Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

Managua, Nicaragua
August 27, 2001

Dear Mr. Köhler:

1. During late 2000 and the first half of 2001 the government of Nicaragua faced difficult economic conditions and policy choices, owing to expenditure overruns and continuing difficulties in the banking sector. In this context, net credit of the central bank to the combined public sector expanded significantly and official international reserves fell substantially during the first semester of 2001.

2. The government is committed to implementing a sound macroeconomic and financial program that will improve economic performance substantially and allow Nicaragua to attain macroeconomic sustainability over the medium term. To this end, the government is requesting Fund staff to monitor its program through December 2001. The authorities consider that strong performance under this program will establish a track record for a new three-year Poverty Reduction and Growth Facility arrangement to be discussed with the incoming administration that will take office in January 2002, and allow Nicaragua to continue on the path toward the enhanced HIPC completion point.

3. The government's program aims at maintaining fiscal discipline and strengthening the banking sector. It also includes the privatization of the electricity generating plants and a substantial stake in the telecommunications company, as well as structural reforms to strengthen the public sector and improve governance. The fiscal stance will allow for a significant recovery of reserves for the year as a whole and will ease the transition to the new administration. The government stands ready to take additional measures as necessary to comply with our commitments under the program.

4. The attached memorandum describes the economic and financial policies that the government is committed to pursue during July–December 2001, as well as quarterly benchmarks. As a signal of the authorities' commitment to the implementation of the program, it also includes targets on monthly fiscal spending and domestic financing. The government will provide to the IMF all necessary data on a timely basis for monitoring purposes, and consistent with its intention to keep the public informed about its policies and objectives, will publish the memorandum of economic and financial policies and will report periodically on progress under the program.

Sincerely,

/s/
Noel Ramírez Sánchez
President of the Central Bank

/s/
Esteban Duque Estrada
Minister of Finance

Memorandum of Economic and Financial Policies (MEFP)

I. Background

1. Nicaragua faced a number of adverse developments in 2000, including higher-than-anticipated energy costs and a drop in coffee export prices. As a result of these factors, and a sharp slowdown in investment after post Mitch high levels, **real GDP grew by 4.3 percent in 2000**, compared with 5.5 percent expected at the beginning of the year. The effects of a drought and the consequences of financial sector problems also contributed to slowing GDP growth. After peaking at 15 percent in April, **12-month inflation slowed to below 10 percent by year-end**, as programmed. The authorities maintained the annual rate of crawl of the córdoba vis-à-vis the U.S. dollar at 6 percent.

2. **The authorities have acted with determination to resolve bank weaknesses, which intensified in the second half of 2000 and were brought to light by enhanced supervision.** From August 2000, four large insolvent banks were intervened and sold to sound domestic banks or liquidated. The central bank provided full guarantee of deposits and liquidity support to the intervened banks, while sterilizing a significant part of the liquidity created through the placement of debt instruments with liquid banks. **These actions helped limit the damage to confidence and stabilize the situation of the financial system, and during the first semester of 2001 deposits in the banking system partially recovered.** The 12-month growth rate of monetary aggregates, which slowed markedly in 2000, remained at about 7.5 percent as of May 2001. Bank **credit to the private sector** growth continued to slow markedly this year, to 14.6 percent, as of April 2001, compared with 28.2 percent in December 2000, as a result of lower growth in economic activity, investment, and imports.

3. **The deficit of the combined public sector in 2000** (after grants) was equivalent to 8.3 percent of GDP, compared with 6.4 percent of GDP projected at the time of the review under the second annual PRGF arrangement in December 2000. This deviation is explained by larger-than-anticipated municipal election-related current expenditures and capital expenditure overruns, which took place during the last quarter of the year. These overruns were financed, to a large extent, by an accumulation of domestic floating debt of almost 2 percent of GDP.

4. **The fiscal stance remained weak in the first half of 2001** mainly because of high expenditures associated with wage increases (teachers, nurses, and police) granted at the beginning of the year, the cost of bank resolutions, the preparation of the national elections (scheduled for November 2001), and substantial domestically financed capital outlays. In this connection, preliminary information points to a combined public sector deficit, after grants, of 3.6 percent of annual GDP during January–June 2001, compared with 2.2 percent during the same period a year earlier. To finance this deficit, and to eliminate the domestic floating debt accumulated at end-2000, net central bank credit to the nonfinancial public sector through June reached a level of about 6 percent of annual GDP.

5. **The external current account deficit narrowed substantially** despite a deterioration of the terms of trade of about 13 percent in 2000, mainly due to a significant increase in coffee export volume and a nearly equivalent decrease in the volume of imports from high post-Mitch levels. In the period through April this year, exports suffered a strong decline due to a halving in coffee prices and lower volumes. During the same period, imports

continued to decline, led by capital goods. The resulting outturn was a slight increase in the trade deficit relative to the same period in 2000.

6. Despite the narrowing of the external current account deficit in 2000, **official net international reserves (NIR) fell short of the programmed level** because of the financial sector crisis, the postponement of large disbursements of balance of payments support associated with delays in the implementation of measures in the financial and electricity sectors, and a weaker than programmed fiscal outcome. In the first half of this year, NIR fell by about US$120 million, largely as a result of a substantial expansion of central bank credit to the government and continued delays in disbursements of balance of payments support.

7. **Implementation of structural reforms advanced** despite delays in certain areas. In 2001, the national assembly approved the law on supervision of the privately managed pension funds in March, and passed reforms of the privatization law of the Nicaraguan Telecommunications Company (ENITEL) in April, which allowed more flexibility in the terms of sale. Tax administration is being improved as the internal revenue and customs departments are required to comply with collection targets agreed to with the ministry of finance, in the context of a program supported by the Inter-American Development Bank (IDB). Improvements in **governance** have been achieved through a reform of the government procurement process, improved efficiency of the Comptroller's Office with IDB technical assistance, and the establishment of property mediation centers and courts.

8. **The Poverty Reduction Strategy Paper** (**PRSP)** has been completed on the basis of a broadly based and intensive consultation process, resulting in an improvement in the

quality of the document since the I-PRSP was endorsed by the Boards of the World Bank and the Fund. The government, civil society, and donors invested substantial resources and effort to consult local representatives and focus groups in regional departments with the highest incidence of poverty. Grass-roots participation helped improve the focus of municipal and other projects in light of local priorities, and identify mechanisms for implementation and monitoring at the local level. The relationship between targets, projects and projected financing has been strengthened, and the proposed projects were re-examined based on preliminary results of a public investment review conducted by the World Bank. These steps have resulted in fewer, but better focused, projects.

II. THE PROGRAM FOR JULY–DECEMBER 2001

9. **The authorities are committed to the implementation of a sound interim program that the staff has agreed to monitor during July–December 2001.** The program aims to improve fiscal performance and strengthen the financial system to facilitate the transition to the new administration that takes office in January 2002, and build a track record in preparation for a new three-year Poverty Reduction and Growth Facility (PRGF) arrangement**.** To this end, the government is taking steps to curtail government expenditure with respect to the levels observed in late 2000 and the first part of 2001, and advance the implementation of key measures in the financial system and structural reforms. The government will also put in place expenditure tracking mechanisms of the implementation of the poverty reduction strategy. To assess performance under the program, the government has requested a Fund mission for September, which coincides with the 2002 budget preparation.

A. Macroeconomic Policies

10. **The program is based on real GDP growth of 3 percent in 2001**. This implies a deceleration with respect to 1999 and 2000, largely because of a drop in coffee output and in investment from the exceptionally high post-Mitch levels. Inflation is projected to decline to 8 percent by end-2001, partly as a result of the decline in international oil prices, with the annual córdoba crawl relative to the U.S. dollar continuing at 6 percent.

11. **The fiscal program aims at reducing the deficit of the combined public sector** from 8.3 percent of GDP in 2000 to 7.4 percent of GDP in 2001, notwithstanding substantial bank resolution costs (equivalent to 2.5 percent of GDP) and higher election-related expenditure (0.3 percent of GDP). Savings of the combined public sector are targeted at negative 0.1 percent of GDP. The reduction in the deficit is to be achieved mainly by restraining expenditures to a path consistent with the lower privatization proceeds and external financing expected to be available during the following years.

12. The program incorporates a scheme to assist coffee growers with debts to the financial system and coffee export houses facing financial difficulties by providing government resources of US$25 per quintal of coffee exported during 2000/01 to restructure a portion of their debt service falling due in 2001. The government is committed to take expenditure measures to fully offset any cost exceeding the program estimate.

13. Total central government outlays have been targeted to remain constant in nominal terms with respect to the level observed in 2000. To this end, efforts to restrain expenditures, which began in March, were significantly strengthened in June. In terms of GDP, current

expenditures of the central government (excluding interest payments) are targeted to decline to 9 percent of annual GDP during the second semester of 2001, compared with 10.2 percent observed during the second semester of 2000. Similarly, total expenditures (excluding interest and foreign financed capital outlays) are targeted to decline to 11 percent of annual GDP from 13.5 percent of GDP, during the same reference period. To enhance monitoring, **the government has set monthly ceilings** on central government expenditures and domestic financing and will report this information no later than 21 days after the end of each month. A cumulative deviation in relation to any of these limits exceeding C$60 million (about 0.2 percent of annual GDP) would trigger a consultation with Fund staff.

14. The program targets an **improvement in NIR of US$50 million** in 2001, which implies an increase of about US$170 million during the second semester, and assumes the **elimination of the domestic floating debt** (equivalent to US$46 million at end-2000). These targets are consistent with the planned expenditure cuts, privatization proceeds estimated at US$115 million, and external disbursement of US$80 million in budgetary support from the IDB (associated with reforms in the financial and electricity sectors, and the pension system).

15. The central bank will continue to utilize **open market operations to conduct credit policy** consistent with the program's inflation and balance of payments objectives. To reduce vulnerabilities, the program allows for a reduction in the stock of central bank paper during the second semester (equivalent to US$25 million), however, interest rates may need to increase further to roll over central bank short-term debt. The central bank will work closely with the banks that took over the intervened banks to ensure that credit lines extended

at that time are repaid. To the extent possible, deposits of the government and other public institutions will be transferred to the central bank as a way to help manage liquidity.

B. Structural Reforms

16. The government intends to **complete the pending structural reforms laid out in its program** supported under the **three-year** PRGF arrangement. Over the remainder of the year, it will take further steps to strengthen the financial system, complete the privatization of the telecommunications and electricity companies, implement the pension system reform, and improve governance. The government will push forward these reforms despite the short-time frame and the limitations faced in the run-up to the presidential and congressional elections in November.

17. To improve the **health of the banking system**, the bank superintendency will complete the agreed program of assisted on-site inspections and implement plans to strengthen banks where weaknesses are encountered. Prudential norms on the classification of bank assets and provisioning, fit and proper criteria, conflict of interest, and related party lending will be modified by September in light of recent experience and consistent with best international practices. A recently established special unit will implement a plan of loan collection and disposal of assets taken over from the recently intervened banks. Also, the government expects the national assembly to approve in September the provisions defining financial crimes as a partial reform of the criminal code.

18. A critical measure adopted by the authorities was the intervention of Banco Nicaraguense de Industria y Comercio (BANIC) on August 4, 2001, a bank found to be weak

during on-site inspections. This action was taken to minimize possible systemic risks and quasi-fiscal costs, after several unsuccessful attempts to arrive at a private solution involving an injection of capital. Following the intervention, on August 5, 2001, the bank's assets and liabilities were auctioned off to BANPRO, a domestic bank, which had also absorbed Interbank in October 2000. BANPRO accepted to receive central bank paper with an 11.49 percent interest, to cover the difference between the assets and liabilities absorbed. While the quasi-fiscal costs will only be determined after a period of 6–9 months, the government is committed to offsetting any increase in interest payments resulting from this operation in excess of 0.2 percent of GDP in 2001 through cuts in other expenditures.

19. **A pension system of privately managed individual accounts will be introduced in the last quarter of 2001**. To this end, the private pension funds superintendency will award the operating licenses for fund management in November. **The bidding process for the sale of the Nicaraguan Electricity Company (ENEL) generating plants and majority ownership and management of ENITEL** will be completed by August 2001. On receipt of acceptable offers, the awarded companies are expected to be transferred to the private owners within a month.

20. **Improvements in governance** will continue to be pursued through judicial reform, improved transparency and monitoring of the budget process, and accelerated regularization of property rights. The national assembly is expected to approve a code on criminal procedures shortly. **The 2002 budget proposal** will be prepared in a multi-year framework, consistent with **full implementation of the Integrated System of Financial Management and Auditing (SIGFA).** This, facilitated by the enhanced Supplementary Social Fund (FSS),

will enable monitoring of poverty reducing expenditures in line with the PRSP and the use of funds from the HIPC debt relief. To help **accelerate the resolution of property rights,** the national assembly has been requested to give priority to approving by October 2001 the proposed law on decentralized real estate registries.

C. Program Monitoring

21. Indicative quantitative benchmarks for September and December 2001, on net domestic financing and savings of the combined public sector, central bank net domestic assets and NIR, and public sector indebtedness on nonconcessional terms are presented in Table 1. The table also shows indicative ceilings on the overall deficit of the combined public sector and the total expenditures of the central government. Monthly indicative ceilings on the central government current expenditure (excluding interest), total expenditure (excluding interest and project-tied financing), domestic financing, and central bank financing are presented in Table 2. In addition, benchmarks for structural policies are shown in Table 3. The program allows for full adjustment in the quantitative targets in the case of shortfalls/windfalls in the HIPC-interim assistance from multilateral institutions. In addition, should the resolution of BANIC require public resources, the combined public sector deficit (savings) would be allowed to increase (decrease) by up to 0.2 percent of GDP. For program monitoring purposes, social security revenue will include all pension contributions in 2001, even after the privately managed pension funds initiate operations.

Table 1. Nicaragua: Quantitative Quarterly Benchmarks for the 2001 Staff-Monitored Program

	Cumulative Flows from December 31, 2000		
	Junio 30, 2001	Septiembre 30, 2001	Diciembre 31, 2001
(In millions of cordobas)			
1. Net domestic financing of the combined public sector (ceilings) 1/ 7/	967	-304	-736
Nonfinancial public sector	299	-1,387	-1,981
2. Savings of the combined public sector (floors) 2/ 7/	101	-114	-39
3. Net domestic assets of the central bank (ceilings) 3/	1,601	331	-622
4. Deficit of the combined public sector, before grants (ceilings) 4/ 7/	-2,336	-3,965	-5,040
5. Total expenditure of the central government (ceilings) 5/	5,719	9,041	12,045
(In millions of U.S. dollars)			
6. Net international reserves of the central bank (floors) 6/ 8/	-129	-43	51
7. Disbursements of nonconcessional external loans contracted or guaranteed by the public sector (ceilings) 9/			
Maturity of more than one year 10/	0	0	0
Maturity of one year or less 11/	0	0	0
8. Stock of external payments arrears 12/	0	0	0

Sources: Central Bank of Nicaragua; Ministry of Finance; and Fund staff estimates.

1/ Comprises the operating results of the central bank, the cost of the bank resolution not included in the monetary accounts, and the change from their respective stocks at end-2000 of the sum of (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$13.4 per U.S. dollar; (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.

2/ Defined as the difference between current revenue and current expenditure of the nonfinancial public sector plus the operating results of the central bank minus the cost of the bank resolution not included in the monetary accounts.

3/ Defined as the difference between the change in the stock of currency issue and net international reserves (as defined below) valued at C$13.4 per U.S. dollar.

4/ Defined as the savings of the combined public sector (as given in footnote 2) plus capital revenue less capital expenditure (including net lending) of the nonfinancial public sector.

5/ Includes current spending, capital spending, and net lending operations (including the loan to coffee producers, which maximum cost is US$15 million).

6/ For program purposes, 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, plus foreign currency deposits of commercial banks at the central bank.

7/ Benchmarks 1 and 4 will be adjusted upward and 2 downward by the amount of the interest cost of central bank paper issued for the resolution of BANIC with an upper limit of 0.2 percent of GDP.

8/ These benchmarks will be adjusted downward/upward to the extent that interim HIPC debt relief is lower/higher than the programmed level of US$16.3 million by September 2001, and of US$34.4 million by December 2001. Corresponding offsetting adjustments will be made to the quantitative benchmarks 1-5.

9/ Includes loans contracted or guaranteed by the public sector, with a grant element of less than 35 percent calculated on the basis of currency specific commercial rates as discount rates. Excludes reserve liabilities of the central bank and the capitalization of interest resulting from rescheduling of refinancing operations.

10/ Excludes Paris Club resources resulting from the deferral of Nicaragua's debt service.

11/ Excludes normal import-related credits.

12/ Excludes reschedulable arrears, measured on a continuous basis.

Table 2. Nicaragua: Central Government Monthly Indicators for the 2001 Staff-Monitored Program

(In millions of cordobas)

	Cumulative Flows from January 1, 2001						
	06/30/01	07/31/01	08/31/01	09/30/01	10/31/01	11/30/01	12/31/01
1. Current expenditure (excluding interest) 1/	2,837	3,296	3,759	4,222	4,684	5,149	5,892
2. Total expenditure (excluding interest and foreign financed outlays)	3,713	4,443	5,029	5,583	6,134	6,679	7,473
3. Domestic financing	766	1,130	1,178	-731	-761	-825	-1,312
4. Central bank net credit 2/	1,682	2,071	2,163	88	98	-64	-520
Memorandum items:							
Untied loans	0	0	0	469	469	469	1,074
Privatization	0	0	0	1,541	1,541	1,541	1,541

Sources: Central Bank of Nicaragua; Ministry of Finance; and Fund staff estimates.

1/ Includes only those "bonos a transportistas" applied as payments of IEC on petroleum products.
2/ Flows are net of CENIS issued for bank resolution.

Table 3. Nicaragua: Structural Benchmarks for the Staff-Monitored Program

Policy Measures	Timetable
1. **Strengthening of the financial system:**	
a. **Complete the current cycle of on-site assisted inspections,** communicate the required adjustments, and implement strengthening programs for banks where capital weaknesses have been found.	September 2001
b. **Modify prudential norms** on classification of bank assets and bank provisioning, fit and proper criteria, conflict of interest, and related party lending in accordance with recent experience and best international practices.	September 2001
c. **Complete the second cycle** of on-site assisted inspections in the banks that absorbed the intervened banks and those banks where weaknesses are found in the first cycle; implement strengthening programs for banks where weakness have been found.	November 2001
d. **Approval of a revision of the criminal code** defining financial crimes.	September 2001
2. **Public sector reforms:**	
a. **Social security reform:**	
- Establish and make operational the supervision agency.	August 2001
- Award licenses to the private fund managers.	November 2001
b. **Privatization of public utilities:**	
- ENEL – Award the hydroelectric plant.	August 2001
- ENITEL – Award management and 40 percent of shares.	August 2001
3. **Good governance:**	
a. **Transparency in the use of public funds;** implement the integrated system for financial management and audit (SIGFA) to the line ministries:	
- The 2002 budget proposal consistent with implementation of the "decentralized" SIGFA;	October 2001
- Decentralized SIGFA implemented in three ministries.	December 2001
b. **Judiciary reform:**	
- Approval of new code on criminal proceedings.	September 2001
- Approval of a law to strengthen decentralized real estate registries.	October 2001