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Minutes of Executive Board Meeting 20/19-4

02:30 p.m., February 21, 2020

4. Nicaragua—2019 Article IV Consultation

Documents: SM/20/36, and Sup. 1, and Sup. 2, and Sup. 3

Staff: Garcia-Saltos, WHD; Gonzalez, SPR

Length: 57 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	**Alternate Executive Directors**
	I. Mannathoko (AE)
	M. Bangrim Kibassim (AF), Temporary
	C. Moreno (AG), Temporary
	C. White (AP)
A. Bevilaqua (BR)	
	Y. Liu (CC), Temporary
	A. Guerra (CE)
	J. Weil (CO), Temporary
	S. Benk (EC)
	P. Rozan (FF)
R. von Kleist (GR)	
	Y. Indraratna (IN)
	A. Korinthios (IT), Temporary
	K. Chikada (JA)
	C. Sassanpour (MD), Temporary
	P. Al-Riffai (MI), Temporary
	V. Rashkovan (NE)
	J. Sigurgeirsson (NO)
A. Mozhin (RU)	
	R. Alkhareif (SA)
	R. Pandit (ST), Temporary
	P. Trabinski (SZ)
	T. Chrimes (UK), Temporary
	P. Pollard (US), Temporary

H. Al-Atrash, Acting Secretary
J. Morco, Summing Up Officer
E. Mannefred, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Legal Department: I. Rossi, J. Swanepoel. Monetary and Capital Markets Department: M. Otero Fernandez. Strategy, Policy, and Review Department: T. Asonuma, M. Gonzalez, D. Hart. World Bank Group: A. Evdokimova, P. Rodriguez. Western Hemisphere Department: F. Arze del Granado, R. Garcia-Saltos, A. Husain, S. Marcelino, M. Sans, A. Santos. Alternate Executive Director: F. Fuentes (BR), W. Nakunyada (AE), B. Saraiva

(BR). Senior Advisors to Executive Directors: B. Lischinsky (AG), C. Wehrle (SZ). Advisors to Executive Directors: M. Albert (FF), A. Arevalo Arroyo (CE), M. Coronel (BR), K. Florestal (BR), A. Maciá (BR), D. Shestakov (RU), J. Yoo (AP), Y. Zhao (CC), J. Al Saud (SA).

4. Nicaragua—2019 Article IV Consultation

Mr. Bevilaqua, Mr. Saraiva and Mr. Coronel submitted the following statement:

On behalf of our Nicaraguan authorities, we thank staff for the constructive and useful discussions during the 2019 Article IV mission, held in Managua last November. The authorities acknowledge the analytical value of the staff report, which will help guide their efforts to restore growth under challenging circumstances that arose from the socio-political unrest in the second quarter of 2018. The authorities are also grateful for the consistent cooperation through technical assistance and advice during the course of the Article IV cycle and look forward to continuing the close engagement with the Fund.

The Nicaraguan economy's impressive growth path was interrupted by a severe shock in 2018. Average growth rate between 2010-2017 reached 5.1 percent, one of the highest in Latin America. Against the background of a stable macroeconomic environment, sound policies, and accumulation of buffers, the social safety net strengthened, poverty levels receded and opportunities for social and economic mobility increased markedly. In the second quarter of 2018, Nicaragua faced an acute shock triggered by a socio-political backlash against a set of measures aimed at restoring long-term financial sustainability to the social security system. The measures taken in April 2018, which were a fiscal imperative and consistent with IMF advice, had to be reverted following protests. They were, however, reintroduced in February 2019. Real GDP contracted by 3.8 percent in 2018 and in 2019 the contraction deepened to an estimated 4½ percent.

The devastating effects of the almost 3-month socio-political unrest, which started in mid-April 2018, struck the core of the financial system and nearly halted economic activity. There were widespread roadblocks, extensive damage to public and private infrastructure, as well as job destruction and loss of confidence. Services (mostly tourism and commercial retail) and construction were hit the hardest, yet the primary sector, notably mining, fisheries, and agriculture emerged generally unscathed. As per the seasonally adjusted Monthly Economic Activity Index (IMAE), economic activity reached its trough in June 2018; it has since stabilized, albeit significantly below pre-crisis levels. As expected, tax revenues dwindled, placing an abrupt fiscal strain on the government.

The financial sector experienced a real-life stress test. An immediate consequence of the 2018 shock was the rapid outflow of bank deposits with a subsequent decline in credit, hence exposing the relatively small Nicaraguan financial system to a liquidity crunch. From March 2018—just before the shock—to June 2019, bank deposits dropped by nearly a third. Similarly, credit contracted by 9 percent and 15 percent in 2018 and 2019, respectively,

thus setting off a negative feedback loop to economic activity. Fortunately, the banking sector's pre-shock conditions were generally robust, as a result of persistently solid performances—including record profits—and ensuing accumulation of buffers throughout the decade.

The response to the shock, built on years of sound policies and accumulation of buffers, succeeded in preserving financial and economic stability. Despite the severe disruptions to the country's activities during the socio-political crisis in 2018, the authorities kept their ability to formulate and execute timely and effective economic policies. From the onset of the crisis, they have focused on preserving financial and macroeconomic stability and this has proven to be a successful strategic approach.

On the monetary and financial fronts, the authorities' firm and prompt response managed to restore financial and economic stability in a relatively short period of time and under exceptionally challenging conditions. This demonstrated not only the underlying resilience of the Nicaraguan banking sector and the overall economy, but also the authorities' firm commitment to sound macroeconomic policies under duress. While banks adjusted, drawing from their inherent strengths, the Central Bank of Nicaragua (BCN) played a decisive role to avoid a liquidity crisis.

The BCN took a series of measures to support the liquidity of the banking system. Those included the reduction of bank's reserve requirements, the introduction of repos, the increase of interest rates to reduce outflows, the provision of direct liquidity at various stages, and the activation of a precautionary liquidity line from the Central American Bank of Economic Integration (CABEI), among others. By the beginning of 2019, bank outflows had decelerated and by mid-year, deposit flows turned positive, while the increase in NPLs appeared to be contained. At that point, the financial sector had stabilized, and albeit emerging with some vulnerabilities, it had not exhausted its buffers to withstand additional adversities going forward.

The BCN also successfully fought off an aggressive speculative attack on the exchange rate, cautiously managing much needed, yet limited international reserves, while simultaneously monitoring inflation developments. By early 2019, the exchange rate stabilized, supported by BCN foreign exchange interventions that amounted to USD 920 million between May 2018 and March 2019. Gross International Reserves (GIR), which hovered around USD 3 billion just before the shock, had recovered from their post-shock low of USD 2,090 million to reach USD 2,430 million as of February 1st, 2020. This represents a coverage of 6.3 months of non-maquila imports, which falls within the range recommended by staff. Headline inflation, on the other hand, closed 2019 at 6.1 percent, higher than in the previous year, yet slightly lower than anticipated. To further anchor inflation,

in November 2019 the BCN reduced the pace of the exchange rate crawl from 5 percent to 3 percent per year.

On the fiscal front, the authorities also responded resolutely to the shock. Given the absence of external financing, the authorities were compelled to adopt a tax package to offset the abrupt fall in revenue while proceeding with a parametric reform of the social security system (INSS). Both measures became effective in February 2019 and succeeded in improving short and medium-term fiscal prospects, as preliminary data suggests. The authorities will review the impact of the tax reform on both revenue and growth, as required by law. Moreover, should financing conditions ease, they stand ready to shift policy towards a more accommodative stance, albeit in a cautious way to avert threatening fiscal sustainability.

During the response to the shock, the authorities have maintained fiscal discipline by curtailing expenditures—including freezing wages through 2019—and streamlining energy subsidies, while safeguarding the social safety net and preserving much-needed investment. In fact, public spending has continued to support unprecedented improvements in health, education, road infrastructure, and access to water and electricity. For instance, access to electricity has reached 92 percent of the population (from 56 percent in 2006, the lowest in the CAPDR region) and its geographical coverage is now at 97 percent. Moreover, education enrollment this year (2020) is at a historic high.

While our authorities concur with staff that growth potential will be slower than in the recent past, they are more optimistic regarding the outlook and the balance of risks. IMAE data shows that economic activity bottomed out as early as June 2018, while yearly growth rates have done so at the end of 2019. The authorities estimated that GDP contracted by 4.5 percent in 2019. This is more than a percentage point above the contraction that staff projected, and the difference is mainly due to a stronger than anticipated recovery of consumption in the fourth quarter of 2019. In addition, exports in 2019 increased by 5.6 percent and unemployment has been gradually descending from its post-shock peak of 6.2 percent to 5.4 percent by the third quarter of 2019.

Growth is expected to climb gradually, driven by exports increase, moderate credit recovery, and job creation. Underpinned by a more accommodative policy stance, growth should move towards positive territory, at the margin, by the end of 2020. By 2021, the authorities project a 1.6 percent expansion, as confidence is expected to improve and the service sector, particularly tourism, builds momentum. There are signs of improved confidence, such as the rebalancing of the current account—from a deficit of 4.9 percent of GDP in 2017 to a surplus of 0.6 percent of GDP in 2018—and the gradual recovery of international reserves and bank deposits. Also,

economic agents are adjusting to the new level of economic activity, banks have reacted positively, and credit activity has started to normalize, particularly to the export sector. Some banks have also resumed mortgage financing.

The Nicaraguan authorities have a high response rate to IMF policy recommendations, as shown in Annex I of the staff report. During the present Article IV cycle, the authorities have heeded staff's advice on overcoming the expenditure rigidities for the 2020 budget to efficiently allocate resources, in line with priorities. The authorities also welcomed staff's inputs on medium-term fiscal sustainability, and on greater fiscal transparency. In this regard, staff's recommendation to improve the financial accounting management of SOEs and municipalities to strengthen the country' overall fiscal framework, as well as the recommendation to establish a fiscal risk unit to reinforce the budget framework were well received.

The authorities appreciate the multiple references to protecting the poor and vulnerable made by staff in the report, a principle that has been at the very core of Nicaragua's policies. In this vein, the authorities reiterated their concern regarding the country's limited access to external financing, which not only hampers the pace of economic recovery but also impairs the authorities' ability to ringfence the social safety net from the effects of the shock, particularly the unavoidable fiscal contraction.

The authorities also welcomed the discussions and advice on competitiveness, governance, and AML/CFT framework. On the latter, recent upgrades were made to the legal framework and the financial intelligence unit (UAF) remains committed to addressing all issues of concern.

Despite the recent shock, the banking system has stabilized and remains well capitalized and liquid. Banks emerged from the crisis generally sound and mostly adjusted to the lower level of economic activity by downsizing and amassing liquidity. Yet, their capitalization and liquidity ratios have remained significantly higher than regional levels. The bank superintendence (SIBOIF) has strengthened supervision and is promoting increased loan-loss provisions while identifying potential sources of further asset distress. SIBOIF has excluded any further regulatory forbearance concerning loan-loss provisioning and has welcomed staff's advice on enhancing the banks' resolution framework, the financial safety net, as well as updating the legal framework to facilitate debt workouts. Further, in 2018, the authorities created the Financial Stability Committee, facilitating the coordination of financial policy and the monitoring of the financial system.

A small, open and vulnerable economy is doing its best to recover. The source of Nicaragua's recession was a strong exogenous shock, and not macroeconomic mismanagement. Throughout the decade-long economic

expansion and subsequently during the crisis a sound macroeconomic policy stance has been sustained. However, Nicaragua does not have the means on its own for a fast V-shaped growth rebound. Recovering from a shock of the magnitude seen in 2018 takes time. Nevertheless, the prompt and successful response articulated by the authorities to restore financial and economic stability after the shock, despite the lack of external financial assistance, is proof of the strong credibility of Nicaraguan economic institutions. It also demonstrates their ability to formulate and implement sound policies under duress, as well as the underlying resilience of the Nicaraguan economy, built upon years of macroeconomic stability, robust growth and sound policies.

The authorities remain committed to implementing coherent macroeconomic and development policies. In this regard, they continue to count on the Fund's support through policy advice and capacity building, tailored to Nicaragua's specific needs and circumstances.

Mr. Mozhin and Mr. Shestakov submitted the following statement:

We thank staff for the informative report and Mr. Bevilaqua, Mr. Saraiva, and Mr. Coronel for their well-written Buff statement. After a sustained economic growth between 2010-2017, the Nicaraguan economy suffered an economic contraction in 2018 and 2019 due to a socio-political backlash against pension reforms. Ensuing collapse in tourism revenue and decline in capital accumulation rate propelled by decreased business confidence took a toll on the economy, and, according to staff projections, positive economic growth will return only in 2022, with a much-reduced growth potential. Despite the lack of external financial assistance, the authorities have remained committed to restoring financial and economic stability. Going forward the commitment to a coherent macroeconomic agenda is crucial for a rebound of the sustained and broad-based economic growth.

In the 2017 Article IV consultation with the IMF the social security reforms were presented as a priority and a call was made for an urgent action to improve fiscal sustainability. However, the announcement of reforms in April 2018 unleashed a wave of violence. Lower growth and informal employment are projected to contribute to the deterioration of the fiscal position over the medium term. Accumulated buffers ensure that Nicaraguan debt burden indicators remain mostly below the threshold in the baseline scenario presented in the staff report. Given the risks to the medium-term outlook, what forms of the future Fund's engagement might be appropriate? Which lessons should be drawn for the Fund's advice from the Nicaragua's experience with the implementation of the necessary social reform in the absence of the broad social consensus?

The sudden stop in the capital account has fully offset the current account improvement and led to a loss of about one third of the country's gross international reserves. During the period of economic distress Nicaragua continued to operate a crawling peg regime, and the BCN has fought off speculative attacks on the exchange rate, while limiting the impact on inflation with reducing the pace of the exchange rate crawl in November 2019. Has the authorities and staff considered measures of prudential capital flow management against the disruptive outflows as a part of a broader policy response?

Over the medium term, Nicaragua might improve its competitiveness through structural reforms aimed at boosting productivity growth. We agree with staff that infrastructure investment, human capital development, and addressing labor skills bottlenecks should be prioritized. There is a need to expedite the steps in dealing with construction permits, protecting minority investors, registering property, and paying taxes. The AML/CFT framework should be strengthened to mitigate the exposure to illicit flows and reduce risks of pressures on correspondent banking relations.

With these remarks, we wish the authorities success in facing challenges ahead.

Mr. Chodos and Ms. Moreno submitted the following statement:

We thank staff for the comprehensive yet concise report and Mr. Bevilaqua, Mr. Saraiva, and Mr. Coronel for a very useful Buff statement.

Nicaragua's growth path was interrupted by a severe socio-political shock in 2018. After three months of unrest activity plummeted, accompanied by a massive outflow of bank deposits and subsequent liquidity crunch, a sharp contraction of imports, an aggressive speculative attack on the exchange rate, and a reversal of foreign investment. The authorities unveiled a package of measures to contain further macroeconomic deterioration and set the ground for recovery. We commend the authorities for the extraordinary effort which is showing incipient signs of success. There are signs of improved confidence, a gradual recovery of international reserves and bank deposits. According to the authorities, growth is estimated to be, at the margin, positive by the end of 2020. Nevertheless, the recovery is still fragile.

The economy is projected to continue to contract in the near-term and risks to the medium-term outlook are tilted to the downside. We take note of staff's assessment that all the shocks specific to Nicaragua have a high short-term relative likelihood and a high impact if realized. Namely, financial, fiscal, political, and external risks. Against this background, and acknowledging the authorities more optimistic view, we consider there is room for policy improvement following staff's policy advice, including

strengthening the financial safety net, fiscal sustainability, the social safety net, and reserve accumulation.

We welcome the commitment of the authorities in placing macroeconomic stability at the forefront of their policies, including addressing fiscal sustainability. We also commend them for maintaining fiscal discipline during the response of the shock, while safeguarding the social safety net. We encourage them to continue this path, raising the quality of public spending, and over the medium term, gradually reducing the fiscal deficit. We concur with staff that greater transparency in fiscal accounts and enhanced fiscal governance could enhance the effectiveness of fiscal policy.

After a liquidity shock, deposit flight, and exchange rate speculation, the banking system has adjusted, in terms of liquidity and solvency, to the lower level of activity. As noted by staff, and considering the jump in non-performing loans, and particularly of other distressed assets—from less than 5 percent to near 20 percent of loan portfolio—, further actions to enhance the timely identification and provisioning of distressed assets appears to be a priority. Adopting the recommendations of the 2017 Financial Action Task Force Mutual Evaluation Report is necessary and we welcome the authorities' commitment as well as the recent upgrades made to the legal framework.

The current account significantly improved as a result of a contraction in imports and steady growth in remittances. Yet, the external position is assessed to be moderately weaker than levels consistent with fundamentals and desirable policy settings. Given the confidence shock, the financial account suffered a sudden stop, and gross international reserves declined significantly. Despite reserves being adequate if assessed using traditional measures, we can go along with staff's recommendation to build additional buffers because of the country's crawling peg regime, the high level of dollarization, and its high vulnerability to external shocks. Regarding debt distress, Nicaragua is assessed to be at moderate risk. It should be noted though that Mr. Bevilaqua, Mr. Saraiva, and Mr. Coronel show concern on the country's limited access to external financing, which they argue hampers the pace of economic recovery.

Tackling structural weaknesses would help to increase competitiveness and sustain growth. We agree with staff in that competitiveness can be enhanced by further improvements. In this regard, it is worth highlighting that the authorities are strongly committed to tackling corruption, a key ingredient to boost confidence.

We would welcome staff's comments on how the engagement with the Fund could be enhanced, including through policy advice and capacity building.

With these comments, we wish the Nicaraguan authorities and people the best in their future endeavors.

Ms. Mannathoko and Mr. Nakunyada submitted the following statement:

We thank staff for a detailed report as well as Mr. Bevilaqua, Mr. Saraiva, and Mr. Coronel for their insightful Buff Statement.

Nicaragua's recession stemmed from a strong shock in 2018: Prudent macroeconomic management by the Nicaraguan authorities had delivered robust growth outcomes for nearly a decade. Then in 2018 the shock of the severe social backlash triggered by the announcement of fiscal and pension reforms intended to address an unsustainable pension system, dampened investor confidence and precipitated the sizable contraction of growth seen in 2018 and 2019. Given the fact that the pension reforms, while owned by the authorities, were based on the IMF's advice in 2017, we would value staff views on lessons learnt on how best to implement such reforms in the future, while preserving social stability.

Preserving confidence: Given the 2018 experience where the steep and rapid erosion of economic performance was fueled by a loss of confidence, the importance of reform plans discussed by this Board and their implications for investor confidence, capital flows, and economic performance at large is significant. We therefore emphasize the importance of ensuring that the summing up and press release are carefully crafted so as not to erode investor and public confidence further and trigger another round of deterioration. We also believe it is worth highlighting that the authorities have implemented sound policies that helped to restore relative macroeconomic stability after the 2018 shock.

Growth outlook: We note the divergence of views on the growth outlook, with staff projecting a further contraction of economic activity in 2020, while the authorities project that the economic decline will bottom out. Against this background, we wonder to what extent recent data on the monthly economic activity index, recovery in exports and credit growth, alongside the strengthening of labor markets, would help tilt the balance of risks to the upside as projected by the authorities. Staff comments are welcome.

Fiscal adjustment: Reforms to tackle medium term fiscal challenges remain essential to ensure fiscal and debt sustainability. In this regard, we commend the authorities for maintaining fiscal discipline through the curtailing of expenditure and streamlining of subsidies. We also commend the authorities for the resolve they showed by re-introducing pension reforms in 2019, despite the difficult circumstances. Importantly, we support the authorities' focus on safeguarding social safety nets and preserving priority

investment expenditures. In this connection, we welcome the improvements in health, education, road infrastructure, and access to water and electricity, as outlined in the Buff statement. That said, effective communication of policy plans remains important, and adequate consultations should be prioritized to garner broad public support and avoid a recurrence of social unrest. We concur that a more comprehensive social impact analysis that clearly outlines the potential costs and benefits of critical fiscal reforms is required to help to adequately cushion vulnerable segments of the population.

Financial stability: We commend the authorities for their swift policy response that helped to mitigate the impact of the large withdrawal of deposits and declining credit growth on financial stability. The resilience of a banking sector that benefitted from ample buffers accumulated prior to the 2018 shock, helped the economy weather the negative repercussions of the shock. Going forward, we encourage the authorities to sustain on-going efforts to strengthen supervisory and resolution frameworks while promoting increased loan-loss provisioning. Importantly, we urge the authorities to sustain current efforts to strengthen their AML/CFT framework in order to enhance financial integrity and mitigate the risk of correspondent bank withdrawals. We also welcome on-going efforts to upgrade the legal framework.

With these comments, we wish the Nicaragua authorities a successful and peaceful reform program.

Mr. Tan and Ms. Pandit submitted the following statement:

We thank staff for their insightful paper and Mr. Bevilaqua, Mr. Saraiva and Mr. Coronel for their informative Buff statement.

Despite its efforts at maintaining sound macroeconomic policies, Nicaragua has been facing severe growth challenges as evident by the negative output growth momentum in the last two years that was largely attributed to social unrest and sanctions. Downside risks that may culminate in a further erosion in confidence, public and private investment, as well as weak external financing could heighten economic stress and the corresponding social impact. While the authorities have responded decisively to restore financial and economic stability, further efforts are needed to stay the course over the near and medium term given the challenging circumstances. In this context, we agree with the broad thrust of the staff appraisal and offer the following points for emphasis.

We welcome the consensus between staff and the authorities on the need to safeguard fiscal sustainability while minimizing adverse impacts on economic activity and social outcomes. We take positive note of the authorities' determined response to date to contain the growing fiscal imbalances, with the moderate fiscal easing in 2020 expected to offset some

of the economic headwinds ahead. Mitigating poverty and social impact of the economic downturn is a key priority given the downstream implications on confidence and social-political tensions. In this vein, we see merit with staff's focus on, among other recommendations, curbing current expenditures on goods and services, subsidies and grants, where there is significant room for recalibration; and revaluating existing expenditures rigidities so that expenditure priorities can be better targeted to generate space for social programs and social safety nets. In the longer term, we also agree that the authorities should remain committed to reduce the fiscal deficit gradually and implement structural reforms to enhance fiscal transparency and governance. With respect to the social impact analysis of critical social reforms, could staff elaborate any lessons learnt from the social protests in 2018 that were triggered by the announced pension reforms, and relevant insights from other country experiences with social security reforms that may help inform the analysis?

The resilience of the banking sector should be preserved with continuing efforts to mitigate potential asset quality and financial integrity concerns. We are encouraged that the banking sector has weathered the 2018 shock reasonably well with support from the authorities to avoid a liquidity crisis. While the banking system may have buffers to withstand a further decline in confidence and economic growth, it is less well-placed than before to cope with new vulnerabilities that may emerge. Could staff share further details on any stress tests done on the banking sector, including the adequacy of their liquidity coverage ratios for example? Given the expected lag effect on loan quality from a further contraction in economic activity, we take comfort that the authorities will remain vigilant and persist in their ongoing efforts to ensure that banks are well prepared for potential additional loan quality deterioration. Further progress toward implementing the 2017 FATF recommendations is also important as correspondent banking relations require significant efforts to nurture over time while pressures could escalate quickly on the other hand.

Further reforms are essential to strengthen anti-corruption efforts, restore business confidence and enhance competitiveness. We agree with staff on the need for policies to bring back private sector confidence, together with efforts in the medium and long term to enhance the country's competitiveness and growth potential. In the same vein, we see merit to staff's call to address the anti-corruption weakness and welcome the authorities' commitment to tackling corruption and adopting international good AML/CFT practices. Notwithstanding their efforts to access external financing for infrastructure spending so as to improve competitiveness and promote long-term growth, the authorities have reiterated their concern in the Buff statement regarding Nicaragua's limited access to external financing which also impairs their ability to strengthen the social safety net. Further comments are welcome from

staff on how else the Fund could help the authorities overcome this key vulnerability.

With these comments, we wish Nicaragua and its people success in their future endeavors.

Mr. Bhalla and Ms. Indraratna submitted the following statement:

We thank staff for the detailed reports and Mr. Bevilaqua, Mr. Saraiva and Mr. Coronel for an informative buff statement.

After a period of significant growth, economic conditions in Nicaragua have deteriorated. Social unrest, triggered by the announcement of pension reforms, has had a devastating impact on the economy. The years 2018 and 2019 have recorded significant contractions in GDP growth and a reduction in employment, which in turn, has adversely affected private consumption and investment. The financial sector has been under stress with liquidity shortages arising from outflows of bank deposits and a subsequent decline in credit, which has further exacerbated the economic downturn. Sanctions imposed by trade partners have sharply reduced access to external financing. Capital outflows have led to a depletion of international reserves although the current account of the balance of payments has improved to a surplus position, driven by import compression and remittance inflows. However, despite internal and external challenges, the authorities have shown their commitment to restoring macroeconomic and financial stability. In recent months, reserves have stabilized, and efforts taken by banks and the monetary authority have reduced vulnerabilities in the financial sector. However, the growth outlook for the medium term remains subdued. We broadly agree with the staff appraisal and make the following comments for emphasis.

We concur with the staff view that given tight financial conditions, the fiscal policy strategy should strike a balance between safeguarding fiscal sustainability and minimizing any adverse impact on economic activity and social outcomes in the short term. Against the backdrop of economic contraction, the fiscal authorities need to adjust public spending to maximize its impact on growth. Accordingly, rationalizing capital expenditures to projects with the highest growth and social impact, increasing outlays on social programs and social safety nets and reducing current expenditures relating to non-social spending are key to improving growth outcomes. In this regard, we are encouraged by the fiscal reforms undertaken by the Nicaraguan authorities, despite the difficult circumstances. We take positive note of the tax policy changes and pension reform measures undertaken in 2019 to recoup revenue and restrain expenditures. As some of the pension reform measures have not yet been implemented, can the staff comment on the time frame for the implementation of these measures? The reduction in the wage bill in the 2020 budget is a move in the right direction as it reflects a freeze on public

wages and hiring of new public servants, with an exclusion of this measure to the health and education sectors. The reduction in the salary bill will increase the fiscal space available for priority expenditures. In the medium term, the authorities should improve the financial viability of SOEs that rely on budgetary transfers. We also call upon the authorities to improve fiscal transparency in order to better manage fiscal risks and improve fiscal governance.

We note the positive measures taken by the authorities to enhance financial stability. We are encouraged by the fact that the banking system remains well capitalized and liquid with capital ratios above the minimum requirement and better than that of regional peers. However, going forward, the authorities need to prevent an increase in the deterioration in the asset quality owing to the lower level of economic activity. We call upon the authorities to improve its AML/CFT framework to reduce pressures on correspondent banking relationships and improve financial sector soundness.

We wish the authorities success in all their endeavors.

Mr. Rosen, Ms. Pollard and Ms. Crane submitted the following statement:

We thank staff for the papers and their efforts to complete this overdue Article IV consultation and Mr. Bevilaqua, Mr. Saraiva, and Mr. Coronel for the Buff statement. We urge the authorities to address the political economy issues that are the root cause of the destabilization of Nicaragua's economy and remain the key impediment to economic recovery and growth. We underscore that the origins of the economic downturn are self-made rather than exogenous. In 2018, when faced with public protests, President Ortega responded with indiscriminate violence and repression, and the real economy crashed as a result. Banks naturally contracted credit, protecting their balance sheets, but further weakening the economy. We have great sympathy for the people of Nicaragua who have endured the resulting hardships. Going forward, a government that can garner broad public support will be able to return to growth.

In this context, we echo staff in calling for stronger anti-corruption efforts and a resumption of timely publication of data to help underpin confidence and credibility. We concur with the thrust of the staff appraisal and would like to make several points for emphasis.

Fiscal Policy. In the near term, fiscal revenues need to be carefully prioritized, while over a longer horizon more sustainable, growth-friendly fiscal measures need to replace hasty tax hikes and expenditure cuts. Spending needs to be oriented toward social protection and more efficient investment. Fiscal structural reforms, which are essential to fiscal sustainability and growth, need to be carefully designed to gain public support and to reduce

adverse impacts on the vulnerable. Increasing fiscal transparency and operational efficiency of SOEs should be a centerpiece of this effort.

Financial Sector. While the financial sector has so far weathered significant outflows, this has come at a significant cost, with banks reining in their credit portfolio by roughly a quarter over 18 months. In the context of continued weak economic activity and uncertainty, we agree with staff that contingency planning could help prepare for potential impacts of further deterioration in asset quality. With respect to financial integrity, implementation of the AML/CFT framework needs to be strengthened, including by addressing deficiencies identified in the FATF mutual evaluation. We note that the United States has applied financial sanctions to corrupt Nicaraguan officials, and to certain enterprises that were a vector for corruption.

Coordination. We encourage the IMF to work with other international financial institutions to develop a coherent policy approach to its engagements and lending with the Government of Nicaragua.

Mr. Alkhareif, Mr. Chikada, Mr. Keshava and Mr. Shimada submitted the following joint statement:

We thank staff for the informative report and Mr. Bevilaqua, Mr. Saraiva, and Mr. Coronel for their helpful Buff statement. We broadly concur with the thrust of the staff appraisal and would limit our remarks to the following issues.

Safeguarding macroeconomic stability is an important priority for Nicaragua. Although growth was robust until 2017, the output contracted sharply both in 2018 and 2019 in the wake of socio-political unrest. The Risk Assessment Matrix also underlines risks from further deterioration in the political situation as well as the imposition of further sanctions by Nicaragua's trading partners. At the same time, we take positive note of the stabilization of financial flows in recent months. In this connection, we agree with staff that restoring confidence and improving external financing flows are critical to promote economic recovery, and hope that the stabilization of financial flows will be a turning point to improve confidence thanks to the authorities' efforts mentioned in the Buff statement. Strengthening buffers is also a priority for dealing with external shocks.

Supporting the economic recovery in the near term is appropriate. In this regard, we take note of the approval of the 2020 budget by the National Assembly, which targets a moderate widening of the fiscal deficit in 2020. We also see the urgency in recalibrating public spending to generate space for additional spending on social programs and social safety nets and ensure inclusive growth. Indeed, while progress has been made in reducing poverty

(Table 11 on Selected SDGs), we are concerned that most recent data of the World Bank Macro Poverty Outlook indicate that poverty is estimated to have increased by more than 3 percentage points between 2016 and 2019. Therefore, the focus should be on mitigating the increase in poverty and the social impact of the prolonged output contraction.

Over the medium term, the fiscal deficit should be gradually reduced to ensure fiscal sustainability. To this end, reducing the deficit of the pension system (INSS) as well as reforming SOEs to improve efficiency and financial viability are some of the important priorities. While we see the benefit in carrying out Social Impact Analysis of critical fiscal reform options to evaluate expenditure rationalization options and ensure that the poor and most vulnerable receive the lowest burden of adjustment, we were wondering about the national capacity to carry out such evaluations. Staff comments would be welcome.

We agree that the resilience of the crawling peg exchange rate regime requires a stronger external position over the medium term especially in view of the Nicaragua's high vulnerability to external shocks. In this context, we take note of the reserve adequacy assessment (Appendix I). While the gross international reserve coverage has improved to 5.2 months of non-maquila imports as of December 2019 as noted in the staff supplement, it is still much below the Fund's suggested adequacy metric for LICs of 8.7 months. We therefore see the need for continued efforts to raise the reserve coverage. On reducing the rate of crawl from 5 percent to 3 percent in November 2019 to help alleviate inflationary pressures, we agree that its impact on the external position would need to be carefully monitored.

The banking sector has exhibited resilience in challenging conditions, but staff has rightly underscored the need for further financial sector reforms. In particular, we agree on the need for strengthening the regulatory and supervisory framework to ensure proper loan-loss provisioning. Enhancing crisis preparedness and strengthening the financial safety net would also bolster financial sector resilience. We would welcome staff's elaboration on the multi-year roadmap of financial sector-related TA, developed under the Financial Sector Stability Review (¶35), and the progress so far. Strengthening the AML/CFT framework is also an important priority, including to help reduce pressures on correspondent banking relationships. Here, we take positive note in the Buff statement that "recent upgrades were made to the legal framework and the financial intelligence unit remains committed to addressing all issues of concern". In this context, we encourage the authorities to continue their efforts to strengthen the implementation of the revamped framework.

Finally, stronger measures to improve governance and competitiveness are essential to promote sustainable economic growth. We especially

encourage the authorities to address the weaknesses in the anti-corruption framework and reduce the risk of corruption. Restoring private sector confidence and improving the investment climate are also important priorities to support the economic recovery. In the medium term, we concur that key priorities include improving infrastructure, investing in human capital, and addressing labor skills bottlenecks.

With these remarks, we wish the authorities further success.

Ms. Levonian, Ms. McKiernan and Mr. Weil submitted the following statement:

We welcome the authorities' re-engagement with the Fund. The renewed relationship has led to a balanced 2019 Article IV consultation, and we thank staff for their thoughtful report.

We support the staff appraisal of the path to recovery and macroeconomic and financial stability. The authorities appear to have managed the macroeconomy about as well as can be expected given the sharp economic contraction sparked by a deep socio-political crisis. That said, the situation clearly remains fragile, as illustrated by the number of 'high likelihood'/ 'high impact' risks identified in the risk-assessment matrix, particularly on the domestic front. Against this backdrop, the authorities' focus should be on those policy measures needed to secure macroeconomic stability and improve the political economy.

We underscore that the origins of the economic downturn are self-made rather than exogenous. In our view, a contributing factor to the downturn was a lack of public trust in the authorities and their institutions. We are hopeful that this trust can be regained through investments in the social safety net, ensuring the full protection of the constitutional rights of all Nicaraguans, engaging in an inclusive electoral reform process and tackling corruption.

With the fiscal situation largely stabilized, the priority should be on ensuring sustainability. The recent tax package was successful in stabilizing revenues following the drastic economic downturn, but it could unduly hamper growth going forward. We encourage the authorities to study the impacts of the tax measures on growth and consider easing the contractionary stance, as appropriate. To ensure that public finances remain sustainable, we encourage the authorities to undertake a review of transfers to other levels of government, SOEs, and public agencies. The public pension system remains in deficit, but before further pension reforms are undertaken, we encourage the authorities to assess the impact of recent reforms in order to develop a medium-term pension strategy. Has an actuarial review been conducted since the 2019 pension reforms to determine what systemic or parametric reforms are needed to retain benefits adequacy while improving sustainability?

Staff's focus on financial stability is appropriate given acute financial vulnerabilities. We agree with staff that the financial sector priority should be to improve banks' approach to impairment and provisioning, as well as developing credible resolution frameworks. As the economy bottoms-out, we would welcome a plan to cautiously revive credit, which will be instrumental to supporting a rebound in investment and growth. To support financial integrity, we encourage the authorities to adopt the recommendations of the 2017 Financial Action Task Force Mutual Evaluation Report.

Mr. Trabinski and Ms. Wehrle submitted the following statement:

We take note of the challenging economic outlook for Nicaragua. We broadly agree with staff's recommendations and their focus on fostering more sustainable and equitable growth. More generally, we encourage the authorities to work constructively towards addressing the domestic political deadlock that is taking a toll on the economy. Restoring trust will require more fundamental governance and public financial management reforms.

Fiscal policy should strike an adequate balance between fiscal sustainability and growth friendliness. The backlash against recent pension and tax measures makes a recalibration of fiscal policy necessary. We thus agree that there is a need to curb expenditures on goods and services and focus on higher-quality and growth-enhancing spending. In this regard, we see safeguarding spending on social programs, prioritizing public investments based on their growth impact, and scaling down transfers to SOEs as key.

We urge the authorities to commit to greater fiscal transparency and fiscal governance. We believe that such measures would be important to rebuild trust and better mitigate fiscal risks. We particularly note that the fiscal risks created by SOEs have yet to be adequately taken into account and that there is substantial room to strengthen public financial management and anti-corruption efforts. In this regard, we welcome that Nicaragua is receiving substantial technical assistance in revenue administration, public financial management, and fiscal reporting.

We take note of the positive progress made by the authorities in strengthening the AML/CFT legal framework. We encourage the authorities to continue advancing with the effective implementation of best practices and look forward to the findings of FATF follow-up assessment in February 2020, especially given the pressures on correspondent banking relationships highlighted in the report.

We agree that a longer-term strategy to improve the overall business environment is needed. We thus encourage the authorities to consider wider-ranging reforms aimed at strengthening institutions, including contract

enforcement, investor and property rights protection, and the insolvency regime.

Mr. Benk and Mr. Kupkovic submitted the following statement:

We thank staff for the interesting set of papers, and Mr. Bevilaqua, Mr. Saraiva, and Mr. Coronel for their helpful Buff statement. The consequences of the social unrest of 2018 continue to weigh heavy on the Nicaraguan economy and the medium-term outlook appears challenging. Restoring confidence and the authorities' commitment to prudent macroeconomic policies will be essential to promote economic recovery.

The fiscal consolidation achieved during 2019 indicates the authorities' determination to curb the growing fiscal imbalances. We encourage the authorities to follow staff's recommendation to adjust the priorities and improve the quality of public spending, as this would help inducing a virtuous cycle by generating fiscal space for additional spending on social programs and social safety nets, which in turn, could help contain future social tensions and be conducive to more inclusive growth. Furthermore, reducing the deficit of the Nicaraguan Institute of Social Security and the much-needed reforms of the state-owned enterprises will be essential for achieving medium-term fiscal sustainability.

The financial sector is subject to growing vulnerabilities. Bank profitability in terms of ROE has declined from 18 percent in March 2018, to 4.4 percent lately, amid deteriorating portfolio quality. Adequate provisioning and portfolio cleaning would be essential to restore the soundness of the sector. What are staff's projections for the future evolution of banks' profitability as an important source of banks' buffers? We welcome the progress with reforming the AML/CFT legal framework, but more efforts are needed to ensure proper implementation.

Structural reforms, including improving infrastructure, investing in human capital, addressing labor skills bottlenecks, and upgrading technological readiness are needed to support medium-term growth. These need to be supplemented by stepping up anti-corruption efforts, restoring business confidence, and improving the business climate. In light of the substantial decline of potential growth following the 2018 socio-political unrest, we would invite staff to elaborate on a more detailed roadmap of structural policies to reverse the persistent and sharp deceleration in potential growth.

Mr. Sigurgeirsson and Mr. Evjen submitted the following statement:

We thank staff for the good report and Mr. Bevilaqua, Mr. Saraiva, and Mr. Coronel for their informative Buff statement. We broadly agree with staff's assessment and have the following comments for emphasis:

Nicaragua's economic situation is challenging. Since April 2018, the impact of social unrest eroded confidence and caused significant capital and bank deposits outflows, adversely affecting Nicaragua's economy. GDP is estimated to have significantly contracted over the past two years owing to lower demand, fiscal consolidation, and sanctions.

The fiscal deficit will need to be gradually reduced to ensure fiscal sustainability. The fiscal deficit doubled in 2018 as revenues collapsed, forcing a fiscal consolidation in 2019. Going forward, staff projects the fiscal position to deteriorate in 2020 and over the medium term. Public sector debt is projected to increase rapidly, from 48 percent of GDP in 2018 to almost 64 percent in 2024. To curb the increasing debt burden and preserve macroeconomic stability, it is essential to promote economic recovery. We agree that restoring confidence and external financial flows is critical to avoid contraction in credit and jobs, which would further hold back investment and consumption.

The authorities should remain focused on structural reforms. We agree that structural reforms should be undertaken to ensure fiscal sustainability and facilitate more inclusive growth over the medium term. Restoring business confidence and improving the business climate will be crucial to promote growth, as well as improving competitiveness through investment in infrastructure and human capital, addressing labor skills bottlenecks, and upgrading technology.

Social spending has grown at a slower pace than current expenditures. Fiscal policy should aim at safeguarding spending on social programs and strengthening social safety nets. Social impact analysis of critical fiscal reform options should be conducted to evaluate expenditure rationalization options and ensure that the poor receive the lowest burden of the adjustment.

The economic downturn has imposed a heavy toll on bank profitability, partly explained by the sizeable contraction of the loan portfolio. We note staff's assessment that the banking system still holds cushions to withstand a further decline in confidence and economic growth. Banks have responded to the economic downturn and financial stress by adjusting the balance sheets. While it could be necessary for individual banks to reduce their balance sheets amid funding constraints and a severe macroeconomic downturn, such a situation will inevitably have a negative pro-cyclical macroeconomic impact. Could staff elaborate on measures that could be taken

in order to mitigate such effects, especially if the stressed situation should deteriorate? Is there room left for further easing of reserve requirements or macroprudential measures?

We strongly encourage the authorities to address the weaknesses in the fiscal governance and the anticorruption frameworks. Gaps in fiscal transparency should be addressed. To provide an accurate view of the fiscal position, the authorities should publish detailed financial statements. The operations of the Non-Financial Public Sector should be audited on a regular basis and made public. Financial governance among SOEs should be improved. Strengthening government institutions in several areas, such as protection of property rights, investor protection, registering property, and resolving insolvencies, could improve the country's competitiveness.

Mr. Fanizza, Mr. Spadafora and Ms. Korinthios submitted the following statement:

We thank staff for an informative report and Mr. Bevilaqua, Mr. Saraiva, and Mr. Coronel for their candid Buff statement. Nicaragua's economy is coping with the detrimental impact of social unrest, with growth set to contract for the third year in a row, formal employment declined by one-fifth and lower revenue affecting public finances and the financial position of the pension system. Gradually easing the policy stance while maintaining macroeconomic stability is paramount to pave the way for a much needed rebound of confidence and growth after addressing the bulk of the shock. It is encouraging that the Debt Sustainability Analysis still classifies Nicaragua at moderate risk of debt distress, although the Albanisa contingent liability stands out as a risk factor for its sizable impact on public debt. We offer a few comments for emphasis.

While we support a moderate widening of the fiscal deficit in 2020 to safeguard economic activity and social spending, we share staff's recommendation to complement this action with an effort to improve the quality of public spending. Indeed, a recalibration of public spending priorities would be essential to mitigate the social impact of the recent economic contraction and to foster more equitable and sustainable growth. We share the staff's call to curb current expenditure with a view to increasing resources for social programs. Overcoming the rigidities in the budget process can further contribute to this objective and we welcome the steps the authorities have taken in this direction.

We commend the Central Bank of Nicaragua for its resolute response to major falls in banks deposits and liquidity, which has succeeded to stabilize the system. However, banks' asset quality has deteriorated and credit to the economy has dropped, with inevitable impact on the real economy. We encourage the authorities to strengthen the financial sector, by enhancing the

framework for bank resolution and the financial safety net. Reinforcing the AML/CFT framework is macrocritical to mitigate risks of further undermining correspondent banking relationships.

Improving fiscal governance and transparency–including for SOEs–as well as establishing a broad-based anti-corruption policy and a strategy to ensure fiscal sustainability in the medium-term remain key priorities to rebuild confidence. We concur with staff that addressing anti-corruption policy weaknesses would go a long way toward boosting confidence, competitiveness and growth. We therefore welcome the authorities' commitment in this area, in particular on improving the existing asset declaration regime.

Mr. White and Mr. Yoo submitted the following statement:

We thank staff for the set of reports and Mr. Bevilaqua, Mr. Saraiva, and Mr. Coronel for their helpful Buff statement. We broadly concur with staff's analysis and recommendations and offer the following comments for emphasis.

Maintaining macroeconomic and financial stability is of critical importance to protect against the risks of further economic downturn. Given weak confidence and a lack of external funding, the Nicaraguan economy looks set to continue to contract in 2020. Further, staff's risk assessment matrix shows a high risk of Nicaragua-specific shocks from financial, fiscal, political and external risks, each of which would have a big impact on the economy if they eventuate. In this context, fiscal policy needs to balance restraint with ongoing provision of social safety nets, and the authorities should make reforms to safeguard financial stability.

Strengthening of social safety nets is needed to mitigate the adverse effects of the continuing economic contraction on the poor and vulnerable, while maintaining an appropriately conservative fiscal stance. Given limited potential for revenue upside in the immediate term, this will require raising the quality of public spending and rebalancing its composition toward social programs and social safety nets. We agree with staff that the authorities should curtail current expenditure on goods and services, subsidies, and grants, particularly to state-owned enterprises and other public agencies, and instead increase social spending such as a targeted transfer to poor families with school-aged children.

Measures to enhance financial stability will guard against future shocks. The authorities should take further measures to improve the timely provisioning of distressed assets to ensure that banks are well prepared for potential further loan quality deterioration. Moreover, crisis preparedness

needs to be enhanced by developing contingency plans, enhancing the banks' resolution framework, and strengthening the financial safety net.

With these remarks we wish the authorities every success.

Mr. Buisse, Mr. Rozan and Ms. Albert submitted the following statement:

We thank staff for their well-written report and Mr. Bevilaqua, Mr. Saraiva and Mr. Coronel for their clear Buff statement. The economic situation is characterized by a considerable level of uncertainty, in particular on the social and political fronts, which is weighing on business confidence and external financing flows. We urge the authorities to work to preserve macroeconomic and financial stability, restore confidence and protect the most vulnerable. Despite significant progress in the past, poverty increased during the past few years, and the country remains one of the poorest in the region. We encourage the authorities to allocate the necessary spending to this while ensuring fiscal sustainability in the long term. Restoring confidence is also key to improve the business environment and improve financial conditions. Combined with strong macroeconomic policies, it will also help to improve the external financing access which is necessary to address the fiscal and external imbalances. We also welcome the authorities' monetary and financial management in this crisis period and encourage them to swiftly implement the AML/CFT framework. We share staff's appraisal and would like to add the following comments:

The economic situation remains fragile and the outlook is uncertain. The country is the only one in recession in Central America and it has suffered from the impact of social-political crisis, though we note that many economic indicators are stabilizing. Uncertainties are high, and risks are still tilted to the downside. We note that the risk of a disorderly migration from Venezuela is mentioned in the Risk Assessment Matrix but there is no mention of the movement of Nicaraguan migrants, for example to Costa Rica. Could staff elaborate on his diagnostic regarding these two risks and their impact on the economy? Moreover, as the country is highly vulnerable to climate change related events, we would welcome an analysis on this topic in the next Article IV. We also note the large deterioration of the estimated potential growth from 4.5 percent to 3 percent and encourage the authorities to take the necessary short term and structural measures to restore confidence and improve the business climate to boost investment, and more globally growth, in the short and long term. Finally, as poverty is estimated to have increased by more than 3 percentage points between 2016 and 2019 (according to the World Bank), we would have welcomed a more detailed analysis on poverty in the report. Could staff provide a quantitative assessment of the impact of sanctions and social protests on GDP and the poorest, for example for the bottom 40 percent of the income distribution?

Regarding the external and fiscal and imbalances, which imply a moderate risk of debt distress, the increase of external financing appears as a top priority. On the external side, we encourage the authorities to build up buffers and increase reserves, which are now below the range of 5 to 10 months of non-maquila exports according to staff but estimated at 6.3 months according to the Buff. Could staff explain this difference? We also note that the IIP position is the weakest in the region and encourage the authorities to improve the external sustainability by improving competitiveness. On the fiscal side, we understand that the estimated level of public financing available would be insufficient to satisfy rising NFPS deficits beyond 2024 which remains an issue as the fiscal position will deteriorate in 2020 and over the long term.

We welcome the efforts made by the authorities to contain the deterioration of public finance in 2019 but see the increase of the necessary expenditures to protect the most vulnerable as paramount. While the country is in moderate risk of debt distress, an adequate, multi-year approach should be taken to avoid a deterioration of public finance going forward, so as not to endanger this risk rating. We welcome the tax and pensions reforms which helped to improve the fiscal situation last year and agree that an analysis of the impact of tax reforms on growth should be done to ensure their sustainability. Priority should be given to increase spending on social programs, social safety nets and public investment as underlined in the report and we fully share staff's view on this issue, with a need to improve the composition of public spending. A credible fiscal framework, which ensure fiscal sustainability in the long run is also important. We encourage the authorities to pay a careful attention to the impact of reforms and fiscal measures on the social climate and we urge them to make strong progress in terms of data transparency, especially regarding SOE.

We welcome the prompt reaction of the authorities to stabilize the financial sector and the monetary front, which helped to avoid a liquidity crisis. The banking system has been robust, and the Central Bank played a key role to deal with the significant bank outflows, even if bank asset quality and profitability significantly deteriorated. Have CFM measures been considered by the authorities and what is staff's view regarding the use of these measures if a similar crisis happens again? We also welcome the decision of the authorities to reduce the rate of the crawl from 5 percent to 3 percent to keep a credible inflation commitment and encourage the authorities to take the necessary measures to maintain the resilience of the crawling peg regime. The financial situation seems to have stabilized and a close monitoring is needed, to remain flexible in case of new financial tensions and further actions could help to reinforce the resilience of the financial sector. The diagnostic regarding the magnitude of NPLs seems still unclear and we encourage staff to work on a more precise analysis on this point and the authorities to identify clearly the sources of further asset distress. Finally, regarding AML/CFT,

while we welcome the recent progress, we urge the authorities to fully and swiftly implement the framework to reduce the pressure on correspondent banking relations and ensure a favorable business climate.

Mr. Guerra and Mr. Tabora Munoz submitted the following statement:

We thank Mr. García Saltos and the team for the insightful and consistent report, and Messrs. Bevilaqua, Saraiva and Coronel for their very informative and well-written buff statement. We broadly concur with the staff's assessment.

The short and medium-term outlook for Nicaragua remains challenging due to the 2018 socio-political shock that eroded business confidence and contracted economic activity causing an important drop in formal employment, depressing private consumption and investments. Despite the recent positive recovery signals, real GDP contraction deepened in 2019, and real economic growth is projected to remain slightly negative or around zero percent until 2021. Potential growth is estimated to have declined by around 2 percentage points from pre-crisis level, mainly due to the lower rate of capital accumulation, thus affecting significantly the remarkable annual average growth of almost 5 percent observed during five years prior to the socio-political crisis. Hence, rapid recovery of private sector confidence and external financing flows are critical to build momentum to regain job creation, as well as boost consumption and investments. Going forward, the clear commitment of the authorities with sound and consistent policies is paramount for a V-shaped growth rebound.

We praise authorities for their decisive commitment to preserve macroeconomic and financial stability under challenging circumstances. The authorities have taken measures to maintain fiscal discipline by adopting timely and effective policies to increase revenues and curtail current expenditures while safeguarding the social safety net and financial sector stability. Furthermore, the authorities have a high response rate to the IMF policy recommendations.

Preserving fiscal sustainability is a cornerstone for the recovery. We encourage authorities to continue upholding their determination to contain fiscal imbalances, raising the quality of public spending and adjusting its composition as far as possible to create fiscal space for social programs and social safety nets, especially those related with education and health services to mitigate the social impact of the fiscal consolidation on the most vulnerable, but also to boost sustained growth through investment in human capital. Even though a more accommodative fiscal stance would seem appropriate in the short-term, over the medium-term, in order to fully restore macroeconomic stability, continuing with the implementation of the revenue mobilization strategy is paramount to avoid further deterioration of fiscal

buffers, but also for restoring the private sector's confidence. Assessing the impact of the tax reform on the economic activity will be key. Reigniting economic activity as soon as possible will help reduce the fiscal deficit and ensure fiscal sustainability.

We stress the importance of steadfast implementation of structural reforms. Taking advantage of the lessons learned from the 2018 pension reform will be key to obtain broad public support for critical fiscal reforms. Accelerating the implementation of growth-enhancing reforms, including human capital development, improvements to the business environment, and having good governance are key drivers for strong inclusive growth. We welcome the authorities' commitment to accelerate and strengthen the AML/FCT framework in line with the 2017 Financial Action Task Force recommendations and consistent with IMF technical advice. We welcome the authorities' willingness to use Fund recommendations to improve the fiscal transparency framework, particularly government procurement, financial accounting management of SOEs and municipalities, and the creation of the fiscal risk unit to reinforce the budget framework. Enhancing the anti-corruption framework, including the upgrade of the asset declaration system in line with best practices, would help to enhance private sector confidence.

Rebuilding and maintaining an adequate level of international reserves to handle unforeseen external shocks should be a medium-term top priority. We commend authorities for their clear signal of commitment with low inflation. However, even though we recognize the importance of reducing inflationary pressures during the crisis, lowering the exchange crawl poses a risk for Nicaragua's external position in the medium-term. We concur with the staff that Nicaragua's competitiveness should be improved by enhancing structural reforms to boost productivity while keeping inflation low. Therefore, gradually returning to a crawling peg exchange regime consistent with the fundamentals will boost Nicaragua's resilience to external shocks and business confidence. We welcome the authorities not considering additional exchange restriction measures.

Strengthening banking supervision will ensure financial sector stability. We welcome the prompt creation of the Financial Stability Committee to monitor the financial sector during the crisis, as well as the actions of the Bank Superintendence (SIBIOF) to maintain financial stability. However, and despite resilience shown by the financial sector during the crisis, we encourage authorities to continue enhancing the regulatory framework to reduce vulnerabilities, including developing contingency plans to deal with the possible failure of financial institutions, enhancing the banks resolution framework as well as the loan-loss provisioning and the financial safety net.

Considering Nicaragua's challenges, maintaining Fund support through policy advice and capacity building is a key priority. In that regard, improving the quality and timely provision of country statistics is crucial to produce sound and proper policy advice. Furthermore, tailoring the Fund's technical assistance to Nicaragua's specific needs and priorities is critical at this stage. We wish the authorities success in confronting challenges ahead.

Mr. Sylla, Mr. Bah and Mr. Bangrim Kibassim submitted the following statement:

We thank staff for the comprehensive set of reports, and Mr. Bevilaqua, Mr. Saraiva and Mr. Coronel for their informative Buff statement.

The difficult social environment in Nicaragua and the impact of sanctions led to a contraction of real GDP in 2018 and 2019. In addition, the fiscal positions deteriorated as a result of both cyclical downturn and procyclical fiscal policy reaction; external imbalances widened while inflation drifted upwards. These imbalances have eroded confidence and triggered sizeable capital and bank deposits outflows. Furthermore, we note that while growth is projected to recover somewhat over the medium term, the dire macroeconomic conditions will continue to weigh heavily on the outlook. Against this background, the authorities should put emphasis in the near term on preventing any further deterioration in confidence and deposit outflows. More broadly, efforts should be stepped up to safeguard macroeconomic stability, tackle financial vulnerabilities, address medium-term fiscal challenges and pursue bold structural reforms geared toward improving the business environment and raising competitiveness.

The authorities should give priority to restoring fiscal sustainability while preserving social safety nets. We take positive note of the fiscal consolidation measures taken in 2019 which are important steps towards addressing the growing fiscal imbalances. To further enhance fiscal sustainability and mitigate the social impact of the economic downturn, we encourage the authorities to improve the quality and composition of public expenditure as early as 2020. In this regard, streamlining current spending, subsidies and grants, and prioritizing capital expenditures while protecting social programs and social safety nets will be needed. A focus should also be placed on continuing reforming the pension system and improve the financial situation of the Nicaraguan Institute of Social Security (INSS). On the revenue side, we encourage the authorities to continue implementing the adopted tax measures to boost revenue and ensure fiscal sustainability over the medium-term in a growth-friendly manner. In addition, the authorities' efforts should aim at further improving the financial viability of state-owned enterprises (SOEs). We see merit in the establishment of a fiscal risk unit to enhance the effectiveness of fiscal policy. We would also support the provision by the Fund of technical assistance to this unit to help achieve its mandate.

Strengthening the external position is crucial to enhancing the resilience of the crawling peg exchange rate regime. We encourage the authorities to maintain the international reserves coverage to a level consistent with preserving the regime and the exchange rate crawl. In this regard, we are pleased to note from the Buff statement by Mr. Bevilaqua, Mr. Saraiva and Mr. Coronel that international reserves have recovered to reach 6.3 months of non-maquila imports which falls within the range recommended by staff of 5 to 10 months of coverage. In addition, we take positive note of the authorities' decision made in November 2019 to reduce the rate of the crawl to 3 percent which could help dampen inflationary pressures. However, the impact of this decision on the external position should be carefully monitored.

We urge the authorities to pursue their efforts to address the vulnerabilities in the financial system. Although the banking system has shown resilience to the economic downturn, there is a need, in a context of lower economic activity, to strengthen the timely identification and provisioning of distressed assets. In this regard, the banking supervision should be enhanced with a regular review of asset quality and collateral valuation. In light of the mounting pressures on correspondent banking relations, we urge the authorities to implement the recommendations of the 2017 Financial Action Task Force and Mutual Evaluation Report to preserve the integrity of the financial system. In the same vein, we welcome the reforms made in the AML/CFT legal framework and encourage the authorities to pursue the implementation of the new framework with a view to complying with international standards on anti-money laundering.

Improving governance, competitiveness and the business climate is crucial to strengthen Nicaragua's economic prospects. To enhance competitiveness and unleash the country's potential growth, there is a need to put emphasis on raising infrastructure, removing bottlenecks to labor market flexibility, strengthening public institutions and stepping up the fight against corruption. Moreover, in their efforts to restore business confidence, the authorities need to address deficiencies in investor protection and address insolvency.

With these remarks, we wish the Nicaraguan authorities every success in their future endeavors.

Mr. Mojarrad and Mr. Sassanpour submitted the following statement:

We thank staff for a concise report and Mr. Bevilaqua, Mr. Saraiva and Mr. Coronel for their insightful Buff statement. We are in broad agreement with the thrust of the staff appraisal.

Nicaragua's decade long period of sustained, robust economic growth, combined with impressive social gains, came to a sudden halt in early 2018

following socio-political unrests triggered by the announcement of pension reforms. The pension reforms were withdrawn and reintroduced less than a year later, but the loss of private sector confidence, and the ensuing fall in investment, output contraction and job destruction endured and have been deeper and more protracted that probably justified by the short period of unrest and work stoppage. The sanctions and the loss of external financing probably also had significant adverse impact on confidence, both directly and indirectly. Paradoxically, the prolonged period of uncertainty and output loss during 2018-2019 was associated with overall price and financial stability, underpinned by the authorities' sound macroeconomic management.

The more recent developments have been encouraging: output and employment seem to have turned the corner, bank deposits are recovering, credit is stabilizing and international reserves have been partially replenished. Moreover, political dialogue is continuing, and elections are slated for 2021. With this background, we were somewhat taken back by the "high" probability ranking assigned to an array of Nicaragua-specific risks in the Risk Assessment Matrix that would surely impact confidence. Staff may wish to elaborate.

We commend the authorities for their prudent fiscal policy, cutting the NFPS deficit in half in 2019, while making sizable contributions to INSS, despite the deep output contraction. The regretful loss of external financing did not allow the authorities to follow countercyclical policies to soften the blow of the external shock on employment and output. We welcome the authorities' intentions to shift towards an accommodative fiscal stance in support of domestic demand should financing conditions ease, especially given the limitations of monetary policy in Nicaragua. Job destruction has been significant and job recovery and social improvements are likely to follow the output recovery with a lag. Under the circumstances, we support the authorities' policy on increasing public spending on infrastructure (particularly in social sectors) and on social safety nets to protect the vulnerable during the transition. Addressing the expenditure rigidities and improving the financial transparency and management of SOEs also merit serious consideration. We take positive note of the approval of the 2020 budget by the National Assembly, with no revisions, and as discussed with staff.

While the scope of monetary policy is limited, we commend the BCN's efforts during this difficult period to maintain financial stability by ensuring adequate liquidity in the banking system in the face of large deposit withdrawals and loan contraction. As put succinctly by Mr. Bevilaqua, Mr. Saraiva, and Mr. Conrel, the financial sector experienced a real-life stress test and emerged fairly unscathed. That is a testament to the resilience of the Nicaragua's financial sector and the authorities' commitment to preserve it.

Staff are suggesting a build-up of FX reserves to ensure the integrity of the currency peg. While we agree in principle, would staff please elaborate on the likely sources of the increase, given that the external financing constraints are projected to continue in the medium term, and that the current account will be roughly in balance as imports recover?

We hope that the difficult 2018-2019 period is a blip in Nicaragua's strong track record of economic and social progress, and wish the authorities all the success.

Mr. von Kleist and Mr. Herold submitted the following statement:[1]

We thank staff for a comprehensive, insightful report and the Debt Sustainability Analysis. We thank also Mr. Bevilaqua, Mr. Saraiva and Mr. Coronel for their very helpful Buff statement.

Nicaragua faces significant social and economic challenges. In the wake of the severe public unrest in early 2018, a profound loss of confidence has led to an abrupt economic adjustment in the country. The authorities now need to steadfastly maintain stability-oriented macroeconomic policies while decisively pushing ahead with the structural reforms necessary to establish more robust, sustainable and inclusive growth going forward.

The authorities' determined fiscal response has contributed to safeguarding macroeconomic stability. Not least with a view to the substantial fiscal risks, we encourage the authorities to seek to adhere to their target of a balanced budget for 2020 by the central government. Going forward, as staff lays out, additional measures will be necessary to ensure sustainable public finances. We support staff's call to recalibrate the composition of public spending towards higher-quality social (and pro-poor) and investment spending, away from unproductive current expenditures, subsidies and non-priority capital expenditure. Fiscal transparency and governance should be strengthened in a timely and comprehensive manner.

Notwithstanding the severe downturn, the financial system appears to still be stable, according to staff. However, further action is needed to counteract potentially deteriorating loan quality and ensure effective compliance with international AML/CFT standards. The implementation efforts in this regard should be increased. We concur with staff that mounting pressures on the external position make a case for substantially strengthening reserves, especially given the country's crawling peg exchange rate regime.

Ambitious reform efforts are necessary to address remaining socio-economic concerns, to support confidence and to strengthen potential growth.

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[1] The gray statement by Messrs. von Kleist and Herold (OEDGR) was not circulated to Executive Directors until after the Board meeting had taken place.

In this regard, we welcome staff's suggestions to remove persistent impediments to growth, including measures aimed at improving human capital and the social safety net, as well as strengthening public institutions, legal certainty, investor protection and contract enforcement. We call on the authorities to take bold steps along international best practices to bolster transparency and good governance while resolutely moving ahead in the fight against corruption.

On a more technical note, we would welcome additional staff comments on the estimated output gap. We note that staff estimates suggest a "potentially large output gap" of almost 8 percent in 2020. Is this a reasonable estimate for the cyclical slack in the Nicaraguan economy or may staff be overestimating the level of potential output?

The Acting Chair (Mr. Furusawa) made the following statement:

We turn to the agenda item on Nicaragua, 2019 Article IV consultation. The economic situation is challenging. In your gray statements you urged the authorities to maintain prudent policies to preserve macroeconomic and financial stability. In our discussion we can focus on issues such as how to restore confidence and how best the Fund can assist the authorities going forward, as well as the political economy lessons learned from implementing reforms.

Mr. Bevilaqua made the following statement:

On behalf of our Nicaraguan authorities, we thank staff for the candid and very constructive discussions during the Article IV mission and look forward to maintaining the close engagement with the Fund that has prevailed over the years. Even during the 2 ½ year gap without Article IV consultation, the authorities and staff kept an active and fluid relationship based on bilateral meetings, the usual provision of data, onsite technical visits, and a candid dialogue. As we pointed out in our buff statement, the Nicaraguan authorities have a high response rate to IMF policy recommendations. They have followed staff's advice on overcoming the expenditure rigidities for the 2020 budget to efficiently allocate resources and have welcomed staff's inputs on medium-term fiscal sustainability, on greater fiscal transparency, and on tackling corruption and weaknesses on the AML/CFT framework. Moreover, the country's first-ever successful IMF-supported program was completed in 2011

That said, Nicaraguan authorities have always taken full responsibility for their policy decisions, even as they recognize and appreciate the fruitful dialogue and valuable policy advice from the Fund. That was the case with the social security reform that triggered the protests in April 2018. The authorities shared with the Fund the diagnosis that reforming the pension system was

crucial to ensure fiscal sustainability and benefitted from helpful IMF technical assistance on the issue. Their ownership of the reform was underscored by the fact that after the political situation stabilized, they decided to reintroduce measures to bring the pension system to a more sustainable path.

Of course, Fund staff and Nicaraguan authorities have diverged on some issues. Nonetheless, IMF policy advice has been highly regarded by the authorities and has underpinned their resolve to promote sound macroeconomic management and reform efforts. The authorities acknowledge the analytical value of the staff report and see it as a working tool to guide their efforts to restore confidence and boost growth after the economic shock of 2018. In this respect, Nicaragua has a long-established track record of publishing the staff report, and the authorities have already reiterated their preliminary willingness in the interest of transparency to publish the staff report this time around.

To conclude, I want to underline that Nicaragua's sound macroeconomic response to the shock was similar to what would be expected from any responsible country in similar circumstances. At the end of the day and against considerable odds, the Nicaraguan authorities managed to preserve the country's macroeconomic stability.

The staff representative from the Western Hemisphere Department (Mr. Garcia-Saltos) made the following statement:

On the FATF decision, during the primary meetings, which concluded today, Nicaragua was included in the FATF list of jurisdictions under increased monitoring, also known as the grey list. Nicaragua would need to report back to FATF on the progress that is being made until it has addressed its action plans. The Nicaraguan authorities have made a high-level political commitment to implement a set of reforms agreed in the action plan tailored to strengthen Nicaragua's AML/CFT framework. This action plan addresses the strategic deficiencies identified in the 2017 Mutual Evaluation Report.

The action plan focuses on the effective implementation of AML/CFT requirements in four key areas: first, the identification and understanding of money-laundering and terrorist financing risks; second, international cooperation; third, supervision of the implementation of AML/CFT requirements by the reporting entities, which includes financial and nonfinancial institutions; and, fourth, beneficial ownership of legal entities.

The authorities have committed to the full implementation of all action items by May 2021. The second aspect on Fund engagement, the staff thanks the Nicaraguan authorities for the fluid and candid economic dialogue maintained during the past few months. The staff intends to maintain this

close engagement by continuing to provide macroeconomic policy advice in a timely manner. Also, the staff sees the opportunity to enhance the capacity development agenda through technical assistance. Subject to authorities' specific requests, dealing with financial sector issues and public financial management are the two key areas on capacity development in the near term. In the financial sector, we intend to continue pursuing the ambitious technical assistance agenda designed during the Financial Sector Stability Review.

On public financial management (PFM), we see the need to strengthen fiscal reporting and transparency, including through state-owned enterprises, asset liability management, and fiscal risk management.

Mr. Rashkovan made the following statement:

The overall economic situation in Nicaragua is challenging, and Nicaragua's economy has been contracting since 2018, and it seems that the contraction is forecasted to end no sooner than 2021. There are signs of further erosion of confidence. Investment is depressed as both public and private investment suffered a significant drop, and deposit withdrawals have been recurrent issues. Many jobs have been lost, particularly in tourism and construction, and credit has contracted sharply.

The authorities have indeed taken measures to adjust the fiscal as well as the current account deficit. The fiscal package aimed at containing wages and pensions and raising taxes led to lower fiscal deficit, which should be commended. We see the current account improvement and the fiscal deficit adjustment as a form of forced savings under a program of internal adjustment, and an indication of this is the diminishing share of private sector consumption to GDP from 74 percent in 2016 to 68 percent in 2019 and a projected 63 percent in 2022. This downward trend is not compensated by an increase in public consumption. Supply-side bottlenecks point to the same direction, and we would ask staff to analyze and monitor the supply-side bottlenecks and the potential evolution of the balance of payment in the absence of these shortages. This aspect is important as it linked to the financing needs and ultimately to debt sustainability, and the current level of the current account does not reflect a steady state.

In respect to the debt sustainability, we see that moderate risk estimated by staff seems to be based on a series of assumptions regarding the resolution of the debt relief negotiations. This analysis should be treated with caution under the likelihood of higher financing needs and current debt capacity. A prolonged recession may put additional strain on the accumulation of public wealth.

On the financial sector, the report points out the fact that financial sector vulnerabilities are growing despite positive steps being taken by the

central bank to address liquidity issues and the forbearance of NPLs. Monetary financing operations are expected to be netted out during this year, and we would appreciate the comments from staff how they see further policies in this area from the central bank side.

We would also urge the authorities to a faster implementation of the FATF recommendations and AML/CFT areas in order to leave the FATF monitoring status. This would improve transparency, and it could contribute to restoring the business confidence in the country. We wish the authorities to use the report as a tool to fine-tune the policies, as Mr. Bevilaqua said in the opening statement.

Ms. Mannathoko made the following statement:

We note that the Nicaragua story is that they had a period of sustained strong growth under sound policies and suffered a significant shock in 2018 that resulted in the two years of recession in 2018 and 2019. We wanted to commend the authorities on their swift response to help contain the impacts of the loss of confidence that led to investment withdrawals and large capital outflows and their firm commitment to sound macroeconomic policies under difficult conditions.

We did note in our gray, however, that more needs to be done to restore investor confidence and sustain growth. First, just to note the interplay between investor confidence and social stability being important for Nicaragua. In this regard, we wanted to encourage staff to do what they can to help the authorities ameliorate the negative perceptions that may impact investor confidence and to also closely support the authorities' efforts to structure and sequence economic reforms in a manner that avoids social unrest in the future. We also wanted to encourage staff to support efforts to contain adverse impacts of ongoing sanctions on social welfare and stability. As we suggested in our gray, it may also be helpful for the press release to highlight the fact that the crisis in 2018 and the recession in 2018-2019 was a direct result of shocks that caused the decline despite a sustained record of sound management.

Second, like many Directors, we also note the need for the authorities to look at expenditure plans with a view to creating more space for social spending and priority investment. We also encourage the authorities to focus on SOE reforms and enhancing fiscal transparency and strengthening anticorruption efforts.

In the financial sector, we urge the proper loan loss provisioning, but we also want to welcome, based on the remarks just made, welcome the authorities' strengthening of the renewed attention to strengthening the

AML/CFT framework and the commitment they have stated to implementing all FATF-related reforms by May 2020.

Mr. Mozhin made the following statement:

The Nicaraguan economy has demonstrated a decade of robust economic growth before the economic contraction of 2018 and 2019 in the wake of the announcement of the unpopular pension system reforms.

Despite the lack of external financial assistance, the authorities have remained committed to restoring economic activity. Going forward, the commitment to a coherent macroeconomic agenda is crucial for a rebound of the sustained and broad-based economic growth. In the 2017 Article IV consultation with the IMF, the social security system reforms were presented as a priority, and a call was made for an urgent action to improve fiscal sustainability. However, the announcement of reforms in April 2018 unleashed a wave of violence. In responses to technical questions, staff highlighted the need for a comprehensive strategy that would include consultations with stakeholders, communication campaign, measures to improve administrative efficiency and to protect the most vulnerable population. This list, however, looks more like the lessons learned by the authorities rather than the Fund, and in this connection, we continue to believe that all these desirable features of the reform implementation should be emphasized in bilateral consultations and surveillance with many member countries. The Fund's research on the political economy of structural reforms and its capacity in this area should be appropriately leveraged. We therefore encourage the Nicaraguan authorities to carefully consider future structural reforms and account for all stakeholders within the broader process of laying out the roadmap of the reforms and its communication. We agree with staff that there are important bottlenecks in areas of construction permits, protecting minority investors, registering property, and paying taxes. Addressing them might improve the green projections of potential economic growth slowdown.

The AML/CFT framework should be strengthened to mitigate the exposure to illicit flows. In connection to this AML/CFT framework, I would want to ask staff to tell me what role has Nicaragua played in the transit of drugs from south to north? Because my sense is that Nicaragua quite uniquely has never been on the map of this drug trade transit flows, and I would want to hear from staff whether my impression is correct or maybe not.

Finally, Mr. Chairman, I would want to really welcome the statement of Mr. Bevilaqua who explained how the authorities continue to value their engagement with the Fund, their intention to continue this close cooperation, and their willingness to make this report public. I think it is very important.

Mr. Sassanpour made the following statement:

This is a rather peculiar case. Economic and financial instability is typically associated with policy missteps and shortfalls or the lack of timely and adequate policy response to external shocks. This obviously does not seem to be the case of Nicaragua over the past two years. The early 2018 protests were triggered by the announcement of pension reforms, as was mentioned earlier. The reforms were withdrawn and subsequently reintroduced in less than a year, and soon after the protests erupted, sanctions were imposed, and external financing dried up. Confidence collapsed and the economy fell. The dramatic loss of confidence and the collapse of economic activity and employment somehow do not seem fully justified by and not proportional to three months of civil unrest and work stoppage.

Despite the heavy headwinds and severe external financing constraints—this is a point also Mr. Mozhin mentioned—however, the authorities managed to maintain, price, fiscal, and financial stability and fight specific attacks on the currency but at the cost of deep output contraction, job destruction, which was 20 percent of formal employment, and also importantly, its impact on the vulnerable. If anything, I think there should be a greater recognition of the authorities' farsighted and prudent policies to hold the ship together in these very turbulent waters of the past two years. We also support what Ms. Mannathoko mentioned regarding the press release, and there should be a recognition that the authorities managed to hold stability despite all the heavy headwinds.

According to various indicators, the economy is on the mend, and recovery seems to be in train. Importantly, the authorities have already demonstrated their determination in real-time stress tests over the past two years to maintain fiscal and financial viability at all costs. They have also proved that they have full ownership of the policies. With that in mind, we were somewhat taken back by the high-risk assessment to all country-specific shocks in the risk assessment matrix. Staff, in answer to our question, mentioned there is a fragile equilibrium. Equilibrium is good, and the authorities are working on the fragility part of it.

Staff further indicate that there is no real sector data for the second half of 2019, and, of course, early 2020, but other data seems to support the recovery. Here maybe we should have given the authorities the benefit of the doubt, and maybe a more balanced risk assessment could be justified, recognizing the impact it would have on confidence, which was a trigger to begin with.

Finally, the authorities' commitment to implement the FATF recommendations, as indicated earlier, should also help confidence. I will stop here and wish the authorities all the success.

Ms. McKiernan made the following statement:

Thank you very much, Chair. I would like to start by welcoming the fact that we are having this meeting today to discuss Nicaragua's 2019 Article IV because it is the fruit of a renewed relationship with the Fund. The authorities and Mr. Garcia-Saltos and your team should be commended for that. I would also like to say that given the trying circumstances, it seems as if the authorities have managed the economy as well as could be expected.

Like Mr. Rosen in his gray, we expressed a view on the genesis of those trying circumstances, which we feel goes well beyond pension reform; and we want to echo the point made by Mr. Buisse that the economic situation remains fragile. There are many acute risks to this recovery, and it is not even entirely clear to us whether the economy has bottomed out yet, so Mr. Garcia-Saltos's observations on that questions would be most welcome.

On fiscal policy, we agree that crisis-driven tax measures should be gradually replaced by reforms to make public finances more sustainable, even if that means relaxing the contractionary stance during a transition. We would also underscore the importance of investing in the social safety net and in addressing governance and financial integrity issues in order to create conditions favorable to sustainable growth. And on financial integrity—and thank you for the mention regarding the FATF listing of Nicaragua—that raises for us an issue regarding what the Fund can do to help countries that arrive in that situation, and that has been relevant for our own constituency; but, of course, it is also to build on what countries can do to help themselves in relation to improving financial integrity conditions.

I would finish with a question, which is whether there is any change in technical assistance strategy, which might be relevant in that respect?

Mr. Guerra made the following statement:

While the short and medium-term outlook remain challenging, we welcome the decisive commitment of the authorities to preserve macroeconomic and financial stability under difficult circumstances. In this regard, maintaining fiscal sustainability is a cornerstone for the recovery. We encourage the authorities to continue upholding the determination to contain fiscal imbalances, raising the quality of public spending, and adjusting its composition as far as possible to create fiscal space for social programs and social safety nets.

On structural reforms, accelerating the implementation of broad enhancing reforms, including human capital development, improving the business environment, are key drives for strong and inclusive growth. Moreover, enhancing the anti-corruption framework will help to enhance

private sector confidence. In this regard, we very much welcome the update by Mr. Garcia-Saltos related to the AML/CFT issues. We very much commend the authorities for their determination to put in place an agenda to deal with this issue. This is a key issue that the authorities should put all their efforts.

Also supporting what Mr. Bevilaqua said about the importance of engagement of the authorities, and in light of Nicaragua's challenges, maintaining foreign engagement through policy advice and capacity building is going to be a key priority. In that regard, improving the quality and timely provision of country statistics is crucial to produce sound and proper policy advice. Furthermore, tailoring the Fund's technical assistance to Nicaragua's specific needs and the authorities' priorities is critical at this stage.

We also welcome the commitment of the authorities for transparency, including the publication of the Article IV report.

Mr. Alkhareif made the following statement:

First, we welcome the recent signals of a somewhat earlier than envisaged bottoming out in economic activity, as alluded to by Mr. Sassanpour. We encourage the authorities to continue their efforts to support the recovery while safeguarding macroeconomic stability.

Second, in our joint gray statement, we underlined the need for mitigating the increase in poverty and social impact of economic downturn. In this context, we take note of the staff response to our question on the social impact analysis of the expenditure rationalization options. Here the authorities may consider requesting a Fund TA on expenditure rationalization as well as a support from the World Bank for public expenditure review.

Third, the Central Bank of Nicaragua deserves to be commended for the timely action in stabilizing the financial sector, including supporting liquidity in the banking system.

Finally, like Mr. Mozhin and others, we welcome the indication by Mr. Bevilaqua's remarks that the authorities intend to publish the staff report.

Ms. Moreno made the following statement:

First, Nicaragua is bottoming out still with a fragile recovery from a very serious shock, but this is thanks to a coordinated and decisive policy response from the authorities. This was deservedly highlighted in the report, but further recognition could be granted, as indicated also by Mr. Sassanpour.

The second point is that external support has not been part of the recovery toolkit, but the authorities wish to further engage with the Fund.

Third, we concur with the authorities in welcoming a report that focuses on the core areas of the Fund mandate. As a final note, we encourage staff and commend staff to continue their efforts to evenhandedness in reports.

Mr. Rozan made the following statement:

I would just like to emphasize four points, the first one being that we agree with staff that monetary and financial measures put in place to deal with the crisis were generally well managed, and signs of stabilization are visible in the country, which is good news. However, as others have noted, Nicaragua remains in a precarious position. It is still in a recession and exposed to many downside risks, among them social and political risks, which make the future uncertain, especially in the context of an election year.

Second, regarding the fiscal policy, we welcome the fact that the authorities made significant effort to avoid a strong deterioration of their public finances, thanks to tax and pension reform. We note that the deficit should increase somewhat this year, and we encourage more expenditure allocated to the poorest as unemployment and poverty rates increased over the last few years. We note the fiscal deterioration in 2020 and over the medium term in the baseline and that the public debt is vulnerable to growth shocks and contingent liabilities shocks, and in this regard, it would be key for the authorities to put in place a medium-term credible fiscal framework.

Third, we thank the mission chief for the information provided on the FATF plenary meeting and the fact that the country is on the grey list, and we encourage the authorities to swiftly implement the AML/CFT framework and to make progress on the 2017 recommendation.

Finally, regarding the future of the Fund's engagement, we very much welcome the various technical assistance missions that are planned, and we think the areas outlined at the outset of the meeting are positive; and we wish to support Mr. Rosen's points in his gray when he encourages the IMF to work with other international financial institutions to develop a coherent policy approach to its engagement and lending with the government of Nicaragua. We think this is a key point going forward.

Ms. Indraratna made the following statement:

The Nicaraguan economy was plunged into a severe recession in 2018 and 2019 after the announcement of pension reforms, which were aimed at restoring the long-term financial sustainability of the social security system. These reforms, in line with the IMF advice, were a necessary structural

adjustment measure to ensure fiscal sustainability in the medium term. Although some of the reform measures were implemented later on, the social unrest created brought the Nicaraguan economy to a crisis situation. In fact, the implementation of pension reforms the world over has really often been marked by some form of protest. In February this year we saw transport workers striking over pension reforms in Athens. In France there are protests with regards to changes to the pension system.

In the context like Ms. Mannathoko and Mr. Mozhin, I would like to emphasize the point on lessons learned from this experience. It is essential to come up with a strategy to manage the political economy of such reforms. Good communications campaign, extensive stakeholder involvement, and measures to mitigate the impact on the vulnerable are key ingredients of such a reform process. Therefore, given the importance of restructuring social security systems, we need to find a way to successfully implement pension reforms in the future while preserving social stability.

Mr. Von Kleist made the following statement:

I have just two points. One is to very much welcome the fact that the authorities are working closely together with the FATF to move forward on the AML/CFT issues, so we strongly welcome it.

The second point is basically building on the comments of Ms. McKiernan, whether the crisis in 2018 was the result of some maybe not well-communicated reforms, which given the extent of this crisis, I also find rather improbable, but probably the expression of imbalances which had built up over time and which sort of like an earthquake resulted in a sudden adaptation.

And the question in this context is whether this crisis had a more fundamental nature, whether the potentially large output gap of almost 8 percent which staff identifies in the documents for 2020, is actually a reasonable estimate or whether through the crisis the economy and the potential output for the economy move to a lower path, which would mean that the potential output gap would be a lot smaller, which would again on the other hand, have implications for the whole macroeconomic framework.

Ms. Pollard made the following statement:

We issued a gray, and I was not going to say anything at this Board meeting, but listening to some of the discussion around the table, I was a bit confused as to what country we were talking about and the facts around the 2018 occurrences. We are a chair who does not hesitate to criticize staff when we think they are in the wrong, but I think staff is clearly not to blame, and all of our interactions with Mr. Garcia-Saltos have shown that he is dedicated to

helping the Nicaraguan people and trying to make the best of a very difficult situation.

I want to take off on the comments that Mr. Von Kleist just made, and I think that to say the origins of this crisis lie at the feet of the Fund is just outrageous. This was a pension reform that went poorly, and we can argue as to why it went poorly; but we all know that there are many cases, and many of us around the table have countries where reforms have resulted in protests, but not many countries have reacted by killing their own people. And I think that that is the origin of the crisis, and to say that we commend the authorities and want to put this in a press release that we commend the authorities for their actions, I cannot agree to.

The staff representative from the Western Hemisphere Department (Mr. Garcia-Saltos), in response to further questions and comments from Executive Directors, made the following additional statement: [2]

Nicaragua is a transit place, so for that purpose, then the national risk assessment considered one of the main elements to have procedures in place to try to prevent the money-laundering coming from drug trafficking, so that is why it is an important element.

Turning to the second point, on the outlook, first let me start with the last observation whether the output gap is probably smaller. Hopefully we would like to see that the output gap is smaller, but currently our projection is between 6 and 9, so between 6 and 8 probably it is smaller. I do not think we are in that moment which we can say that in the next six months we have some pressures from demand so while we really are observing that there is a significant lag.

Now, on the big point of whether we see that the financial indicators can provide a signal that the economy has reached bottom as well, we would like to see that that is the case, but the hard data that we have basically points to a contraction in formal employment through the second quarter, a contraction on the manufacturing and construction and tourism still for the second quarter. The central bank does not have numbers. It has also a projection, so the central bank projection for 2018 is minus 4.5. We would like to see that we are wrong. Really, we are keen to see that the economy has not fallen more than 4.5. Unfortunately, we do not have this. What we have learned from the financial crisis that we have seen in 2008 and 2009 in the advanced economies is that the process of deleveraging has protracted effects on the economy, and when we see that the credit has contracted for more than 30 percent and investment FDI has contracted by half, and some activities

[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

basically have contracted by 80 percent, like tourism, so what we are seeing is that there is a process in which the balance sheet repair is going to take a sufficient amount of time.

Once we started to see that the deposits start to recover is a good thing; but from the point of view of the financing, we have banks that have 50 percent in cash, and they are not willing to lend basically because there is no investment opportunities that can justify to start giving credit because the level that has occurred is a realization that the new normal is going to be much lower than before. From that point of view, we are hopefully thinking that the transition and the financial arbitrage or the financial variables, it is near completion. And hopefully with restoration of some financial flows coming from other multilaterals, the fiscal situation can be improved, and then we can start to see a little more of infrastructure, but that is where we are. So making a forecast in a downturn is subject to a large uncertainty. We would like to see that the bottom has reached. We think that the economy is not decreasing at the speed it was decreasing, and observing the evolution of credit is key to understand whether the economy is starting to recover, but we do not see that yet.

On the changes in the priorities for TA strategy, in fact, it has changed because now we are concentrated in trying to implement the agenda that was defined with the FSSR on the financial sector. I think that the priority is to move towards having an Asset Quality Review in order to try to have a better understanding of the assets, but at the same time, there are issues on the quality of fiscal spending and then on PFM that is important to move forward. With the FATF decision, there has to be also a priority to try to put in place TA that will help them to move quickly towards addressing these concerns.

The staff representative from the Strategy, Policy, and Review Department (Ms. Gonzalez), in response to questions and comments from Executive Directors, made the following statement:

I would like to address the question on how the Fund is trying to absorb the lessons from episodes in which reforms recommended by the Fund may have been associated with social or political instability in general. First of all, of course, we agree with the importance of observing these lessons, and there is work underway both on surveillance and lending in this area. These are, of course, complex issues to tackle, and the Board will be able to continue providing advice in this regard.

In the case of Fund lending, the 2018 Review of Program Conditionality recommended two things. First, that the staff strengthen analysis of institutional and political capacity to deliver the four program objectives and reforms and improving the way communication with the broader public to support buy-in to increase the likelihood of successful

implementation. As a result, we will cover these topics in the forthcoming operational guidance note on program design and conditionality, which will be issued later this year.

In addition, on the surveillance area, there are two streams where this is being included already. One has to do with the recognition of political economy risks, and the second is the Comprehensive Surveillance Review. As Directors may recall, the CSR midpoint note already emphasized that while the staff must continue to provide the membership with its best possible advice, a greater awareness of political economic considerations should be a factor in assessing the sustainability of the recommended policies. Staff is considering various approaches for how to strengthen the Fund capacity in this regard.

Separately I would also like to highlight that complementing these efforts and related to them the recently published strategy for engagement on social spending is also part of this package. The strategy noted that the design of social safety nets should depend on the country's social and political preferences consistent with fiscal and administrative constraints. The paper recognized that the implementation of this strategy requires granular and gradually evolving guidance to staff, and to this end it is currently working on a detailed guidance note that will be completed by the end of the year.

Mr. Mozhin made the following statement:

If I may, I would want to have a follow-up question on drug trade. The way I understood the response is that, yes, Nicaragua is a transit country in the drug trade. The question is, of course, what is Nicaragua's share in this massive transit, whether they have drug barons; what their role is in the economy or the political system? Did they play any role in the violence, for example, which took place in early 2018 and after? I am asking this because I have not seen in the press, too many stories about the issue of Nicaragua having these severe problems associated with the drug trade like in quite a few neighboring countries. My question is how would you compare Nicaragua with some of the neighboring countries on that side?

Ms. McKiernan made the following statement:

For the record, I want to support every comment that Ms. Pollard made earlier.

The staff representative from the Western Hemisphere Department (Mr. Garcia-Saltos), in response to further questions and comments from Executive Directors, made the following statement:

The only thing I can say is that the government implemented a containing wall, a strategy that seeks to focus on the prevention, combat, and prosecution of drug trafficking and crime. In terms of comparison with other countries, all I can say is that Nicaragua implemented a substantial reform and is in the process of implementing the laws that it has enacted on the anti-money laundering, so my understanding is that the process of implementation is in the early stages, so that is what triggered the decision of the FATF.

Mr. Bevilaqua made the following concluding statement:

I want to thank my colleagues for their overwhelming encouragement and support, as well as their helpful comments and suggestions. Your thoughtful and constructive advice on how Nicaragua can cope with its macroeconomic challenges is invaluable. It clearly illustrates the gains from being a member of this institution. The generosity, solidarity, and engagement you display in the discussion of so many important economic issues for the country will be faithfully conveyed to my authorities. I also want to take the opportunity to express the deep appreciation of my office and my Nicaraguan authorities to the mission chief, Mr. Garcia-Saltos, the Western Hemisphere Deputy Director, Aasim Husain, and the whole IMF Nicaraguan team. Their attention to the specific country circumstances and the clarity of their views have bolstered a high-quality policy dialogue that is much valued. I trust that IMF engagement with Nicaragua will continue to support the efforts to promote economic growth while reducing poverty and inequality.

My Nicaraguan authorities appreciate the emphasis given by staff to protecting the poor and vulnerable. They expressed a deep concern about the significant impact that the limited access to external financing has on their ability to strengthen the social safety net. They have also reiterated their commitment to implement sound macroeconomic policies and continue to reform the economy to the benefit of the Nicaraguan people. For that they keep counting on the Fund advice and engagement.

The Acting Chair (Mr. Furusawa) noted that Nicaragua is an Article VIII member and no decision is proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They noted that the authorities' determined policy response had contained the impact of the fiscal and financial sector shocks in 2018 and 2019. Nonetheless, with domestic and external vulnerabilities persisting, they emphasized the importance of measures to preserve macroeconomic and financial stability and restore confidence. They stressed that commitment to prudent policies will remain important. The careful design and communication of reforms will also be crucial in ensuring their social acceptability. Continued support from development partners, in collaboration with the Fund, will be important.

Directors considered that the fiscal position outlined in the 2020 budget is adequate to support the economic recovery. They underscored the importance of rebalancing public expenditures in the short term to generate fiscal space for spending on social safety nets, critical social programs, and efficient investments. Over the medium term, the fiscal deficit will need to be gradually reduced to ensure sustainability, together with reforms to strengthen the financial position of state-owned enterprises and the pension system. It will be important to strike the right balance to provide enough expansionary impulse to medium term economic growth. Greater fiscal transparency will be needed in assessing fiscal risks and enhancing fiscal governance.

Directors highlighted the need to increase the international reserves coverage to support the crawling peg exchange regime and restore external buffers. Keeping inflation low while adopting structural reforms to raise productivity will increase competitiveness and resilience to shocks.

Directors welcomed the resilience of the financial sector to recent confidence shocks but called for further efforts to mitigate risks from the elevated level of distressed assets. Enhancing crisis preparedness, strengthening banking sector supervision, and improving institutional coordination for resolution activities, including adequate resources for the financial safety net, would shield the financial system against downside risks. Directors welcomed the reforms to the AML/CFT framework but stressed the need for further efforts to ensure its effective implementation. They also emphasized the importance of addressing governance weaknesses in line with the recommendations of the 2017 Financial Action Task Force.

Directors recommended the steadfast implementation of structural reforms aimed at restoring investors' confidence and improving the business environment, in consultation with key stakeholders. Strengthening institutions, improving infrastructure, investing in human capital, addressing labor skills bottlenecks, and upgrading technological readiness would improve competitiveness.

Directors urged the authorities to improve the quality and timeliness of economic data with continued Fund technical assistance.

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

APPROVAL: October 5, 2022

CEDA OGADA
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and risks

1. ***We note the divergence of views on the growth outlook, with staff projecting a further contraction of economic activity in 2020, while the authorities project that the economic decline will bottom out. Against this background, we wonder to what extent recent data on the monthly economic activity index, recovery in exports and credit growth, alongside the strengthening of labor markets, would help tilt the balance of risks to the upside as projected by the authorities. Staff comments are welcome.***

- The projections used the latest available data on the monthly economic activity index (IMAE) through the second quarter of 2019, in which the overall index continued to contract. While the stabilization of bank credit and deposits in late 2019 may signal a somewhat earlier than envisaged bottoming out in activity, no actual data on the real sector for the third and fourth quarters of 2019 is yet available.

2. ***We note that the risk of a disorderly migration from Venezuela is mentioned in the Risk Assessment Matrix but there is no mention of the movement of Nicaraguan migrants, for example to Costa Rica. Could staff elaborate on his diagnostic regarding these two risks and their impact on the economy?***

- Staff has no official data on migration from Venezuela to Nicaragua or from Nicaragua to neighboring countries. However, the authorities from Costa Rica reported in December 2019 applications from 77,000 Nicaraguans refugees since April 2018. The migration could explain in part the decline in the labor force participation observed through 2019.Q2 (to 71 percent from 74 percent in 2017). Note, however, that the negative effect from migration could be reduced by rising remittances.

3. ***The more recent developments have been encouraging: output and employment seem to have turned the corner, bank deposits are recovering, credit is stabilizing, and international reserves have been partially replenished. Moreover, political dialogue is continuing, and elections are slated for 2021. With this background, we were somewhat taken back by the "high" probability ranking assigned to an array of Nicaragua-specific risks in the Risk Assessment Matrix that would surely impact confidence. Staff may wish to elaborate.***

- In staff's assessment the economy remains under a fragile equilibrium subject to high domestic risks, following the pronounced economic contraction in 2018 and 2019, and the

uncertainty related to the stabilization of the main economic indicators (as stressed by staff's response to question number 1).

Fiscal policy

4. ***We are encouraged by the fiscal reforms undertaken by the Nicaraguan authorities, despite the difficult circumstances. We take positive note of the tax policy changes and pension reform measures undertaken in 2019 to recoup revenue and restrain expenditures. As some of the pension reform measures have not yet been implemented, can the staff comment on the time frame for the implementation of these measures?***

- The authorities are evaluating the outcome of the current reform. We understand that once this evaluation is completed the authorities will decide on the implementation of the pending measures.

5. ***While we see the benefit in carrying out Social Impact Analysis of critical fiscal reform options to evaluate expenditure rationalization options and ensure that the poor and most vulnerable receive the lowest burden of adjustment, we were wondering about the national capacity to carry out such evaluations. Staff comments would be welcome.***

- Staff is not able to directly assess our counterparts' capacity on this topic. Local research institutions and think tanks could also support in conducting the impact analysis. The IMF's Fiscal Affairs Department has provided technical assistance on expenditure rationalization in several countries, and so the authorities could request support in this area. This could potentially be complemented with support from the World Bank in the form of a Public Expenditure Review.

6. ***The public pension system remains in deficit, but before further pension reforms are undertaken, we encourage the authorities to assess the impact of recent reforms in order to develop a medium-term pension strategy. Has an actuarial review been conducted since the 2019 pension reforms to determine what systemic or parametric reforms are needed to retain benefits adequacy while improving sustainability?***

- To the best of our knowledge, no actuarial review has been conducted since enacting the 2019 reforms.

External financing

7. ***Regarding the external and fiscal and imbalances, which imply a moderate risk of debt distress, the increase of external financing appears as a top priority. On the external side, we encourage the authorities to build up buffers and increase reserves, which are now below the range of 5 to 10 months of non-maquila exports according to staff but estimated at 6.3 months according to the Buff. Could staff explain this difference?***

- Discrepancy reflects new data. Supplement 3 uses data until end-December 2019, while the BUFF/ED/20/23 refers to February 1, 2020.

FX reserves

8. ***Staff are suggesting a build-up of FX reserves to ensure the integrity of the currency peg. While we agree in principle, would staff please elaborate on the likely sources of the increase, given that the external financing constraints are projected to continue in the medium term, and that the current account will be roughly in balance as imports recover?***

- Consistent and sustained efforts to keeping inflation low while adopting structural reforms to raise productivity would increase competitiveness and attract FDI, which in turn would result in higher reserves and enhance the external position.

Capital flows measures

9. ***Has the authorities and staff considered measures of prudential capital flow management against the disruptive outflows as a part of a broader policy response?***

10. ***Have CFM measures been considered by the authorities and what is staff's view regarding the use of these measures if a similar crisis happens again?***

- The Fund staff reiterated that CFMs should not be a substitute for macroeconomic, structural, and financial policies to achieve necessary macroeconomic adjustment. Since the adjustment is underway and fiscal and external imbalances are narrowing, and reserves and bank deposits appear to have stabilized, the adoption of CFMs is not recommended. Moreover, given the exchange rate peg/crawl and near full dollarization, any such measures at this stage could possibly prove counterproductive.

Financial sector

11. ***Could staff share further details on any stress tests done on the banking sector, including the adequacy of their liquidity coverage ratios for example?***

- Whereas the focus in 2018 was on strengthening liquidity management, the main challenges in 2019 were related to managing distressed assets. In this regard, the stress scenario presented in the report assumed a further deterioration in the loan portfolio equivalent to one-third of total non-distressed loans. Under such stress scenario, there would be room for keeping the provisions with a coverage level of 60 percent, and most banks would remain above the minimum capital requirement of 10 percent of risk-weighted assets.

12. ***Bank profitability in terms of ROE has declined from 18 percent in March 2018, to 4.4 percent lately, amid deteriorating portfolio quality. Adequate provisioning and portfolio cleaning would be essential to restore the soundness of the sector. What are staff's projections for the future evolution of banks' profitability as an important source of banks' buffers.***

- Bank profitability is experiencing a considerable reduction, which is largely explained by the sizeable contraction of their loan portfolio and their larger holdings of low yield liquid assets. In addition, a significant portion of bank profits is explained by accounting profits from the banks' long foreign exchange positions.

13. ***We note staff's assessment that the banking system still holds cushions to withstand a further decline in confidence and economic growth. Banks have responded to the economic downturn and financial stress by adjusting the balance sheets. While it could be necessary for individual banks to reduce their balance sheets amid funding constraints and a severe macroeconomic downturn, such a situation will inevitably have a negative pro-cyclical macroeconomic impact. Could staff elaborate on measures that could be taken in order to mitigate such effects, especially if the stressed situation should deteriorate? Is there room left for further easing of reserve requirements or macroprudential measures?***

- The Central Bank of Nicaragua reduced reserve requirements in order to ensure adequate liquidity in the financial system. Further easing of the reserve requirements could be implemented. In staff's view, a key measure that should be taken is to increase the loan provisioning by banks in order to be able to mitigate the effects if the stressed situation should deteriorate further. Other important measures to take are those aimed at enhancing the framework for bank resolution and strengthening the financial safety net in order to increase the resilience of the financial sector and protect it against downside risks. Actions could also include ensuring market-oriented rules to facilitate private bank mergers and reforming the legal framework to facilitate debt-workouts.

14. ***We would welcome staff's elaboration on the multi-year roadmap of financial sector-related TA, developed under the Financial Sector Stability Review (¶35), and the progress so far.***

- Resulting from the Financial Sector Stability Review (FSSR) finalized in February 2019, there are several workstreams which are focused on: i) Strengthening the institutional framework for financial stability and inclusion; ii) Strengthening the function of banking supervision; iii) Strengthening bank resolution capacity; iv) Implementing the functions of the BCN as rector of the national payments system; v) Updating critical legal issues in support for financial stability; vi) Promoting the national agenda for financial inclusion; and vii) Improving financial statistics

- One workstream focused on the assessment of loan portfolios has been finalized to date. At the request of the Nicaraguan authorities, a mission of Regional Technical Assistance Center for Central America, Panama and the Dominican Republic (CAPTAC-DR) visited Nicaragua to assist the Superintendence of Banks and Other Financial Institutions (SIBOIF) of Nicaragua in strengthening the credit risk supervision of financial institutions.

Structural reforms

15. ***In light of the substantial decline of potential growth following the 2018 socio-political unrest, we would invite staff to elaborate on a more detailed roadmap of structural policies to reverse the persistent and sharp deceleration in potential growth.***

- Both staff and the authorities have revised down potential growth resulting from lower rate of capital accumulation and weaker prospects for robust job creation. A key element to buttress the recovery is to restore investor confidence, which can be achieved by embarking in structural reforms to continue closing infrastructure and skills gaps, strengthen government institutions and improve business climate. Besides the areas listed in the staff report, the latest WB report on Doing Business 2020 and the Global Competitiveness Report highlight the need adopt reforms to reduce the high costs for starting a business, getting electricity, and facilitating registering properties in a timely manner.

Political economy issues

16. ***Which lessons should be drawn for the Fund's advice from the Nicaragua's experience with the implementation of the necessary social reform in the absence of the broad social consensus?***
17. ***Given the fact that the pension reforms, while owned by the authorities, were based on the IMF's advice in 2017, we would value staff views on lessons learnt on how best to implement such reforms in the future, while preserving social stability.***
18. ***With respect to the social impact analysis of critical social reforms, could staff elaborate any lessons learnt from the social protests in 2018 that were triggered by the announced pension reforms, and relevant insights from other country experiences with social security reforms that may help inform the analysis?***

- Like in other reforms that have a significant social impact one significant challenge faced by policymakers is to gain social acceptance by creating awareness about the need and objectives of pension reforms. Successful reforms are usually implemented following a comprehensive strategy that includes: having a detailed impact assessment of the impact of the reform; consultation with stakeholders; a far-reaching communication campaign that carefully explains the need for and benefits from reform; measures to improve the administrative efficiency and reduce fiscal burden of the pension administration, strengthen governance and government credibility, and have ready-to-implement measures to mitigate the impact of reforms on the vulnerable population.

19. ***Could staff provide a quantitative assessment of the impact of sanctions and social protests on GDP and the poorest, for example for the bottom 40 percent of the income distribution?***

- We have not conducted such an assessment of the sanctions. On poverty, preliminary results from the World Bank suggest that a measure of poverty rate (using a $3.2 in 2011 PPP) increased by 2.8 percentage points between 2016 and 2019. Part of this could be due to sanctions and the macroeconomic difficulties following the social protests in 2018.

Fund engagement

20. ***Given the risks to the medium-term outlook, what forms of the future Fund's engagement might be appropriate?***
21. ***We would welcome staff's comments on how the engagement with the Fund could be enhanced, including through policy advice and capacity building.***
22. ***Notwithstanding their efforts to access external financing for infrastructure spending so as to improve competitiveness and promote long-term growth, the authorities have reiterated their concern in the Buff statement regarding Nicaragua's limited access to external financing which also impairs their ability to strengthen the social safety net. Further comments are welcome from staff on how else the Fund could help the authorities overcome this key vulnerability.***

- The staff has maintained a fluid economic dialogue with the authorities as well as active capacity development agenda through technical assistance. The staff intends to continue this close engagement by continuing to provide macroeconomic policy advice in a timely manner. Subject to authorities' specific requests, key areas for capacity development that the Fund could provide support for include: financial regulatory, supervision, and prudential frameworks, and public financial management (reporting, asset and liability management, and fiscal risk management).