Managua, Nicaragua
January 9, 1998

Mr. Michael Camdessus
Managing Director
International Monetary Fund
700 19th Street, N. W.
Washington, D.C. 2043 1

Dear Mr. Camdessus:

1. Attached is a memorandum on the economic and financial policies of Nicaragua, setting forth the objectives and policies that the government intends to pursue for the three-year period 1998-2000, and the objectives and policies for the first annual program there-under. The Government of Nicaragua believes that the policies set forth in the memorandum are adequate to achieve these objectives and will take any further measures that may become appropriate for this purpose. In support of these objectives and policies, Nicaragua hereby requests a three-year arrangement under the Enhanced Structural Adjustment Facility in a total amount equivalent to SDR 100.9 million (105 percent of the quota), and the first annual arrangement thereunder in the amount equivalent to SDR 33.6 million (3 5 percent of the quota).

2. During the period of the first annual arrangement, the Government of Nicaragua will consult with the Fund on the adoption of any measures that may be appropriate, at the initiative of the government or whenever the Managing Director of the Fund requires such consultation. In addition, the government will conduct with the Fund a midterm ***review*** of the first annual program. In this connection, in the case of fiscal under performance, large shortfalls in external resources or difficulties in rolling over short-term central bank financial instruments, the government would take additional measures, including increases in the VAT rate and in the retention rate on coffee.

3. After the period of the first annual arrangement and while Nicaragua has outstanding financial obligations to the Fund arising from loans under the arrangement, the government will consult with the Fund from time to time, at the initiative of the government or whenever the Managing Director requests consultation on Nicaragua's economic and financial policies.

4. Nicaragua is committed to provide the Fund with such information as the Fund requests on the progress made in policy implementation and the achievement of the program objectives.

Sincerely yours,

/s/	/s/
Noel Ramirez Sanchez President Central Bank of Nicaragua	Esteban Duque Estrada Minister of Finance

Attachment

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

I. INTRODUCTION

1. By 1990, following a decade of civil war and economic decline, public sector expansion, and hyperinflation, real GDP in Nicaragua had dropped to two-thirds and export volume to one-half of the pre-1980 levels, with per capita income falling to the same level as in the 1920s. The extent of the deterioration was reflected in the country's social indicators with those on infant and maternal mortality, and birth weight the poorest in the Western Hemisphere. At the same time, external debt multiplied tenfold to US$l 1 billion (700 percent of GDP). Social conditions had severely deteriorated and poverty became widespread. Consequently, Nicaragua was not only one of the poorest countries in the Western Hemisphere but also one of the most indebted countries in the world.

2. Subsequently, Nicaragua changed its course drastically, peace was re-established, democracy restored, and substantial progress in policy implementation was made to reduce macroeconomic imbalances and to transform to a market-based economy. Financial policies were strengthened, most price controls were eliminated, and the foreign exchange and trade system was liberalized. A program of public asset divestment was implemented, and public employment and military outlays were cut substantially. Private banks were allowed to operate again and the Superintendency of Banks (SBIF) was created. Substantial progress was achieved in obtaining debt relief from external creditors. Nevertheless, macroeconomic conditions remained fragile and the structural reform process virtually stalled in mid- 1996. Despite important progress in social conditions, poverty remained widespread.

3. In early 1997, a new administration took office. The change of administration provided an opportunity for Nicaragua to retake the path toward macroeconomic stabilization and structural reform to achieve sustainable economic growth and improve social conditions. In this context, the government has prepared a medium-term economic and structural reform program, covering the 1997-2000 period, which is detailed below. In support of this program the government is requesting a new three-year ESAF arrangement from the International Monetary Fund and the corresponding annual arrangements thereunder.

II. ECONOMIC BACKGROUND

4. Nicaragua's economic condition has improved substantially since 1994. After more than a decade of decline, real GDP grew by 3.3 percent in 1994 and by 4.5 percent in 1996. Domestic investment and private capital inflows have increased noticeably, and unemployment-which had risen since the late 1980s—started to decline in 1994. The

12-month rate of inflation fell from 20 percent at end-1993 to 12 percent at end-1996. During the first ten months of 1997, economic activity continued to expand at a strong pace while the 12-month rate of inflation declined to 9 percent.

5. The public finances deteriorated significantly during 1996, reflecting large expenditure overruns in the period leading up to the presidential elections, and a weak performance of the public enterprises (mainly of the power company (ENEL) and the water company (INAA)) and the social security institute (INSS). Thus public sector savings (including the losses of the central bank (BCN)) fell to 1½ percent of GDP and the combined public sector deficit (before grants) reached 15% percent of GDP. Compared to 1996, the fiscal position improved in the first nine months of 1997 reflecting, in part, increased tax collections. However, with a large shortfall in net external financing, BCN net credit to the public sector was equivalent to almost 7 percent of the year's GDP (compared with net credit to the public sector of over 3 percent of GDP in 1996).

6. Control over credit policy weakened in 1996 because of the deterioration of the public finances and the financial difficulties of the state-owned banks associated with problem loan recoveries. While currency grew in line with nominal GDP, the rate of growth of broad money accelerated markedly associated with an increase in foreign currency deposits, and demand and time deposits; at the same time, the growth of bank credit to the private sector also accelerated. In the face of pressures on the net official international reserves (NIR), the BCN began selling exchange rate indexed instruments (CENIS) at interest rates of up to 25 percent (declining to 11 percent by mid- 1997). Despite the placement of CENIS equivalent to US$340 million (18 percent of GDP), at end-November 1997 the stock of NIR stood at US$159 million. Gross reserves were about equivalent to the outstanding amount of CENIS.

7. In 1995-96 Nicaragua reached restructuring and debt-reduction agreements with its official and private bilateral creditors that reduced its debt to US$6 billion at end-1996 (300 percent of GDP). Moreover, an agreement was reached in September 1997 on the restructuring of the US$560 million of outstanding debt (including all arrears) with the Central American Bank for Economic Integration (CABEI) which eases considerably the cash-flow burden on Nicaragua. Total scheduled external debt-service obligations are projected at the equivalent of 40 percent of exports of goods and services in 1997, compared with 92 percent in 1996 and an average of 309 percent in 1993-94.

8. During 1994-96 progress was made on structural reforms, although advances in some areas were slower than expected. In November 1995, the National Assembly approved legislation for the privatization of the telephone company (ENITEL). However, following an unsuccessful international bidding process, a new process of privatization has been undertaken which contemplates the sale of the company by mid-1998. To this effect updated and improved legislation has been sent to the National Assembly for its consideration. Regarding property rights, progress has been made in the process of delivering urban and rural property titles to the poor, the continuing return of state-owned properties, and the compensation of claimants. Interest on compensation bonds (issued to compensate owners of confiscated

property) is being paid on time. Reflecting a political consensus, a new law ("Ley de la Propiedad Reformada Urbana y Agraria") was approved in November 1997 by the National Assembly, that will allow the resolution of pending claims and speed up the delivery of property titles. This law should allow the settlement of a large number of small property claims and it also creates special property courts to address pending cases. The government plans to deliver 90,000 property titles to small urban and rural plot holders in the next two years.

III. THE ECONOMIC PROGRAM FOR 1997-2000

9. The main objective of the government's economic program for 1997-2000 is to fight poverty and reduce unemployment. The program includes measures that aim at restoring the sustainability of the government and external finances, and at implementing needed structural reforms to achieve sustained high rates of economic growth. The government will focus its efforts in developing the rural sector and will redirect public investment toward the rural areas. Under the program real GDP is projected to grow by 5 percent a year (2 percent in per-capita terms) on the basis of increased private sector investment and the strength of agricultural and nontraditional exports. At the same time, inflation would decline to 8 percent in 1998 and 5 percent by 2000. The financial program targets an increase in NIR by a cumulative US$155 million during 1997-98; furthermore gross reserves (net of the stock of outstanding CENIS) would increase from 1.7 months of imports by end-1998 to around three months of imports by end-2000. The authorities expect to be considered for eligibility under the HIPC initiative by-end 1999 on the basis of the significant domestic effort being undertaken and the successful implementation of the program.

10. Achievement of the program's high rates of economic growth will require a significant effort to implement structural reforms that increase efficiency and foster private investment. Following the successful introduction of a tax reform in May 1997, the government is strengthening tax and customs administration. Government expenditure will be rationalized and the size of the state reduced. The foreign investment code will be revised to eliminate any bias against investors and the privatization process will be sequenced appropriately, starting in sectors with a high likelihood of success (telecommunication and energy sectors). The process of state banking reform has been initiated; the Development National Bank (BANADES) will cease banking functions and alternative financial institutions for small producers, without direct participation of the government, will be established. Particular attention will be paid to decentralizing and increasing social spending (for education and health), and settling property rights to ensure civil peace and economic prosperity.

11. The fiscal program aims at putting the public finances on a sustainable path given the projected external financing and the likelihood of external debt relief under the HIPC initiative. The combined public sector deficit (before grants) would decline from 15½ percent of GDP in 1996 to under 4 percent of GDP by 2000. Public savings are expected to rise

significantly during the three-year ESAF arrangement, with an important part of the adjustment coming in the first year (an increase of 1% percentage points of GDP in 1998 and an additional increase of 4 percentage points of GDP by 2000). Public sector investment (in terms of GDP) is projected to decline markedly in the 1997-2000 period but, this is expected to be offset by a rise in private sector investment reflecting both planned privatization of public utility companies and strengthening in confidence.

12. The program includes a number of actions to raise central government revenue by a total of 2% percentage points of GDP through 2000, with all of the increase coming in 1997-98. The government is committed to improve the transparency of the public sector operations by broadening the budget coverage to include revenue and expenditure operations not previously reported. In this connection, the fiscal accounts include 1 percentage point of GDP of current revenue that previously was part of extra budgetary revenues. In May 1997 a tax reform was passed that aims at correcting structural deficiencies of the tax system and expanding the tax base by reducing or eliminating discretionary and other exemptions to the VAT and customs duties, and introducing a land tax while reducing import duties to two tiers (5 and 10 percent) by end 1999. Moreover, in September 1997 the government initiated a process to correct the distortion in the relative prices of gasoline and diesel, increasing the price of diesel and decreasing that of gasoline, and took measures to improve the control mechanism of the retention of the coffee income tax. The government stands ready to take additional measures in case of fiscal under performance, large shortfall in external resources, or difficulties in rolling over CENIS.

13. Current outlays of the central government are programmed to decline from about 22½ percent of GDP in 1996 to 18% percent of GDP in 2000 (one-half of this reduction is to take place in 1997-98) reflecting a freeze in these expenditures (excluding interest payments and transfers mandated by the constitution but including wages) and a reduction in export subsidies. The government will request technical assistance from the Fund to establish mechanisms to ensure compliance with this objective. In an effort to increase the transparency of government operations, the fiscal accounts include almost 2 percentage points of GDP of expenditure that previously were part of extra budgetary expenditure. The decline in current outlays will be achieved, in part, through a civil service reform program consistent with the restructuring of the government. In addition to the 1,800 public sector positions closed during 1997, it is estimated that a further 1,500 positions a year will be cut during 1998-99. These figures are subject to revision in light of the law for restructuring the Executive Branch, that has been presented to the National Assembly for approval.

14. The government will continue to make efforts to shift current expenditures toward the social sectors, particularly health and education and will emphasize programs that alleviate poverty. In this effort, social expenditure would be increased (in consultation with the IMF and IBRD) beyond the amount budgeted, and will be financed through the use of proceeds from ENITEL's privatization and increased contributions by donors through a support group that will be formed for this purpose and the Consultative Group meeting for Nicaragua scheduled in April 1998.

15. Capital outlays and net lending of the public sector are programmed to decline by 5 percentage points of GDP in 1997 to 12 percent of GDP and to remain on average at about that level through 2000. As mentioned, private sector participation in the provision of infrastructure services formerly reserved to the public sector (energy, telecommunications, ports, and roads) is expected to increase substantially after the passing of a set of new laws, by end-1997 (described in Table 6). The public investment program will give priority to investment in the social sectors and in basic infrastructure and will aim at greater medium-term sustainability in the services provided. The institutional capacity for the formulation, evaluation, prioritization, execution, and follow up of investment projects shall be upgraded, so that the public investment program reflects the short- and medium-term expenditure capacity of the government, and a more rational allocation of resources.

16. The strengthening of the financial position of the state enterprises through revenue increases and cost containment will be an important component of the fiscal program. The long standing financial problems of ENEL have continued to compound as the level of energy losses have risen and the increasing reliance on thermal generation has raised generation costs. Beginning in April 1997 ENEL raised its monthly rate adjustments from 1 percent to 1.5 percent. However, this has not been sufficient to compensate for recent cost increases that have been driven, in part, by drought conditions associated with El Niño. In this context, ENEL instituted a step adjustment of 5 percent effective October 1, 1997; in addition, the government has approved the introduction of a permanent thermal factor in the pricing structure of ENEL to help offset the increase in costs attendant to the use of thermal energy during drought situations (low-income consumers have been exempted from these tariff increases); ENEL also will strengthen its collection procedures, and enforce a tight rein on current outlays. Also, the government has requested assistance from the IBRD and IDB to support ENEL's investment program and financing requirements, including to compensate for the effect of El Niño on its finances. To protect the financial situation of INAA from energy cost increases, tariff rates will be increased in line with the recommendations of a recent study undertaken with technical assistance from the IDB. During the program period, the electricity and water rates will continue to be adjusted by 1.5 percent a month.

17. The government intends to carry out a study to develop options for the reform of the social security system. This study, which will be concluded with the technical assistance from the IBRD and the IDB, will aim at strengthening the current system while allowing participation of the private sector in the supply of health services and ensuring actuarial viability of the pension system. In the meantime, in order to improve the finances of the social security system, the government intends to revise contribution rates, pensions, retirement age, and to improve the financial management of the social security institute.

18. The monetary program will be consistent with the inflation and external objectives of the program and will be based on an increase in currency issue broadly in line with the growth of nominal GDP. The net domestic assets of the BCN (NDA) are projected to contract by an amount equivalent to some 2 percent of GDP in 1997 and are programmed to decline by about 3 percent of GDP on average in 1998-2000. The contraction of NDA will reflect the

planned improvement in the nonfinancial public sector position with the BCN, and the expected reduction in the BCN losses starting in 1999 (after a projected marked increase in 1997-98). This reduction reflects lower interest payments associated with the net redemption of CENIS (beginning in 1998) and higher interest revenue resulting from increased international reserves.

19. The BCN will conduct a tight credit policy while the fiscal position strengthens. In this context, directed credit policies (in favor of agriculture) recently were eliminated and will not be reintroduced. Also, in October 1997, reserve requirements were unified at 17 percent across deposit maturities as well as currency denomination and were extended to all bank liabilities with the private sector. The BCN increasingly will use open market operations as the main instrument of monetary control. Along these lines, the authorities recently have replaced the system of selling an open quantity of CENIS at a pre-set interest rate with an auction system where the quantity of CENIS offered is determined on the basis of the need to sterilize excess liquidity in line with the monetary program, and the interest rate determined in the auction. In this regard, the authorities intend to reduce the stock of CENIS by at least the equivalent of US$130 million during the program period.

20. Measures are being undertaken by the government to ensure the soundness of the banking system. Improvement in the regulatory framework and in its implementation shall be furthered in order to reduce discretionality, enhance banking competition, and increase bank solvency through increasing the capital base. In order to consolidate the successful growth that the private banking sector has shown since 1991, a concept of capital adequacy was adopted in 1992 based on Basle norms. The capital adequacy ratio was increased from 6 percent to 8 percent in 1996, and the government intends to increase the capital adequacy ratio further, to 10 percent by 2000. In 1993, the BCN and the SBIF promoted development bonds (BOFOS) that could be issued by private banks and counted as secondary capital. Beginning in July 1999, these bonds will no longer serve as secondary capital. The SBIF will pay particular attention to the strict enforcement of the existing prudential norms, including restrictions regarding the concentration of banks' assets. Also, the SBIF role of regulating new lines of banking business such as leasing and mortgage financing will be reviewed to ensure that any existing discretionality will be eliminated. The government will support financially the SBIF to ensure the successful implementation of its duties.

21. Implementation of the financial policies and structural reforms described in this memorandum will further strengthen Nicaragua's external position. However, because of the country's still low export base and high debt-service obligations, the external financing requirements would remain large over the next several years. The government will request a comprehensive rescheduling of the eligible debt on Naples terms from Paris Club creditors in early 1998. To advance toward external viability, the government's debt management policy is to rely solely on securing grants and highly concessional loans to cover its external financing requirements, while at the same time continuing to actively pursue agreements with remaining creditors on debt and debt-service reduction on terms at least comparable to those granted by Paris Club creditors. The public sector commits to refrain from contracting or guaranteeing

any new loans on nonconcessional terms. In order to enhance the effectiveness of its debt management, the Ministry of Finance will coordinate all external debt functions with the BCN ensuring on a continual basis that no new external arrears are incurred during the program period, except for obligations which are subject of ongoing negotiations with creditors, or which were considered under the program to be potentially eligible for refinancing or rescheduling, or other debt relief mechanisms.

22. The BCN approved the unification of the exchange system effective January 1, 1996. The BCN buys or sells any amount of foreign exchange from the financial institutions at an exchange rate determined by a crawling peg system. While Nicaragua has maintained its external competitiveness as evidenced by the strong growth of exports and improvement in the trade balance in the past several years, its external position remains fragile. As inflationary pressures are expected to continue to fall, as a result of fiscal and monetary policies in line with the program, the rate of crawl is expected to be gradually reduced.

23. The government is committed to maintaining a trade system free of nontariff restrictions and to continue the process of reducing import duties and export subsidies. For the vast majority of import items, the recently approved tax reform law reduced the maximum tariff to 30 percent as of July 1997. It also establishes a timetable for further reductions to 20 percent in January 1998, and to 10 percent in July 1999. The export promotion law, which provides income tax rebates and other tax benefits for some exports in the form of negotiable certificates (CBTs), is being phased out in 1997. Firms producing for export shall continue having access to imported machinery, equipment, and intermediate goods without duty.

24. At the end of 1997 the government will introduce a law for restructuring the Executive Branch which reduces significantly the number of government ministries, and in addition agencies that report directly to the president. In order to increase the efficiency and transparency of the public finances, the government will introduce legislation during the first quarter of 1998, that will permit, the implementation of a new system of financial administration for the central government ("Sistema de Evaluación Integral Financiera del Estado," SEIF). It also will develop pilot projects for local SEIF representative offices. At the same time, the government will strengthen the National System of Public Investment (SNIP), with the Office of the Presidency empowered to oversee public investment across ministries to provide greater cohesion to the country's development strategy.

25. On financial system reform, the government is reducing state participation in the banking sector while ensuring that financial services remain available to small farmers. The government is taking steps to cease the banking function of the largest state bank (BANADES) and to sell to the private sector its controlling interest in Banco Nicaraguense (BANIC). The IBRD and the IDB will provide support to finance the losses resulting from the negative net worth of BANADES branches that have been or will be sold. As of October 1997 a total of 22 agencies and branches representing 80 percent of BANADES deposits had already been sold to private banks. By May 1998 the Banking Superintendency will withdraw BANADES' license to operate as a financial intermediary. To serve the credit needs of small

poor farmers, the government will establish a small farmers fund that will operate as a second tier institution relying on commercial bank branches, cooperatives, and specialized NGOs with the best practices in rural finance to directly reach poor farmers.

26. The government will increase BANIC's capital by issuing shares to the private sector and in the process diluting its ownership, becoming a minority shareholder by mid-1998. To address possible legal issues concerning the ownership of the bank, a law will be passed by March 1998 establishing that the government is responsible for the eventual indemnization of the previous owners. In addition, the government intends to privatize a second-tier financial institution (FNI), which provides financing to commercial banks with government-guaranteed external borrowing.

27. The government plans to privatize public utilities, the state oil distribution company, and the services of major ports. To establish the relevant legal framework, legislation for the hydrocarbon, electricity, and water sectors is under discussion in National Assembly and is expected to be approved by February 1998. The government will coordinate the privatization process to ensure transparency and efficiency, reform the tariff structure of electricity and water services to reflect marginal costs, and eliminate cross subsidization; and will initiate the required reorganization of ENEL and INAA. Consistent with the electricity law, ENEL will be vertically separated and its generation and distribution assets will be sold or given in concession. Required new law to privatize ENITEL will be approved by February 1998 and the bidding process finalized by end-1998.

28. The government plans to modernize the commercial code, the bankruptcy law, the intellectual property law, and to make appropriate revisions to the foreign investment law. The latter will be done in a way that avoids unnecessary restrictions, discriminatory treatment, and the granting of tax benefits not contemplated in the general tax regime, while guaranteeing stability in the tax and regulatory environment to foreign investors. Also, the Executive Branch is initiating a comprehensive plan for judiciary and legal reforms that aims at improving legal procedures and enforcing legal contracts and property rights. The government is supporting the judiciary branch by investing in and setting up court houses and civic centers in most municipalities of the country, enhancing the governability and the rule of law in every part of Nicaragua. To this effect, the government has requested technical and financial assistance from foreign donors.

29. Concerning the social programs for 199%2000, in collaboration with the IBRD and IDB, the authorities will continue to improve the efficiency and quality of social spending and will invest increased resources in sanitation and water treatment and housing for the lower income families. In addition, the government will reallocate resources to primary education and health. The authorities will aim to reduce drop-out rates in the school system by improving the quality of primary education and education infrastructure. In the health sector, the government will develop a modem health care system, strengthening primary and preventive health services. The strengthening of the safety net for the protection of the most vulnerable sectors of the Nicaraguan population will be a key element of the poverty

alleviation strategy. However, the core of the strategy will be employment generation through economic growth, based on an improved environment to increase private investment.

30. The attached tables (Tables 1-5) specify the following quantitative and structural performance criteria for mid-1998: (i) ceilings on the central bank NDA, on the domestic financing of the nonfinancial public sector; and on net disbursements of nonconcessional external loans; and floors on net international reserves and on savings of the combined public sector; and (ii) structural benchmarks that include the divesture of the state banks, the privatization program, closure of government agencies, and employment reduction (Table 6). There will be indicative limit on the deficit of the combined public sector for 1998. Prior actions for Board presentation of the request (most of which already have been taken) include the approval of the 1998 budget consistent with the program, the implementation of a critical mass of fiscal measures (such as an increase in public sector revenues by correcting the relative prices of gasoline and diesel and an improvement in the control mechanism of the retention of the coffee income tax); the sale of at least 80 percent of the assets of BANADES; substantive measures to improve the financial position of ENEL and INAA; and the setting up of a plan by the government for the modernization of the state and presentation to the National Assembly of the required legislation (in agreement with the IDB) to implement such a plan.

Attachments

Table 1. Nicaragua: Ceiling on the Net Domestic Financing of the Nonfinancial Public Sector 1/2/

(In millions of cordobas)

Period	Limits
December 3 1, 1996–December 1997	45
December 3 1, 1997–March 3 1, 1998	-365
December 31, 1997–June 30, 1998 3/	-1,000
December 31, 1997–September 31, 1998	-1,850
December 3 1, 1997–December 3 1,1998	-2,050

1/ The net domestic financing of the nonfinancial public sector is defined as the change from their respective stock at end of the previous year of the (i) outstanding stock of indebtedness of the nonfinancial public sector to the domestic banking system (central bank and commercial banks including the FNI) net of deposits (including arrears that correspond to obligations considered eligible for refinancing or rescheduling, or other debt-reduction mechanism) with the foreign currency part of the net debt to the banking system converted into cordobas at C$9.5 per U.S. dollar in 1997 and at C$10.4 per U.S. dollar in 1998; (ii) outstanding stock of domestic public debt (excluding compensation bonds) held by the private sector; (iii) outstanding stock of supplier credits; and (iv) outstanding stock of floating debt. In addition, the net domestic financing includes the net financial support provided by the government to commercial banks to finance the losses resulting from the negative net worth of BANADES branches that are sold.

2/ These ceilings will be adjusted: (i) downward by the proceeds from privatization of ENJTEL except those used for debt-reduction operations; to finance the reform of the social security system; or finance the additional social expenditure, with respect to that in the program approved by the Fund and IBRD, that will be financed with resources from the privatization of ENJTEL up to a maximum equivalent to US$20 million a year and a total equivalent to US%50 million over the entire ESAF period; (iii) downward (unlimited)/upward (by a maximum equivalent to US$30 million over 1997-98) in the event of higher (lower) disbursement of balance of payments support resources with respect to the equivalent to US$84.3 million in 1997, US$120.4 up to the first quarter of 1998, US$172.9 million up to the first half of 1998, US$264.9 million up to the first three quarters of 1998, and US$272.3 million in 1997-1998. In addition, in December 1997 the ceiling will be adjusted upward by up to US$45.5 million in the event that the IDB does not disburse the public administration reform and/or the public enterprise loans.

3/ Performance criteria.

Table 2. Nicaragua: Floors on Savings of the Combined Public Sector

(In millions of cordobas)

Period	Limits
December 31, 1996–December 1997	485
December 31, 1997–March 31, 1998	75
December 31, 1997–June 30, 1998, 3/	285
December 31, 1997–September 31, 1998	610
December 31, 1997–December 31, 1998	940

1/ Defined as the difference between current revenue and current expenditure of the nonfinancial public sector plus the operational balance of the central bank.

2/ These floors will be adjusted downward by the additional social expenditure, with respect to that in the program, approved by the Fund and the IBRD and financed by concessional proceeds obtained from the Consultative Group and Support Group or from the privatization of ENITEL up to a maximum of US$20 million a year and a total of US$50 million over the entire ESAF period.

3/ Performance criteria.

Table 3. Floors for Cumulative Flows of Net International Reserves of the Central Bank 1/2/

(In millions of U.S. dollars)

Period	Cumulative Flow
December 31, 1996–December 31, 1997	53
December 3 1, 1996–March 3 1, 1998	73
December 3 1, 1996–June 30, 1998 3/	99
December 31, 1996–September 30, 1998	149
December 3 1, 1996–December 3 1, 1998	155

1/ Net international reserves are defined as the difference between the (i) foreign assets of the central bank, and (ii) central banks reserve liabilities (including outstanding purchases from the IMF) plus arrears on foreign debt service, stock adjustments resulting from the CABEI agreement (US$152.4 as of December 1997), the outstanding debt to Lehman Brothers resulting from an issue of CENIs in 1997 (US$75.5 million as of December 1997), and foreign currency deposits of commercial banks at the central bank.

2/ These floors will be adjusted: (i) upward (unlimited)/downward (by a maximum of US$30 million over 1997-98) by the increase/decrease in the stock of CENIs with respect to the net issue of CENIs of the equivalent of US$210.7 million in 1997; cummulative flows from end-1996 of US$207.2 million up to the first quarter of 1998, US$$181.5 million up to the first half of 1998, US$161.7 million up to the first three quarters of 1998, and US$15 1.5 million in 1997-98; (ii) upward (unlimited)/downward (by a maximum of US$30 million over 1997-98) in the event of higher (lower) disbursements of balance of payments support resources with respect to US$109.3 million in 1997, cummulative flows from end-1996 of US$145.4 up to the first quarter of 1998, US$207.9 million up to the first half of 1998, US$299.9 million up to the first three quarters of 1998, and US$307.3 million in 1997-98; and (iii) upward (unlimited) by the proceeds from the privatization of ENITEL except those used for debt-reduction operations and to finance the reform of the social security system or finance social expenditure (see Tables 1 and 2). In addition, the December 1997 target will be adjusted downward by up to US$45.5 million in the event that the IDB does not disburse the public administration reform and/or the public enterprise loans.

3/ Performance criteria.

Table 4. Nicaragua: Ceilings on the Cumulative change in the Net Domestic Assets of the Central Bank 1/2/

(In millions of cordobas)

Period	Limits
December 31, 1996–December 31, 1997	-403
December 31, 1996–March 31, 1998	-654
December 31, 1996–June 30,1998 3/	-995
December 31, 1996–September 31, 1998	-1,531
December 31, 1996–December 31, 1998	-1,390

1/ The change in the net domestic assets of the central bank (NDA) is defined as the difference between the change in the stock of currency issue, and in the net international reserves (as defined in footnote 1 of Table 3) valued at C$9.5 per U.S. dollar in 1997 and at C$10.4 per U.S. dollar in 1998.

2/ Corresponding offsetting adjustments will be made to the ceilings *to* the net domestic assets of the central bank for the adjustments in net international reserves spelled out in the footnotes in Table 3.

3/ Performance criteria.

Table 5. Nicaragua: Ceilings on Cumulative Disbursements of Nonconcessional External Loans Contracted or Guaranteed by the Public Sector 1/2/

(In millions of U.S. dollars)

Period	Limits
More than one year maturity	
December 31, 1996–December 31, 1997	77
December 31, 1996–March 31, 1998	80
December 31, 1996–June 30,1998 3/	100
December 31, 1996–September 31, 1998	102
December 31, 1996–December 31, 1998	130
One year or less maturity 4/	
December 31, 1996–December 31, 1997	22
December 31, 1996–March 31, 1998	37
December 31, 1996–June 30,1998 3/	37
December 31, 1996–September 31, 1998	37
December 31, 1996–December 31, 1998	37

1/ These ceilings refers to loans contracted or guaranteed by the public sector, with maturity of more than one year and grant element of less than 35 percent calculated on the basis of currency specific Commercial Interest Reference Rate (CIRR) as discount rates. These limits exclude reserve liabilities of the central bank and the capitalization of interest resulting from rescheduling or refinancing operations.

2/ These ceilings will be adjusted downward to the extend that certain credits for the Republic of China are converted to concessional.

3/ Performance criteria.

4/ Excludes normal import related credits.

Table 6. Nicaragua: Structural Benchmarks Under the Enhanced Structural Adjustment Facility

Policy Measure	Program Schedule
1. Public sector	
a. Approval by the National Assembly of the 1998 budget.	December 1997 1/
b. Present to the National Assembly a draft law **for** restructuring the executive **branch** consistent with the IDB's public sector reform.	December 1997 1/
c. Approval by the National Assembly of **a** law for restructuring the executive branch.	March 1998
d. Implement **a labor mobility program** aiming at reducing public sector positions by a minimum of:	
- **1,800** employees	Through end-December 1997 1/
- **2,550** employees	Through end-June 1998
- **3,300** employees	Through end-December 1998
These figures are cumulative from January 1997, do not include reductions resulting from the privatization of public enterprises, and are subject to revision in light of the law for restructuring the Executive Branch, that has been presented to the National Assembly for approval.	
2. Privatization	
a. Approval by the National Assembly of **the electricity law and regulations** as agreed with the IDB. This law will allow to divide ENEL's operations into transmission, generation and distribution. In addition, it would enable to divest ENEL's assets or grant concessions to the private sector for generation and distribution.	November 1997 1/
b. Approval by the National Assembly of two laws needed to reorganize the water and sewerage sector as agreed with the IDB. The laws transform INNA into a regulatory agency and create a new water and sewerage company (ENACAL).	November 1997 1/
c. Approval by the National Assembly of the **two hydrocarbons** laws to regulate commercialization and exploration of hydrocarbons.	March 1998
d. Continue adjusting **electricity rates** by 1.5 percent a month, and introduce a step **increase** of **5** percent **in** electricity rates and a permanent **thermal factor.**	October 1997 1/
e. Maintain the periodic adjustment for INAA's tariffs of 1.5 percent a month.	Throughout the ESAF arrangement 21
f. Commission a study to establish new system of adjusting electricity rates based on long term marginal costs as agreed with the IDB.	June 1998
g. Approve the new water and sewerage tariff structure as agreed with the IDB.	March 1998
h. Approval by the National Assembly of a new **law to privatize the telecom company (ENITEL).**	June 1998 21
i. Offer for sale of at least 40 percent of ENITEL's capital, as agreed with the IBRD.	June 1998 2/
3. Social security reform	
a. Commission a study of the social security to rationalize and strengthen the current pension system, define alternatives to ensure medium and long-term actuarial viability of the pension system, and allow private sector participation in the pension system.	June 1998

Table 6. Nicaragua: Structural Benchmarks Under the Enhanced Structural Adjustment Facilit

Policy Measure	Program Schedule
3. Social security reform	
b. Separate the pension and health insurance accounts.	December 1998
4. Legal reform	
a. Present to the National Assembly of a **draft** law for **property rights** to facilitate the resolution of remaining property claims.	October 1997 **1/**
b. Approval by the National Assembly of an apppropriate **property right law.**	June 1998 **2/**
5. Financial system reform	
a. Unify banks' minimum reserve requirement across deposit maturities as well as currency denominations.	Novernber 1997 **1/**
b. Sale of at least 80 percent of BANADES's assets.	November 1997 **1/**
c. Superintendency of banks will withdraw **BANADES's** license to operate as a financial intermediary.	May 1998 **2/**
d. The government will sell **BANIC's** equity to the private sector, and keep the minimum participation required by law.	December 1998
e. Sell at least 49 percent of **FNI's** equity.	December 1998
6. Trade policy	
a. End tax incentives to promote nontraditional exports in the form of **negotiable** tax certificates **(CBTs)**.	December 1997 **1/**
b. Reduce maximum tariff to: - 20 percent	January 1998

1/ Prior action to go to the Fund Board.
2/ Performance criteria.

Table 7. Nicaragua: Ceilings on the Deficit of Combined Public Sector 1/2/

(In millions of cordobas)

Period	Limits
December 3 1, 1996–December 1997	-1,825
December 3 1, 1997–March 3 1, 1998	-495
December 3 1, 1997–June 30, 1998	-1,135
December 3 1, 1997–September 31, 1998	-1,605
December 3 1, 1997–December 3 1, 1998	-1,970

1/ These are only indicative. The balance of the combined public sector (excluding grants) in 1997-98 will be measured from above the line and is defined as the savings of the combined public sector plus capital revenue less capital expenditure (including net lending) of the nonfinancial public sector plus the operational balance of the central bank. As of 1999 the balance of the nonfinancial public sector (NFPS) will be measured by the nonfinancial public sector borrowing requirement (PSBR).

2/ These ceilings will be adjusted upward by the full amount of any additional social expenditure, with respect to that on the program, that is approved by the Fund and the IBRD, and financed by concessional proceeds obtained from the Consultative Group (and the Support Group) or from the privatization of ENITEL (up to a maximum of US$20 million a year and a total of US$50 million over the entire ESAF period).

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FOR
AGENDA

EBS/98/7
Correction 1

CONFIDENTIAL

March 13, 1998

To: Members of the Executive Board

From: The Secretary

Subject: **Nicaragua-Staff Report for the 1997 Article IV Consultation and Request for Arrangements Under the Enhanced Structural Adjustment Facility-Letter of Intent**

The following corrections have been made in EBS/98/7 (l/l 5/98):

Page 11, title: for "Nicaragua: Floors.. . Sector"
read "Nicaragua: Floors.. . Sector 1/2/"

Page 13, last column: Revised
footnote 1, lines 3 and 4: for "U.S. dollar...in 1997"
read "U.S. dollar."

Page 16, item 6b, column 1, line 2: for "-20 percent"
read "-25 percent"

new line 3: Added

Corrected pages are attached.

Att: (3)

Other Distribution:
Department Heads

FOR AGENDA

EB S/98/7

CONFIDENTIAL

January 15, 1998

To: Members of the Executive Board

From: The Secretary

Subject: **Nicaragua-Staff Report for the 1997 Article IV Consultation and Request for Arrangements Under the Enhanced Structural Adjustment Facility-Letter of Intent**

Attached for consideration by the Executive Directors is a letter of intent from the Minister of Finance of Nicaragua and the President of the Central Bank of Nicaragua, together with the memorandum of economic policies for the Government of Nicaragua.

This subject, together with the staff report for the 1997 Article IV consultation with Nicaragua and its request for arrangements under the Enhanced Structural Adjustment Facility (to be issued shortly), will be brought to the agenda for discussion on a date to be announced.

Mr. Kalter (ext. 38501) or Mr. Arbulú-Niera (ext. 37685) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

Managua, Nicaragua
January 9, 1998

Mr. Michael Camdessus
Managing Director
International Monetary Fund
700 19th Street, N. W.
Washington, D.C. 2043 1

Dear Mr. Camdessus:

1. Attached is a memorandum on the economic and financial policies of Nicaragua, setting forth the objectives and policies that the government intends to pursue for the three-year period 1998-2000, and the objectives and policies for the first annual program there-under. The Government of Nicaragua believes that the policies set forth in the memorandum are adequate to achieve these objectives and will take any further measures that may become appropriate for this purpose. In support of these objectives and policies, Nicaragua hereby requests a three-year arrangement under the Enhanced Structural Adjustment Facility in a total amount equivalent to SDR 100.9 million (105 percent of the quota), and the first annual arrangement thereunder in the amount equivalent to SDR 33.6 million (35 percent of the quota).

2. During the period of the first annual arrangement, the Government of Nicaragua will consult with the Fund on the adoption of any measures that may be appropriate, at the initiative of the government or whenever the Managing Director of the Fund requires such consultation. In addition, the government will conduct with the Fund a midterm review of the first annual program. In this connection, in the case of fiscal under performance, large shortfalls in external resources or difficulties in rolling over short-term central bank financial instruments, the government would take additional measures, including increases in the VAT rate and in the retention rate on coffee.

3. After the period of the first annual arrangement and while Nicaragua has outstanding financial obligations to the Fund arising from loans under the arrangement, the government will consult with the Fund from time to time, at the initiative of the government or whenever the Managing Director requests consultation on Nicaragua's economic and financial policies.

4. Nicaragua is committed to provide the Fund with such information as the Fund requests on the progress made in policy implementation and the achievement of the program objectives.

Sincerely yours,

/s/
Noel Ramirez Sanchez
President
Central Bank of Nicaragua

Esteban Duque Estrada
Minister of Finance

Attachment

Table 2. Nicaragua: Floors on Savings of the Combined Public Sector 1/ 2/

(In millions of cordobas)

Period	Limits
December 31, 1996–December 1997	485
December 31, 1997–March 31, 1998	75
December 31, 1997–June 30, 1998, 3/	2x5
December 31, 1997–September 31, 1998	610
December 31, 1997–December 31,1998	940

1/ Defined as the difference between current revenue and current expenditure of the nonfinancial public sector plus the operational balance of the central bank.

2/ These floors will be adjusted downward by the additional social expenditure, with respect to that in the program, approved by the Fund and the IBRD and financed by concessional proceeds obtained from the Consultative Group and Support Group or from the privatization of ENITEL up to a maximum of US$20 million a year and a total of US$50 million over the entire ESAF period.

3/ Performance criteria.

Table 3. Floors for Cumulative Flows of Net International Reserves of the Central Bank 1/2/

(In millions of U.S. dollars)

Period	Cumulative Flow
December 3 1, 1996–December 3 1, 1997	53
December 31, 1996–March 3 1, 1998	73
December 31, 1996–June 30, 1998 3/	99
December 31, 1996–September 30, 1998	149
December 3 1, 1996–December 3 1, 1998	155

1/ Net international reserves are defined as the difference between the (i) foreign assets of the central bank; and (ii) central bank's reserve liabilities (including outstanding purchases from the IMF) plus arrears on foreign debt service, stock adjustments resulting from the CABEI agreement (US$152.4 as of December 1997), the outstanding debt to Lehman Brothers resulting from an issue of CENIs in 1997 (US$75.5 million as of December 1997), and foreign currency deposits of commercial banks at the central bank.

2/ These floors will be adjusted: (i) upward (unlimited)/downward (by a maximum of US$30 million over 1997–98) by the increase/decrease in the stock of CENIs with respect to the net issue of CENIs of the equivalent of US$210.7 million in 1997; cummulative flows from end-1996 of US$207.2 million up to the first quarter of 1998, US$$181.5 million up to the first half of 1998, US$161.7 million up to the first three quarters of 1998, and US$15 1.5 million in 1997-98; (ii) upward (unlimited)/downward (by a maximum of US$30 million over 1997–98) in the event of higher (lower) disbursements of balance of payments support resources with respect to US$109.3 million in 1997, cummulative flows from end-1996 of US$145.4 up to the first quarter of 1998, US$207.9 million up to the first half of 1998, US$299.9 million up to the first three quarters of 1998, and US$307.3 million in 1997-98; and (iii) upward (unlimited) by the proceeds from the privatization of ENITEL except those used for debt-reduction operations and to finance the reform of the social security system or finance social expenditure (see Tables 1 and 2). In addition, the December 1997 target will be adjusted downward by up to US$45.5 million in the event that the IDB does not disburse the public administration reform and/or the public enterprise loans.

3/ Performance criteria.

Table 4. Nicaragua: Ceilings on the Cumulative change in the Net Domestic Assets of the Central Bank 1/2/

(In millions of cordobas)

Period	Limits
December 3 1, 1996–December 3 1, 1997	-403
December 3 1, 1996–March 3 1, 1998	-635
December 3 1, 1996–June 30, 1998 3/	-955
December 3 1, 1996–September 31, 1998	-1,445
December 3 1, 1996–December 3 1, 1998	-1,300

1/ The change in the net domestic assets of the central bank (NDA) is defined as the difference between the change in the stock of currency issue, and in the net international reserves (as defined in footnote 1 of Table 3) valued at C$9.5 per U.S. dollar.
2/ Corresponding offsetting adjustments will be made to the ceilings to the net domestic assets of the central bank for the adjustments in net international reserves spelled out in the footnotes in Table 3.
3/ Performance criteria.

Table 5. Nicaragua: Ceilings on Cumulative Disbursements of Nonconcessional External Loans Contracted or Guaranteed by the Public Sector 1/2/

(In millions of U.S. dollars)

Period	Limits
More than one year maturity	
December 31, 1996–December 31, 1997	77
December 31, 1996–March 31, 1998	80
December 31, 1996–June 30, 1998 3/	100
December 31, 1996–September 31, 1998	102
December 31, 1996–December 31, 1998	130
One year or less maturity 4/	
December 31, 1996–December 31, 1997	22
December 31, 1996–March 31, 1998	37
December 31, 1996–June 30, 1998 3/	37
December 31, 1996–September 31, 1998	37
December 31, 1996–December 31, 1998	37

1/ These ceilings refers to loans contracted or guaranteed by the public sector, with maturity of more than one year and grant element of less than 35 percent calculated on the basis of currency specific Commercial Interest Reference Rate (CIRR) as discount rates. These limits exclude reserve liabilities of the central bank and the capitalization of interest resulting from rescheduling or refinancing operations.

2/ These ceilings will be adjusted downward to the extend that certain credits for the Republic of China are converted to concessional.

3/ Performance criteria.

4/ Excludes normal import related credits.

Table 6. Nicaragua: Structural Benchmarks Under the Enhanced Structural Adjustment Facility

Policy Measure	Program Schedule
1. Public sector	
a. Approval by the National Assembly of the 1998 budget.	December 1997 1/
b. Present to the National Assembly a draft **law for restructuring the executive branch** consistent with the IDB's public sector reform.	December 1997 1/
c. Approval by the National Assembly of a law for restructuring the executive branch.	March 1998
d. Implement a **labor mobility program** aiming at reducing public sector positions by a minimum of:	
- 1,800 employees	Through end-December 1997 1/
- **2,550** employees	Through end-June 1998
- **3,300** employees	Through end-December 1998
These figures are cumulative from January 1997, do not include reductions resulting from the privatization of public enterprises, and are subject to revision in light of the law for restructuring the Executive Branch, that has been presented to the National Assembly for approval.	
2. -Privatization	
a. Approval by the National Assembly of the **electricity** law **and** regulations as agreed with the IDB. This law will allow to divide ENEL's operations into transmission, generation and distribution. In addition, it would enable to divest ENEL's assets or grant concessions to the private sector for generation and distribution.	November 1997 1/
b. Approval by the National Assembly of two laws needed to reorganize the water and sewerage sector as agreed with the IDB. The laws transform INNA into a regulatory agency and create a new water and sewerage company (ENACAL).	November 1997 1/
c. Approval by the National Assembly of the two hydrocarbons laws to regulate commercialization and exploration of hydrocarbons.	March 1998
d. Continue adjusting electricity **rates** by 1.5 percent a month, and introduce a step increase of 5 percent in electricity rates and a permanent thermal factor.	October 1997 1/
e. Maintain the periodic adjustment for INAA's tariffs of 1.5 percent a month.	Throughout the ESAF arrangement 2/
f. Commission a study to establish new system of adjusting electricity rates based on long term marginal costs as agreed with the IDB.	June 1998
g. Approve the new water and sewerage tariff structure as agreed with the IDB	March 1998
h. Approval by the National Assembly of a new **law to privatize the telecom company** (ENITEL).	June 1998 2/
i. Offer for sale of at least 40 percent of ENITEL's capital, as agreed with the IBRD.	June 1998 2/
3. Social security reform	
a. Commission a study of the social security to rationalize and strengthen the current pension system, defme alternatives to ensure medium and long-term actuarial viability of the pension system, and allow private sector participation in the pension system.	June 1998

Table 6. Nicaragua: Structural Benchmarks Under the Enhanced Structural Adjustment Facility

Policy Measure	Program Schedule
3. Social security reform	
b. Separate the pension and health insurance accounts	December 1998
4. Legal reform	
a. Present to the National Assembly of a draft law for property rights to facilitate the resolution of remaining property claims.	October 1997 1/
b. Approval by the National Assembly of an appproprlate property right law.	June 1998 2/
5. Financial system reform	
a. Unify banks' minimum reserve requirement across deposi maturities as well as currency denominations.	November 1997 1/
b. Sale of at least 80 percent of BANADES's assets.	November 1997 1/
c. Superintendency of banks will withdraw BANADES's license to operate as a financial intermediary.	May 1998 2/
d. The government will sell BANIC's equity to the private sector, and keep the minimum participation required by law	December 1998
e. Sell at least 49 percent of FNI's equity.	December 1998
6. Trade policy	
a. End tax incentives to promote nontraditional exports in the form of negotiable tax certificates (CBTs).	December 1997 1/
b. Reduce maximum tariff to:	
- 25 percent	January 1998
- 20 percent	July 1998

1/ Prior action to go to the Fund Board
2/ Performance criteria