.1	183.5	177.4	188.3	188.7	183.8	171.4	176.4	181.1	64.1	63.0	47.5	49.2
Investment	20.4	22.0	25.8	30.5	30.0	38.4	31.0	28.2	26.1	25.9	28.3	29.3	28.2	29.1
Private sector	13.0	14.3	17.1	24.6	24.6	29.3	23.4	20.9	21.1	20.4	21.2	22.5	22.5	22.5
Public sector	7.4	7.7	8.6	5.9	5.4	9.1	7.6	7.4	5.0	5.4	7.1	6.8	5.6	6.6
Savings	-10.3	-0.6	0.9	5.6	10.7	13.5	10.9	8.8	7.0	7.6	12.8	13.4	13.9	15.3
Private sector	-11.4	-3.0	-0.8	3.3	7.5	10.3	8.6	9.0	7.4	5.6	8.3	8.2	9.5	10.0
Public sector	1.1	2.3	1.7	2.4	3.2	3.2	2.2	-0.2	-0.4	2.0	4.5	5.2	4.4	5.3
Memorandum items:														
Nominal GDP (C$ millions)	20,008	24,029	28,009	31,967	37,805	44,198	49,952	55,155	57,376	61,959	71,661	82,162	94,318	104,963
GDP (US$ millions)	2,976	3,191	3,320	3,383	3,573	3,743	3,938	4,102	4,025	4,100	4,496	4,910	5,369	5,689

Sources: Nicaraguan authorities; and Fund staff estimates/projections.

1/ Domestic debt is linked to devaluation rate.

2/ After HIPC relief, assuming that negotiations with non-Paris Club and commercial creditors are completed by end-2006.
Includes accrued interest on private debt in arrears.

Table 2. Nicaragua: Timeline of IMF-supported Programs, 1994–2006

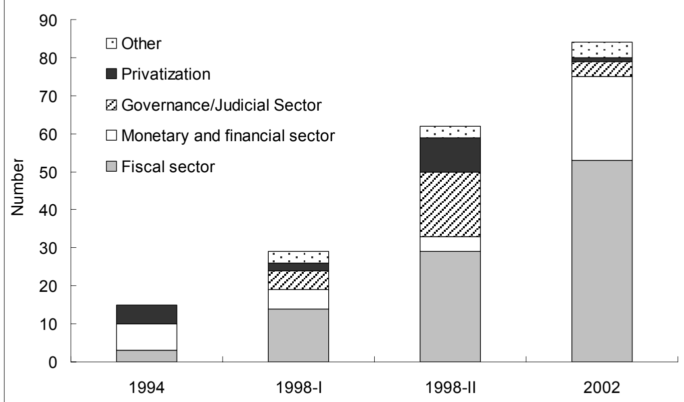
Date	Events
June 1994 - June 1997	1st ESAF arrangement period.
Late 1994 - June 1997	Program off track.
September 1995	SMP initiated.
October 1996	Presidential election.
March 1998 - March 2002	2nd ESAF/PRGF arrangement period.
March 1998	1st annual program approved.
October 1998	Hurricane Mitch.
February 1999	Completion of mid-term review and augmentation of access.
September 1999	2nd annual program approved.
December 2000	Completion of 1st and 2nd reviews and HIPC decision point.
Early 2001-March 2002	Program off track.
July 2001	SMP initiated.
November 2001	Presidential election.
December 2002 - December 2006	3rd PRGF arrangement period.
June 2003	Completion of 1st and 2nd reviews.
October 2003	Completion of 3rd review.
January 2004	Completion of 4th review and HIPC completion point.
September 2004	Completion of 5th and 6th reviews.
Late 2004 - Late 2005	Program off track.
December 2005	Qualified for MDRI relief.
January 2006	Completion of 7th, 8th, and 9th reviews.
September 2006	Completion of 10th review.
November 2006	Presidential election.
December 2006	Completion of 11th review.

Sources: IMF staff reports

6. Key quantitative targets under successive programs focused on public finances and monetary policy. They encompassed central government and public sector balances, the net domestic financing of the public sector, net domestic assets and net international reserves of the central bank, limits on public and publicly guaranteed external debt, and non-accumulation of external arrears. The 2002 program also included a quantitative target for net repayment of the domestic debt of the central bank following the banking crisis of 2000–01.

7. The structural content of programs evolved over the course of the programs (Figure 2 and Appendix). The 1994 ESAF arrangement included conditionality on reducing the size of the public sector, restricting support for and reducing the losses of state-owned banks, privatization, and addressing distortionary exchange and trade policies. This program, however, went off-track soon after the initial disbursement because of poor implementation, which led to a deterioration in public finances, and a slow pace in implementing structural reforms.

Figure 2. Nicaragua: Sectoral Composition of Conditionality



Sources: IMF staff reports, MONA database, and staff calculations.

8. The scope of structural reforms was expanded to include tax and labor market reforms under an “interim monitoring program” initiated by the staff in September 1995 designed to bring the program back on track. Implementation of structural reforms, however, continued to be uneven, and efforts to revive the ESAF arrangement eventually failed. While the Fund continued to remain engaged through discussions on a new ESAF arrangement, progress on reforms was limited as implementation continued to disappoint. Policy implementation improved in late 1997 in anticipation of the new ESAF arrangement, including through passage of a new property rights law, seen as important to improving the investment climate and attracting FDI.

9. Structural conditionality in the 1998 ESAF arrangement increased the focus on measures aimed directly at facilitating the achievement of quantitative targets, including the passage of an appropriate government budget and tariff adjustments to reduce emerging losses in the utility sector. Conditionality also expanded in scope to include social security reform, and legal reform aimed at speeding up the resolution of property rights claims. As conditionality moved beyond areas where administrative action would be sufficient, assembly submission and approval became a prominent feature of conditionality.

10. Implementation of structural reforms in 1998 continued to be slow, and rising concerns about governance delayed donor disbursements. The first mid-term review was delayed by the devastation from Hurricane Mitch and included an augmentation of access under the arrangement. Reacting to donor concerns about governance, conditionality in this area was introduced in the second annual arrangement approved in late 1999 (subsequently converted into a PRGF arrangement) leading to a further increase in the scope of structural conditionality.

11. Slippages in fiscal, structural, and governance areas began to emerge soon after approval of the second annual arrangement. With further macroeconomic slippages in

early 2000 related to excessive public spending, understandings on a modified program were reached to build a track record of implementation ahead of completion of reviews under the PRGF arrangement. Meanwhile, weaknesses in the supervisory and regulatory system for banks became evident as a banking crisis emerged. Overall progress in structural reforms was mixed: progress was made in reform of the social security system, improvements in public procurement, and strengthened tax administration, but delays occurred in the approval of a new code on criminal proceedings and the civil service reform law. While performance under the modified program was uneven, there was mounting pressure to reach HIPC Decision Point. The combined first and second reviews of the second annual arrangement (which preceded the HIPC Decision Point) were completed with delays, but required waivers for most performance criteria (PCs) under the modified program.

12. Economic performance deteriorated significantly after HIPC Decision Point (December, 2000), and the discussion on the third annual program could not be concluded because of delays in addressing policy slippages. Against this background, a staff monitored program (SMP) was established for the second half of 2001 to build a track record for a new Fund-supported program. However, implementation was disappointing as election-related spending soon slipped out of control, and macroeconomic performance deteriorated significantly.

13. The focus of structural conditionality under the PRGF arrangement approved in late 2002 was narrowed almost exclusively to fiscal and financial sector issues. This reflected a number of factors. First, several broader reforms were subsumed under HIPC conditionality. These included decentralization, pension and civil service reforms, and privatization in the energy and telecommunications sectors. Second, the banking crisis required dealing more comprehensively with the banking system, the resolution of failed assets, and the spike in domestic debt of the central bank that resulted from its intervention in the banking system. Third, the experience over previous years had firmly established the need for fiscal reforms to ensure a sustainable improvement in public finances. Finally, there was a general shift in Fund-supported programs toward greater streamlining and focus with respect to conditionality.

14. Program implementation initially was broadly satisfactory, although large wage increases under the 2003 budget required offsetting measures, delaying completion of the 1st review. However, as the political climate worsened (Box 1), implementation of structural reforms became increasingly difficult. The program eventually went off track after the combined 5th and 6th reviews in late 2004, and was resumed only at the end of 2005 with the completion of the combined 7th, 8th and 9th reviews.

Box 1: Politics and Program Implementation During the 2002 PRGF Arrangement

Program implementation under the 2002 PRGF arrangement was significantly complicated by the deteriorating political environment. During the Alemán administration, the Sandinista and Liberal party had agreed on the '*Pacto*' which divided up the composition of the judiciary and the Electoral Council between supporters of the two parties. This was widely perceived as a reflective of the decline in the quality of governance during that time. The Bolaños administration's vigorous pursuit of corruption allegations against the previous administration led to a significant shift in allegiance in the assembly away from the executive, as supporters of former President Alemán formed an alliance with the opposition. With diminished support in the assembly, enacting reforms became increasingly difficult for the executive. The implementation of fiscal policies, for example, was complicated by the assembly's ability to alter the main parameters of the budget for political gains, including expenditure ceilings and revenue targets. The assembly also passed the Municipal Transfers Law in 2003 forcing the central government to immediately transfer a significantly increased share of revenue to municipalities—many controlled by the opposition party—without requiring a devolution of expenditure responsibilities.

Despite this difficult environment, progress was made on governance and institution building including through the passage of the civil service law, improved financial management and auditing and the presentation of a plan for judicial reform. Maintaining domestic consensus, however, became even more challenging after the HIPC Completion Point in early 2004, as demands for a HIPC "dividend" increased among various segments of society, and as municipal elections scheduled for November 2004 approached. As advancement of the structural reform agenda became increasingly difficult, the PRGF arrangement went off-track after the combined fifth and sixth review late in 2004. The program was resumed in late 2005 after a domestic political accord made possible the implementation a large number of pending prior actions.

Technical Assistance under Fund-Supported Programs

15. Technical assistance over the past twelve years has been calibrated to reflect areas critical to the success of the program, focusing mainly on monetary operations, banking supervision, restructuring and regulation, tax reform and administration, and statistical

capacity building. In the aftermath of the banking crisis, a Financial Sector Assessment Program (FSAP) was conducted.

The Role of the World Bank and the Inter-American Development Bank

16. Both the World Bank and the Inter-American Development Bank (IADB) have remained active in Nicaragua. The World Bank's priorities have been in the areas of pension reform, public sector management and civil service reform, decentralization, financial intermediaries, telecommunications and natural resources management. The IADB mainly supported the strengthening of the financial system and judicial system, pension reform, and energy and utility sector reform. The Fund has cooperated closely with other IFIs, deferring to the World Bank and the IADB in their respective areas of expertise. However, as new issues and concerns emerge, the Fund is typically able to adapt its priorities and staff resources much more quickly than the other multilateral institutions.

III. Key Economic Issues and Challenges

17. This section examines key economic issues that, while not exhaustive, capture the main challenges facing the economy in the quest for stable long-term growth, the sustained reduction of poverty, and the reduction of underlying vulnerabilities. They provide a framework within which the subsequent section assesses the role the Fund has played through successive programs, and the main policy challenges going forward.

A. Medium-Term Growth and Poverty Reduction

18. Higher medium-term growth, which is essential to the reduction of poverty and debt sustainability, has been a key objective of all Fund-supported programs in Nicaragua. However, the track record on growth has been uneven, with average annual growth of 4.2 percent during 1994–2006, but only 3.3 percent since 2000. As a result, per capita income growth since 1994 has averaged an annual rate of 1.6 percent, given Nicaragua's high rate of population growth. This mixed growth performance reflects a number of factors, including the uneven implementation of macroeconomic and structural policies, price movements for Nicaragua's principal exports, the impact of Hurricane Mitch, and the 2000–01 banking crisis.

19. A key factor underlying the lackluster medium-term growth performance is disappointing productivity growth, especially in light of investment levels (at nearly 30 percent of GDP) that are the highest in the region (Figures 3 and 4).[2] [3] Raising

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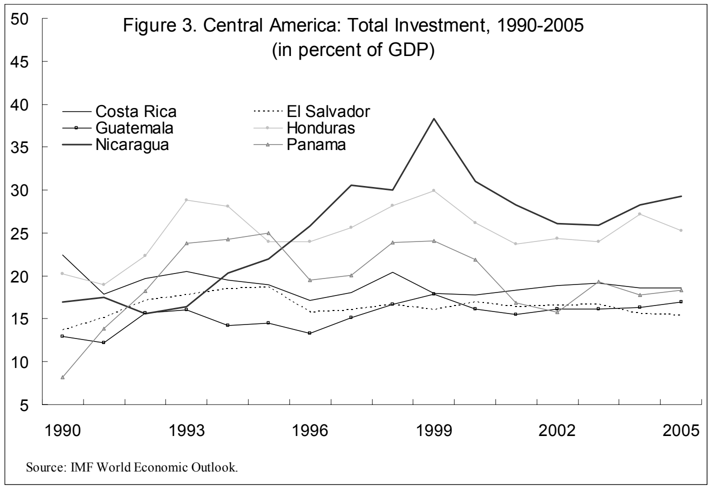
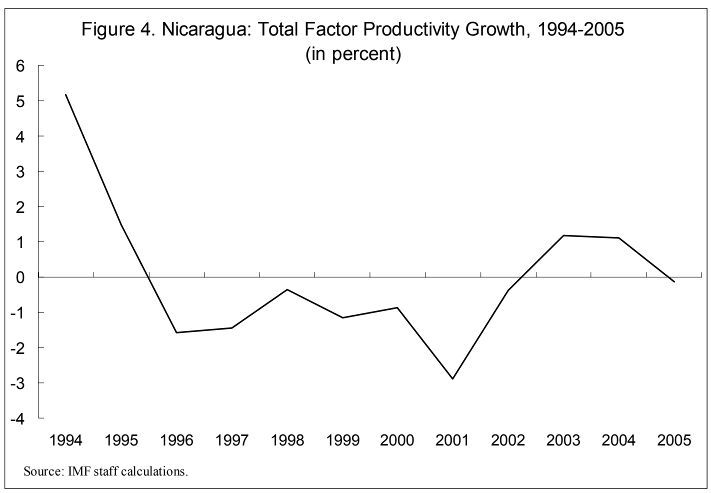
[2] Investment surged to almost 40 percent in 1999 on account of Hurricane Mitch-related reconstruction.

[3] Public investment may be exaggerated by the potential misclassification of some current expenditures, including salaries, as public investment (see IMF (2004)), but the underlying trends for private investment are consistent with the overall increase.

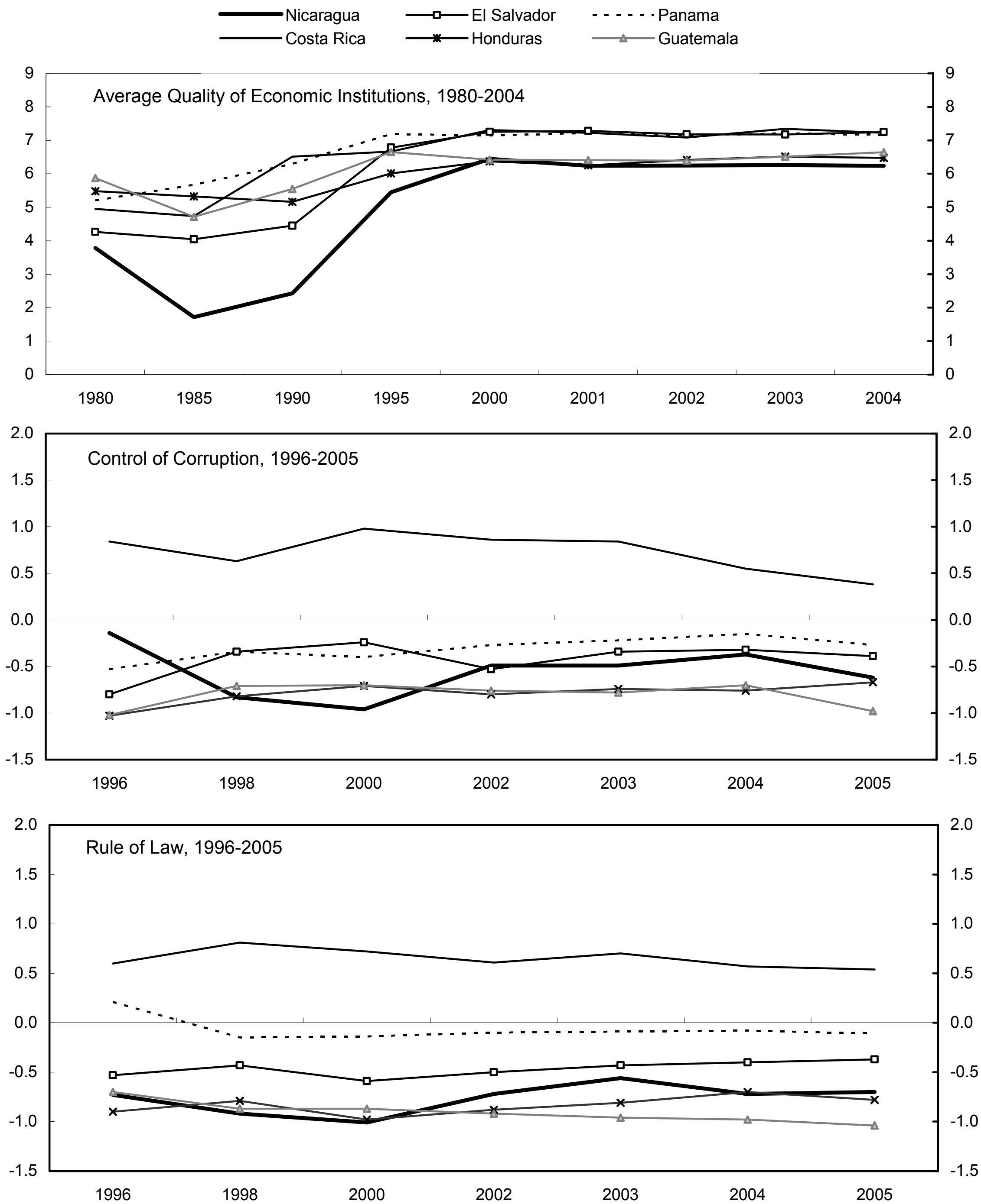
productivity growth has been key to explaining major shifts in per capita output growth in Latin America. The following highlights some of the factors underlying low productivity growth.





20. The quality of economic institutions in Nicaragua remains relatively low, particularly in the areas of government effectiveness, regulatory quality, governance and the rule of law (Figure 5). The Fund has promoted better economic institutions through conditionality and technical assistance (in the area of property rights, transparency in fiscal and national accounts, tax administration processes, budgetary operations, and independence of banking supervisors), but broader reforms needed to improve the quality of overall institutions have lagged.

Figure 5. Central America: Indicators of Institutional Quality



Sources: Cato Institute, *Economic Freedom of the World,* Annual Report, 2006 and World Bank, *Worldwide Governance Indicators* .

21. Available indicators suggest that Nicaragua also compares less favorably along many dimensions of setting up and operating a business. Among these are the costs of starting a business, dealing with licenses and exporting containers, and the time required to register property. Encouragingly, Nicaragua compares favorably with other countries in the efficiency of tax payments, suggesting that efforts at improving tax administration have paid off.[4]

Table 3: The Business Environment in Central America

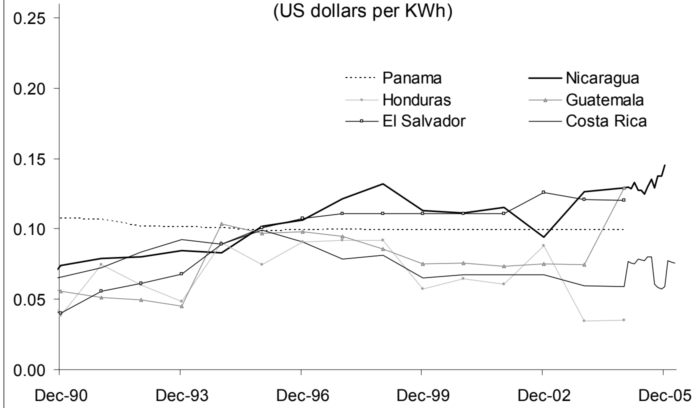
	Nicaragua	El Salvador	Panama	Costa Rica	Honduras	Guatemala
Starting a Business						
Cost (% of income per capita)	131.6	75.6	23.9	23.5	60.6	52.1
Dealing with Licenses						
Cost (% of income per capita)	1002.2	201	114.7	140.2	636.8	496.5
Employing Workers						
Hiring cost (% of salary)	17	8.9	19.4	26	9.5	12.7
Separation costs (weeks of wages)	23.8	85.7	44	35.3	43.3	101.1
Registering Property						
Time (days)	124	33	44	21	36	37
Cost (% of property value)	3.5	3.6	2.4	3.5	5.8	1.1
Getting Credit						
Public registry coverage (% adults)	12.5	30.5	0	2.5	8.3	16.1
Private bureau coverage (% adults)	3.4	79.6	59.8	39.2	18.7	9.2
Paying Taxes						
Time (hours)	240	224	560	402	424	294
Total tax rate (% profit)	66.4	27.4	52.4	83	51.4	40.9
Trading Across Borders						
Time for export (days)	36	22	16	36	28	20
Cost to export (US$ per container)	1020	515	920	660	500	1785
Time for import (days)	38	30	13	42	39	33
Cost to import (US$ per container)	1020	515	920	660	670	1985
GDP per unit of energy use (2000 PPP US$ per kg of oil equivalent), 2002	5.7	7.1	5.9	9.4	5	6.4
Electricity consumption per capita (kilowatt-hours), 2002	496	665	1654	1765	696	660
Electricity (% of managers surveyed ranking this as a major business constraint)	34.7	21.5	n.a.	n.a.	36.4	26.6
Paved roads (in percent of total roads), 1999 \1	11.4	19.8	34.6	22.5	20.4	34.5
Telephone mainlines (per 1,000 people)	40	131	118	316	53	92

1\ Latest available information for each country. Value for Nicaragua in 2002, Costa Rica in 2003, and others in 1999.
Sources: World Bank, *World Bank Development Indicators* and *Doing Business Database* .

[4] See Escribano and Guasch (2005) for a cross-country comparison of the impact of investment climate on productivity.

22. Nicaragua appears to lag other countries in several measures of infrastructure such as the availability of paved roads, the cost and reliability of power, and the availability of communications. Electricity consumption, for example, remains low by regional standards, costs are high and the supply is unreliable (Figure 6). The reform of the utilities sector has been a focus of successive Fund-supported programs, but measurable outcomes have been mixed. Telecom privatization was successful in improving the availability of communications and increasing competition in the sector. While privatization of the power sector was successful, complementary legal and regulatory reforms to encourage new investment and diversification of the generation mix need to be followed up.

Figure 6. Central America: Cost of Electricity in Industry, 1990-2005
(US dollars per KWh)



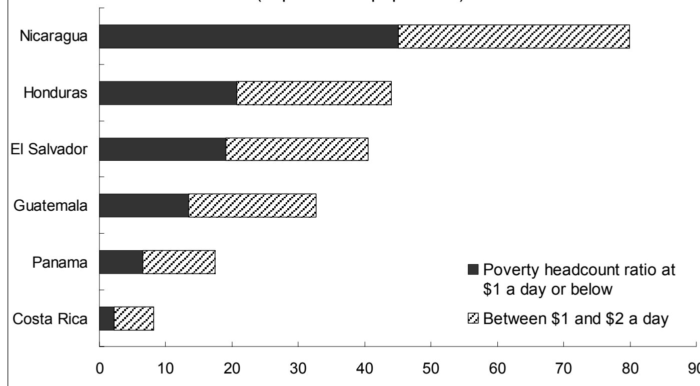
Source: Latin American Energy Agency (OLADE), 2006.

23. The financial sector's role in promoting development and providing mechanisms for risk management remains inadequate. The establishment of a strong credit culture and stronger enforcement of claims and the judicial process remain work in progress, as reflected in the very high collateralization ratios in Nicaragua. Capital market development would serve to broaden the sources of financing for enterprises, while channeling a greater proportion of household savings to productive activities.

Poverty in Nicaragua

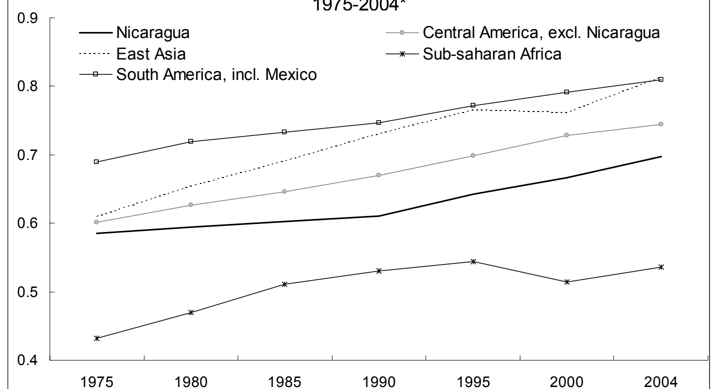
24. Nicaragua remains the second poorest country in Latin America, after Haiti. While the resumption of the growth in the 1990s has raised per capita incomes, they still remain below those of the 1970s. Based on the most recently available data, the population living in poverty fell from 50 percent to 46 percent between 1993 and 2001, while those in extreme poverty fell from 19 percent to 15 percent (Figure 7).[5] Preliminary results from the 2005 poverty survey suggest that while overall poverty edged up slightly over the past four years, extreme poverty has fallen and the distribution of income has improved. Underscoring the link between growth and poverty, broader indicators of human development indicate an acceleration in the pace of improvement since the early 1990s (Figure 8). Rapid and sustained growth has, however, allowed other countries—most notably in East Asia—to achieve even greater progress.

Figure 7.Central America: Poverty Headcount Ratio at $1 and $2 per day in PPP (in percent of population)



Source: World Bank, *World Development Indicators* .

Figure 8. Less Developed Countries: Indicators of Human Development, 1975-2004*



*Weighted by PPP. East Asia includes: Indonesia, Malaysia, The Phillipines, Thailand, Hong Kong SAR, and Singapore.
Sources: IMF World Economic Outlook and United Nations, *Human Development Report* (2006).

25. Available data through 2001 suggest that poverty remains much more prevalent in rural areas, and that progress in poverty reduction exhibits regional differences (Table 4). The reduction in poverty was mainly associated with increased production of basic grains and other essential foods and not with export products, which saw major drops in their prices during this period.

[5] The poverty data need to be interpreted with some caution as they appear to imply an unusually kurtotic distribution of income relative to, say, Honduras, which has a similar per capita income and gini coefficient.

Table 4. Nicaragua: Evolution of Poverty

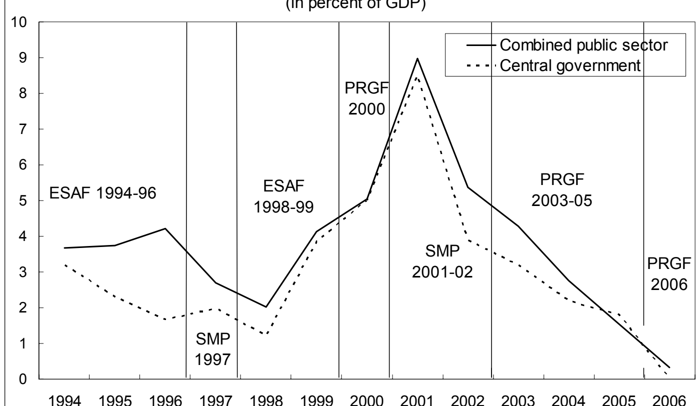
Item	Extreme Poverty				Poverty			
	1993	1998	2001	Change 1998-2001	1993	1998	2001	Change 1998-2001
	Percentage of Population							
National	19.4	17.3	15.1	-2.2	50.3	47.9	45.8	-2.1
Urban	7.3	7.6	6.2	-1.4	31.9	30.5	30.1	-0.4
Rural	36.3	28.9	27.4	-1.5	76.1	68.5	67.8	-0.7
Managua	5.1	3.1	2.5	-0.6	29.9	18.5	20.2	1.7
Pacific								
Urban	6.4	9.8	5.9	-3.9	28.1	39.6	37.2	-2.4
Rural	31.6	24.1	16.3	-7.8	70.7	67.1	56.8	-10.3
Central								
Urban	15.3	12.2	11.1	-1.1	49.2	39.4	37.6	-1.8
Rural	47.6	32.7	38.4	5.7	84.7	74.0	75.1	1.1
Atlantic								
Urban	7.9	17.0	13.1	-3.9	35.5	44.4	43.0	-1.4
Rural	30.3	41.4	26.9	-14.5	83.6	79.3	76.7	-2.6

Sources: National Institute of Statistics and Censuses (INEC) and Living Standards Measurement Survey 1993, 1998, and 2001.

26. In addition to growth, as noted in the Joint Staff Assessment (EBD/03/120), consideration needs to be given to other measures to support poverty reduction, such as a greater allocation of expenditures to poverty related spending and better targeting. Poverty related spending has risen from 11.4 percent in 2003 to 13.5 percent in 2006, within the context of the PRSP and PRSP-II medium-term framework. Nevertheless, Nicaragua's performance in achieving its PRSP social indicators continues to show mixed results. PRSP targets in education and water coverage between 2003 and 2004 were exceeded while performance in achieving health targets has been less solid. The quality of public expenditure related to poverty spending, and the link between spending and measurable outcomes remain important areas that need attention going forward.

B. The Process of Fiscal Adjustment

Figure 9. Nicaragua: Fiscal Deficit, 1994-2006
(in percent of GDP)



Source: Nicaraguan authorities and IMF staff estimates.

27. Fiscal adjustment has been at the core of adjustment efforts in all Fund-supported programs in Nicaragua, given the need for fiscal sustainability and higher national savings. Despite these efforts, the overall public sector deficit (including grants) has declined relatively modestly as a share of GDP from 3.7 percent in 1994 to 1.6 percent in 2005 (Figure 9). The recently

concluded PRGF arrangement had the most success in fiscal consolidation, with the public sector deficit declining from 9 percent in 2001 to 0.3 percent in 2006.[6]

28. The expansion of current expenditures stymied early efforts at fiscal consolidation. Hurricane Mitch triggered a further fiscal expansion, leading to a cumulative increase in the central government deficit (after grants) of 7 percent of GDP between 1998 and 2001, of which 4.3 percentage points were due to current expenditures (Table 5 and Figure 10).[7] The

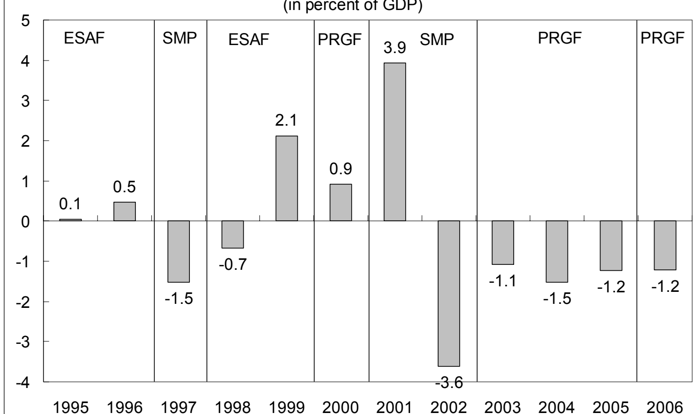
Table 5. Nicaragua: Decomposition of Changes in the Fiscal Deficit, 1995–2006
(changes in percent of GDP; combined public sector)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1999-2001
												Est.	Cumul.
Overall change (- decline)	0.1	0.5	-1.5	-0.7	2.1	0.9	3.9	-3.6	-1.1	-1.5	-1.2	-1.2	7.0
due to changes in:													
Total revenue	-0.8	0.7	2.3	0.8	-0.3	-1.0	-1.0	1.1	1.5	1.2	1.0	0.3	-2.2
Tax revenue of the general government	0.3	0.0	2.7	0.4	-0.1	0.3	-0.8	2.2	1.7	0.9	0.8	0.8	-0.6
Operating balance of the public utility enterprises	-1.0	0.1	-0.1	0.4	-0.1	-1.0	-0.1	-0.1	-0.2	0.3	0.2	-0.5	-1.2
Nontax revenue and current transfers	-0.3	0.6	-0.3	0.1	-0.2	-0.1	-0.1	-1.1	0.0	0.0	0.0	0.0	-0.4
Capital revenue	0.1	-0.1	0.0	-0.1	0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1
Total expenditure	-1.8	3.2	-1.2	-2.5	5.6	-0.7	2.3	-2.4	0.9	0.2	-0.7	0.2	7.1
Current expenditure	-1.7	2.0	0.7	-1.5	0.5	0.1	3.7	-0.2	-0.7	-1.3	0.0	1.9	4.4
Capital expenditure and net lending	-0.2	1.3	-1.9	-1.0	5.1	-0.9	-1.4	-2.2	1.6	1.5	-0.7	-1.7	2.7
Memorandum items:													
Overall balance (as percent of GDP)	-3.7	-4.2	-2.7	-2.0	-4.1	-5.1	-9.0	-5.4	-4.3	-2.8	-1.5	-0.3	-28.7
before grants	-6.6	-9.2	-5.6	-2.4	-8.3	-8.5	-11.8	-8.3	-7.7	-6.7	-5.0	-4.9	-18.2
primary balance (before grants)	2.0	-1.9	2.1	1.9	-0.6	0.2	-4.6	2.5	2.4	2.2	0.8	-1.1	-5.0

Source: Nicaraguan authorities, IMF staff reports and staff estimates.

recently concluded arrangement has been more successful in curtailing fiscal deficits and current expenditures, but the exceptionally tight fiscal stance in 2006 was attributable to a significant under-execution of the budget.

Figure 10. Nicaragua: Changes in the Fiscal Deficit (decline -), 1995-2006
(in percent of GDP)



Source: IMF staff estimates.

29. Nicaragua's inability to contain expenditures since 1994 (total expenditure of the consolidated

[6] This includes the effect of the under-execution of foreign-financed projects amounting to some 1.5 percent of GDP in 2006.

[7] Following Hurricane Mitch, capital expenditures rose by over 5 percentage points of GDP in 1999.

public sector has fluctuated between 24 and 31 percent of GDP) has been the result of several factors:

- The growing fiscal burden of mandated transfers has been difficult to curtail. The universities and the Supreme Court receive transfers equal to a fixed percentage of expenditures without taking into account the budget priorities or the financing constraints of the government.[8] In 2006, total current and capital transfers (excluding transfers to municipalities) accounted for more than one third of total expenditure and they continue to significantly reduce fiscal space for priority spending. Expenditure rigidities are, of course, not unique to Nicaragua, and pose problems in several Latin American countries.

- Fiscal decentralization after passage of the Municipal Transfers Law of 2003 has effectively implied a five-fold increase in the devolution of revenues to municipalities without a corresponding transfer of expenditure responsibilities. The central government transferred some 1 percent of fiscal revenues annually to municipalities in the context of a bargaining process prior to the 2003 law, but this is now expected to rise to at least 10 percent by 2010. Under the recently concluded PRGF arrangement, the fiscal impact of decentralization has been limited by across-the-board expenditure cuts of one-third of total transfers in 2005 (resulting in a decline of capital expenditures by 0.7 percent of GDP) and by cuts in investment projects targeted at municipalities amounting to one-half of total transfers in 2006.

- The uneven financial performance of public sector enterprises has also prevented fiscal adjustment. Most notably, energy sector losses contributed to widening the deficit before tariff adjustments and collection rates were improved in the late 1990s. However, as oil prices began to rise in 2004, electricity sector losses began to re-emerge.

- Public sector wages continue to create uncertainty surrounding expenditure plans, as wage policies are subject to large adjustments driven by political and social pressures (Box 2).

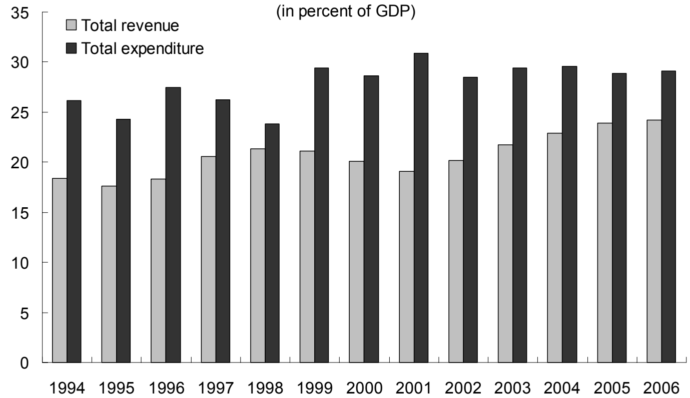
- The weakness of fiscal institutions has also undermined efforts geared toward fiscal consolidation. The Ministry of Finance takes the lead role in preparing the government's budget, but congress has broad discretion to change fiscal parameters, including the overall deficit, the ceilings for and composition of expenditures, and

[8] For example, constitutionally mandated transfers were excluded from proposed ceilings on current expenditure during the 1998 program negotiations, because transfers could not be transparently monitored or enforced.

revenue targets.[9] In addition, the lack of coverage of public entities in the budget framework obscures the true fiscal stance of the government and raises the costs of fiscal adjustment for the central government.

30. Tax reform in Nicaragua in recent years has bolstered fiscal performance. The tax reform measures of 1996 sought to broaden the tax base by reducing exemptions on VAT and customs duties. However, implementation delays impeded any gains in tax collections (tax revenue stayed constant as a percent of GDP in 1995 and 1996, at 15.2 percent). The second round of tax reforms, initiated in 2002, had a more significant and lasting impact on tax collections (Figure 11). Approved measures included a substantial reduction in the number of imports exonerated from tariffs , limits on VAT exemptions and preferential rates, removal of ad-hoc tax exemptions for the financial system, and a broadening of the excise tax base. In February 2003, additional tax measures were approved to compensate for higher-than-envisaged expenditures, including increases in the tax rates on automobiles and cigarettes and a new tax on commercial banks. Reforms in 2003 included measures to eliminate the VAT zero-rating on most goods, creation of a minimum corporate income tax, and changes to the excise tax code. Tax administration improvements included the reorganization of the tax department along functional lines. Largely as a result of the tax policy and administration reforms initiated in 2002, combined public sector revenues rose nearly 3 ½ percent of GDP in three years.

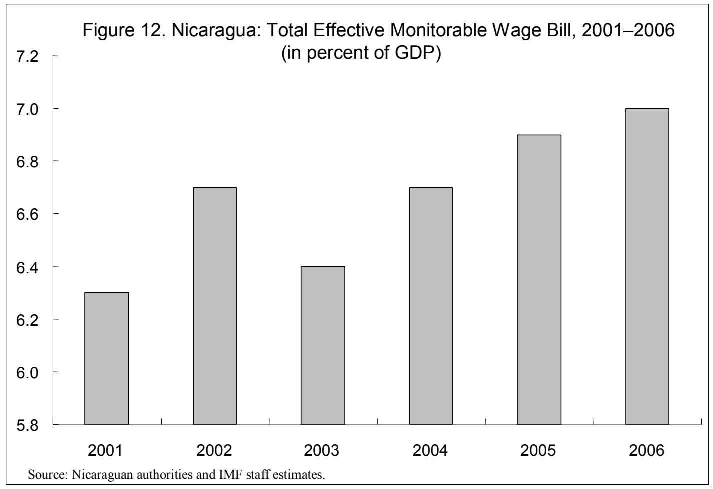
Figure 11. Nicaragua: Combined Public Sector Revenue and Expenditure, 1994-2006
(in percent of GDP)



Source: Nicaraguan authorities and IMF staff estimates.

[9] The implementation of a Fiscal Responsibility Law under the 2002 PRGF arrangement was aimed at overcoming the shortcomings of the existing organic budget law by setting floors and ceilings that are less vulnerable to social and political pressures. After failure to implement the FRL, a Financial Administration Law was passed as an intermediate step.

Box 2: Public Sector Wage Growth



Large and ad hoc increases in public sector wages have repeatedly undermined efforts at fiscal consolidation envisaged in Nicaragua's adjustment programs. Nicaragua's public sector wage bill is estimated at around 7 percent of GDP, and median public sector wages in the country are higher than in the private sector, and this disparity appears to be widening (Figure 12).[10] The wage setting mechanism is subject to political pressures, resulting in decreased budget flexibility and reduced fiscal space for poverty reduction.

Fund conditionality initially focused on controlling the wage bill through reductions in public sector employment. Wage restraint was, however, achieved through administrative measures, rendering wage policies vulnerable to political pressures. After a period of wage freezes, large wage increases were granted to teachers, healthcare workers, and the police in 1998 and 1999. Wage bill ceilings were introduced in program conditionality at the time of the second review of the 1998 ESAF. While these targets envisaged further increases in wages to primary school teachers, social pressures for additional ad hoc wage increases persisted, and wage increases for teachers, nurses and police were granted once again in 2001. Through a combination of increases in real wages, benefits and transfers, by 2003 average real wages in the public sector surpassed those in the private sector.

The civil service reform of 2003 sought to reduce inequities among civil servants and enable the government to recruit and retain qualified staff, but had unintended consequences. Salaries among civil servants increased further, and labor mobility was reduced, but the latent issue of persistent ad hoc policymaking on the wage bill remained unresolved. In 2005, the national assembly raised public sector wages, on average, by 20 percent. In 2006, large additional wage increases were granted to healthcare workers and teachers who were on strike, and are expected to result in public wage bill growth of 4.6 percent in real terms, compared to 0.8 percent targeted under the program.

31. Medium- and long-term fiscal sustainability will depend to a large extent on the Nicaragua's ability to diffuse fiscal pressures and create consensus around adhering to a sound medium-term expenditure framework, leading to lower levels of domestic debt. Factors such as recent wage increases, decentralization, mandatory transfers, and pensions risk undermining the gains of several concurrent years (2002–06) of low deficits and

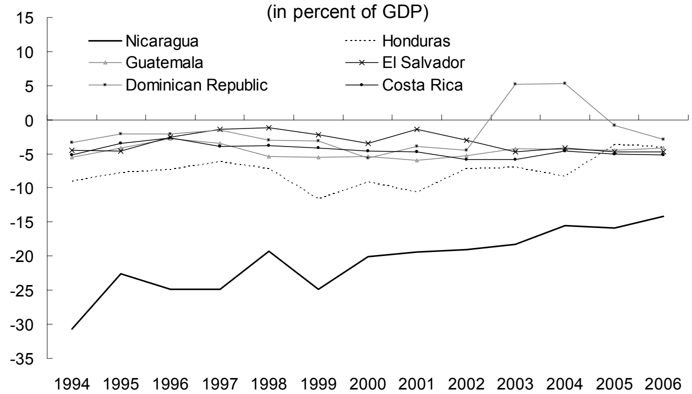
[10] Estimating the precise wage bill is difficult due to the dispersion of wage expenditures among different budget categories, and there is a need to improve transparency to arrive at more reliable estimates.

significant debt relief.[11] Despite substantially reduced debt following the HIPC and MDRI initiatives, debt levels in Nicaragua remain elevated (70 percent of GDP) and subject to moderate risk of debt distress (EBS/05/201).

C. Persistent Current Account Deficits

32. Moving toward external viability has been a longstanding objective of Fund-supported programs in Nicaragua. The current account deficit, at around 15 percent of GDP, remains substantially higher than in other countries in the region (Figure 13). The current account deficit and the related dependency on foreign aid and remittances make Nicaragua vulnerable to shifts in the financing environment and to unanticipated shocks.[12] [13]

Figure 13. Central America: Current Account Balance, 1994-2006
(in percent of GDP)

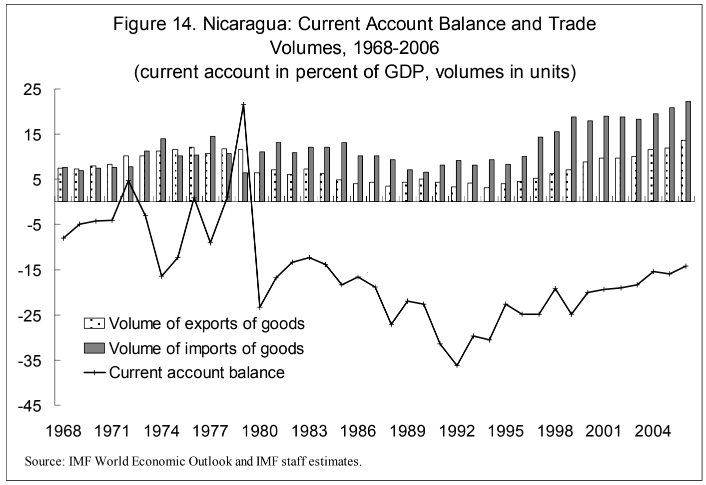


Source: IMF World Economic Outlook and IMF staff estimates.

[11] The possible approval in 2007 of Law 539 (*Ley de Seguridad Social),* which was put on hold, poses a risk in the near term. Parts of this law implied a reverse parametric reform of pensions that would have led to immediate fiscal costs from increased benefits and no measures to ensure the medium-to-long term sustainability of the pension system.

[12] This was evident, for example, during previous electoral cycles (though not in 2006) and when donor flows were delayed in 1997-98 on account of concerns about governance.

[13] The size of Nicaragua's current account deficit may be exaggerated by the under-recording of remittance inflows and recording of all budgetary support as capital transfers even though some of this is used for consumption. Remittances are estimated at about 13 percent of GDP in 2005, but do not include inflows through informal channels. One study estimates remittances in 2004 to be 56 percent higher than the official figures (ECLAC, 2006). Regardless, a significant trade imbalance exists.

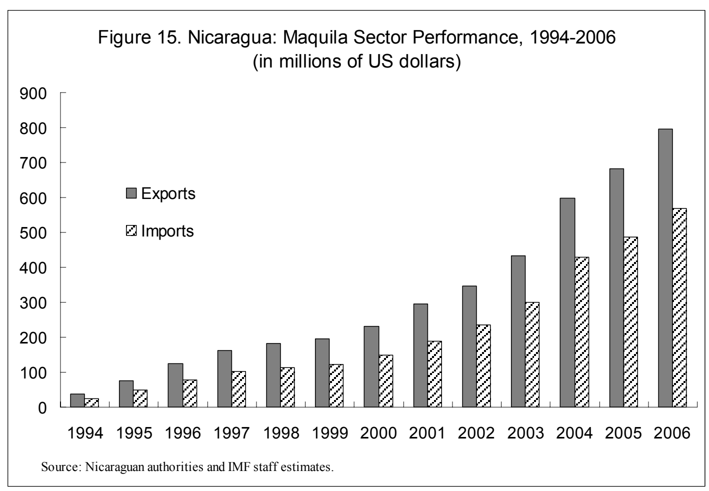


33. The focus of Fund-supported programs has been on improving the savings of the public sector, but with the public sector deficit at 0.3 percent in 2006, more attention is needed to improve private savings. Private savings in Nicaragua, while steadily increasing, still appear low at under 10 percent of GDP.[14] More precise data are available for trade balances, the main counterpart to savings-investment imbalances, which show a persistent gap between imports and exports (Figure 14). This trade deficit has coincided with a steady depreciation of the real effective exchange rate, suggesting the level of exchange rates is not the main underlying cause, and structural impediments to boosting exports and containing imports may play an important role.

34. A persistent trade gap has emerged as a result of several factors[15]:

- The softer global demand for agricultural exports beginning in the late 1970s, and the subsequent nationalization of large agricultural properties and the pursuit of a strategy for self sufficiency in food: since the 1990s, the recovery of agricultural exports has not been sufficient to offset import growth, although rising remittances and reduced debt service outflows have limited the impact on the current account.

- The limited contribution of the manufacturing re-export (*maquila*) sector: this sector now amounts to some 40 percent of total exports, but its value-addition and contribution to net exports is limited by its high import content and its limited integration with the domestic economy, generating few positive spillovers (Figure 15).



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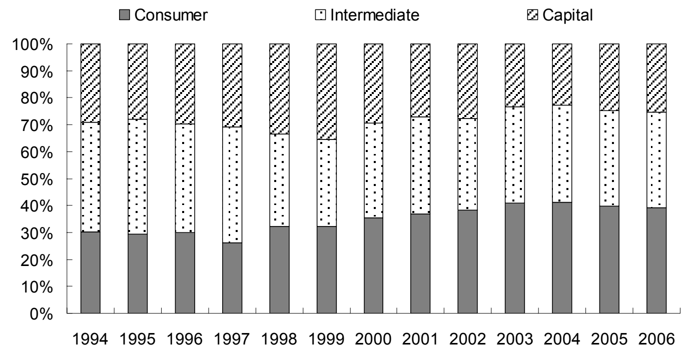
[14] The under-recording of remittances may lead to an underestimation of private savings.

[15] Although tariffs were reduced from 10 percent in 1997 to 4 percent in 1999, their impact on the trade deficit is small given their already low levels.

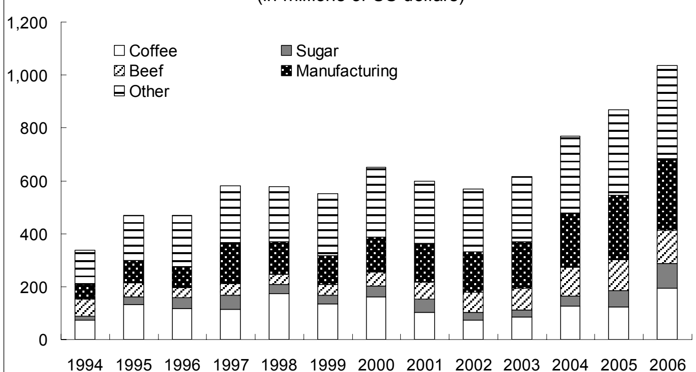
- The pressure on import growth from aid inflows, remittances and the electricity sector: aid inflows have boosted the import of capital and intermediate goods, while remittances have been channeled in part to consumption imports (Figure 16). Heavily oil-dependent electricity generation has also added to pressure on trade imbalances, with oil imports alone accounting for 13 percent of GDP in 2005.

Figure 16. Nicaragua: Imports by Components, 1994-2006
(in percent of total non-oil non-maquila imports)



Source: Nicaraguan authorities and IMF staff estimates.

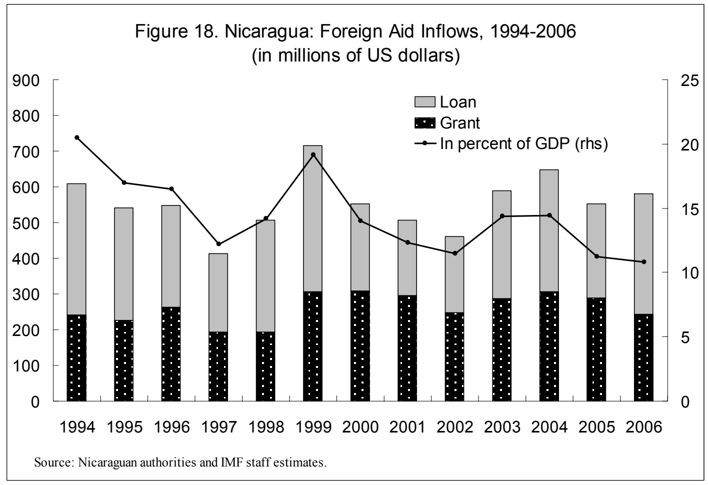
Figure 17. Nicaragua: Non-maquila Exports, 1994-2006
(in millions of US dollars)



Source: Nicaraguan authorities and IMF staff estimates.

35. Looking forward, reducing trade imbalances will have to depend on strengthening both traditional and nontraditional exports (Figure 17). Higher growth of traditional exports will depend on enhanced productivity and improved infrastructure, including better roads and ports to get products to market, and better processing facilities for exports, such as refrigeration units. The manufacturing sector will also have to play a more dynamic role, going beyond the maquila sector. This will require improvement in the general business environment and removing the impediments to higher growth—as identified in the preceding section—so that nontraditional exports can take advantage of the opportunities from CAFTA-DR. Reforms in the energy sector, in addition to improving infrastructure, will also have a more direct impact by reducing dependence on oil imports for electricity generation in the medium term.

D. The Dependency on Foreign Aid



36. Foreign aid to Nicaragua, while declining as a share of GDP, remains above 10 percent of GDP (Figure 18). Nicaragua's dependence on foreign aid is a result of both demand and supply factors. The main supply-side factor has been its geopolitical position, which has attracted large sums of foreign aid from either Western donors (through the 1970s and since the 1990s) or Soviet bloc countries (during the 1980s).[16] On the demand side, Nicaragua's substantial development needs and the damage from natural disasters have required reliance on foreign aid. The heavy external debt burden also contributed to the need for new official assistance, with one-third of gross official inflows during 1994-2005 used for servicing debt. Successive debt relief operations have supported a reduction in the external debt burden in recent years (Box 3).

37. Reducing Nicaragua's dependence on foreign aid depends on progress on several fronts. In addition to policies to increase growth, boost exports and improve the resilience of the economy, efforts need to be stepped up to ensure that aid inflows are used effectively. Indeed, there is no economy-wide mechanism to monitor the effectiveness of aid, but some sectoral studies suggest severe deficiencies in the coherence of donor funded projects and programs, including poor targeting and the lack of an outcome-oriented approach.[17]

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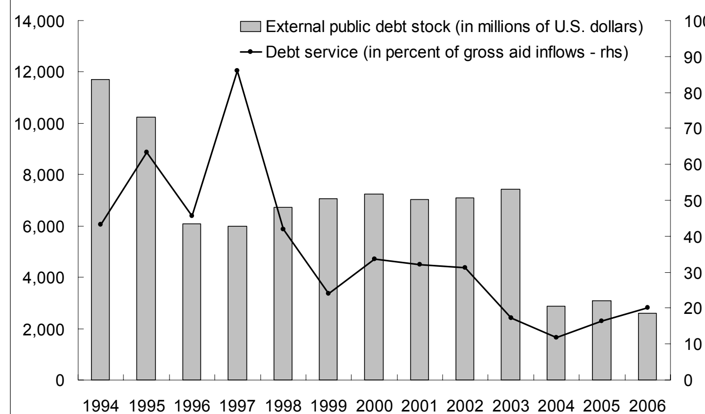
[16] See Alesina and Dollar (2000), World Bank (2002), Nunnenkamp et al (2004) and Weder (2002) for the link between geopolitical factors and aid flows.

[17] Case study for Nicaragua in IMF (2004).

Box 3. Nicaragua: Debt Relief, 1990–2006

Facing an extremely high external debt burden, Nicaragua has engaged in numerous debt relief and rescheduling exercises with official creditors. Nicaragua had three rescheduling agreements with the Paris Club in the 1990s. The first (December 1991) provided for flow rescheduling on London terms (50 percent NPV reduction). The second (March 1995) and third (April 1998) provided for flow rescheduling on Naples terms (67 percent NPV reduction). Nicaragua also reached rescheduling agreements in 1995-96 with a number of non-Paris Club official bilateral creditors, including agreements with Mexico and the Czech Republic providing about 92 percent debt reductions in NPV terms. A commercial debt buyback was concluded in December 1995 at a similar discount, financed through the IDA debt reduction facility, a concessional loan from the IADB, and assistance from bilateral donors.

Figure 19. Nicaragua: External Debt Stock and Debt Services, 1994-2006



Source: Nicaraguan authorities and IMF staff estimates.

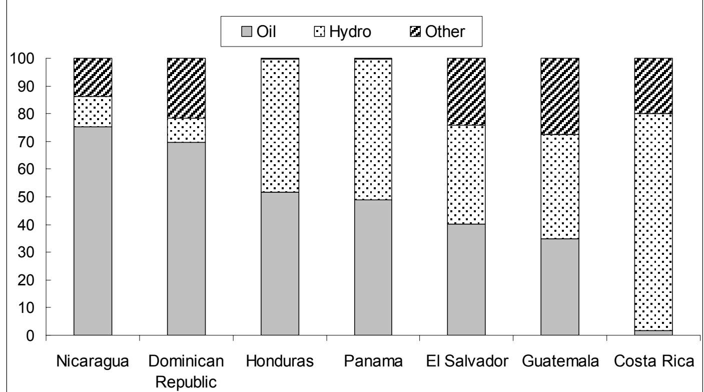
Despite these agreements, Nicaragua's NPV of debt to exports ratio was over 600 percent at end-1998, four times of the threshold under the HIPC Initiative. Most of the expected debt relief from the HIPC Initiative was delivered after completion point in January 2004. Nicaragua also signed debt relief agreement with almost all its Paris Club creditors and a number of non-Paris Club creditors (Figure 19). Nevertheless, despite significant efforts by the authorities to reach agreements, negotiations have been difficult with a few major non-Paris Club and commercial creditors. As of late 2005, around US$0.9 billion in NPV terms (18 percent of GDP) of HIPC debt relief was still uncommitted. The Multilateral Debt Relief Initiative (MDRI) provided further debt relief equivalent of 8 percent of GDP. External debt at end-2006 amounted to 47.5 percent of GDP and 131 percent of exports at end-2006, and indicators of external debt sustainability suggest a sustainable debt burden going forward provided supportive fiscal policies remain in place.[18]

[18] See Joint DSA by IMF and World Bank staff (EBS/05/201).

E. The Role of the Energy Sector

38. Despite years of reforms, the Nicaraguan energy sector remains an impediment to growth and an important source of vulnerability to the economy. The overall electrification rate of 47 percent is lower than in neighboring countries and about 89 percent of the rural population still lacks access to electricity.[19] For those with access, supply is unreliable with rolling blackouts of eight hours a day not uncommon since mid-2005. The sector also remains a recurring source of quasi-fiscal losses. With more than 75 percent of generation dependent on imported oil, the sector contributes to the vulnerability of inflation and the current account to fluctuations in international oil prices (Figure 20).

Figure 20. Central America: Sources of Electricity Generation, 2003



Source: Latin American Energy Agency (OLADE), 2006.

39. The sector's heavy reliance on oil for generation traces its roots to the early 1990s when oil prices were substantially lower. Given the large upfront investment required for hydroelectric generation and the legal restrictions to medium and large scale hydroelectric generation by private investors, oil-based electricity generation was dominant. Conditionality in the early 1990s was focused primarily on reducing the quasi-fiscal losses from the sector through ad-hoc tariff increases by the publicly-owned distributor and reform of the regulations governing private investment, while privatization of the generation and transmission units was contained in HIPC conditionality. Privatization of the sector was a success, but regulatory reform of the sector to encourage greater private investment needs to be followed up, and greater harnessing of the country's substantial capacity in the hydroelectric sector could significantly reduce the dependence on oil for power generation.

40. The sharp rise in global oil prices in recent years has exposed the weaknesses of the politicized tariff setting process, and quasi-fiscal losses have reemerged. Paradoxically, limiting tariff increases in the face of rising costs is difficult to justify on the ground of protecting the poor, as most of the poor do not have access to electricity, particularly in rural areas.[20] While the program required implementation of tariff increases, modifications to the energy sector law that would have implemented an automatic pricing mechanism failed in late 2006. Progress in reforming the energy sector will have to continue to rely on effective

[19] World Bank (2005).

[20] The automatic pricing mechanism for fuel could serve as a useful example of success.

cooperation with the World Bank and the IADB, and strong ownership rooted in domestic consensus.

F. Monetary and Financial Sector Policies

41. The current monetary policy relying on a crawling peg is reflective of the history of hyperinflation in the late 1980s and early 1990s. The use of the exchange rate as the nominal anchor has served to generally contain inflation around the pre-determined rate of crawl of the cordoba. However, loose credit policies in the 1990s, often in conflict with program targets, led to periodic losses in reserves, higher inflation, and increased vulnerability to balance of payments crises. In recent years, the framework has also restricted the ability of the economy to respond to inflationary pressures from rising oil prices. In general, the rate of crawl was aimed at achieving the multiple objectives of inflation stabilization, external competitiveness, and additional fiscal flexibility when donor inflows were delayed. Against this background, inflation objectives during successive Fund-supported programs, aimed at reducing inflation to 4-5 percent have not been met.

42. While supporting the crawling peg, the Fund has repeatedly drawn attention to the limitations of the monetary framework in achieving its inflation objectives and responding appropriately to external shocks. Important preconditions to moving to a more flexible exchange rate regime are the independence of the central bank, a deeper domestic debt market and improved inflation-forecasting capabilities.

43. The financial sector in Nicaragua is heavily dominated by banks. The initial focus of Fund-supported programs was on limiting government support to state-owned banks and banks' credit expansion. After Hurricane Mitch, a Financial Analysis Unit was created to monitor deterioration in banks' portfolios. Looking back, the measures taken to strengthen the banking system were insufficient in preventing a banking crisis in 2000. This crisis wiped out five out of eleven banks and severely affected the level of credit in the economy. The banking resolution process led to the issuance of a large stock of central bank instruments to banks to compensate them for acquiring deposits of the failed banks.

44. In the aftermath of the banking crisis, conditionality in the 2002 PRGF arrangement emphasized the importance of valuing residual assets of the failed banks and a transparent auction process. Even though this was a long and difficult process because of strong opposition from vested interest groups, the main objectives of the asset recovery program were met, sending a positive signal that the public sector would not keep absorbing losses in the sector. Strengthening the regulatory and supervisory system also became a significant component of conditionality and an FSAP was conducted to establish the priorities for future financial sector reform. A financial sector roadmap has been devised by the authorities to strengthen and modernize the legal framework and to promote greater financial and administrative autonomy of Nicaragua's monetary authority. Its implementation will be

important to developing a financial sector that can make a greater contribution to fostering growth and improving the economy's resilience.

IV. Assessment of The Role of the Fund

45. The economy in the early 1990s was characterized by severe macroeconomic imbalances, a high incidence of poverty, the lack of institutions to support a market-oriented economy, and deep divisions in the society and polity at the end of the civil war. The task of restoring macroeconomic viability and reducing the economy's vulnerability to shocks required fundamental and deep-rooted reforms covering broad sectors of the economy. Addressing these challenges would have gone beyond the parameters of a single program under the best of circumstances, and a long term program engagement was a natural outcome. In this context, the continued program relationship helped maintain broad economic stability, lent credibility to the policy framework, and ensured the steady flow of donor support.

46. The longer-term program engagement was marked by notable successes. The Fund's engagement helped lend credibility to economic policies, guided the direction of major reforms, and facilitated the steady flow of donor support. The Fund also played a crucial role in preventing worse policy outcomes than may have occurred in the absence of a close engagement, such as through even higher wage increases or a more rapid pace of fiscal decentralization without an associated increase in expenditure responsibilities. The role of the Fund was also crucial in reaching the HIPC completion point and facilitating several rounds of debt reduction. Importantly, given the vulnerabilities facing the economy and the periodic shocks it has been exposed to, program engagement helped avoid a return to the macroeconomic and financial instability experienced throughout the 1980s. The banking system, for example, weathered recent presidential elections with no difficulty, unlike in the past.

47. Despite the positive role played by the Fund, success in achieving the narrowly defined objectives of programs was mixed. The broad objectives of successive programs were: (a) growth of around 5 percent in the medium term, (b) inflation at around 4-5 percent and (c) reserve coverage of at least 3-3½ months of imports. Growth during 1994-99 averaged 5 percent (including 7 percent in 1999 due to post-Mitch reconstruction), but has since averaged 3.3 percent, although it should be kept in mind that the latter period also straddled a banking crisis. The inflation objectives of the programs were not met, with inflation averaging nearly 9 percent over 1994-2006. The gross reserve coverage reached the equivalent of three months of imports only at the end of 2006. Progress on poverty reduction also remains mixed, with preliminary data indicating that the number of people living in poverty has not declined over the past five years, but progress has been made in reducing inequality and reducing the proportion of the population living in extreme poverty.

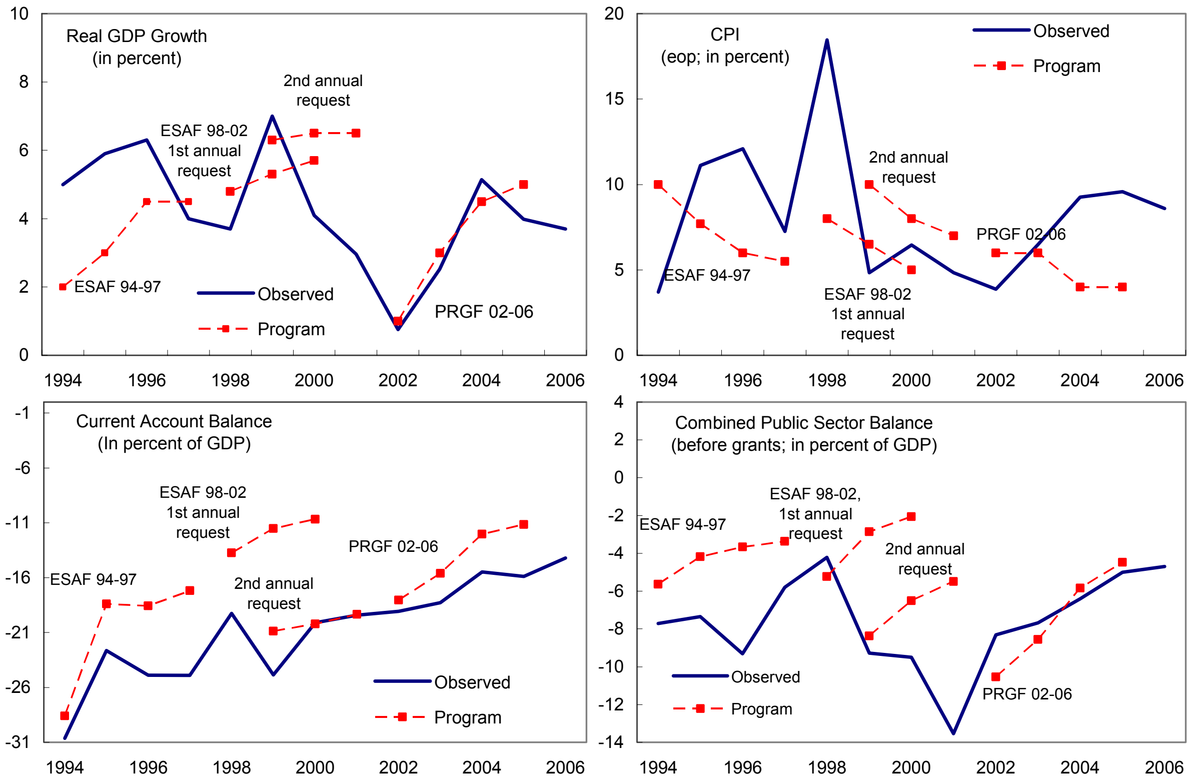
48. Overall, there is sufficient evidence to conclude that while progress under successive Fund-supported programs was not as rapid or as widespread as under ideal circumstances, the alternative of a sustained disengagement by the Fund in the past would have led to substantially worse economic outcomes. The impact such an adverse outcome would have had on poverty and growth should not be underestimated. Moreover, this would have set back and possibly reversed important progress made in reforms.

A. The Realism of Program Projections

49. In retrospect, growth projections were not overly optimistic in each of the programs (Figure 21). While the 1994 program underestimated the size of the economic rebound, it was impossible in 1998 to foresee Hurricane Mitch as well as the collapse of growth once the program went off track in 2000-01.[21] The projections for inflation and the current account deficit turned out to be, in hindsight, substantially more optimistic, with disappointing performance reflecting both implementation weaknesses (such as from excessive credit expansion) as well as unanticipated shocks (such as from Hurricane Mitch and oil prices). Public sector balances proved highly optimistic in earlier programs, but a very high degree of realism was in evidence by the time of the 2002 PRGF arrangement.

[21] Substantial revisions of national accounts data complicate the assessment of projections vs. outturns of growth. The collapse of growth in 2000–01 was associated with significant policy slippages that led the program off track.

Figure 21. Nicaragua: Macroeconomic Outcomes and Program Targets/Assumptions, 1994-2006



Source: Nicaraguan authorities and IMF staff estimates.

B. The Appropriateness of Macroeconomic Policy Recommendations

50. Even with hindsight, it is difficult to devise an alternative set of broad macroeconomic policies that would have led to greater success in achieving program objectives. However, implementation of these policies, particularly in the 1990s, was often disappointing and required ex-post corrective actions. As a result, by the time of the 2002 PRGF arrangement, the Fund became increasingly candid in highlighting risks to the program.[22] Overall, the Fund was flexible in adapting the macroeconomic framework to evolving conditions through the modification of targets, devising offsetting measures or granting waivers.[23] The following two areas are illustrative:

51. **Fiscal deficits**: The expenditure overruns soon after the initiation of the 1994 program were met with corrective actions which proved insufficient. Further expenditure slippages in 1995 led the program off-track and resulted in an "interim monitoring program"

[22] This was also reflective of generally increased candor in Fund documents relating to program risks.

[23] Despite this, substantial deviations caused each of the programs to go off-track, with only the most recently concluded program successfully brought back on track again.

which failed to bring the program back on track. Fiscal performance improved in the run-up to and the initial stages of the 1998 ESAF arrangement. Fiscal slippages that emerged in the latter half of 1999 were first met through a modification of program criteria and then by a renegotiation of key program targets and the reaching of understandings on key prior actions. Nevertheless, six waivers were needed for the completion of the first and second reviews under the PRGF arrangement including for the non-observance of fiscal targets on public sector savings and domestic financing. During recent years, fiscal tightening led by expenditure underexecution and debt relief have put fiscal policy on a more sustainable path. However, as in past programs, the macro framework was repeatedly modified after repeated but modest fiscal slippages. Offsetting measures were again required in the 2002 Fund-supported program after passage of a budget incompatible with program objectives, leading to a delay in completing the first review. Waivers were subsequently requested for fiscal PCs under the third review. When the fiscal PCs were again missed, the program was modified to included prior actions for the completion of the fourth and fifth reviews, including expenditure cuts and a reduction in transfers. Missed PCs on fiscal performance led to delays in completion of the 7th and 8th reviews, and targets were ultimately revised for the completion of the 9th review.

52. **Monetary policy**: Monetary policy has been set in the context of a crawling peg since 1993. While the primary objective of monetary policy has been to maintain low and stable inflation, the rate of crawl has also been guided by the objective of preventing a rapid appreciation of the real exchange rate. Furthermore, the central bank has also provided financing to the public sector—particularly when external disbursements were delayed—and extended credit to state owned banks, leading to reserve outflows and higher than expected inflation. While the Fund has pointed to the shortcomings and vulnerabilities arising from the crawling peg regime, it has been accommodating of the limitations imposed by the use of the crawling peg to pursue multiple objectives, and the need to maintain competitiveness while also keeping inflation low and stable.

C. The Appropriateness of Structural Polices

53. Structural conditionality under the programs were aimed at ensuring achievement of the main short-term macroeconomic objectives of the program, with relatively few conditions aimed at addressing key medium term challenges. The following serve as illustrative examples of how conditionality evolved:

- The submission to the assembly of a property rights law was introduced as a prior action in 1998, with its approval a PC. However, conditionality responded to the slow progress in actual property settlement by introducing benchmarks for establishing a center for property mediation and the number of title issuances and resolution of claims.

- After repeated difficulties in passing a budget in line with the agreed program, the submission of a Fiscal Responsibility Law (FRL) was introduced as a PC at the time of the 4th review under the 2002 PRGF arrangement. Failure to pass the FRL resulted in further discussions with the authorities where it was determined that the preconditions for passage of a meaningful FRL were not in place. As a result, a more narrow Financial Administration Law was passed through a prior action for the combined 7th, 8th and 9th reviews.

- Following the banking crisis of 2000–01, detailed conditionality was required over several reviews to complete the asset recovery process, including for the selection of an asset management firm, the signature with this firm, conducting the final auction, the end of the asset auction process, and the conclusion of the asset recovery plan.

- Submission to the assembly of a draft law granting legal protection to bank supervisors was a benchmark for end-2003, but with parts of the draft law deemed unconstitutional, the Fund responded by requiring approval of a resolution to cover legal expenses which bank supervisors may have to incur to defend themselves in legal actions initiated in connection with the performance of their duties.

The above examples are illustrative of a few general conclusions:

- Implementation of conditionality was often accompanied by significant delays. On many occasions, the Fund included conditionality before recognizing that legal or constitutional hurdles prevented implementation (e.g. the FRL and the law granting legal protection to banking supervisors) or that important technical or institutional preconditions had not been met adequately. Limited program ownership by the various stakeholders in Nicaragua also played a role in delaying implementation of other reforms.

- Delays in compliance required modifying some benchmarks into PCs or PAs to ensure implementation. However, PAs and PCs were used relatively sparingly in relation to structural benchmarks, suggesting that either ownership was systematically overestimated in the design of conditionality or that Fund staff were hesitant to impose conditions that could jeopardize program disbursements and additional donor flows if they were not met (Box 4).

- The evidence suggests that structural benchmarks under successive Fund-supported programs were often viewed as desirable but not necessarily critical, leading to a proliferation in the number of benchmarks and a mixed implementation record.

- Conditionality often evolved from broad goals to detailed specific intermediate steps. This reflected the recognition that maintaining forward momentum often required incremental progress.

- The Fund showed flexibility in adjusting its conditionality to domestic constraints when the "first best" could not be achieved. To the extent medium-term issues were included, they were often dropped when implementation became unlikely.

54. It is no surprise that successive rounds of debt relief were associated with periods of close engagement between Nicaragua and the Fund. Greater leverage associated with the prospect of debt relief allowed the Fund to shift key structural reforms to HIPC conditionality, while this also served as a galvanizing factor in Nicaragua's difficult political environment, as reflected in the strong popularity of the recently concluded Fund-supported program. While it may be argued that more reforms could have been pursued as pre-conditions for debt relief, the approach taken by the Fund appears, on the whole, appropriate and balanced as excessive conditionality may have had disincentive effects and weakened the reform effort. On the other hand, the performance after debt relief was less encouraging, raising broader questions about how reform efforts associated with external "push" factors could be institutionalized.

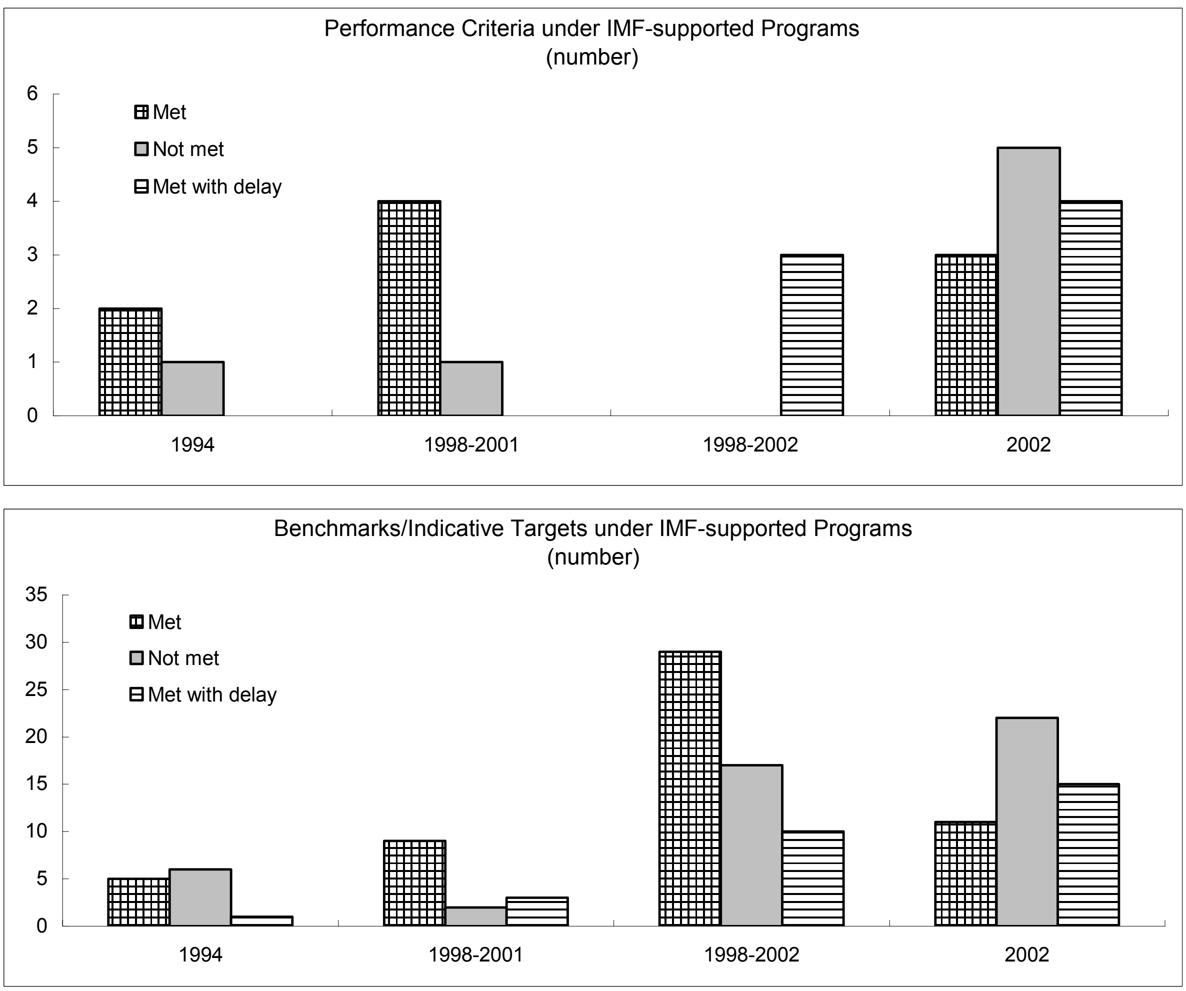
55. Conditionality within the program comprised only a small subset of reforms that were needed to establish the foundations for strong and sustainable growth and reduce economic vulnerabilities. Program design did not explicitly recognize the three fundamental characteristics of the economy, namely the susceptibility to shocks, the unequal distribution of income, and the divisions in polity and society. The evolution of programs, and in particular the recently concluded PRGF arrangement, did implicitly recognize the key role these factors play.[24] Indeed, the Fund was well aware of the comprehensive nature of reforms across the economy that were needed to achieve the main economic objectives of Nicaragua. Should conditionality have covered more areas of reform as outlined in staff reports? The focus of conditionality, particularly in the recently concluded PRGF arrangement, related to areas close to the mandate of the Fund, while the World Bank and the IADB took the lead in the other main reform areas. This narrowing of conditionality and the division of labor was appropriate, given the need to maintain the reform momentum without spreading resources and attention too thin.

[24] This is evident, for example, in the focus on strengthening the financial system to withstand shocks and the increased focus on poverty.

Box 4: Ownership of Reforms in Nicaragua

Conditionality under successive Fund-supported programs in Nicaragua has relied on a greater number of structural benchmarks and indicative targets in the second annual arrangement of the 1998 ESAF arrangement (subsequently converted into a PRGF arrangement) and the 2002 PRGF arrangement than in previous arrangements (Figure 22). In part, this reflects the reluctance to use prior actions and performance criteria that risked not being met subsequently. Implementation was complicated by several factors reflecting the political situation in Nicaragua: the Chamorro administration was widely perceived as weak and unable to implement many important reforms; the Alemán administration was plagued with accusations of poor governance and the unwillingness to address major economic reforms; and, the Bolaños administration, which had a much stronger ownership of reforms, but faced stiff resistance in congress. Nevertheless, in recent years, important progress made on key economic reforms, which is not captured by a simple measure of the number of conditions implemented.

Figure 22. Nicaragua: Ownership of the Reform Process



Source: IMF staff estimates.

56. It could, however, be argued that greater attention should have been paid to reforms of a medium-term nature, both in terms of the design of conditionality and the focus of discussions. Some of the short term focus was an appropriate response to emerging concerns and the need for corrective measures to mitigate short-term risks, but this came at the cost of postponing reforms of a medium term nature. Stronger implementation may have allowed greater attention to be focused in designing medium-term reforms which are inherently difficult given the need to take into account socio-political, institutional or legal constraints that have an important bearing on such reforms.

D. Main Macroeconomic Priorities for the Future

57. While progress has been made in maintaining macroeconomic stability and advancing structural reforms, the reform agenda is far from complete. Looking ahead, addressing structural impediments comprehensively and vigorously will be important to lay the foundations for medium-term growth and the reduction of poverty. The following identifies some of the key areas for reform.

(i) Fiscal Responsibility Law: As discussed, the delay in adopting the FRL has been followed by the adoption of a Law on Financial Administration as an intermediate step. With the publication of a detailed implementation plan spelling out the roadmap toward adoption of a Fiscal Responsibility Law in 2007, the implementation of an appropriate FRL will be important to establishing a medium-term fiscal strategy less vulnerable to political pressures. However, adoption of an FRL faces considerable hurdles, including constitutional constraints that will require a significant political consensus to overcome, and other technical preconditions need to be met. The Fund has been assisting the authorities at the technical level, but political consensus will be key to adoption of the FRL.

(ii) Mandated transfers: As a result of the adoption of the Law on Municipal Transfers in 2003, offsetting subsequent administrative measures in the budget were necessary as an attempt to restore fiscal neutrality. Maintaining fiscal neutrality will become increasingly difficult as mandated transfers rise under the law, and may have the unintended effect of penalizing pro-poor and growth-oriented spending. The experience with decentralization has been difficult across a range of countries, suggesting that addressing this issue, while important, will be a complex and lengthy process. The constitution also mandates the transfer of 6 and 4 percent of total expenditures to universities and the judiciary, respectively. Consideration needs to be given to increasing accountability for the use of resources transferred.

(iii) Energy Sector: Significant increases in quasi-fiscal losses by the energy sector in recent years and rolling blackouts have again highlighted the urgent need for following through on energy sector reform with the required legal and regulatory changes. Solving chronic problems in the electricity sector need to be at the forefront of efforts to create the essential preconditions for growth and to reduce inflationary, current account and quasi-fiscal risks. In this context, the recent need for a waiver on the PC to reform the energy sector law—which envisaged the removal of controls on the spot market and limits on margins in the oil industry, an automatic price adjustment mechanism and elimination of discretion by the regulator—is discouraging. Other priorities are measures to facilitate a reduction in distribution losses, including legal enforcement of payment claims, and the removal of legal and regulatory constraints to investment in hydro-electric power. Reforms in this area will require the continued cooperation of the Fund, the World Bank and the IADB in setting reform priorities.

(iv) Governance: Improving governance is key to improving the institutional environment in Nicaragua and fostering a robust private sector. While important measures have been taken to improve transparency in the public sector, measures to strengthen the capability and independence of the Comptroller General's Office and improve the quality and independence of the judiciary need to be advanced.

(v) Pension reform: New efforts need to be made to implement a parametric reform of the system—by increasing contribution rates and/or decreasing benefits—that will lead to fiscal sustainability and promote labor market flexibility. The Fund and the World Bank can play an important supportive role in the transition to a new fiscally sustainable pension system over the medium term.

(vi) Wage policy and civil service reform: The rise in median public sector wages and the total wage bill highlight the need for a transparent medium term wage policy consistent with the objectives of fiscal sustainability and equity compared with the private sector. Such a policy is urgently needed in order to reduce both political discretion in the wage setting process and uncertainties in budget planning. Efforts by the World Bank in the area of civil service reform will form an important component of the agenda going forward.

(vii) Central bank independence and the monetary policy framework: Meeting the objective of low and stable inflation is important to a sound macroeconomic framework. Nicaragua's crawling peg regime has been useful in anchoring inflationary expectations, but renders the economy vulnerable to exogenous shocks. Furthermore, the inflation record over the review period also exposes the limits of the current monetary policy framework in achieving its objectives. Monetary policy now needs to evolve to more directly aim at price stability, but important preconditions need to be met before a change in the monetary policy operating framework can be considered. Foremost among these, the operations of the central bank need to be made independent of the political cycle and the discretion of the executive. The financial sector roadmap provides a solid basis for taking efforts forward in this area.

V. The Lessons from Experience and Options for the Future

58. Nicaragua faces significant challenges in the quest for sustainable growth and the reduction of poverty. A review of the experience suggests that program engagement has led to some considerable successes. Among these are the establishment of positive growth, improvements in the areas of property rights, public sector balances, privatization, public debt, and the removal of restrictions on exchange and trade. As a result, the economy is considerably less vulnerable than it was at the beginning of the reform process. At the same time, there are many challenges that still need to be addressed, including how to raise

medium term growth, greater progress on poverty reduction, reduced reliance on external financing over the medium term, and a further reduction in the vulnerability of the economy to internal and external shocks.

59. More generally, more progress needs to be made in establishing hard budget constraints at various levels of the economy, including for the central and local governments, autonomous entities, and the energy sector. This suggests that more progress is needed to improve the overall quality of economic institutions. While specific local conditions will dictate the design of appropriate institutional mechanisms, the overall aims are clear: economic institutions need to reduce the opportunities for and rewards from rent-seeking activities, expand economic opportunities across the population, and promote a more efficient allocation of resources.

60. The broad-based nature of the challenges for the economy underscores the need for the authorities to develop an economic reform program that is appropriate to address the challenges and that enjoys broad support across society. The economic reform program of the authorities needs to identify and prioritize the main reforms that will be needed over a medium term horizon, clearly articulate the trade-offs that will have to be managed, and develop a broad-based consensus for the reform program. These are essential conditions for the successful implementation of a nationally-owned reform agenda that will address the main economic challenges over the medium term.

61. The Fund can play a supportive role in the evolution of Nicaragua's reform process along several dimensions, while incorporating key lessons from the past:

- The Fund can play a constructive role in helping the authorities develop their economic reform agenda by identifying the key medium term policy challenges and the measures that will be needed to successfully address these challenges. In this context, continued outreach efforts by the Fund may support the authorities' efforts to develop broad-based ownership for the government's economic reform agenda among stakeholders.

- Given the still large imbalances and external financing needs, a Fund-supported program appears necessary in order to ensure a stable macroeconomic environment and maintain the steady flow of donor support. A program would also lend credibility to the authorities' reform agenda and help anchor the reform process. This would ensure continuity in reforms that are underway and need to be brought to fruition in the medium term.

- Experience suggests that the Fund will need to be realistic about attainable goals within the timeframe of any program. Even under exemplary implementation, achieving stable long-term growth and the rapid reduction of poverty will require measures that are well outside the purview of Fund-supported programs and will require a strong domestic effort. In this context, highlighting risks to the program will have to continue to be important in setting expectations appropriately.

- Program design should also consider greater focus on reforms essential to addressing medium-term challenges. In this context, program conditionality should take greater account of legal and institutional constraints to implementation of required measures, and provide a realistic timeframe for implementing reforms. Programs should, however, be careful to avoid the perception of micromanaging the reform process when specifying the intermediate steps often needed as guideposts in advancing the objectives of the program. Consideration should also be given to more parsimonious use of structural benchmarks by focusing them on areas where implementation will be essential to achieve program objectives. This would also help underscore the importance of meeting structural benchmarks in achieving the main objectives of programs,

- While flexibility will clearly be needed in areas where implementation proves difficult due to technical factors or unanticipated shocks, the Fund should continue to take a firm stance in those areas where political issues or lack of determination lead to significant deviations from the reform agenda. Combined with strong initial understandings on the main objectives and elements of the program and a demonstrated commitment to implementation, less ex-post discretion in program implementation will help foster policy credibility in Nicaragua and ensure greater success of program objectives.

- Finally, cooperation with other institutions—in particular, the World Bank—will continue to be important in moving the reform agenda forward, given that several macro relevant areas (e.g., decentralization, energy sector reform, pension reform) are outside the expertise of the Fund.

62. Program engagement is not without risks, with considerable reputational costs to the Fund and loss of reform credibility for the authorities. Gauging success of a future arrangement will have to rely on several different elements: (a) the record of implementation of not just conditionality but broader areas identified in the context of program discussions, (b) progress toward achievements of the program's main objectives, and (c) the staff's assessment of the prospects for exit from a program relationship with the Fund.

63. Successful implementation of the key elements of a future Fund-supported program will be an important step toward external sustainability and an eventual exit from Fund-supported programs in the medium term. However, the success of Nicaragua's economic reform program will also depend on broader reforms outside the scope of Fund expertise, such as governance and institutions. Nicaragua and the Fund will, however, be well served by a candid discussion of progress in those areas within the context of the Article IV consultations discussions.

VI. Discussions with The Authorities

64. The authorities were in broad agreement with the findings and recommendations of the Ex Post Assessment of longer-term program engagement.[25] They agreed that successive Fund-supported programs had helped maintain broad macroeconomic stability, although difficult political conditions had contributed to the mixed performance in meeting quantitative targets and structural conditionality.

65. Regarding ownership, the authorities provided a somewhat different perspective. They emphasized that broad-based consensus has emerged over the past decade on the need to preserve macroeconomic stability through disciplined fiscal and monetary policies. This is reflected in the wide support enjoyed by Fund-supported programs, which are seen as important to maintaining macroeconomic stability. In their view, there is broad ownership in respect to the principle and goals of structural reforms. However, there is less consensus on specific elements, which are often opposed by certain political groups or segments of civil society.

66. Looking forward, the authorities noted that decisions on economic policies and the modalities for future engagement with the Fund would be made by the economic team of the new administration. The outgoing authorities, however, agreed that a future Fund-supported program would be important in maintaining macroeconomic stability and providing an anchor for a reform strategy consistent with attaining the medium-term priorities highlighted in the EPA report. In particular, they underscored the need to maintain fiscal discipline, build up an adequate reserve cushion to safeguard the economy against shocks, and improve donor coordination to more effectively utilize aid resources.

[25] Discussions were held with members of the economic team of the outgoing administration in early January. The new authorities have indicated they will present their views on the Ex Post Assessment report at the time of the Executive Board discussion.

APPENDIX TABLE. Nicaragua: Structural Conditionality Under Fund-Supported Programs

ESAF (1994–1997)	Test Date	Status 1/2/
Performance Criteria		
Eliminate central bank financing of state-owned banks on a net basis.	Throughout program period	NM
Limit incremental central bank financing of the FNI to the re-lending of the external resources provided by institutions and external donors for specific programs, net of repayments to the Central bank.	Throughout program period	M
Maintain the mechanism by which central bank interest rates are set quarterly on basis of average 30-day deposit rate+0.25%	Throughout program period	M
Benchmarks		
Implement the voluntary employment reduction program to reduce the number of public sector employees by 7,000 through end 1994.	End-1994	NM
Implement the voluntary employment reduction program to reduce the number of public sector employees by an additional 2,000 from 1/01/95 to 6/30/95.	End-June 1994	NM
Avoid any recapitalization of BANADES (the largest state-owned bank) or BANIC (The 2nd largest state-owned bank) with government resources (throughout program period).	Throughout program period	M
Reduce BANIC's operating losses during 1994 to at least half of the 1993 level.	End-1994	M
Proceed with the issuance of regulations pertaining to the privatization law and present to the National Assembly a law for the telecommunications permitting the privatization of TELCOR.	End-July 1994	M
Offer for sale at least 40 percent of the state-owned telecommunications company (TELCOR), including a management contract.	End-October 1994	NM
Offer for sale, offer for lease to the private sector, or cease the all but 39 enterprises still managed by CORNAP.	End-May 1994	M
Offer for sale, offer for lease to the private sector, or cease the operation of at least another 33 enterprises still managed by CORNAP.	End-1994	NM
Present draft legislation to the National Assembly allowing private sector participation in the hydrocarbon and electricity sectors.	End-1994	NM
Lift existing restrictions on payments for education, health, and travel expenses through official market.	February 28, 1995	MWD
Eliminate multiple currency practice through full unification of the exchange markets (including capital transaction).	June 30, 1995	MWD
Refrain from introducing any non-tariff barriers on exports or imports not justified by health or security reasons.	Through June 30, 1995	M

1/ No review is completed. The status is based on the 1995 Article IV consultation staff report (SM/95/150).
2/ M=met; NM=not met; MWD=met with delay.

APPENDIX TABLE (continued)

ESAF (1998–2002)	Test Date	Status 1/2/
First Annual Program		
Prior actions		
Approval by the National Assembly of the 1998 budget.	December-97	M
Present to the National Assembly a draft law for restructuring the executive branch consistent with the IDB's public sector reform.	December-97	M
Implement a labor mobility program aiming at reducing public sector positions by a minimum of 1800 employees.	Through end-December 1997	M
Approval by the National Assembly of the electricity law and regulations as agreed with the IDB.	November-97	M
Approval by the National Assembly of two laws needed to recognize the water an d sewerage sectors as agreed with the IDB.	November-97	M
Continue adjusting electricity rates by 1.5 percent a months, and introduce a step increase of 5 percent in electricity rates and a permanent thermal factors.	October-97	M
Present to the National Assembly of a draft law for property rights to facilitate the resolution of remaining property claims.	October-97	MWD
Unify banks' minimum reserve requirement across deposit maturities as well as currency denominations.	November-97	M
Sale of at least 80 percent of BANADES's assets.	November-97	M
End tax incentives to promoted nontraditional exports in the form of negotiable tax certificates (CBTs).	December-97	M
Performance Criteria		
Maintain the periodic adjustment for INAA's tariffs of 1.5 percent a month.	Throughout the ESAF arrangements	M
Approval by the National Assembly of a new law to privatize the telecom company (ENITEL).	June-98	M
Offer for sale of at least 40 percent of ENITEL's capital, as agreed with the IBRD.	June-98	NM
Approval by the National Assembly of an appropriated property right law.	June-98	M
Superintendency of banks will withdraw BANADES's license to operation as a financial intermediary.	May-98	M
Benchmarks		
Approval by the National Assembly of a law for restructuring the executive branch.	March-98	M
Implement a labor mobility program aiming at reducing public sector positions by a minimum of		
2550 employees	Through end-June 1998	NM
3300 employees	Through end-December 1998	NM
Approval by the National Assembly of the two hydrocarbons laws to regulate commercialization and exploration of hydrocarbons law for restructuring the executive branch.	March-98	M
Commission a study to establish new system of adjusting electricity rates based on long term marginal costs as agreed with the IDB.	June-98	M
Approve the new water and sewerage tariff structure as agreed with the IDB.	March-98	M
Commission a study of the social security to rationalize the strengthen the current pension system, define alternatives to ensure medium- and long-term actuarial viability of the pension system, and allow private sector participation in the pension system.	June-98	M
Separate the pension and health insurance accounts.	December-98	MWD
The government will sell BANIC's equity to the private sector, and keep the minimum participation required by law.	December-98	MWD
Sell at least 49 percent of FNI's equity.	December-98	MM
Reduce maximum tariff to		
25 percent	January-98	M
20 percent	July-98	M
15 percent	January-99	M
10 percent	July-99	M

1/ Staff reports on request and reviews.
2/ M=met; NM=not met; MWD=met with delay; MM=modified and met.

APPENDIX TABLE (continued)

ESAF (1998-2002)	Test Date	Status 1/2/
Second Annual Program		
Prior action		
Announce a program to reduce the enterprise's operating expenditure by a least 20 percent and start implement.	June-99	M
Approve tariff adjustment along the lines recommended by the World Bank and the advisory international investment bank.	August-99	M
Announce tariff adjustment to fully cover the long-term marginal production cost in accordance with the tariff adjustment plan developed with IDB assistance. 3/	December-99	MWD
Performance Criterion		
Invited final bids of potential investors for 40 percent of ENITEL's assets.	January-00	MWD
Issue final bidding documents for ENEL's generation and distribution units. 4/	December-99	MWD
Approval of the social security reform law by the national assembly. 4/	December-99	MWD
Benchmark/Indicative Target		
Implement regulations on the functions and organization of the Executive Law No. 209 to reduce the number of high ranking officials by 25 percent	June-99	M
Restructuring of the revenue and customs departments:		
a law on transformation of the revenue and customs department approved	November-99	MWD
start implementation of performance indicators for collection, as recommended by the IDB.	January-00	NM
Continue to implement a labor mobility program aiming at reducing public sector positions:		
700 positions	June-99	M
1,200 positions	December-99	NM
ENITEL (reactivated privatization program)		
Start negotiation to transfer ENITEL's debt to CABEI to the government.	July-99	M
ENACAL: continue adjusting water and sewerage tariffs by 1.5 percent a month.	Jun-98	M
ENEL:		
Issue a decree to divided ENEL into generation, transmission, and distribution units as a preparatory step to divestment.	April-99	M
Issue regulations on setting tariffs for electricity generation and distribution by the ENEL units to be privatized. 4/	October-99	MWD
Include all extra budgetary revenues and expenditures into the budget	May-99	M
Ensure that all domestic receipts are recorded at the treasury. 4/	Jul-99	NM
Achieve full coverage of revenues and transfers in the financial control system (SIGFA).	September-99	MWD
Submit revisions to the draft procurement law in line with recommendations of the World Bank, the IDB, and the IMF to the national assembly	August-99	M
Approval of the above law	September-99	MWD
Issue the regulations for the above law. 4/	September-99	MWD
Establish a national center for property mediation.	September-99	MWD
Accelerate issuing of property titles and continue progress in resolving property rights claims:		
Urban		
3,000	June-99	NM
10,000	December-99	NM
Rural		
1,600	June-99	M
4,000	December-99	M
Property rights claims settlements		
1,000	During 1999	M
1,400	During 2000	NM
Passage of the revised laws on the central bank, commercial banks, and the Superintendency of banks:		
complete draft laws in consultation with the IDA, the IDB, and the IMF, and submit the laws to the national assembly.	August-99	M
approval of the three laws by the national assembly.	October-99	M
Exclude BOFOS (development bonds) from secondary capital.	June-99	M

APPENDIX TABLE (continued)

ESAF (1998-2002)	Test Date	Status 1/2/
Implement fully according to the initially established schedule of the prudential norms on banks' capital adequacy and lending to related parties.	mid-1999 to mid-2000	M
Issue a revised prudential norm on asset-risk classification and provisioning based on review conducted with the World Bank.	October-99	NM
Separate the pension insurance from health insurance accounts of the social security.	April-99	M
Submit to the national assembly a draft social security reform law with revised parameters to reduce losses of the current system and introduce a new system of individually funded accounts managed by private sector.	August-99	M
Implement the revised parameters	January-00	MWD
Start to introduce the new pension system based on individually funded accounts.	September-99	NM
Reduce maximum tariff to:		
15 percent	January-99	M
10 percent	July-99	M
Submit to the National assembly a revised law on foreign investment.	September-99	MWD
Have the law on foreign investment approved.	January-00	MWD
Announce results of the ENEL bidding (award): 5/		
The distribution units	September-00	M
The thermal generating plants	October-00	NM
The hydroelectric plant	December-00	NM
ENABAS: Divest or lease 75 percent of assets. 5/	December-99	M
ENAP: offer to private investors long-term concessions for ports facilities. 5/	December-00	M
Approval of the administrative dispute settlement law. 5/	December-99	MWD
Approval of the laws on the reform of judicial process: 5/		
a new law on public prosecutors	October-00	NA
a new penal code	December-00	NA
a new law on penal procedures	December-00	NA
Submit to the Assembly a law on supervision of private pension funds. 5/	September-00	M
Adopt new procedure for selecting directors of autonomous schools. 5/	December-99	NM
Management by local boards of 95 percent of secondary schools and 65 percent of primary schools. 5/	December-99	M
Enable normal operations of the Comptroller's General Office (CGR): 5/		
Complete the review of pending cases, and announce the list of priority cases to be audited.	July-00	M
Approval by the National Assembly of a satisfactory law on the CGR.	September-00	NA
Adopt and announce an action plan for CGR, including a program for its technical strengthen.	September-00	NA
Implement improved mechanism and procedures for accepting and processing allegations of misuse of pu	October-00	M
Submit to the Assembly a draft law on accountability of public officials.	October-00	M
Approval by the National Assembly of a civil service law.	September-00	NM
Issue the results of the poverty survey, establish and start a consultative process with civil society. 5/	November-99	M
Prepare an outline of the strategy and consult it with civil society. 5/	December 1999-April 20(	M
Complete a broadly consulted interim policy reduction strategy paper (I-PRSP). 5/	August-00	M

1/ Staff reports on request and reviews.
2/ M=met; NM=not met; MWD=met with delay; MM=modified and met; NA=information not available.
3/ For the first review of the second annual program.
4/ Later on, converted to prior actions for the combined first and second reviews.
5/ Added under the revised program.

APPENDIX TABLE (continued)

ESAF (2002-2006)	Test Date	Status 1/2/
Board consideration of the three-year PRGF arrangement		
prior actions		
Submission to the national assembly of a 2003 budget for the central government, which together with the estimated yield of the 2003 tax package, is consistent with a combined public sector deficit (after grants)	October-02	M
Confirmation by the authorities of compliance by all commercial banks with prudential norms, including on	October-02	M
Public announcement of the selection of a reputable firm with international experience in asset management to implement asset recovery.	November-02	M
First and second reviews		
Prior actions		
Approval by the national assembly of a tax reform package.	April-03	M
Approval of the implementing tax reform regulations.	May-03	M
Performance criteria		
Confirmation by the authorities of compliance by all banks with existing capital adequacy requirements	December-02	M
Asset Recovery Plan:		
Signature of a contract with an international firm to implement asset recoveries.	December-02	M
Approval by the national assembly of a 2003 budget for the central government, which together with the estimated yield of the 2003 tax package, is consistent with a combined public sector deficit (after grants)	December-02	NM
Third review (EBS/03/138, October 6, 2003)		
Prior actions		
Submission to the assembly of the 2004 budget, consistent with a combined public sector deficit (after grants) equal or less than 4.4 percent to GDP.	October-03	M
Conduct final auction of the asset recovery plan.	Aug-03	M
Performance criteria		
Asset Recovery Plan:		
End of the asset auction process.	June-03	MWD
Fourth review (EBS/03/177, December 30, 2003)		
Prior actions		
Approval by the assembly of the 2004 budget, consistent with a combined public sector deficit (after grants) equal or less than 3.8 percent to GDP (C$ 2,555 million).	Mid-December 2003	M
Performance criteria		
Asset Recovery Plan:		
Conclude implantation of asset recovery plan for assets received from intervened banks.	September-03	MWD
Grant legal protection to staff of the Superintendency of Banks:		
Submission of a draft law to the assembly.	End-2003	M
Fifths and sixth reviews (EBS/04/125, August 25, 2004)		
Prior actions		
Fiscal measures	May 25, 2004	
Collect at least C$40 million from the revenue measures.		M
Implement expenditure savings measures of a least C$20 million		M
Establish a timetable to reduce transfers by C$37 million to INIFOM, IDR, FISE, and INVUR during		M
Implement a budget reform consistent with the 2004 fiscal program discussed with Fund staff.	August-04	M
Establish a monthly monitoring system for current and capital expenditure, by institution.	April-04	M
Appoint a special advisor to make specific recommendations on reorganizing intergovernmental relationships and to devise a clear calendar and management process for devolving expenditures and responsibilities.	August-04	M
Approval a new Superintendency of banks resolution to cover explicitly legal expenses for staff sued for actions taken in the course of their official duties.	August-04	M
Performance criteria		
Grant legal protection to staff of the Superintendency of Banks:		
Approval of a law by the assembly.	Mid-may 2004	NM

APPENDIX TABLE (continued)

ESAF (2002-2006)	Test Date	Status 1/2/
Seventh, eighth, and ninth reviews (EBS/05/201, December 28, 2005)		
Prior actions		
Passage of 2006 budget consistent with the program including a CPS deficit (after grants) of 2.2 percentage	November-05	M
2006 budgetary wage bill consistent with expected average inflation.	November-05	NM
Decentralization-devolution of expenditure equivalent to half of revenue transfer to municipalities.	November-05	M
Passage of a satisfactory law on financial administration (FAL).	August-05	M
Passage of a satisfactory banking law.	November-05	M
Passage of a satisfactory deposit insurance law.	November-05	M
Passage of a satisfactory superintendency law.	November-05	M
Defer implementation of social security law pending for review by new government after election.	October-05	M
Electricity tariff adjustment of at least 10 percent.	October-December 2005	M
Performance criteria		
Submit the Fiscal Responsibility law to the assembly.	October 15, 2004	NM
Tenth review (EBS/06/116, August 25, 2006)		
Performance criteria		
Passage of a satisfactory tax code, that strengthens administration, including auditing, payment enforcement	March-06	NM
Eleventh Review		
Preparation of a detailed strategy and implementation plan on pension reform.	June-06	MWD
Publication of a detailed implementation plan spelling out the roadmap toward adoption of a Fiscal	August-06	MWD
Energy stability law amended to eliminate distortions.	August-06	NM
Structural Benchmarks (all reviews)		
Adoption by the general directorates of customs and revenue of an action plan to strengthen tax administration during the period 2003-2005.	June-03	NM
Approval by the assembly of the law on domestic and external public indebtedness	End-2003	M
Approval by the national assembly of an appropriated 2003 tax reform package, in line with paragraph 17, yielding 1.0 percent of GDP on an annual basis.	June-03	MM
Approval of new on-site technical and administrative procedures for banking supervision.	December-03	MWD
Approval of prudential norms to limit risks derived from maturity mismatches between assets and liabilities.	March-03	MWD
Central Bank legal protection - Approval by the assembly.	Mid-May 04	NM
Central Bank legal protection - Submission to the assembly.	December-03	M
Creation and staffing of unit in ministry of finance to report on decentralization	September-04	M
Establish a legal framework that redefines the responsibilities of the FISE and INIFOM.	September-04	NM
Expenditures equivalent to one-third of revenue transfers shifted to municipalities as part of the 2005 budget.	September-04	M
Issue a presidential decree to modify the municipality law's regulations.	September-04	M
To achieve effective decentralization with devolution of responsibilities to municipalities a revision to the relevant laws will be submitted to National Assembly.	June-06	NM
Divest the remaining government stake in ENITEL	September-03	MWD
Financial administration law - approval by the assembly	December-04	MWD
Financial administration law - submission to the assembly	October 15, 2004	MWD
Fiscal responsibility law - approval by the assembly	December-04	NM
Fiscal responsibility law - submission to the assembly	June-04	NM
Grant legal protection to staff of the Superintendency of Banks and the Central Bank of Nicaragua.	End-2003	NM
Judicial Reform: Complete and make public the authorities' proposal.	September-03	M
Judicial Reform: Establish academic degrees for graduating judicial students.	September-04	NM
Judicial Reform: Launch national consultation process of authorities' proposal.	December-03	M
Judicial Reform: present a detailed action plan.	September-04	NM
Measurement of the execution of the budget from the financing side.	June-06	MWD
National Accounts actual figures for 1994-2000.	March-03	MWD
National Accounts preliminary estimates for 2001 and 2002.	June-03	C
Pension reform. complete a review of the pension reform strategy, with technical assistance from the World	October-04	NM
Preparation of a budgetary classification manual of the total NFPS with the objective to move accounting of the budget in to an accrual basis.	June-06	NM
Present to the economic cabinet roadmap for further financial sector reforms.	August-06	MWD

APPENDIX TABLE (concluded)

ESAF (2002-2006)	Test Date	Status 1/2/
Public Spending:		
Agree on terms of reference and establish the Commission.	Mid-June 2003	MWD
Define efficiency indicators for MECD and MINSA, and report them, quarterly, in the "Informe Ejecutivo del presupuesto de 2005."	September-04	NM
Improve classification of capital and current expenditures, starting with the 2005 budget.	September-04	NM
Present the findings and recommendations for 2004 budget and beyond.	Mid-September 2003	NM
Review public spending with the aim of improving efficiency of MINSA, MEC, MTI, INIFOM, IDR, and	March-04	M
Revised Tax Code Approval by the assembly.	March-04	NM
Revised Tax Code Submission to the assembly.	End-2003	M
Submission to the assembly of amendments to financial sector laws in line with Basel Core Principles for effective bank supervision and for changes in FOGADE	September-03	MWD
Submission to the national assembly of an appropriated 2003 tax reform package, in line with paragraph 17, yielding 1.0 percent of GDP on an annual basis.	March-03	NM
Submission to the national assembly of the law on domestic and external indebtedness of the public sector	December-02	M
Tax Administration:		
Adopting by the DGA (customs) of an action plan for 2004-06.	September-04	NM
Adopting by the DGI (internal tax administration) of an action plan for 2004-06.	December-03	MWD
DGI (internal tax administration) to adopt an action plan, including:	December-03	M
DGI Implement effective procedures to monitor stop filers and delinquent taxpayers in all local	December-04	NM
DGI Present a three-year strategic IT plan	September-04	NM
DGI Strengthen the tax office's large taxpayers unit	March-04	MWD
Progress in the implementation of the action plans	End-2003	NM
Start implementing a plan for regular on-site bank inspections, in line with the recommendations of MAE	Jun-03	MM
The adoption by the DGA (customs) and DGI (internal tax administration) of action plans for the period	June-03	NM
The adoption by the DGA (customs) and DGI (internal tax administration) of action plans for the period	September-03	NM

1/ Staff reports on request and reviews.

2/ M=met; NM=not met; MWD=met with delay; MM=modified and met; NA=information not available;

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