DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

EBS/91/157
Supplement 1

CONFIDENTIAL

September 25, 1991

To: Members of the Executive Board

From: The Secretary

Subject: Nicaragua - Stand-By Arrangement

Attached for the records of Executive Directors is the Secretary's understanding of the decision on the stand-by arrangement for Nicaragua as agreed at Executive Board Meeting 91/126 (9/18/91), together with the text of the stand-by arrangement. Paragraph 4(b) of the arrangement has been revised in the light of the Board discussion to provide that Nicaragua will not make purchases under the arrangement "4(b) during any period, (i) after February 14, 1992 and August 14, 1992. until the reviews contemplated in paragraph 5 of the attached letter of September 10, 1991 have been completed and suitable performance criteria for the remaining period of the arrangement after December 31, 1991 have been established or after such performance criteria have been established, while they are not being observed; (ii) after December 31, 1991. until the Fund finds that satisfactory arrangements have been reached on the external financing of Nicaragua's program, based on the quarterly assessments contemplated in paragraph 5 of the attached letter of September IO, 1991; or".

Att: (2)

INTERNATIONAL MONETARY FUND

Nicaragua - Stand-By Arrangement

Executive Board Decision - September 18, 1991

1. The Government of Nicaragua has requested a stand-by arrangement for a period of 18 months from September 18, 1991 in an amount equivalent to SDR 40.86 million.

2. The Fund approves the stand-by arrangement set forth in EBS/91/157, Supplement 1.

Nicaragua: Stand-By Arrangement

Attached hereto is a letter, with annexed Memorandum on Economic Policy, dated September 10, 1991, from the Minister President of the Central Bank of Nicaragua and the Minister of Finance of Nicaragua requesting a stand-by arrangement and setting forth:

(a) the objectives and policies that the authorities of Nicaragua intend to pursue for the period of this stand-by arrangement; and

(b) understandings of Nicaragua with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Nicaragua will pursue for the remaining period of this stand-by arrangement.

To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period of 19 months from September 18, 1991 to March 17, 1992, Nicaragua will have the right to make purchases from the Fund in an amount equivalent to SDR 40.86 million, subject to paragraphs 2, 3, 4, 5, and 6, below, without further review by the Fund.

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 17.03 million until November 15, 1991, the equivalent of SDR 21.00 million until February 15, 1992, the equivalent of SDR 24.97 million until May 15, 1992, the equivalent of SDR 28.94 million until August 15, 1992, the equivalent of SDR 32.91 million until November 15, 1992. and the equivalent of SDR 36.88 million until February 15, 1993.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Nicaragua's currency in the credit tranches beyond 25 percent of quota.

3. Purchases under this stand-by arrangement shall be made from ordinary resources only.

4. Nicaragua will not make purchases under this stand-by arrangement that would increase the Fund's holdings of Nicaragua's currency in the credit tranches beyond 25 percent of quota:

(a) during any period in which the data at the end of the preceding period indicate that

(i) the quarterly ceilings on the total current expenditure of the Central Government set forth in Table 1 of the annexed Memorandum; or

(ii) the quarterly limits on the net domestic bank credit of the nonfinancial public sector set forth in Table 2 of the annexed Memorandum; or

(iii) the quarterly ceilings on the net domestic assets of the Central Bank of Nicaragua set forth in Table 3 of the annexed Memorandum; or

(iv) the quarterly targets for the net international reserves of the Central Bank of Nicaragua set forth in Table 4 of the annexed Memorandum; or

(v) the quarterly targets for reducing arrears on external debt set forth in Table 5 of the annexed Memorandum; or

(vi) the limits on the contracting of external credits by the public sector and the Central Bank of Nicaragua with an original maturity range of betveen 1 to 5 years and of 1 to 12 years, and of short-term (less than 1 year) external debt set forth in Table 6 of the annexed Memorandum are not observed; or

(b) during any period

(i) after February 14, 1992 and August 14, 1992 until the reviews contemplated in paragraph 5 of the attached letter of September 10, 1991 have been completed and suitable performance criteria for the remaining period of the arrangement after December 31, 1991 have been established or after such performance criteria have been established, while they are not being observed; or

(ii) after December 31, 1991, until the Fund finds that satisfactory arrangements have been reached on the external financing of Nicaragua's program, based on the quarterly assessments contemplated in paragraph 5 of the attached letter of September 10, 1991; or

(c) during the entire period of this arrangement if Nicaragua

(i) imposes new or intensifies existing restrictions on payments and transfers for current international transactions; or

(ii) introduces or modifies multiple currency practices; or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII; or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Nicaragua is prevented from purchasing under this stand-by arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Nicaragua and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Nicaragua will not make purchases under this stand-by arrangement during any period of the arrangement in.which Nicaragua has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action with respect to a noncomplying purchase or pursuant to Decision No. 9331-(89/167), as amended.

6. Nicaragua's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility. or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Nicaragua. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 6, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Nicaragua and understandings have been reached regarding the circumstances in which such purchases can be resumed.

7. purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Nicaragua, the Fund agrees to provide them at the time of the purchase.

8. Nicaragua shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

9. (a) Nicaragua shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund. including those relating to repurchases as Nicaragua's balance of payments and reserve position improves.

(b) Any reductions in Nicaragua's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

10. During the period of the stand-by arrangement Nicaragua shall remain in close consultation with the Fund. These consultations may include correspondenct and visits of officials of the Fund to Nicaragua or of representatives of Nicaragua to the Fund. Nicaragua shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund may request in connection with the progress of Nicaragua in achieving the objectives and policies set forth in the attached letter and annexed Memorandum.

11. In accordance with paragraph 5 of the attached letter, Nicaragua will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirrable. In addition, after the period of the arrangement and while Nicaragua has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Nicaragua's balance of payments policies.

ATTACHMENT

Managua, Nicaragua
September 10, 1991

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

1. The Government of Nicaragua has been implementing since it assumed office in April 1990 an economic program that is aimed at restoring conditions for reactivating the economy, strengthening the balance of payments, and re-establishing relations with the international financial community to achieve external viability over the medium term'.

2. The objectives of the program for 1990 were not achieved because of the difficult situation stemming from the need to foster peace through a, process of demilitarization, a move to greater reliance on market forces after almost a decade of government directed economic activity, and inconsistency in the implementation of policy measures. In March 1991 the Government put in place stronger adjustment measures to attain macroeconomic stability in 1991-92 as the basis for coordinated efforts by external donors and creditors to assist in clearing arrears to major multilateral financial institutions and generate new financial support. Early positive results under the program include a sharp reduction in the rate of inflation, an improvement in central government finances, and an increase in international reserves, on the basis of which Nicaragua obtained pledges of assistance from bilateral donors to clear arrears to the World Bank and the Inter-American Development Bank. This economic program and the underlying policy measures for 1991-92 are described in the annexed Memorandum on Economic Policy of the Government.

3. In support of its economic program for 1991-92, the Government of Nicaragua hereby requests an Id-month stand-by arrangement from the International Monetary Fund in an amount equivalent to SDR 40.86 million.

4. Nicaragua continues to maintain exchange restrictions subject to Fund approval under Article VIII as evidenced by the existence of external arrears and certain limitations on current service payments. The Government will not impose new, or intensify existing, restrictions on payments and transfers for current international transactions; introduce new multiple currency practices; impose or intensify existing import restrictions for balance of payments reasons: or enter into new bilateral payments agreements with member countries of the Fund that art inconsistent with Article VIII.

5. The Government of Nicaragua will complete two reviews with the Fund by February 14, and August 14, 1992, respectively. The conclusion of the first review, will depend, inter alia, on satisfactory progress in the implementation of the policies described in the annexed memorandum and on reaching understandings for the establishment of quarterly performance criteria in 1992. The second review, will be concluded on the basis of continued progress in the implementation of policy measures described in the annexed memorandum. Tn addition, on the occasion of each of the quarterly purchases and the two reviews contemplated, the progress in securing adequate external financing for the program also will be assessed, pending the conclusion of satisfactory arrangements with external creditors.

6. The Government of Nicaragua believes that the policies set forth in the annexed Memorandum of Economic Policy are adequate to achieve the objectives of the economic program for 1991-92, but will take further measures that may become appropriate for this purpose. The Government will consult with the Fund on the adoption of any measures that may be appropriate, in accordance with the Fund's policies on such consultations.

Sincerely,

/s/

Raul Lacayo S.
Minister President
Central Bank
of Nicaragua

/s/

Emilio Pereira A.
Minister of Finance

September 10, 1991

Memorandum on the Economic Policy of Nicaragua

Background

1. By the end of the 1980s Nicaragua's economic situation had weakened markedly because of a combination of factors that included a deterioration in the terms of trade, a U.S. trade embargo, inclement weather, and a civil war. Shortcomings in the policy response to these adverse circumstances exacerbated the problems that were experienced. Beginning in 1984 real GDP declined in every year and the rate of price increase accelerated to hyperinflation levels in the latter part of the decade. Gross national savings were highly negative during most of the 1980s and Nicaragua relied heavily on foreign assistance, mostly in the form of goods and services. Official international reserves were depleted, exports were at half the level of the 1970s, and the stock of external debt in 1989 had risen to the equivalent of nine times GDP, of which about 40 percent was in arrears.

2. During the 1980s the Government moved progressively toward the establishment of a centrally controlled economy with increasing public ownership of the means of production acquired through expropriation and confiscation. The financial and external trade sectors were nationalized, and activities that remained private were affected adversely by pervasive regulations and relative price distortions. Public sector expenditure reached close to 50 percent of GDP, &ax revenue in relation to GDP fell, and the public sector absorbed a disproportionate share of domestic bank credit. Some 350 state-owned enterprises were operating with heavy subsidies. The nationalized financial system contracted severely, bank supervision and prudential regulations were deficient, and traditional monetary instruments were not used effectively. Health and social indicators fell and the incidence of poverty rose.

3. There were a number of attempts by the authorities to correct the serious macroeconomic imbalances faced by Nicaragua. The previous Administration put in place an economic program in 1989 which succeeded in moderating inflation and improving public sector finances. However, in the first few months of 1990 before the outgoing Administration left office, policies were relaxed with wage adjustments of 800 percent granted to public sector workers at the same time that public sector prices and the exchange rate were frozen. The resulting increase in the public sector deficit was financed by central bank credit and inflation accelerated. Moreover, regulations were put in place which made it difficult for the new Administration to lay off workers and privatize state enterprises, and a large amount of state assets were distributed to supporters of the outgoing Administration.

Developments in 1990

4. The Administration that assumed office in Late April 1990 thus faced a seriously deteriorated economic situation in an uncertain and unstable political environment. The Government of President Chamorrc saw as its most urgent short-term task the need for national political and social reconciliation and the restoration of macroeconomic stability. These objectives were to be pursued within a strategy aimed at reactivating the economy, attaining stable prices, and strengthening the balance of payments. The strategy called for a drastic reduction in the size and scope of the public sector in economic activity, structural measures to foster a greater reliance on market forces and a normalization of relations with Nicaragua's external creditors.

5. Economic policy implementation in 1990 fell well short of achieving stabilization in part because of the effects of the sharp increase in public sector expenditure in the beginning of the year. The efforts at stabilization also were hampered by the need to demobilize the security and guerilla forces, cater for large groups of returning refugees, and establish a more stable political environment. Real GDP stagnated in 1990 after six successive years of decline and inflation accelerated to 13,500 percent.

6. The new Administration implemented a combination of tax and expenditure measures and raised public sector prices aimed at lowering the public sector deficit. However, attempts to reduce expenditure through a scaling down of the wage bill were thwarted by widespread strikes and as a result the overall deficit of the public sector (as defined under the program) remained at 30 1/2 percent of GDP in 1990 due to a sharp weakening of the finances of the Central Government. Government tax revenue fell to 14 percent of GDP and expenditure rose to 45 percent of GDP despite a 60 percent reduction of military personnel to 28,000. The public sector deficit was financed almost entirely by central bank credit which, together with the granting of a large amount of loans to the agricultural sector, led to a rapid expansion of domestic bank credit. Interest rates continued to be negative in real. terms.

7. Nicaragua's balance of payments position continued to weaken in 1990 to some extent because a reduction of assistance from Eastern European countries and the U.S.S.R. was not made up by assistance from other donors. As in previous years, the large overall deficit of the balance of payments was financed by a further accumulation of external arrears. Exchange rate policy became more flexible as the cordoba was devalued frequently around mid-1990 but the expected benefits from this policy did not materialize because the adjustments did not keep pace with inflation. The Government introduced a second currency (córdoba oro) in mid-1990 fixed at par to the U.S. dollar, and in attempting to maintain its convertibility while financial policies were lax and inflation was accelerating, the Central Bank continued to lose international reserves.

8. Progress was made in the implementation of some structural measures during 1990. A tax reform package introduced in the latter part of the year aimed at reducing distortions and increasing efficiency included the reduction and simplification of income tax rates, the elimination of certain consumption and indirect taxes that yielded little revenue, the lowering of import tariffs to a range of 0-20 percent for most goods, and the removal of some tax exemptions and quantitative import restrictions. More importantly, the Government was able to restore peace in the countryside through the demobilization of the opposing military forces and reached consensus with diverse political and social groups on the need for implementing the far-reaching macroeconomic and structural policy measures.

The economic program for 1991-92

9. Against this background, the Government began to implement a comprehensive economic program in early 1991 to improve performance and to provide thr basis for obtaining support from external donors and creditors and to regularize its relations with the international financial community. Among the aims were to clear external arrears to the major multilateral creditors and then to initiate a strategy to deal with other arrears and generate new financial assistance. The main objectives of the economic program for the next two years were to lower monthly inflation to low single digits and strengthen the balance of payments So as to create the conditions for real GDP growth of 3-4 percent by 1992. The detailed elements of the program for 1991-92, including its initial results through June 1391, the performance targets for the period through December 1991, and the indicative targets for 1992 are described in the following paragraphs. By mid-February 1992 and mid-August 1992 the Government will establish the performance criteria covering 1992 and will review with the Fund the progress made in the implementation of the program, especially in the areas of fiscal and monetary policies and in the process of securing adequate external financing.

10. The economic program began in March 1991 with a major up-front devaluation, the tightening of financial policies following a sizable wage adjustment, and increases in public sector prices. In the wake of these policy measures the pace of price increases slowed from 40-50 percent a month in January-February 1991 to 20 percent in April: subsequently, prices declined by an average of 4 percent a month in May-July. Contrary to expectations, there was a pickup in economic activity, particularly in the output of certain consumer and industrial products in the period through July 1991. On this basis, inflation is projected to fall to 765 percent in 1991 and to a range of 20-25 percent in 1992.

Fiscal policy

11. The centerpiece of the economic program was the reduction of the overall deficit of the public sector (including central bank losses and unpaid foreign interest) to a level that could be financed by external grants and concessional loans from bilateral donors and credits from multilateral institutions without recourse to net financing from the domestic banking system. To this end the overall deficit of the public sector was to

narrow from 30 1/2 percent of GDP in 1990 to 16 percent of GDP in 1991. Fiscal adjustment was to stem mainly from the finances of the Central Government, where the overall position was expected to shift from a deficit of 15 percent of GDP to a balanced position in 1991. The overall position of the rest of the nonfinancial public sector was expecte.i to shift to a deficit of 1 percent of GDP in 1991. Central bank losses were to narrow from 2 percent of GDP in 1990 to 1/2 percent in 1991. Unpaid external interest obligations were expected to remain at close to 14 percent of GDP in 1991.

12. A combination of revenue and expenditure measures underpin the projected improvement in government finances. Central government tax revenue was projected to increase by 6 percentage points of GDP in 1991, on the basis of measures implemented in late 1990, further measures introduced during 1991, and the effects of the devaluation, Revenue measures implemented in 1990 included: (a) unifying the general sales tax from a range of 5 to 15 percent into a rate of 15 percent while expanding the base to cover additional services; (b) increasing selective consumption taxes on alcoholic and nonalcoholic beverages, cigarettes, and petroleum products and switching the rates to an ad valorem basis; (c) simplifying and reducing income taxes to facilitate compliance and introducing presumptive income taxes; (d) eliminating most tax exemptions; and (e) improving tax administration. Further revenue measures introduced in 1991 included increasing excise tax rates, eliminating exemptions on import duties and excise taxes granted to public enterprises and other sectors, and increasing the penalty for noncompliance and improving customs administration to reduce tax evasion.

13. Total central government expenditure (excluding external interest payments) was to be contained to C$1,627 million in 1991 and current outlays in particular were to be limited to C$1,432 million (equivalent to US$342 million). After a large initial adjustment in wages following the major devaluation of the cbrdoba, wages were to be restrained for the remainder of 1991, outlays on goods and services were to be closely controlled, the size of the military was to be reduced by a further 2,700 persons, and the civil ian work force was to be pared down by 12 percent (8,500 persons) through a voluntary separation scheme financed with external donations during the year.

14. The results for the first six months of 1991 show that the public sector financial performance is largely on track, as government expenditure sas been limited to the resources available from revenue and foreign grants. Central government operations were in surplus, which permitted repayment of credits to the Central Bank. Tax receipts in the first semester of the year were some 36 percent above the level programmed reflecting larger than expected gains from the improvement in tax administration and a higher than envisaged level of economic activity. Government expenditure also was some 16 percent higher than had been programmed for the first half of 1991 reflecting higher indemnification payments because 11,510 workers instead of the 8,500 envisaged agreed to separate voluntarily, but the higher outlay was offset by additional donor funds.

15. On the basis of the outturn in the first semester of 1991, the Government now expects the public sector overall deficit to narrow from 30 1/2 percent of GDP in 1990 to 16 percent of GDP in 1991 before widening to 20 1/2 percent of GDP in 1992 in reflection of higher public sector investment 20 1/2 percent of GDP in 1992. The objective for the Central Government's overall position has been revised to a surplus of 2 percent of GDP in 1991 and to shift to a deficit of 1 percent of GDP in 1992. The overall deficit of the rest of the nonfinancial public sector is expected to be less than 1/2 of 1 percent of GDP in 1991 and to widen to almost 1 1/2 percent of GDP in 1992, in order to allow for needed investment outlays. The adjustment in public sector finances in 1992 is to come from an improvement in the saving performance with the public sector current account balance projected to shift from a deficit of 2 percent of GDP in 1931 to a surplus of about 1 1/2 percent of GDP in 1992. With the unification of the dual currency system and the elimination of exchange rate guarantees, the losses of the Central Bank arc projected to disappear in 1991 and 1992. The public sector will meet interest obligations to the IBRD and IDB and the remaining foreign interest obligations falling due in 1991 amounting to 18 percent of GDP are assumed to be rescheduled under the program. In 1992 except for foreign interest payments to multilateral institutions and a portion of moratorium interest due, all interest obligations totaling some 17 1/2 percent of GDP also are assumed to be rescheduled.

16. The current account deficit of the Central Government is expected to narrow by 24 percentage points to 4 percent of GDP in 1991 (C$289 million) and to shift to a balanced position in 1992. The Government will take additional measures in 1992 to strengthen the revenue performance including the decentralization of customs to a system of bonded warehousing, improvement in tax management controls, and taxpayer identification and intensified training of personnel in the internal and customs revenue department, in part with assistance from the IDB. Total expenditure (including external interest payments) in 1991 is to be contained to C$1,840 million, within which current outlays are not to exceed C$1,665 million. In 1992 total expenditures are to be held to C$2,450 million, of which current expenditure will not exceed C$1,890 million (equivalent to about US$375 million or 20 percent of GDP). The expenditure figure for 1992 takes into account an adjustment in wages, which the Government intends to limit to between 10 and 12 percent. A prudent public sector wage policy is central to the success of the program as it should contribute to the moderation of wage adjustments freely negotiated in tha private sector and thus strengthen the conditions for the recovery of employment and output. The Government also is committed to reducing the share of remuneration in current outlays and will continue the voluntary separation scheme in 1992. In addition, before mid-1992 the Government will identify a program, to be implemented by the end of the year, for the adjustment of the operations of numerous institutes either through mergers or closures, and for streamlining the Ministries of Health and Education, including transferring some of their functions to the private sector. The Government will take additional revenue and expenditure measures in a timely manner to ensure attainment of the programmed fiscal

targets. Financial control procedures will continue to be applied, which will ensure that expenditure is carried out on the basis of available current revenue and already disbursed foreign resources.

17. The authorities are committed to the restructuring of the public utilities with the aim of improving their financial position to achieve, as a minimum, operational self-sufficiency. For that purpose overstaffing will be reduced and operations will be streamlined to lower costs, a flexible tariff and pricing policy will be pursued, and wages will be kept under strict control. The Government plans to establish executive boards at the utilities, constituted by representatives of the Ministries of Finance and Economy and the Central Bank, at the highest level, starting in the fourth quarter of 1991. With the help of the World Bank those boards will review operational procedures and help ensure that expenditure policies pursued by the enterprises are consistent with the overall economic program of the Government. The Government has taken action to reinforce the monitoring of the financial performance of the rest of the nonfinancial public sector.

18. In line with the fiscal targets described above, quarterly ceilings for September and December 1991 and indicative ceilings for 1992 on total cumulative central government current expenditures and the use of net domestic bank and nonbank financing by the public sector have been established as set out in attached Table 1 and Table 2, respectively.

Monetary policy

19. The monetary program for 1991 envisaged no further decline in the net international reserve position of the Central Bank of Nicaragua. The improvement in public finances was to facilitate the pursuit of a tight credit policy consistent with the targeted reduction in the rate of inflation and the achievement of the balance of payments objectives described below. Repayments of existing bank loans was to be strictly enforced and no new credit was to be granted to borrowers with overdue loan obligations. Domestic financial reintermediation was to be fostered through financial sector reform, the licensing of new private commercial banks, and a more active interest rate policy aimed at achieving positive interest rates.

20. Data for the first six months of the year indicate that the stock of central bank credit to the public sector and domestic financial institutions, the main impetus behind the high rate of inflation in recent years, declined relative to the position at the beginning of the year. Net international reserves of the Central Bank increased by US$78 million over the same period. Taking into account expected external payments, the net international reserves in 1991 are projected to remain unchanged as originally targeted under the program and to increase by US$15 million in 1992. Gross international reserves would rise to the equivalent of about four months of imports by end-1991 and remain at that level in 1992. Consistent with these aims and assuming an increase in currency issue somewhat lover than projecced inflation, quarterly limits for September and December 1991 and an indicative limit for 1992 have been established for the net domestic assets

the Central Bank of Nicaragua as set out in attached Table 3; and quar-ly performance and indicative targets on the net international reserves the Central Bank have been established as set out in attached Table 4.

21. The Government has acted decisively in raising interest rates to positive levels in real terms in recent months as a major component of monetary policy aimed at stimulating financial reintermediation and generating confidence in the use of the national currency. Until the program for the restructuring of the state-owned banks and the participation of private banks has taken place, the monetary authorities will set ceilings on deposit and loan interest rates. However, these rates will continue to be set at positive level; in real terms and greater flexibility in the iatermination of the rates will be introduced gradually as the financial system recovers. As an initial step, the Central Bank will convert the ceiling on deposit and loan rates to a floor on such rates by the end of 1991 and by mid-February 1992, the Central Bank will eliminate controls on the loan rate and will set only the floor on 30-day deposits. To make monetary instruments more effective, rediscount facilities will be offered only for intermediating financial assistance, which is channeled by external donors and creditors through the Central Bank. The rediscount rate of the Central Rank will be set above the 30-day deposit rate and be no lower than the average cost of funds obtained by the financial system.

22. The financial reform program of the Government consists of the following elements : (1) The restructuring of the five state-owned financial institutions. By mid-1992 two commercial banks are to be merged, their personnel reduced, and the management charged with the task of running a profit-making banking operation. 'Iwo other commercial banks are to be turned into service institutions by end-1993 for channeling, to agricultural and small business sectors, technical and financial services which are to be financed with external funds and budgetary resouxes. The remaining financial institution will be reconverted into a second-tier wholesale banking entity. (2) Private banking institutions are to be permitted; in August 1991 one private bank began operations. (3) The Government enacted earlier in 1991 a new law defining the functions of a Superintendency of banks and financial institutions, which is expected to begin operations once the regulatory framework becomes effective. In addition, the Government is preparing a new Central Bank law and a comprehensive law for the banks and financial institutions, to modernize the legal framework under which a sound financial system could operate. These laws are projected to be enacted by mid-1992.

Exchange rate policy and structural measures

23. The large devaluation of the córdoba led to an improvement in the competitiveness for Nicaragua's exports and reduced the premium on the parallel exchange market to a negligible level. The liberalization of the exchange and trade system and the reduction of import tariffs reduced distortions and import protection in the economy. Because of the continued uncertainty about price and cost developments and given the low level of liquid international reserves, the Government will keep exchange rate policy

under close scrutiny. This policy will be determrned on the basis of a number of factors, including the need to restore confidence in the córdoba, to ensure that competitiveness of exports is maintained, and to provide the basis for the recovery of domestic and foreign private investment.

24. Import protection stemming from import and domestic consumption taxes was lowered to a range of 3 to 143 percent late in 1990. Through a combination of adjustments in import and domestic taxes, which is designed to be neucral for the collection of revenue, the effective protection is programmed to decline to a range of LO to 60 percent by the end of 1991, 10 to 40 percent by mid-1992, and 10 to 20 percent by December 1993. By the latter date, import tariffs will have fallen to a range of 10 to 20 percent and certain domestic selective taxes which are now being applied to imports will have been eliminated. By mid-1992 the Government is committed to eliminate the remaining quantitative restrictions on basic grain imports and the foreign exchange surrender requirement for major traditional exporters.

25. In addition to financial, fiscal, and exchange and trade system reforms, the Government will continue the implementation of other structural measures. A major area of structural change involves the divestment of the 350 state-owned enterprises to be completed by 1993, for which the Government has drawn up an action plan. To date 23 entities have been returned to their former owners, 3 fully privatized, 34 partly privatized and/or partly returned to former owners, and 26 liquidated or merged with other entities. By mid-1992 the Government expects to privatize another 25 companies, liquidate or return another 50 entities, and have ready for divestment another 30 companies. Earlier in 1991 the Government had eliminated the monopoly of state marketing companies in the export of Nicaragua's major exports and the import of most products. Except for bus fares, petroleum products, public utility services, and products subject to excise taxes, prices in Nicaragua are completely free of controls. To improve the transparency of price setting for basic foodgrains, the Government intends to cut back the operations of the state agricultural marketing authority (ENABAS) and to cease the setting of support prices for certain basic grains by the end of 1991.

Social and poverty alleviation policy

26. Nicaragua's indicators for nutritional standards, infant mortality, and the delivery of health and education services are among the poorest in Latin America. As part of the overall aim to reduce absolute poverty, the Government believes that a determined implementation of strong financial policies will bring about a rapid decline in inflation and halt the erosion of earnings of the most vulnerable groups while arresting the deterioration in the social conditions. The Social Emergency Investment Fund (FISE) and the Fund for Assistance to Oppressed Sectors (FASO) were established to facilitate the channeling of resources into programs to improve primary nutrition and health care, retrain workers and generate emergency employment, and provide credit to micro-enterprises. External donors have made available to FISE US$15 million co support about 100 projects (of which 32 have been started). to be implemented by local governments, existing social

welfare centers, private community groups, and other nongovernmental organizations. FASO is discussing with some OECD member countries, Venezuela, and UNDP its funding rsquirements for already identified projects.

External sector policy

27. The external current account deficit (excluding official grants and interest payments) is projected to widen somewhat from US$330 million in 1990 to US$370 million in 1991 and further to US$475 million in 1992. International prices for traditional agricultural exports are forecast to remain low and slow growth of nontraditional exports is expected. Imports in 1991 are projected to be lower in real terms than in 1990, reflecting the effects of tne tight financial policies. In 1992 imports are projected to increase sharply in response to higher public investment expenditure.

28. Scheduled debt service obligations are estimated to total some US$1,240 million in 1991 and US$1,100 million in 1992, of which US$320 million and US$270 million, respectively, represent scheduled interest payments. However, the Government is receiving strong financial support from the international community in response to the implementation of the economic program and the effort to normalize relations with external creditors. Nicaragua expects to obtain gross disbursements of grants and loans totaling US$725 million in 1991 and US$660 million in 1992 to help finance part of its balance of payments needs and meet the net international reserves targets described in paragraph 20 above. Financing gaps of US$5,200 million in 1991 and US$1,400 million in 1992 are projected for the balance of payments, including the effects of the reduction of an estimated US$4,000 million in external arrears by the end of 1991. Nicaragua would need exceptional external financial assistance to help fill these large gaps.

29. Over the medium term Nicaragua's balance of payments outlook is heavily dependent on the treatment the Government obtains for its large outstanding external debt, which at the end of 1990 stood at some US$10.7 billion (ten times GDP). Even with the sustained implementation of adjustment policy, the Government is of the view that without substantial external assistance at exceptional terms over an extended period of time, Nicaragua would continue to be unable to service its external debt obligations. To this end, the Government initiated discussions in 1990 with external donors and creditors in the context of the Consultative Group, which led to the development of a strategy for normalizing relations with the international financial community. This strategy, which is proceeding as planned, calls for the payment of arrears to the World Bank and the Inter-American Development Bank (IDB) by September 1991 with financial assistance that has already been made available by donor and creditor countries. The continued implementation of the economic program would subsequently be supported by multilateral financial institutions once their arrears are cleared. The Government will request the rescheduling of most arrears and current debt service obligations due to Paris Club creditors by end-1991 and to other bilateral creditors by end-1992. Nicaragua already has reached the final stages of discussions with the International Development Association for an

Economic Recovery Credit amounting to US$110 million and with the IDB for a Trade and Finance Adjustment Loan amounting to US$110 million. Agreements also were reached with ths Governments of Mexico and Venezuela for restructuring Nicaragua's debt, which imply a reduction of about 90 percent in the present value of debt outstanding to these two countries. At the same time, the Government intends to renegotiate its debt with foreign commercial banks and discussions with these banks have been initiated. The program assumes that no payments on medium- and long-term debt obligations would be made to commercial bank and other private creditors in 1991-92.

30. Attached Table 5 sets out a schedule for the reduction in the stock of external arrears outstanding at the end of 1990. In addition, the Government will not incur new arrears. In line with the Government's intention to rely basically on foreign grants, official long-term concessional loans, and the multinational financial institutions, limits on nonconcessional external borrowing have been established as set out in attached Table 6.

Attachments

Table 5. Nicaragua: Targets for Reducing Arrears on External Debt 1/

(In millions of U.S. dollars)

Date	Cumulative Amount from June 30, 1991
June 30-September 30, 1991	360
Of which: to be refinanced	(--)
June 30-December 31, 1991	3.502
Of which: to be refinanced	(3,142)

1/ Refers to arrears outstanding at the end of 1990. Excludes arrears on commercial bank debt obligations.

Table 6. Nicaragua: Limits on the Contracting of External Credits by the Public Sector and the Central Bank 1/

(Cumulative amounts in millions of U.S. dollars)

Date	With Maturities of:	
	1-5 years	1-12 years
July l-December 31, 1991	20	75
January l-December 31, 1992 (indicative)	30	12s
	Less than 1 year	
July l-December 31, 1991	20	
January l-December 31, 1992 (indicative)	20	

1/ Includes external credits guaranteed by the public sector or the Central Bank and excludes refinancing transactions.