

**FOR
AGENDA**

EBS/08/101
Supplement 1

August 28, 2008

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Nicaragua—First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Review of Financing Assurances, and Requests for Waiver of Nonobservance of Performance Criteria and Augmentation of Access—Letter of Intent and Technical Memorandum of Understanding**

Attached for consideration by the Executive Directors is a letter of intent and technical memorandum of understanding from the government of Nicaragua. This subject, together with the paper on Nicaragua's first review under the three-year arrangement under the Poverty Reduction and Growth Facility, the review of financing assurances, and Nicaragua's requests for a waiver of nonobservance of performance criteria and augmentation of access (EBS/08/101, 8/28/08), is tentatively scheduled for discussion on **Wednesday, September 10, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Nicaragua indicating that they consent to the Fund's publication of the letter of intent and technical memorandum of understanding.

Questions may be referred to Mr. Cubeddu (ext. 36231), Ms. Jenkner (ext. 35861), and Mr. Di Bella (ext. 37483) in WHD.

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

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Department Heads

August 28, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C.

Dear Mr. Strauss-Kahn:

1. The Nicaraguan economy is continuing to perform satisfactorily. The quantitative performance criteria set out in the Poverty Reduction and Growth Facility (PRGF)-supported program for end-December 2007 were met comfortably, and preliminary information indicates that the majority of targets for end-June 2008 have also been complied with. More specifically, the ceiling for the central bank's net domestic assets at June was observed with a margin whereas the adjusted net international reserves target was missed by US\$14 million during the first half of the year due to the US\$148 million overperformance in 2007. Progress was also made in implementing the structural agenda and policies linked to social goals. In this context, the Government of National Unity and Reconciliation (GRUN) continues to be committed to the objectives and policies set out in the letter of August 24, 2007, and to the changes included in this letter and in the annex to the Technical Memorandum of Understanding (TMU).

2. Quantitative performance criteria have been set for December 2008, as well as indicative targets for June 2009. New structural performance criteria and benchmarks have also been agreed, including specific measures related to the strengthening of public sector institutions and the monitoring of external cooperation. The second review, which is expected to be completed by end-December 2008, will focus on assessing the performance of the economic program and on agreeing macroeconomic policies for 2009, including measures to implement the structural agenda. Meanwhile, the third program review is expected to be carried out in March 2009.

3. Due to the adverse effects of hurricane Felix and high food and oil prices, which have entailed a larger oil import bill, an augmentation equivalent to 5 percent of quota (around US\$10 million) in the resources provided under the Poverty Reduction and Growth Facility (PRGF) is requested.

Macroeconomic framework

4. Real GDP growth in 2007 was 3.8 percent, slightly below target, mainly as a result of higher input costs due to higher international oil prices, the adverse effects of hurricane Felix and the subsequent heavy rains on agricultural production, as well as electricity supply disruptions during the first part of the year, amongst other things. The same factors contributed to inflation reaching 16.9 percent, exceeding the program projection. This increase was basically attributable to a series of supply shocks, including the natural disasters that affected food supply, coupled with higher commodity prices (including for oil), which

constitute a significant share of the consumer price index. Core inflation (excluding food, fuel and transport), on the other hand, remained in single digits. International reserves increased significantly, continuing to cover the monetary base comfortably, despite the fact that the current account deficit widened more than expected as a consequence of higher prices for oil and oil derivatives.

5. The GDP growth projection for 2008 has been revised to 3–4 percent. This projection assumes that the negative impact of lower growth in the United States and higher oil prices will be mitigated by an increase in agricultural production supported by government programs as well as an increase in bilateral financing to cover the rising cost of oil imports. However, the continuing upward trend in the prices of oil and other primary commodities will continue to have an impact on inflation, which is projected to reach 15–17 percent at year-end. The current account deficit is also expected to widen considerably as a consequence of the higher oil import bill and significantly increased imports of capital goods. However, this deterioration in the external accounts will be financed by foreign direct investment, grants, concessional loans, and capital transfers. As a result of increased inflows (of private and official origin), the balance of payments is expected to show a positive balance overall, which will be reflected in an accumulation of international reserves. Given the uncertainty surrounding the external environment, and should aggregate demand pressures materialize, policies to preserve economic stability will be strengthened.

6. During 2008, the government implemented a set of measures intended to contain inflation and compensate the sectors most affected by rising energy and food prices. As well as continuing to implement prudent macroeconomic policies to ensure that the pressures arising from external and supply shocks do not affect inflation expectations permanently, the government: (i) reduced import duties on selected foodstuffs; (ii) sought to facilitate the agricultural sector's access to credit and to increase its productivity, in order to stimulate food supply; and (iii) sought to reduce rigidities in the marketing of agricultural products to prevent sudden price fluctuations. At the same time, to alleviate the negative impact of the fuel price increase, the urban transport subsidy for Managua was maintained (US\$10 million annually), and intercity passenger transport and taxis are expected to receive transfers from Venezuela amounting to about US\$75 million a year.

Nicaragua: Macroeconomic Indicators

	2006	2007		2008	
		Prog.	Prel.	Prog.	Proj.
Real GDP growth (in percent)	3.9	4.2	3.8	4.7	3–4
Inflation (end of period, in percent)	9.5	7.3	16.9	7.0	15–17
Inflation (period average, in percent)	9.1	8.2	11.1	7.3	18.1
Overall balance of Combined Public Sector after grants (in percent of GDP)	0.2	-1.0	0.9	-1.8	-1.8
External current account deficit (in percent of GDP)	13.6	16.1	18.3	16.3	25–27
Gross International Reserves (US\$ million)	924	925	1,103	1,044	1,230
in months of imports of goods (excluding maquilas)	3.4	3.1	3.4	3.2	3.0
Net international reserves (program definition, US\$ million)	535	595	737	665	797

Social policy

7. A new National Human Development Plan (PNDH) has been prepared, and is being consulted with key stakeholders in Nicaraguan society and the donor community. The main elements of this new PNDH are in line with those described in the August 2007 Memorandum on Economic and Financial Policies. The new PNDH, which will be presented in a more complete version by end-September 2008, describes in detail the government's social and economic policies, designed to enhance the impact of social programs on poverty reduction. At the same time, it will include indicators to monitor and assess the effects of new government policies—such as the free provision of education and health services—that have increased coverage in the short-term. The PNDH will also set out a new approach to measuring poverty-reducing expenditure, with the aim of estimating more accurately its impact on reducing poverty levels, improving the allocation of resources, and strengthening operational efficiency. At the same time, the National Institute of Information for Development (INIDE) will continue to be strengthened to improve its capacity to monitor the impact of social policies.

8. Social policy has been aimed at improving the coverage and quality of the provision of goods and services in health, education, nutrition and safe drinking water, giving priority to the poorest sectors. Accordingly, resources were primarily assigned to health and education, and the government launched the programs *Hambre Cero*, which consists in providing the poor with capital to help them overcome their poverty by tapping their potential; and *Usura Cero*, which provides access to credit at highly preferential rates for individuals that are normally excluded from formal credit markets. Under these programs, during 2007 capital in the form of *bonos productivos* (productive bonds) amounting to C\$184 million was distributed to micro producers in the rural sector, directly benefiting 11,000 families, or 55,000 individuals. In addition, C\$44 million were channeled to microcredits, directly benefiting 8,294 recipients of credit. During 2007, the central government increased poverty-reducing expenditure by more than one percentage point of GDP, to 13.3 percent of GDP, still slightly below the program's indicative target.

9. The new boost in social spending has started to produce positive results, as reflected in the progress report on the program's social indicators published in July (*June 2008 structural benchmark*). In the health sector, maternal mortality rates were reduced to 80 per 100,000 (surpassing the goal of 96 per 100,000); the number of deliveries in hospitals and clinics, medical consultations and surgical procedures was increased, and the target for immunizations was reached. In education, school enrollment exceeded 1.3 million students; literacy programs reduced illiteracy by 59,000 people; and basic school utensils and meals were distributed as part of general nutrition programs. Moreover, due to sanitation and water policies the index for access to safe water increased to 65 percent (compared with 63 percent in 2006), reflecting efforts to maintain existing networks, the reactivation of pumping equipment, and the drilling of wells.

Fiscal policy

10. Fiscal policy has remained prudent, and the overall balance of the consolidated public sector (CPS) at end-December 2007 was in line with program targets. The strong performance was the result of revenue collection at programmed levels with lower-than-projected execution of the capital budget, despite an acceleration in investment spending during the second half of the year. The fresh impetus given to social policy yielded improvements in a number of social indicators (paragraphs 8 and 9), despite the fact that expenditure on poverty reduction programs continued to be insufficient. In this context, the government will continue to improve the targeting of social expenditures, while increasing its spending as a share of GDP.

11. In 2008, fiscal policy will remain in line with the CPS deficit target of 1.8 percent of GDP set out in the program. The National Assembly approved a budget consistent with this target in mid-February 2008 (*December 2007 structural performance criterion*). Preliminary information suggests that the overall CPS balance exceeded programmed amounts through June 2008, as a result of continued underexecution of the public investment budget as well as higher-than-programmed revenue collection. Additional resources from tax revenues and the renegotiation of bank bonds will allow increased outlays to meet social, energy, transport, and reconstruction expenditure needs, amongst others. At end-June 2008, the National Assembly approved a supplementary budget to allocate the savings arising from the renegotiation of the bank bonds, while an additional budgetary supplement to allocate higher tax receipts is expected to be submitted in the last quarter of 2008. Both of these supplements will be consistent with program targets (*continuous structural performance criterion through end-December 2008*). Submission to the National Assembly of a 2009 budget that is consistent with program objectives will be a structural performance criterion for end-October.

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

	2006	2007		2008	
		Prog.	Prel.	Prog.	Proj.
Overall balance of CPS (a+b+c+d)	0.2	-1.0	0.9	-1.8	-1.8
Primary balance	2.2	0.8	2.4	-0.1	0.0
Interest	2.0	1.8	1.5	1.7	1.8
a. Central government	0.1	-0.9	0.4	-1.2	-1.3
Revenue	18.8	19.6	19.5	19.7	18.5
Tax	17.5	18.2	18.0	18.3	17.1
Other	1.3	1.4	1.5	1.4	1.4
Expenditure	22.7	24.7	22.8	25.1	23.9
Current	15.4	15.7	15.7	15.6	16.7
Capital	7.3	9.0	7.1	9.5	7.3
Grants	4.0	4.2	3.7	4.2	4.1
b. INSS and ALMA	1.3	1.5	1.7	1.5	1.7
c. Public enterprises	-0.7	-1.2	-0.9	-1.5	-1.3
d. Central bank	-0.4	-0.4	-0.3	-0.6	-0.9

12. The government will ensure that the public sector wage increases remain in line with nominal GDP growth. To correct lags in wage increases in priority sectors, pay increases of 16 percent were granted to teachers, health-sector workers, the army, and the police, which, together with increases in other sectors, is consistent with a policy of maintaining average wage increases in the public sector below 14 percent for the year. At the same time, 1,500 new teachers and 600 new health sector workers will be recruited to improve service provision with a view to meeting the Millennium Development Goals.

13. The finances of public enterprises have been improved, particularly in the case of ENEL (electricity generation) and ENACAL (water and sewerage systems), and tariff adjustments will contribute to strengthening the financial position of ENEL further. Moreover, in the budget supplement approved in June 2008, the central government assumed the payment of US\$20 million in arrears accumulated by ENEL to help finance the stabilization of tariffs. In the case of ENACAL, the approved 2008 rate adjustments differentiated by indexation (of 25 percent, on average, as May 2008) will substantially narrow the gap with production costs.

Monetary and financial policy

14. The monetary program for 2008 is consistent with an inflation rate of 15–17 percent and an increase in net international reserves to further strengthen the main coverage indicators, including base money. In addition to the measures set out in paragraph 6, the monetary and financial authorities will influence short-term liquidity by using open-market operations and will monitor the rate of credit growth in the financial system in order to meet program objectives. At the same time, the Board of Directors of the Superintendency of Banks recently approved, after a process of consultation with the banking sector, a set of prudential measures to preserve the soundness of banks' credit portfolios, especially with regard to consumer credit. The central bank will maintain the rate of crawl at 5 percent.

15. In order to improve monetary policy instruments, work will continue towards standardizing central bank securities. At the same time, the central bank's financial position was analyzed with the help of the IMF, and a set of recommendations will be prepared by end-September 2008. Therefore a rescheduling of the structural benchmark is requested (*June 2008 structural benchmark*). In coordination with the central government, the monetary authorities have decided to gradually concentrate on the shorter-term domestic security market so that the central government can focus on longer-term bonds. This decision is consistent with international best practices and will assist the development of a domestic market for public debt.

16. The central bank recently completed the renegotiation of bank bonds with the banks that hold such securities. The agreements reached are being implemented (involving the early redemption and issuance of new bonds) and they are expected to be approved by the Board of Directors of the central bank by end-September 2008 (*structural performance criterion*). For this purpose, the government recently submitted the nominations for the new members of the Board to the National Assembly for confirmation. For its part, the government will continue to make budgetary transfers to the central bank to cover the debt service associated with the

new bank bonds. In January 2008, a new chart of accounts, reflecting adherence to international accounting standards, became effective. Regarding the accounting treatment of the new bank bonds previously mentioned, the Superintendency of Banks has communicated to banks that the effects of the new chart of accounts will be gradually implemented in line with a timetable to be discussed in the context of the second review. Currently, the Superintendency of Banks is reviewing plans submitted by the involved banks holding these bonds to continue meeting local prudential rules. The Superintendency of Banks will continue to coordinate closely with the parent supervisor of the involved banks, and adopt the appropriate measures to ensure the continued stability of the financial system. In this regard, and in an effort to contribute towards the development of a consolidated supervision framework of financial groups, the prudential and accounting norms will continue to be strengthened consistent within the recently-signed regional harmonization agreement.

Financing policy

17. In 2007, official foreign aid to the public and private sectors are estimated at 16-18 percent of GDP, and it is expected to reach 20–22 percent of GDP in 2008, which will help to cover the expected financing gap. In particular, assistance from Venezuela has been channeled in different ways, including through investment in Nicaragua by a semi-public enterprise (ALBANISA, in which the Venezuelan state oil company (PDVSA) is the majority shareholder and in which PETRONIC has a minority interest), the granting of loans, and a framework for oil cooperation. Specifically, oil cooperation has been structured as follows: of the total value of purchases of oil and oil derivatives from PDVSA by PETRONIC and/or ALBANISA, (i) 25 percent is earmarked for a “fund” on behalf of PDVSA, administered by a private body; (ii) a further 25 percent is earmarked for the same private Nicaraguan entity, which thereby receives concessional financing from PDVSA (payable over 25 years, 2 year grace period, and a rate of 2 percent); and (iii) the remaining 50 percent will be paid in cash to PDVSA. Thus, the resources associated with Venezuelan oil cooperation will continue to be channeled mainly through the said private entity and as such will not generate public debt (direct or contingent).

18. Given the extent of foreign official aid inflows to Nicaragua, they will continue to be monitored and recorded in the balance of payments and in the fiscal accounts. In addition, a report on the amounts and sources of such aid, including that channeled to the private sector, will be published periodically (twice a year). The first report, with information through end-2007, will be published by end-August, and a report with information on the first half of 2008 will be published by end-October 2008 (*structural benchmark*).

19. Efforts will continue to conclude the negotiations on external debt relief within the framework of the HIPC Initiative. In this context, the agreement to buy back external commercial debt, sponsored by the World Bank and the donor community, has delivered positive results. By June 2008, creditors holding approximately 95 percent of eligible commercial debt had participated in the operation. With regard to bilateral creditors, efforts will be continued to achieve debt relief provided for under the HIPC Initiative. Completion

of these negotiations, in addition to the debt relief received under the MDRI initiative, would reduce public external debt from 161 percent of GDP in 2003 to around 39 percent of GDP in 2008.

Structural agenda

20. Progress has been made in implementing the structural reform agenda, despite some delays. Advances in the electricity sector will be consolidated and the fiscal and monetary institutions will continue to be strengthened to improve the productivity of public expenditure and the investment climate.

21. **Electricity sector.** In 2007, the government managed to normalize the electricity supply through the installation of 60 MW of diesel generating capacity, extraordinary savings measures, and the distribution of 1.8 million energy-saving light bulbs. Also, major steps were taken toward improving the sector's financial position. A comprehensive agreement was recently signed with the distribution company intended to improve electricity service provision and the financial soundness of the sector, where the government will become a minority partner once the agreement has been ratified by the National Assembly.

- In order to better reflect increases in energy costs, electricity tariffs were adjusted cumulatively by 26.9 percent between August 2007 and August 2008. However, new tariff slippages emerged as a result of the spike in input costs since May, though these prices have weakened in recent weeks. The government expects to compensate the electricity sector for the cost of tariff slippages through August 2008 without affecting its fiscal position. Going forward, it is expected that additional slippages will be corrected through tariff adjustments.
- To smooth the impact of electricity tariff increases, the National Assembly approved in August a law extending for a period of 5 years: (i) the policy of freezing tariffs for small consumers (those with consumption under 150 Kwh); and (ii) the application of a preferential VAT rate of 7 percent to medium-sized consumers (300–1000 Kwh). The cost of these measures will be assumed by the central government within the program's fiscal envelope.
- The transparency of the regulatory framework has been strengthened through the publication, in December 2007, of the formula establishing the mechanism for adjusting electricity rates in line with changes in input costs (*structural benchmark*). Moreover, a new distribution tariff schedule was adopted in July in line with the Energy Stabilization Law (*structural benchmark*).
- To reinforce the viability of the sector and reduce distribution losses, clear procedures have been laid down to punish fraud in electricity consumption (*December 2007 structural performance criterion*). In May, the new Penal Code was published, which defines the offense of fraudulent consumption of electricity and the applicable criminal penalties. In addition, in June the National Assembly adopted a Law on the responsible use of electricity, which establishes the rights and duties of consumers and distributors and lays down procedures and administrative penalties for the irregular consumption of energy at a lower level of consumption than that required to constitute an offense under the Penal Code. To ensure enforcement of the Law, the Nicaraguan Energy Institute (INE)

will increase the number of inspectors. The Ministry of Energy and Mines and the INE will monitor the implementation of the plan on investment and reductions in distribution losses. At the same time, a diagnostic assessment of the underlying reasons for distribution losses was completed in August (*April 2008 structural benchmark*), with the aim of preparing a comprehensive plan jointly with the distributor to limit both technical and nontechnical losses.

- In 2008, 100 MW of fuel-oil powered generating units will start operating to address shortfalls in electricity generation in the short term, to which a further 80 MW will be added in the course of 2009. In addition, 40 MW of wind-power generated capacity will enter the Nicaraguan electricity system during 2008. This new capacity will make it possible to keep older, less efficient units in reserve and to tackle the increases in demand and to be prepared for contingencies. The investment in fuel-oil powered generation plants was made by ALBANISA, which has signed an agreement with ENEL for the operation of such plants. However, in the medium and long terms, the objective of the government's investment plan is to change the country's power generation matrix and to strengthen the transmission mechanism to significantly reduce dependence on oil. A important proportion of the financing for this investment plan comes from multilateral institutions (IDB, CABI, and EIB), with more than US\$100 million targeted at private sector initiatives.

22. **Tax and Customs Administration.** The government has continued to work on the design of a set of measures aimed at improving tax and customs administration (*March 2008 structural benchmark*). With the assistance of the IMF, progress has been made on: (i) implementing a system of tax payments through banks, starting with large taxpayers; (ii) updating and improving the reliability of information in the taxpayers registry; (iii) increasing the number of inspections (comprehensive and specific) conducted by the DGI, especially of large taxpayers; (iv) strengthening control mechanisms and inspections of importers; and (v) designing a plan to strengthen the IT system of the DGA. However, implementation of these measures will take more time than envisaged and therefore a rescheduling for September 2008 is requested. With respect to regional integration, an important step was taken in signing the framework agreement for the establishment of a Central American Customs Union in December 2007. This framework agreement set out several key characteristics, including the maintenance of internal customs institutions and allocation of tariffs and internal taxes for destination countries. The development of an action plan before end-November is expected with a view to gradually adopt measures to ensure regulatory convergence, develop institutions, and strengthen the administrative capacity of the DGA.

23. **Tax reform.** A reform proposal is being prepared to rationalize tax exemptions, reduce the complexity of the tax structure, reorganize the existent dispersion in the tax system and promote economic development without undermining fiscal revenues. Should the tax reform envisage a reduction in tax rates, these will be implemented only in so far as the reform yields higher overall revenues. Therefore, this proposal will be consistent with the objective of ensuring that tax revenues do not fall as a percentage of GDP, as well as with the tax harmonization efforts taking place in Central America.

24. **Strengthening public financial management.** The development of an action plan to strengthen budget management (*structural performance criterion*) was completed in June. It is focused on completing the development of the Integrated Financial and Administrative Management System (SIGFA) with a view to: (i) improve the service it provides and reduce its operating costs; (ii) adapt its products to planning needs and the monitoring of the budgetary position; and (iii) incorporate the various modules that allow for effective use of the system in the formulation, planning, and implementation of budget execution at its various stages. Progress has also been made in revising the Budget Classification Manual and the Chart of Accounts (*April 2008 structural benchmark*) with the aim of ensuring its adherence to the budget classification standards of the *Government Finance Statistics Manual 2001*, and it is estimated that the revision will be completed by end-September 2008. However, its actual implementation will have to be delayed until SIGFA's new technological platform is operational. The coordination between MHCP and the President's Secretariat (SEPRES) has been strengthened to ensure that planning of the public investment program is consistent with budget ceilings. In addition, and with the objective of strengthening accountability, in June the National Assembly approved a Transparency Law for public enterprises. Within this new legal framework, public enterprises are obliged to submit to the Assembly information about the extent, financing and objectives of their operations. The law also establishes external audit requirements and sets out minimum public access to information.

25. **Medium-term wage policy.** A study of current wage policies and practices is being carried out with the aim of preparing a report that will include recommendations on reducing the complexity of the wage structure. This report is expected to be finalized by end-August 2008. At the same time, an IT system will be developed (Sistema de Información del Servicio Civil, SISEC) to enable the monitoring in real time of the composition of the public workforce. In this connection, various modules of the system have already been designed, including the payroll module. The system is expected to be tested in a subset of public institutions in November 2008.

26. **Strengthening the pension system.** In January 2008, the Supreme Court declared Law 539 unconstitutional. The Nicaraguan Social Security Institute (INSS) presented in August an actuarial study of the current system, conducted in collaboration with an independent firm (*June 2008 structural benchmark*). An interinstitutional commission will develop a reform proposal, which will be discussed by workers, employers, and the government, to improve the system's financial position and gradually correct the actuarial deficit.

27. **Financial system.** In November 2007, *Produzcamos* was established, a public bank that does not receive deposits from the public. The Superintendency of Banks issued a number of regulations that ensure that this bank is subject to similar prudential and supervisory standards as private commercial banks. The 2008 budget includes an initial capital transfer of C\$37 million. In future years, transfers from the government will continue to be in line with those set out in the charter of the bank.

28. **Improvement in the business climate.** The government recognizes the key importance of an improved business climate in promoting growth and reducing poverty through private investment and employment generation. In this context, the government has (i) established regular meetings with the private sector with a view to elaborating joint action plans to promote investment in key sectors such as energy, infrastructure, agriculture and livestock, fishing, forestry, tourism, and free trade zones; (ii) created service centers for small and medium-sized enterprises with the objective of facilitating access to market information and training; and (iii) initiated the creation of an interinstitutional technical committee to streamline and reduce the cost of business start-up procedures.

29. In view of the progress made under the PRGF-supported program and the commitment to implementing the remaining measures, the government requests approval of the first review of the program, as well as an augmentation of the resources provided under the PRGF. Going forward, the government will continue to consult with Fund staff on all matters relating to the policies included in the program.

Sincerely yours,

/s/
Antenor Rosales Bolaños
President
Central Bank of Nicaragua

/s/
Alberto Guevara Obregón
Minister
Ministry of Finance and Public Credit

LOI Table 1. Nicaragua: Quantitative Performance Criteria and Indicative Targets, 2007-09 1/

	2007			2008			2009					
	Jan.-Dec.			Jan.-Mar.			Jan.-Sep.					
	Prog.	Adjusted	Prel.	Prog.	Prel.	Prog.	Adjusted	Prel.	Prog.	Adjusted	Prel.	Prog.
Performance Criteria (for end-Jun. 2008 and end-Dec. 2008, indicative targets otherwise)												
1. Floor on combined public sector overall balance, after grants	-1,064	-1,180	988	-59	1,265	-1,036	-1,403	822	-392	-2,340	-342	-1,786
2. Ceiling on change in net domestic assets of the central bank 2/	-560	-451	-2,593	-179	374	-849	-409	-526	-702	416	-534	-532
						(In millions of US dollars)						
3. Floor on change in net international reserves of the central bank	60	54	202	0	-52	22	-1	-14	7	40	0	80
4. Continuous ceiling on nonconcessional external debt contracted or guaranteed by the consolidated public sector	0	0	0	0	0	0	0	0	0	0	0	0
5. Continuous ceiling on the accumulation of new external arrears of the combined public sector	0	0	0	0	0	0	0	0	0	0	0	0
Indicative targets												
1. Ceiling on central government primary expenditure 3/	24,181	24,181	22,512	6,328	5,161	13,552	13,552	12,012	19,756	29,114	14,822	32,912
2. Floor on poverty-related expenditures of the central government 4/	15,349	14,330	14,226	3,749	2,916	8,061	6,945	7,207	12,351	18,558	7,763	20,067

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

1/ Cumulative flows starting at the beginning of the calendar year. Definitions are specified in the TMU.

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

3/ Defined as the difference between expenditures and interest.

4/ Adjusted for shortfall in external financing as specified in TMU, as well as by the spending excluded from the poverty spending definition due to the reclassification of capital to current spending in 2008.

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

	Date		Type	Status	Requested
	Program	Revised Program			Waiver
Energy					
1. Introduce measures establishing criminal penalties to discourage fraud in the consumption of electricity (MEFP ¶27, TMU ¶28).	End-Dec. 2007		PC	Done. Penal code published in May 2008 and law approved by Assembly in June 2008	√
2. Preparation of a diagnostic assessment of the causes for the technical and nontechnical distribution losses, including recommendations for reducing them (MEFP ¶27, TMU ¶30).	End-Apr. 2008		SB	Done (August 2008)	
3. Publish the formula for adjusting electricity tariffs in response to changes in costs (MEFP ¶27, TMU ¶31).	End-Dec. 2007		SB	Done (December 2007)	
4. Introduce new tariff schedule to cover distributing fees as required by law (MEFP ¶27, TMU ¶32).	End-Jul. 2008		SB	Done (July 2008)	
Fiscal					
5. Approval of the 2008 budget consistent with a combined public sector deficit of 1.8 percentage point of GDP (MEFP ¶19).	End-Dec. 2007		PC	Done (February 2008)	√
6. Prepare an action plan for strengthening the public sector financial administration system (MEFP ¶28, TMU ¶29).	End-Jun. 2008		PC	Done (June 2008)	
7. Approval of the 2008 budget supplements consistent with a combined public sector deficit of 1.8 percentage point of GDP (LOI First Review ¶11)		Continuous (through end-Dec. 2008)	PC	First budget supplement approved in June 2008 consistent with program	
8. Submission to Assembly of a draft 2009 budget consistent with program objectives (LOI First Review ¶11).		End-Oct. 2008	PC		
9. Finalize the revision of the Budget Classification system and the chart of accounts (MEFP ¶28).	End-Apr. 2008	End-Sep. 2008	SB	First draft finalized. Final revision is pending.	
10. Complete the study on the actuarial status of the pension system (MEFP ¶29, TMU ¶33).	End-Jun. 2008		SB	Done (August 2008)	
11. Adopt measures to strengthen tax administration (MEFP ¶30, TMU ¶34).	End-Mar. 2008	End-Sep. 2008	SB	Fund TA mission in Mar-08; Measures in process of implementation.	
Monetary					
12. Approval of renegotiation with banks by the Central Bank Board (LOI First Review ¶16)		End-Sep. 2008	PC		
13. Complete an assessment of the financial position of the central bank and make recommendations to strengthen its finances (MEFP ¶31, TMU ¶35).	End-Jun. 2008	End-Sep. 2008	SB	Fund TA mission in Apr-08.	
14. Submission of Central Bank Board Nominees to the Assembly (LOI First Review ¶16)		Aug. 2008	PA	Done	
15. Communicate to affected banks decision to gradually apply International Reporting Standards on newly issued bonds (LOI First Review ¶16)		Aug. 2008	PA	Done	
16. Submission of action plans by affected banks to comply with prudential norms (LOI First Review ¶16)		Aug. 2008	PA	Done	
Social					
17. Initiate the bi-annual publication of the principal social indicators for the health, education, and water and sanitation sectors (MEFP ¶6).	End-Jun. 2008		SB	Done (July 2008). Publication will now be annual.	
Transparency					
18. Publication of a report on all official aid inflows with information through end-2007 (LOI First Review ¶18).		End-Aug. 2008	PA	Pending	
19. Publication of a report on all official aid inflows with information through mid-2008 (LOI First Review ¶18).		End-Oct. 2008	SB		

1/ PC= Performance criterion; SB= Structural benchmark; PA=Prior action

TECHNICAL MEMORANDUM OF UNDERSTANDING
August 28, 2008

All aspects of the Technical Memorandum of Understanding (EBS/07/103, Supplement I) issued on September 4, 2007, remain in effect, except for the revisions incorporated in the letter of intent of August 28, 2008 and those indicated below.

A. Program Targets

1. **The program targets for the quantitative performance criteria** for end-December 2008, as well as the indicative targets for end-September 2008, end-March, and end-June 2009 are set in Table 1 of the August 2008 letter of intent.

B. Adjustors

2. **The adjustors related to external financing** that were defined in paragraph 25 of the Technical Memorandum of Understanding (TMU) from September 2007 will be applied using the detailed projections of TMU Table 1.

TMU Table 1. Programmed External Financing 2008
(in millions of US\$)

	External loans	Budget support loans 1/	Project- related loans	External grants	Budget support grants	Project- related grants	Total financing	Budget support	Project- related
	(a=b+c)	(b)	(c)	(d=e+f)	(e)	(f)	(g=a+d)	(h=b+e)	(i=c+f)
Cumulative from January 2008									
Q1-08	33	0	33	29	5	24	62	5	57
Q2-08	81	0	81	97	5	92	179	5	174
Q3-08	175	10	165	211	45	166	386	55	331
Q4-08	332	40	292	322	77	245	654	117	536

1/ Excludes IMF.

3. **The indicative target for poverty-reducing spending** will be adjusted *downwards* by the cumulative amount by which external financing linked to poverty-reducing spending is *below* the programmed amounts specified in TMU Table 2. Poverty spending has been redefined as a result of the reclassification of capital spending and current spending, which led to a more consistent and adequate recording of wages and salaries as well as other operational expenditures.

TMU Table 2. Nicaragua: Central Government Poverty Spending and Financing Sources, 2007-08
(in C\$ millions)

	2007		2008			
	Jan.-Dec. Prog.	Prel.	Jan.-Jun. Prog.	Prel.	Jan.-Sep. Prog.	Jan.-Dec. Prog.
Poverty Spending	15,349	14,226	8,061	7,207	12,351	18,558
Domestic Financing	7,570	7,467	3,867	4,129	6,223	8,740
External Financing	7,779	6,760	4,194	3,078	6,128	9,818
Grants	2,440	2,500	946	1,248	1,864	3,214
Loans	3,140	2,030	2,138	743	2,432	3,800
Debt Relief	2,199	2,230	1,110	1,087	1,832	2,804

Source: Ministry of Finance and Public Credit.

4. **The adjustor associated with the external loans to the CPS as a result of the ALBA cooperation (see ¶26 of Technical Memorandum of Understanding from September 2007) will also apply to concessional financing from any resident private entity that may channel these resources.** In 2008, the target for the overall balance of the CPS after grants will be adjusted *downwards* up to a maximum total of US\$120 million from concessional loans associated with the ALBA cooperation less the loans from this cooperation directed to public entities not included in the program's definition of the CPS. The government will make sure that the use of the resources from the ALBA cooperation will be consistent with macroeconomic stability. To this extent, once the first US\$60 million are used, the government will perform an assessment before utilizing the rest of the resources from this cooperation.

C. Reporting and Monitoring

5. **Report on the external official cooperation flows to Nicaragua.** The Central Bank and the Ministry of Finance and Public Credit will publish periodically (every semester) a report based on available information of the amounts and sources of this cooperation. In particular, the report will present the following table (see TMU Tables 3a and 3b). Publishing this report with information for the first semester of 2008 is a new structural benchmark for end-October 2008.

6. **Official financing is defined as** that provided by multilateral and bilateral institutions and entities; in particular, bilateral financing includes that provided by governments, public institutions, public entities and state banks.

TMU Table 3a. External Official Flows (in millions of US\$)

	Multilaterals							Total
	IDB	WB	CABEI	IMF	European Union	Alba 1/	Other	
a. Grants								
Public Sector								
Project-related								
Budget Support								
Private Sector 2/								
b. Loans								
Public Sector								
Project-related								
Budget Support								
Private Sector 2/								
c. Foreign Direct Investment 2/								
Total Multilaterals (a+b+c)								

1/ Includes flows related to ALBA institutions such as Fondo ALBA, Fondo PDVSA, and Banco ALBA.

2/ Defined as all resident private entities in Nicaragua.

TMU Table 3b. External Official Flows (in millions of US\$)

	Bilaterals										Total
	Canada	Denmark	Finland	Germany	Japan	Netherlands	Spain	United States 1/	Venezuela	Other 2/	
a. Grants											
Public Sector											
Project-related											
Budget Support											
Private Sector 3/											
b. Loans											
Public Sector											
Project-related											
Budget Support											
Private Sector 3/											
c. Foreign Direct Investment 3/											
Total Bilaterals (a+b+c)											

1/ Includes the Millennium Challenge Account.

2/ Includes Belgium, South Korea, Italy, Luxemburg, Norway, U.K., Sweden, and Switzerland.

3/ Defined as all resident private entities in Nicaragua.

7. **Monitoring of private external debt.** The Central Bank will finalize the private external debt survey for 2006 before August 2008. It will obtain preliminary results before December 2008. The results will be published in the first quarter of 2009.

D. Safeguards Assessments

8. The Central Bank has been working to implement the recommendations of the assessment completed in November, 2007 and has established an agenda for additional measures that will be taken in 2008 (see TMU Table 4).

TMU Table 4. Safeguards Implementation of Recommendations Timetable, 2008

Measure	Date	Status
1. Introduction of periodic internal audits in the area of international reserves operations.	Jul-08	Done
2. Presentation of semi-annual status reports on the implementation of International Financial Reporting Standards (IFRS).	Sep-08	
3. Publication of audited financial statements and auditor's opinion for 2006	Nov-08	
4. Completion of the audit of the financial statements of 2007.	Dec-08	
5. Publication of the audited financial statements for 2006 and 2007 including key differences from IFRS and their quantification	Dec-08	