MISSION CONCLUDING STATEMENT

Nicaragua: 2017 Article IV Consultation Concluding Statement

May 5, 2017

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

This statement summarizes the preliminary findings and recommendations of the mission that visited Managua during April 24-May 5 in the context of the 2017 Article IV consultation. The mission is grateful to the authorities for the constructive dialogue and hospitality.

Growth has been robust while inflation remains well anchored. External imbalances improved moderately in 2016 while the fiscal deficit increased marginally. Given heightened uncertainties with respect to the external environment, Nicaragua needs to continue strengthening its policy framework to stave off downside risks and promote sustained and inclusive growth. Policy discussions focused on (i) creating fiscal space to manage risks and promote sustainable growth; (ii) strengthening monetary management, financial stability and the AML/CFT framework; and (iii) improving external resilience and competitiveness.

Recent Developments and outlook

1. Macroeconomic performance in 2016 was solid

- **Economic activity remained robust** . Real GDP grew by 4.7 percent in 2016, supported by strong domestic demand, while inflation remained subdued at 3.1 percent as of end-2016, owing largely to low food prices. Inflation expectations remain well anchored by the crawling peg.

- **The fiscal deficit increased slightly in 2016** . Revenues increased by over 0.6 percent of GDP in 2016, because of advances in tax administration and the impact of the full implementation of the 2012 tax reform. Nevertheless, the deficit of the consolidated public sector (CPS) widened from 2.2 percent in 2015 to 2.4 percent in 2016 due to election-related spending, expansion of public investment and a higher Social Security Institute (INSS) deficit. The CPS debt ratio edged up to 40.1 percent of GDP in 2016 from 39.3 percent in 2015, excluding state-owned enterprises (SOEs) and municipalities.

- **The external position improved moderately from the previous year** . The current account deficit for 2016 is estimated to have narrowed to 8.6 percent of GDP, compared with 9 percent in 2015. The deficit reduction is largely explained by maquila exports, which have been better captured due to improvements in statistical compilation. The current account deficit remained financed by foreign direct investments (FDI) and other long-term inflows. Gross international reserves remained broadly stable at US$2.3 billion at end-2016, with coverage of about 4 months of non-maquila imports.

- **Monetary and financial conditions remained stable** . Bank soundness indicators as of end-2016 were relatively robust. However, balance sheet risk from an expansion of bank credit in dollars to unhedged borrowers is rising in the context of increasing interest rates, continued dollar strength and higher reliance on external financing. Consolidated supervision of regional banks continues to be a challenge and some non-bank financial institutions, including deposit-taking credit cooperatives, remain unsupervised.

2. GDP growth is expected to moderate to its potential. Real GDP growth in 2017 is projected at 4.5 percent, while inflation is expected to remain contained at about 6 percent, assuming food and oil prices remain consistent with projections of the IMF's World Economic Outlook. The deficit of the CPS is projected to moderate somewhat, to about 2.2 percent of GDP, implying a broadly neutral fiscal stance in line with the authorities' fiscal anchor. At the same time, however, the deficit of the INSS is expected to continue increasing up to 0.43 percent of GDP in 2017. CPS debt, excluding domestic debt of SOEs and municipalities, is projected at rise further to about 40.6 of GDP. The current account balance is projected to remain stable at about 8.4 percent of GDP.

3. Risks are tilted to the downside against a background of high global uncertainties . In addition to the growing deficits of the INSS, risks include spillovers related to the decline in Venezuelan oil cooperation and potential shifts in U.S. trade and migration policies, which might have global spillovers on exports and remittances.

Policy Recommendations

The key challenge is to reduce economic vulnerabilities while maintaining policies geared towards strong, sustained, and inclusive growth. It will be critical to create fiscal buffers to insure against downside risks, while preserving social and infrastructure investment; bolstering financial stability by strengthening the macroprudential framework, boosting liquidity, provisions and capital buffers, broadening the supervisory perimeter to all deposit-taking institutions, and effectively implementing the AML/CFT framework; continue developing central bank's monetary management capacities and deepening financial markets; and improve external resilience and competitiveness.

A. Creating Fiscal Space to Manage Risks and Promote Sustained Growth

4. The fiscal stance for 2017 is broadly appropriate . With the output gap closed and a stable external debt ratio, the projected CPS deficit of 2.2 percent of GDP represents a broadly neutral fiscal stance. Adhering to the fiscal anchor of no more than 2 percent of GDP for the CPS deficit, consistent with debt sustainability given current financial conditions, would help increase the transparency and credibility of the fiscal policy stance. However, Nicaragua is likely to face increased spending pressures going forward due to reduced financing from Venezuela and the weakening financial situation of INSS. At the same time, should the NICA Act pass, financing costs might increase. To insure against these risks and maintain fiscal sustainability, the mission recommends building additional fiscal buffers of about 1.6 percent of GDP over the next two years through revenue mobilization and improving expenditure composition and efficiency, while safeguarding pro-growth public investment and strengthening and better-targeting social safety nets. The mission considers that implementing these measures would provide sufficient insurance against the risks described.

5. Ensuring the sustainability of the INSS remains a key priority . The increase of INSS's deficits might increase public debt in the long run, threatening its sustainability. Under current policies, the INSS will continue to run deficits and deplete its liquid reserves by 2019, potentially necessitating transfers from the government. A sustainable outcome could be achieved by a combination of: (i) streamlining and rationalizing operational and health costs; (ii) increasing the retirement age; (iii) raising the minimum contribution period; (iv) increasing employer and employee contribution rates; (v) revising the pension indexation mechanism; (vi) reducing benefits; and (vii) assuming some expenditures by the government (for instance, reduced and special pensions). It is important that the government, labor unions, and the private sector arrive at a mutually agreeable solution as a matter of priority, as delaying the reforms will lead to a worsening of the situation and increase the costs.

6. Policy efforts should focus on broadening the tax base, further strengthening tax administration, and improving expenditure composition and quality. Additional fiscal consolidation needed to address the challenges mentioned above could be obtained by eliminating tax expenditures, rationalizing and better targeting subsidies and implementing the legislation on international taxation, while strengthening tax administration. Further, quality of public infrastructure spending could be enhanced by strengthening public investment management processes and practices, and improving the efficiency and governance of the major SOEs. Progress made by the authorities on the analysis of fiscal risks, including the monitoring of SOEs, is welcome, and further advances in this area are encouraged.

7. Going beyond insuring against immediate downside risks, the fiscal stance should strive to improve resilience against potential external shocks, including climate change and natural disasters. Given the fiscal risks related to external uncertainties and Nicaragua's vulnerability to climate change and natural disasters, fiscal policy should aim to be more counter-cyclical—building space in good times to be able to avoid volatility in expenditure and the need for abrupt adjustments should tail-risks materialize.

B. Strengthening Monetary Management, Financial Stability and the AML/CFT Framework

8. Strengthening risk-based supervision and tightening the macroprudential framework remain a priority. Higher interest rates, sustained U.S. dollar strength, and possibly lower remittances, might have a negative impact on banking sector soundness in the context of large un-hedged dollar assets. The authorities should continue monitoring and further strengthening their monetary, regulatory and macroprudential toolkit, including by conducting regular stress tests, notably to assess systemic risks, and crafting contingency plans. The mission supports the authorities' plans to gradually strengthen regulatory liquidity ratios, countercyclical provisions and capital requirements.

9. Gaps to the financial supervisory perimeter need to be addressed. Effective supervision of the savings and credit cooperatives and microfinance industry requires further resources, capacity development and, in some cases, better prudential regulation. All deposit-taking institutions and institutions with strong macro-financial links should be subject to effective risk-based supervision. While consolidated supervision of cross-border banking groups has improved since the establishment of the Liaison Committee at the Regional Group of Financial Sector Superintendents and the commissioning of the regional College of supervisors, further progress is needed to fully assess the risks of Nicaraguan banking groups that report consolidated financial statements to the supervisory authorities of other countries in the region.

10. There is a need to deepen financial markets, strengthen liquidity management and increase financial inclusiveness. Deeper financial markets are needed to increase the ability of financial institutions to manage their risks, and enhance liquidity management by the central bank. The efforts of the central bank to strengthen its liquidity management capacity through better liquidity forecasting and introducing shorter-term liquidity management tools are welcome developments that will, in time, allow establishing a short-term monetary reference rate and corridor, reduce interest rate volatility, and deepen the interbank and domestic bond markets. In this context, efforts to capitalize the central bank need to continue. Initiatives to increase financial inclusion, including by developing a simplified savings account, facilitating access to payment methods, and developing a national plan of financial education, are welcome and should be pursued with a greater sense of urgency, notably in the context of a comprehensive strategy to enhance inclusive growth, reduce poverty and strengthen financial stability.

11. Additional efforts are needed to improve the Anti-Money Laundering/ Combating the Financing of Terrorism (AML/CFT) regime . Nicaragua has made significant progress in improving the AML/CFT regime and is no longer subject to the FATF's monitoring process under the International Cooperation Review Group. Nevertheless, efforts should continue to ensure the effective implementation of the AML/CFT regime particularly with regard to preventive measures. Nicaragua is scheduled to undergo in 2017 a full assessment, under the revised FATF standards that emphasize implementation and effectiveness. The assessment should be finalized before the end of the year and the authorities are encouraged to implement its recommendations.

C. Improving External Resilience and Competitiveness

12. Vigilance of external shocks is warranted. The crawling peg exchange regime has been effective in anchoring inflation expectations. However, the peg will likely exacerbate the negative impact of an external shock on output, competitiveness and exports. There is, therefore, a tradeoff between the price stability anchor provided by the peg and the cost of limited adjustment policy tools. Better understanding and continuous monitoring of the spillover effects of a persistently strong dollar, higher interest rates and other U.S. policy changes would help the authorities in making the appropriate policy choice.

13. Improvements in competitiveness would reduce vulnerabilities to external shocks . Supply side reform policies should focus on strengthening medium and long-term competitiveness. Efforts should be made to diversify products and markets and reduce external dependence. Although Nicaraguan wages remain the most competitive in Central America, other aspects of competitiveness are lagging. Improving infrastructure, investing in human capital, and addressing labor skills bottlenecks would facilitate structural transformation and enhance potential growth.

D. Other Issues

14. Significant progress has been made in strengthening macroeconomic statistics, but shortcomings remain . The mission welcomes the progress made in implementing IMF recommendations on data compilation, particularly in the external sector and base statistics. Addressing remaining shortcomings in national accounts, fiscal, debt, and external sector statistics—particularly data on FDI—entails continued building on the Fund's technical assistance to improve the timeliness, quality, and consistency of statistics. Regulations to enforce data collection and facilitate exchange of information across units and institutions should be implemented and procedures need to be established to monitor data quality.

Table 1: Nicaragua: Selected Social and Economic Indicators, 2012 - 17

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Table 1. Nicaragua: Selected Social and Economic Indicators, 2012-17

I. Social and Demographic Indicators

Main export products: beef, coffee, and gold.			
GDP per capita (current U.S.$, 2016)	2,091	Income share held by the richest 10 percent (2014)	37.9
GNI per capita (Atlas method, current U.S.$, 2015)	1,940	Unemployment (percent of labor force, 2016)	6.1
GINI Index (2014)	47.1	Poverty rate (national pov. line, in percent, 2014)	29.6
Population (millions, 2016)	6.3	Adult literacy rate (percent, 2015)	82.5
Life expectancy at birth in years (2014)	74.8	Infant mortality rate (per 1,000 live births, 2015)	18.8

II. Economic Indicators

	2012	2013	2014	2015	2016	2017 Proj.
Output			(Annual percentage change)			
GDP growth	6.5	4.9	4.8	4.9	4.7	4.5
GDP (nominal, U.S.$ million)	10,532	10,983	11,880	12,748	13,230	13,942
Prices						
GDP deflator	6.2	4.3	8.4	7.5	4.1	5.9
Consumer price inflation (period average)	7.2	7.1	6.0	4.0	3.5	5.4
Consumer price inflation (end of period)	6.6	5.7	6.5	3.1	3.1	5.8
Exchange rate						
Period average (Cordobas per U.S.$)	23.5	24.7	26.0	27.3	28.6	…
End of period (Cordobas per U.S.$)	24.1	25.3	26.6	27.9	29.3	…
Fiscal sector			(Percent of GDP)			
Consolidated public sector						
Revenue (excl. grants)	25.4	25.3	25.5	26.3	27.9	28.0
Expenditure	28.3	28.3	28.6	29.6	31.2	31.2
Current	23.0	22.4	22.6	23.0	24.2	24.2
of which: wages & salaries 1/	7.6	7.7	7.4	7.4	7.6	7.5
Capital	5.3	5.9	6.0	6.7	7.0	7.0
Overall balance, before grants	-2.8	-3.0	-3.1	-3.3	-3.3	-3.2
Overall balance, after grants	-0.8	-1.3	-2.0	-2.2	-2.4	-2.2
Money and credit			(Annual percentage change)			
Broad money	16.3	18.5	15.9	18.7	10.8	10.9
Credit to the private sector	26.3	20.2	20.5	23.5	17.4	14.5
Net domestic assets of the banking system	24.5	17.6	6.2	18.4	12.7	11.7
External sector			(Percent of GDP, unless otherwise indicated)			
Current account	-10.7	-10.9	-7.1	-9.0	-8.6	-8.4
of which: oil imports	11.9	10.4	9.2	5.6	4.9	6.1
Capital and financial account	16.9	14.4	13.7	14.0	8.8	9.4
of which: FDI	6.7	6.1	6.7	7.1	6.5	6.3
Gross reserves (U.S.$ million) 2/	1,778	1,874	2,147	2,353	2,296	2,401
In months of imports excl. maquila 2/	3.6	3.7	4.2	4.6	4.0	3.9
Net international reserves 2/	1,609	1,721	2,024	2,262	2,236	2,315
Public sector debt 3/	41.5	42.4	40.5	39.3	40.1	40.6
Private sector external debt	44.7	47.2	45.6	43.7	44.4	42.5

Sources: Country authorities; World Bank; and Fund staff calculations and estimates.

1/ The figures for 2013 include an off-budget wage bonus that was financed with Venezuela-related resources. Starting in 2014 the wage bonus is included in the budget.

2/ Excludes the Deposit Guarantee Fund for Financial Institutions (FOGADE).

3/ Assumes that HIPC-equivalent terms were applied to the outstanding debt to non-Paris Club bilaterals. Does not include SDR allocations.