FOR AGENDA

EBS/08/101
Correction 1

October 8, 2008

To: Members of the Executive Board

From: The 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**

The attached corrections to EBS/08/101 (8/28/08) have been provided by the staff:

Mischaracterizations of the Views of the Authorities

Page 10, footnote 4, line 4: "The authorities agreed to discuss measures to address these budget rigidities following the municipal elections." removed

Page 11, line 3: "independent" removed

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 8, para 4, line 2: "(CENIs)" removed

Page 8, para 4, lines 5 and 10, Page 13, para 12, lines 6 and 9, Page 14, para 15, line 1: for "CENI(s)" read "bank bonds"

Page 9, text table "Nicaragua: Key…Indicators" line 5: for "19.5" read "18.1"

Page 13, para 13, line 8: "(structural PC)" removed

Page 13, footnote 7, line 3: for "where only banks participate" read "where private financial institutions participate"

Page 15, Box 3, line 6: clarify that "bonos bancarios" are "bank bonds"

Page 16, para 17, line 4: for "19" read "20½"

Page 16, para 17, line 4: for "12" read "about 14½"

Page 19, footnote 12, line 2: for "8-10 percent" read "6 percent"

Page 19, footnote 12, line 2: for "tariffs" read "tariffs for the bulk of residential consumers"

Page 19, footnote 12, line 3: for "US$3 million per month (0.2 percent of GDP)" read "0.1 percent of GDP"

Page 20, para 22, line 5: "in line with IFRS" removed

Typographical Errors

Page 20, para 21, line 1: for "Work is progressing technical assistance a much-needed reform of the pension system" read "Work is progressing on a much-needed reform of the pension system"

Page 29, Figure 1, chart 3: for "Federal government" read "Central government"

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

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- *The current account has widened, though international reserves have risen* (Panel 3). The external current account deficit jumped to 18.3 percent of GDP in 2007, from 13.6 percent of GDP in 2006, reflecting largely higher oil prices and a pickup in imports of capital and intermediate goods, which were partly offset by an increase in commodity and nontraditional exports.[1] The deficit was financed mainly through FDI, official aid from nontraditional sources, and likely some repatriation of assets following outflows related to election uncertainties in late 2006. Gross international reserves now exceed US$1.1 billion (3.4 months of imports, excluding maquilas) and net international reserve (NIR) accumulation since 2007 is over US$100 million above the program target.

- *Credit conditions have been tightened, and the financial system remains sound* (Panel 4). The large increase in NIR in 2007 was largely sterilized through a buildup in government deposits, and the ceiling on net domestic assets (NDA) was met with a large margin. More recently, the central bank raised interest rates to absorb part of the seasonal decline in money demand and the liquidity injection associated with maturing government debt through open-market operations (OMOs). Banks remain very liquid, despite buoyant—though slowing—private credit growth. Prudential norms were recently strengthened to curb consumer lending and contain the slight deterioration in asset quality.

- *Fiscal performance has been stronger than expected*. Fiscal outcomes for 2007 were much stronger than programmed, as the consolidated public sector posted an overall surplus of 0.9 percent of GDP in 2007, compared with a deficit of 1 percent of GDP under the program. This overperformance mainly reflected delays in the execution of investment spending. For 2008, the fiscal targets are expected to remain in line with those agreed under the original program; preliminary information through end-June suggests continued underexecution of investment spending, though there are signs of sluggish revenue performance, particularly of domestic VAT and excises on petroleum products (which are indexed to the exchange rate).[2]

3. **Performance under the PRGF-supported program has been broadly satisfactory.**

- *All quantitative performance criteria (PCs) through end-2007 were met with large margins (Table 1).* Available data through end-June indicate that most quantitative PCs were also met, except for NIR accumulation, which came in US$14 million below program (a waiver will be requested at the time of the second review). However, the larger-than-programmed accumulation during 2007 (by about US$150 million) more than compensated the small deviation observed in 2008.

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[1] While Nicaragua is a net food exporter (9½ percent of GDP in 2007) it imports the equivalent of 3½ percent of GDP of its key staples rice, vegetable oil, and wheat.

[2] The under execution of infrastructure spending mainly reflected: (i) delays in the approval of the 2008 budget, and certain foreign-financed projects; (ii) difficulties in granting contracts on construction projects, resulting from post-auction increases in construction costs; and (iii) restrictions on equipment spending.

- *The structural reform agenda has been implemented, albeit with some delays (Table 2):* (i) a budget for 2008 consistent with the program was approved in mid-February (*December 2007 structural PC*); (ii) electricity tariffs have been raised to better reflect costs, and legislation criminalizing electricity theft was approved in early June (*December 2007 structural PC*); and (iii) an action plan to revamp public financial management practices was finished in a timely manner (*June 2008 structural PC*). Waivers are being requested for the first two as they reflect delays in their approval by the Assembly, where the administration does not hold a majority.

4. **Completion of the review was delayed following the suspension of debt service on public bonds (*bank bonds*) ~~(*CENIs*)~~with potentially significant implications for financial stability.** An investigation by the Attorney General into alleged improprieties in the handling of the 2000-01 banking crisis led the courts in April to order the suspension of public debt service on ~~*CENIs*~~ *bank bonds* held by two major banks. These two banks risked becoming severely undercapitalized as questions were being raised on the legality of these bonds. Against this background, negotiations between the banks and the central bank resumed in May and restructuring agreements were reached in June/July. Subsequently, the courts lifted the sequestering order and banks recently executed the agreed bond swap. However, the main bank holding ~~*CENIs*~~ *bank bonds* was downgraded marginally by a credit rating agency. The central bank board has been without quorum since May, however, following the resignation of three out of six board members over the handling of this issue, impeding board approval of the restructurings and complicating monetary policy management more generally.

III. Policy Discussions

A. The Macroeconomic Outlook for 2008

5. **Growth has been revised downward, inflation is now expected to reach double digits, and the external current account is projected to widen further, reflecting a more complicated external environment.**

- Given Nicaragua's high oil dependency and strong links with the U.S. economy (mainly through exports and remittances), real GDP growth is now projected at 3–4 percent in 2008 (compared with a program projection of 4.7 percent).[3] Increased agricultural production and higher external aid are expected to partially offset the negative external shocks.

- Inflation is expected in the 15–17 percent range by year-end, 10 percentage points higher than programmed, assuming prudent policies are maintained, particularly on wages.

- The external current account deficit is projected to widen to about 25.7 percent of GDP in 2008, though a strong capital account—reflecting increased official aid, particularly from non-traditional sources—should allow further reserve accumulation. The current account widening reflects mainly: (i) increased intermediate and capital imports (e.g.,

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[3] Staff estimates that a one-percentage point decline in U.S. growth below trend is associated with roughly a one-percentage point decline in the cyclical component of Nicaragua's growth.

fertilizers, agricultural machinery, power plants) resulting from FDI and external assistance; (ii) higher oil imports, owing to higher prices as well as the expansion of public transport and electricity subsidies; and (iii) the envisaged fiscal expansion. The private sector is expected to continue to absorb the bulk of the commodity price shock, as fuel and food prices remain largely unregulated in Nicaragua and electricity tariffs are projected to rise with costs for the bulk of consumers.

Nicaragua: Key Macroeconomic Indicators

	2005	2006	2007 Prog.	2007 Prel.	2008 Prog.	2008 Proj.
Real GDP growth	4.3	3.7	4.2	3.8	4.7	3-4
CPI Inflation (percent change, eop)	9.6	9.5	7.3	16.9	7.0	15-17
CPI Inflation (percent change, average)	9.6	9.1	8.2	11.1	7.3	18.1
External current account balance (in percent of GDP)	-14.9	-13.6	-15.8	-18.3	-16.3	-25.7
According to 5th Manual 1/	*...*	*-12.3*	*...*	*-16.7*	*...*	*-21.9*
Gross International Reserves (US$ million)	730	924	925	1,103	1,043	1,230
in months of imports of goods (excl. Maquilas)	3.1	3.4	3.1	3.4	3.2	3.0
Net international reserves (US$ million, adjusted)	282	535	595	737	665	797
Oil price (US$ per bbl, period average)	53.4	64.3	63.8	71.1	68.8	117.0
Food price index (2004=100, eop)	99.6	113.2	…	140.8	…	147.5

Source: Nicaraguan authorities and staff estimates.
1/ Includes official grants and transfers above the line.

B. Fiscal Policy

6. **The 2008 fiscal program remains appropriate, though budget execution ahead of the elections will have to be closely monitored.** The temporary fiscal expansion envisaged in the program for 2008, financed mainly through concessional assistance, remains appropriate given Nicaragua's social and infrastructure needs and relatively subdued domestic demand pressures. The budget approved in February was consistent with a much lower combined public sector deficit (0.9 percent of GDP compared with a program target of 1.8 percent), with the understanding that budget supplements would be prepared with the availability of financing to allow for increased spending. A supplementary budget was approved in June, with higher external support and savings derived from the restructuring of the bank bonds to finance higher wages, electricity subsidies, and increased social transfers. A second supplementary budget, in line with the agreed deficit target (*continuous structural PC through end-December 2008*) is expected in late 2008 to allocate the revenue overperformance. Staff welcomed the fiscal overperformance, but warned that care should be exercised in the

Operations of the Combined Public Sector, 2007-08
(in percent of GDP)

	2007 Prog.	2007 Prel.	2008 Prog. 1/	2008 Proj.
CPS overall balance	-1.0	0.9	-1.8	-1.8
Primary balance	0.8	2.4	-0.1	0.0
Total interest	1.8	1.5	1.7	1.8
a. Central government	-0.9	0.4	-1.2	-1.3
Revenue	19.6	19.5	19.7	18.5
Expenditure 1/	24.7	22.8	25.1	23.9
Current	15.7	15.7	17.1	16.7
of which: interest	1.6	1.5	1.4	1.3
Capital and net lending	9.0	7.1	8.0	7.3
Grants	4.2	3.7	4.2	4.1
b. INSS and Managua Municipality	1.5	1.7	1.5	1.7
c. Public enterprises	-1.2	-0.9	-1.5	-1.3
d. Central bank	-0.4	-0.3	-0.6	-0.9

1/ Adjusted to reflect reclassification of capital to current spending.

execution of the budget during the remainder of the year, particularly in light of election-related spending pressures, high inflation and uncertainties related to aid inflows (¶17).

7. **The 2009 fiscal program envisages a slower pace of consolidation to help protect vulnerable groups from the commodity price shock.** The 2009 consolidated fiscal deficit is now targeted at 1.2 percent of GDP, slightly higher than the 1 percent of GDP in the original program, to accommodate partially the impact of higher fuel prices on public spending. In particular, the government plans to maintain subsidized tariff rates for urban transport, as well as make room for the Assembly-approved 5-year extension of the subsidy to small electricity consumers, and the preferential VAT rate for medium-sized electricity consumers. In light of the strong fiscal performance thus far and the importance of protecting the poor, staff accepted the proposed higher deficit target for 2009, while stressing the need to avoid further increases to preserve debt sustainability.

8. **Concerns have arisen, however, over the implications of higher subsidies for long-term fiscal sustainability (Box 2).** Public transport and electricity subsidies have been expanded to partly shield households from rising fuel costs. In the case of public transport, subsidies have been extended to include taxis and inter-urban transport and scaled up to maintain urban transport fares unchanged. Preliminary estimates suggest that transport subsides could reach 1.2 percent of GDP in 2008, albeit largely off-budget, compared to a budget transfers of 0.1 percent in 2007. Moreover, slippages in the adjustment of electricity tariffs during 2007 increased arrears to the sector by roughly 0.4 percent of GDP, and similar costs are expected for 2008, despite recent tariff increases (¶18). The authorities explained that the bulk of these subsidies would be financed through a grant provided by Venezuela under the oil-collaboration scheme, thus not affecting public finances.[4] Staff underscored the risk that the government may be forced to maintain these subsidies even in the absence of financing, and encouraged the authorities to gradually dismantle them, particularly as commodity prices soften.

9. **Social programs should be strengthened and carefully assessed to ensure their effectiveness**. Given the impact of food price inflation on the poor, social safety nets should be strengthened within the existing budgetary envelope, while care should be taken to limit direct food-price subsidies. In line with World Bank advice, staff recommended the expansion of school lunch and nutritional programs with a particular focus on infants and pregnant or breast-feeding women, and that consideration be given to relaunching the conditional cash transfer program (*Red de Protection Social*). Staff argued that the government's flagship program *Hambre Cero* had a rural focus and that greater emphasis was required to protect the urban and extreme poor, including by bolstering *Usura Cero* (its other flagship program which provides cheap credit primarily to female heads of households). The authorities countered that recent poverty-reduction efforts had resulted in

[4] In the case of public transport, the Venezuela grant is off-budget since it is channeled directly to the transport cooperative. Some observers argue that this mechanism seeks to circumvent the system of earmarked transfers. Currently, 10 percent of total expenditures must be assigned to the Assembly and Judiciary, while 8 percent of total revenues is shared with municipalities. ~~The authorities agreed to discuss measures to address these budget rigidities following the municipal elections~~.

improvements in access to education, health care and water and sanitation, as summarized in the draft National Development Plan and the recently-published social indicators report (*June 2008 structural benchmark*). The government agreed to conduct an ~~independent~~ impact assessment of its flagship programs, the precise timing of which would be discussed during the second review.

10. **Further efforts to contain wage increases are needed to avoid fueling a wage-price spiral.** Staff commended the authorities for ensuring approval of a 2008 supplementary budget consistent with an average increase in public sector wages of 14 percent, while recognizing the importance of compensating lags in the adjustment of real wages for certain priority sectors. However, further efforts are necessary to contain the legally-mandated minimum wage hikes resulting from the tripartite negotiations (involving the government, employers and workers) that were initiated in July.[5] Staff argued that while minimum wages were currently binding for a small share of formal sector employees only, these increases could affect wage-setting more generally (particularly in the current inflationary environment) and lead to a wage-price spiral, increased unemployment and loss in competitiveness. The authorities concurred with staff, but noted that links between minimum wage increases and inflation have historically been very weak.

Nicaragua- Public Sector Wages

		2008	
	2007	Prog.	Proj.
Wage bill			
in C$ millions	7,693	8,741	9,078
in percent of GDP	7.3	7.4	7.1
nominal percent change	14.7	13.6	18.0
Wages 1/			
nominal percent change	14.0	10.2	14.0
of which:			
Education sector	17.6	12.6	16.0
Health sector	18.6	12.6	16.0
Other	8.6	6.7	13.4
real percent change	5.8	2.9	-5.5

Source: Nicaraguan authorities and staff estimates.

1/ Excludes effect of new hires and one-off salaries of elections.

11. **Recent measures to boost food production, alleviate supply-side constraints, and reduce tariffs may help to lower inflation over the medium term**. The government is implementing a number of initiatives to increase agricultural production, particularly by small farmers, through improved access to seeds, fertilizers, agricultural machinery, and financing. Moreover, the role of the state-owned food marketing board (ENABAS) in preventing large food price fluctuations is being revamped, while import tariffs have been temporarily lowered on key staples (such as beans, wheat flour and vegetable oil) with a negligible fiscal impact. Staff agreed on the need to boost food production but stressed the importance of managing the financing channeled to the agricultural sector transparently (¶17) while preserving the role of private microfinance institutions. Moreover, staff warned against actively managing domestic market conditions through ENABAS and policies to restrict exports. The authorities agreed to maintain open trade policies and to address supply-side constraints in a market-friendly fashion within the existing budgetary envelope.

[5] In June 2007, the Assembly approved a new minimum wage law that requires bi-annual adjustments in the minimum wage with a floor on wage increases equivalent to accumulated inflation plus real GDP growth. Minimum wages have been raised by an average of 33 percent since June 2007, far above the floor established in the law.

BOX 2. TRANSPORT, ELECTRICITY, AND WATER SUBSIDIES

Transport Subsidies

- **Budget transfers:** Until recently, transport subsidies were limited to urban bus transport in Managua and financed through central government transfers (0.1 percent of GDP in 2007). This subsidy bridged the gap between the regulated bus tariff (currently set at C$2.5 per passenger) and the cost-based tariff, calculated by the transport regulator using a formula with detailed cost and traffic data. The central government transfers resources to the transport regulator, who in turns compensates the urban bus cooperative.

- **Expansion of urban bus transport subsidies:** In 2007, Venezuela (through its local PDVSA Trust Fund) began providing a direct grant to the urban bus cooperative, to finance increased subsides arising from higher diesel prices. The grant stabilizes the diesel prices paid at the pump (at about US$2 per gallon), allowing the government to maintain the bus tariff at C$2.5. In turn, the PDVSA Trust reimburses pump operators for the difference between the market and reduced price for diesel. Budgetary and off-budget transfers to the bus cooperative reached 0.3 percent of GDP in 2007.

Transport, Electricity and Water Subsidies
(in percent of GDP)

	2007 Prel.	2008 Proj.
Transport subsidies	**0.3**	**1.2**
a. Budget transfers	0.1	0.1
b. Venezuela grant	0.2	1.1
Managua bus	0.2	0.3
Taxis	0.0	0.3
Inter-urban	0.0	0.3
Other	0.0	0.1
Electricity subsidies	**1.0**	**0.9**
a. Budget transfers	0.4	0.4
b. VAT preferential rate	0.2	0.2
c. Tariff slippages 1/	0.4	0.3
Water subsidies	**0.4**	**0.4**

Source: Authorities and staff estimates

1/ Reflects cost of tariff slippages and delays in raising distribution fees. In 2008, the government transferred US$20 million (0.4% of GDP) to compensate for slippages in 2007.

- **Extension of subsidy:** In May 2008, transport subsidies were extended to other forms of transport, without direct fiscal cost. A specific subsidy equivalent to US$1.3 per gallon of diesel (relative to the current market of about US$4.8 per gallon) is now provided to licensed taxis, urban bus transport outside Managua, inter-urban buses, and lake-crossing ferries. A maximum daily consumption quota has been established by transport type, and electronic cards are gradually being distributed among public transport providers in an effort to reduce leakages. The subsidy is financed through a direct grant from the PDVSA Trust to the transport cooperatives. Currently about 15–20 percent of fuel consumed domestically is subsidized, costing roughly 1.2 percent of GDP.

Electricity subsidies

- **Targeted subsidies** reached about 0.4 percent of GDP in 2007, reflecting assistance to: (i) households consuming under 150 kWh (costing US$12–15 million); (ii) households living in low-income neighborhoods or *asentamientos* (US$8–10 million); and (iii) retirees who receive a 50 percent discount on the first 150kWh of consumption (US$1–2 million). Furthermore, the recently-introduced **preferential VAT rate** (of 7 percent compared to the standard 15 percent) on medium-sized consumers (300–1000kwh) cost an additional US$10 million. In August 2008, the Assembly approved a 5-year extension to the subsidy for small consumers (representing about 20 percent of total consumption) and to the preferential VAT rate on medium-sized consumers.

- **Slippages in tariff adjustments** during 2007 was associated with an increase in arrears to the sector of roughly US$25 million and similar costs are expected in 2008. The 2008 budget supplement included transfers of US$20 million to clear half the stock of arrears accumulated through end-2007.

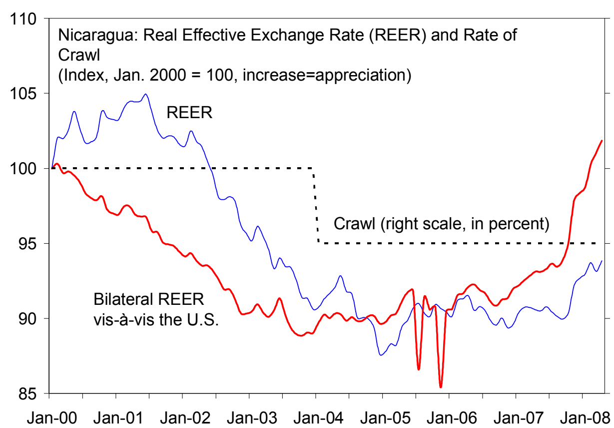
Water and sewer subsidies. Central government-financed water subsidies were limited to 0.4 percent of GDP in 2007, targeted to: (i) households who consume under $50m^3$ (about US$14 million); (ii) households living in *asentamientos* (about US$7.5 million); and (iii) retirees who receive a 30 percent discount on their water bills (about US$0.6 million).

C. Monetary and Exchange Rate Policies

12. **Monetary policy will aim to control inflation, while allowing for a further buildup in international reserves (Panel 4).** The monetary program for 2008 is consistent with a growth in monetary aggregates roughly in line with nominal GDP but a somewhat lower than originally programmed buildup in international reserves.[6] The central bank (BCN) has been aiming to tighten bank liquidity conditions through open-market operations (OMOs), although the suspension of debt service on the ~~*CENIs*~~ *bank bond*~~(s)~~ limited the BCN's ability to place debt with banks despite interest rate hikes (400 basis points in since the start of the year) and transmission of these increases to bank interest rates has been limited. The authorities expect that this situation will be reversed with the completion of the ~~*CENI*~~ *bank bond*~~(s)~~ restructuring agreements, and pointed out that increased demand from public sector institutions has helped to sterilize liquidity and more than compensated for shortfalls in private sector placements.[7] Moreover, steps have been taken toward developing a longer-term treasury bill market, better suited for investments by the public pension system.[8]

13. **It will be critical to restore the institutional framework of monetary policy by establishing quickly a new central bank board.** While the absence of a board has thus far not directly impaired the BCN's ability to conduct OMOs (as debt issuance is still US$100 million below the annual ceiling of about US$400 million approved in late 2007), any decision to raise reserve requirements or increase the ceiling of bond issuance is subject to board approval. The President recently submitted to the Assembly his nominations to fill central bank board vacancies (*prior action*) and agreed to seek their ratification by end-September ~~(*structural PC*)~~, noting that building a majority in the Assembly would require some time.

14. **The exchange rate regime remains adequate and competitiveness does not appear to have been impaired by the recent surge in inflation (Panel 5).** While the REER has risen in recent months, real appreciation has been small in comparison with other countries in the region. Moreover, real wages have fallen over this period and manufacturing exports remain buoyant, suggesting that the *cordoba* is not overvalued–as also indicated by relative productivity levels.



[6] While the agreed monetary program is consistent with a NIR accumulation of US$60 million, a program floor of US$40 million was established, given transitory factors associated with last year's large overperformance.

[7] In recent months, the Social Security Institute has been investing its surplus in BCN paper through the noncompetitive window, while reducing its deposits in commercial banks. The rate in the noncompetitive window is referenced to that in the competitive auction, where ~~only banks participate~~ private financial institutions participate.

[8] The Ministry of Finance has issued US$18 million in treasury bills (with maturity of up to 3 years) through end-May out of projected total of US$45 million in 2008.

Staff advised against reducing the rate of crawl, and given Nicaragua's exposure to large terms of trade shocks, it suggested that a move toward increased flexibility would seem more desirable over the medium term.[9] Staff expressed concern about increased vulnerabilities (growing current account deficit and dependency on official aid inflows, as well as rising dollarization) and stressed the need to maintain prudent policies.

D. Financial Sector Policies

15. **A durable solution to the ~~*CENIs*~~ *bank bond*~~*(s)*~~ controversy is critical to safeguard the stability of the banking system (Box 3).** Staff expressed concern over the uncertainties generated by the handling of the bank bonds and urged the authorities to provide a sound legal basis to the restructuring agreements by ensuring their approval by the BCN board as soon as the new members were ratified. It will be critical for the central bank to resume debt-service obligations to banks according to the newly agreed terms, on the basis of budgetary transfers provided by the government. Given the impact of the restructuring on the banks' financial position, the Superintendency of Banks (SIBOIF) must enforce banks' compliance with prudential norms and recently-introduced international accounting standards over a reasonable period of time. In that regard, the following strategy has been agreed:

- Banks recently submitted action plans including measures to achieve compliance with local prudential norms dealing with market risks (*prior action*). The SIBOIF is currently evaluating these plans to ensure that banks remain well-capitalized and that any mismatches (in maturity, interest rates and currency denominations) arising from the restructuring are resolved within a reasonable period of time.
- To avoid an immediate impairment in the banks' capital position, the SIBOIF informed banks of its intention to waive the requirement (established in the new chart of accounts that came into effect in January 2008) to apply NPV accounting standards to the restructured bonds (*prior action*). Staff underscored that any forbearance must be implemented transparently and granted for a limited time period only. In this regard, the SIBOF agreed to discuss during the second review a calendar for phasing out this forbearance, while coordinating this decision closely with the Panamanian supervisor, since the banks' holding companies will be subject to similar accounting standards.

16. **The newly-adopted prudential and accounting frameworks should be enforced, in line with regional coordination and harmonization efforts**. Staff emphasized the importance of limiting forbearance to the newly restructured bonds and ensuring implementation of the new chart of accounts, including key internationally accepted accounting standards. The authorities argued that banks may need some time to comply with these new accounting standards (e.g., the valuation of restructured assets) and that consideration was also being given to revising prudential norms for market risks to better reflect local conditions. Moving away from the already adopted international regulatory and accounting standards would hinder regional harmonization efforts and complicate effective supervision of cross border conglomerates.

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[9] The official exchange rate of the Córdoba against the U.S. dollar is preannounced by the BCN and depreciates by 5 percent a year.

BOX 3. THE CENIS CONTROVERSY–BACKGROUND AND RECENT RESTRUCTURINGS

Background: During the 2000–01 banking crisis, the central bank issued roughly US$400 million (about 10 percent of GDP) in bonds (*Certificados Negociables de Inversion,* CENIs) to cover the difference between performing assets and liabilities of insolvent banks that were intervened and absorbed by other private banks. The CENIs were indexed to the U.S. dollar, had maturities of up to 3 years, and carried market interest rates of roughly 14½ percent. In 2003, banks holding CENIs agreed to provide debt-service relief to the government by accepting new bank bonds (*bonos bancarios*) of 10-year maturity, semi-annual principal payments, and lower interest rates of 8¼ percent. This restructuring was approved by the central bank board, and subsequent annual central government budgets have included transfers to the central bank to cover debt-service obligations. These *bonos bancarios* were held by two large privately-owned local banks, which together account for close to 60 percent of total banking system deposits, and represent an important share of their capital and assets.

Bonos Bancarios and Selected Financial Indicators

	Total
(in percent, at end-March 2008)	
Bonos bancarios / Regulatory capital	122.0
Bonos bancarios / Risk-weighted assets	16.4
Total public sector debt / Risk-weighted assets 1/	32.9
Memorandum items	
Regulatory capital to risk-weighted assets	13.5
Liquid assets to total assets 2/	19.2
Return on Equity 2/	21.8
Assets (in percent of total banking system)	44.1
Deposits (in percent of total banking system)	54.7

Source: Superintendency of Banks and Staff estimates.

1/ Includes bonos bancarios and Property Indemenization Bonds (BPIs) at end-2007.

2/ Based on simple average of banks.

Legal challenges: These bonds have long been mired in controversy. In 2005, the Comptroller General questioned the authority of the central bank to issue and restructure these bonds, and in late 2007 the Attorney General (AG) initiated an investigation on the adequacy of the amounts of CENIs issued in 2000–01 and the subsequent restructuring of 2003. In April 2008, responding to the AG's investigation, the courts temporarily sequestered the bonds falling due in 2008, halting debt service payments to banks. In July, the AG levied criminal charges against 39 individuals, mainly former public officials, for improprieties in resolving the banking crisis, including allegedly overcompensating private banks and failing to conduct proper audits and competitive public auctions.

The 2008 restructurings: In light of legal challenges, in June/July the banks again agreed to the central bank's request to replace the outstanding bonds (US$186 million or 3½ percent of GDP) with new debt instruments at the same face value. The restructuring agreement (involving the early redemption of the *bonos bancarios* bonds and issuance of new bonds) extended the maturity to 20 years, lowered interest rates (to 5 percent for the initial 15 years and 5¼ percent for the last 5 years) and allowed banks to extend the use of these new bonds for liquidity purposes and dividend payments. In addition, a technical committee was formed to address a past-due government obligation (US$10 million) to one of the banks linked to the resolution of an intervened bank in 2000–01.

Impact of restructurings: The 2008 restructuring will impact the banks' capital levels (CAR), liquidity and market risks and compliance with prudential norms for concentration limits. Local prudential norms require banks to maintain a minimum CAR at 10 percent. New accounting rules introduced in Nicaragua in January 2008 would require any NPV loss to be reflected by discounting future debt service flows at the original interest rate. Preliminary estimates suggest that of the two banks holding *bonos bancarios* only one could suffer losses resulting in a CAR slightly under the required 10 percent.

Regional dimension: The two affected banks are subsidiaries of regional financial groups incorporated in Panama, which have a small presence in Costa Rica, Honduras, El Salvador and Guatemala. Coordination with the Panamanian supervisor and other supervisors in the region will be critical.

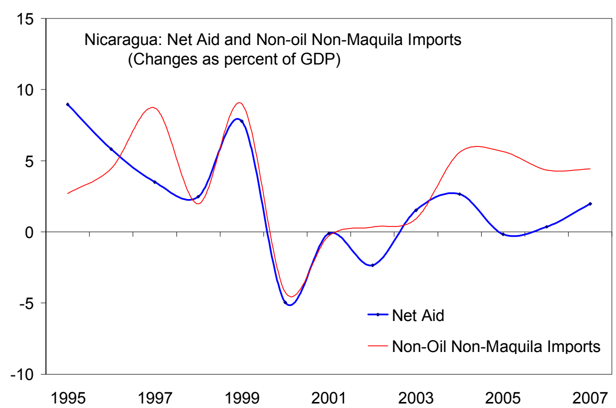
E. Aid Management and Transparency

17. **While increased aid inflows have helped Nicaragua weather the impact of rising oil prices, it will be critical to continue monitoring closely and reporting transparently all official assistance (Box 4).** Total official assistance to Nicaragua is estimated to reach ~~19~~20½ percent of GDP in 2008, from ~~12~~ about 14½ percent of GDP in 2007. Specifically, official financing from Venezuela, under the auspices of ALBA (*Alternativa Bolivariana de las Americas*), is projected to grow from 2.7 percent of GDP in 2007 to 9.4 percent in 2008. While staff analysis shows that increased aid does not appear to have serious implications for absorption capacity and external debt sustainability, the authorities agreed to monitor developments closely. Moreover, the uncertainty and mechanisms through which part of the official aid is being channeled present additional challenges.[10]

Nicaragua - Official Assistance (in percent of GDP)

	2006	2007	2008
Total Assistance	12.2	14.7	20.6
Grants	6.6	8.7	8.0
Public sector 1/	6.5	7.9	5.0
Private sector 2/	0.1	0.8	3.1
Loans	5.6	5.3	8.3
Public sector	5.6	4.5	5.7
Private sector	0.0	0.8	2.6
FDI (private sector)	0.0	0.7	4.3
Memorandum item			
ALBA-related	0.0	2.7	9.4

Source: Authorities and staff estimates
1/ Includes natural disaster grants (US$80m), yet excludes debt buy-back grant for US$58m.
2/ Includes ALBA and Millenium Challenge Account grants.



- **Absorption capacity:** Though about half of the increase in aid is associated with higher FDI (3½ percent of GDP) for electricity generation and oil storage (which should not have a direct impact on inflation), the remaining half is in the form of concessional financing and transfers to the private sector. While high rates of unemployment, slowing growth, and the high import-content of any additional spending indicate that additional aid could be absorbed comfortably, the authorities agreed to tighten policies should demand pressures emerge.

- **External sustainability (Appendix):** Given that the bulk of additional assistance is channeled through the private sector, and according to the authorities does not generate public debt (direct or contingent), staff's external debt sustainability analysis has been extended to include increased indebtedness by the private sector. Preliminary analysis suggests that although total external debt rises in the next five years, debt levels seem to be sustainable and debt-service obligations manageable (under 15 percent of exports) over the medium to long term, as most of the financing to private cooperatives is concessional.

[10] The original program's baseline projections excluded ALBA financing. However, given uncertainties, an adjustor for ALBA-related financing for the public sector was established, equivalent to 2½ percent of GDP. This adjustor remains dormant as the bulk of ALBA collaboration has been benefiting the private sector.

the year through August 2008 to reflect igher generation costs and the legally mandated increase in distribution fees (*July 2008 structural benchmark*), deviations between the actual tariff and input costs emerged reflecting the spike in oil prices. The authorities plan to compensate the costs of tariff deviations during the first eight months of 2008 (US$20 million) as well as remaining arrears at end-2007 (US$20 million) through a direct grant from Venezuela, hence not affecting the fiscal deficit. Looking forward, the authorities agreed to adjust tariffs in line with costs, explaining that recent slippages reflected unusually large increases in energy costs, which have softened significantly since.[12] Staff stressed the importance of de-politicizing tariff setting to reduce fiscal risks and enhance transparency.[13]

- **Addressing electricity theft:** The Assembly approved a law penalizing electricity theft in June (*December 2007 structural PC*) as well as amendments to the Penal Code aimed at discouraging electricity theft, including criminalizing theft for higher-end residential consumers and industry. To ensure implementation, the authorities are in the process of increasing the number of inspectors and have recently finalized a study identifying and addressing the sources of the high distribution losses (*April 2008 structural benchmark*). This study will be used to develop a plan, in collaboration with the private distribution company, for gradually reducing losses. The swift and uniform implementation of the new law remains a key challenge.

- **Improving electricity services:** The government and the private distributor signed an agreement in June aimed at improving the sector's performance and eliminating cross-arrears. This agreement, which is currently being considered by the Assembly, would result in the government acquiring a minority stake (16 percent) in the distribution company, in exchange for assuming the arrears that the distribution company has with the public generation company. Under the agreement, the government is expected to adjust tariffs in line with costs, while the distribution company is committed to a multi-year investment plan to improve service provision.

Fiscal reforms

19. **Steps have been taken to improve budgetary controls, and the focus has shifted to implementing a carefully-sequenced action plan.** An action plan to revamp public financial management (PFM) practices was finalized in June (*structural PC*) broadly in line with Fund TA recommendations. The plan includes measures to improve and update the platform used to register fiscal accounts (SIGFA) to allow for better planning, management and monitoring of the budget process in all its different stages. In addition, good progress was made in revising the chart of accounts and budget classification in line with new government accounting standards (*April 2008 structural benchmark*), though its finalization is now only expected in September and its effective implementation will have to await the installation of the new SIGFA platform. The authorities agreed to discuss a timetable for

[12] Oil prices (WTI) have fallen to US$115 per barrel from a peak of US$145 in early July 2008. At current prices, ~~for tariffs~~ tariffs for the bulk of residential consumers would need to be raised by ~~8–10~~ 6 percent to close the gap. The cost of keeping tariffs unchanged is estimated at ~~US$3 million per month 0.2 percent of GDP~~0.1 percent of GDP until the end of the year.

[13] The formula for adjusting tariffs with input costs was published in December 2007 (*structural benchmark*).

further steps in this area during the second review. Some of these steps would form part of program conditionality in 2009.

20. **Efforts to strengthen revenues must be stepped up to ensure a sustainable fiscal consolidation:**

- In the area of revenue administration, some progress has been made in adopting a plan to strengthen: (i) the taxpayer registry system, (ii) large taxpayer audits; and (iii) custom inspections and controls. However, final adoption of this plan (*March 2008 structural benchmark*) has been postponed until end-September, to take into account recent Fund TA recommendations. Staff stressed the importance of not losing momentum, as well as the need to frame these actions in the context of ongoing regional integration efforts, including the Central American Customs Union Agreement that was approved by the Assembly in December 2007.
- Technical work has progressed in the design of a tax reform aimed at improving the equity of the system through a streamlining of tax exemptions, while preserving revenue-neutrality. A proposal is expected to be ready by end-2008, and TA has been requested from the IDB.

21. **Work is progressing on a much-needed reform ~~technical assistance a much-needed reform~~ of the pension system.** An actuarial study of the pension system (*June 2008 structural benchmark*) was recently finalized, and an inter-ministerial commission has been setup to develop a reform proposal to correct the actuarial gap. The authorities plan to request Fund TA to provide options for a parametric reform, the timing and content of which will be discussed in the context of the second review. Staff stressed the need to adapt the INSS's investment norms to international best practices and prevent past practices of granting direct loans to government-friendly private firms. The Supreme Court recently declared Law 539 unconstitutional. The Law—approved in 2005, but never implemented—could have further undermined the sustainability of the pension system, as it proposed unfunded increases in entitlements, as well as reductions in the retirement age for certain workers.

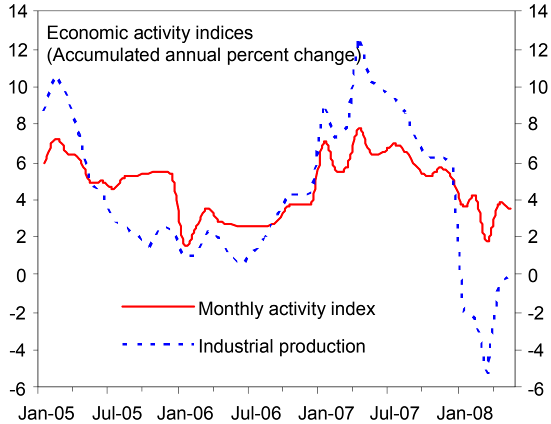
Central bank, financial sector, and governance reform

22. **Strengthening central bank finances is critical for the effective conduct of monetary policy.** A recent Fund TA mission found that the BCN's balance sheet was very large by international standards, owing to the presence of sizable external liabilities in the process of renegotiation that constantly generate revaluation losses. A comprehensive assessment of the BCN's financial position ~~in line with IFRS~~ is expected by September 2008 (*June 2008 structural benchmark*), as more time was required to reflect TA recommendations.[14] The authorities have also been implementing the recommendations of the safeguards assesment completed in November 2007, and a timetable of additional measures including for 2008 has been agreed (TMU ¶7). In particular, an external auditor has been appointed for 2006–08, and the audited financial statements for 2004/05 have been

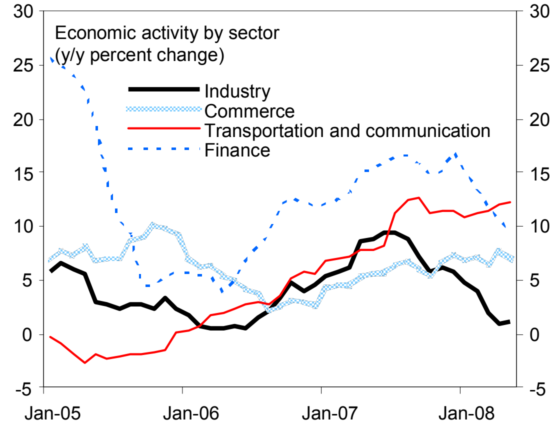
[14] Among other elements, the mission recommended that the government assume debt-service obligations on the rescheduled foreign debt in exchange for a cancellation of all BCN claims on the central government.

Figure 1. Nicaragua: Real Sector Developments

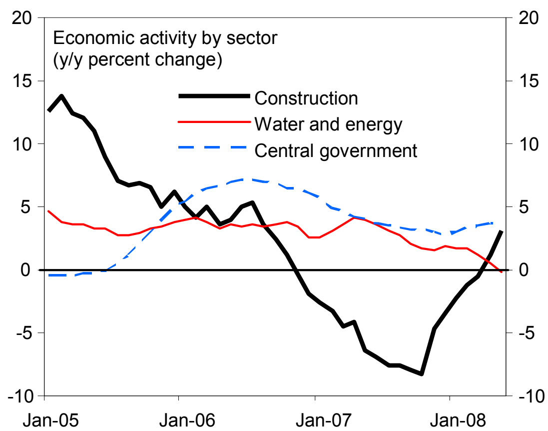
Economic activity recovered following the 2006 elections, though it has slowed in recent months.



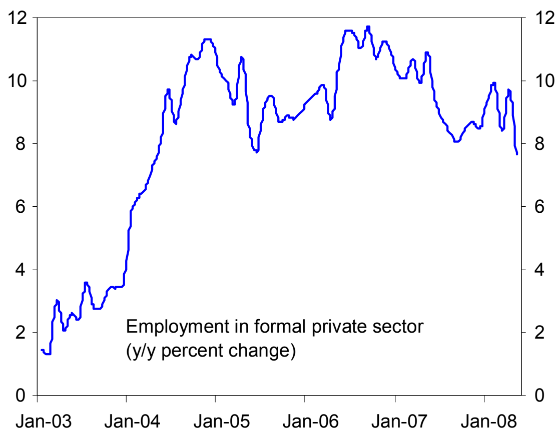
The slowdown has been most pronounced in the industry and finance sectors...



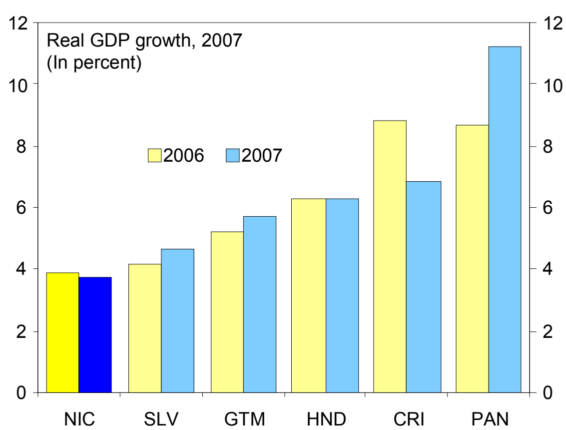
...while construction has stabilized after a sharp downturn.



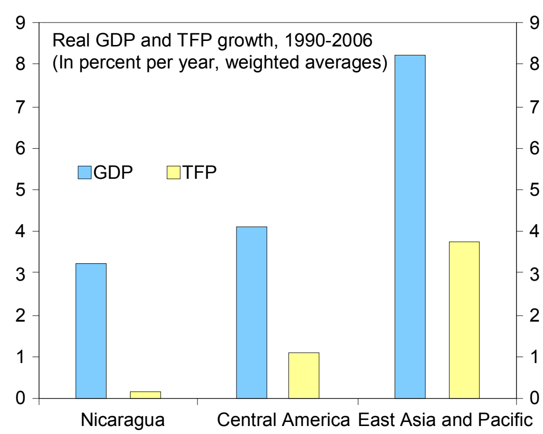
Employment continues to expand, though there are signs of some softening.



Nicaragua's growth has been lower than that of other countries in the region, reflecting low productivity increases...



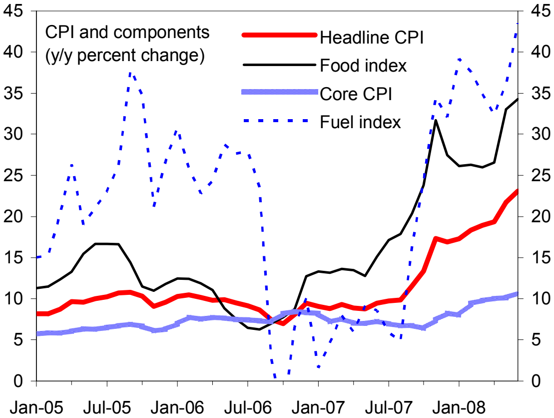
...which can be attributed to deficiencies in infrastructure and high fuel-dependency.



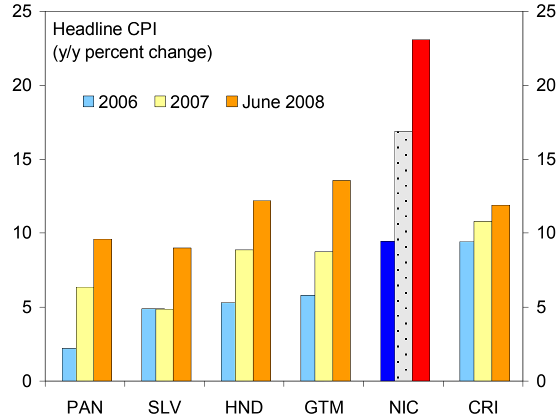
Sources: Central Bank of Nicaragua; IMF World Economic Outlook; and IMF staff calculations.

Figure 2. Nicaragua: Inflation Developments

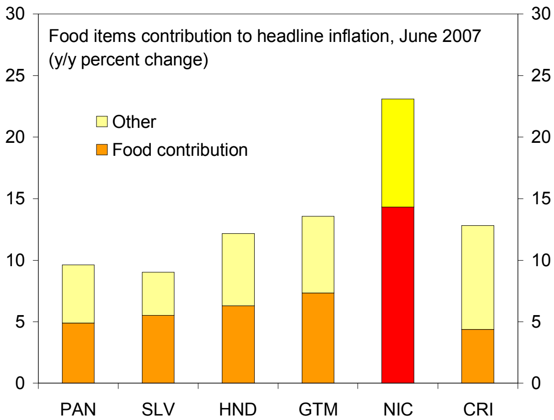
Inflation has risen, driven mainly by commodity prices, and second-round effects are starting to emerge.



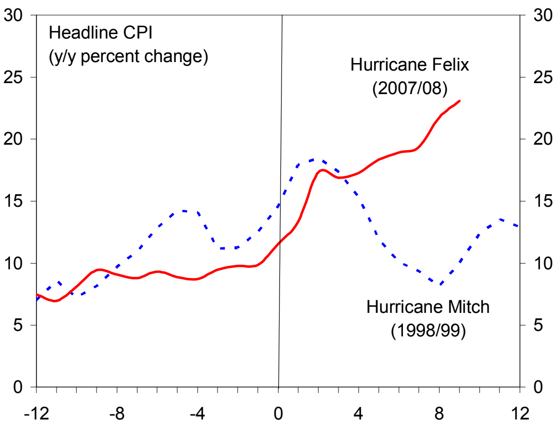
Inflation in Nicaragua is the highest in the region...



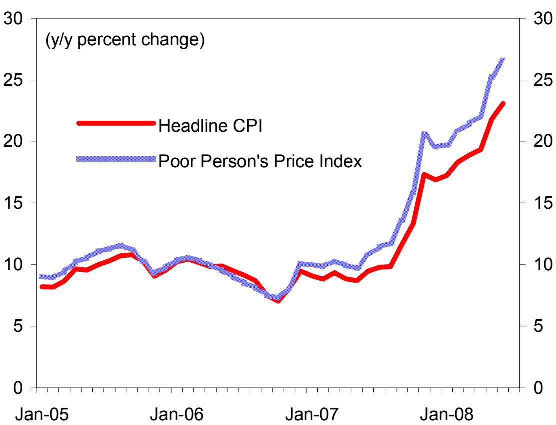
...partly reflecting the relatively high weight on food items in the consumption basket...



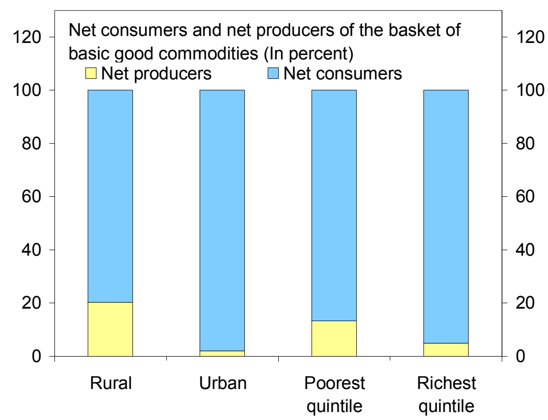
...and the impact of Hurricane Felix, that has not yet reverted.



The poor have been facing even sharper increases in the cost of their basic consumption basket...



...although some are protected from food price increases as they are net producers of food.



Sources: Central Bank of Nicaragua; World Bank; and IMF staff calculations.