International Monetary Fund

Public Information Notice (PIN) No. 01/104

October 2, 2001

International Monetary Fund
700 19th Street, NW
Washington, D.C. 20431 USA

IMF Concludes 2001 Article IV Consultation with Nicaragua

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

On September 19, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Nicaragua.[1]

Background

Economic performance during 1998 and the first half of 1999 was in line with the program supported by the three-year Poverty Reduction and Growth Facility (PRGF) arrangement approved in March 1998, despite the adverse effects associated with Hurricane Mitch. Policy implementation weakened in late 1999 and early 2000. In particular, fiscal policy was more expansionary than anticipated, as the combined public sector deficit increased and the external current account deficit widened significantly. In addition, the accumulation of net international reserves (NIR) fell short of programmed levels. Against this background, a modified program for 2000 was agreed with the authorities. However, economic performance deteriorated further during the final months of 2000 and the first half of 2001, with economic growth decelerating as investment tapered off from post-Hurricane Mitch highs. After increasing in 2000 as a result of higher energy costs, the 12-month rate of inflation declined to about 8 percent by mid-2001.

The deficit of the combined public sector in 2000, at 8.3 percent of GDP, was higher than anticipated, owing to substantial spending overruns in the fourth quarter of the year. These overruns were financed mainly by an accumulation of domestic arrears (mostly to suppliers). The fiscal stance remained weak during the first half of

2001 owing to the cost of bank resolutions, continued high spending, and payments of domestic arrears, which contributed to substantial central bank financing of the combined public sector and a decline in NIR of close to US$120 million.

While difficulties in the banking system intensified in 2000, the authorities took decisive actions to strengthen banking supervision. In addition, since August 2000 four banks, found to be weak through on-site inspections, were intervened and their performing assets sold to other private banks. The increase in central bank debt associated with the first three bank resolutions is estimated at about 10 percent of GDP, while the cost associated with the bank is still being evaluated. Demand deposit growth, after declining in late 2000, has been recovering in 2001. However, the growth of broad money has continued to decelerate, with evidence of portfolio shifts toward liquid assets. Similarly, after a marked slowdown in 2000, the expansion of bank credit to the private sector slowed further in the first half of 2001.

Exchange rate policy continued to be based on a 6 percent annual rate of crawl vis-à-vis the U.S. dollar. The real effective exchange rate appreciated by about 11 percent during the 18-month period ending on June 30, 2001, largely as a result of the appreciation of the U.S. dollar, while the terms of trade deteriorated owing to a significant drop in coffee prices and an increase in oil-import prices.

Structural reforms advanced during 2000 and so far in 2001. The national assembly approved legislation to reform the social security system and improve government procurement. In addition, the electricity distribution companies were privatized. As regards governance, efforts to improve the efficiency of the Comptroller's Office have continued and property rights have been strengthened with the establishment of mediation courts and the approval of a law on administrative procedures and dispute settlement.

Discussions on the third annual PRGF arrangement could not be completed because delays in addressing policy slippages during the first part of 2001 made it unfeasible to bring the program back on track in 2001. The authorities' program for July-December 2001, which they have requested the staff to monitor as a Staff-Monitored Program (SMP), aims at advancing toward macroeconomic stability and implementing pending structural measures. This will facilitate the transition to the new administration that will take office in January 2002, and help build a track record for a program that could be supported by a new three-year PRGF to be negotiated in 2002. The authorities' program assumes a GDP growth rate of 3 percent, the continuation of a 6 percent annual exchange rate crawl to the U.S. dollar, and targets an inflation rate of 8 percent by year-end.

The authorities' fiscal program aims at reducing the combined public sector deficit to 7.4 percent of GDP in 2001, by restraining expenditure growth during the second half of the year. The monetary program envisages an increase in base money in line with nominal GDP growth and a contraction in central bank net domestic assets. These policies in combination with the privatization of the electricity generating plants and a 40 percent stake in the telecommunications company and the release of balance of payments support would allow for an accumulation of NIR of US$50 million.

The authorities have prepared a Poverty Reduction Strategy Paper (PRSP) that presents a comprehensive and coherent strategy to reduce poverty in Nicaragua; the outlined macroeconomic policies provide an appropriate medium-term framework and a solid basis for concessional assistance and debt relief.

Executive Board Assessment

Directors observed that adverse terms of trade shocks, a decline in investment from high post-Hurricane Mitch levels, drought, and slippages in policy implementation, particularly in the fiscal and monetary areas, had contributed to the recent weak performance of the Nicaraguan economy. Economic activity slowed in 2000-01, the fiscal position has deteriorated, and international reserves have declined. Some Directors were disappointed that discussions on the third annual PRGF arrangement could not be completed because of delays in addressing policy slippages. Directors emphasized the importance of establishing a track record in policy implementation as a necessary element for continued support for HIPC and PRGF participation.

Against this background, Directors welcomed the authorities' intention to restore macroeconomic discipline in the context of an SMP for the period July-December 2001, although a few Directors would have preferred that it continue into 2002. Noting the risks associated with further slippages, Directors stressed that meeting all program targets for end-2001 is critical to maintaining the positive outlook envisaged in the PRSP, relieving pressures on the balance of payments, and building a track record in preparation for a possible new three-year PRGF arrangement, which could be discussed with the new administration taking office in January 2002.

In particular, Directors noted that an effective implementation of the fiscal program under the SMP, together with a stepped-up effort on the envisaged privatization and structural reforms, is crucial to maintaining macroeconomic stability, laying the basis for sustained growth, and strengthening the reserve position. In this context, Directors expressed concern about the continued decline in reserves experienced in recent weeks. They stressed that the authorities should stand ready to further restrain government expenditure and raise interest rates, as needed, to encourage the rollover of maturing central bank debt in order to protect the reserve position.

Directors noted that the achievement of medium-term fiscal and external sustainability requires a strong effort to increase the efficiency of public spending, focusing it on delivery of key social services, while increasing public savings by raising government revenue. In this regard, they stressed the importance of implementing a comprehensive tax reform in 2002, including by eliminating exemptions and special regimes under the value added tax and import taxes.

Directors welcomed recent steps to improve liquidity management and strengthen the banking system, including the intervention of Banco Nicaraguense de Industria y Comercio (BANIC). They urged the authorities to push ahead with current plans to improve prudential norms and reinforce bank supervision, noting that vulnerabilities remain.

Directors welcomed the progress made in improving the efficiency of the Comptroller's Office, implementing the new government procurement law, strengthening the institutions for the resolution of property rights, and approving legislation to reform the social security system. They stressed the need to proceed with the planned actions to further improve governance and transparency in the public sector.

Directors welcomed recent steps to deepen trade liberalization, including the removal of the temporary protection tariff. They urged the authorities to implement promptly pending measures on intellectual property rights and customs valuation, and to eliminate the punitive 35 percent tariff charged on imports from two countries in the region. Directors agreed that the crawling peg exchange rate system has served Nicaragua well, but stressed that its viability hinges on the implementation of prudent fiscal and credit policies. Some Directors indicated that there is also a need to assess the long-term impact of secular changes in coffee prices, and its implications for the external sector and exchange rate policy.

Directors were of the view that the PRSP prepared by the authorities constitutes a very comprehensive and coherent strategy to reduce poverty in Nicaragua, and that it could serve as a solid basis for concessional assistance and debt relief once the authorities have established a satisfactory track record of policy implementation. They noted, however, that the authorities should develop a structured action plan to ensure broad-based participation in the implementation of the poverty strategy, an integrated financial management system to monitor implementation and track poverty-related spending, and a set of economic indicators to complement social indicators in monitoring the progress in poverty reduction, with a focus on the poorest segments of society. Directors also encouraged the authorities to strengthen the institutions involved in implementing the strategy.

While statistical information was regarded as sufficient for surveillance purposes, Directors urged the authorities to strengthen both the quality and the timeliness of data, and stressed the importance of advancing in the revision of the national accounts.

Nicaragua: Selected Economic Indicators

	1997	1998	1999	2000	SMP 2001
(Annual percentage change; unless otherwise indicated)					
National income, prices, and unemployment					
GDP at constant prices	5.1	4.1	7.4	4.3	3.0
Consumer prices (end of period)	7.3	18.5	7.2	9.9	8.0
Consumer prices (period average)	9.2	13.0	11.2	11.6	8.3
Unemployment rate (percent)	14.3	13.2	10.7	9.9	...
External sector					
Exports, f.o.b.	-6.6	-0.6	-4.9	18.3	-6.1
Export volume	-7.2	-2.3	9.3	21.1	-1.7
Imports, f.o.b.	12.8	0.9	23.1	-5.7	-4.5
Import volume	19.7	8.6	15.9	-15.9	-5.2
Terms of trade (deterioration -)	6.8	7.7	19.1	-12.8	-3.7
Nominal effective exchange rate end of period (depreciation -)	-2.0	-11.9	-2.7	2.1	...
Real effective exchange rate end of period (depreciation -)	3.5	2.0	1.6	8.8	...
Money and credit					
Net domestic assets of the central bank 1/	-36.8	27.5	-39.3	22.7	-35.5
Net credit to nonfinancial public sector 1/	132.3	-85.8	-75.6	-36.2	-23.7
Net credit to financial institutions 1/	-22.3	-4.8	-2.6	95.4	-45.0
Currency in circulation	26.8	22.2	29.5	1.2	4.0
Financial system liabilities to private sector	65.6	28.6	22.4	7.3	6.6
Financial system credit to private sector	9.7	45.3	40.0	14.2	4.4
Money income velocity (GDP/M3)	1.6	1.6	1.5	1.6	1.7
Interest rate on deposits (percent per annum) 2/	11.5	12.4	11.5	11.2	...
(In percent of GDP)					
Public sector					
Combined public sector saving 3/	4.0	5.6	5.4	3.6	-0.1
Combined public sector overall balance (before grants) 3/	-9.7	-7.4	-15.7	-15.7	-14.9
Combined public sector overall balance (after grants) 3/	-4.5	-3.6	-7.0	-8.3	-7.4
Nonfinancial public sector saving	4.5	8.9	7.1	5.2	3.6
Nonfinancial public sector overall balance (before grants)	-9.2	-4.1	-14.0	-14.1	-11.2
Central bank operational results (deficit -) 4/	-0.5	-3.3	-1.7	-1.6	-3.7
Savings and investment					
Gross domestic investment	30.5	33.8	43.3	34.4	28.5
Public	13.7	13.0	21.1	19.2	14.2
Private	16.8	20.8	22.2	15.2	14.3
National savings	3.3	2.3	1.4	3.0	0.2
Public	4.0	5.6	5.4	3.6	-0.1
Private	-0.7	-3.3	-4.0	-0.6	0.3
External savings 5/	27.2	31.5	41.9	31.4	28.3
External sector					
External current account balance	-31.8	-37.2	-47.9	-37.3	-30.5
(Excluding interest obligations)	-21.3	-26.9	-37.7	-27.0	-22.3
Trade balance (deficit -)	-30.1	-39.2	-52.3	-40.1	-36.8
Outstanding external public debt (end of year)	296.7	296.0	289.0	278.0	...

(In percent of exports of goods and nonfactor services)

Contractual debt service	50.2	43.5	47.1	44.1	38.5
Gross international reserves (in months of imports)	2.5	2.3	3.3	3.2	3.6

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

1/ In relation to currency in circulation at the beginning of the year.
2/ Six-month deposits, end of period.
3/ Includes central bank operational losses.
4/ For 2001, includes the cost of bank resolution on accrual basis.
5/ External current account deficit, excluding interest on debt to non-Paris Club bilateral creditors that is eligible for debt rescheduling and deferred interest to Paris Club.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the September 19, 2001 Executive Board discussion based on the staff report.

IMF EXTERNAL RELATIONS DEPARTMENT
Public Affairs: 202-623-7300 - Fax: 202-623-6278
Media Relations: 202-623-7100 - Fax: 202-623-6772