Folder Title:	Nicaragua - Correspondence File - Project Evaluation - Project Performance Audit Report [PPAR] - Volume 1
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OEDCR Shared Unit Files
MANAGEMENT AND OVERSIGHT
Operations Evaluation

Project Evaluation – PPARs
NICARAGUA – Cr. 2302 & Cr. 2631
ERC AND ERC II Vol. 1

AUDIT PANEL REVIEW

Log No:	218
Project Type	PAR
Loan/Credit No.	C2302, C2631
Country/Project Name	Nicaragua
Prepared by	Garcia-Garcia
Date received	12/23/2002
Assigned to	GRASSO
Date Assigned	1/16/2003
Review Completed	
Comments	Please discuss your comments with Task Manager within 5 working days from this date. Task Manager would be expected to resubmit the final package for your initials and signature by the Group Manager.

Wednesday, January 15, 2003

Project Performance Assessment Report NICARAGUA
Economic Recovery Credit (Credit No. 2302-NI)
Second Economic Recovery Credit(Credit No. 2631-NI)

Project ID:	P007781
Evaluation Type :	PPAR
Country :	Nicaragua
Project Description :	Econ.rec.cr.
Sector :	Economic Policy
Subsector :	EP
Lending Instrument :	Structural Adjustment Loan
L/C :	C2302

Operations Evaluation Department
PROJECT INFORMATION FORM

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Operations Evaluation Department
Project Information Form

Project ID : P007781
Evaluation Type : PPAR

A1. General Project Information

Project ID :	P007781	**3. Key Dates**	**Original**	**Latest**
Evaluation Type :	PPAR	Departure of Appraisal Mission		6/6/1991
Country :	Nicaragua	Approval		9/26/1991
Project Description :	Econ.rec.cr.	Signing / Agreement		
Sector :	Economic Policy	Effectiveness	1/6/1992	11/15/1991
Subsector :	EP	Physical Completion		
Lending Instrument :	Structural Adjustment Loan	Closing	12/31/1992	2/25/1994
L/C :	C2302	ICR receipt in OED		
		Review date		12/13/2002
		ES posting or PAR approval		

1. Reviewer : Jorge Garcia

2. Do you agree with the assigned primary Sector and Subsector? Yes

Suggested Sector/Subsector:
Suggested Sector Code:
Suggested Subsector Code:

4. Key Amounts ($US million)

Original Commitment	128.79
Total Cancellation	
Total project cost	
Original	110
Latest	110

5. Cofinanciers

	First	Second	Third
Name	Government of Japan	Government of Germany (KfW and GTZ)	Government of Switzerland
Original Commitment ($US million)			
Total Cancellation ($US million)	74.1	35	5

6. Distribution of latest cost among component types ($US million)

Physical	0
Technical assistance	0
Balance of payments	100
Line of credit	0
Other	10

7. Applicable disbursement profile (no. of years)

1

8. Number of supervision missions : 5

9. Name(s) of primary author(s) of ICR (indicate if not known) :

10. Names of managers

	At entry	At exit
Task manager	Baran Tuncer	Ivan Rivera
Division chief	Marco Voljc	Robert Lacey
Department Director	Rainer Steckhan	Edilberto Segura

A2. Project Objectives Evaluation

1. Were the project objectives substantially revised during implementation? No

If yes, did the Board approve the revised objectives as part of a formal restructuring?

Date of Board approval

Note: If objectives were substantially revised, reference the online help for guidance in using original or revised objectives in sections B1 and B2.

2. Taking into account the country's level of development and the competence of the implementing agency, to what extent did the project design have the following characteristics:

Demanding on Borrower/ Implementing Agency	High
Complexity	High
Riskiness	Substantial

3. Did the project include a monitoring and evaluation system for the implementation phase? No

If yes, rate the extent to which the system met each of the following criteria for a good M&E system

Clear project and component objectives verifiable by indicators

A structured set of indicator

Requirements for data collection and management

Institutional arrangements for capacity building

Feedback from M&E

4. For this particular project, rate the importance of the project's objectives:

Physical	Not Applicable	Institutional	Substantial
Financial (interest rates; pricing/ tariff policies; cost recovery	Modest	Social	Not Applicable
		Direct poverty alleviation	Not Applicable
		Gender	Not Applicable
Economic		Environmental	Not Applicable
Macro-economic policies (fiscal; monetary; trade)	High	Private sector development	Substantial
Sector policies	Substantial	Other (specify):	

B1a. Outcomes- Relevance

Definition: The extent to which the project's objectives are consistent with the country's current development priorities and with current Bank country and sectoral assistance strategies and corporate goals (expressed in PRSPs, CASs, SSPs, OPs).

1. Indicate the relevance of each category of the project's objectives:

Physical	Not Applicable
Financial (interest rates; pricing / tariff policies; cost recovery)	Substantial
Economic	
Macro-economic policies (fiscal; monetary; trade)	High
Sector Policies	Substantial
Institutional	Substantial
Social	Not Applicable
Direct poverty alleviation	Not Applicable
Gender	Not Applicable
Environmental	Not Applicable
Private sector development	Substantial
Other (specify):	

2. Summary Rating of Relevance

Rate the extent of the project's overall relevance, taking account of the relevance and relative importance of each of the project's objective categories:	Substantial
Average rating (weighted by scores on relative importance)	Substantial

If your overall rating differs from the average rating, please comments on reasons for this difference:

B1b. Outcomes-- Efficacy

Definition: The extent to which the project's objectives were achieved, or expected to be achieved, taking into account their relative importance.

1. Indicate the extent to which each of the following objectives was in fact accomplished

Physical	Not Applicable
Financial (interest rates; pricing / tariff policies; cost recovery)	Substantial
Economic	
Macro-economic policies (fiscal; monetary; trade)	High
Sector Policies	Modest
Institutional	Modest
Social	Not Applicable
Direct poverty alleviation	Not Applicable
Gender	Not Applicable
Environmental	Not Applicable
Private sector development	Substantial
Other (specify):	

2. Summary Rating of Efficacy

Rate the extent of the project's overall efficacy, taking account of the efficacy and relative importance of each of the project's objective categories:	Substantial
Average rating (weighted by scores on relative importance)	Substantial

If your overall rating differs from the average rating, please comments on reasons for this difference:

B1b. Outcomes-- Efficacy (cont'd)

3. Rate the extent to which each of the following factors affected the achievement of this project's objectives:

World markets/prices	No Effect	Performance of contractors / consultants	Not Applicable
Natural events	No Effect	War / civil disturbance	Negative
Cofinancier(s) performance	No Effect	Other (specify):	Not Applicable

B1c. Outcomes -- Efficiency

Definition: The extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and deliver benefits at least cost compared to alternatives.

1. Is an **Economic Rate of Return** (ERR) available for this project ? No

If No, is a **Financial Rate of Return** (FRR) available? No

If a rate of return is available, provide the following information (in percent):

	Point Value	Range	Weighted Average	Coverage of Objectives/Results
At Appraisal		From: To:		
At Completion		From: To:		

2. Was another measure of efficiency provided? No

If Yes, then answer the following:

Measure used
Coverage/scope of measure
Comparison to appraisal estimate

3. If no measure of efficiency was provided for this project, would it have been reasonable to expect one? No

If Yes, explain:

4. Rate the quality of the ex-post economic analysis according to the following criteria:

Soundness of analysis	Substantial	Overall rating of quality of analysis	Substantial
Conduct of sensitivity/ risk analysis	Not Applicable	Average rating	Substantial
Consideration of institutional constraints to achieving results	Substantial	If your overall rating differs from the average rating , please comment on reasons for this difference	
Extent to which benefits accrue to target population	Not Applicable		
Consideration of environmental externalities	Not Applicable		
Consideration of fiscal impact	High		
Consideration of alternatives to meeting objectives	Not Available		

B1c. Outcomes -- Efficiency (cont'd)

5. Summary Rating of Efficiency

Rate overall to what extent the project accomplished its goals efficiently:	Substantial
Average rating	no automatic average rating of efficiency is provided

B1d. Outcomes -- Summary

Definition: The extent to which the project's major relevant objectives were achieved, or are exposed to be achieved, efficiently.

1. SUMMARY OUTCOME RATING

Rate the project's outcome, taking account of its relevance, efficacy, and efficiency:	Satisfactory
Average rating	Satisfactory
If your overall rating differs from the average rating, please comment on reasons for this difference:	

B2. Sustainability

Definition: The resilience to risk of net benefits over time.

1. Rate the resilience of the project's net benefits in terms of the following:

Technical resilience	Not Applicable	Institutional support:	Substantial
Financial resilience (including policies on cost recovery)	Substantial	Exogenous influences:	Substantial
Economic resilience	Substantial	Other stakeholder ownership:	Not Applicable
Social conditions (including those subject to Safeguard Policies)	Substantial	Other (specify):	
Environmental conditions	Not Applicable		
Government ownership (including supportive legal/regulatory framework, and organizational and management effectiveness)	Substantial		

2. SUMMARY SUSTAINABILITY RATING

Rate the project's overall sustainability:	Likely
Average rating	Likely
If your overall rating differs from the average rating, please comment on reasons for this difference:	
For analytical purposes, also rate the projects' overall sustainability using the previous 3-point rating scale (Likely, Uncertain, Unlikely):	Likely

B3. Institutional Development Impact

Definition: The extent to which a project improves the ability of a country or region to make more efficient, equitable and sustainable use of its human, financial, and natural resources through: (a) better definition, stability, transparency, enforceability, and predictability of institutional arrangements and/or (b) better alignment of the mission and capacity of an organization with its mandate, which derives from these institutional arrangements. IDI includes both intended and unintended effects of a project.

1. Was this project directed primarily toward Institutional Development? No

2. If not, did the project contain components with significant Institutional Development objectives? Yes

3. Did the project's Institutional Development activities include each of the following:

Establishment of a new organization	No
Elimination of an existing organization	Yes
Restructuring / privatizing of an organization	Yes

4. For this particular project, rate the relevance of the following Institutional Development objectives:

National capacity	
Economic management	Substantial
Civil service reform	High
Financial intermediation	Substantial
Legal/regulatory system	Modest
Sectoral capacity	Not Applicable
Other (specify):	
Agency capacity	
Planning / policy analysis	Not Applicable
Management	Not Applicable
Skills upgrading	Not Applicable
MIS	Not Applicable
Other (specify):	
NGO Capacity	Not Applicable

5. For this project, rate the extent to which each of the following ID objectives was achieved:

National capacity	
Economic management	Substantial
Civil service reform	Substantial
Financial intermediation	
Legal/regulatory system	Substantial
Sectoral capacity	Not Applicable
Other (specify):	
Agency capacity	
Planning / policy analysis	Not Applicable
Management	Not Applicable
Skills upgrading	Not Applicable
MIS	Not Applicable
Other (specify):	
NGO Capacity	Not Applicable
Overall ID Efficacy	Substantial

6. SUMMARY INSTITUTIONAL DEVELOPMENT IMPACT RATING

Rate the project's overall institutional development impact, taking account of unintended effects not specifically supported by the project:	Substantial
Average rating	Substantial

If your overall rating differs from the average rating, please comment on reasons for this difference:

C1. Bank Performance

Definition: The extent to which services provided by the bank during all project phases, (i) ensured quality at entry, and (ii) implementation support through appropriate supervision (including ensuring adequate transition arrangements for regular operation of the project)

1. Rate the quality at entry of the project with respect to:

Project Concepts, Objectives and Approach During Identification

Government ownership:	Substantial	Institutional capacity analysis:	Modest
Involvement of stakeholders/beneficiaries:	Not Applicable	Social and stakeholder analysis:	Not Applicable
Project consistency with Bank strategy for country:	High	Environmental aspects:	Not Applicable
Grounding in economic and sector work (ESW)	Substantial	Risk assessment (inc. adequacy of conditionalities):	Substantial
Development objectives statement (including Logframe, if applicable):	High	Incorporation of M&E indicators:	Not Applicable
Approach and design appropriateness:	High	Incorporation of lessons learned:	Not Applicable
Technical aspects:	Substantial	Readiness for implementation:	Substantial
Financial aspects (including funding provisions, fiscal impact):	Modest	Suitability of lending instrument:	High
Economic aspects:	Not Applicable	Financial management aspects:	Substantial
Rate the overall quality at entry:	Satisfactory		

2. Rate the quality of project supervision by the Bank with respect to:

Focus on development Impact		**Adequacy of supervision inputs and processes**	
Timely identification / assessment of implementation and development impact problems	Substantial	Adequacy of Bank supervision resources	Substantial
Advice to implementing agency	Substantial	Supervision reporting quality	Substantial
Flexibility in suggesting / approving modifications	Not Applicable	Attention to fiduciary aspects	Not Available
Use of performance indicators	Substantial	Attention to M&E data	Not Applicable
Enforcement of loan covenants/ exercise of remedies	High		
Effectiveness of Bank actions	High		
		Rate the overall quality of supervision	Satisfactory

C1. Bank Performance (cont'd)

3. SUMMARY RATING OF BANK PERFORMANCE

Rate the Bank's overall performance, taking account of quality at entry and supervision:	Satisfactory
Average rating	Satisfactory
If your overall rating differs from the average rating, please comment on reasons for this difference:	

C2. Borrower Performance

Definition: The extent to which the borrower assumed ownership and responsibility to ensure quality of preparation and implementation, and complied with covenants and agreements, towards the achievement of development objectives and sustainability

1. Rate the Borrower / Implementing Agency performance on the preparation of this project: Satisfactory

2. Rate the extent to which government / implementing agency performance on the following dimensions supported project implementation:

Dimensions generally subject to government control

Macro policies / conditions:	Substantial	Administrative procedures:	Not Applicable
Sector policies / conditions:	Substantial	Cost Controls:	Not Applicable
Government commitment:	Substantial	Timely actions:	Substantial
Appointment of key staff:	Substantial	Other (specify):	
Counterpart funding:	Not Applicable		

Dimensions generally subject to implementing agency control

Management:	Substantial	Use of technical assistance:	Not Applicable
Staffing:	Substantial	Beneficiary participation:	Not Applicable
Cost changes:	Not Applicable	Other (specify):	
Timely actions:	Substantial		

C2. Borrower Performance (cont'd)

3. Summary Rating of Borrower Performance on Project Implementation

Overall rating	Satisfactory
Average rating	Satisfactory

If your overall rating differs from the average rating, please comment on reasons for this difference:

4. Rate Borrower compliance with loan covenants / commitments:

Highly Satisfactory

5. SUMMARY RATING OF BORROWER PERFORMANCE

Overall rating	Satisfactory
Average rating	Satisfactory

D. Special Themes

1. Indicate whether each of the following social concerns was a major project emphasis:

Gender related issues	Not Applicable
Settlement / resettlement	Not Applicable
Beneficiary participation	Not Applicable
Community development	Not Applicable
Skills development	Not Applicable
Nutrition and food security	Not Applicable
Health improvement	Not Applicable
Other (specify):	

3. Was this a Poverty Targeted Intervention? No

Did the project place a major emphasis on poverty alleviation?	No
If Yes:	
Did it emphasize broad-based growth with labor absorption?	
Did it emphasize human development (education, health or nutrition)	
Did it emphasize the provision of a social safety net?	
Did it focus mainly on the:	
Did the project include a specific mechanism for achieving poverty reduction benefits?	
If explicit, were these mechanisms implemented?	
Is there evidence, that the intended poverty reduction benefits were realized?	
Did it include impact studies?	
Did it include beneficiary assessments?	

2. Did the project have an unintended or unexpected effect on social concerns, regardless of the project's objectives

Not Available

4. Indicate whether each of the following environmental concerns was a major project emphasis:

Natural resource management	Not Applicable
Air / water / soil quality	Not Applicable
Urban environmental quality	Not Applicable
Other (specify):	

D. Special Themes (cont'd)

5. Did the project have an unintended or unexpected effect on social concerns, regardless of the project's objectives
No

If Yes, was the effect positive or negative?

6. Indicate whether each of the following private sector development (PSD) concerns was a major project emphasis:

Improvement in legal or incentive framework designed to foster PSD (e.g., trade, pricing)	Yes
Restructuring / privatization of public enterprises	Yes
Financial sector development	Yes
Direct government financial and / or technical assistance to the private sector	No
Other (specify):	

7. Rate the priority of the project for audit

High

If the priority is High or Medium, indicate the reason(s)
Audit would be a building block towards a forthcoming CAE

If the priority is High or Medium, indicate the desired timing of the audit:
Immediately

8. Rate the priority of the project for impact evaluation
Medium

E. Rating of ICR

1. Rate the quality of the ICR by the following characteristics:

Analysis
Coverage of important subjects
Ex-post economic analysis
Soundness of analysis
Internal consistencies
Evidence complete / convincing
Adequacy of lessons learned
Aide-memoire of the ICR mission
Poverty Analysis

Future operation of project
Plan for future project operation
Performance indicators for the project's operational phase
Plan for monitoring and evaluation of future operation of the project

Borrower / cofinancier inputs
Borrower input to ICR
Borrower plan for future project operation
Borrower comments on ICR
Cofinancier comments on ICR

2. SUMMARY RATING OF ICR

Rate the quality of the ICR

Average rating

If your overall rating differs from the average rating, please comment on rating for this difference:

E. Rating of ICR (cont'd)

3. Rate the quality of borrower participation in the project completion process on the following:

Analysis	Focus on lessons learned
Concern with development impact	Self-evaluation
Internal consistency	Evaluation of Bank
Evidence to justify views	

F. Summary of Ratings

1. SUMMARY OF RATINGS

	ICR	ES	PPAR
Outcome	Satisfactory		Satisfactory
Sustainability	Unlikely		Likely
Institutional Development efficacy / impact	Negligible		Substantial
Bank performance	Satisfactory		Satisfactory
Borrower performance	Satisfactory		Satisfactory
ICR quality			
Achievement of Direct Poverty Alleviation Objectives	Not Applicable		Not Applicable

2. Explain any difference between OED ratings and those in the ICR:

After ten years of ERC I being executed, the reforms have brought benefits to the country and will probably be sustained

G. Overall Judgments / Miscellaneous Comments

1. Enter any overall judgments or rationales and miscellaneous comments below:

Project ID:	P007784
Evaluation Type :	PPAR
Country :	Nicaragua
Project Description :	Econ. Rec. Crd Ii
Sector :	Economic Policy
Subsector :	EP
Lending Instrument :	Sector Adjustment Loan
L/C :	C2631

Operations Evaluation Department

PROJECT INFORMATION FORM

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Operations Evaluation Department
Project Information Form

Project ID : P007784
Evaluation Type : PPAR

A1. General Project Information

Project ID :	P007784	**3. Key Dates**		
			Original	**Latest**
Evaluation Type :	PPAR	Departure of Appraisal Mission		4/4/1994
Country :	Nicaragua	Approval		6/21/1994
Project Description :	Econ. Rec. Crd Ii	Signing / Agreement		
Sector :	Economic Policy	Effectiveness	9/20/1994	6/29/1994
Subsector :	EP	Physical Completion		
Lending Instrument :	Sector Adjustment Loan	Closing	6/22/1995	4/24/1997
L/C :	C2631	ICR receipt in OED		
		Review date		12/13/2002
		ES posting or PAR approval		

1. Reviewer : Jorge Garcia Garcia

2. Do you agree with the assigned primary Sector and Subsector?	Yes	**4. Key Amounts ($US million)**	
		Original Commitment	79.7
Suggested Sector/Subsector:		Total Cancellation	
Suggested Sector Code:		**Total project cost**	
Suggested Subsector Code:		Original	67.5
		Latest	67.3

5. Cofinanciers

	First	Second	Third
Name	OECF (Japan)		
Original Commitment ($US million)	60		
Total Cancellation ($US million)	23		

6. Distribution of latest cost among component types ($US million)

Physical	0
Technical assistance	0
Balance of payments	100
Line of credit	0
Other	0

7. Applicable disbursement profile (no. of years)

2

8. Number of supervision missions : 4

9. Name(s) of primary author(s) of ICR (indicate if not known) :

Ian Bannon

10. Names of managers

	At entry	At exit
Task manager	Ulrich Lachler	Violeta Rosenthal
Division chief	Robert Lacey	n/a
Department Director	Edilberto Segura	Donna Dowsett-Coirolo

A2. Project Objectives Evaluation

1. Were the project objectives substantially revised during implementation? No

If yes, did the Board approve the revised objectives as part of a formal restructuring?

Date of Board approval

Note: If objectives were substantially revised, reference the online help for guidance in using original or revised objectives in sections B1 and B2.

2. Taking into account the country's level of development and the competence of the implementing agency, to what extent did the project design have the following characteristics:

Demanding on Borrower/ Implementing Agency	High
Complexity	Substantial
Riskiness	Substantial

3. Did the project include a monitoring and evaluation system for the implementation phase? No

If yes, rate the extent to which the system met each of the following criteria for a good M&E system

Clear project and component objectives verifiable by indicators

A structured set of indicator

Requirements for data collection and management

Institutional arrangements for capacity building

Feedback from M&E

4. For this particular project, rate the importance of the project's objectives:

Physical	Not Applicable	Institutional	Substantial
Financial (interest rates; pricing/ tariff policies; cost recovery	Substantial	Social	Not Applicable
		Direct poverty alleviation	Not Applicable
		Gender	Not Applicable
Economic		Environmental	Not Applicable
Macro-economic policies (fiscal; monetary; trade)	Substantial	Private sector development	Substantial
Sector policies	Substantial	Other (specify):	

B1a. Outcomes- Relevance

Definition: The extent to which the project's objectives are consistent with the country's current development priorities and with current Bank country and sectoral assistance strategies and corporate goals (expressed in PRSPs, CASs, SSPs, OPs).

1. Indicate the relevance of each category of the project's objectives:

Physical	Not Applicable
Financial (interest rates; pricing / tariff policies; cost recovery)	Substantial
Economic	
Macro-economic policies (fiscal; monetary; trade)	Substantial
Sector Policies	Substantial
Institutional	High
Social	Not Applicable
Direct poverty alleviation	Not Applicable
Gender	Not Applicable
Environmental	Not Applicable
Private sector development	Substantial
Other (specify):	

2. Summary Rating of Relevance

Rate the extent of the project's overall relevance, taking account of the relevance and relative importance of each of the project's objective categories:	Substantial
Average rating (weighted by scores on relative importance)	Substantial

If your overall rating differs from the average rating, please comments on reasons for this difference:

B1b. Outcomes-- Efficacy

Definition: The extent to which the project's objectives were achieved, or expected to be achieved, taking into account their relative importance.

1. Indicate the extent to which each of the following objectives was in fact accomplished

Physical	Not Applicable
Financial (interest rates; pricing / tariff policies; cost recovery)	Substantial
Economic	
Macro-economic policies (fiscal; monetary; trade)	Substantial
Sector Policies	Modest
Institutional	Modest
Social	Not Applicable
Direct poverty alleviation	Not Applicable
Gender	Not Applicable
Environmental	Not Applicable
Private sector development	Substantial
Other (specify):	

2. Summary Rating of Efficacy

Rate the extent of the project's overall efficacy, taking account of the efficacy and relative importance of each of the project's objective categories:	Modest
Average rating (weighted by scores on relative importance)	Modest

If your overall rating differs from the average rating, please comments on reasons for this difference:

B1b. Outcomes-- Efficacy (cont'd)

3. Rate the extent to which each of the following factors affected the achievement of this project's objectives:

World markets/prices	Not Applicable	Performance of contractors / consultants	Not Applicable
Natural events	Not Applicable	War / civil disturbance	No Effect
Cofinancier(s) performance	Positive	Other (specify):	Not Applicable

B1c. Outcomes -- Efficiency

Definition: The extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and deliver benefits at least cost compared to alternatives.

1. Is an **Economic Rate of Return** (ERR) available for this project ? No

If No, is a **Financial Rate of Return** (FRR) available? No

If a rate of return is available, provide the following information (in percent):

	Point Value	Range	Weighted Average	Coverage of Objectives/Results
At Appraisal		From: To:		
At Completion		From: To:		

2. Was another measure of efficiency provided? No

If Yes, then answer the following:

Measure used
Coverage/scope of measure
Comparison to appraisal estimate

3. If no measure of efficiency was provided for this project, would it have been reasonable to expect one? No

If Yes, explain:

4. Rate the quality of the ex-post economic analysis according to the following criteria:

Soundness of analysis	High
Conduct of sensitivity/ risk analysis	Not Applicable
Consideration of institutional constraints to achieving results	Substantial
Extent to which benefits accrue to target population	Not Applicable
Consideration of environmental externalities	Not Applicable
Consideration of fiscal impact	Modest
Consideration of alternatives to meeting objectives	Not Available

Overall rating of quality of analysis	Substantial
Average rating	Substantial

If your overall rating differs from the average rating , please comment on reasons for this difference

B1c. Outcomes -- Efficiency (cont'd)

5. Summary Rating of Efficiency		
Rate overall to what extent the project accomplished its goals efficiently:	Substantial	
Average rating		no automatic average rating posted

B1d. Outcomes -- Summary

Definition: The extent to which the project's major relevant objectives were achieved, or are exposed to be achieved, efficiently.

1. SUMMARY OUTCOME RATING	
Rate the project's outcome, taking account of its relevance, efficacy, and efficiency:	Satisfactory
Average rating	Satisfactory
If your overall rating differs from the average rating, please comment on reasons for this difference:	

B2. Sustainability

Definition: The resilience to risk of net benefits over time.

1. Rate the resilience of the project's net benefits in terms of the following:

Technical resilience	Not Applicable	Institutional support:	Not Applicable
Financial resilience (including policies on cost recovery)	Substantial	Exogenous influences:	Not Applicable
Economic resilience	Substantial	Other stakeholder ownership:	Not Applicable
Social conditions (including those subject to Safeguard Policies)	Not Applicable	Other (specify):	
Environmental conditions	Not Applicable		
Government ownership (including supportive legal/regulatory framework, and organizational and management effectiveness)	Substantial		

2. SUMMARY SUSTAINABILITY RATING	
Rate the project's overall sustainability:	Likely
Average rating	Likely
If your overall rating differs from the average rating, please comment on reasons for this difference:	
For analytical purposes, also rate the projects' overall sustainability using the previous 3-point rating scale (Likely, Uncertain, Unlikely):	Likely

B3. Institutional Development Impact

Definition: The extent to which a project improves the ability of a country or region to make more efficient, equitable and sustainable use of its human, financial, and natural resources through: (a) better definition, stability, transparency, enforceability, and predictability of institutional arrangements and/or (b) better alignment of the mission and capacity of an organization with its mandate, which derives from these institutional arrangements. IDI includes both intended and unintended effects of a project.

1. Was this project directed primarily toward Institutional Development? No

2. If not, did the project contain components with significant Institutional Development objectives? Yes

3. Did the project's Institutional Development activities include each of the following:

Establishment of a new organization	No
Elimination of an existing organization	Yes
Restructuring / privatizing of an organization	Yes

4. For this particular project, rate the relevance of the following Institutional Development objectives:

National capacity	
Economic management	Substantial
Civil service reform	Substantial
Financial intermediation	Substantial
Legal/regulatory system	Substantial
Sectoral capacity	Substantial
Other (specify):	
Agency capacity	
Planning / policy analysis	Modest
Management	Not Applicable
Skills upgrading	Not Applicable
MIS	Not Applicable
Other (specify):	
NGO Capacity	Not Applicable

5. For this project, rate the extent to which each of the following ID objectives was achieved:

National capacity	
Economic management	Modest
Civil service reform	Substantial
Financial intermediation	
Legal/regulatory system	Substantial
Sectoral capacity	Not Available
Other (specify):	
Agency capacity	
Planning / policy analysis	Not Applicable
Management	Not Applicable
Skills upgrading	Not Applicable
MIS	Not Applicable
Other (specify):	
NGO Capacity	Not Applicable
Overall ID Efficacy	Modest

6. SUMMARY INSTITUTIONAL DEVELOPMENT IMPACT RATING

Rate the project's overall institutional development impact, taking account of unintended effects not specifically supported by the project:	Substantial
Average rating	Substantial

If your overall rating differs from the average rating, please comment on reasons for this difference:

C1. Bank Performance

Definition: The extent to which services provided by the bank during all project phases, (i) ensured quality at entry, and (ii) implementation support through appropriate supervision (including ensuring adequate transition arrangements for regular operation of the project)

1. Rate the quality at entry of the project with respect to:

Project Concepts, Objectives and Approach During Identification

Government ownership:	Substantial	Institutional capacity analysis:	Substantial
Involvement of stakeholders/beneficiaries:	Not Applicable	Social and stakeholder analysis:	Not Applicable
Project consistency with Bank strategy for country:	Substantial	Environmental aspects:	Not Applicable
Grounding in economic and sector work (ESW)	Substantial	Risk assessment (inc. adequacy of conditionalities):	Substantial
Development objectives statement (including Logframe, if applicable):	Substantial	Incorporation of M&E indicators:	Not Applicable
Approach and design appropriateness:	Substantial	Incorporation of lessons learned:	Substantial
Technical aspects:	Substantial	Readiness for implementation:	Substantial
Financial aspects (including funding provisions, fiscal impact):	Substantial	Suitability of lending instrument:	Substantial
Economic aspects:	Not Applicable	Financial management aspects:	Not Applicable
Rate the overall quality at entry:	Satisfactory		

2. Rate the quality of project supervision by the Bank with respect to:

Focus on development Impact		**Adequacy of supervision inputs and processes**	
Timely identification / assessment of implementation and development impact problems	Substantial	Adequacy of Bank supervision resources	Substantial
Advice to implementing agency	Substantial	Supervision reporting quality	Substantial
Flexibility in suggesting / approving modifications	Substantial	Attention to fiduciary aspects	Not Applicable
Use of performance indicators	Substantial	Attention to M&E data	Not Applicable
Enforcement of loan covenants/ exercise of remedies	Substantial		
Effectiveness of Bank actions	Substantial		
		Rate the overall quality of supervision	Satisfactory

C1. Bank Performance (cont'd)

3. SUMMARY RATING OF BANK PERFORMANCE

Rate the Bank's overall performance, taking account of quality at entry and supervision:	Satisfactory
Average rating	Satisfactory
If your overall rating differs from the average rating, please comment on reasons for this difference:	

C2. Borrower Performance

Definition: The extent to which the borrower assumed ownership and responsibility to ensure quality of preparation and implementation, and complied with covenants and agreements, towards the achievement of development objectives and sustainability

1. Rate the Borrower / Implementing Agency performance on the preparation of this project: Satisfactory

2. Rate the extent to which government / implementing agency performance on the following dimensions supported project implementation:

Dimensions generally subject to government control

Macro policies / conditions:	Substantial	Administrative procedures:	Not Applicable
Sector policies / conditions:	Substantial	Cost Controls:	Not Applicable
Government commitment:	Substantial	Timely actions:	Modest
Appointment of key staff:	Substantial	Other (specify):	
Counterpart funding:	Not Applicable		

Dimensions generally subject to implementing agency control

Management:	Not Applicable	Use of technical assistance:	Not Applicable
Staffing:	Not Applicable	Beneficiary participation:	Not Applicable
Cost changes:	Not Applicable	Other (specify):	
Timely actions:	Not Applicable		

C2. Borrower Performance (cont'd)

3. Summary Rating of Borrower Performance on Project Implementation

Overall rating	Satisfactory
Average rating	Satisfactory

If your overall rating differs from the average rating, please comment on reasons for this difference:

4. Rate Borrower compliance with loan covenants / commitments:

Satisfactory

5. SUMMARY RATING OF BORROWER PERFORMANCE

Overall rating	Satisfactory
Average rating	Satisfactory

D. Special Themes

1. Indicate whether each of the following social concerns was a major project emphasis:

Gender related issues	Not Applicable
Settlement / resettlement	Not Applicable
Beneficiary participation	Not Applicable
Community development	Not Applicable
Skills development	Not Applicable
Nutrition and food security	Not Applicable
Health improvement	Not Applicable
Other (specify):	

3. Was this a Poverty Targeted Intervention? No

Did the project place a major emphasis on poverty alleviation?	No
If Yes:	
Did it emphasize broad-based growth with labor absorption?	
Did it emphasize human development (education, health or nutrition)	
Did it emphasize the provision of a social safety net?	
Did it focus mainly on the:	
Did the project include a specific mechanism for achieving poverty reduction benefits?	
If explicit, were these mechanisms implemented?	
Is there evidence, that the intended poverty reduction benefits were realized?	
Did it include impact studies?	
Did it include beneficiary assessments?	

2. Did the project have an unintended or unexpected effect on social concerns, regardless of the project's objectives

No

4. Indicate whether each of the following environmental concerns was a major project emphasis:

Natural resource management	No
Air / water / soil quality	No
Urban environmental quality	No
Other (specify):	

D. Special Themes (cont'd)

5. Did the project have an unintended or unexpected effect on social concerns, regardless of the project's objectives
No

If Yes, was the effect positive or negative?

6. Indicate whether each of the following private sector development (PSD) concerns was a major project emphasis:

Improvement in legal or incentive framework designed to foster PSD (e.g., trade, pricing)	Yes
Restructuring / privatization of public enterprises	Yes
Financial sector development	Yes
Direct government financial and / or technical assistance to the private sector	No
Other (specify):	

7. Rate the priority of the project for audit

Not Applicable

If the priority is High or Medium, indicate the reason(s)

If the priority is High or Medium, indicate the desired timing of the audit:

8. Rate the priority of the project for impact evaluation
Low

E. Rating of ICR

1. Rate the quality of the ICR by the following characteristics:

Analysis
Coverage of important subjects
Ex-post economic analysis

Soundness of analysis

Internal consistencies
Evidence complete / convincing
Adequacy of lessons learned
Aide-memoire of the ICR mission
Poverty Analysis

Future operation of project
Plan for future project operation
Performance indicators for the project's operational phase
Plan for monitoring and evaluation of future operation of the project

Borrower / cofinancier inputs
Borrower input to ICR
Borrower plan for future project operation
Borrower comments on ICR
Cofinancier comments on ICR

2. SUMMARY RATING OF ICR

Rate the quality of the ICR

Average rating

If your overall rating differs from the average rating, please comment on rating for this difference:

E. Rating of ICR (cont'd)

3. Rate the quality of borrower participation in the project completion process on the following:

Analysis	Focus on lessons learned
Concern with development impact	Self-evaluation
Internal consistency	Evaluation of Bank
Evidence to justify views	

F. Summary of Ratings

1. SUMMARY OF RATINGS

	ICR	ES	PPAR
Outcome	Satisfactory		Satisfactory
Sustainability	Likely		Likely
Institutional Development efficacy / impact	Substantial		Substantial
Bank performance	Satisfactory		Satisfactory
Borrower performance	Satisfactory		Satisfactory
ICR quality			
Achievement of Direct Poverty Alleviation Objectives	Not Applicable		Not Applicable

2. Explain any difference between OED ratings and those in the ICR:

G. Overall Judgments / Miscellaneous Comments

1. Enter any overall judgments or rationales and miscellaneous comments below:

December 20, 2002

Soon-Won Pak
Room No. H3 – 452

Dear Soon Won,

Subject : PPAR (Nicaragua)

The documents enclosed for the above are :

1) Routing Slip
2) Draft PPAR
3) Transmittal Memo
4) PIFs
5) ICR (Report No.16775) dated June 17, 1997 , Title – Second Economic Recovery Credit (Credit No. 2631-NI)
6) PCR (Report No. 14829) dated July 5, 1995, Title – Economic Recovery Credit (Credit 2302-NI)
7) Memorandum of the President dated May 27, 1994, Report no. P-6340-NI
8) Memorandum of the President dated September 3, 1991, Report No.

Should you require any assistance on the above, please contact me at extension 31678. I am filling in for Norma Namisata for the coming weeks.

Best regards,

Janice

Janice

THE WORLD BANK GROUP

ROUTING SLIP	DATE: 20 December 2002

NAME	ROOM. NO.
Mr. Ridley Nelson, Chair, Assessment Review Panel	H3-381

	URGENT		PER YOUR REQUEST
	FOR COMMENT		PER OUR CONVERSATION
✔	FOR ACTION		NOTE AND FILE
	FOR APPROVAL/CLEARANCE		FOR INFORMATION
	FOR SIGNATURE		PREPARE REPLY
	NOTE AND CIRCULATE		NOTE AND RETURN

RE: NICARAGUA: ERC-I (C2302-NI), ERC-II (C2631-NI)
Draft Project Performance Assessment Report

REMARKS:

This report is now ready for panel review. It was prepared by Georges Cahuzac (consultant) and myself.

Jorge García García

FROM	ROOM NO.	EXTENSION
Jorge García-García, OEDCR	35298	H3-325

DRAFT CONFIDENTIAL

Document of
The World Bank

Report No.

PROJECT PERFORMANCE ASSESSMENT REPORT

NICARAGUA

ECONOMIC RECOVERY CREDIT
(Credit No. 2302-NI)

and

SECOND ECONOMIC RECOVERY CREDIT
(Credit No. 2631-NI)

December 20, 2002

See substantive points at #1.2 + #4.16 - Edits throughout.

Country Evaluation and Regional Relations Group
Operations Evaluation Department

Currency Equivalents (annual averages)

Currency Unit = Córdoba Oro

1994	US$1.00 =	6.72		1998	US$1.00	=	C$10.58
1995	US$1.00 =	7.55		1999	US$1.00	=	C$11.81
1996	US$1.00 =	8.44		2000	US$1.00	=	C$12.68
1997	US$1.00 =	9.45		2001	US$1.00	=	C$13.37

Abbreviations and Acronyms

BANADES	Banco Nacional de Desarrollo
BANIC	Banco Nicaragüense de Industria y Comercio
BIN	Banco Inmobiliario
BP	Banco Popular
COBANICA	Junta liquidadora de activos de BANADES
CORFIN	Corporación Financiera de Nicaragua
CORNAP	Corporaciones Nacionales del Sector Público
ENEL	Empresa Nicaragüense de Electricidad
ENIGAS	Empresa Nicaragüense de Gas
ENITEL	Telecommunications Enterprise *(Empresa Nicaragüense de Telecomunicaciones)*
ERC	Economic Recovery Credit
ESAF	Enhanced Structural Adjustment Facility
GDP	Gross Domestic Product
ICR	Implementation Completion Report
IDA	International Development Association
IDB	Inter-American Development Bank
IMF	International Monetary Fund
INAA	Nicaraguan Institute for Water and Sewerage
INE	Nicaraguan Energy Institute
INIFOM	Instituto Nicaragüense de Fomento Municipal
INSS	Instituto Nicaragüense del Seguro Social
LUBNICA	Lubricantes de Nicaragua
MARENA	Ministry of Environment and Natural Resources
MCT	Ministry of Construction and Transportation
MEDC	Ministry of Education, Sports and Culture
MEDE	Ministry of Economy and Development
MIFIN	Ministry of Finance
NFPS	Non-financial public sector
OED	Operations Evaluation Department
PCR	Project Completion Report
PETRONIC	State Petroleum Company *(Empresa Nicaragüense del Petróleo)*
PPAR	Project Performance Assessment Report
SBIF	Superintendencia Bancaria y de Instituciones Financieras
TELCOR	Telecommunications and Postal Services Company

Fiscal Year

January 1 to December 31

Director-General, Operations Evaluation	:	Mr. Gregory K. Ingram
Acting Director, Operations Evaluation Department	:	Mr. Nils Fostvedt
Senior Manager, Country Evaluation and Regional Relations	:	Mr. R. Kyle Peters
Task Manager	:	Mr. Jorge García-García

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The World Bank
Washington, D.C. 20433
U.S.A.

Office of the Director-General
Operations Evaluation

MEMORANDUM TO THE EXECUTIVE DIRECTOR AND THE PRESIDENT

SUBJECT: Project Performance Assessment Report on Nicaragua Economic Recovery Credit (Credit No. 2302-NI) and Second Economic Recovery Credit (Credit No. 2631-NI)

Attached is the Project Performance Assessment Report (PPAR) on the above credits to Nicaragua, made from 1991 to 1996. The main objectives of the two operations supported stabilization, adjustment and structural reforms. They intended to support the government's program to arrest the decline of GDP, to revive growth in a sustainable and equitable manner, and to achieve lasting price stability. Besides supporting the macroeconomic objectives, the Second Economic Recovery Credit aimed at helping the county adjust to lower levels of foreign aid and establishing conditions to revive the private sector.

The adjustment credits succeeded in achieving their objectives, specially the First Economic Recovery Credit, but it took beyond the implementation ~~period~~ to see their impact on the economy. The First Economic Recovery Credit met all the conditions and succeeded in bringing inflation down, from about 380 percent in 1991 to about 24 percent in 1992, and in arresting the decline in GDP. Its short term impact on output was below the strong and fast response that the authorities and IDA had expected when they agreed to the loan, but the higher growth rates since 1994 (above 4 percent) owe much to the large structural reforms and initial stabilization effort that ERC I supported. After the political uncertainty about the direction of economic policy ended, investors and producers have responded as expected, and GDP has grown every year since 1994.

The PPAR rates the outcome of the Economic Recovery Credit I as *satisfactory*, higher than the marginally satisfactory of the ICR and the marginally unsatisfactory of OED's evaluation summary. The PPAR rates the sustainability of the ECR I as *likely*, higher than the uncertain of the evaluation summary, and institutional development impact as *substantial*, higher than the negligible of the evaluation summary. Borrower performance is rated satisfactory, as the evaluation summary. Bank performance is rated satisfactory, higher than the evaluation summary.

The Second Economic Recovery Credit met part of its goals for structural reform. The labor mobility program met its objective of reducing public sector employment, which fell more than its target of 13,500 positions (about 8 percent of public sector employment). The privatization program achieved most of its objectives, and the Government divested of 76 of the 89 enterprises that remained, but did not complete the transfer of ownership for all, especially two important ones, PETRONIC (petroleum) and TELCOR (telecommunications). The Government also began to improve the climate for private sector development; it advanced in resolving *property rights* disputes by, among others, reviewing more than 100,000 cases related to properties in the housing and rural sectors, and solving the disputes in 82 percent of rural cases and 98 percent of housing cases. The reform of the *financial system* fell short of plans, and the strategy for containing the growth of state banks was partially executed; two state banks continued dominating the banking sector, and were exempted from complying with prudential norms. On the positive side, the Government submitted to the Legislature a General Banking Law that aimed at strengthening the regulatory powers of the Superintendencia Bancaria y de Instituciones Financieras (SBIF).

The PPAR rates the outcome of the Economic Recovery Credit II as *satisfactory*, higher than OED's evaluation summary, the sustainability as *likely*, higher than the uncertain of the evaluation summary, and institutional development impact as substantial, higher than the evaluation summary.

The main lessons derived are:

- IDA must tone down its expectations of what reforms can achieve in a short time. IDA identified correctly the nature of the risks of failure, but it overestimated the response to the reforms supported by both credits. IDA and the Borrower assumed unrealistically that stabilization could be achieved in two years, and that an economic recovery based on private sector growth would occur in parallel.

- An adjustment program that aims at private sector led growth should focus from the beginning on developing and guaranteeing property rights, ~~critical~~ to restore ~~the~~ confidence to private investors. ERC-I did not focus on the property rights issue and the desired response of the private sector did not materialize.

- When the adjustment program requires deep economic changes, problems that need long-run solutions must be tackled early, under a global strategy whose rationale, constraints and benefits must be understood and accepted prior to approval of the credit. IDA and the Borrower should work to prepare the civil society for the changes needed and forthcoming, and whose benefits are not evident to the general public at first.

OED Mission: Enhancing development effectiveness through excellence and independence in evaluation.

About this Report

The Operations Evaluation Department assesses the programs and activities of the World Bank for two purposes: first, to ensure the integrity of the Bank's self-evaluation process and to verify that the Bank's work is producing the expected results, and second, to help develop improved directions, policies, and procedures through the dissemination of lessons drawn from experience. As part of this work, OED annually assesses about 25 percent of the Bank's lending operations. In selecting operations for assessment, preference is given to those that are innovative, large, or complex; those that are relevant to upcoming studies or country evaluations; those for which Executive Directors or Bank management have requested assessments; and those that are likely to generate important lessons. The projects, topics, and analytical approaches selected for assessment support larger evaluation studies.

A Project Performance Assessment Report (PPAR) is based on a review of the Implementation Completion Report (a self-evaluation by the responsible Bank department) and fieldwork conducted by OED. To prepare PPARs, OED staff examine project files and other documents, interview operational staff, and in most cases visit the borrowing country for onsite discussions with project staff and beneficiaries. The PPAR thereby seeks to validate and augment the information provided in the ICR, as well as examine issues of special interest to broader OED studies.

Each PPAR is subject to a peer review process and OED management approval. Once cleared internally, the PPAR is reviewed by the responsible Bank department and amended as necessary. The completed PPAR is then sent to the borrower for review; the borrowers' comments are attached to the document that is sent to the Bank's Board of Executive Directors. After an assessment report has been sent to the Board, it is disclosed to the public.

About the OED Rating System

The time-tested evaluation methods used by OED are suited to the broad range of the World Bank's work. The methods offer both rigor and a necessary level of flexibility to adapt to lending instrument, project design, or sectoral approach. OED evaluators all apply the same basic method to arrive at their project ratings. Following is the definition and rating scale used for each evaluation criterion (more information is available on the OED website: http://worldbank.org/oed/eta-mainpage.html).

Relevance of Objectives: The extent to which the project's objectives are consistent with the country's current development priorities and with current Bank country and sectoral assistance strategies and corporate goals (expressed in Poverty Reduction Strategy Papers, Country Assistance Strategies, Sector Strategy Papers, Operational Policies). *Possible ratings:* High, Substantial, Modest, Negligible.

Efficacy: The extent to which the project's objectives were achieved, or expected to be achieved, taking into account their relative importance. *Possible ratings:* High, Substantial, Modest, Negligible.

Efficiency: The extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and benefits at least cost compared to alternatives. *Possible ratings:* High, Substantial, Modest, Negligible. This rating is not generally applied to adjustment operations.

Sustainability: The resilience to risk of net benefits flows over time. *Possible ratings:* Highly Likely, Likely, Unlikely, Highly Unlikely, Not Evaluable.

Institutional Development Impact: The extent to which a project improves the ability of a country or region to make more efficient, equitable and sustainable use of its human, financial, and natural resources through: (a) better definition, stability, transparency, enforceability, and predictability of institutional arrangements and/or (b) better alignment of the mission and capacity of an organization with its mandate, which derives from these institutional arrangements. Institutional Development Impact includes both intended and unintended effects of a project. *Possible ratings:* High, Substantial, Modest, Negligible.

Outcome: The extent to which the project's major relevant objectives were achieved, or are expected to be achieved, efficiently. *Possible ratings:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Bank Performance: The extent to which services provided by the Bank ensured quality at entry and supported implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of the project). *Possible ratings:* Highly Satisfactory, Satisfactory, Unsatisfactory, Highly Unsatisfactory.

Borrower Performance: The extent to which the borrower assumed ownership and responsibility to ensure quality of preparation and implementation, and complied with covenants and agreements, towards the achievement of development objectives and sustainability. Possible ratings: Highly Satisfactory, Satisfactory, Unsatisfactory, Highly Unsatisfactory.

Contents

Figure

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Annexes

S

This report was prepared by Georges Cahuzac (Consultant) who assessed the project in January–March 2002 and by Jorge García-García (Task Manager) who finished the report. Norma Namisato provided administrative support.

Principal Ratings

Economic Recovery Credit (Credit 2302-NI)

	*ES**	*PPAR*
Outcome	Mod. Unsat.	Satisfactory
Sustainability	Uncertain	Likely
Institutional Development Impact	Negligible	Substantial
Bank Performance	Marg. Sat.	Satisfactory
Borrower Performance	Satisfactory	Satisfactory

* The Evaluation Summary (ES) is an intermediate OED product that seeks to independently verify the findings of the ICR.

Key Staff Responsible

Project	*Task Manager/Leader*	*Division Chief/ Sector Director*	*Country Director*
Appraisal	Baran Tuncer	Marco Voljc	Rainer Steckhan
Completion	Ivan Rivera	Robert Lacey	Edilberto Segura

Principal Ratings

Second Economic Recovery Credit (Credit 2631-NI)

	*ES**	*PPAR*
Outcome	Mod. Sat.	Mod. Sat.
Sustainability	Uncertain	Likely
Institutional Development Impact	Modest	Modest
Bank Performance	Satisfactory	Satisfactory
Borrower Performance	Satisfactory	Satisfactory

* The Evaluation Summary (ES) is an intermediate OED product that seeks to independently verify the findings of the Implementation Completion Report (ICR), a self-evaluation by the responsible operational division of the Bank.

Key Staff Responsible

Project	*Task Manager/Leader*	*Division Chief/ Sector Director*	*Country Director*
Appraisal	Ulrich Lachler	Robert Lacey	Edilberto Segura
Completion	Violeta Rosenthal		Donna Dowsett-Coirolo

Preface

This is a Project Performance Assessment Report (PPAR) for Nicaragua Economic Recovery Credits I and II. The projects supported economic stabilization and economic reforms aimed at arresting the decline of GDP, reviving growth, achieving price stability, establishing conditions for private sector development and helping Nicaragua adjust to lower levels of foreign aid. The projects were financed through IDA credit 2302-NI for US$110 million, approved on September 3, 1991 and closed on June 10, 1992; and IDA credit 2631-NI for US$60 million approved on May 27, 1994, and closed on June 30, 1996.

The findings of this assessment report are based on a review of President's Reports for the projects, legal documents, project files, related economic and sector work, IMF country reports, and discussions with Nicaraguan officials and the IMF and Bank Group staff.

[The draft PPAR was sent to the Borrower, and their comments have been taken into account and reproduced in Annex ___ of the report.]

1. Introduction

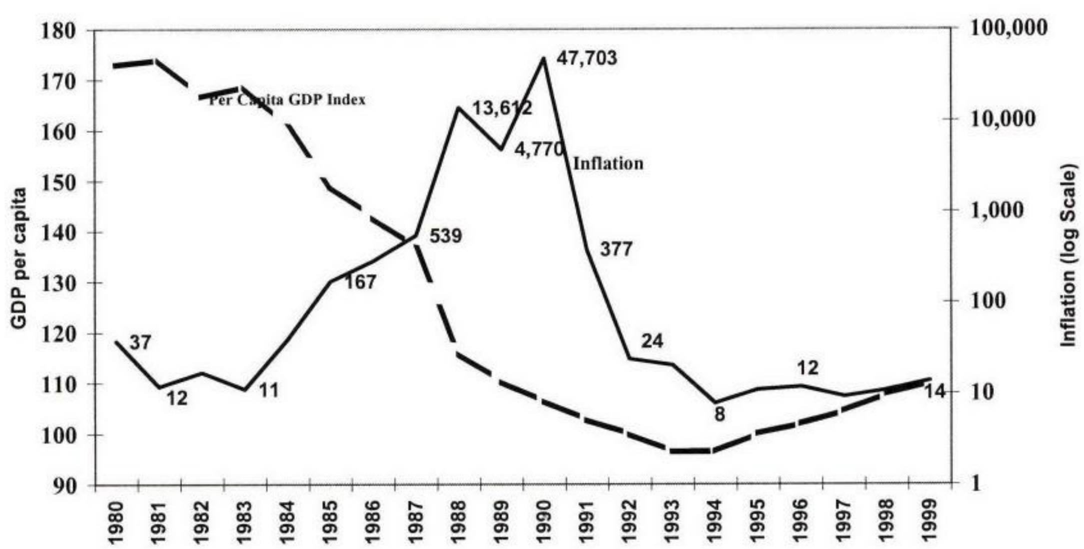
1.1 OED selected two credits (Economic Recovery I and II) to evaluate the Bank's program of assistance for stabilization, adjustment and reform in Nicaragua, and to derive lessons for future assistance to other countries. The two adjustment operations supported economic reforms during the period 1991–1996.

Background

1.2 ***The Sandinista legacy***. For eleven years (1979–1990) the Sandinista regime sought to organize the economy along socialist lines. The Sandinista regime had nationalized most privately-owned firms and left a non-financial public sector that spent about 50 percent of GDP, of which state-owned companies accounted for 29 percent of GDP. Regulations drowned what remained of a private sector, and a land reform and an urban property redistribution program left a complex property rights problem. Foreign trade was heavily regulated, and state-trading companies did almost all the exporting and about half of import trade. By 1990 the basic institutions of a market economy were defunct and the economy was in tatters: prices rose at about 48,000 percent (see graph below), exports and GDP per capita were about 40 percent their level in the mid 1970s, the fiscal and current account deficits reached 29 and 36 percent of GDP and the external debt was six times the GDP. For the economy to revive, Nicaragua had to eliminate its macro-economic imbalances, reduce the external debt and shift from a command to a market economy. On the political front, Nicaragua had to build its democratic institutions.

seems odd not to mention that a civil war was being fought the whole time

Annual Inflation (percent) and Per Capita GDP (1995=100)



1.3 ***The Chamorro Administration: Reversing Sandinista Policies.*** Violeta Chamorro, who took over the Presidency in April 1990, inherited a devastated economy, a polarized society and a large and inefficient state sector. Her administration tried to solve the problems inherited while making efforts to establish civil peace and build a national consensus to liberalize the economy. To reduce inflation, in May 1990 the Government introduced a second currency (the Córdoba Oro, to be used as a unit of account), pegged it to the US dollar, and tried to reduce the public

Then we get a need for "civil peace".

sector deficit by reducing the wage bill and increasing taxes and the prices of public sector services. The measures failed to achieve their objectives that year, and economic decline and hyperinflation continued as the Government accumulated arrears and financed its deficit with money printed by the Central Bank.

1.4 The administration began to adjust the economy in 1991, under the umbrella of an IMF monitoring program concerted with IDA and IDB. The program set targets for the fiscal deficit and domestic credit expansion. Under the program the Government restrained public expenditures (among others through a program of voluntary retirement of public employees), increased tax collection and reduced the deficit to a level that foreign financial assistance could cover (see Table 1). Also, the Government devalued the Córdoba Oro by 400 percent, and, after increasing wages for public sector employees, it increased the prices of public services.

1.5 The Government also took steps to improve fiscal and financial management and to set the basis for structural change. Specifically, it

- completed processing voluntary employment reductions in the public sector (see Annex B);

- had, by the end of 1992, sold, liquidated or returned to their former owners 233 of the 351 firms under CORNAP (Junta General de Corporaciones Nacionales del Sector Público), the State-owned holding company in charge of divesting of state-enterprises (see Annex B);

- limited the role of state-owned trading companies, reduced import taxes and eliminated quantitative restrictions;

- obtained from the National Assembly the approval of a bill to set up a Superintendency for the financial sector, and submitted to Congress a banking and financial institutions law;

- began to restructure the State-owned banks (see Annex D), a sensitive decision that some in the Government questioned; it liquidated Banco Inmobiliario (BIN) and closed the Corporación Financiera de Nicaragua (CORFIN), a holding company that controlled the state banks; it also authorized the operation of three private banks, and adopted a mostly market-determined interest rate policy.

Disagreements

1.6 Political and constitutional crises hampered the adjustment and structural reforms during the implementation of the two economic recovery credits. ~~Discrepancies~~ between the Sandinistas and the Government and within the governing party on ~~whether to liberalize~~ the economy made it difficult to decide what to do and when. The conflict slowed the restructuring of state banks because the Government and the Superintendency refused to be responsible for the privatization of Banco Nacional de Desarrollo (BANADES), as the Constitution and Banking laws had conflicting provisions on the matter. Political controversy around property rights and the conflict between the Government and the National Assembly, caused by the Assembly's decision to reduce the power of the Government to handle disputes over property rights, slowed down their solution.

1.7 Even with political consensus, the country lacked the capacity to carry out the changes required. The military conflict that preceded the Sandinistas' takeover of power produced a brain drain that reduced the managerial capabilities of the Government, a loss accentuated during the Sandinista administration. The Chamorro administration could hardly execute its March 1991 stabilization and adjustment program as originally planned. The technical assistance from donors and multilateral institutions could not make up for the country's lack of experience and know-how needed to manage such program. 4a

1.8 Private investors perceived the risk of doing business as high. The fragile political situation, the weak rule of law, the scant respect for property rights, and the disagreement over economic stabilization clouded the economic prospects. Such perceptions contributed to the weak response of the economy to the economic policies of the administration. Moreover, in 1992 and 1993 the political consensus within the governing party broke down, preventing the National Assembly from approving some of the legislation that supported the Government's stabilization and adjustment program. Rural violence spread, and strikes and demonstrations against restrictive economic policies helped to arrest attempts to introduce fiscal discipline and bring about structural change.

1.9 Despite the difficulties of imposing economic discipline and the risks perceived by the private sector, the economy improved slowly. By the end of 1993 inflation fell to 20 percent but, contrary to the expectations held when the stabilization program started, GDP stagnated, unemployment rose and the current account deficit stayed high, at some 50 percent of GDP (see Table 1). The outstanding external debt remained at about 600 percent of GDP. GDP per capita fell, and an IDA Poverty Profile found that in 1993 more than 50 percent of the population lived in poverty. After three years in government, the Chamorro administration realized that it had to reduce government expenditure further, privatize state-owned companies and rely on the private sector to ignite growth and stabilize the economy.

Table 1. Key Economic Indicators: 1990–1993

	1990	1991	1992	1993
GDP Growth (percent)	-0.1	-0.2	+0.4	-0.4
Inflation (percent)	7,485	2495	24	20
Unemployment rate (percent)	7.6	11.5	14.4	17.8
Non-financial public sector (NFPS) balance before grants (percent of GDP)	-33.2	-7.7	-8.4	-8.8
NFPS Revenue (percent of GDP)	18.3	25.0	28.6	29.6
NFPS Expenditures (percent of GDP)	51.5	32.7	37.1	38.3
Current Account Balance (percent of GDP)	-36	-49	-59	-48
External Debt (percent of GDP)	685	592	583	608

Source: Banco Central de Nicaragua, IMF, World Bank.

1.10 The administration sped changes in 1994, with reforms in the state, in the financial sector and, more profoundly, in the conditions of doing business by private sector agents. Most property disputes were reviewed, but the National Assembly added to the climate of uncertainty after approving a law that gave security of possession to the beneficiaries of agrarian and housing reforms during the Sandinista regime. The reforms of the state and the financial sector advanced: tax and fiscal regulations were made more transparent, the ceiling and floor on import duties and surcharges was reduced, and a new Labor Code gave employers more flexibility to hire and dismiss employees. Central government spending fell, but higher spending in the rest of the public sector still resulted in high public sector deficits (9 to 15 percent of GDP) and high levels of spending, 41 to 48 percent of GDP. The support of donors spared the government the need to finance the deficit with central bank credit. That support allowed Nicaragua to write off about 50 percent of its official debt, and to buy back part of its commercial debt; as a result, outstanding debt fell from 600 percent of GDP in 1994 to about 300 percent of GDP in 1997; the debt deals helped reduce the current account deficits by some 20 points of GDP, to 30 percent of GDP (see Table 2).

Table 2. Key Economic Indicators: 1994–1997

	1994	1995	1996	1997
Real GDP growth (percent)	+3.3	+4.3	+4.8	+5.1
Inflation (percent)	+7.8	+10.9	+11.6	+9.2
Unemployment rate (percent)	17.1	16.9	16.0	14.3
NFPS Balance (percent of GDP)	-13.8	-12.5	-15.4	-9.2
NFPS Revenue (percent of GDP)	29.6	29.3	31.6	34.4
NFPS Expenditure (percent of GDP)	44.90	40.6	47.5	43.9
Current Account Balance (percent of GDP)	-51.5	-36.1	-31.2	-30.3
External Debt (percent of GDP)	638	543	309	297

Source: Central Bank of Nicaragua; World Bank and IMF.

1.11 The policies carried out in 1994–97 improved economic conditions and the country's prospects (see Table 2). Total and per capita GDP grew, while unemployment declined. Inflation fell to about 10 percent per year, and the devaluation of the Córdoba (from 6 to 9 Córdobas per US dollar) led to a real depreciation and higher incentives for exporters. Tax incentives for exporters also helped to trigger the large increase in exports observed over the period. Except for government services, every sector began to recover. Notable in the recovery was manufacturing, which benefited from the free trade zones, programs for small and medium size companies, and ~~from a~~ progressive flow of foreign investments. Exports of goods increased from 26 to 46 percent of GDP, and imports rose from 52 to 72 percent of GDP. Although the trade deficit remained high, 26 percent of GDP, the large reduction in external debt helped reduce the deficit in current account from 52 to 30 percent of GDP. Despite the gains, Nicaragua still has much to do to improve the economic well being of its population. By 1997 per capita income was five percent higher than in 1990, but poverty and extreme poverty remained high, at about 50 and 25 percent of the population. After Haiti, Nicaragua has the lowest income per capita in Latin America, and its social indicators rank among the worst in the region.

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1.12 Economic performance improved in 1998–2000, as the economy grew faster and inflation and unemployment continued falling (see Table 3). Hurricane Mitch caused large economic losses in 1998, but, with Nicaraguans' own resources and support of the donor community, investment increased sharply and the economy recovered quickly in 1999. The large transfers received permitted the Government to finance ~~larger~~ levels of investment and expenditure, but the Government kept its high level of expenditure in 2000 even after the assistance declined; the large expenditure also reflected large outlays related to municipal elections at the end of 2000. The expansive fiscal policy continued in 2001, triggered in part by wage increase, the cost of bank resolutions, the preparation of national elections and a large increase in capital outlays. All these elements helped to pull down the rate of growth in 2001 and 2002, but it is expected that the economy will begin to recover in 2003, as the Government returns to sounder fiscal policies, in part supported by an IMF poverty reduction growth facility (PRGF) program under discussion.

Table 3. Key Economic Indicators: 1998–2001

	1998	**1999**	**2000**	**2001**	**2002** prel
Real GDP growth (percent)	4.1	7.4	5.8	3.0	1.5
Inflation (percent)	13	11.2	11.6	7.4	5.8
Unemployment rate (percent)	13.2	10.7	9.9	n.a.	n.a.
NFPS balance (percent of GDP)	-4.1	-14.1	-14.1	-11.2	-8.9*
NFPS revenue (percent of GDP)	36.9	35.7	33.0	n.a.	n.a.
NFPS expenditure (percent of GDP)	41.1	49.7	47.1	n.a.	n.a.
Current account balance (percent of GDP)	-37.2	-48.0	-38.0	-38.0	-38.0
External debt (percent of GDP)	296	289	278	250	250

* after grants.
Source: Central Bank of Nicaragua; World Bank and IMF.

1.13 Over the past 12 years, new economic policies helped to stop economic decline and to lay the basis for faster growth. The political uncertainty of the early nineties prevented a quick response of the economy to the changes in economic policy introduced at the time, but as the uncertainty declined and the direction of economic policy was maintained, the economy started growing faster, and poverty and unemployment declined. The pace of growth faltered in 2001 and 2002, mainly as a result of economic policies, but the new Bolaños administration expects that better governance and sound fiscal and financial policies will help to accelerate growth. If the administration succeeds, the beneficial impact of the changes supported by ERC-I and ERC-II will stand.

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2. Objectives and Design

2.1 The two operations, part of IDA's assistance strategy, were complementary and supported stabilization, adjustment and structural reforms; they aimed at:

(i) Arresting the decline of GDP;

(ii) Reviving growth in a sustainable and equitable manner; and

(iii) Achieve lasting price stability.

2.2 The program focused on:

(i) Economic management: helping the Government, in coordination with the IMF, to address key fiscal and monetary policy issues;

(ii) Reform of the State: reducing public sector employment, privatizing government companies, and improving the management and institutional capacity of the public sector;

(iii) Financial sector reform: restructuring and closing state-banks, allowing private banks to operate, and establishing a system of supervision and prudential regulation; and

(iv) Private sector development: encouraging the Government to guarantee property rights, to conduct economic policy by rules rather than by discretion of the authorities, and to liberalize the trade regime and labor legislation.

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2.3 Both credits had a broad agenda and a complex conditionality for the institutional capacity of the country. Table 4 shows the main groups of reforms supported by each credit. From 1994, IDA realized that the Government had to restore the confidence of the private sector for the country to achieve high growth rates, and to do so required to focus its support on reorienting the role of the State, reducing barriers to private initiative, improving access to domestic financial institutions, and promoting a stable legal framework.

Table 4. Main Components of Economic Recovery Credits I and II

	ERC I	ERC II
I. Economic Management		
Economic Policy Formulation	(i) Create a stable macroeconomic environment, reducing Central Government non-interest current expenditures to less than US$325 million, and NFPS deficit to 3% of GDP, by 1992. (ii) Implement recommendations of joint Government/IDA public expenditure review.	Maintain supportive macro-economic framework: inflation to reach 10% in 1994 and single digit by 1996; public savings to increase by 2.3% of GDP in 1994, and 1.5% of GDP in 1995 and 1996.
Fiscal Policy	(i) Increase tax revenues removing income tax exemption, approving and satisfactorily implementing a program to phase out indirect tax exemptions including import tax.	Maintain appropriate policy.

	(ii) Initiation of an action plan to improve tax administration with specific emphasis on income tax collection.	
Monetary Policy	(i) Maintain tight credit policy and positive real interest rates. (ii) Eventual liberalization of interest rates.	
Exchange rate policy	Achieve full convertibility of Córdoba to create competitiveness in the trade sector.	Accumulation of international reserves to reach over 3 months of import by 1996.
II. Reform of the State		
Labor Mobility Program	(i) Demobilize military forces and militias and retire military officers (5,000). (ii) Stop hiring new employees in Central Government. (iii) Introduce and complete voluntary employment reconversion program (target: 10,000 employees)	Design an implement an action plan in order to reduce employment by 13,500 positions during 1994–1996.
Privatization	Adopt and implement action plan to divest of or complete preparation for divestiture of at least 90% of the enterprises still under CORNAP administration, by the end of 1993.	(i) Complete all the administrative steps needed for liquidation or transfer of ownership of the divested CORNAP and MCT enterprises, and two enterprises in the energy sector (ENIGAS and LUBNICA). (ii) Liquidate or bring to the point of sale some of PETRONIC's operations, especially the distribution of gasoline (iii) Satisfactory implementation of TELCOR privatization plan, and bringing to the point of sale a 40 percent share of TELCOR's telecommunications operations (ENITEL).
Public Sector Reform	(i) Start a study on public enterprise rationalization. (ii) Strengthen tax administration through: operation of unit for large tax payers; issuance of decrees on sanctions applying to delayed payers and non-compliance; initiation of program on automated management control for personnel of Customs and Internal Revenue.	Preparation and satisfactory implementation of a three year Public Sector Reform Program and Action Plan, in line with the Governments' Policy Statement, including the restructuring of at least two major public institutions.
III. Financial Sector Reform		
Improve Banking Sector Discipline	(i) Adoption of regulation for the implementation of the Law on Superintendency of Bank and start operations of the Superintendency. (ii) Submission of a bill to the National Assembly on Banking and Financial Institutions.	(i) Implement agreed action plan to modify or introduce new prudential norms and to improve the functioning of the Superintendency. (ii) Enact decree, action plan, or draft law to increase penalties for non-compliance.
Improve financial information and accounting systems		(i) Design and implement a debtor management system. (ii) Implement a new chart of accounts.

Reform the state-owned banks	Adoption of an action program for their restructuring, carrying out the: (i) liquidation or merger of BIN with BANIC; (ii) dissolution of CORFIN; restructuring of BANIC, BANADES and BP.	Maintain policy of: (i) not recapitalizing state banks through new public sector funds or revaluation of non-financial assets; (ii) ensuring compliance with prudential norms and banking regulations; (iii) no pre-assigning of rediscounts from the Central Bank for specific activities.
Develop a private sector based financial system	Authorize the operation of three private commercial banks.	
IV. Private Sector Development		
Improve guarantees of property rights		(i) Establish a program to review compliance with current administrative procedures to resolve conflicts over property. (ii) Satisfactory implementation of the verification process. (iii) Commission and complete study to analyze financial mechanisms that increase attractiveness of compensation bonds, and implement recommendations in a satisfactory manner.
Reduce uncertainty by eliminating discretionality in the management of economic policy		Issue presidential decree establishing a policy disclosure for tax and fiscal measures, abrogating the powers of Ministries and Agencies to change rules and to create state-owned enterprises, and move these powers to the Office of the President.
Deregulate and reform domestic and foreign trade policy, and increase private sector participation in foreign trade	(i) Issue trade deregulation decree opening exports and imports trade to the private sector. (ii) Liberalize foreign exchange allocation mechanism, achieving full convertibility. (iii) Reduce nominal tariff protection to a range of 10–40%. (iv) Eliminate selective consumption tax and stamp tax on imports by the end of 1993. (v) Design a price based mechanism to replace import quotas, and eliminate quantitative restrictions on food-grain imports. (vi) Eliminate most domestic price controls.	(i) Reduce nominal protection rate to 10%–37% except for fiscal industries. (ii) Present a time-bound tariff reduction program. (iii) Complete preparation of action-plan to replace existing export promotion mechanism by a duty draw back system.

Promote greater labor productivity		Comply with agreement on labor policy as stated by Government. The Labor Code will give priority to free contracting and will guarantee the rescission, suspension or termination of contracts, despite the existence of collective bargaining agreements.

3. First Economic Recovery Credit (ERC-I)

3.1 The political, economic and social crisis prompted IDA, with the cooperation of IDB, to start preparing in January 1991 a long-term assistance strategy. By April 1991, IDA considered Nicaragua eligible for IDA credit, and by May 1991 donors and Nicaragua agreed on clearing Nicaragua's arrears to multilateral development banks. With the agreement in hand, the IMF approved on September 1991 a stand-by ~~credit of US$55.7~~ million, to be disbursed over 18 months. After approval of the stand-by, IDA granted an Economic Recovery Credit (ERC I) for US$110 million. The ERC-I (September 1991–June 1992) was designed as a first step in support of a longer term structural adjustment program aimed at moving the economy from a command economy to a market based one. The financial package included US$132.5 million from IDB, a US$114 million co-financing from the Governments of Japan ($74 million), Germany ($35 million) and Switzerland ($5 million), and US$101 million equivalent from other bilateral donor agencies. In 1990 the U.S. Government had pledged more than US$500 million, of which it had already disbursed some US$300 million by September 1991.

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3.2 ***Objectives.*** ERC-I aimed to support the Government's effort in arresting the ongoing decline in the economy, achieving price stability and reviving economic growth on a sustained basis. The credit supported four areas of the Government's economic program, detailed in the Letter of Development Policy. They were:

- *Macroeconomic policies.* The Government intended to carry out: (i) a fiscal policy that would maintain the proper balance between revenues and expenditures and would avoid using Central Bank financing; (ii) a monetary policy that would encourage financial resource mobilization and improve the efficiency of resource allocation; and (iii) an exchange rate policy that would encourage the diversification of exports and help to maintain the competitiveness and profitability of the tradable sector.

  (~~respectively~~)

- *Public sector.* The Government committed itself to: (i) reduce non-interest current expenditure ~~to~~ US$338 million and US$315 million in FY91 and FY92, and reduce it by nine percent ~~in~~ FY93; (ii) reduce public sector employment by 10,000 in FY92; (iii) divest ~~of~~ or prepare for privatization 90 percent or more of state-owned enterprises by the end ~~of~~ 1993; (iv) reform the customs and revenue services to increase revenues and improve the efficiency of the tax system.

- *Financial sector.* The Government intended to reduce the role of the public sector in financial intermediation activities, and to create the conditions for more participation by the private sector. Restructuring the state-owned banks (through closure and privatization) constituted the cornerstone of the program. Other actions and plans complemented the program. The Government decided to create a Superintendency of Banks, announced its intention to free deposit rates and abolish substantive controls on lending rates, and committed to draft and present to the National Assembly a Law of Banking and Financial Institutions.

- *Incentives for private sector development.* The strategy aimed at reducing the size of the state and eliminating obstacles to the functioning of internal and external markets. The Government expected that restraining government expenditure and closing and selling state-owned companies would produce a smaller government. It planned to improve the working of markets by: (i) abolishing state trading monopolies and quantitative restrictions on imports and exports; (ii) reducing the level and dispersion of import duties; (iii) eliminating support prices for agricultural products; (iv) abrogating the legal framework for price controls; (v) eliminating barriers to entry by the private sector into sugar production, banana for export and slaught~~ering~~ houses for exports; and (vi) lifting restrictions on foreign exchange trading until ac~~hieving~~ full current account convertibility of the Córdoba by March 1992.

3.3 ***Relevance.*** ERC-I adopted relevant objectives and its comprehensive approach to solving the problems was necessary as called for by the scope and size of the crisis. Nicaragua needed fiscal and monetary discipline to stop inflation, to create the conditions for growth, and to reduce the public sector and the current account deficits. Lower fiscal deficits required improving tax management, removing tax exemptions, privatizing state enterprises and restructuring those remaining in government hands—including state-owned banks; it also implied demobilizing military forces and completing programs of voluntary retirement of public sector employees. Mobilizing domestic savings and increasing credit to the private sector required restructuring the state-owned banks and adopting prudential regulation and efficient supervision of financial institutions. The reforms were also needed to engage the private sector in developing the financial sector. An appropriate market environment for developing the private sector required freeing domestic prices, abolishing state monopolies, and reducing import tariffs and quantitative restrictions to imports and exports.

3.4 ***Implementation experience.*** The credit was closed in June 1992, nine months after its approval. Two reasons contributed to the fast disbursement. First, Nicaragua's execution of an IMF stand-by had helped to improve fiscal and monetary policies. Second, a technical assistance program helped the Government to start the reforms; the substantial technical assistance would have been more effective if donors and the Government had coordinated their efforts better.

3.5 ***Outcome.*** The Government met all the conditions of the credit, but its outcome fell below the optimistic expectations of IDA and the Borrower. In fact, despite the actions taken, the economy stagnated because political instability continued, the Government wavered in its efforts to reform the public sector and was slow in solving property rights problems, and after the credit was disbursed it backslid in some areas, especially in the financial sector. The PPAR rates the ERC-I outcome as satisfactory, higher than OED's Evaluation Memorandum. The PPAR rates outcome higher because the actions taken constituted a first, fundamental, step to turn the economy around. Had these steps not been taken, the economy would have performed worse than it did, and reforms in later years would have been more difficult to carry out. Without ERC-I Nicaragua would not have had access to international credits, the arrears could not have been cleared and it would have been deprived ~~from~~ of the financial and technical assistance of the donor community. ERC-I established the conditions for good management of economic policy and, after the political uncertainty faded away, for faster growth.

3.6 ***Macroeconomic policies***. The public finances improved over their pre-stand by and pre-credit situation, but throughout the execution of the credit they remained unchanged. The consolidated public sector deficit fell from 29 percent of GDP in 1990 to about 7.7 percent and

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8.4 percent of GDP in 1991 and 1992. Public sector revenues increased from 18 percent of GDP in 1990 to 25 and 29 percent of GDP in 1991 and 1992, higher than originally expected. Expenditures fell from 52 percent of GDP in 1990 to 34 percent of GDP in 1991, but increased to 37 percent of GDP in 1992, rather than falling to the agreed 32.6 percent. Avoiding financing from the Central Bank helped bring inflation down, from 7,485 percent in 1990 to 24 percent in 1992. The Government cut 8,000 jobs from its payroll, privatized 161 of 351 enterprises, reducing their share in GDP from 30 to 20 percent, and carried out some of the recommendations of IDA'S public expenditures study (see Annex B).

3.7 ***Financial sector.*** The Central Bank carried out a tight monetary policy, controlling the growth of credit and monetary aggregates. The Government created a Banking Superintendency and submitted to the National Assembly a draft law to regulate financial institutions. It merged Banco Inmobiliario (BI) with Banco Nicaragüense de Industria y Comercio (BANIC), reduced the staff and networks of the remaining state-owned banks, and began plans to restructure BANIC, Banco Nacional de Desarrollo (BANADES) and Banco Popular (BP). It also authorized the operation of seven private commercial banks (five more than initially intended), but state banks continued dominating the market. The Government stammered at giving more room to private financial entities because it: (a) lacked clarity on whether the Constitution mandated that the financial sector was solely state property; and (b) believed that state-owned banks would relieve the credit constraints for small borrowers in rural areas.

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3.8 ***Private sector development***. Incentives for private sector development were granted through deregulation and liberalization of domestic and external trade. On domestic trade it abolished state-trading monopolies, eliminated official price controls, and privatized state-trading activities. On external trade, it unified the exchange rate, brought import tariffs to within a range of 10–40 percent, eliminated most non-tariff barriers, and introduced in 1992 an export promotion mechanism that, to be more effective in achieving its goal, had to be simplified.

3.9 Despite the reforms, and contrary to expectations, growth did not take off. Real GDP fell 0.1 percent in 1991, increased 0.4 percent in 1992 and decreased 0.4 percent in 1993. Besides the negative impact of natural factors and volatile international coffee prices, the stagnation reflected the private sector's lack of confidence in the capacity of the Government to transform the structure of the economy. Private sector uncertainty arose from the unstable political climate, the slow pace in solving property rights disputes and the perceived indecisiveness of the Government in moving fast to establish a market-driven economy.

3.10 ***Sustainability.*** In July 1995, the PCR rated the sustainability of ERC-I results as dubious and OED rated it as *uncertain*. The political uncertainty and the weak administrative capacity of the central and local governments explained the ratings. In the mid-1990s the Government had not shown convincingly that it could maintain sound macroeconomic policies, reduce its dependence on foreign aid and continue the reforms started in 1991. Although still dependent on foreign lending to cover its external imbalances, the Chamorro and Alemán administrations have demonstrated their commitment to economic stability and to structural adjustment. The sound economic policies reduced inflation to about 10 percent and helped to increase annual growth rates to about 4.7 percent between 1994 and 2001. Today, ten years after they started, the reforms supported by the ERC-I are *likely* to be sustained and few question Nicaragua's adherence to the principles of a market-based economy.

3.11 ***Institutional development impact***. The ERC-I identified the institutional weaknesses of the country, and supported better economic policies and some institution building. By promoting private sector development, economic stability and respect for property rights, the credit helped to take important steps in moving the economy from a centrally planned towards a market based system. OED's evaluation summary rated the ID impact of the credit as negligible. The credit was critical for the identification and assessment of the institutional weaknesses of the country. Time has shown that the reforms supported by the credit have had a lasting impact on economic management and the development of institutions that encouraged growth and stability. The reforms also gave birth to a nascent respect for property rights and the rule of law. Based on the credit's long-term effects, the institutional development impact of the loan should be rated *substantial*.

3.12 ***IDA performance.*** IDA performance is not rated in the PCR. OED rated IDA performance at entry unsatisfactory and its performance for supervision satisfactory. This PPAR rates Bank performance as satisfactory. IDA helped the Government in preparing its program, define its policies and normalize relations with the international financial community but, at the time, it failed to properly assess the risks associated with the operation and to predict the outcomes of reforms. Also, IDA overestimated the potential impact of uncoordinated technical assistance on alleviating the shortcomings in the Government's capacity to implement the changes needed. Opening a resident mission in January 1992 constituted a major step for improving results and maintaining the dialogue with the authorities.

3.13 ***Borrower performance.*** The PPAR rates Borrower performance as satisfactory. Although the Government had few policy options and contributed little to the technical preparation of ERC-I, it should receive the credit for supporting the principles underlying the program proposed by IDA and for having implemented and met the conditionality in its entirety, despite the domestic controversy its execution raised.

4. Second Economic Recovery Credit (ERC-II)

4.1 The reforms ERC-I supported touched some of the most fundamental problems of the country, but they were insufficient to make the economy grow faster, recover and entice the private sector to invest and produce more. Aware that the program supported by ERC-I could only deal with part of the problems that plagued the economy, IDA began to prepare with ~~the~~ Government an operation to complement and expand on what ERC-I had achieved ~~already~~. Political uncertainty delayed the preparation and negotiation of the credit, but ~~in~~ on May 27, 1994, the Board approved the Economic Recovery Credit II for US$60 million and an IDA reflow of US$7.6 million. The financial package included US$37 million from Japan.

4.2 ***Objectives.*** The ERC-II supported the Government's structural adjustment program, and aimed at helping the country adjust to lower levels of foreign aid and establishing conditions to revive the private sector. The ERC-II, processed in parallel with an IMF ESAF arrangement, supported fiscal measures to strengthen macro-economic stability.

4.3 The ERC-II sought to reduce the scope of government intervention in the economy, increase the efficiency of financial intermediation, and improve conditions for private sector development. Like ERC-I, ERC-II focused on (i) reform of the state; (ii) reform of the financial sector; and (iii) private sector development.

- For the reform of the state (see Annex B) the credit supported: (a) reducing public sector employment; (b) completing the divestiture of most of the companies under CORNAP, and extending it to utilities in oil, gas and telecommunications; and (c) implementing over 1994–1997 a program to decentralize government activities, to strengthen the

Judicial and Legislative branches of the State, and to reform civil service, budget and expenditure management, and tax and customs administration.

- For the financial sector, the credit supported: (a) reforming the two largest state banks (BANADES and BANIC); (b) improving supervision of commercial banks and extending the government's oversight over FNI (the second-tier state-bank), INISER (the state insurance company) and the stock market.

- For private sector development the credit supported a program to: (a) strengthen procedures for solving conflicts in property rights and for making compensation bonds more attractive to their holders; (b) abrogate the powers of Ministries and Government agencies to change tax and fiscal policies, and to create new commercial enterprises; (c) reduce import tariffs up to a maximum of 37 percent and replace the current export promotion mechanism for a duty drawback system or a temporary admission regime; and (d) update labor market legislation according to principles set in the "Letter of Labor Policy" (see Annex E). but

4.4 ***Relevance.*** The objectives of ERC-II were consistent with those of ERC-I and relevant to address Nicaragua's economic problems. After the political disorder of 1994–95, the Government realized that it had to restore economic stability and increase public savings for the economy to grow and the central bank to gain international reserves. To achieve these goals, the government had to reduce its payroll, divest of state-owned enterprises and prepare and execute a program to reform the public sector.

4.5 **Reordering the state** required keeping the rules of the game stable, reorganizing public sector organizations—to deliver services effectively—and administering the legal framework fairly. The changes were expected to improve the management of budget, tax and customs, thereby increasing revenues and reducing the public sector deficit. **Improving financial intermediation** required to let private banks enter the market and the Government and Central Bank to stop capitalizing and lending to state banks. A sound financial system also required proper economic incentives, good supervision, and enforcement of financial norms and regulations on all banks.

4.6 Economic uncertainty made the private sector reluctant to invest, and to allay its fears the Government had to: (i) protect property rights; and (b) set clear rules of the game by ending the discretionary changes of tax policies, applying incentives transparently, and clarifying labor market regulations.

4.7 The ERC-II's dealt with some of the most serious problems in the country, and took into account the volatile political situation and the weak institutional and managerial capacity.

4.8 ***Implementation experience.*** Closed in June 1996, six month(s) later than planned, ERC-II fell victim to the breakdown of the political consensus that occurred between late 1994 and the Fall of 1995, when the Executive and the National Assembly clashed. The National Assembly amended the Constitution and reduced the power of the Executive, triggering a constitutional crisis that ended in June 1995. The Executive, in turn, opposed the new Labor Code, a code that did not comply with the Labor Policy Letter agreed with IDA.

4.9 The political crisis ~~deviated~~ diverted the Government's attention from economic matters, making it fail to meet the fiscal and monetary targets agreed in the ESAF; as a result, the IMF canceled the mid-review scheduled for early 1995. As the ESAF stumbled so did the ERC-II. The political impasse delayed the execution of the labor mobility program and the reforms in the public sector program. The clash made the divestiture of TELCOR, PETRONIC and the state banks more difficult because the National Assembly, in a conflict mood, had to approve the transfer of state assets to private parties.

4.10 The standstill led IDA to postpone disbursing the second tranche to February 1996, one year later, when the conditionality was fulfilled, a satisfactory macro-economic framework was in place, and the IMF's ESAF was back on track. The third tranche was disbursed in June 1996. Reform advanced in all sectors, notably in the development of the **private sector,** where the government went beyond project covenants. IDA's capacity to disburse later, when conditions were met, helped to implement the project successfully.

4.11 ***Outcome.*** ERC-II outcome is assessed as *satisfactory*, as in OED's Evaluation Memorandum, and lower than the ICR. ERC-II was relevant and succeeded in achieving most of its relevant objectives. The economy grew faster, inflation fell below 10 percent and unemployment fell from 17 percent in 1994 to 14 percent in 1997.

4.12 ***Main achievements.*** ERC-II met part of its goals for structural reforms**.** The *labor mobility* program met its objective of reducing public sector employment, which fell more than its target of 13,500 positions (about 8 percent of public sector employment). The *privatization program* achieved most of its objectives. The Government divested of 66 of CORNAP's 72 enterprises and of 10 of the 17 companies of the Ministry of Construction and Transport, but did not complete the transfer of ownership for all. By the end of 1996 the Government still owned PETRONIC and TELCOR. The sale of TELCOR, transferred to ENITEL, a newly created agency set for privatization, was left to the new government. Although it liquidated ENIGAS, it kept 75 percent of LUBNICA's assets. The Government deregulated the gasoline market, and proposed the full privatization of PETRONIC, an action that required legislative approval by the National Assembly. IDA accepted that full privatization was preferable to privatization of gasoline distribution but the Assembly approval would extend beyond the life of ERC-II. When the Government submitted to the Assembly a law for privatizing PETRONIC, IDA agreed to seek a waiver to this condition in March 1996.

4.13 The reform of the *financial system* fell short of plans. The strategy for containing the growth of state banks (keeping them under close monitoring, avoiding their recapitalization and subjecting them to prudential regulations) was partially executed, so BANADES and BANIC continued dominating the banking sector. Because BANADES and BANIC could not recover their loans they were exempted from complying with prudential norms. After deciding to downsize BANADES, sell a majority of BANIC to private parties, and transfer their non-performing assets to COBANICA, a new collection agency, the Government postponed their restructuring.

4.14 While failing with BANADES and BANIC, the Government managed to advance some reforms in other areas of the financial sector. The Government submitted to the Legislature a General Banking Law that aimed at strengthening the regulatory powers of the Superintendencia Bancaria y de Instituciones Financieras (SBIF). SBIF approved new *prudential norms* in line with international standards, notably the capital adequacy requirements, and the Central Bank improved its management of monetary and exchange rate policies, by carrying out open-market operations and establishing an inter-bank foreign exchange market.

4.15 The Government also began to improve the climate for private sector development. It advanced in resolving *property rights* problems by: (a) reviewing more than 100,000 cases related to properties in the housing and rural sectors, solving the disputes in 82 percent of rural cases and 98 percent of housing cases; (b) increasing the returns on the 20-year bonds introduced in 1992 to compensate those whose property had been confiscated, making them negotiable and accepting that their holders use them to settle liabilities with the tax office and state enterprises (see Annex E). It also ratified a constitutional reform that allowed people linked to the Somoza regime to claim back confiscated properties, and signed a landmark law that secured property rights and constrained compensation to former owners.

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4.16 Other actions reinforced those on property rights. The Government abrogated the discretionary powers of Ministries and agencies to modify taxes and economic regulations, concentrated those powers in the Presidency, and ordered ~~to publish~~ changes to law and regulations in the Official Gazette; the constitutional amendment of 1995 vested in the Assembly most of the powers until then held by the Executive on tax matters. It liberalized *foreign trade* and, except for eight industrial products, it reduced the maximum tariff to 35 percent; and in late 1997 the National Assembly decided to reduce to 10 percent the tariff ceiling by the end of 1999. The reforms to the Labor Code, passed in October 1996 after two years of negotiations between the executive and the National Assembly, went beyond those agreed to in the Letter of Labor Policy.

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4.17 ***Sustainability.*** The reforms supported by ERC-II have stood well, and the PPAR, like the ICR, rates sustainability as *likely*, above OED's uncertain rating in 1998. With support from the international community, the administration of President Alemán continued the reforms started by the Chamorro administration. After Hurricane Mitch, the international community forgave some of the country's debt and postponed service payment, the IMF approved in 1998 a second three year ESAF, and IDA included the country in the group of highly indebted poor countries (HIPC). Entry into the HIPC scheme gave the country another chance to get more debt relief. IDA's ongoing Institutional Development Credit, Financial Sector Adjustment Credit, and an Economic Management TA credit have helped to consolidate the reforms of the state (privatization of ENITEL, Tax Reform Law) and of the financial system (privatization of BANADES and BANIC, and closure of Banco Popular [BP]). The credits supported the Government's efforts to bring competition to the insurance market, to reduce import tariffs to 10 percent and to offer guarantees to foreign investors. The administration of President Bolaños, who took over in January 2002, pledged to create conditions for private sector growth, and to combat corruption by reforming the Judiciary. His administration is discussing a new Poverty Reduction and Growth Facility agreement with the IMF, focusing on public sector reform to boost private sector confidence in the economy.

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4.18 ***IDA performance.*** IDA performance is rated *satisfactory*, the same as the ICR and OED's evaluation memorandum. IDA moved quickly during identification and appraisal, benefiting from an active policy dialogue, and supported a relevant credit for the country. IDA also helped to attract co-financing and tried to ensure the consistency of the donors' technical assistance programs. IDA's assistance could have been more effective had it anticipated the problem of access to credit for small farmers, a problem that delayed the Government's decision to divest of the state-owned banks.

4.19 ***Borrower performance.*** Borrower performance is rated *satisfactory*. In spite of adverse political circumstances, the Borrower owned the strategy, maintained its commitment to the adjustment program, met most of the credit's covenants and did its best to keep the program on track. The country's weak institutions and the initial inexperience of the administration in planning and economic management contributed to the delays and problems in selling and restructuring state-owned enterprises.

4.20 ***Institutional development impact.*** ERC-II is considered as having a *substantial* institutional development impact.

5. Lessons

5.1 When the adjustment program requires deep economic changes, problems that need long-run solutions must be tackled early, under a global strategy whose rationale, constraints and benefits must be understood and accepted prior to approval of the credit. IDA and the Borrower should work to prepare the civil society for the changes needed and forthcoming, and whose benefits are not evident to the general public at first.

5.2 Under a fragile political environment and new democratic institutions, institutional capacity tends to be weak. IDA and the Borrower must address this problem early on, working with other donors and making the building of that capacity and the strengthening of institutions an integral part of the assistance program.

5.3 IDA must tone down its expectations of what reforms can achieve in a short time. IDA identified correctly the nature of the risks of failure, but it overestimated the response to the reforms supported by both credits. IDA and the Borrower assumed unrealistically that stabilization could be achieved in two years, and that an economic recovery based on private sector growth would occur in parallel.

5.4 An adjustment economic program that aims at private sector-led growth should focus from the beginning on developing and guaranteeing property rights, critical to restore ~~the~~ confidence to private investors. ERC-I did not focus on the property rights issue and the desired response of the private sector did not materialize.

5.5 The structural reforms that Nicaragua required needed a medium- to long-term horizon, and they are served better with programmatic lending credits than with fast disbursing credits operating with a short-term horizon. Adopting a programmatic lending approach fits ~~better to a~~ best with multiyear phased support, where each operation needs to be self contained, and conditionality can be simpler and more specific.

Annex A

Basic Data Sheet

Nicaragua – Economic Recovery Credit (Credit 2302-NI)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	110	110	100
Credit amount	110	110	100

Cumulative Estimated and Actual Disbursements

	FY91	*FY92*
Appraisal estimate (US$M)	110	
Actual (US$M)	55	110
Actual cumulative as % of Credit	50	100

Project Dates

	Original Plan	*Revised Plan*
Initiating Memo	01/10/91	01/10/91
Preparation mission	01/15/91	01/15/91
FEPS/IM-OC	05/13/91	05/13/91
Depart appr.	06/06/91	06/06/91
Yellow cover	07/05/91	07/05/91
Documents to RVP	07/11/91	07/11/91
Start negotiations	07/23/91	07/23/91
Board approval	09/26/91	09/26/91
Signing date	12/31/91	12/31/91
Credit closing	06/30/92	12/31/92
PCR completion	12/15/93	03/31/94

Staff Inputs (staff weeks)

Stage of Project Cycle	*Actual Weeks*
Appraisal	22.7
Preparation	86.3
Negotiation	25.0
Supervision	45.9
Completion	10.0
Total	189.9

Mission Data

Stage of project cycle	*Date (mm/yr.)*	*No. of persons*	*Duration of mission (# of days)*
Preparation	01/91	7	2
Pre-appraisal	04/91	12	2
Appraisal	06/91	5	2
Negotiation	07/91	-	-
Supervision	12/91	1	2
	02/92	3	2
	04/92	3	1
	05/92	1	1
	06/92	2	2

Other Project Data

Borrower/Executing Agency: Republic of Nicaragua

Related Bank Credits

Credit title	*Purpose*	*Year of approval*	*Status*	*Closing date*
ERC II	Support the Government's structural adjustment program	1994	Completed	06/30/96
Institutional Development Credit	Improvement in delivery of public services and increasing public savings	1995	Completed	12/31/01

Nicaragua – Second Economic Recovery Credit (Credit 2631-NI)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	60	61.7	103
Credit amount	60	61.7	103
Cofinancing	60	37.0	62

Cumulative Estimated and Actual Disbursements

	FY95	*FY96*
Appraisal estimate (US$M)	52.6	67.5
Actual (US$M)	31.0	61.7
Actual cumulative as % of Credit	59	91.4

Project Dates

	Original	*Actual*
Identification	01/15/93	01/15/93
Preparation	03/05/93	03/15/93
Appraisal	06/03/93	04/04/94
Negotiations	n.a.	07/23–25/94
Board Presentation	n.a.	06/21/94
Signing	n.a.	06/22/94
Effectiveness	n.a.	06/29/94
Credit Closing	12/31/95	06/30/96

Staff Inputs (staff weeks)

Stage of Project Cycle	*Actual*	
	Weeks	*US$*
Through Appraisal	68.9	185.1
Appraisal–Board	1.1	2.2
Board –Effectiveness	7.3	23.8
Supervision[1]	20.0	67.7
Completion	4.0	19.1
Total	101.3	297.9

[1] Task management of ERC-II was performed by the Bank's Resident Representative in Nicaragua. The 20 SW figure refers mainly to inputs of others, and likely understates the intensity of supervision.

Mission Data

Stage of project cycle	Date (mm/yr.)	No. of persons	Duration of mission (# of days)	Specialized staff skills represented[2]	Performance rating[1]		Types of problems
					Implement. Status	Develop. objectives	
Through Appraisal	06/92	6	14	i (2), j, k, l			
	05/93	12	12	a, e, i (2), n, o, q, r, s,			
	07/93	3	5	t, u			
	03/94	9	9	c, i, m a, b (2), e (2), i n, o, p			
Appraisal through Board approval	05/27/94						
Board approval through effectiveness					S	S	
Supervision	04/94	5	12.3	a, b, c, d, e	S	S	
	03/95	5		a, b, c, f, g	S	S	
	03/96	2		h, i	S	S	
Completion	12/96	2	2				

[1] Performance rating as shown in Supervision Form 590.
[2] Key to specialized staff skills:

a Lead Economist
b Financial Economist
c Banking Specialist
d Lawyer
f Public Sector Specialist
g Telecommunications Specialist
h Country Economist
i Economist
j Mining Specialist
k Energy Specialist
l Water and Sewerage Specialist
m Financial Sector Specialist
n Privatization Specialist
p Resident Representative
q Taxation, Public Enterp. Natural Res.
r Property Rights Specialist
s Export Development Specialist
t Country Analyst
u Country Officer

Other Project Data

Borrower/Executing Agency: Republic of Nicaragua

Related Bank Credits

Credit title	Purpose	Year of approval	Status	Closing date
ERC I	Support the Government's structural adjustment program	1991	Completed	12/31/92
Institutional Development Credit	Improvement in delivery of public services and increasing public savings	1995	Completed	12/31/01

Annex B

Reform of the State

Background

1. By 1990, Nicaragua's non-financial public sector (NFPS) was large and consisted of:

- **The General Government**, comprising the Central Government, the Social Security and Welfare Institute (INSSBI), and 143 municipalities;
- **Four public utility enterprises**: The Nicaraguan Energy Institute (INE), the Nicaraguan Institute for Water and Sewerage (INAA), the Telecommunications and Postal Services Company (TELCOR), and the Nicaraguan Urban Bus Company (ENABUS);
- **Other public utilities**, (11) subordinated to the four majors, including the State Oil Company (PETRONIC) a subsidiary of INE;
- A large number of **production companies** that were expropriated or created over the 1979–1990 period, and were either controlled by Ministries, notably the Ministry of Construction and Transportation (MCT) or by the National Corporation of Public Enterprises (CORNAP).

2. As a result of political pressures stemming from strong unionization public sector employment had swelled between 1979 and 1990. By the end of 1990 the number of public employees was about 219,000, fivefold its 1978 level. Out of 209,000 NFPS employees, about 109,000 were in the Central Government, and 91,300 in public companies, of which 78,000 under CORNAP. Moreover, public sector salaries were high compared to the level of skills. same? ?

3. Consequently the resources used in public sector expenditures exceeded public sector revenue. Consolidated NFPS expenditures represented about 49 percent of GDP while NFPS revenue barely exceeded 19 percent of GDP. Moreover, the distribution of public expenditures between current and capital expenditures was not appropriate and by 1990 the NFPS only dedicated 2.1 percent of GDP to capital expenditures.

4. The fiscal adjustments required to bring progress toward a sustainable stabilization led the Government to: (i) reduce NFPS expenditures and increase its revenue; (ii) initiate medium-term public sector reforms; and (iii) undertake, under the Second Economic Recovery Credit, a major reform of the state based on the recommendations of studies, notably those of the 1992 Public Sector Expenditure Review.

5. Both Credits contributed to restoring some macroeconomic stability and to supporting the public sector reforms that addressed all the issues related to expenditures, revenue, and size of the State.

Labor Reduction Program

6. The employment reduction program supported by ERC-I was a success. Despite implementation difficulties, during 1991–1992, public sector employment was reduced at least by 98,500 positions, to 120,200, mainly demobilizing armed forces (from 83,000 to 15,000) and offering early retirement plan. Additional 13,200 positions were eliminated in 1993. During

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1994–1996, ERC-II supported successfully the extension of the redeployment to the entire public sector under the Public Sector Mobility Program which reduced the number of public employees by 18,000 positions, surpassing the initial goal of 13,500.

Public Sector Employment
(Number of Employees at end of year)

	1990	1991	1992	1993	1994	1995	1996	1997	1999
Central Government	109,160	95,120	93,000	82,230	81,020	75,930	73,020	70,970	65,090
Public Enterprises	13,280	10,480	10,040	9,910	9,450	8,340	7,970	8,160	7,310
CORNAP	78,000	9,910	5,720	4,300	1,160	1,100	n/a	n/a	n/a
Banking Sector	9,920	6,550	5,060	4,100	4,120	3,810	2,960	2,020	1,690
Others	8,340	6,190	6,400	6,460	5,410	4,970	4,940	3,940	3,790
Total	218,700	128,250	120,220	107,000	101,160	94,150	88,890	85,090	77,880

As shown in the table, by the end of 1996, public sector employment had been cut by 31 percent over its level in 1991, the major downsizing having occurred at the enterprise level in CORNAP.

Privatization Program

7. The Government's strategy was to privatize companies of the *"Area de Propiedad del Pueblo"* (APP), but retain ownership of public utilities. The privatization of the APP enterprises was a major component for structural adjustment. Privatization involved the sale of companies legally owned by the Government, the return of confiscated companies to their legal owners, or liquidation. By divesting of these companies, the Government aimed to: (i) reduce the public-sector share in the economy; (ii) lower its administrative functions and management responsibilities; and (iii) earn additional revenue for the budget.

8. ERC I helped to start-up the divestiture by helping CORNAP to: (i) complete, by March 1992, the divestiture of at least 75 companies out of which 25 were fully privatized while the remaining 50 were returned to their former owners or liquidated; and (ii) prepare for sale another 30 companies. Under ERC-I, the Government divested 233 of the 351 CORNAP enterprises. An additional 46 enterprises were privatized by May 1994.

9. However, the international business community showed little interest in bidding for CORNAP's assets and there was small capital repatriation connected with privatization. The income generated by the divestiture was small, because, in many cases, enterprises were returned to their previous owners and the operation included "buying-out" the collective agreement and compensating the fired workers. bargaining (3)

10. ERC II supported more ambitious targets that were partially achieved. Sixty-three of the remaining CORNAP enterprises were fully divested or closed and three other lost their public majority ownership, but six CORNAP companies remained under the control of the State. Regarding the public utility enterprises, the results were mixed. In the energy sector, ENIGAS was liquidated and workers were paid with the company's assets; twenty five percent of the oil company LUBNICA's capital was transferred to its workers and the remaining 75 percent to INE, by in order to repay debts to PETRONIC. The Government's attempt to privatize PETRONIC seeking the approval of the National Assembly failed. However, deregulation of the gasoline market

occurred: by August 1995, private companies were in charge of the bulk of the distribution process and regulatory functions were vested in INE.

11. Moreover, 10 of the 17 original enterprises under the Ministry of Construction and Transport were privatized or liquidated, and the personnel and equipment of its remaining enterprises ~~had been~~ reduced.

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12. The major setback occurred with the privatization of TELCOR in the telecommunications sector. The privatization program was well advanced by the fourth quarter of 1994: nine bidding companies had been prequalified, TELCOR's regulatory powers had been transferred to ENITEL, the newly created agency to be privatized as service provider, and a new Telecommunications Law had been sent to the National Assembly. However, the Constitutional crisis that ensued interrupted the advance, which resumed in July 1995. The sale of ENITEL was advertised in January 1996, and public call for bids ~~were~~ was made before June 1996; with these steps IDA considered that the Government had complied with the conditionality of "making progress." Nevertheless, bid opening was postponed several times and the new Administration that took over in 1997 was left with the responsibility of privatizing ENITEL.

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Public Sector Reforms

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13. Increasing government revenue was part of the strategy for the stabilization program and ensure the non-inflationary financing of public programs. Such effort required an improvement of tax administration and tax management.

14. ERC I supported the initiation of an action plan with specific emphasis on: (i) the General Value Tax (GVT) and income tax collection; and (ii) the removal of income tax exemptions and the phasing out of indirect tax exemptions. It also contributed to organizational and procedural changes and to the strengthening of control and enforcement of tax regulations. Notably, tax declaration and payment procedures were simplified, corporate income tax unified and the number of brackets for personal income tax was reduced. Programs on automated management control system and computerized taxpayer identification system were also initiated.

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15. ERC II focused on the implementation of the recommendations of the 1992 Public Sector Expenditures Review. The conditionality associated ~~to~~ the operations resulted in the adoption, in October 1994, of a five-year Public Sector Reform and Action Plan, covering: (i) institutional restructuring; (ii) civil service reform; (iii) budgetary management; (iv) tax and customs administration; (v) decentralization; and (vi) strengthening of the Judicial and Legislative branches.

16. By 1996 the following actions had been taken:

- The creation of a Reform of the State Management Unit to design and coordinate the implementation of ERC-II.
- The completion of six Institutional Restructuring Agreements (ARIs) with four Ministries (Ministry of Construction and Transport; Ministry of Finance; Ministry of Natural Resources and Environment; Ministry of Economy and Development) as well as with the National Institute for Social Security.
- In MCT a planning division for economic infrastructure was established and an Integrated Management System (SIGFA) was installed in all Central Government ministries.

17. Moreover, (i) a multi-year modernization program of the Judicial System, including the construction of court houses and training for judges was implemented; and (ii) a new social

security system was designed and implemented, with ~~the~~ social welfare separated from pension and health insurance.

18. Supported by IDA sector credits, public sector reforms continued ~~beyond~~ after ERC-II was closed. Notably, a reorganization of the Executive Branch ~~would~~ occur, as well as a reform of the pension system.

Annex C

Public Sector Expenditure Review

Main Recommendations

Background

1. The main purpose of the Public Expenditure Review was to assist the Government in improving the allocation of public resources and strengthening the institutions involved in financial management and project implementation.

2. Although the Government had taken steps to improve the fiscal balance, larger effort were required on the current expenditure side. Severe institutional and management problems magnified the difficulties resulting from the large size of the public sector. The system leading to expenditure decision was inadequate and deficient. Poor methods of planning and control were used by most ministries. The entire system of expenditure management and control need to be strengthened. Institutional weakness was particularly worrisome in the management of external aid.

Diagnosis and Strategy of Reform

3. The expenditure review identified six main problems: (i) institutional, procedural and processing problems of budgeting, investment planning and aid coordination; (ii) weak accounting function, leading to poor ex-post control and non-existing auditing; (iii) recurrent expenditure; (iv) expenditure patterns (in particular in the social sectors) not reflecting government priorities; (v) weak institutional and administrative capacity, both in the line ministries and in the public enterprise; and (vi) too large public investment program (PIP) for the Government's implementation capacity.

4. The Government could not tackle all the problems at once, and three phases were proposed to deal with them. The first should deal with recurrent expenditures to reduce the risks of destabilization from large budget deficits. The second phase would consist of: (i) a comprehensive reform of the civil service; (ii) rationalization of budget preparation; (iii) rationalization of project preparation; and (iv) reforms in the education, transport, energy and water sectors.

5. The actions to be implemented were the following:

Issues that need to be addressed most urgently

(a) *Reduce and restructure the Central Government current expenditures*: (i) reduce the wage bill while increasing wages for professionals; (ii) reduce expenditures in goods and services, while increasing allocations for operations and maintenance; and (iii) reduce expenditures for defense.
(b) *Strengthen and restructure budgetary management* by defining responsibilities for the core units which deal with budgetary practices and expenditure control, and establishing an accounting system.
(c) *Establish a new expenditure control mechanism* by: (i) revitalizing expenditure control by the Auditor General; and (ii) extending overall budgetary practices and expenditure control to the Ministries of Defense and Police and the item "Unforeseen Expenditures."

(d) *Improve the mechanism for coordination and control of external aid* by establishing an External Aid Coordination Committee that regulates the aid flows.
(e) *Establish a government-wide accounting system.* The proposed Budgeting and Accounting Units in each institution would be headed by a Ministry of Finance (MIFIN) appointed Accountant, and would bear key responsibility for bookkeeping and preparing year-end final accounts of the institutions. Each institution must submit its year-end final accounts to the Auditor General via MIFIN for legality and veracity clearance.
(f) *Prepare an implement a Technical Assistance program.* In order to expedite the above restructuring efforts, short-term three-pronged technical assistance needs to be provided to MIFIN consisting of: (i) training seminars for MIFIN staff on improved budget preparation, implementation and control issues, and some academic training abroad for Budget Directorate staff; (ii) technical assistance for the formulation of an overall government accounting system; and (iii) several short-term consultants in ex-post expenditure control, revision of the auditing mechanism by the Auditor General, and mid-term expenditure planning.
(g) *Reallocate funds toward primary health care* from curative to preventive care, and introduce a targeted fee system for both consultations and drugs, to improve efficiency and signal to users the cost of the different kinds of treatment. The funds collected should be allocated to primary health care.
(h) *Reallocate funds towards primary education* by: (i) reducing subsidies to higher education; (ii) developing cost-recovery options (in particular in higher education); (iii) charging universities for the use of public utilities; and (iv) reforming the retirement provisions of the "Ley de Carrera Docente" in line with Nicaraguan Institute of Social Security (INSSBI) national rules.
(i) *Produce a sectoral strategy in the agricultural sector*: Define the short and medium-term sectoral objectives, and the roles of the different institutions in meeting those objectives. A Committee should be set up to assist in the coordination of the overall sector policy.

Issues to be addressed subsequently

(a) *Establish* the *accountability of government institutions*. The Auditor General of the Republic should audit all government expenditures and institutions on behalf of the National Assembly as a superior organization and officially inform that body of its findings.
(b) *Improve the mechanism for preparing the Public Investment Program*. The Ministry of Economy and Development (MEDE) needs a clear mandate to: (i) coordinate the preparation of national and sectoral strategies, to be then translated into specific investment projects; and (ii) enforce agreed upon priorities and allocate domestic and external resources to the priority projects.
(c) *Strengthen institutional capacity for PIP elaboration* through technical assistance to the core ministries, the line ministries, and the public utility companies.
(d) *Restructure the civil service system and establish a sound salary scale* by: (i) establishing a separate Civil Service organization; (ii) setting up a system of establishments and payroll lists (iii) preparing position tables for each institution; and (iv) forbidding institutions to appoint staff without having a position authorized by MIFIN.
(e) *Reduce personnel in public enterprises.* INE, INAA and TELCOR should devise programs to reduce staffing levels to their revised functions.
(f) *Privatize or close* all firms producing goods that are now operating under the Ministries.

Final Phase

6. The final phase of the reforms includes an emphasis in reforming sectoral policies and strengthening sectoral institutions.

(a) *Reduce expenditures on the item "General Services"* by: (i) reducing the number of independent institutes; (ii) restructuring the urban transport subsidy; and (iii) reforming the Law earmarking funds for the University.
(b) *Reduce the size of central administration* after doing a study assessing where and by how much the ratio of service to administrative personnel should be increased.
(c) *Set up a preliminary model for mid-term expenditure planning* to establish consistency between revenues and expenditures as well as with expenditure priorities.
(d) *Ministry of Education (MED)* has to change teacher training, accreditation and reward alternatives.
(e) *Promote private sector investment in the energy sector* by: (i) creating an autonomous regulatory entity that promotes an efficient development and use of energy resources; and (ii) promoting private sector participation, particularly in power generation, distribution and commercialization.
(f) *Improve operational and financial performance of the Nicaraguan Energy Institute (INE)* by: (i) reducing personnel; (ii) undertaking an effective power losses reduction program; and (iii) improving budgeting, auditing, control and managerial information systems.
(g) *Develop institutions for the rural water sector.* Plans should be elaborated in coordination with donors (that provide most of the services in rural areas): (i) to determine how their technical and financial assistance will be phased out and (ii) operations and maintenance handed over to municipal water companies, communities or private water companies.
(h) *Improve Nicaraguan Institute for Water and Sewage (INAA) and other sectoral institutions' management capacity* to execute and supervise more projects

Annex D

Financial Sector Reform

Background

1. By 1979, Nicaragua had one of the most advanced financial systems in Central America, with a combination of state, private national and foreign subsidiaries banks providing a wide range of financial services.

2. After taking power, the Sandinista Government: (i) eliminated private national institutions and nationalized all private commercial banks; (ii) transferred control of state-bank operations to a holding company which would evolve into the *Corporación Financiera de Nicaragua (CORFIN)*; and (iii) reduced the number of financial institutions to five:

- *Banco Nacional de Desarrollo (BANADES)* servicing the agriculture and livestock sector;
- *Banco Nicaragüense de Industria y Comercio (BANIC)* servicing industry and trade, largely oriented toward the urban sector;
- *Banco de Crédito Popular (BCP)* servicing the small scale sector;
- *Banco Inmobiliario (BIN)*, servicing the housing sector; and
- *Fondo Nicaragüense de Inversión (FNI)*.

3. The ~~complete~~ specialization of the five institutions and persistently negative real interest rates on loans ~~had~~ reduced management incentives to improve the quality or efficiency of their operations. ~~Myriad~~ subsidies and the use of the banking system to pursue political objectives ~~had~~ undermined the loan repayment culture. Bank managers rolled over poor and non-performing loans to maintain the flow of resources to targeted sectors and, periodically, the Government forgave or rescheduled overdue loans. All banks were highly dependent on Central Bank rediscount. Eighty-three percent of the growth in credit originated in the Central Bank and 96 percent of it was granted to the public.

4. Since ~~the~~ the early 1980s, monetary policy was managed to provide inexpensive loans to the productive sector and finance the large borrowing requirements of the Government. Credit expansion ~~had~~ resulted in accelerating inflation. Attempts to restrain its growth in 1988–1990 failed. In response to hyperinflation and the ~~a~~ steady decline in the economy, the holdings of money and quasi-money fell from 55 percent ~~of~~ GDP at the end of 1988 to 27 percent by the end of 1989.

Financial Sector Reform

5. Starting in 1991, a number of steps were taken to reform the financial system and improve the efficiency of financial intermediation. By March 1991, a law was enacted that set forth the functions of the Superintendency of Banks and allowed ~~private financial~~ intermediaries to coexist with state-owned restitutions.

6. The restructuring of the state-owned banks along with the cessation of Central Bank subsidies and discounts, and the promotion of an efficient private ~~financial~~ sector were the key elements of the reform program that both ERCs supported. Over the ERC-I implementation period, CORFIN

was closed and BIN was liquidated. In June 1992, the restructuring of BANADES and BANIC was prepared as the Government wrote off and bought their non-performing loans recapitalizing them indirectly. Both institutions were also submitted to the prudential norms issued by the Superintendency and had to undertake a major cost-reduction program, substantially reducing branches and staff. Over the ERC-II implementation period, the state banks were kept under close monitoring and not recapitalized; their non-performing assets were transferred to COBANICA, their loans growth submitted to ceilings and their network further downsized.

7. A legal and regulatory framework appropriate to private banking operations has been progressively established. Rules and standards to initiate operations were issued by October 1991. The Superintendency of Banks and other Financial Institution (SBIF) strengthened guidelines on capital adequacy, loan concentration and assets evaluation, as well as penalties for non-compliance. A General Banking Law was also submitted to the National Assembly, which approved it in 1997. Finally, the insurance sector had been liberalized in July 1996, when the National Assembly passed a reform opening up the market to private competition.

8. The Central Bank Law approved in 1992 gave the monetary authority part of the autonomy it had lost. Stringent conditions were placed on Central Bank of Nicaragua (CBN) financing of both the Government and the financial system. Notably, credit lines to the State banks were discontinued. A mostly market-determined interest rate structure was gradually adopted, direct controls over the financial system were lifted and reserve requirements varied by category of deposits imposed. New monetary policy instruments were also introduced. The placement of negotiable investment certificates with maintenance of value (CENIS) for open market operations was initiated in 1995. An inter-bank foreign exchange market was established, exchange restriction were phased out and the exchange rate was unified by early 1996.

9. The regulatory framework for the banking system is established and broadly appropriate, with two key laws: (i) the 1963 Law on Banks and Other Financial Institutions; and (ii) Law 125 of 1991 creating the SBIF. Other legal sources, sometimes contradictory and with vague definitions, give room for discretion in the application of norms and regulations

The Financial System After the Reform experienced ?

10. The financial system structure has experimented a major transformation. Notably:

- The commercial state banking system is restricted to three institutions: BANADES, BANIC and BCP.
- Ten private banks were established and nine were operating by the end of 1996.
- Four private insurance companies were set up by banks and were competing with INISER, the state insurance institute.
- The stock exchange was operating but its activity was limited.

11. The bases for financial system supervision have been established. Even though mainly focused on banks, SBIF was empowered to: (i) supervise all institutions, including the Central Bank; (ii) establish regulations and norms for all institutions; and (iii) license new financial intermediaries. SBIF has a widespread jurisdiction over the state and private banking sector, the stock exchange, insurance companies, deposit warehouses and any other activity or institution that intermediates funds from the public (leasing, factoring, credit cards, funeral companies and pawn shops are included).

12. The system has gained depth as reflected by the rise in the ratio of liquid liabilities of financial intermediaries to GDP. The growth has been mainly in US dollar denominated deposits, whose share was close to 63 percent in 1997 compared to 29 percent in 1991. The allocation of financial resources has improved. The share of state banks in total private sector credit has declined with the transfer of their non-performing assets, nearly 40 percent of their portfolio, to a private collection agency, COBANICA, in 1996. State banks accounted for 21 percent of total assets, down from nearly 95 percent in 1991.

13. Despite the improvements in 1996, the financial system is still fragile. State banks (BANADES and BANIC) continue to control an important share of the sector, and their performance remains poor. BANADES was not fulfilling its mandate to serve small producers, its clientele had fallen, credit recoveries continued to be low and the annual operating costs were high. BANIC had similar problems and its portfolio was highly concentrated. *Private banks* have achieved substantial annual rates of return (15–35 percent), because of high intermediation margins and highly profitable investments in public bonds. Despite that each of the 12 banks remains small in terms of credit market share , which is reflected in high administrative costs. They are also undercapitalized, with an overall equity amounting ~~with~~ US$70 million in 1996, compared with US$500 million in El Salvador. Private banks were subject to a capital adequacy ratio of 8 percent, but the development bonds (BOFOS) they issued, and the Central Bank repurchased, contributed to a significant part of their capital. The *Managua Stock-Exchange* remained small. The main traded instruments are Central Bank and Government paper (CENIS and Compensation Bonds). As of 1996, the total volume of transactions in equities and bonds had reached US$320 million.

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no more recent data? ?

Annex E

Matrix of Policy Actions, Measures and Results Within the Two Economic Recovery Credits Over the Period 1991–1996

Objectives	Conditionality	Status/Results
I. Macro-economic Framework Ensure an appropriate and stable macroeconomic framework	1) Maintain a stable macroeconomic framework including fiscal deficit and domestic credit ceilings consistent with stabilization objectives. 2) Maintenance of exchange rate policy consistent with export competitiveness, which reflects changes in monetary indicators notably.	1) In 1991, Nicaragua initiated an economic adjustment program within a Stand-by Credit (September 1991–March 1993). Targets were partially met. 2) In April 1994, Nicaragua entered into an ESAF framework for a three-year period, but recurrent difficulties for meeting targets (fiscal) led to a Monitoring Program agreement in September 1995, and in September 1996, to ESAF suspension. 2) Done, with reservations.
	3) Satisfactory progress implementation through reduction of public expenditures, in military areas and increasing public revenues.	3) Done, with reservations.
	4) Action plan for carrying out recommendations of the study on public expenditures to be presented.	4) Done.

II. Reform of the State **A. Public Sector Labor Mobility** Achieve a permanent cost reduction to strengthen the fiscal balance through reduction in the labor force.	1) Demobilization of militia and military draftees by 35,000, as well as retiring of 5,000 military officers (1991). 2) Introduction of an externally funded employment redeployment program to relocate 9,000 of 69,000 central government employees, (including 3,000 additional military personnel) to be completed for 8,000 personnel (in 1991). 3) Preparation of an action plan to extend redeployment to entire public sector, including CORNAP, initiating its implementation (1992) in order to reduce employment by 13,500 positions during 1994–1996.	1) During 1990–1993, public sector employment was reduced, by 183,000 positions to 107,000, through downsizing armed forces (83,000 to 15,000), privatization or closure of public enterprises (74,000 employees involved) and an early retirement plan. 2) During 1994–1996, public sector employment was reduced by 10,300 positions. The target would be surpassed in 1999, as 14,000 positions were cancelled.

B. Privatization Program		
1) Promote more efficient resource allocation and lower fiscal burden through divestiture of state enterprises. 2) Improve the efficiency and service coverage by promoting private sector participation in the utilities sector, notably the telecommunications.	1) Established CORNAP and endowed it with responsibility for both managing and privatizing 351 state enterprises grouped in 22 corporations, while working out a strategy for divestiture, and adopting an action plan to privatize CORNAP (1991). 2) Complete the privatization of at least 25 companies through CORNAP; the devolution of their original owners, or the liquidation or the transfer to private sector of at least 50 companies through CORNAP (1992). 3) At least 30 additional companies under CORNAP prepared for sale to private sector (1992). 4) Bring to the point of sale or closure enterprises under CORNAP and MCT(1994–1996)	1) All but five of the companies under CORNAP were privatized, returned to their former owners, or liquidated, over the 1990/1995 period. 2) By the end of 1995 was completed the process of selling the assets of CONSULTRAN (MCT enterprise). A study on the privatization of another 7 firms under MCT was completed awaiting its implementation.
	5) Bring to the point of sale or liquidation some of the operations (gasoline distribution) of PETRONIC, while its regulatory functions are defined.	3) As of December 1994, PETRONIC ceased to have a state-monopoly on distribution activities. Its organic law was then reformed (1995) to place it as a commercial company. 4) Twenty-five percent of the capital of LUBNICA was transferred to its workers, the remaining 75% being transferred to INE, to repay debts to PETRONIC.
	6) Take steps for the sale of 40% of ENITEL shares, including the offer of a management contract for the winning bidder (1994–1996).	5) In 1995, Legislature approved laws to separate the regulatory and operational activities of the following public utilities: • Telecommunications (TELCOR, ENITEL) • Power (INE, ENEL) 6) In December 1995, a law created ENITEL to operate public telecommunications services, and authorized to sell up to 40% of its shares, as requested.

C. Tax System and Administration 1) Increase and maintain tax revenue to ensure objectives of stabilization and non/inflationary financing of medium/term government program. 2) Simplify and strengthen tax administration.	1) Removal of income tax exemptions and approval of a program to phase out indirect tax exemptions, including import tax exemptions (1991). 2) Adoption of a plan to improve tax administration with specific emphasis on GVT and income tax collections (1991), to be initiated immediately.	1) Corporate income taxes were unified, number of tax brackets for personal income taxes were reduced, the maximum marginal income tax was reduced in line with regional standards, and the VAT was raised from 10 to 15% (1990–1991). 2) The registry of the 10,000 largest tax contributors was updated and modernized (1990–1992). 3) Tax exemptions were reduced; public enterprises were subjected to taxation; income taxes applicable to agricultural and non-agricultural activities were unified; and coffee exporters were subjected to withholding tax (1993–1995).
D. Public Sector Reforms Create an efficient, smaller and modern public sector.	1) Prepare and begin implementing a 3-year plan in line with the Government's public sector reform policy statement covering: institutional restructuring, civil service reform, budgetary management, tax and customs administration, decentralization and strengthening of the Judicial and Legislative branches (1994–1996). 2) Create and initiate staffing of a Reform of the State Program Management Unit, which will design and coordinate the program (1994). 3) Achieve satisfactory progress in its implementation, including the restructuring of at least 2 important public institutions.	1) Conditionality was fulfilled. 2) Multi-year modernization program of the judicial system, including the construction of courthouses in most principal capital and training program for all judges was implemented, from 1992 to 1998. 3) Improved transparency and accountability in management of public finances through the adoption of an Integrated Management System (SIGFA) in central government ministries. 4) As of December 1996, six Institutional Restructuring Agreements (ARI) had been finalized (for MCT, MIFIN, MARENA, MEDE, INIFOM and INSS) and reforms started to be implemented, notably: (i) In MCT, a Planning Division for Economic Infrastructure was created; (ii) In INSS, a new social security system was designed and implemented (social welfare being separated from pension and health insurance).

III. Financial Sector Reform **A. Banking Sector Policy** Improve the allocation of resources and the efficiency of financial intermediation regulating banking activities, strengthening monetary control and developing a private sector based financial system.	1) Adoption of an action program for the restructuring of state owned banks and carrying out the: i) liquidation/merger of BIN with BANIC; ii) dissolution of CORFIN; iii) restructuring BNIC, BND and BP according to plans.	1) A policy of reducing the size of the state banking sector has been implemented within the framework of a state reform program agreed with IMF, World Bank and IDB. As of January 1997, the state banking sector included 3 institutions: BANADES, BANIC and BCP.
	2) Maintaining policy of : i) not recapitalizing state banks, through new public sector funds or revaluation of non-financial assets; ii) ensuring compliance with prudential norms and banking regulations; iii) no pre/assigning of rediscounts from the Central Bank for specific activities.	2) Non performing assets of BANADES and BANIC were transferred to COBANICA, a new collection agency (1996); ceiling was set on BANADES loans growth and its network downsized.
	3) Submission to Legislature of a bill on Banking and Financial Institutions, to be developed and implemented with technical assistance support.	3) A new law permitting the establishment of private banks and creating a Superintendency of Banks was approved (1991). Further on in 1995 and 1996, a new General Banking Law and a new Central Bank Law were approved.
	4) Adoption of an interest rate policy close to the market. 5) Cessation of Central Bank subsidies and discounts except for agriculture and micro-enterprises.	4) Interest rate controls were progressively removed and directed credit was eliminated.
	6) Issuance of licenses (3 at least) to start-up private financial institutions.	5) Private banking has developed rapidly. Moreover, insurance market was opened up to private interests (1996).

B. Superintendency of Banks 1) Establishment of a appropriate regulatory framework to be progressively strengthened. 2) Enforcement of prudential norms adopted by the Superintendency. 3) Improve the financial information system and accounting systems.	1) Adoption of regulations for the implementation of the Superintendency Law and start-up of activities. 2) Increase penalties, create new prudential norms and improve the operations of the Superintendency of Banks, under an agreed action plan. 3) Design and implement a debtor management system. 4) Implement a new chart of accounts.	1) In May 1996, the Superintendency of Banks and other Financial Institutions (SBIF) approved new prudential norms on loan concentration, capital adequacy and assets evaluation, and reforms to exception to the norms. 2) The new General Banking Law included the strengthening of the Superintendency. 3) The system is operating with three tools: relevance analysis, balance information, loan amounts and provisions. The central risk system is tested, to maintain it current. 4) A new chart of accounts has been implemented since 1994, including all state and private banks.

IV. Private Sector Development Improve climate and incentives for private sector activity. **A. Property Rights** (ERC II only) Resolve property rights disputes/ problems in order to improve security of land tenure.	 1) Establish a program to review compliance with current procedures to resolve property conflicts. 2) Satisfactory implementation of the verification process. 3) Complete study on potential uses of the Compensation Bonds, with the objective of raising their value.	 1) Established a National Review Commission, an Office of Territorial Ordering and the Office of Quantification of compensation, during 1992–1993. 2) As of 1996, the Office of Territorial Ordering had resolved 12, 117 cases (houses) equivalent to 98% of the total number of cases presented for review. With respect to rural sector, 82% of the 106,130 cases submitted were reviewed. Progress was also made on 91% of the Agrarian Reform cases. 3) As of December 1996, 4501 resolutions were issued, covering 89% of the total claims presented to the Integrated System for Review of Property Claims. Since 1993, Compensation Bonds had been issued for an amount of C$3,933 million. Moreover, on the basis of the study a Law reduced the period of the Bonds from 20 to 15 years, their fixed interest rate was increased to reach 5% and the use of the bonds was extended, to cover tax payments notably. Late 1996, a redemption system was created allowing these.
B. Discretion in Economic Policy Promote a more stable and transparent policy environment, reducing ministerial discretion..	Issue a presidential decree establishing a policy disclosure for tax and fiscal matters, abrogating and elevating to the Presidency, the powers of Ministries and government agencies to change policies and to create state enterprises.	Two Presidential Decrees were issued in April 1994 enforcing publication of Decrees and Administrative Rulings in the Official Gazette, and abrogating the discretionary powers of Ministries.

C. Foreign Trade Reform and Deregulation Increase output and diversification of tradable goods by increasing private sector participation in trade. Promote export growth	1) Trade deregulation opening import and export trade to private sector. 2) Design a price-based mechanism to replace import quotas, and eliminate quantitative restrictions on food grain imports. 3) Reduce nominal protection rates to a range of 10%–37% (except for fiscal industries). 4) Foreign exchange allocation mechanisms liberalization. 5) Action plan to replace existing export promotion mechanisms by a duty drawback system. 6) Elimination of most domestic price controls.	1) State exporting and importing monopolies were eliminated (1991-1992). 2) A schedule for the reduction of nominal tariff ceilings was established (1994) and at the end of 1996 the ceiling was below 40%. 3) Price controls were eliminated on all products except public utilities (1991–1993).
D. Labor Market Reform Promote greater labor productivity	Comply with agreements on labor policy.	New Labor Code was promulgated in 1996.

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Report No. 16775

IMPLEMENTATION COMPLETION REPORT

NICARAGUA

SECOND ECONOMIC RECOVERY CREDIT
(Credit No. 2631-NI)

June 17, 1997

Central America Department
Latin America and the Caribbean Region

CURRENCY EQUIVALENTS

Currency Unit: Córdobas (C)

1994: US$1 = C6.72
1995: US$1 = C7.53
1996: US$1 = C8.44
1997: US$1 = C9.13 (March)

FISCAL YEAR

January 1 to December 31

MAIN ACRONYMS AND ABBREVIATIONS

ARI	Institutional Restructuring Agreement (*Acuerdo de Reestructuración Institucional*)
BANADES	National Development Bank (*Banco Nacional de Desarrollo*)
BANIC	State Bank for Industry and Trade (*Banco Nicaragüense de Industria y Comercio*)
CACM	Central American Common Market
CORNAP	State Holding Corporation (*Junta General de Corporaciones del Sector Público*)
ESAF	Enhanced Structural Adjustment Facility
ENITEL	Telecommunications Enterprise (*Empresa Nicaragüense de Telecomunicaciones*)
ESW	Economic and Sector Work
FNI	National Investment Fund (*Fondo Nacional de Inversiones*)
IDB	Inter American Development Bank
IDC	Institutional Development Credit
KfW	German Development Agency (*Kerditanstalt für Wiederaufbau*)
MCT	Ministry of Construction and Transport
MIFIN	Ministry of Finance
OECF	Overseas Economic Cooperation Fund of Japan
PETRONIC	State Petroleum Company (*Empresa Nicaragüense del Petróleo*)
PFP	Policy Framework Paper
PSRC	Public Sector Reform Credit
TELCOR	Telecommunications Corporation (*Corporación Nicaragüense de Telecomunicaciones*)
UCRESEP	Project Management Unit for the Public Sector Reform Program (*Unidad Coordinadora para la Reforma del Sector Público*)
UNDP	United Nations Development Programme

Vice President:	Shahid Javed Burki
Director:	Donna Dowsett-Coirolo
Staff member:	Ian Bannon

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IMPLEMENTATION COMPLETION REPORT

NICARAGUA

SECOND ECONOMIC RECOVERY CREDIT (Credit 2631-NI)

one year delay.

Preface

This is the Implementation Completion Report (ICR) for the Second Economic Recovery Credit to Nicaragua, for which Credit No. 2631-NI in the amount of SDR42.5 million was approved on June 21, 1994 and made effective on June 29, 1995. ERC II was supplemented by IDA Reflows of SDR5.36 million (Cr. 26311-NI) approved on June 21, 1994, SDR4.40 million (Cr. 26312-NI) approved on December 8, 1994, and SDR3.9 million (Cr. 26313-NI) approved on December 12, 1995.

6 months delay

The Credit was closed on June 30, 1996, compared with the original closing date of December 31, 1995. The first tranche, released upon effectiveness, was fully disbursed by September 1994, the second and third tranches were released in February and June 1996, respectively. In addition, a total of SDR13.66 million in IDA Reflows were added to ERC II. Cofinancing in the amount of ¥3,878 million was provided by the Overseas Economic Cooperation Fund (OECF) of Japan. The German Kerditanstalt für Wiederaufbau (KfW) provided parallel financing of DM20 million, disbursed at the time of the release of the second and third tranches of ERC II.

This ICR was prepared by Ian Bannon (Lead Economist of the Central America Department) based on a report prepared by Mr. Claudio Pardo (Consultant). The ICR was reviewed by Ms. Violeta Rosenthal (Task Manager for ERC II, Central America Department) and Ms. Donna Dowsett-Coirolo (Director, Central America Department). The Borrower contributed to this ICR by preparing its own evaluation of the program. A translation of the Government's evaluation is included as Annex A of this report. OECF, the co-financier, did not submit comments on the ICR.

The ICR draws from the President's Report, the Development Credit Agreement, and other material in the files. The report is based on discussions with IDA staff, and on the findings of a mission to Nicaragua in early December 1996. The mission did not leave an Aide Memoire with the Government, although it discussed major findings and key lessons.

SECOND ECONOMIC RECOVERY CREDIT

NICARAGUA

Evaluation Summary

i. When the Government of President Chamorro assumed office in April 1990, following 11 years of civil war, it faced a highly polarized society and an economy devastated by the conflict and inappropriate policies. Over the next two years, the Government successfully implemented a comprehensive reform program, designed to bring hyperinflation and major macro imbalances under control, and begin the longer-term transition from central planning to market-led development. The initial phase of this program was supported by IDA's first Economic Recovery Credit (ERC), completed in June 1992. The follow-on operation (ERC II) was delayed by a political crisis which emerged in the second half of 1992 and continued throughout 1993. Once the political crisis was resolved in early 1994, IDA moved quickly with ERC II, which was approved by the Board of Directors on June 21, 1994

ii. ERC II aimed to support the second phase of the Government's economic reform program. The operation had three major components: public sector reform, increased efficiency in financial intermediation, and an improved private sector climate. The balance of payments support provided by ERC II and its associated bilateral financing would allow the Government to plan for a more gradual and predictable path as the economy adjusted to the expected decline in aid flows. The two main risks identified were. (i) a breakdown of the political consensus and strong opposition to some of the reforms, leading to a political crisis, as had happened in 1993; and (ii) weak institutional capacity, which could delay implementation of reform measures. Political risks proved critical.

iii. Although throughout program implementation, the Government had some difficulty maintaining macroeconomic targets, especially in the fiscal area, it largely succeeded in maintaining relative macro stability (supported by an IMF Staff-Monitored program), especially during the lead up to National elections in late 1996. More impressive has been the strong economic recovery during program implementation, especially after the negative growth and stagnation that characterized the early 1990s. Key achievements have been: high economic growth over the past two years; a strong export recovery, including high growth of non-traditional exports; falling unemployment; and a marked reduction in the country's massive external debt. As the new Administration, inaugurated in January 1997, retakes the stabilization and adjustment agenda, there are good prospects that Nicaragua's economic recovery will be maintained.

iv. Despite this impressive economic recovery, the ICR rates achievements in macro and sectoral policies as only **partial**, due to continuing weaknesses in fiscal policy, remaining problems with the state banking sector and the still large external imbalances that affect the economy. Achievement of institutional and public sector management objectives is also rated as **partial**, since progress in some of the institutional reform aspects of the public sector reform program was slower than expected. By far the strongest area has been private sector development, where achievements are rated as **substantial**. The reform program supported by ERC II contributed to a substantial improvement in the business climate, increasing transparency, strengthening prudential supervision of the financial system, encouraging the adoption of a modern labor code, improving trade policies and carrying out a large privatization program.

v. Based on the achievements of the program, Nicaragua's marked economic recovery and early signs from the new Administration (including some concrete steps already taken) that the stabilization and adjustment program will be continued and deepened, the ICR rates program sustainability as **likely**.

vi. IDA's performance is rated as **satisfactory** in all aspects. As discussed in the ICR, two aspects of IDA's performance can be noted. First, it designed the adjustment operation with considerable flexibility, taking into account Nicaragua's very difficult political environment. Second, with the approval of the Government, IDA was prepared to engage in a debate and dialogue on the need for adjustment with Nicaraguan opinion-makers beyond the immediate circle of the Government's economic team. This proved key in muting outright opposition to some of the more difficult reform measures. Borrower performance is also rated **satisfactory** in all aspects. Despite Nicaragua's often turbulent and confrontational political environment, the Government was able to maintain its sights firmly set on the longer-term objectives of the reform program. Taking all the above factors into account, and the shape of Nicaragua's economy today compared to when the adjustment program started, this ICR rates the overall outcome as **satisfactory**

vii. Key lessons learned flow from the very special and difficult circumstances which confronted Nicaragua during program implementation. The lessons are not unexpected and have been learned in other adjustment operations, but they bear restating in the case of Nicaragua.

- The design of adjustment operations should be flexible. This is important under any circumstance, but proved critical in the case of Nicaragua where the Government had to deal with a highly polarized and confrontational political environment. The design of an adjustment program, especially in a difficult domestic environment, needs to consider the possibility that in the course of program implementation, the Government may decide on alternative means to meet program objectives.

- In countries with weak implementation capacity, a high degree of political polarization and weak democratic institutions, conditionality should focus on a few key priorities. From program identification to appraisal, trade-offs and priorities need to be intensively evaluated and discussed with the Government, as well as the IMF where structural reforms will be an integral part of an ESAF program.

- Where the political discussion in the country specifically questions the aims and rationale for the adjustment process, IDA should be prepared, at the request and with the express approval of the Government, to participate in the national dialogue. IDA's willingness to extend the dialogue on adjustment beyond the Administration and to engage in a dialogue with the opposition on the alternatives to adjustment proved invaluable in mitigating outright opposition to the reforms. Interestingly, the second episode of political impasse in Nicaragua no longer involved the adjustment process but focused instead on the relative powers between the Executive and Legislature.

- Reliance on quick-disbursing adjustment operations to support public sector reform, especially institutional restructuring is questionable. Easily monitorable measures such as employment reductions and privatization are amenable to adjustment conditionality, but the broader aim of modernizing and radically transforming institutional structures is not well suited to the scope and constraints inherent in adjustment operations. The inadequacy of the adjustment instrument is exacerbated in countries with weak institutional capacity.

- The one negative lesson that can be drawn from the ERC II experience involves the Bank's readiness to work with the Government on alternatives to the closure of BANADES. Although the strategy of containment proposed by the Government and accepted by IDA was appropriate at the time that ERC II was designed and approved, IDA might have been able to move more quickly and effectively when it started to become clear that the Government would need support in terms of designing a viable alternative to rural credit. It has only recently began the analytical work that can reach closure on alternatives to the traditional state development bank model for rural credit.

PART I: PROGRAM IMPLEMENTATION ASSESSMENT

Background

1. The Chamorro Government, which came to office in April 1990, designed a stabilization and structural adjustment program which received broad support from the donor community. Within this framework, IDA's first Economic Recovery Credit (ERC I) was approved in September 1991 and fully disbursed in June 1992.[1] Following successful completion of ERC I, IDA moved quickly to identify a follow-on operation, but the process was complicated by a deteriorating political situation in the second half of 1992 and in 1993. Splits emerged within the Government coalition and between it and the Sandinista party. In these circumstances, the Government found it difficult to carry forward the second phase of its stabilization and structural reform programs. Attempted fiscal measures were met with violent strikes and demonstrations leading to their withdrawal. GDP fell, inflation accelerated, reserves dropped, and aid flows were interrupted.

2. During 1993, the donor community, including IDA, continued a dialogue with the Government on the need to develop a national consensus, and offered to help in the process. Some bilateral donors offered their good offices to mediate the political conflict; IDA and the IMF participated in a round of discussions with key opposition and Government figures on the need to continue with the stabilization and adjustment effort. Partly as a result of these efforts, but also because of a growing realization that the confrontational politics of 1993 would lead to chaos, the political situation stabilized in the closing weeks of 1993 and then began to improve In this improved political climate, IDA and other donors moved quickly to assist the Government restart the stabilization and adjustment process.

A. Statement/Evaluation of Objectives

3. The Nicaragua Second Economic Recovery Credit (ERC II) for SDR42.5 million ($60 million equivalent) was approved by the Board of Directors on June 21, 1994, signed on June 22, 1994 and became effective on June 29, 1994. It consisted of three tranches, the first at effectiveness of $30 million and two tranches of $15 million each. ERC II was supplemented by an IDA Reflows credit of SDR5.36 million ($7.6 million) to be disbursed upon effectiveness. ERC II was co-financed by Japan with a $37 million credit. In addition, Germany provided parallel financing of $13.3 million, although it did not formally co-finance the IDA credit. ERC II supported measures to: (i) reform the State by reducing public employment, privatization and initiation of a comprehensive and longer-term public sector reform program; (ii) improve financial intermediation by increasing the efficiency of the public banks and strengthening prudential supervision; and (iii) improve incentives for private sector activity by increasing transparency, reducing protection, supporting resolution of property disputes and improving labor policies.

4. ERC II was designed to deepen the structural reforms supported under ERC I and allow the Government to carry out an orderly adjustment in response to the expected decline in aid levels, while establishing the conditions for a revival of private sector-led growth. The balance of payments support would allow the Government a more gradual and predictable economic adjustment path to reduced aid flows. The principal risks identified included: (i) a breakdown of the political consensus and strong opposition to some of the reforms, leading to a political impasse as had occurred in 1993; and (ii) the Government's weak institutional capacity, which could delay implementation of several components of the program

[1] The Project Completion Report (No. 14892) for the Economic Recovery Credit (Credit 2302-NI) was distributed to the Board on August 10, 1995

B. Achievement of Objectives

Macroeconomic Framework

5. ERC II was processed in parallel with an IMF ESAF arrangement. Major elements of the Government's program were outlined in the Policy Framework Paper covering 1994-97, presented to the Board in conjunction with ERC II. The ERC II President's Report also included the Country Assistance Strategy for Nicaragua.[2]

6. Macroeconomic conditions improved considerably during 1994. (Key economic indicators, actuals and projected, are presented in Table 2.) GDP expanded by 3.3 percent, inflation was reduced to 12.4 percent compared to 19.5 percent in 1993, and gross domestic investment increased by 5 percentage points of GDP to 25 percent The main area of disappointment in 1994 was the inability of the public sector to raise its savings, which at 1.8 percent of GDP remained basically unchanged and fell far short of the 1994 program target of 4 percent. The overall fiscal deficit increased from 8.8 percent of GDP in 1993 to 12.4 percent in 1994. The fiscal deterioration continued during the first three quarters of 1995, driven mainly by expenditure overruns and the poor performance of state enterprises, especially the power company which was affected by a severe drought. Also, net domestic assets exceeded the program targets due to a combination of shortfalls in external flows and Central Bank credit expansion to finance economic recovery. As a result, the IMF decided not to complete the mid-year review of the ESAF, scheduled for early 1995, and IDA delayed release of the second tranche of ERC II.

7. From mid-1995 the Government and the Fund worked on developing a set of corrective measures to bring the ESAF program back on track. A Staff-Monitored Program, which included monthly performance targets, was agreed in the last quarter of 1995. Performance under this program was satisfactory and 1995 ended up being an encouraging year for the economy, continuing the recovery that had begun in 1994. GDP expanded by 4.2 percent, merchandise exports continued to grow strongly, rising by 50 percent in dollar terms from the previous year, and inflation was reduced somewhat to 11.1 percent. Perhaps more impressive was the return to fiscal austerity in the last four months of 1995, which made it possible to achieve public savings of 4 percent of GDP for the year as a whole, exceeding the IMF target, and to lower the overall fiscal deficit somewhat. Based on this progress, IDA concluded that an appropriate macroeconomic framework was in place, which permitted release of the ERC II second tranche in February 1996

8. In the first quarter of 1996, the Government reached agreement with the Fund on targets for 1996. In the second quarter of 1996, the Fund advised that the Staff-Monitored Program remained on track, and IDA concluded that the macroeconomic framework was consistent with the objectives of the program and proceeded to approve release of the ERC II third tranche in June 1996. Economic performance in 1996 continued to improve. GDP grew by an impressive 5.5 percent (among the highest in Latin America), inflation was contained at 12 percent, and merchandise exports expanded by 27 percent in dollar terms. The Government's efforts to renegotiate its external debt, supported by IDA and other donors, produced a marked drop in total external debt outstanding, from $10.3 billion in 1995 to $6.1 billion in 1996

Reform of the State

9. ERC II aimed to continue supporting the process of state reform, initiated under ERC I, focusing on three key areas: (i) strengthening of the fiscal position by reducing public sector employment through a labor mobility program; (ii) continuation of the privatization process, covering most of the remaining nationalized enterprises and bringing private sector capital and management into the telecommunications sector; and (iii) laying the base and taking initial steps to begin a longer-term process to create an efficient, smaller and modern public sector.

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[2] Report No P-6430-NI, May 27, 1994.

10. **The Labor Mobility Program.** Prior to Board presentation, the Government prepared an action plan to reduce public sector employment by 13,569 positions over 1994-96, or about 13 percent of all public sector employees. These targets were to be achieved through attrition and voluntary retrenchments encouraged by a severance package. The program included safeguards to avoid rehiring and the loss of the more productive employees. IDA conditionality specified a reduction of 5,000 positions for second tranche and a cumulative reduction of 7,000 positions by third tranche. The lower IDA target was due to the fact that the Government's program would cover 30 months, whereas ERC II was designed to be implemented over 12-18 months. Rather than set detailed quarterly targets and in order to allow flexibility in the implementation of the labor reduction program, IDA chose the 7,000 figure to measure progress, which would roughly correspond to the mid-point in the labor mobility program. This inbuilt flexibility was also prompted by a desire to avoid the common perception which tends to associate public sector reform programs exclusively with labor retrenchments. This was felt to be especially important in the case of Nicaragua, given its still fragile political environment and serious unemployment problems.

11. The labor mobility program had a slow start. By February 1995, the originally projected date for second tranche release, the employment reduction was only about 1,150 The Government had found some problems with the original design of the severance arrangements, and therefore introduced modifications to attract more interest among potential candidates for voluntary separations and to make the program more effective in targeting the least needed positions. By the time of second tranche release early in 1996, the Government had clearly met the ERC II targets and was well on the way to meeting the 7,000 required for third tranche. Official figures show that from January 1994 to November 1996, public sector employment had fallen by 8,438 positions, of which 3,798 were in the Central Government and the rest in state enterprises.[3]

12. **The Privatization Program.** During the first phase of adjustment, CORNAP, a holding company was created and charged with the divestiture of 351 state enterprises, most of them nationalized during the Sandinista Administration. By the time of ERC II, CORNAP still held 72 enterprises, of which 33 had been brought to the point of sale by Board presentation. By second tranche, CORNAP was to have brought an additional 33 enterprises to the point of sale or closure. Although the objective was to complete the process initiated by CORNAP, ERC II left a cushion of 6 enterprises to allow some flexibility in meeting the conditions in the event that unforeseen legal problems delayed or impeded full divestiture. In addition, ERC II aimed to. (i) divest 9 out of 17 enterprises under the Ministry of Construction and Transport (MCT); (ii) divest two enterprises in the energy sector (ENIGAS and LUBNICA); (iii) bring to the point of sale 40 percent of the telecommunications company TELCOR, including the transfer of management control to the foreign partner; and (iii) bring to the point of sale some of the commercial operations of PETRONIC, the state petroleum company, including its gasoline distribution operations.

13. ***CORNAP, MCT and Energy.*** By Board presentation, the Government had divested 2 enterprises in the energy sector and 8 MCT enterprises, leaving only one additional MCT enterprise to divest by second tranche. By the time of third tranche release, IDA determined that of the 66 CORNAP enterprises to be divested, the Government had fully divested or closed 63 and had divested a majority interest in 3 others MCT had completed divestiture of 10 enterprises.

14. ***TELCOR.*** Although the privatization of TELCOR was mainly seen as a way of improving services and coverage, and to give a strong signal to foreign investors, the Government also saw it as an opportunity to help improve the property resolution process by making the compensation bonds more attractive. It planned to use part of the privatization proceeds to back the government bonds issued as

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[3] The total reduction would have been about 2,650 higher had the privatization of TELCOR taken place as planned.

compensation to owners of properties that could not be returned. As part of the reform program, the Government aimed to create a regulatory agency, able to supervise the new private sector operator.

15. At the time of appraisal, the TELCOR divestiture process was well advanced, with 9 reputable international companies having been pre-qualified. Progress continued until the third quarter of 1994, when the regulatory powers of TELCOR were transferred to a newly-created agency. At the same time ENITEL, the new service provider and company to be privatized, came into existence and had prepared drafts of all the bidding documents and the management concession. In the fourth quarter of 1994, the Government decided to send to the Assembly a new Telecommunications Law, to improve the regulatory framework. Although the existing legal framework permitted the privatization of TELCOR, it was obsolete and did not provide for a competitive regime for the future (after the end of the exclusivity period). Unfortunately, this privatization process came to a stand-still in late 1994, when the country was again engulfed in a political crisis, this time centered on proposed Constitutional amendments. During the following months Constitutional issues dominated the political agenda, until mid-1995 when a political agreement was reached which enabled enactment of selected amendments. Included in the constitutional changes was the provision that privatization of State assets would now require approval by the Assembly. The ENITEL privatization process resumed soon after the amendments came into effect. In July 1995, the Assembly passed the Telecommunications Law and in November 1995 the Law to Incorporate Individuals in the Operation and Expansion of Public Telecommunications Services (required under the reformed Constitution). The Government proceeded to advertise the sale of ENITEL (January 12 in The Financial Times and January 13 in The Economist) specifying the privatization process and the calendar to be followed. The announcement specified that the award notification would take place no later than June 10, 1996. On the basis of the new legal framework and the Government's public call for bids on the ENITEL privatization, IDA considered that the Government had complied with the condition of making progress in the implementation of the TELCOR Privatization Plan.

16. By the time of third tranche release, it was found that the process was further advanced and due diligence had been largely completed. Although at the time the opening of bids had been postponed to July, the Government maintained its commitment to proceed with the privatization process. Ultimately, the opening of bids was postponed a number of times, apparently at the request of a key bidder. Finally, on October 3 1996, rather than announcing the winner of the bidding process, the Government decided to postpone the sale of ENITEL shares due to the lack of substantial interest among potential foreign investors. The Government had been led to understand that there would in effect be only one bidder and its offer price would be extremely low. In retrospect, it appeared that investors considered that the Law to Incorporate Individuals in the Operation and Expansion of Telecommunications Services contained a number of onerous conditions, especially those related to investment obligations and labor flexibility. The fact that Presidential elections were imminent may also have played a role. Also, in the year of delay there was a noticeable change in the international climate, as new privatization opportunities were opening up and deregulation in the U.S. and Europe was, reportedly, leading major players to reassess their expansion plans in foreign markets. In the event, the Government felt it had no option but to leave the privatization process to the new Administration that would take office in early 1997.

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17 *PETRONIC.* The conditionality associated with PETRONIC was quite specific. At the time of appraisal, it was felt that the full privatization of the company was not politically feasible, because it had an import monopoly for hydrocarbons and was vested with regulatory functions for the sector. However, it was decided that the process could be advanced by partial privatization of some commercial activities of PETRONIC, especially its gasoline distribution operations. By the time of third tranche release, the Government had deregulated the gasoline market and private companies were in charge of the bulk of the distribution process. PETRONIC by then was playing a rather small role in gasoline distribution and the regulatory functions were vested in the National Energy Institute, independent of PETRONIC. Moreover, the Government proposed to proceed with the full privatization of PETRONIC and indicated that since under the modified Constitution even the partial privatization of PETRONIC would require legislative

approval, it preferred to seek Assembly approval for the full privatization of the company. IDA accepted that the full privatization of PETRONIC was preferable to the privatization of only gasoline distribution, and that given the Assembly's calendar, approval of the privatization would be lengthy and extend well beyond the life of ERC II. In March 1996, the Government submitted to the Assembly a Law for the Privatization of PETRONIC. On this basis, IDA agreed to seek a waiver to this condition for third tranche release.

18. **Public Sector Reform.** Because of the long-term nature of public sector reform, ERC II would concentrate on defining the process and the initial stages of implementation. It was understood that the process would have to be continued under a new Administration that would inevitably want some flexibility in defining its own public sector reform program. In addition, the Government recognized its weak institutional capacities and requested IDA technical assistance to bolster the capabilities of the management unit in charge of the design and coordination of the broad-based reform program. In March 1995, IDA approved an Institutional Development Credit ($23 million) to support the public sector reform effort which would continue beyond the life of ERC II.

19. As part of Board presentation conditions, the Government: (i) prepared a detailed policy statement outlining the overall State reform process and its broad elements, imbedded in its Letter of State Reform; and (ii) created the Project Management Unit within the Ministry of Finance (UCRESEP).

20. The PSRP got off to a good start. In October 1994, the Government issued Presidential Decree 94-44 establishing the goals and management structure for a 5-year reform program. The Decree created a high-level executive committee, CERAP, in charge of guiding the reform process. This initiated a process of negotiation with various Ministries, state agencies and other Government institutions, to reach agreements on detailed plans for institutional restructuring and a schedule for achieving specific goals. This effort provided a consistent direction for the reform program and helped with overall coordination of the various donor efforts that were supporting public sector reforms. By the time of second tranche, CERAP had signed the first Institutional Restructuring Agreement (ARI) with MCT and was making progress in the negotiation of several others. By the time of third tranche in mid-1996, CERAP had signed an additional ARI with the Social Security Institute. In addition, progress continued with the initiation of restructuring of several ministries and the drafting of key legislation, including the General Financial Management Law. Progress had been achieved in the design of a new civil service legal framework, including the proposed Senior Technical and Management Service, and initial steps to reform financial management practices, although implementation of the two ARIs was slower than expected. In particular, the procurement effort to hire the consulting teams to provide the technical assistance to implement the ARIs took much longer than anticipated, due largely to local inexperience with international procurement practices. On balance, however, IDA concluded that satisfactory progress was being achieved in the implementation of the overall public sector reform program.

Financial Sector Reform

21. The process of financial liberalization was well advanced at the conclusion of ERC I. Two important problems remained, however. Although private banks had quickly emerged, the financial system continued to be dominated by two large state banks, BANADES and BANIC. Under ERC I the Government had initially sought to transform BANADES into a small, pass-through agency, channeling externally-funded lines of credit, but the political obstacles to effectively closing BANADES proved formidable. It therefore opted for a strategy of reforming the state banks, with technical support from IDB for BANADES. Despite major recapitalizations and restructuring, these banks remained heavy money losers and continued to have dismal loan recovery rates.

22. The issue of what to do about the two state banks was extensively debated internally within IDA and with the Government. In addition, the problem was also discussed with the IMF, as the poor financial position of the banks posed a serious threat to the stabilization program under preparation. Within IDA

some held the view that, since the effort under ERC I to reform the two banks, especially BANADES, had not worked, ERC II should either seek the divestiture of the two banks (through closure or, if feasible, privatization), or steer clear from the issue. The Government had taken the position that while it recognized the inefficiency of the banks and the threat to the stabilization program, it felt it could not master the needed support for their closure/privatization. This was due to two reasons: (i) politically it could not push for the closure of the banks, especially BANADES which was the more serious problem, because it carried too much weight in the banking system; and (ii) the Constitution specifically required the Government to guarantee the existence of state banks. The legal interpretation of the Constitutional requirement was not entirely clear, but the Government felt any attempt to divest itself of the banks would leave it open to a Constitutional challenge.

23. Instead, the Government proposed to keep the two banks under close monitoring to avoid major expansion, while allowing private banks to grow. As private banking expanded, the state banks would become increasingly marginal, eventually making it politically easier to close or privatize. In the end, IDA took the position that while ERC II could not achieve a lasting solution to the state bank problem, it would support the Government's strategy of containment, provided that there would be no recapitalization of the state banks with public money or revaluation of assets and that the state banks would be subject to the prudential norms issued by the Superintendency. It was felt that this would provide some breathing space while the legal issues were clarified and other options explored (such as the partial privatization of BANIC). In addition, ERC II required the implementation of an action plan to strengthen prudential supervision, including issuing revised prudential norms on capital adequacy, portfolio classification and portfolio concentration.

24. No efforts were made to recapitalize the two state banks, but BANADES and BANIC continued to have serious loan recovery problems. External audits confirmed that the need to make loan-loss provisions made them effectively insolvent. The Superintendency of the Financial System (SBFI) monitored these institutions effectively, but since neither the option of recapitalization or outright closure due to bankruptcy was available, it had no option but to exempt the state banks from prudential norms for two and a half years. At the same time the two banks were put under restructuring programs monitored by SBFI and agreed with IDA, IDB and the IMF The restructuring programs tried to make progress beyond IDA's containment strategy with two key aims in mind: (i) substantially downsizing BANADES, leaving it as a very small financial intermediary focused only on small-scale farmers; and (ii) privatize BANIC through a capital increase from private investors, who would also have operating control of the bank. As a first step in this process, in early 1996 non-performing assets in the two banks (nearly 40 percent of their portfolios) were transferred to a newly-created collection agency (COBANICSA). The further downsizing of BANADES and the actual privatization of BANIC were to be supported through a proposed Public Sector Reform Credit (PSRC) which IDA had began preparing as a follow-on to ERC II. As the elections approached both the proposed PSRC and the state bank reform program were postponed.

25. Toward the end of the ERC II period, the Government began raising the issue of alternative credit delivery systems to reach small-scale farmers. It argued that it could not solve the BANADES problem unless it could put in place an alternative rural credit scheme targeted on small-scale farmers. IDA responded by: (i) organizing a local workshop to explore rural credit options in early 1995; and (ii) preparing a rural credit pilot program under the ongoing Land Management and Agricultural Technology Project.

26 SBFI has played a key role in improving the prudential supervision of the financial system. Its supervisory functions have been extended to cover the stock exchange and insurance companies. A General Banking Law is currently before the Assembly, which would replace the old legislation dating to the 1960s, and would further strengthen SBFI's supervisory and regulatory functions. Despite this progress, much remains to be done to strengthen SBFI and prudential supervision in Nicaragua.

Private Sector Development

27. There were four main objectives under the private sector development component: (i) resolution of property rights disputes, in order to improve security of land tenure and the private sector climate; (ii) provision of a more stable and transparent policy environment for the private sector, by reducing ministerial discretionality in changing tax and fiscal policies and the creation of new commercial enterprises; (iii) promotion of export growth and efficient import substitution, by reducing the level and dispersion of nominal protection and creating a more transparent and effective export incentive system; and (iv) promotion of greater labor productivity by ensuring flexibility in the operation of the labor market.

28. **Property Rights.** The long-standing problem of inadequate property rights guarantees in Nicaragua, which was exacerbated during the Sandinista Administration, presented the Chamorro Government with a very complicated problem. In 1992, following a major information gathering effort, a comprehensive administrative procedure to address property disputes was established. The National Review Commission was created to review claims by previously confiscated owners and to recommend equitable solutions, and the Office of Territorial Ordering was established to review the legitimacy of property assignments during the transitional period between February and April of 1990. Also, the Government created the Office of Quantification of Compensation, to determine just compensation amounts for those whose properties could not be returned. This scheme, which provided compensation via dollar-indexed government bonds, was intended as a faster administrative solution and not as a replacement for legal recourse, which remained an option for claimants

29. By end 1993, the Government had made significant inroads in the resolution of property disputes but the problem remained large. At the time of appraisal, it was estimated that there were about 5,400 claimants involving more than 16,000 disputed properties. The problem was exacerbated by the fact that a large number of disputes involved U.S. citizens. Although IDA recognized the critical importance of resolving the property issue in Nicaragua, because of the domestic and international politicization of the issue, it was felt that specific conditionality and targets on the resolution of disputed cases would be counterproductive and would merely add to its politicization.[4] Instead, ERC II supported the process through: (i) the establishment of a mechanism at the Ministry of Finance to carry out random inspections to verify compliance with adopted procedures to resolve property conflicts, and to report deviations for their correction; and (ii) the commissioning of a study to analyze potential new uses for the compensation bonds, which could raise their value in secondary markets and thus be more attractive for claimants whose property could not be returned Actions expected before releasing the second tranche were a satisfactory implementation of the verification process and the completion of the study on potential uses for the compensation bonds. The third tranche was made contingent on having implemented the recommendations agreed on in the context of the study.

30. There was substantial progress made on both topics during program implementation. A new Vice-Ministry was created in the Ministry of Finance exclusively in charge of addressing problems related to property conflicts and disputes, including a unit to carry out the inspections agreed in ERC II. UNDP, IDB and other donors supported the random inspection scheme. The Government actually commissioned two studies to enhance the value of the bonds, which provided the basis for the *Ley Especial de Valorización de Bonos de Pago por Indemnización*, approved by the Assembly in July 1994.

31. As a result of this Law, the maturity of the compensation bonds was reduced from 20 to 15 years, their interest rate increased and uses extended, so that they could be used also as guarantees in public works contracting and collateral for bank loans, and as means of payment for settling liabilities with the tax office and state enterprises. Despite the new enhancements, the compensation bonds rose only moderately in price in the secondary market after the passage of the new legislation, so further ways to increase their

4 The Government, however, included its own targets in its Letter of Development Policy.

market attraction were sought by the Government.[5] Thus, in the context of the ENITEL privatization, the Government decided that part of the privatization proceeds would be used to buy zero-coupon U.S. Treasury bonds to back the compensation bonds. This would place the compensation bonds in the category of "Brady bonds", a class of heavily traded instruments in the international financial market today.

32. As of October 1996, the Government had issued the equivalent of $501 million in compensation bonds, of which $120.5 million, or 24 percent of the total, had been redeemed by bondholders through the various options open to them. A significant portion of today's outstanding compensation bonds are held as part of the portfolios of international investors. Although not a condition in ERC II, the Government also made substantial progress in the resolution of actual property right disputes. At the end of October 1996, 90.8 percent of the disputes involving agricultural land were settled, 94.6 per cent of those involving family homes, and 88.3 percent of those disputes related to just home sites. Of the politically sensitive 2,293 cases involving properties of U.S. citizens, Government figures for October 1996 showed that only 573 cases remained unresolved, with a total claim value of $51 million.

33. **Discretion in Economic Policy.** In Nicaragua, the President had ample discretionary powers to change taxes and regulations. At the time of program design, the President had delegated many of these powers to the Ministerial level in an effort to facilitate and expedite the policy and incentive changes required to eliminate the policy-induced distortions inherited from the Sandinista era. However, this was causing significant uncertainty in the private sector, as the discretionality and lack of transparency was undermining investor confidence. In order to improve the business climate and ensure that there was a level and transparent playing field for the private sector, it was agreed that it was time to sharply reduce the discretionary powers vested in the different Ministries Thus, as a Board condition, it was agreed that: (i) to be legally binding, any changes in tax and fiscal policies had to be published in the Official Gazette, except in cases of *force majeure*, in which event it had to be published in at least one daily newspaper of broad circulation, (ii) the powers of Ministries and government agencies to change tax and fiscal policies were abrogated, and simultaneously elevated to the Presidency; and (iii) the powers of Ministries and government agencies to create new commercial enterprises were eliminated. These policy changes have been maintained contributing to increased transparency and an improved business climate. Furthermore, the Constitutional amendment of 1995 vested in the Assembly most of the powers until then held by the Executive on tax matters.

34. **Trade Reform.** Trade liberalization and lower protection was at the core of the Government's program of structural reform supported by ERC I. Although substantial advances were made to reduce nominal protection and render it more uniform, at the time of ERC II appraisal the level and dispersion of tariff rates remained high. The rate of import protection at the time, including tariffs and specific import consumption taxes, ranged between 10 and 40 percent, with a few exceptions below 10 percent. Virtually all trade-related non-tariff barriers had already been abolished. Nonetheless, the pace of advance had been slower than that promised by the Government in the Letter of Development Policy agreed for ERC I where the maximum nominal rate of import protection was set at 20 percent. During this time, Nicaragua had agreed with its partners in the Central American Common Market (CACM) on a slower pace of tariff adjustments, setting the longer-term objective of a maximum tariff of 20 percent for year-end 1999. IDA accepted the program agreed under CACM.

35. Another source of concern at the time of appraisal was the temporary export promotion mechanism introduced in 1991 and modified in 1992. The scheme established tariff exemptions on inputs and capital goods for all exporters, and a generous package of income tax relief plus direct subsidies in the form of tax-rebate certificates for non-traditional exporters. The 1992 amendment to the export scheme had

[5] Today, the discount rate implicit in the market value of the compensation bonds appears reasonably in line with the interest rates paid on similar-risk dollar-indexed financial instruments in Nicaragua. This suggests that to further increase the value of the compensation bonds, alternative options that actually reduce Nicaraguan risk have to be explored.

extended the timetable of benefits for non-traditional exporters, which gradually diminished through 1997, to be discontinued at the end of that year.

36. ERC II sought to make further progress in promoting export growth and efficient import substitution through a reduction in the level and dispersion of nominal protection, and by creating a more transparent and effective export incentive system. More specifically, the Government agreed that before Board presentation it would approve a satisfactory phased tariff reduction program reaching an all-inclusive nominal protection ceiling of 37 percent by mid-1995 and 20 percent by 1999. This condition was met by Decree 24-90 of May 1994, which specified a calendar of tariff reductions in line with the program agreed with CACM. The next set of actions by the Government included two conditions for third tranche release: (i) satisfactory progress in implementing the import tariff reduction program, in particular achieving a nominal protection ceiling of 37 percent (except for 8 products referred to as the fiscal industries, which accounted for a large share of fiscal revenues); and (ii) preparation of an action plan to replace the existing export promotion mechanism, either by a duty drawback system or a temporary admission regime.

37. In January 1996 the Government reduced the nominal protection ceiling on imports to 35 percent, except for the 8 fiscal industry products. It thus met the first part of third tranche conditionality. As to the duty drawback system and the temporary admission regime, the Government studied and rejected them as practical alternatives to promote non-traditional exports. It estimated that it lacked the capacity and could not afford the costs of administering such systems. Instead, it opted for the simpler strategy of drastically lowering tariffs on inputs. As a general rule, inputs are subject to a 5 percent stamp tax plus a 5 percent import tariff, the latter only for those coming from outside the CACM. The Government sent tax reform legislation to the Assembly in 1996, including a provision to lower these tariffs to 1 percent, but failed to gain approval. In May 1997, however, the current Administration succeeded in passing a new tax package, including the proposed trade reforms.

38. The expansion of Nicaraguan exports has been substantial in the last few years. They went up in value from some $267 million in 1993 to an estimated $635 million in 1996, the period covered by ERC II. The growth of non-traditional exports has been the most impressive, as illustrated by last year's performance, when they accounted for some 47 percent of the total, after having a net gain over 1995 of about $104 million.

39. **Labor Market Reform.** While faster output growth was considered essential to address unemployment and underemployment, the Government sought also to promote greater labor productivity and more flexible labor markets. The Labor Code in effect at the time of ERC II appraisal was not unduly restrictive, but modifications had been under discussion in the Assembly for some time. The Government felt that some of the proposals being made could result in an extension of troubling privileges already enjoyed by a small segment of the labor force, comprising mainly workers in the public sector and some of the newly-privatized state enterprises. If enacted, it was felt that the changes could seriously jeopardize the structural reform effort, by imposing stronger rigidities on labor mobility and making it more difficult for private firms to compete at an international level. The Government and IDA agreed that a more modern Labor Code would be needed in the future but that this was not the time to initiate what would be a politically-difficult process. The Government was prepared to veto any modifications of the existing Labor Code that went in that direction, in particular those changes that imposed excessive restrictions on the ability of employers to hire or fire employees. In this context, the Government wanted to have the backing of IDA. To that end, it was agreed that the Government prior to Board presentation would prepare a detailed Letter of Labor Policy stating the policy and objectives concerning the functioning of labor markets in Nicaragua. Compliance with this Policy Letter was made a condition for all tranche releases.

40. On October 1994, the National Assembly approved a new Labor Code containing provisions that the Executive opposed, so in January of 1995 it proceeded to partially veto the proposed legislation. The

main concern was that the changes would lead to a deterioration in labor-employer relations and growing rigidities in the labor market. Several months of negotiations followed until a compromise was reached among all interested parties. The new Labor Code was published in the National Gazette at the end of October 1996. As a result of the negotiations, some of the concepts in the new Labor Code do not totally agree with those contained in the Letter of Labor Policy, but by and large Nicaragua now has a modern body of labor legislation in place. Unemployment, although still high, has fallen steadily, from 20.4 percent in 1993 to 16.1 percent in 1996.

C. Major Factors Affecting the Program

41. The President's Report recognized that an important risk for implementation of ERC II was a breakdown of the political consensus, although it foresaw this as coming from opposition to the reform program. The risk proved real but it emerged from an unexpected quarter. In February 1995, the Assembly approved a set of Constitutional reforms which essentially aimed to redraw the balance of power between the Executive and the Legislature The Executive opposed the reforms and refused to promulgate them. The Assembly published the Constitutional amendments but the Executive did not recognize them and maintained that the old Constitution remained in force. Over the next four months, the country was enmeshed in a full-blown Constitutional crisis, which dominated the Government's attention. A negotiated settlement was reached in the third quarter of 1995 and important Constitutional amendments were enacted. The political crisis and its aftermath had two important effects on ERC II. First, the political impasse delayed overall program implementation as the Government attempted to resolve the Constitutional crisis. Second, one of the amendments specified that privatization of State assets would now require approval by the Legislature. As explained above, this new requirement affected the privatization of ENITEL and PETRONIC.

D. Program Sustainability

42. Program sustainability is considered **likely**. This assessment is based on IDA's preliminary discussions with the new Administration. The Government has indicated broad agreement with the structural reforms supported by ERC II and its interest in deepening the adjustment process A key component of the Government's reform program will be public sector reform and our current policy dialogue is focusing on the design of the reform program and further efforts to reduce the size of the State. As a first step, UCRESEP has been placed under the Vice-President's Office to give the process increased political backing. The Government has also announced continuation of the Labor Mobility Program targeting the elimination of at least 3,000 positions during the rest of 1997. Our dialogue on the financial sector has concentrated on the issue of the state banks, with the Government having agreed to close BANADES and proceed with a partial privatization of BANIC. In addition, IDA is working with the Government on design of an alternative rural credit scheme that would substitute for the role of BANADES. In the area of privatization, the Government has requested technical assistance from IDA in order to redesign the ENITEL privatization process and get it back on track. The Government has indicated it supports the privatization of PETRONIC, while also stating its intention to proceed with privatization or concessioning of ports and to attract private participation in the power sector. In terms of import tariffs, the Assembly recently passed legislation to reduce the tariff ceiling to 10 percent by end-1999. IDA is continuing discussions on a follow-on adjustment operation to support the Government's reform program.

E. IDA Performance

43 IDA's overall performance is considered **satisfactory**. IDA moved quickly after ERC I with the identification of a follow-on operation. Although political events delayed preparation of ERC II, IDA maintained the focus on the new operation and was thus ready to move quickly as soon as the political impasse was resolved. IDA performance during identification, preparation and appraisal was satisfactory,

as it carefully evaluated options with the Government, IMF and other donors, and appropriately focused on the issues that appeared as priorities for Nicaragua at the time. Drawing lessons from recent adjustment operations in the Region, it avoided the temptation to overload ERC II with an excessive number of detailed conditions and exercised considerable flexibility in assessing overall compliance with program objectives. Performance in supervision was also satisfactory with appropriate staffing and effort. The one weakness in IDA's performance relates to the issue of the state banks. Although the concern over the design of alternative rural credit systems did not emerge until after ERC II had been approved, IDA could have either: (i) foreseen the issue; or (ii) once it emerged, taken a more pro-active stance to assist the Government. While agreeing to the Government's containment strategy, IDA could have also moved in parallel through ESW to assist the Government design an alternative rural credit system.

F. Borrower Performance

44. Borrower performance is considered **satisfactory**. Preparation work involved close collaboration with IDA and a strong commitment to the continuation of the adjustment program initiated under ERC I. Despite considerable political volatility, a difficult external environment and weak implementation capacity, the Borrower maintained a commendably strong commitment throughout program implementation. Covenant compliance was also satisfactory. The waiver for the partial privatization of PETRONIC resulted from a Government decision to aim instead for full privatization. The failure to complete the privatization of ENITEL was in large measure due to factors beyond the Government's control.

G. Assessment of Outcome

45. The overall outcome of the reform program supported by ERC II is considered **satisfactory**. The economy has recovered strongly during the ERC II implementation period Noteworthy is the strong economic growth following the stagnation of the early 1990s, the continuing export recovery with high growth of non-traditional exports, the improved business environment and the sharp fall in Nicaragua's massive external debt. Although the country's stabilization and adjustment agenda remains formidable, the economy is in far better shape today than at the end of 1993, when many in IDA and the donor community despaired over Nicaragua's development prospects.

H. Future Operation

46. Following completion of ERC II, IDA and the Government identified a one tranche adjustment operation (PSRC) focusing on public sector reform and the state banks. Although during the first half of 1996 the Government advanced considerably in preparation of this operation—including draft legislation to reform the tax system, further steps to deepen the public sector modernization process, establishment of a collection agency to recover arrears in the state banks and a detailed plan for the partial privatization of BANIC—the plans were overtaken by the proximity of the general elections in late 1996. In particular, approval of the Government's proposed tax package, which was supported by the proposed PSRC and was a key element for a reactivation of the Fund's ESAF program, was held up in the Assembly. As mentioned above, IDA is currently preparing a new adjustment operation with the current Administration, which will likely focus on public sector reform, state banks and further measures to improve the business climate

I. Key Lessons Learned

47. Key lessons learned flow from the very special and difficult circumstances which confronted Nicaragua during program implementation. The lessons are not unexpected and have been learned in other adjustment operations, but they bear restating in the case of Nicaragua.

- The design of adjustment operations should be flexible. This is important under any circumstance, but proved critical in the case of Nicaragua where the Government had to deal with a highly polarized and confrontational political environment. The design of an adjustment program, especially in a difficult domestic environment, needs to consider the possibility that in the course of program implementation, the Government may decide on alternative means to meet program objectives.

- In countries with weak implementation capacity, a high degree of political polarization and weak democratic institutions, conditionality should focus on a few key priorities. From program identification to appraisal, trade-offs and priorities need to be intensively evaluated and discussed with the Government, as well as the IMF where structural reforms will be an integral part of an ESAF program.

- Where the political discussion in the country specifically questions the aims and rationale for the adjustment process, IDA should be prepared, at the request and with the express approval of the Government, to participate in the national dialogue. IDA's willingness to extend the dialogue on adjustment beyond the Administration and to engage in a dialogue with the opposition on the alternatives to adjustment proved invaluable in mitigating outright opposition to the reforms. Interestingly, the second episode of political impasse in Nicaragua no longer involved the adjustment process but focused instead on the relative powers between the Executive and Legislature.

- Reliance on quick-disbursing adjustment operations to support public sector reform, especially institutional restructuring is questionable. Easily monitorable measures such as employment reductions and privatization are amenable to adjustment conditionality, but the broader aim of modernizing and radically transforming institutional structures is not well suited to the scope and constraints inherent in adjustment operations. The inadequacy of the adjustment instrument is exacerbated in countries with weak institutional capacity.

- The one negative lesson that can be drawn from the ERC II experience involves the Bank's readiness to work with the Government on alternatives to the closure of BANADES. Although the strategy of containment proposed by the Government and accepted by IDA was appropriate at the time that ERC II was designed and approved, IDA might have been able to move more quickly and effectively when it started to become clear that the Government would need support in terms of designing a viable alternative to rural credit. IDA has only recently began the analytical work that can reach closure on alternatives to the traditional state development bank model for rural credit.

PART II: STATISTICAL TABLES

Table 1: Summary of Assessments

A. Achievement of objectives	Substantial	Partial	Negligible	Not applicable
Macro policies		✓		
Sector policies		✓		
Financial objectives				✓
Institutional development		✓		
Physical objectives				✓
Poverty reduction				✓
Gender issues				✓
Other social objectives				✓
Environmental objectives				✓
Public sector management		✓		
Private sector development	✓			

B. Program sustainability	Likely	Unlikely	Uncertain
	✓		

C. Bank performance	Highly satisfactory	Satisfactory	Deficient
Identification		✓	
Preparation assistance		✓	
Appraisal		✓	
Supervision		✓	

D. Borrower performance	Highly satisfactory	Satisfactory	Deficient
Preparation		✓	
Implementation		✓	
Covenant compliance		✓	

E. Assessment of outcome	Highly satisfactory	Satisfactory	Unsatisfactory	Highly unsatisfactory
		✓		

Table 2: Key Economic Indicators: Projected and Actuals, 1990-96

	Actuals				ERC II	Actual	ERC II	Actual	ERC II	Actual
	1990	1991	1992	1993	1994	1994	1995	1995	1996	1996
GDP Growth (%)	-0 1	-0 2	0 4	-0 2	2.0	3.3	3 0	4.2	4.5	5.5
Inflation (end year, %)	13,500	866	3 5	19 5	10.0	12 4	7.7	11 1	6.0	12.1
Gross Dom. Investment[1]	19 3	20 1	18.0	20 2	21.5	25 0	21.4	26 9	21.2	27 6
o/w Private[1]	18 0	13 1	9 7	9 0	11.1	10.4	10.6	10 6	10.1	13.4
Overall Fiscal Balance[2]	-29 4	-7 7	-8 4	-8 8	-8 8	-12 4	-6.8	-11.1	-6.3	-13.4
Current Account Balance[2]	-35 6	-48 9	-59 3	-48 0	-48.1	-54 0	-33 2	-37 5	-32.9	-32 5
Exports[3]	330 6	272 4	223 1	267 0	291 0	351 2	330.0	526 4	368.3	670 1
Imports[3]	567 4	668 6	771 2	668 4	658 0	783 8	690.0	865 0	714.0	1023 8
Ext Debt Outstanding[4]	10 7	10 7	11 1	10 5	12 6	11 0	12 4	10 3	12.7	6.1

Projections are form the President's Report
1 As a share of GDP
2 As a share of GDP, excluding grants
3 Merchandise
4 Billions of US$

Table 3: Related IDA Credits

Credits	Purpose	Amount (SDR m)	Year of Approval	Status (03/18/97)
ERC I (2302)	Support the Government's structural adjustment program	83 5	09/26/91	Completed
Institutional Development Credit (2690)	Improvement in delivery of public services and increasing public savings	15.7	03/16/95	Ongoing

✓ ### Table 4: Program Timetable

Steps in Program Cycle	Date Planned	Actual Dates
Identification (Initial Executive Project Summary)	01/15/93	01/15/93
Preparation	03/05/93	03/15/93
Appraisal	06/03/93	04/04/94
Negotiations	na	07/23-25/94
Board Presentation	na	06/21/94
Signing	na	06/22/94
Effectiveness	na	06/29/94
Credit closing	na	06/30/96

na: not available in project files

Table 5: Program Financing

Sources	Appraisal estimate (US$m)	Actual (US$m)
IDA credit	60 0	61.7
IDA reflows	7 6	19.9
OECF (Japan)	60 0	37.0[1]
KfW (Germany)	12 0	13.3[2]
Government of Sweden	9.0	--
Government of Switzerland	6.0	--
Total	154.6	131 9

1 Cofinancing
2 Parallel financing

Table 6.a: Credit Disbursements (US$ million)

	FY95	FY96	FY97
Appraisal estimate			
• Annual	52.6	15.0	0.0
• Cumulative	52 6	67.5	0.0
Actual disbursements			
• Annual	31.0	30.7	0.0
• Cumulative	31.0	61 7	61.7
IDA Reflows actuals	7.9	6.4	5 6

Table 6.b: ERC II IDA Disbursement Profile

	ERC II (26310)	FY94 Reflows (26311)	FY95 Reflows (26312)	FY96 Reflows (26313)	Total
Original	**60.0**	**7.6**	**6.3**	**5.8**	**79.7**
FY95	**31.0**	**7.9**	**0.0**	**0.0**	**38.9**
7/94	19.9				19.9
9/94	10.6	7.8			18.4
10/94	0 4	0.1			0 4
11/94	0.2				0.2
FY96	**30.7**	**0.0**	**6.4**	**0.0**	**37.1**
2/96	15.3		6.3		21.6
3/96	0.1		0.1		0.3
6/96	15.3				15.3
FY97	**0.0**	**0.0**	**0.0**	**5.6**	**5.6**
11/96				5.6	5.6
TOTAL	**61.7**	**7.9**	**6.4**	**5.6**	**81.6**

Table 7: Dates of Tranche Disbursements

Tranche	Date
First	6/94
Second	2/96
Third	6/96

Table 8: Studies Included in the Program

Study	Purpose	Comments
Additional enhancements for Compensation Bonds issued to resolve outstanding property disputes between the private and public sector.	Analysis of mechanisms that could render the Compensation Bonds more attractive to holders without jeopardizing fiscal stability	Two studies were completed; recommendations were used to prepare legislation that improved the term and conditions of the Compensation Bonds as well as their use to settle fiscal obligations of the private sector.

Table 9: Status of Covenants and Conditionality

Agree-ment Section	Covenant/ Conditionality Type	Description	Present Status	Fulfill-ment Date	Comments
1.01 (b)	General condition	Evaluation report by the Borrower on the Program's execution	C	4/23/97	Report due no later than 6 months after the Closing Date.
3 03 (b)	Accounts/ audits	Furnish externally audited reports not later than 4 months after the end of each FY or not later than 90 days after the last withdrawal in connection with the expenditures financed out of the proceeds of each tranche.	C	First tranche report: 6/23/97	There was an Amendment to the Credit Agreement that made the delivery of the externally audited report for the second and third tranches contingent on a specific request by the Association, which IDA has chosen not to exercise.
Schedule 1	Macroecono-mic policy conditionality	The macroeconomic policy framework of the Borrower is consistent with the objectives of the Program.	CD	Condition to be fulfilled at the time of each disburse-ment	Significant policy slippages in the macroeconomic program during the last quarter of 1994 and the first half of 1995 Then, after some months of satisfactory performance, substantial deviations from the macroeconomic targets re-emerged in mid-1996 on.
Schedule 3, Part A (1)	Sector policy conditionality adm /budgetary /allocative change	The Borrower shall have made progress in the implementation of the Labor Mobility Program (LMP).	CD	Second tranche condition.	Initial delays in reducing the number of positions due to the postponed privatization of TELCOR and the need to enhance the LMP's incentive package to attract potential beneficiaries.
Schedule 3, Part A (2)	Divestiture of state enterprises	The Borrower shall have brought to the point of sale, offered for lease or ceased the operations of at least 33 of CORNAP's enterprises, 1 MCT enterprise and have made progress in the privatization of TELCOR	CD	Second tranche condition.	CORNAP divested or closed 63 enterprises, sold its majority interest in another 3 enterprises and completed the privatization 2 MCT enterprises Initially there were delays in the privatization program of TELCOR due to changes in the Constitution that made its privatization contingent on a law, rather than on a decree, as originally planned by the Government Although the Government took the privatization of TELCOR to the point of sale, the programmed privatization failed to materialize.
Schedule 3, Part A (3)	Sector policy conditionality adm./budgetary /allocative change	The Borrower shall have prepared and commenced implementation of the Public Sector Reform Program	C	Second tranche condition.	Decree 94-44 of October 1994 established the goals and management structure for a comprehensive 5-year public sector reform program.
Schedule 3, Part A (4)	Sector policy conditionality. regulatory change	The Borrower shall have made progress in the implementation of the action plan to improve prudential supervision of the financial system.	C	Second tranche condition	Emphasis of the action plan was on. (a) introduction of a new charts of accounts; (b) design of a centralized MIS on debtors; (c) inclusion of FNI and INISER in the Superintendency's inspection plan; and (d) higher penalties for non-compliance with prudential norms.
Schedule 3,	Sector policy conditionality:	The Borrower shall have made progress in the	C	Second tranche	This program included: (a) the creation of a Vice Ministry at the

PSD

PSD

Agreement Section	Covenant/ Conditionality Type	Description	Present Status	Fulfillment Date	Comments
Part A (5)	allocative change	implementation of the Property Rights Improvement Program.		condition.	MIFIN to address property-related issues; (b) 2 studies to prepare legislation (enacted 7/94) to enhance the value of the Compensation Bonds, and (c) cumulative targets for resolving property cases over time
Schedule 3, Part B (1)	Sector policy conditionality. adm /budgetary / allocative change	The Borrower shall have made further progress in the implementation of the Labor Mobility Program (LMP)	C	Third tranche condition.	A cumulative elimination of 7,000 positions was deemed satisfactory for third tranche release. Actual reductions reached 7,432 positions.
Schedule 3, Part B (2)	Divestiture of state enterprises	The Borrower shall have: (a) offered for sale or lease, or liquidated all but 6 of CORNAP's enterprises and all but 8 of MCT's enterprises, (b) discontinued PETRONIC's gasoline distribution operations, and (c) defined the regulatory functions, if any, of PETRONIC	CP	Third tranche condition	Under the Project, CORNAP divested or closed 63 enterprises Also, it sold its majority interest in another 3 enterprises in which maintained only minority equity positions MCT completed the divestiture of 10 enterprises Since gasoline distribution by PETRONIC continued beyond third tranche release a waiver was granted. Currently, PETRONIC still is in Government's hands, but it has no regulatory functions

Agree-ment Section	Covenant Type	Description	Present Status	Fulfill-ment Date	Comments
Schedule 3, Part B (3)	Sector policy conditionality. adm /budgetary /allocative change	The Borrower shall have made progress in the implementation of the Public Sector Reform Program including, in particular, the restructuring of at least two major public institutions	C	Third tranche condition	Two Institutional Restructuring Agreements (ARIs) were signed (between CERAP and MCT and ISS), the implementation of the agreed action plans is underway. Credit 2690-NI is currently providing financing to carry out the implementation of ARIs.
Schedule 3, Part B (4)	Sector policy conditionality. regulatory change	The Borrower shall have made further progress in the implementation of the action plan to improve prudential supervision.	C	Third tranche condition.	Three actions were taken: (a) the new chart of accounts was adopted by all private banks; (b) the centralized risk management system run by the Superintendency of Banks became operational; and (c) the Superintendency of Banks was designated by decree as the regulatory agency of the Nicaraguan Stock Exchange. Compliance of state banks with prudential regulations remains unsatisfactory and they do not follow the adopted accounting principles.
PSD* Schedule 3, Part B (5)	Sector policy conditionality· allocative change	The Borrower shall have made further progress in the implementation of the Property Rights Improvement Program.	C	Third tranche condition	The Government succeeded in substantially meeting its cumulative targets for resolving property cases through administrative means, although for a minority of claims a final resolution remains to be found.
PSD* Schedule 3, Part B (6)	Sector policy conditionality. adm./budgetary /allocative change	The Borrower shall have made progress in the implementation of the Tariff Reduction Program and shall have prepared a satisfactory action plan for the replacement of its export promotion scheme by an another regime satisfactory to the Association.	C	Third tranche condition.	The Government implemented the import tariff reduction program as expected and approved a satisfactory action plan to phase out the fiscal incentives provided to non-traditional exporters by end-1997. It determined that a duty drawback system or temporary admission regime would be too complex to administer, and instead proposed a simpler strategy of lowering tariffs on inputs. This alternative approach was found acceptable by IDA.

<u>Present status.</u>
C = complied with
CD = complied with after delay
CP = complied with partially

Table 9: Missions

Stage of Project cycle	Month/ year	No. of persons	Days in field	Specialized staff skills represented [2]	Performance rating [1] Implement. Status	Develop. objectives	Problem Types
Through appraisal	06/92 05/93 07/93 03/94	6 12 3 9	14 12 5 9	i (2),j,k,l a,e,i(2),n,o,q,r,s,t,u c,i,m a,b(2),e(2),i,n,o,p			
Appraisal through Board approval							
Board approval through effectiveness					S	S	
Supervision	04/94 03/95 03/96	5 5 2	12.3	a,b,c,d,e a,b,c,f,g h,i	S S S	S S S	
Completion	12/96	0 2	0 2				

1 Performance rating as shown in Supervision Form 590
2. Key to Specialized Staff Skills

a Lead Economist
b Financial Economist
c Banking Specialist
d Lawyer
f Public Sector Specialist
g Telecommunications Specialist
h Country Economist
i Economist
j Mining Specialist
k Energy Specialist
l Water and Sewerage Specialist
m Financial Sector Specialist
n Privatization Specialist
p Resident Representative
q Taxation, Public Enterp , Natural Res. Specialist
r Property Rights Specialist
s Export Development Specialist
t Country Analyst
u Country Officer

Table 10: Bank Resources: Staff Inputs

Stage of project cycle	Actual	
	Staff Weeks	US$'000
Through appraisal	68.9	185.1
Appraisal-Board	1.1	2.2
Board-effectiveness	7.3	23.8
Supervision[1]	20.0	67.7
Completion	4 0	19.1
TOTAL	101.3	297.9

[1] Task management of ERC II was performed by the Bank's Resident Representative in Nicaragua The 20SW figure refers mainly to inputs of others, and likely understates the intensity of supervision.

ANNEX A

Government Evaluation of the Second Economic Recovery Program (ERC II)

Annex A presents an unedited translation of the Government's evaluation of the Second Economic Recovery Credit. The Government evaluation was prepared by the Ministry of Finance and also included a table of selected economic indicators (Annex I) and a matrix showing the results of the adjustment program (Annex II)

Managua, April 23, 1997

Ministry of Finance
The Minister's Office

Re: Assessment of the Second Economic Recovery Program (ERC II)

During the last six years, Nicaragua has made significant progress in the stabilization and structural reform process with the aid of the international economic community. With this support, the deficit of the balance of payments was eliminated and economic and social projects and programs were developed. In this context, the Government of Nicaragua reached agreement on an Enhanced Structural Adjustment Facility (ESAF) program with the IMF, and contracted the First and Second Economic Recovery Credit with the World Bank, agreeing on the implementation of economic policies to support macroeconomic stability and structural adjustment to consolidate the basis for sustained growth.

In this document, I outline the main results of the Government's management during the 1994-1996 period, regarding the commitments undertaken for the execution of the Second Economic Recovery Credit (ERC II) in June, 1994.

I. Economic Developments during 1994-1996

During this period, Nicaragua showed significant signs of recovery, achieving incremental growth rates of 3.3% in 1994, 4.5% in 1995, and 5.5% in 1996. The main sectors which contributed to the economic growth were agriculture (average 13.2% during the period), construction and mining (16.1%) and fishing (37.1%). In agriculture, strong growth was recorded by export products—mainly coffee and sugar—as well as non-traditional exports and basic grains for domestic consumption (see Annex I).

Regarding the price system, the Government succeeded in keeping inflation at manageable levels, with a moderate inflation of around 10% on average during the last three years (see Annex I).

In the external sector, exports of goods and services increased from US$267.0 million in 1993, to US$634.8 million in 1996 (equivalent to a 137.8% growth). On the other hand, imports increased at lower rates than exports (50.2% between 1993 and 1996). This resulted in a decrease of the trade gap, from US$402.6 million in 1993, to US$371.2 million in 1996. Furthermore, there was an improvement in the net international reserve position, with an increase of US$66.0 million during 1996. Lower accrued interests due to a debt restructuring with the Paris Club, the buy-back of commercial debt and debt forgiveness, contributed to this result. In 1996, debt totaling US$4,165.6 million with Russia and Mexico was canceled.

During these three years, the focus of fiscal policy continued to aim at improving the current account balance, which moved from a deficit to a surplus since 1992. This was mainly the result of the major down sizing of the State and a proactive revenue policy, so as to enhance tax collection efficiency and other tax reforms. Current savings increased to an average of 4.4% relative to GDP during the last three years

However, fiscal policy was not successful enough to comply with the ESAF targets. For this reason, toward the end of 1995 the country agreed with the IMF on a monitoring program, which encompassed corrective measures, including larger tax collections and fiscal restraint, as well as a tight monetary policy through the reduction of net credit to the financial sector and the Government, which would set the basis for the second phase of the ESAF in 1996. Overall compliance with the monitoring program during September 1995 and March 1996 was satisfactory.

Subsequently, due to the delay in the approval of the Tax Reform Law (*Ley para el Fomento de la Estabilidad, las Inversiones y el Empleo*), there was a lag in compliance with the revenue collection targets. In addition, public expenditures increased significantly due to the electoral campaign, the rise in social security expenditures, and in transfers to the education sector. On the other hand, credit recovery of the state-owned banks did not meet expectations. As a result of the above, negotiations with the IMF for the second phase of the ESAF under the policy framework adopted by the new Government were delayed until 1997.

Results of the 1994-1996 period show that the Nicaraguan economy is gradually approaching stability and sustained growth, given a gradual reduction and reversion of foreign trade, fiscal, and employment imbalances, through the boost in exports, the generation of public savings, the containment of in inflationary pressures, and the creation of new jobs in the private sector.

II. Public Sector Reforms

State reform was part of the ESAF and ERC II framework. A key component of this reform was the down sizing of the Central Government, through the elimination of 13,500 posts in the public sector between 1994 and 1996. By December 1996, the public sector labor force had been reduced by 10,285 posts, 76.2% of the proposed target, its reduction is foreseen to continue during 1997, until reaching an optimum level for the operation of the State apparatus.

The Government implemented a privatization program aimed at promoting an efficient allocation of resources, and reducing the size of the Central Government. The privatization process of 351 enterprises owned by the *Corporación Nacional del Sector Público* (CORNAP) began in 1990, and by 1996 97% of all CORNAP firms were privatized. The privatization process of the remaining firms is in its last phase; its completion is expected for the first semester of 1997. The privatization of one of the MCT firms and LUBNICA and ENIGAS was also completed.

As part of this same reform process, operations of PETRONIC were opened to the private sector, so as to position it as a business enterprise within a competitive market, pursuant to the regulations of Decrees 56-94 and 26-95. Three Draft Laws were submitted to the National Assembly for the restructuring of the electric power industry, and the operation and prospecting of hydrocarbons, as well as for their supply; this is also aimed at allowing the involvement of the private sector (Appendix II, point II B).

Under the ERC II policy matrix, the Government committed itself to undertake the sale of 40% of the TELCOR shares, and to award a management concession. In this regard, Law No. 210, *Incorporación de Particulares en la Operación y Ampliación de Servicios Públicos de Telecomunicaciones*, was approved in December, 1995. ENITEL was created under this Law, which was charged with the operation of the public telecommunications services. This Law enables the Government to sell up to 40% of ENITEL shares—including the management contract—to a worldwide known company.

A reform plan and its implementation was proposed to complete the public sector reform program, including the restructuring of at least two public agencies. There has been significant progress in this issue. Six reorganization agreements (ARIs) were signed, for the Ministry of Construction and Transport (MCT), the Ministry of Finance (MIFIN), the Ministry of Environment and Natural Resources (MARENA), the Ministry of Economy and Development (MEDE), the Nicaraguan Institute for Municipal Development (INIFOM), and the Nicaraguan Institute for Social Security (INSS). The reform in these Ministries and governmental agencies is under way in several aspects:

- A new organization was designed in the MCT, creating an Economic Infrastructure Planning Division and preparing a diagnosis for the installation of a new data processing system.
- Progress has been made in the design of the new Social Security System, and in the development of a study aimed at strengthening the Health Insurance model within the INSS.
- In the MIFIN, a study was carried out on the staffing structure and pattern according to the *Sistema Integrado de Gestión Financiera, Administrativa y Auditoria* (SIGFA).
- The INIFOM made efforts to procure financing for the measures set forth in its ARI, which was attained with donor aid from the Danish Government.
- The design of the *Sistema Gerencial y Técnico del Estado* (SGTE) was completed, and 400 officials of the public sector were trained.
- The first draft of the Financial Management Law (*Ley de Administración Financiera*) was prepared, which will lay the legal basis for SIGFA's operation, and submitted to the National Assembly. Likewise, this system began its implementation in several Ministries.
- In 1996, four contracts with international consulting firms were signed, to provide technical assistance to agencies that have signed ARIs, in the four components of Institutional Restructuring, Civil Service, Budgeting and Auditing, and Data Processing Technology.

III. Reform of the Financial Sector

Components planned for the financial sector were to promote the development of an efficient financial intermediation system, with greater involvement of the private sector, strengthening compliance with prudential regulations of the Superintendency of Banks, enhancing the data system on bank debtors, and implementing a new chart of accounts.

Under a state bank reform program agreed with the World Bank and the IDB, the down sizing of the state banking system is being implemented. The latter is carried out through the transfer of approximately C1,500 million of the banks' portfolio to the Central Bank—which represents over half of the state banks' portfolio—by way of debt payments due to the Central Bank. Moreover, a cut-back in the number of offices and branches, especially in the case of the *Banco Nacional de Desarrollo* (BANADES) is being carried out. Restrictions have also been imposed on the growth of the BANADES portfolio.

As of July 1995, the Central Bank canceled the 3- and 12-month rediscount line of credit, and only the overnight and 10-day liquidity support facilities will remain in place Thus, the Central Bank will only act as lender of last resort.

Using its own powers, the Superintendency of Banks has increased penalties for the non-compliance with its prudential norms. In May, 1996, the Superintendency of Banks approved new prudential norms on credit concentration, asset valuation and classification, capital adequacy, and reforms to the exception norms (*norma sobre excepcionalidades*). The draft General Banking Law, which is under review in the National Assembly, includes the strengthening of bank supervision powers.

The debtor system is performing well, and pursuant to the prudential norms of the Superintendency of Banks, the banks are committed to provide reports to keep the system up to date. A new chart of accounts was implemented as from 1994 under resolution CBI-DIF-I-4-93, currently including all state banks and private banks.

IV. Development of the Private Sector

To establish a favorable environment for the development of the private sector, the Government intends to address the problem of property rights so as to ensure land tenure security, and also to solve conflicts resulting from the land seizures of the Sandinista Government. With this objective in mind, the Government created a program for the administrative settlement of property claims. Up to 1996, the *Oficina de Ordenamiento Territorial* (OOT) had reviewed 12,117 cases of Law 85 (urban areas), 98% of the total cases submitted to the revision process. With respect to Law 86 (rural areas), 82% of the 106,130 cases submitted to this process were reviewed, and a 90.8% progress was achieved in the cases related to the Agrarian Reform (Law 88) (Annex II, point IV)

In turn, the Government increased its efforts regarding the compensation and indemnification process. Up to December 1996, 4,501 resolutions were issued, accounting for 79% of all claims submitted under the *Sistema Integrado de Atención de Reclamos de Propiedades* (SIARP).

The indemnification process involved the issuance of C3,933 7 million in Compensation Payment Bonds (BPI) since 1993, and interest coupons for the years 1995-1996 amounting to C23.9 million have been paid.

As a result of an agreement among the National Assembly, the Association of Bond Holders, and the Government, and based on the recommendations of a study by Dr. Strasma, Law No. 180 was passed. This Law modified the terms of the bonds from 20 to 15 years, increased the fixed 3% interest rate to an incremental interest rate of up to 5%, established semi-annual interest payments, and extended the use of these bonds to the payment of tax, basic services, and other debts originating before June, 1993.

At the end of 1996, Ministerial Agreement No. 17-96 was issued defining the establishment of a BPI exchange system. Through this system, the bonds can be traded in international financial markets (Appendix II, point IV A).

Other reforms proposed in support of a productive private sector, under the terms of this Credit, refer to foreign trade. A strategy to foster export growth was developed, as well as a more efficient import policy through the reduction of the level and dispersion of nominal protection. In May, 1994 a gradual schedule to reduce the nominal ceiling rates of Import Tariffs (DAI, *Derechos Arancelarios de Importación*), Fiscal Stamp Tax (ITF, *Impuesto de Timbre Fiscal*), and Temporary Protection Tariff (ATP, *Arancel Temporal de Protección*) was prepared. Through Decree No. 41-95, DAI rates for a wide range of products were cut from 5% to 1%. Concurrently, ATP rates for a series of products included in Appendix I published in Decree No. 22-94 were modified, reducing the 5-15% range to a 10-12% range. With respect to Appendix II of the ATP, the maximum level was cut from 30% to 25%. At the end of 1996, the maximum ceiling of the sum of DAI, ITF, and ATP of Appendix II was less than 40%, in accordance with the import duty reduction schedule announced by the Government in 1994.

Mr. President, this new Government considers that our country has progressed satisfactorily during the last three years. Reforms carried out have aimed to maintain both price stability and structural adjustment, as key steps to achieve sustained growth. As part of these reforms, a set of policy measures were implemented in the areas of expenditure reductions, privatization of Government assets, and trade liberalization. These reforms were carried out in the context of macroeconomic policies that guarantee overall stability.

Economic performance improved significantly under the economic policies followed, but we know that we still face enormous challenges. We cannot be satisfied until we achieve a strong, market-oriented economic recovery, able to offer a bright future for our people. The Government of Nicaragua is willing and determined to continue deepening the economic transformations leading to growth with equity. Then, a new and prosperous phase will begin, where the true rule of law is re-established, and a stable environment consolidated; domestic and foreign investments will increase, and with it production and productive employment for all Nicaraguans. In such context, support from the international community, mainly the World Bank, is critical to continue transforming our economy and take firm steps in the difficult road ahead of us.

We are currently undertaking a series of activities in coordination with the IMF, in order to reach agreement on a second economic program in June, 1997. Considering the success obtained under ERC II, we are sure that we will be able to count on the support of the World Bank as a co-financing agency for our economic program, through a third economic recovery credit.

ANNEX I

NICARAGUA: SELECTED ECONOMIC INDICATORS

	1993	1994	1995	1996
A. Gross Domestic Product (1980 Córdobas)	-0.4	3.3	4.5	5.5
Primary	1 8	10.8	5.5	9.8
Agriculture	-6 2	16.1	8.2	15.4
Fishing	62.7	55.8	47.5	7.9
Secondary	0 3	2.7	5.4	4.7
Manufacturing	0 0	1.0	3.0	2.0
Construction	1 5	17.8	16.3	15 4
Mining	2.7	-10 1	30 3	27 2
Tertiary	-1.8	-0 1	3.3	3 4
Trade	-2.3	1.6	5 0	5 7
B. GDP (current Córdobas)	11,067.3	12,445 4	14,455 5	17,126 0
C. Inflation Rates				
Annual average	20.4	7.8	11 2	11.6
Cumulative	19.5	12 4	11.1	12.1
D Unemployment (national)	21.8	20.7	18 2	16 1
E Public Finances (% of GDP)				
Non-Fin. Public Sector Balance (after grants)	-0 2	-5 9	-2 4	-4 9
Non-Fin. Current Balance	3 2	2.4	6 1	4 7
F External Sector (US$ million)				
Exports FOB	267.0	351.2	526 4	634.8
Imports FOB	669.6	784.7	865.0	1006.0
Trade Balance	-402.6	-433.5	-338.6	-371.2
Net International Reserves of Central Bank	40.5	105.1	99.2	165.2
External Public Debt	10,987 3	11,695 0	10,298.9	6,104.8

Sources: Central Bank Annual Reports, 1994, 1995 and 1996.

ANNEX II

NICARAGUA: SECOND ECONOMIC RECOVERY CREDIT
MATRIX OF RESULTS, 1994-96

Objective	Commitment or Action Required	Status or Results
I Macroeconomic Framework Ensure a stable macroeconomic framework.	Maintain a stable macroeconomic framework.	During 1994-96, Nicaragua initiated an economic program within the ESAF framework During this period, the Nicaraguan economy has shown significant signs of recovery, reaching average economic growth rates of 4.5% and a recovery of exports. Nonetheless, in 1995 and 1996 fiscal and monetary targets were out of line, which prevented continuation of the ESAF program. Agreement was reached in end-1995 on a monitoring program with the IMF. The new Administration of Dr. Alemán aims to agree with the IMF, during the first semester of 1997, on a program which can restart the ESAF
II. Reform of the State **A. Labor Mobility Plan** Achieve a permanent reduction in costs to strengthen the fiscal balance through a reduction in the public sector labor force.	Design and implement an action plan for the labor mobility program in order to reduce employment by 13,500 positions during 1994-96.	As of December 1996, almost 10,300 positions had been eliminated from the public sector labor force; 76% of the target.
B. Privatization Program Promote more efficient resource allocation and lower fiscal burden through disincorporation of state enterprises.	Bring to the point of sale or closure enterprises under CORNAP and MCT	The process of disincorporating the 351 enterprises was started in 1990. By 1996, 97% of the goal was achieved, with 10 pending enterprises which are in the final stages of liquidation or closure. The process of selling the assets of CONSULTRAN, an MCT enterprise, was completed in end 1995. Another 7 enterprises continue to be part of this Ministry, grouped under the *Corporación Regional de Empresas de Construcción*, located in different parts of the country. A Bank-financed study on the privatization of these enterprises is in the hands of the relevant Ministry, awaiting its implementation.
	Bring to the point of sale or liquidation some of the operations of PETRONIC, including gasoline distribution, while the eventual regulatory functions of PETRONIC are defined	Decree 56-94 of December 1994, established that the importation, export, refining, transport, storage and marketing of hydrocarbons could be carried out by national or international natural and legal entities which obtained the appropriate license, with the State guaranteeing the corresponding regulations. With this law, PETRONIC ceased to have a state monopoly on these activities. Subsequently, Decree 26-95 reformed PETRONIC's organic law in order to place it as a commercial enterprise in a competitive market.

NICARAGUA: SECOND ECONOMIC RECOVERY CREDIT
MATRIX OF RESULTS, 1994-96

Objective	Commitment or Action Required	Status or Results
		In the case of LUBNICA, 25% of its capital was transferred to its workers, and the remaining 75% was transferred to INE to repay debts to PETRONIC In the case of ENIGAS, workers were paid with the enterprise's assets.
Improve the efficiency and service coverage by promoting private sector participation in the telecoms sector.	Take steps for the sale of 40% of ENITEL shares, including the offer of a management contract for the winning bidder.	Law No 210, *Incorporación de Particulares en la Operación y Ampliación de los Servicios Públicos de Telecomunicaciones*, was approved on December 7, 1995. The Law created ENITEL to operate public telecommunications services. This same law authorized the Government to sell up to 40% of ENITEL shares, including a management contract to an internationally-renowned enterprise. In addition, if necessary to back up the compensation bonds, an additional 10% of shares could be sold. A Committee was created in charge of carrying out the pre-qualification process, the public bidding of the concession and the sale of ENITEL shares.
C. Public Sector Reforms Create an efficient, smaller and modern public sector	Prepare a 3-year plan, in line with the Government's public sector reform policy Achieve satisfactory progress in its implementation, including the restructuring of at least 2 important public institutions.	As of December 1996, 6 Institutional Restructuring Agreements (ARIs) were finalized, for MCT, MIFIN, MARENA, MEDE, INIFOM and INSS. Reforms have begun to be implemented in a number of aspects in the Ministries and institutions. In **MCT**, a new structure was designed, creating a Planning Division for Economic Infrastructure, and a diagnosis was carried out for the adoption of new computer installations. In **INSS**, progress was made on the design of a new social security system and completion of studies to strengthen preventive health. In **MIFIN**, a study was carried out on the structure and payroll in line with the Integrated Financial Management System (SIGFA). **INIFOM** managed to secure financing from the Government of Denmark to carry out actions stipulated in the ARI Design of the Public Management and Technical Service was completed. A draft law for SIGFA was prepared and implementation was started in a number of Ministries. In 1996, 4 contracts were signed with international consulting firms to provide technical assistance to institutions with ARIs, in the areas of institutional restructuring, civil service, budget and auditing, and information technology
III. Financial Sector Reform **A. Banking Sector Policy** Encourage development of an efficient financial intermediation system, with increased private sector participation.	Maintain policy of: (i) not recapitalizing state banks through new public sector funds or revaluation of non-financial assets;	A policy of reducing the size of the state banking sector has been implemented within the framework of a state reform program agreed with the World Bank and IDB.

NICARAGUA: SECOND ECONOMIC RECOVERY CREDIT
MATRIX OF RESULTS, 1994-96

Objective	Commitment or Action Required	Status or Results
	(ii) ensure compliance with prudential norms and instructions issued by the Superintendency of Banks; and (iii) no pre-assigning of rediscounts from the Central Bank for specific activities. Any revaluation of non-financial assets can only be made to cover a deficit in loan provisions—when revenues are insufficient to cover required provisions and capital adequacy is at its minimum—or to cover severance payments.	This has been achieved through a portfolio transfer to the Central Bank in the order of C1,500 million, equivalent to more than half of the portfolio of state banks, on account of debt payments to the Central Bank, as well as reduction in the number of offices and branches, especially in the case of BANADES. At the same time, limits were set on the growth of loans of BANADES>
B. Superintendency of Banks Strengthen compliance with prudential norms of the Superintendency, improve the financial information system and accounting systems.	Enact decree, action plan or draft law to increase penalties, create new prudential norms and improve the operations of the Superintendency of Banks.	The Superintendency has increased penalties for non-compliance with its prudential norms, relying on its own attributions In May 1996, the Superintendency approved new prudential norms on loan concentration, evaluation and classification of assets, capital adequacy and reforms to exceptions to the norms The National Assembly is discussing the draft General Law of Banks which includes the strengthening of the Superintendency.
	Design and implement a debtor management system.	The system is in operation and the Superintendency's prudential norms include the requirement that banks report in order to maintain the system current. A user manual on the central risk system is being tested. The system has three tools: relevance analysis, balance information, loan amounts and provisions. The modules on repayment status, and repayment analysis are being developed.
	Implement a new chart of accounts	A new chart of accounts has been implemented since 1994 through resolution SBI-DIF-I-4-93, currently including all state and private banks.
IV Private Sector Development		
A. Property Rights Resolve property rights problems in order to improve land tenure security and improve private sector climate	Establish a program to review compliance with established procedures to resolve property conflicts.	As of 1996, the *Oficina de Ordenamiento Territorial* had reviewed 12,117 cases under Law 85 (houses) equivalent to 98% of the total number of cases presented for review. With respect to Law 86 (rural sector) 82% of the 106,130 cases submitted were reviewed. Lastly, progress was made on 91% of the agrarian reform cases (Law 88). At the same time, the Government made greater efforts on the compensation process. As of December 1996, 4,501 resolutions were issued, covering 79% of the total claims

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87027
99144

NICARAGUA: SECOND ECONOMIC RECOVERY CREDIT
MATRIX OF RESULTS, 1994-96

Objective	Commitment or Action Required	Status or Results
		presented to the Integrated System for Review of Property Claims. The compensation process meant the issuing of C3,933 million in compensation bonds since 1993, with coupon interest payments for a total of C23.9 million during 1995-96
	Carry out a study and implement its recommendations with the aim of raising the value of compensation bonds.	On the basis of the study by Dr. John Strasma, Law 180 was approved, following consensus between the Assembly, the Association of Bond Holders and the Government. This Law reduced the period of the Bonds from 20 to 15 years, the fixed 3% interest rate was gradually increased to reach 5%, interest payments would be every 6 months, and the use of the bonds was extended to cover tax payments, basic services and other debts prior to June 1993 The Ministerial Accord No 17 was published in late 1996, creating a redemption system that would allow these bonds to be transacted in international markets.
B. Discretion in Economic Policy Promote a more stable and transparent policy environment for the private sector, reducing ministerial discretionality to change tax and fiscal policies and the creation of new state enterprises.	Issue a presidential decree establishing: (i) that any change in tax or fiscal policy, to be legally binding, must be published in the Official Gazette, except in cases of *force majeure*, in which case it must be published in at least one daily newspaper of broad circulation; (ii) abrogating and elevating to the Presidency the powers of Ministries and government agencies to change tax and fiscal policies; and (iii) abrogating the powers of Ministries and government agencies to create new commercial enterprises.	Presidential Decree 20-94 was issued in April 1994, which established that Executive Decrees and Administrative Rulings of a fiscal nature must be published in the Official Gazette to be legally binding In the same month, Presidential Decree 21-94 abrogated the discretionary powers of Ministries and autonomous and decentralized agencies of the Executive Power to create and change taxes.
C. Foreign Trade Reforms Promote export growth and efficient import substitution by reducing the level and dispersion of nominal protection , and the creation of a transparent and efficient export incentive system.	Reduce nominal protection rates from a range of 10-40% to 10-37% (except for fiscal industries). Present a time-bound tariff reduction program.	A schedule for the reduction of nominal tariff ceilings for the DAI, ITF and the ATP was established in May 1994. 37% for July 1, 1995; 35% for January 1, 1996; 32% for January 1, 1997. At end 1996, the ceiling (including the DAI, ITF and ATP of Annex II) was below 40%.

NICARAGUA: SECOND ECONOMIC RECOVERY CREDIT
MATRIX OF RESULTS, 1994-96

Objective	Commitment or Action Required	Status or Results
	Complete preparation of action plan to replace existing export promotion mechanisms by a duty drawback system	
D. **Labor Market Reform** Promote greater labor productivity and reduce the incentives toward informal activities by ensuring flexibility in the operation of the labor market.	Comply with agreements on labor policy	A new Labor Code was promulgated in end 1996.

IMAGING

Report No.: 16775
Type: ICR

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Report No. 14829

PROJECT COMPLETION REPORT

NICARAGUA

ECONOMIC RECOVERY CREDIT
(CREDIT 2302-NI)

JULY 5, 1995

Country Operations Division
Country Department II
Latin America and the Caribbean Region

Glossary

BI	Banco Inmobiliario
BND	Banco Nacional de Desarrollo
BNIC	Banco Nicaraguense de Industria y Comercio
BP	Banco Popular
CO	Cordoba Oro
CORFIN	Corporación Financiera de Nicaragua
CORNAP	Corporaciones Nacionales del Sector Público
ERC	Economic Recovery Credit
ESAF	Extended Structural Adjustment Facility
GDP	Gross Domestic Product
GON	Government of Nicaragua
IDA	International Development Association
IDB	Interamerican Development Bank
IFI	International Finance Institution
IMF	International Monetary Fund
PCR	Project Completion Report
SAC	Structural Adjustment Credit
SITC	Standard International Tariff Classification
SOE	State-owned Enterprise
TFAL	Trade and Financial Adjustment Loan
UNDP	United Nations Development Programme
UNO	Unión Nacional Opositora
USAID	United States Agency for International Development

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THE WORLD BANK
Washington, D.C. 20433
U.S.A.

Office of Director-General
Operations Evaluation

July 5, 1995

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: **Program Completion Report on Nicaragua - Economic Recovery Credit (Credit 2302-NI)**

Attached is the Program Completion Report (PCR) for the Nicaragua Economic Recovery Credit (Credit 2302-NI, approved in FY92) prepared by the Latin America and Caribbean Regional Office. Part II was prepared by the Borrower.

The PCR gives a very good account of the preparation and implementation of the ERC. The principal objective of the credit was to support the Government's endeavor to arrest the decline in the economy and revive growth on a sustained basis. The reforms proposed were to help reorient the economy from a command to a competitive free-market system. The program was prepared in close coordination with the IMF. Important risks — weak institutions, resistance by interest groups, a reluctant private sector — were identified in the President's Report and judged to be manageable.

Through the ERC, IDA was successful in mobilizing substantial support from other donors, including financing for clearance of Nicaragua's arrears to the International Financial Institutions. The credit itself was cofinanced by the Inter-American Development Bank and the Governments of Japan, Germany and Switzerland. All tranche release conditions were met and the credit was fully disbursed within one year of approval. The outcome, however, was disappointing: contrary to expectations, GDP remained stagnant in 1992-93 and both the budget deficit and resource gap were larger than predicted. Restoration of private sector confidence remained elusive and, following second tranche release, there were some policy reversals. The program did not directly address Nicaragua's enormous debt burden: the external debt has remained at about eight times the level of GNP. The risks associated with the operation were underestimated and the assumption in the President's Report that implementation of the proposed reforms would yield fairly quick results proved far too optimistic.

On balance, the outcome of the ERC is rated as marginally unsatisfactory. Given the prevailing political uncertainty and limited institutional capacity, sustainability is rated as uncertain. The institutional impact is rated as negligible.

Following a policy impasse in 1993, conditions started to improve in 1994. In June 1994, two years after the closing of ERC I, a follow-up operation, ERC II, was approved by the Board. A joint audit of ERC I and ERC II is planned, after completion of ERC II.

Attachment

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PREFACE

This is the Project Completion Report (PCR) of the Economic Recovery Credit to the Republic of Nicaragua for which Credit 2302-NI in the amount of SDR 83.5 million was approved by the Board of Executive Directors on September 26, 1991. It was disbursed in two equal tranches and was closed on June 10, 1992, upon disbursement of the second tranche.

The PCR was jointly prepared by the Country Operations Division (LA2C2) of the Latin American and the Caribbean Office (Preface, Evaluation Summary, Parts I and III) and by the Borrower (Part II).

Preparation of the PCR started during a mission to Nicaragua in mid-September, 1993. It is based on the Report and Recommendation of the President of the International Development Association to the Executive Directors on the Economic Recovery Credit, the Development Credit Agreement, mission reports, correspondence between IDA and the Borrower, and discussions with Bank staff, Nicaraguan officials who worked on the Credit Program, and representatives of major donor/assistance organizations in Nicaragua.

NICARAGUA

PROJECT COMPLETION REPORT

ECONOMIC RECOVERY CREDIT
(2302-NI)

EVALUATION SUMMARY

1. Project Objectives (paras. 23-28). The main objective of the Economic Recovery Credit (ERC) was to support the Government of Nicaragua in its endeavors to arrest the ongoing decline in the economy, to achieve lasting price stability and to revive economic growth on a sustained basis. This was to be achieved with structural reforms that were to return Nicaragua to a private-sector-led economy from the command economy which lasted from 1979 till 1990.

2. The ERC supported the adjustment program which consisted of downsizing and restructuring the public sector, privatizing the state-owned enterprises (SOEs), reforming the financial system to improve resource allocation, establishing a competitive environment to widen the private sector participation in economic activities, and reforming the incentive system by eliminating existing barriers to private sector's entry into production and trade. The ERC was designed as a first step to assist Nicaragua's efforts through an IDA credit totalling SDR 83.5 million which was released in two equal tranches upon full completion of the conditionalities specified for each tranche.

3. Implementation Experience (paras. 29-34). IDA coordinated the efforts to put together a financial package to clear Nicaragua's arrears to International Financial Institutions (IFIs). It also helped the authorities to prepare the documents for the Paris Club debt restructuring. This led to the resumption of much needed financial assistance to Nicaragua. The financial package included, in addition to the IDA credit, US$130 million from IDB and US$193 million equivalent from other bilateral donor agencies. IDA also assisted the Government in shaping the required policy objectives and actions more concretely. In addition, Nicaragua signed a stand-by agreement with the IMF.

4. Between April and June 1991 IDA fielded several missions culminating in the negotiations of July 1991 and leading to the Board approval and signing of the credit documents upon which the first tranche of the credit was released. The second tranche was disbursed in June 1992 again upon verification of the compliance with the conditions set out in the Development Credit Agreement.

5. Program Results: Macroeconomic Performance (paras. 35-51). The Government of Nicaragua was extremely optimistic with respect to the impact of the economic recovery program on growth. IDA took a much more cautious attitude, and a modest economic recovery was foreseen for only 1993. Even the cautious optimism proved to be an over-estimation. In fact, the economy declined. Several factors explain this situation. First, the political stability hoped for after the elections never materialized. Second, the process to address the property rights issue was extremely slow. Third, the Government wavered in its efforts to reform the public sector and gave conflicting signals to the private sector. As a result, the hoped for take-off of private sector expansion never occurred. While exports stagnated, imports rose; investment did not rise. Fourth, after the release of the second tranche backslidings and policy reversals occurred in a number of areas, especially in financial sector reform. Public banking institutions continued to crowd out newly set up private banking institutions. Other reversals occurred in raising the protection

on imports.

6. Nicaragua has yet to experience a major economic recovery. The high risk of doing business did not diminish substantially. The main barrier to private sector development continues to be the fragile political environment. The managerial capabilities of the Government are still limited despite considerable but unfortunately uncoordinated technical assistance, and the financial dependency on foreign assistance continues.

7. These developments should not necessarily be taken as a criticism of either the conception or implementation of the ERC setting the framework for adjustment. Without the ERC much needed imports could not have been financed and Nicaragua would have no access to international credits. Without the World Bank's efforts a financial package most probably could not have been put together; the arrears could not have been cleared, and Nicaragua would have been deprived from the financial and technical assistance of the donor community.

8. Sustainability (paras. 52-57). Under the present circumstances the limited success of the restructuring and adjustment efforts cannot be sustained, unless a more stable political environment is achieved and the Government makes further efforts to streamline its budget, enhance its institutional capacity for a better economic management, resolves the property rights issue, and realizes the financial reforms which were designed before the release of the second tranche, but were never fully carried out.

meaning? ?!

9. Nicaragua continues to depend on external assistance and the extent and likely reduction in donor support are disconcerting. Without further financial and technical assistance the sustainability of the limited results already achieved will be in jeopardy. If sufficient foreign aid does not come forth in subsequent years and if an institutionalized aid coordination effort is not made within the Government to allocate such aid efficiently in full accordance with the restructuring efforts, the gains made so far are likely to be lost.

10. The private sector hesitates to respond to the Government's reform and restructuring efforts. Restoring political stability and resolving the property rights issues, as foreseen in ERC's design, are two of the most essential elements for the sustainability of the project results.

11. The weakness of the overall administrative capacity of the central and local governments also endangers sustainability. The weakness partly stems from the excessive number of civil servants and the budget constraint that impedes their better remuneration, which in turn hampers efforts to improve public management. Failure to improve public management leads to waste and inefficient administration and prevents in turn concerted efforts to improve public management. Unless the budget, current and investment, is trimmed and unless a concerted effort is undertaken to improve public management with better remunerated civil servants, Nicaragua will continue to depend on technical assistance and the economic reform will be extremely slow in taking off.

12. Nicaragua needs to accelerate its structural transformation and move rapidly towards a market-based economy with a much smaller but more efficient public sector. The public sector is still oversized and inefficient, crowding out the private sector and generating waste. The Government has spread its limited managerial capabilities too thinly and its specialized human capital skills in too many activities. The sustainability is challenged unless public sector functions efficiently and stops crowding out the private sector.

13. Lessons Learned (paras. 58-61). Several lessons emerge from IDA's experience. First, when the countries' credit needs are inextricably related to transforming rather than reforming their economies, a longer term vision is necessary. In an economy where institutions are being overhauled and new organizations are being created, the "adjustment" necessarily takes much longer than in market-oriented economies. Concomitantly with structural adjustment, long-run development problems must also be tackled from the outset. IDA's longer range view with respect to Nicaragua's restructuring and adjustment program is yet to be carried out.

14. Second, with the view that there would be follow-up structural adjustment credits, the ERC did not always contain sufficiently tightly designed conditionalities; in some cases leaving the completion of actions to the follow up operations. Each ERC should be self-contained without leaving the completion of actions to other operations.

15. The third lesson that emerges is that a much better donor technical assistance coordination is a sine qua non. IDA should insist on an effective aid coordination that would set the priorities and be an integral part of the adjustment package. Especially in cases where transformation of the economy is in question, as was the case in Nicaragua, to set up such a coordination mechanism within the Government may very well be considered as one of the conditions for the tranche release. IDA should make every effort to secure the coordination of technical assistance via an appropriate mechanism as warranted.

16. The fourth lesson is that the extent and the depth of technical assistance and training needs must be estimated correctly. If not, to improve the economic management capabilities of the public sector becomes a near impossibility.

NICARAGUA

PROJECT COMPLETION REPORT

ECONOMIC RECOVERY CREDIT
(2302-NI)

PART I: PROGRAM REVIEW FROM THE IDA'S PERSPECTIVE

A: PROGRAM IDENTITY

Credit Name:	Economic Recovery Credit
Credit No.:	2302-NI
Region:	Latin America and the Caribbean
Country:	Republic of Nicaragua
Sector:	Non-Project Lending

B. BACKGROUND

1. The Economic Recovery Credit (ERC) in the amount of SDR 83.5 million (equivalent to US $ 110 million) was approved by the Board of Executive Directors on September 26, 1991 and signed on October 8, 1991. ERC was released in two tranches of US$ 55 million each (equivalent of SDR 41.75 million) and was closed on June 30, 1992. The credit was designed to help the Government in its efforts to transform the economy from a command to a market economy and improve resource allocation by establishing a competitive environment with private sector participation. The Government's structural adjustment program consisted mainly of downsizing and restructuring the public sector and privatizing the SOEs; reforming the financial system; reforming the system of incentives and eliminating the obstacles to private sector's entry into production and trade, liberalizing trade, and easing or abolishing price controls and related regulations.

2. Nicaragua was declared eligible for IDA-only support on April 15, 1991, and the ERC carried standard IDA-only terms, including repayment in 40 years and a grace period of 10 years. Co-financing was provided out of concessionary funds from the Inter American Development Bank (IDB) and the Governments of Japan, Germany, and Switzerland.

3. The credit extended by IDA was surrounded by a set of unusual economic and political circumstances. It was one of the first -- if not the first -- attempt to assist a country to move from a command to a market economy. After the demise of the Somoza regime in 1979, the Sandinista

Government established a centrally controlled economy, confiscated or expropriated many privately-owned firms, nationalized the financial and external trade sectors, and heavily regulated the remaining private sector. The Sandinista Government's inappropriate macroeconomic policies and price controls distorted resource allocation. Gross inefficiencies in resource use resulted. Public sector expenditures trebled over the decade, reaching an average of 57 percent of GDP in 1983-87. The Government's resort to central bank financing fueled an inflation level that reached 14,300 percent in 1988. The guerrilla warfare against the Sandinista regime (Contra War), the United States trade embargo, the worsening of the terms of trade in general, and natural disasters that afflicted heavy losses on the agricultural sector compounded the problems. The deterioration in the economy accelerated towards the end of the eighties. The real GDP that had grown only at the moderate annual rate of 1.0 percent at the beginning of the eighties declined at the annual average rate of 4.1 percent during 1985-1990. By the end of the decade real per capita GDP had fallen drastically (from US$ 730 in 1980 to US$ 448 in 1990), total exports in current dollars amounted to less than half the levels achieved in the mid-1970s, inflation had spiralled out of control, and the public sector deficit averaged 20 percent of GDP during the period 1985-1990. During the same period the current account deficit averaged 33 percent of GDP and it was mainly financed through grants and the accumulation of arrears with foreign creditors, on which the country had grown extremely dependent. External debt, including accrued interest, ballooned from US$ 1.7 billion in 1978 to over US$ 10 billion in 1990, at more than 6 times the estimated GDP.

4. The Sandinista Government launched an emergency stabilization package to curb hyperinflation in 1989. The program significantly reduced the public sector deficit by halving Central Government expenditures, dramatically cutting credit to the public sector, and frequently devaluing the currency to create a 90 percent real depreciation of the Cordoba in 1989. Inflation was temporarily reduced to only 4700 percent in 1989, and the current account deficit was narrowed slightly. However, in early 1990, the Sandinista Government abandoned the program without waiting for its full results and returned to highly expansionary policies. In only three months public sector wages were raised by 800 percent in nominal terms, while public sector prices remained fixed. The Central Bank financed the ensuing deficits; and, as inflation accelerated, the Cordoba appreciated by 45 percent in real terms.

5. The political coalition Unión Nacional Opositora (UNO) headed by Violeta Chamorro that took office in April 1990 inherited a totally devastated economy with an oversized and extremely inefficient public sector which had crowded out private sector participation through a deep involvement in economic activities and ownership of productive means. Total non-financial public sector expenditures represented about 50 percent of GDP, while state-owned financial enterprises accounted for another 29 percent of GDP. The banking system was completely nationalized and bankrupt after a decade of mismanagement during which credit was allocated largely according to political criteria. Foreign trade was heavily regulated, with state trading companies accounting for almost all exports and over 50 percent of imports. Import transactions were subject to a multiple exchange rate system and a high and dispersed tariff structure. In domestic commerce, over 50 products were subject to price control. The legal framework that defined and enforced property rights and the land tenure system became inappropriate and inoperative. Many skilled technicians and managers had left the country.

6. The tasks of achieving stability, economic revival, and the prerequisites for sustained growth were daunting. Moreover, the economic agenda had to be pursued in the environment of a very fragile political peace. The new Administration, which had received from the people a clear mandate to govern at the February 1990 elections, had to come to terms with the Sandinistas, and felt the transfer of power was only possible with the proviso that the armed forces and the police be left to Sandinista supervision and control. This was to contribute to political instability in subsequent years; yet at the time of the

installation of the Chamorro Administration no other recourse appeared to be feasible.

7. The new Government hoped to restructure the economy in a relatively short time. Yet it was fully aware that neither the financial nor human resources of the public sector would allow it to undertake such a drastic change on its own. It needed the full support of IFIs, i.e., the IMF, the World Bank, and the Inter-American Development Bank (IDB), and bilateral agencies of the whole donor community, including the USA, not only for financial resources, but for technical advice as well. The new Government re-established its ties with both development banks almost immediately by indicating its intentions to take steps to clear its arrears with the Bank and IDA undertake a program of economic reforms. It attempted to implement a combination of fiscal and monetary policies aimed at reducing the size and role of the government, as well as increasing reliance on market forces.

8. The Government approached the Bank and IDA to support its stabilization and recovery efforts after six years of near interruption of relations with the two institutions. Beginning in April 1990 Bank staff visited Nicaragua on several occasions, assessed the economic situation, and discussed with the authorities the elements of a program for stabilization and adjustment. At the same time the Government initiated measures to stabilize the economy. As a result, Central Government expenditures rose by only 2 percentage points of GDP in 1990 despite the doubling of the wage bill resulting from the wage increases prior to the new Government's term. The financial performance of the public utilities improved dramatically after prices were raised and then indexed to the US dollar. However, the 1990 measures fell significantly short of achieving the objectives: government revenue declined by 7 percentage points of GDP; the overall public sector deficit widened to 43 percent of GDP; and domestic bank credit increased rapidly because of deficits in state enterprises.

9. In May 1990, the Government introduced a currency of account, the Cordoba Oro (CO), and pegged it to the US dollar. It was used to pay part of public sector wages. Loans and deposit rates were indexed to the CO. The introduction of the CO in an inflationary environment, however, complicated monetary management. The fact that transactions were denominated in CO and effected in Cordobas sped circulation of the Cordoba. Lax financial policies combined with enforcement of parity to the US dollar also depleted scarce international reserves. Economic performance continued to worsen throughout 1990. This was exacerbated by political volatility and persisting macroeconomic imbalances. The GDP dropped by 4.4 percent. Unchecked monetary expansion and a large fiscal deficit caused the annual inflation rate to accelerate to over 7,400 percent. The current account deficit remained high (18.5 percent of GDP).

C. THE STABILIZATION AND ADJUSTMENT PROGRAM OF THE GOVERNMENT

10. The most significant achievements of the Government in 1990 were the progress toward establishing peace and reaching broad national consensus on the main thrust of its economic policies after an initial period of prolonged strikes. The efforts culminated in the October 1990 agreement of "Concertación Económica y Social" (Economic and Social Accord) between the Government and worker and employee representatives that secured a formal consensus on the need for structural reforms: liberalizing trade, removing state monopolies from the financial and foreign trade sectors, and returning expropriated properties to their rightful owners. The Chamorro Administration also enacted significant policy changes in tax and tariff reforms and the de-regulation of the economy.

11. On March 3, 1991, the Government announced a major stabilization and adjustment program with the support of the IMF and IDA. The IMF/IDA coordination allowed the Government to take steps

towards the implementation of the stabilization program. The program called for a balance between the money supply and the demand for real balances in order to constrain the Central Bank's stock of net domestic credit. It adopted a fixed exchange rate policy. The Cordoba Oro was devalued by 400 percent and set at 5 new Cordobas per US dollar. The correction of the exchange rate and increased competition in input and output were aimed at providing appropriate price incentives for a production recovery in the tradables sector. Strict ceilings were placed on expenditures and credit expansion. A public sector employment reduction program was initiated, financed mainly with foreign grants. The aim was to downsize the public sector and balance revenue and expenditures through selective expenditure cuts and better revenue collection procedures. The financial sector was to be reformed. A system of incentives was to be restored to assure the private sector's participation in a market-oriented environment. Trade was to be liberalized by reducing nominal tariffs. Distorting domestic regulatory practices were to be erased by reducing the Government's involvement in the economy and changing the regulatory framework governing the SOEs. The remaining agricultural support prices were to be eliminated.

D. THE ROLE OF IDA

12. An IDA mission visited Nicaragua during January 15-31, 1991, to initiate the preparation of the proposed ERC. It reviewed the developmental issues and policies and identified those to be incorporated into the ERC. The mission received good cooperation from the Government, and meetings were held with key ministers, high level ministerial staff and advisers, with members of parliament, and business and labor leaders. The mission interacted with the IMF and IDB missions in the field and reached understandings with the authorities on the broad outline of an economic recovery and adjustment program.

13. At first the authorities expressed some concern regarding the implications of implementing a far-reaching stabilization and adjustment program and indicated that they had already taken significant steps towards stabilization and adjustment. But through background analyses and a series of meetings the mission succeeded in reaching an understanding with the Government on the urgent need for a major stabilization effort and the measures necessary to restructure the economy.

14. There was basic agreement from the start on the direction of adjustments towards a market-oriented economy free of unnecessary regulations and government ownership in the productive sectors. The mission worked with the authorities on the components of such a program. In the final meeting the officials indicated their full agreement with the assessments and the recommended policies. The consensus was that there was no viable alternative to a credible stabilization and adjustment program to overcome the current economic crisis and that, with its timely implementation, ties would be re-established with international financial institutions, and bilateral donor support would be mobilized.

15. An IDA pre-appraisal mission visited Nicaragua between April 22 and May 7, 1991, to work on the details of the program.

16. In June 1991 the IDA fielded an appraisal mission which was joined by two persons from the Overseas Economic Cooperation Fund of Japan and a representative of IDB. The Japanese Government and the IDB intended to cofinance the ERC. The mission discussed with the authorities the details of the Government's economic recovery program. Agreements were reached with the Government in line with the policies and measures presented in the Memorandum. A draft "Letter of Development Policy" was prepared by the authorities which was fully consistent with the policy matrix approved by the Operations

Committee. It was initialed by the members of the Economic Cabinet.

17. The appraisal mission observed that the stabilization program announced on March 3, 1991, had already had a visible impact on price levels. After a major initial rise, price increases had moderated dramatically in late March, April, and May, with the consumer price index declining by 6 percent in May. The Government had adhered to the expenditure ceilings, and public revenues had displayed a rising trend above programmed levels. It was not possible for the mission to establish with any precision the 1991 trends in output, due to shortcomings in statistical data. However, it appeared that the recession in the economy had not worsened since the initiation of the stabilization program. If anything, output was expected to be around 1990 levels. The Government had engaged in lengthy negotiations with labor and business representatives to review and revise the "concertation" agreement that was to provide the basis for the settlement of labor demands. The issues of compensating labor further for price changes and the settlement of property rights appeared to be the major preoccupation of the parties engaged in deliberations. The outcome of these discussions had a strong bearing on the Government's ability to carry through its program for stabilization and adjustment. Negotiations took place in Washington in July 1991.

18. IDA also played a key role of mobilizing the support of various donors. In a May 1990 Rome meeting coordinated by the World Bank the donors discussed the multifaceted aspects of Nicaragua's economic situation and the need for external support. In December 1990 the first Consultative Group chaired by the Bank convened in Paris. The Group urged the Government of Nicaragua to develop a stabilization and adjustment program with the support of the World Bank and IMF. Subsequently in March 1991 another donor meeting was held in Washington in which the Government of Nicaragua explained its stabilization program and the structural measures already taken. Eventually in Paris, in the May 1991 Consultative Group meeting, the donors pledged strong support for Nicaragua's stabilization and adjustment program and also agreed on a plan to clear the arrears to the World Bank and to IDB which stood at US$ 327 million. The plan provided for bridge loans of US$ 193 million from Mexico, Venezuela, Spain, and Colombia, and bilateral contributions from other donors. These countries would be paid back from the proceeds for their repayment from the IMF, IDA's ERC (co-financed with Japan and Switzerland) and IDB's Trade and Financial Adjustment Loan (TFAL) operation of US$ 130 million. Hence IDA's ERC became the catalyst of a concerted effort to revive the economy that was highly distorted by the policies of the previous regime and severely damaged by the subsequent armed conflict between the Contra guerrillas and Sandinista forces.

19. Thus, assistance to Nicaragua started at the end of 1991 after meticulous preparation of a well-coordinated multifaceted aid/credit package. IDA, sensitive to the needs of the new Government, acted with speed (the first tranche was released only nine months after the initiation of the Project preparation). It also provided technical input to steer the Government's restructuring policy in the appropriate direction. Last but not least, it mobilized the donor community. Expectations ran high and the new Government appeared determined to put the economy on the right track.

20. It is important to point out several outstanding contributions of IDA to the Government's program. First and foremost, during the preparations IDA helped the Government to shape the required policy objectives and actions more concretely. The Government had inherited a weak civil service and apart from the high echelon of decision-makers (ministers, vice-ministers, and their handful of advisers) it lacked the internal mechanisms and know-how to mold the broad policy actions precisely. Moreover, the decision-makers themselves, though committed to stabilization and restructuring, did not have the experience in administering such a program. IDA's presence, therefore, contributed to crystallize a

coherent vision of the direction of the stabilization and restructuring program and also provided part of the much needed technical input. Secondly, to help the Government in both implementing the adjustment program and in dealing with IDA with respect to its requirements, the World Bank also established a resident mission (January 1992) in Managua, which is the World Bank's only resident mission in Central America. The main function of the resident mission was to assist the Government of Nicaragua with policy dialogue and monitor the implementation of the adjustment program.

E. PROGRAM OBJECTIVES AND DESCRIPTION

21. The principal aim of the Government was the re-orientation of the economy from a command system to one based on competitive free market forces. It called for structural changes in macroeconomic policies, public and financial sector reforms, revamping the incentives system, and redesigning the property rights, including privatization.

22. The Government's program consisted of:

- introduction of a macroeconomic policy framework supportive of price stability, trade and exchange rate liberalization, and balance of payments equilibrium;
- restraining the growth in public expenditures and significant reduction in military expenditures;
- reduction in public sector employment and initiation of an occupational conversion program;
- major reduction in the size of the state enterprise sector through privatization and restructuring;
- redesigning property rights to foster private investment and growth;
- reforming the tax system and improving the tax administration to increase efficiency in collections and raise government revenues;
- liberalizing domestic trade through the elimination of price controls;
- improving the allocation of financial resources and efficiency of financial intermediation;
- expanding output by increased private sector participation in trade;
- lowering tariff protection; and
- minimizing welfare losses and creating focused social safety nets.

F. ERC OBJECTIVES, DESIGN AND ORGANIZATION

23. The ERC was designed as a first step in support of a longer-term structural adjustment program for Nicaragua that aimed at moving the economy as fast as possible from a command to a market-led economy. The Credit was to support the Government's structural adjustment program described in ¶ 22.

24. The implementation of the structural adjustment program intended to promote growth through increased private sector participation, improved incentives for production, and a more efficient allocation of domestic resources. It aimed to increase employment opportunities, help alleviate poverty, and facilitate the flow of external financing and foreign investment. The program was not without risks, the principal ones of which were perceived as weaknesses in institutional capacity to carry out the program, resistance on the part of organized groups to fiscal and financial restructuring, slow private sector response due to uncertainty regarding the property rights, and shortfalls in timely donor support.

25. The Credit was a key instrument in clearing Nicaragua's substantial arrears to multi-lateral agencies and paved the way for the resumption of lending programs to support further structural reforms. The solution to problems of macroeconomic instability, deteriorated infrastructure, unemployment, poverty, and environmental degradation, and a speedy transformation from the command to the market economy could not all be attained with domestic resources alone and with the existing institutional capacity of the public sector. Hence IDA's assistance had to address the right areas, since the problems called for the mobilization of a multi-faceted assistance. The Credit, in terms of its scope, design, and scale, was well prepared and timely.

26. The proceeds of the ERC to support the Government's program were to be disbursed in two tranches. The Government was to take measures, prior to Board presentation, aimed at achieving a set of objectives prior to the disbursement of the first tranche. A second set of actions were stipulated as conditions for the release of the second tranche. The Annex details the objectives and the corresponding actions to be taken prior to making the first ERC tranche available and releasing the second tranche.

27. The ERC was to reimburse the C.I.F. cost of general imports excluding those financed by other multilateral or bilateral sources, luxury goods, military equipment, and those in the negative list of SITC. Because of lack of adequate procurement procedures, a cut-off limit of US$ 3 million was adopted for international competitive bidding. Imports valued at below that level were to be procured with established commercial practices. Public sector imports valued at US$ 1 million or less could be procured as long as at least two suppliers entered competitive bidding. The Central Bank was entrusted with the administration of the ERC and reviewed relevant procurement documentation according to eligibility criteria.

28. The first tranche of the ERC amounting to SDR 41.75 million (US$ 55 million) was disbursed upon effectiveness of the Credit Agreement. The second tranche was disbursed in June 1992 as anticipated, after compliance with the conditions for tranche release, including maintenance of a consistent macroeconomic framework, as specified in the Credit Agreement, was established.

G. PROGRAM IMPLEMENTATION

29. The Board presentation was conditioned on a set of policy actions (see also Annex) by the Government of Nicaragua. These can be grouped into three categories:

- <u>Fiscal actions</u>:
    - Reduction of non-interest current expenditures to the equivalent of US$ 325 million in the FY 1992 budget to be accomplished partly by reducing public sector employment by 8,000 through a voluntary employment reduction scheme;

- improvement of tax administration with specific emphasis on the General Value Tax and the Income Tax;

- removal of income tax exemptions and phasing out the exemptions from indirect taxes and import duties; and

- an action plan satisfactory to IDA to privatize CORNAP (Corporaciones Nacionales del Sector Público) enterprises.

■ Monetary and Banking actions:

- creating a Banking Superintendency;

- an action plan satisfactory to IDA for restructuring the state-owned banks; and

- cessation of Central Bank subsidies and discounts, except for micro enterprises in agriculture.

■ The Foreign Trade Regime:

- lowering protection to the 10-60 percent level;

- automatic registration of importers and exporters; and

- a price-based mechanism with variable levies for rice and corn with the aim of liberalizing agricultural trade.

30. The Government of Nicaragua took these actions, the accomplishment of which was verified by IDA. This led to taking the project to the Board and eventually the release of the first tranche of the ERC in December 1991.

31. The release of the second tranche hinged upon the following actions of the Government of Nicaragua:

(a) the budget for Fiscal Year 1992 has been adopted;

(b) an action plan for the carrying out of the recommendations of the study on public expenditures carried out by the Borrower has been presented to the Association;

(c) the following measures to strengthen tax administration have been taken: (i) the unit in the Borrower's Internal Revenue Service (Dirección General de Ingresos) in charge of large taxpayers has become operational; (ii) decrees imposing sanctions for non-compliance and/or late payments of taxes have been issued; and (iii) programs on automated management control system, computerized taxpayer identification system and training for personnel of the Borrower's Internal Revenue Service (Dirección General de Ingresos and Customs (Dirección General de Aduanas) have been initiated;

(d) the privatization of at least 25 companies under the control of the Borrower, through

CORNAP, has been completed;

(e) the devolution to the original owners or the liquidation or the transfer to the private sector of at least 50 companies under the control of the Borrower, through CORNAP, has been completed;

(f) at least 30 companies under the control of the Borrower, through CORNAP, other than those referred to in paragraphs (d) and (e) above, have been prepared for sale to the private sector;

(g) BI (Banco Inmobiliario) has been liquidated or merged with BNIC (Banco Nicaraguense de Industria y Comercio);

(h) CORFIN (Corporación Financiera de Nicaragua) has been dissolved;

(i) progress has been achieved in the carrying out of the action plan, agreed with the Association, for the restructuring of BNIC, BND (Banco Nacional de Desarrollo) and People's Bank (BP);

(j) a bill or bills of law regulating the functions and activities of the banks and other similar financial institutions operating in the territory of the Borrower has been presented to the Borrower's National Assembly;

(k) at least 2 licenses allowing private banks to operate in the territory of the Borrower have been issued;

(l) the protection resulting from combined tariffs and taxes that apply to imports in Nicaragua has been reduced to a minimum of 10 percent and a maximum of 40 percent, except with respect to medicines, books and newsprint which may be exempt from such tariffs and taxes or subject to tariffs and taxes at a combined rate lower than the minimum rate referred to above;

(m) the quotas on the importation of rice, yellow corn and white maize have been abolished and a mechanism for the importation of such commodities, based on price with variable levies, has been established;

(n) all restrictions on the importation of food grains other than those referred to in paragraph (m) above have been abolished; and

(o) a certified copy of the audit report referred to in Section 3.03(ii) of this Agreement in respect of the First Tranche has been furnished to the Association.

32. In mid-June 1992 IDA reviewed compliance with the second tranche conditionalities and reached the conclusion that all the stipulated conditions had been met. The budget for FY 1992 and the recommendation of IDA public expenditure study were adopted. The large taxpayer unit had begun to operate, sanctions were put in place, and a computerized management system and training were initiated at the Ministry of Finance. CORNAP was set up to supervise the state-owned enterprises and privatize them according to an agreed upon program. The speed of the divestiture process was faster than expected.

Twenty-five SOEs were privatized; 50 SOEs were either returned to their original owners, liquidated, or transferred to the private sector; and 30 companies were in the process of being prepared for privatization. In fact, by mid 1992 the Government had privatized 161 out of 352 enterprises, and the share of SOEs in GDP was reduced from 30 to 20 percent.

33. Conditions referring to financial reform were met. CORFIN, the holding company for state-owned banks, was dissolved; the plans for restructuring the National Development Bank (BNIC) and the People's Bank (BP) were prepared; a draft law was submitted to the National Assembly to regulate financial institutions, and 7 private banks (5 more than targeted) were licensed to operate in Nicaragua by the Superintendency of Banks.

34. The Government of Nicaragua took the measures to reduce the distortions in the trade sector. Import duties were reduced as stipulated. A price mechanism was established for rice, corn, and sorghum. And in March 1992 all restrictions on the importation of food grains were abolished.

H. MACROECONOMIC RESULTS AND ASSESSMENT OF THE ERC

35. The Government of Nicaragua was extremely optimistic that the economic recovery program would succeed in attaining a real growth rate of about 10 percent in GDP. IDA was much more cautious; it expected a positive real growth rate, but at a modest amount reaching 4 percent by 1993. Even IDA's modest projections did not materialize. GDP declined by 0.4 percent in 1991 as opposed to the projected growth rate of 1.0 percent. It increased by a mere 0.8 percent in 1992 as opposed to the projected rate of 3.0 percent. Currently, the growth rate is estimated at a decline of 0.7 percent in 1993.[1] The national accounts statistics do not include the informal sector. The growth in GDP may, therefore, be underestimated given the informal sector's rather rapid annual rate of growth (40 percent during 1990-1993).[2] The estimates regarding the size of the informal sector vary; but the consensus is that it represents no less than 30 percent of the economy. Part of the reasons for the phenomenal growth of the informal sector may be attributed to the layoff of public employees, part of whom have moved into the sector, and the attractiveness of contraband imports under the lax border controls.

36. The resource balance/GDP ratio[3] has also worsened. While the original figures were -25.2, -22.7, and -21.6 percent for the three years in question, the revised figures reveal somewhat larger negative figures of -29.9, -31.9, and -23.0 percent, respectively.

37. Although gross domestic investment was stable around 19 percent of GDP during 1990-1992, the

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[1] These and subsequent figures are taken from the Credit Document and the Bank's new estimates of June 1993, which give actual data for 1991, and estimated and projected figures for 1992 and 1993, respectively.

[2] The national income accounting in Nicaragua leaves much to be desired, since the methodology used at present suffers from a variety of shortcomings. Therefore, the degree of confidence of the published statistics is rather low. See "Cuentas Nacionales de Nicaragua: Evaluación y Propuestas," Convenio FMI/BID, Informe sometido 14 de mayo de 1993.

[3] The resource balance is the difference between resources available (GDP) and resources utilized for consumption and investment. A negative balance indicates that expenditures exceed output. This is also reflected in imports exceeding exports.

share of private domestic investment was halved between 1990 and 1992 to about 9 percent of GDP, reflecting the deteriorating investor confidence in the economy.

38. The performance of government revenues was better than expected. The tax-to-GDP ratio was 24.6 percent in 1991 as opposed to the expected ratio of 22.6 percent. The ratio is estimated to be 27.7 percent in 1992 as opposed to the projected 23.7 percent; and the projection for 1993 is revised to rise to 28 percent as opposed to 23.9 percent. While tax revenue exceeded expectations, expenditures rose. In 1991 with the planned expenditure cuts at the time of extending the Credit the expenditure-to-GDP ratio was reduced from the expected 34.8 percent to 32.1 percent. In 1992 and 1993, however, the ratios are revised to be higher than those estimated and projected. In 1992 the ratio is estimated to be 36.6 percent rather than 32.6 percent; and in 1993 it is projected to be 36.4 percent rather than 29.3 percent. As a result the budget deficit persisted and worsened slightly.

39. Successful implementation of various aspects of the fiscal program were linked to the timely availability of technical assistance. The technical assistance program to improve tax administration, financed by IDB, to the order of US$ 2.5 million, did not in fact start until November 1992. It was inflicted with several problems. For one, to assign the right counterparts to the international experts was and still continues to be a difficulty for the "Dirección General de Tributación" (General Tax Directorate). The provision of hardware and software took longer than programmed. Secondly, the planned training was also slow in starting and did not begin until recently. Thirdly, the operations of the Large Taxpayer Unit were confined to Managua and were extended to two additional "departamentos" only recently. The efforts to improve tax administration were further fortified by three IMF missions. The July 1992 mission provided technical input to design the strategy for an administrative reform. The December 1992 mission helped the administration with informatic requirements, and the July 1993 mission dealt with problems of control and auditing. It is evident, therefore, that any increase in Government revenues from improvements in tax administration cannot be expected earlier than 1994/95. Customs continue to be problematic as well. The design of the training program was a second tranche release condition. However, the implementation of the program is yet to start. At present too much is left to the discretion of untrained customs officials; also clear customs rules and regulations are absent. Discretion breeds mismanagement and loss of revenue. Also, not all exemptions have as yet been eliminated. Aware of the need to modernize the customs, the Government recently secured a loan of US$ 14 million from CABEI (Central American Bank for Economic Integration) to overhaul the customs administration and its procedures. Again, any improvements resulting from this program cannot be reflected in higher revenues any earlier than 1995/96.

40. While exports stagnated, imports increased much faster than expected. The export-to-GDP ratio declined while the import-to-GDP ratio continues to hover around 50 percent. This was particularly due to the stable real exchange rate resulting from foreign aid inflows combined with a tightened monetary policy. These measures prevented a major run on the Cordoba, but led to the deterioration of export incentives. The overvaluation of the Cordoba was only partly corrected early in 1993 when it was devalued by only 20 percent (despite IMF's higher recommendation), because the Government of Nicaragua considered that a higher devaluation would have entailed an adjustment in public sector salaries, which the Government could ill afford, and an inflationary impact which, politically, the Government was not willing to face. The 20 percent devaluation was not sufficient to stimulate the exports. At the same time the terms of trade worsened in contrast to their projected stability at the time of Board Approval. World prices for all export products fell, except for shrimp and lobster. Also production and yields declined reflecting a loss of competitiveness. The most important reason in the decline of production and yields occurred in cotton. During the Sandinista regime cotton was the most

important export commodity. However, its cultivation was maintained by heavily subsidized fertilizer prices and indiscriminate use of pesticide. When the present Government eliminated the subsidy on fertilizers, cotton stopped being an attractive export crop for the private sector. Moreover, to remedy the ecological damage to the soil caused by the indiscriminate use of pesticides became an expensive proposition for the private sector. Coupled with the decline in cotton prices in the world market, cotton exports became totally uncompetitive.

41. The Government maintained a tight monetary policy. The trauma caused by the hyperinflation of the previous years and possible political repercussions that inflationary pressures may generate were phenomena that the Government could not afford. The tight monetary policy targeted especially the reduction of the large Central Government budget deficit and the control of the state banks' credit to the private and public sectors. During implementation a tight rein was maintained on domestic credit and money supply.

42. After the release of the second tranche there was some policy backsliding. Even though there was an ongoing policy dialogue with the Government, IDA did not have an active instrument to deal with the issue. First of all, in February 1993 stamp duties on certain items were raised from 3 to 5 percent which, in turn, caused the nominal import duties on certain items to rise from 40 to 45 percent. Secondly, the Superintendency of Banks does not function properly and the restructuring of state banks is yet to be carried out. At the time of release of the second tranche (June 1992) the two state banks continued to dominate the financial sector holding 86 percent of total loans and 72 percent of total deposits. The situation is basically unchanged. This stems from two reasons. One is a constitutional impasse arising from the constitution's provision that the financial system belongs solely to the state. The legal boundaries between the constitution and the existing banking law, which allows private banks, were to be delineated by the Superintendency. This has not yet been done; the Superintendency still lacks complete autonomy as well as well-trained and qualified personnel. The second reason is the Government's conviction that state banks are necessary since they mostly lend to small rural borrowers. This is contradicted by the fact that small rural producers and micro enterprises are served mostly by informal credit markets, as stated by several bankers, with the state banks reaching only a fraction of the intended beneficiaries. The Superintendency at present is not an independent entity, and hence its actions are not free from political considerations and pressures. Nor does it have sufficient instrumentalities, human resources, informatics to carry out its functions properly. In short, the serious reduction of the state's role in the financial sector is yet to be achieved. Finally, although CORNAP has gone beyond ERC's targets in privatization, part of this success consisted of the quick devolution of the confiscated medium and small enterprises to the rightful owners. The larger enterprises, such as public utilities which were not under CORNAP's supervision, are yet to be privatized, and so are some large agricultural enterprises, because the property rights issue has not been solved.

43. As can be gauged from the previous analysis, Nicaragua has yet to experience a major economic recovery. The legitimate question, therefore, is whether the ERC failed in its objectives or whether other circumstances impeded the originally foreseen recovery. Before answering the question regarding the ERC's role in the economic recovery, it should be pointed out that in Nicaragua five factors, among others, have played a prominent role in preventing the economic recovery from taking off. These are (i) the political instability that continues to reign in the country; (ii) the slow process in solving the property rights issues; (iii) the slow response of public sector institutions to the program; in consequence (iv) the hesitation and slow response of the private sector to engage in productive activities; and (v) the obsolete machinery and equipment imported from various socialist countries incompatible with each other, and the dire shortage of spare parts.

44. The high risk of doing business in Nicaragua did not, and could not be expected to, diminish substantially. As anticipated by the IDA, the main barrier to private sector development was the fragile political environment. The delicate balance worked out between the Sandinistas and the Chamorro Government (leaving the control of the army and the police force in the hands of Sandinistas) eventually became a source of friction. The National Assembly became inoperative in late 1992. The political climate worsened in 1993 with incidents of hostage taking in August. In addition, economic policy management continued to rely on excessive discretion which spread the fear that in the event of worsening macroeconomic conditions the Government could reverse policies. This easily becomes a self-fulfilling prophesy with increases in tax rates, import duties, etc., and impedes private sector development. Also, a variety of political factors have prevented the Government from solving once and for all the property rights issue and overhauling the judiciary system. Hence, in a climate of political uncertainty the expected private sector investments that could have contributed to economic growth did not take place. The delicate political balance still continues.

45. The managerial capabilities of the Government of Nicaragua are limited. It is doubtful whether the managerial requirements of the economic recovery program are fully understood and fulfilled by all public sector managers. After 10 years of managing the economy by command, it was overoptimistic to expect a drastic change in the organizations, established habits, and ingrained inflexibilities in the institutional set up in only a short period of two years. The mid-level public management cadre is yet to be developed and the expected influx of human capital has yet to take place.[4]

46. In addition, the public sector is still oversized and the expenditures have not yet been sufficiently reduced. The Government continues to be involved in activities that are normally performed by the private sector, such as banking, and hence crowds it out from areas in which it should be engaged.

47. Finally, natural disasters, namely the eruption of the Cerro Negro volcano in April 1992 and tidal waves in the Pacific Coast in September 1992 have had considerable negative impacts on the economy. Agricultural production, forestry, fishing, and tourism were seriously affected. The direct damage is estimated to amount to US$ 25 million. The direct and indirect impact combined was estimated to be 0.5 percent of GDP of that year.

48. These developments should not be taken as a criticism of either the conception or implementation of the ERC. It would be inappropriate to assess the impact of a US$ 110 million credit only in quantitative terms. For, first of all, in the absence of the credit much less of the needed imports could have been financed and Nicaragua would have no access to international credits. Secondly, IDA played a very important catalytic role in mobilizing co-financing from bilateral assistance. Thirdly, IDA assisted the Government to articulate and take or initiate the right policies and drove the Government in the direction of opening the economy to the private sector. Finally, IDA directly or indirectly led to the provision of technical assistance by bilateral and multilateral agencies.

[4] A USAID project (implemented from June 1990 to December 1992) had the purpose of providing technical advisors to the ministries to enhance their capabilities and train counterparts. In total 33 advisors were funded by the project about half of whom were Nicaraguans residing abroad. At the end of the project none stayed with the public sector, simply because the public sector could ill afford the salary scales paid by USAID. Many went back, and due to lack of counterparts very little training took place. The expected reverse brain drain did not take place; this could not be otherwise without changing the overall working conditions in the country and establishing a lasting stability.

49. The Bank itself conducted two important studies in support of institutional strengthening and better economic management of the public sector. "Public Expenditure Review" (Report No. 10785-NI, September 11, 1992) aimed at assisting the Government of Nicaragua to improve the allocation of public resources and strengthen the institutions involved in financial management and project implementation. Another study "Deregulation of Public Utilities and Natural Resources" (June 1993) examined the structure of these sub-sectors, highlighted the features that generate bottlenecks for growth, and made recommendations for a market-oriented growth strategy and for the improvement of their management.

50. Other assistance agencies also extended support to the new Government. To help implement the ERC, IDB financed technical assistance to the Ministry of Finance (US$ 2.5 million) and IMF provided direct technical assistance to improve the tax administration. UNDP, within the fifth cycle of its five-year country program of US$ 39 million, fielded several technical assistance missions aimed at public sector institutional strengthening. External cooperation, privatization, macroeconomic policy-making have been some of the attention areas for the UNDP. In addition, UNDP also extended technical assistance for sectoral development. USAID's technical assistance was also spread over a number of areas. One consisted of providing various ministries, for at least one year, with high level experts (mostly Nicaraguans living abroad). In addition, the project also aimed to reverse the brain drain. USAID also provided twelve short-term technical assistance between December 1991 and mid-1993 to various ministries for institutional strengthening and macroeconomic policy formulation. This assistance amounted to about US$ 2 million. USAID will implement in early 1994 another technical assistance of US$ 8 million over the next five years, directed to the provision of assistance to the Economic Cabinet.

51. The major technical assistance programs summarized above do not constitute a complete inventory of assistance extended to Nicaragua, but highlight the major ones. It is important to note that these programs were not well coordinated. The responsible entity for aid coordination in the Government is the Ministry of External Cooperation. This Ministry was not fully effective in coordinating external assistance, nor did it have the capacity for priority setting. As a result the totality of technical assistance is yet to yield optimal results. The diffused and uncoordinated technical assistance tends to result in conflicting opinions and confusion in the Government. The need to coordinate technical assistance became apparent at the time when ERC was being prepared. Initially, IDA was not prepared to undertake the coordination of technical assistance; nor did the Government make a formal request to that effect. As the necessity of coordination became apparent as an essential component of overall assistance, IDA indicated its willingness to assume such a responsibility. But there was no consensus within the Government as to which international agency should be responsible for it, nor which government entity should be the counterpart organization. UNDP was also reluctant to support IDA's leadership on the matter. Hence, no coordination took place and each agency began to provide assistance as it saw fit. On the Government's side the Ministry of External Cooperation remained ineffective as an aid coordination organization. With respect to external resource transfers, IDA, however, did succeed in coordinating the efforts of several donor agencies to put together a financial assistance package which helped clear the arrears.

I. SUSTAINABILITY

52. All the expected results of the reform and restructuring initiated with the support of the ERC are yet to become apparent. Nicaragua continues to depend on external assistance and the extent and likely reduction in donor support are disconcerting. While imports surged, exports at best stagnated and investment did not take place in sufficient magnitudes to bring about economic growth and allow

adjustment to occur. Given the uncertain political conditions and yet to be resolved property rights issues, the private sector is hesitant to respond to the Government's reform and restructuring efforts. Unless political stability begins to reign and property rights issues are resolved, the originally perceived reform and restructuring will lack one of the most essential element for their successful implementation and whatever meager achievements attained thus far are likely to dissipate in the future.

53. Sustainability is also dubious because of the weakness of the overall administrative capacity of the central and local governments. The weakness partly stems from the excessive number of civil servants and the budget constraint that impedes their better remuneration, which in turn hampers efforts to improve public management. Failure to improve public management leads to waste and inefficient administration and prevents in turn concerted efforts to improve public management. Unless the budget, current and investment, is trimmed and unless a concerted effort is undertaken to improve public management with better remunerated civil servants, Nicaragua will continue to depend on technical assistance and the economic reform will be extremely slow in taking off.

54. The current expenditures of the Central Government need to be reduced further. The "Public Sector Expenditure Review" conducted by the Bank suggested that the number of the civil servants be streamlined so that salaried of the professionals can be adjusted. However, expenditures on goods and services, and for defense spending also need trimming. It is yet to be seen whether the Government can tackle these issues in a proper and timely manner. The reduction of defense expenditures alone will in all probability not suffice. Moreover, public investment program was much too large for the Government's implementation capacity. The need continues to lie in mastering the techniques of prioritizing public investment projects.

55. Finally, Nicaragua needs to realize that foreign aid may not be forthcoming as abundantly in the future as it did in the past. Yet, it is highly dependent on foreign aid. For example, the temporary stoppage in 1992 of US$ 104 million (equivalent to 7 percent of GDP) of the US$ 450 million United States direct support aggravated the resource problem and put the stabilization program off-track. When the aid was subsequently restored, it did solve the short-term liquidity problem. The incident revealed the fragility of the stabilization effort and the high dependence on foreign aid. If sufficient foreign aid does not come forth in subsequent years and if an institutionalized aid coordination effort is not made within the Government to allocate such aid efficiently in full accordance with the restructuring efforts, the gains made so far are likely to be lost.

56. Nicaragua needs to accelerate its structural transformation and move rapidly towards an export-oriented market-based economy with a much smaller but more efficient public sector. The public sector is still oversized and inefficient, crowding out the private sector and generating waste. Central Government expenditures still command the highest share of GDP in Central America. The Government has spread its limited managerial capabilities too thinly and its specialized human capital skills in too many activities. The sustainability is challenged unless public sector functions efficiently and stops crowding out the private sector.

57. Nicaragua still continues to depend on financial and technical assistance. If such assistance were not to come forth, and if the ERC is not followed by another Economic recovery credit from IDA, the sustainability of the policies of the Government and the limited results achieved so far will certainly remain in doubt.

J. LESSONS LEARNED

58. Several lessons emerge from the Bank's experience. First, when the countries' credit needs are inextricably related to transforming rather than reforming their economies, a longer term vision is necessary. In an economy where institutions are being overhauled and new organizations are being created, the "adjustment" necessarily takes much longer time than in market-oriented economies. Nicaragua is a case of the former type. In retrospect, the expectations for the degree of change under the ERC within a relatively short period of time have proven to be optimistic.

59. Second, concomitantly with structural adjustment, long run development problems must also be tackled. From the outset IDA conceived the ERC only as a first step in a medium-term adjustment process. But long-term adjustment and transformation of the economy was not detailed in a comprehensive and consistent fashion. Nor was there any demonstrable willingness or ability from the part of the Government to follow up such a long-term adjustment process at the time of the ERC design. Once, for example, the political and economic problems became persistent and the Government was unable to come to an agreement with IMF on ESAF (Extended Structural Adjustment Facility), IDA was unable to follow up the first operation with subsequent credit operations for a long time. It is only recently that the Government was able to commit itself to the preparation of an ERC II operation. When the structural adjustment in fact is part of the transformation process of the country, the time horizon of the lending needs to be much longer. At the same time, each ERC should be self-contained, without leaving the completion of actions to other operations.

60. The third lesson that emerges is that much better donor technical assistance coordination is a sine qua non. IDA should have insisted on an effective aid coordination. (The proposed ERC II operation is being supported by a Technical Assistance Credit that will address the key institutional weakness in the public sector.) that would set the priorities and be an integral and effective part of the Economic Cabinet. A proper functioning of aid coordination might have been one of the tranche release conditions. At present the Nicaraguan institutional weakness for the formulation and execution of integral technical assistance policies creates a situation in which each donor, agency, or organism with its respective national counterparts has no choice but to act in a separate and autonomous manner to achieve sectorial goals that in many cases do not complement each other or are even sometimes plainly contradictory. There is an urgent need to formulate integral policies for a rapid transition to market economy and concomitantly the technical assistance required. If this is not done, the tardy implementation of these policies could imply the undoing or substantial modification of policies already in execution with subsequent delays and risks.

61. The fourth lesson is that the extent of technical assistance needs to be estimated correctly. In Nicaragua the width and the depth of technical assistance was underestimated. At a time when the country was just beginning to transform from a command to a market-based economy, political complications and administrative capacities were underestimated. The political stability was assumed to settle in rapidly; this was not the case and had negative repercussions on reform and adjustment. In addition, one of the essential elements of the assistance package should have been a well-conceived and well-designed longer-term package directed to the improvement of the economic management capabilities of the public sector, including a strong training component. Instead the practice, in more cases than not, consisted of the temporary utilization of technical assistance experts in the role of civil servants.

PART II. PROGRAM REVIEW FROM THE BORROWER'S PERSPECTIVE

This review was prepared by the Government of Nicaragua, upon request of the World Bank, as part of the Project Completion Report on the Economic Recovery Credit to the Republic of Nicaragua (Credit 2302-NIC).

A. THE BORROWER'S ERC REVIEW

The assessment of program implementation in Part I confirms that the ERC's first and second tranche release conditions were met on schedule by the Borrower. The analysis in Part I also documents that the program did not fully achieve its hoped-for impact: the program succeeded in eliminating hyperinflation and stopping the decline in output, but so far has not succeeded in reviving economic growth as has been projected for 1992 and 1993.

While implementing free markets and uprooting private sector constraints were the essential focus of structural reforms supported by the ERC, the key issue is whether these adjustments were enough to produce sustained growth in the case of Nicaragua. The question whether the ERC objectives were too ambitious is a legitimate one. Government's responsibility for the program outcome has to be recognized. Nonetheless, the more basic question of means-to-ends adequacy has to be fully taken into account for future ERCs.

Part I mentions a few instances of policy "backsliding" (with respect to tariff reductions, tax increases and downsizing of the state banks) after the last tranche of ERC was released. However, the Government of Nicaragua does not consider these to have been very significant, neither in terms of constituting major policy reversals nor in explaining the lack of growth response. Rather, the main factors that prevented the hoped-for revival of growth included three successive years of unusually bad weather conditions, international commodity price declines, interruptions in aid flows from bilateral donors, and a fragile political situation that prevented a quicker resolution of property conflicts in rural and urban areas. These factors, in turn, also generated uncertainties among private investors that resulted in a slower response that initially projected to the reforms made. The Government believes that, in spite of these adverse circumstances, the policy reform process has been maintained substantially on the course envisaged when the program was adopted.

This first experience of Nicaragua with an ERC confirms that greater economic efficiency is an indispensable, although insufficient condition for sustained growth. In sum, a more balanced approach to the Nicaraguan adjustment was required that should have provided for reform policies to drive private investment and improve the relative price structure in behalf of the Nicaraguan tradeables and exports.

In view of the program results, as documented in Part I, we consider that the reform measures taken so far were necessary for providing a better basis than existed before for achieving faster and sustained growth, but have not been sufficient to ensure that such growth materializes.

B. THE BORROWER'S PERFORMANCE

The Government of Nicaragua demonstrated a strong commitment to its reform program, as evidenced by its fulfillment of the ERC disbursement conditions, in spite of severe political and external constraints. Progress in implementing the structural adjustment measures came about at high political cost for the Government, to the extent of putting at risk its continuation in power on several occasions. The maintenance of a fragile political balance has been fundamental in determining the Government's ability to function effectively, including its ability to maintain public security. The need to sustain this political balance revealed itself as equally important for purposes of reaching fundamental program objectives as maintaining economic balances in order. A major lesson learned during the implementation of the ERC supported program is that the advancement of reforms demands a supportive political environmental and a firm national consensus on the future socio-economic development of the country.

C. IDA'S PERFORMANCE

The Government of Nicaragua wishes to use this opportunity to express its high praise for the World Bank in making this first ERC for Nicaragua possible. The Bank played a very valuable role in the preparatory stages of the program. With its help, Nicaragua was able to normalize its relations with the international financial community and develop a policy framework for designing and implementing its adjustment program. The ERC itself provided necessary financial report to the Government's effort since March, 1991 in sustaining macroeconomic stability and in facilitating the reform measures designed to create a more market-based and private sector oriented economy. An undisputed achievement of the ERC was the mobilization of sufficient foreign financial assistance to render the Government's stabilization program successful. This made a key difference compared to previous adjustment attempts in Nicaragua.

D. RELATIONSHIP BETWEEN IDA AND BORROWER

The Bank's missions during the ERC's preparatory stage were effective and timely in helping the Government prepare its structural adjustment program. The cooperation between the Bank's and Government's staff was fluid and fruitful during the course of ERC preparation and implementation. Furthermore, the Bank opened a resident mission in January 1992, which reinforced relationships with the Government in policy dialogue, the ERC implementation and technical assistance. The ERC funds were disbursed in a timely manner, based on the compliance by the Central Bank of Nicaragua with the ERC procurement, disbursement and auditing guidelines.

E. RELATIONSHIP BETWEEN CO-FINANCIERS AND THE BORROWER

Disbursement of ERC co-financing commitments by the official agencies of Germany, Japan, and Switzerland proceeded in an agile and expedite manner.

F. ADEQUACY AND ACCURACY OF FACTUAL INFORMATION IN PART III

The description of the program elements, and the timing of Bank's missions and disbursements, conform with the Government's figures and information base.

PART III. STATISTICAL INFORMATION

A. PROJECT TIMETABLE

Core Steps	Original Plan	Revised Plan
Init. Memo	01/10/91	01/10/91
Prep. mission	01/15/91	01/15/91
FEPS/IM-OC	05/13/91	05/13/91
Depart appr.	06/06/91	06/06/91
Yellow cover	07/05/91	07/05/91
Docs to RVP	07/11/91	07/11/91
Start neg.	07/23/91	07/23/91
Board approv.	09/26/91	09/26/91
Signing date	12/31/91	12/31/91
Credit closing	06/30/92	06/30/92
PCR complet.	12/15/93	03/31/94

B. CUMULATIVE LOAN DISBURSEMENTS (US $ million)

	1991	1992
Appraisal estimate	110	-
Actual	55	55
Actual as % of estimate	50	100
Date of final disbursement	June 1992	

C. STAFF INPUTS (staff weeks)

appraisal or assistance ? resident mission was installed in January 1992

preparation

	1991	1992	1993
LENA	11.5	11.2	
LENP Preappraisal	86.3		
LENN Negotiations		25.0	
SPN Supervision		44.9	1.0
PCR			10.0
Total	97.8	81.1	11.0

D. MISSION DATA

	Month/Year	# of Weeks	# of Staff Persons	Weeks
Preparation	January 1991	2	7	14
Pre-appraisal	April 1991	2	12	24
Appraisal	June 1991	2	5	10
Negotiation	July 1991			(no mission)
Supervision	Dec. 1991	2	1	2
Supervision	Feb. 1992	2	3	6
Supervision	April 1992	1	3	3
Supervision	May 1992	1	1	1
Supervision	June 1992	2	2	4

ANNEX. MATRIX OF ACTIONS

Issues and Objectives	Actions Adopted		Actions to be Adopted
	Before Negotiations	Before Board Presentation	Before Second Tranche
• Macroeconomic Policies and Program Implementation Achieve and maintain a macroeconomic policy framework consistent with the objectives of price stability, trade and exchange rate liberalization, and balance of payments equilibrium.	A stabilization program has been initiated: Cordoba was evaluated by 400 percent. Expenditures targeted in line with expected revenue. Adopted cash-budgeting procedures for expenditures. Monthly credit ceilings for Central Bank credits established.	Maintenance of an appropriate macroeconomic framework, including fiscal deficit and domestic credit ceilings consistent with stabilization objectives (Board Presentation Condition. Maintenance of exchange rate policy which is consistent with export competitiveness, and which reflects changes in monetary, balance of payments, and trade and foreign exchange reserve indicators. Satisfactory progress implementation (Board Presentation Condition).	Maintenance of a macroeconomic policy framework consistent with the objectives of the program. Satisfactory progress achieved by the Borrower in the carrying of the Program.

Issues and Objectives	Actions Adopted		Actions to be Adopted
	Before Negotiations	Before Board Presentation	Before Second Tranche
• Public Expenditures			
Large size of public sector with high total expenditures/GDP ratio and current expenditure/GDP ratio.	Budgetary expenditures for FY91 have been restrained, including a significant reduction in military expenditures.	Reduction of Central Government non-interest current expenditures in the proposed FY92 budget to less than US$325 million equivalent (Board Presentation Condition).	(a) The Budget for Fiscal Year 1992 has been adopted; (b) an action plan for the carrying out of the recommendations of the study on public expenditures carried out by the Borrower has been presented to the Association.
Weak institutional capacity to plan and monitor public expenditures.			

Issues and Objectives	Actions Adopted		Actions to be Adopted
	Before Negotiations	Before Board Presentation	Before Second Tranche
• Public Sector Employment Excessive public sector employment and large wage bill. Resource public sector work force and facilitate reallocation of redundant labor to productive employment in the private sector, especially in tradeables.	Government demobilization of 35,000 military draftees and militia and retiring of 5,000 military officers. Institution of a hiring freeze in Central Government.		
	Introduction of an externally funded "employment reconversion program to relocate 9,000 of 69,000 central government employees, including an additional 3,000 military personnel during 1991.	Completion of the processing of voluntary employment reduction in the public sector for 8,000 personnel (<u>Board Presentation condition</u>).	
		Preparation of an action plan to extend employment reconversion program to the entire public sector with a target of 10,000 employees including CORNAP, public utilities, and the banking sector.	Satisfactory progress in implementing the action plans for employment reconversion program.

Issues and Objectives	Actions Adopted		Actions to be Adopted
	Before Negotiations	Before Board Presentation	Before Second Tranche
• Public Utilities Major restructuring of public utilities is needed to improve efficiency in their operations and responsiveness to the demands of a growing and competitive economy.	Elimination of indiscriminate price subsidies for the goods and services supplied by most state enterprises. Creation of an informal oversight central government committee for public utilities.		Initiation of a study with IDA support, on Public Enterprise rationalization.

Issues and Objectives	Actions Adopted		Actions to be Adopted
	Before Negotiations	Before Board Presentation	Before Second Tranche
• Privatization Major reduction of the size of state enterprise sector. Quick sales of state enterprises to reduce the structural deficit of the public sector, to encourage private sector participation, and to generate revenue. Clarify and guarantee private property rights to remove uncertainty and foster private investment and growth.	Established CORNAP and endowed it with responsibility for both managing and privatizing about 350 state enterprises. Study completed on privatization strategy. Strategy for divestiture is worked out. 86 companies have already been returned to previous owners, liquidated or privatized, including one large group of agricultural enterprises -Matonic-.	Adopt an action plan, satisfactory to IDA, to privatize CORNAP enterprises (<u>Board Presentation condition</u>).	(d) The privatization of at least 25 companies under the control of the Borrower, through CORNAP, has been completed. (e) The devolution to the original owners or the liquidation or the transfer to the private sector of at least 50 companies under the control of the Borrower, through CORNAP, has been completed. (f) At least 30 companies under the control of the Borrower, through CORNAP, other than those referred to in paragraphs (d) and (e) above, have been prepared for sale to the private sector.

Issues and Objectives	Actions Adopted		Actions to be Adopted
	Before Negotiations	Before Board Presentation	Before Second Tranche
• Public Revenue			
Increase and maintain tax revenue to ensure objectives of stabilization and non-inflationary finance of medium-term government program.	Tax reform measures were implemented, including reduction in the number of brackets in personal income tax, and reduction of top rates for personal and corporate income taxes.		
	Withholding provisions were improved, and new presumptive methods were introduced for both of above taxes.	Removal of income tax exemptions, and approval of a program to phase out indirect tax exemptions including import tax exemptions (Board Presentation Condition).	Satisfactory progress in implementing the action plan to phase out indirect tax exemptions.
	The General Value Tax base was expanded and the rate increased to 15 percent. Administratively granted tax exemptions were eliminated.		(c) The following measures to strengthen tax administration have been taken: (i) the unit in the Borrower's Internal Revenue Service (Dirección General de Ingresos) in charge of large taxpayers has become operational; (ii) decrees imposing sanctions for non-compliance and/or late payments of taxes have been issued; and (iii) programs on automated management control system, computerized taxpayer identification system and training for personnel of the Borrower's Internal Revenue Service (Dirección General de Ingresos) and Customs (Dirección General de Aduanas have been initiated.
Simplify and strengthen tax administration.	Adoption of a plan, satisfactory to IDA, to improve tax administration with emphasis on GVT and Income Tax Collections. Preparation of a pilot project to register and collect taxes from large tax payers.	Initiation of an action plan, satisfactory to IDA, to improve tax administration with specific emphasis on GVT and income tax collections (Board Presentation Condition).	

Issues and Objectives	Actions Adopted		Actions to be Adopted
	Before Negotiations	Before Board Presentation	Before Second Tranche
• Financial Sector			
Improve the allocation of financial resources by rationalizing regulations on banking activities and by strengthening instruments of monetary control.	Established deposit interest rates at 12 percent and lending rates at 18 percent and tied both to dollar. Introduced a monthly deposit rate for non-indexed deposits.		Adoption of an interest rate policy which approximated rates to market rates, by setting up a band for lending rates and freeing the deposit interest rates.
Improve the efficiency of financial intermediation through the development of a profit oriented, private sector based financial system.	Assembly approved a bill for setting up a Superintendency.	Adoption of regulations, satisfactory to IDA, for the implementation of the Superintendency law. Appointment of a superintendent and start-up of Superintendency activities (Board Presentation Condition). Adoption of an action program, satisfactory to IDA, for the restructuring of state-owned banks, along with cessation of Central Bank subsidies and discounts except for agriculture and micro enterprises (Board Presentation Condition). Preparation of terms of reference for developing and implementing the new Law for Banking and Financial Institutions which identifies a term, a technical assistance financing source, and a timetable.	Preparation of transitory normatives to establish necessary prudential regulations. (g) BI has been eliminated or merged with BNIC. (h) CORFIN has been dissolved. (i) Progress has been achieved in the carrying out of the action plan, agreed with the Association, for the restructuring of BNIC, BND and BP. (j) A bill or bills of law regulations the functions and activities of the banks and other similar financial institutions operating in the territory of the Borrower has been presented to the Borrower's National Assembly. (k) At least 2 licenses allowing private banks to operate in the territory of the Borrower have been issued.

Issues and Objectives	Actions Adopted		Actions to be Adopted
	Before Negotiations	Before Board Presentation	Before Second Tranche
• Trade Regime			
Increase output and diversification of tradables by increasing private sector participation in trade.	Trade Deregulation Decree opens import and export trade to the private sector.		Consolidate the legal framework to ensure permanence of minimum government intervention in foreign trade.
	After the devaluation of the Cordoba, foreign exchange allocation mechanisms were significantly liberalized, eliminating ministerial and Central Bank permits for importers, and giving de-facto full access to foreign exchange to exporters (except cotton and coffee exporters).	Allow full foreign exchange retention for exporters under an Export Promotion Decree.	Achieve full current account convertibility of the Cordoba.
Move to a more uniform, transparent, and lower nominal protection structure.	Reduction in the dispersion and average "basic" tariff rates. Elimination of selective consumption tax on a number of imports. Conclusion of a free agreement with Mexico to become fully operational by 1996.	Lowering nominal protection in trade sector to a range of 10%-60% through a combination of reductions in the levels of tariffs, SCT, and stamp tax; and announcement of a target tariff range of 10%-20% and elimination of SCT and stamp tax by 1993; and approval of arrangements for automatic registration for imports and exports (<u>Board Presentation Condition</u>).	(l) The protection resulting from combined tariffs and taxes that apply to imports in Nicaragua has been reduced to a minimum of 10 percent and a maximum of 40 percent, except with respect to medicines, books and newsprint which may be exempt from such tariffs and taxes or subject to tariffs and taxes at a combined rate lower than the minimum rate referred to above.
		Develop action plan to provide free trade status, i.e., exemption of tariffs and indirect taxes, for exporters.	Satisfactory progress in the implementation of the action plan for giving free trade status to exporters.
		Design a price-based mechanism with variable levies for rice, yellow corn and white maize (<u>Board Presentation Condition</u>).	(m) The quotas on the importation of rice, yellow corn and white maize have been abolished and a mechanism for the importation of such commodities, based on price with variable levies, has been established. (n) All restrictions on the importation of food grains other than those referred to in (m) above have been abolished.

Issues and Objectives	Actions Adopted		Actions to be Adopted
	Before Negotiations	Before Board Presentation	Before Second Tranche
*** Deregulation**			
Curb and eventually minimize static and dynamic welfare losses occasioned by pervasive state intervention.	Elimination of most domestic price controls other than those of public utilities and the fiscal industries.		Abrogation of the legal framework permitting price controls, except for natural monopolies. Removal of transitory price setting adopted for selected products in government-owned stores.
	Abrogation of legal export monopolies for several products by allowing private sector access to export licenses.		Present an action plan, satisfactory to IDA, to remove price controls of the fiscal industries and to reformulate the ISC extending it to luxury goods.
		Elimination of barriers to entry to natural resource exploitation by transferring licensing regulations from state enterprises to the Ministry of Economy. Prepare terms of reference for studies on the regulatory framework of natural resources.	Implementation of the study's findings on a regulatory framework for the management of natural resources. Disallow ENABAS to trade in all but basic grains.
		Elimination of support prices for basic grains. ENABAS to begin offering services (storage, bundling import orders) and to rent facilities to private entrepreneurs.	Present a program for privatizing ENABAS retail and wholesale outlets, such that at least 20% of its corresponding assets will be sold to private parties or to laborers by March 1992 and the remainder will be divested by the end of 1992. Present an action plan to redefine the future role of ENABAS.

IMAGING

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Type: PCR

END

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Report No. P-6340-NI

REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL DEVELOPMENT ASSOCIATION

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED SECOND ECONOMIC RECOVERY CREDIT

IN AN AMOUNT EQUIVALENT TO SDR 42.5 MILLION

AND AN

IDA REFLOWS SUPPLEMENTAL CREDIT

IN AN AMOUNT EQUIVALENT TO SDR 5.36 MILLION

TO THE REPUBLIC OF NICARAGUA

MAY 27, 1994

CURRENCY EQUIVALENTS

US$1 = 6.4 Nicaragua Córdobas (March 1994)

FISCAL YEAR

January 1 - December 31

ABBREVIATIONS AND ACRONYMS

ATP	Temporary Protection Tariff *(Arancel Temporal para la Protección)*
BANADES	National Development Bank *(Banco Nacional de Desarrollo)*
BANIC	State Bank for Industry and Trade *(Banco Nicaragüense de Industria y Comercio)*
CACM	Central American Common Market
CEM	Country Economic Memorandum
CET	Common External Tariff
CG	Consultative Group
CORNAP	State Holding Corporation *(Junta General de Corporaciones Nacionales del Sector Público)*
ESAF	Enhanced Structural Adjustment Facility
ESW	Economic and Sector Work
ENIGAS	State Gas Company *(Empresa Nicaragüense de Gas)*
FISE	Emergency Social Investment Fund *(Fondo de Inversión Social de Emergencia)*
FNI	National Investment Fund *(Fondo Nacional de Inversión)*
GATT	General Agreement on Tariffs and Trade
ICB	International Competitive Bidding
IDC	Institutional Development Credit
IDB	Inter-American Development Bank
IDF	Institutional Development Fund
IEC	Special Consumption Tax *(Impuesto Especial al Consumo)*
INISER	State Insurance Company *(Instituto Nicaragüense de Seguros)*
ISC	Selective Consumption Tax *(Impuesto Selectivo al Consumo)*
LUBNICA	State Oil Products Company *(Lubricantes de Nicaragua)*
MOH	Ministry of Health
MCT	Ministry of Construction and Trade
NAFTA	North American Free Trade Agreement
NEAP	National Environmental Action Plan
NTB	Non-Tariff Barrier
PETRONIC	State Petroleum Company *(Empresa Nicaragüense del Petróleo)*
PFP	Policy Framework Paper
PMU	Reform of the State Program Management Unit
SILAIS	Departmental Health Units *(Sistema Local de Asistencia Integrada para la Salud)*
TAC	Technical Assistance Credit
TELCOR	State Telecommunications Company *(Instituto Nicaragüense de Telecomunicaciones y Correos)*
UNDP	United Nations Development Programme
UNO	United National Opposition *(Unidad Nacional Opositora)*
USAID	United States Agency for International Development

NICARAGUA

SECOND ECONOMIC RECOVERY CREDIT

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ANNEXES

NICARAGUA: SECOND ECONOMIC RECOVERY CREDIT

CREDIT AND PROGRAM SUMMARY

Borrower: Republic of Nicaragua

Amount:

	IDA	SDR 42.5 million (equivalent to US$60 million)
	IDA Reflows	SDR 5.36 million (equivalent to US$7.6 million)

The proposed Supplemental Credit for Nicaragua was contained in the President's Memorandum of January 4, 1994 entitled "Distribution of FY94 Annual Allocations from IDA Reflows—Proposed Supplemental Credits for Bolivia, Ethiopia, Ghana, Guyana, Honduras, Kenya, Malawi, Mauritania, Senegal, Sierra Leone, Uganda and Zambia" (IDA/R94-1), approved by the Board on January 14, 1994.

Terms: Standard IDA terms, with an amortization period of 40 years, including a grace period of 10 years.

Program Objectives: The proposed second Economic Recovery Credit (ERC II) would support the Government's structural adjustment program, which aims to: (i) carry out a major reform of the State; (ii) increase the efficiency of financial intermediation; and (iii) improve conditions for private sector development.

Credit Description: To help achieve the program's objectives, the proposed ERC II would support measures to: (i) maintain a stable macroeconomic framework; (ii) reform the State, including: (a) reducing public sector employment, (b) privatizing state-owned enterprises, and (c) implementing a comprehensive public sector reform program; (iii) improve the efficiency of state-owned banks and strengthen prudential supervision of the financial system; and (iv) improve incentives for private sector activity by: (a) strengthening the property rights resolution process, (b) increasing transparency and reducing discretionality in incentives and policies, (c) implementing a phased program to reduce protection, and (d) improving labor policies. A policy matrix spelling out the objectives of the proposed credit, measures already taken, measures to be taken under the credit, and proposed timing is provided as Annex C.

Benefits: Implementation of the reform program would allow the Government to carry out an orderly adjustment in response to the prospective decline in foreign aid and establish the conditions for a revival of private sector-led growth. Approval of ERC II would enable the Government to mobilize additional balance of payments support, which would permit a more gradual and predictable economic adjustment path to reduced aid flows. Moreover, to the extent that the program succeeds in reviving growth within a stable macroeconomic environment, there would be modest but important improvements in living standards and the Government would be in a better position to address the country's complex, longer-term development challenges.

Risks: The proposed credit will involve two major types of risks. First, a breakdown of the consensus-building process and strong opposition to some of the reforms could lead to a political impasse as occurred in 1993. Although the political situation remains uncertain, there is also greater awareness in Nicaragua that the country has no option but to adjust to the decline in external aid, and that this will necessarily involve a reduction in the public sector. Second, the Government's weak institutional capacity could delay implementation of several components of the program. To address this risk, the proposed credit has been designed with considerable flexibility, relying on implementation of action plans, which allow for the monitoring of overall program execution while leaving sufficient room for variability in implementation of different components. Implementation of the structural adjustment program would also be supported by a proposed Technical Assistance Credit and other capacity-building elements of IDA's country assistance strategy.

Poverty Category: Not applicable.

Estimated Disbursement: The credit would be disbursed in three tranches. The first tranche of US$30 million, supplemented by the IDA Reflows Credit of SDR 5.36 million (US$7.6 million equivalent), would be eligible for disbursement upon effectiveness, planned for July 1994. Two tranches of US$15 million each would be available for disbursement upon fulfillment of second and third tranche conditionality, expected by December 1994 and August 1995, respectively. Retroactive financing will be permitted for those eligible imports made before the date of the credit agreement and after February 1, 1994, up to an amount not to exceed one third of the credit (SDR 14.17 million equivalent).

Schedule of Disbursements:

	US$ million	
	FY95	FY96
Annual	52.6	15.0
Cumulative	52.6	67.6

Financing Plan: The Governments of Germany, Sweden and Switzerland are considering cofinancing equivalent to US$12 million, US$9 million and US$6 million, respectively. In addition, the Government of Nicaragua has requested cofinancing of US$60 million from the Government of Japan.

Appraisal Report: This is a combined staff appraisal and President's Report.

This report was prepared by Ian Bannon (LA2C2). Contributors to the report were: Ulrich Lächler (Resident Representative, Nicaragua), Nancy Cooke and Harold Bedoya (LA2C2). The Task Manager for ERC II is Ulrich Lächler who led a team composed of: Ian Bannon, Douglas Tinsler (LA2C2); Richard Clifford (LA2IE); Luis Guasch (LATAD); Ligia Carvajal, Juan Luis Daly, Carola Pessino and Rafael Ravettino (consultants). The Division Chief is Robert Lacey, the Departmental Project Advisor is Paul Knotter and the Country Department Director is Edilberto Segura.

REPORT AND RECOMMENDATION OF THE PRESIDENT OF IDA TO THE EXECUTIVE DIRECTORS ON A PROPOSED SECOND ECONOMIC RECOVERY CREDIT AND AN IDA REFLOWS SUPPLEMENTAL CREDIT TO THE REPUBLIC OF NICARAGUA

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1. I submit for your approval the following report and recommendation on a proposed Second Economic Recovery Credit (ERC II) for SDR 42.5 million (US$60 million equivalent), and an IDA Reflows Credit for SDR 5.36 million (US$7.6 million equivalent) to the Republic of Nicaragua in support of the Government's structural adjustment program. The credits would be on standard IDA terms, with an amortization period of 40 years, including a grace period of 10 years. Cofinancing possibilities are being explored with Germany, Sweden and Switzerland. In addition, the Government of Nicaragua has requested cofinancing of US$60 million from the Government of Japan.

Part I. COUNTRY ASSISTANCE STRATEGY[1]

A. HISTORICAL PERSPECTIVE AND RECENT DEVELOPMENTS

2. When the Government of President Chamorro assumed office in April 1990, following 11 years of civil war, it faced a highly polarized society. The United National Opposition (UNO), which Mrs. Chamorro led into the elections, was a loosely knit coalition, united only in its antagonism to the then Sandinista Government. The Sandinistas, by contrast, represented (even after their electoral defeat) a consolidated, coherent front, and controlled the security apparatus, including the Armed Forces. Under these circumstances, the Government attempted to govern through consensus, leaving largely intact both Sandinista control of the security forces and other key institutions (including the Judiciary), as well as many of the property transfers that took place during the Sandinista administration. Initially, this strategy was successful. Relying on the high popularity of the President and massive support by the international donor community, the Government embarked on an ambitious stabilization and reform program. The economy was devastated and characterized by a cumbersome, centralized public sector, a small, overregulated private sector and atrophied market institutions. Exports and GDP per capita had declined to 40 percent of the levels attained in the mid 1970s, and major macroeconomic imbalances inherited from the previous Administration had resulted in hyperinflation and a massive external debt of more than five times the size of GDP. In 1991-92, the Government implemented a strong stabilization program, supported by an IMF Stand-by arrangement. At the same time, it began to implement a structural adjustment program aimed at transforming Nicaragua into a market economy capable of achieving sustained growth. IDA supported the Government's reforms through an Economic Recovery Credit (ERC I), approved in September 1991. Program implementation was satisfactory, and the second and last tranche of ERC I was released on schedule in June 1992. stabilization

3. The stabilization measures introduced in March 1991 were remarkably successful. Inflation was reduced from hyperinflationary levels in 1988-90 to single digit annual rates from April 1991 through December 1992, and in 1992, the economy recorded a very modest output growth for the first time since 1983. The key factors responsible for this success were a major reduction of the fiscal deficit, the maintenance of credit discipline and the adoption of a fixed exchange rate system facilitated by large inflows of foreign aid. With strong donor support, the Government succeeded in clearing its arrears with the Bank/IDA and IDB in September 1991, and reached a Paris Club Agreement on enhanced terms in December 1991, as a first step toward normalizing relations with external creditors.

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1. This will be the first Board discussion of Nicaragua's Country Assistance Strategy.

4. The Government also succeeded in implementing the first phase of its structural adjustment program supported by ERC I. In addition to underpinning the stabilization effort, the main achievements of the structural reform program by early-1993 were:

(i) **Public Sector Adjustment**: a major downsizing of the public sector through reductions in current expenditures, the reduction of military personnel by over 80 percent and of government employees by 12 percent, and the divestiture of 233 out of an initial 351 state-owned enterprises;

(ii) **Foreign Trade**: liberalization of foreign trade through unification of exchange rates, the adjustment of most import tariffs to a range of 10-40 percent, the elimination of most non-tariff import and export barriers, and the abolition of state-trading monopolies;

(iii) **Domestic Trade Liberalization**: liberalization of domestic commerce through the elimination of official price controls, especially for agricultural goods, and privatization of state trading activities;

(iv) **Financial Sector**: creation of an autonomous Superintendency of Banks; and financial sector liberalization through the elimination of interest controls, the restructuring of state-owned commercial banks (including the liquidation of one state bank and a 50 percent reduction in staff and branch offices of the remaining ones), and the opening of the financial system to private banks (7 private banks are now in operation); and

(v) **Social Impact**: creation of systematically targeted social safety nets, including an IDA-supported emergency social investment fund (FISE) and an employment generation program, coupled with an expanded public investment program designed to rehabilitate the deteriorated infrastructure.

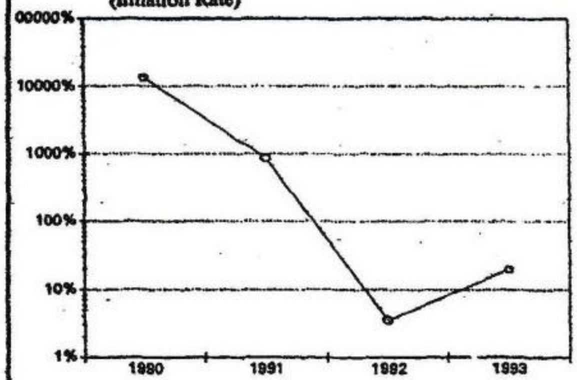
5. Despite this progress, the political situation began to deteriorate in the second half of 1992. The continued influence over certain key state powers by the Sandinistas, combined with the slow resolution of property rights disputes, led to disaffection with the Government among certain groups within UNO. This was exacerbated by the extension of the debate over property rights and the role of the Sandinistas to the floor of the US Senate and the consequent suspension of USAID disbursements of balance of payments support. The National Assembly ceased to function effectively and by the end of 1992, the Government had established a fragile working majority in the Assembly by relying on the Sandinistas and a small group of former UNO members. The majority of UNO continued to boycott the Assembly and to challenge its legitimacy.

6. **Developments in 1993.** The political impasse deepened in 1993. The crisis in the Assembly, weak law enforcement, continued rural violence which disrupted agriculture, and a malfunctioning judicial system, deepened polarization and splits began to emerge, not only within UNO, but also among the Sandinistas. Guerrilla warfare re-emerged in the countryside and at times spread to urban areas. Under these circumstances, it became very difficult for the Government to achieve and sustain the necessary consensus to carry forward its stabilization and reform programs. Attempted fiscal adjustment measures were met with violent strikes and demonstrations leading to their withdrawal. The turbulent political environment was accompanied by economic deterioration. GDP decreased by 0.9 percent, inflation increased to 19.5 percent and net international reserves declined by US$100 million. Output growth also fell victim to a marked drop in commodity prices and adverse weather. Moreover, the interruption of important bilateral aid flows led to an abrupt tightening of credit that added uncertainty to the business climate. As a result of these developments, the overall fiscal performance was below target during 1993 and contributed to delays in preparation of the IMF's ESAF program and IDA's proposed ERC II, with the result that balance of payments support declined significantly compared to 1992 levels. Despite these adverse conditions, the Government succeeded in maintaining macroeconomic stability by postponing investment expenditures and tight monetary control.

Box 1: THE ECONOMIC CHALLENGE

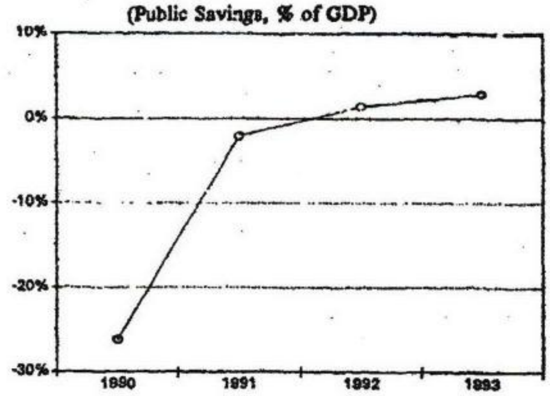
A remarkable stabilization effort...

(Inflation Rate)



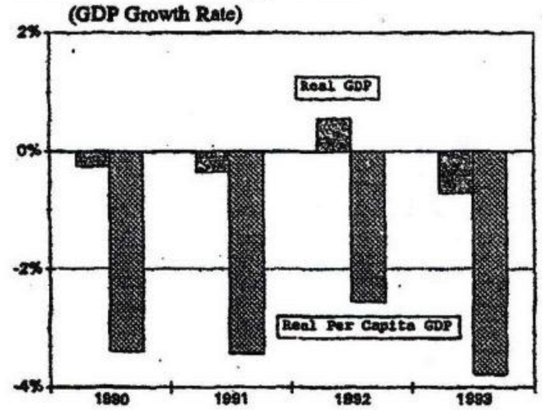
...with strong fiscal adjustment...

(Public Savings, % of GDP)



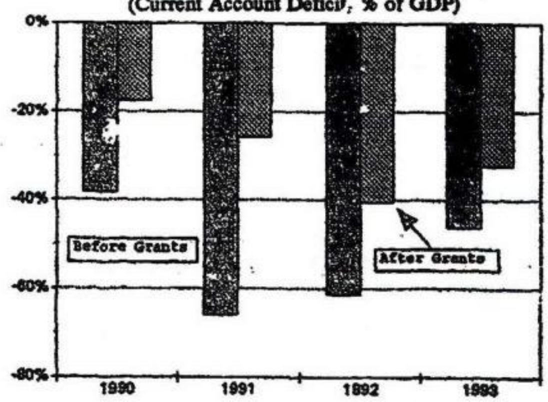
...but no economic growth...

(GDP Growth Rate)



...and continuing external imbalance.

(Current Account Deficit, % of GDP)



7. **Recent Progress.** During the April 1993 Consultative Group meeting, the donor community expressed grave concerns over Nicaragua's political impasse and growing polarization. At the same time, donors sent a clear signal that while bilateral aid would certainly decrease (para. 10), future prospects would depend on the Government's ability to continue economic reforms and forge a political consensus to support the effort. During 1993, donor agencies, including IDA, continued to impress on the Government the need to develop a national consensus and offered to help in the process. Partly as a result of these efforts, but also a growing national realization that the confrontational politics of 1993, if continued, would lead to chaos, the political situation stabilized in the closing weeks of 1993 and then began to improve. This process benefitted from the increasing influence of moderate elements on the left and right, and greater awareness throughout the body politic of the depth of the economic crisis and the paucity of available options. In recent months, rural violence has diminished, a negotiated settlement was reached on a simmering insurgency in the North, changes have been made or agreed to in the leadership of the armed forces, the Assembly is functioning again, a new Controller General has been appointed by the Assembly, political negotiations are underway to modify several key aspects of the Constitution, and changes have been made in the Supreme Court. These developments provide Nicaragua with an important opportunity to reach the political consensus required to implement the strong stabilization and adjustment measures that would maintain stability and revive growth. While political prospects have improved, to reinforce this emerging consensus the Government must move quickly to implement its reform program and mobilize the support of the donor community.

8. **Poverty and Social Developments.** Although reliable trend data are not available, economic and social indicators show mixed results over the past three years. GDP per capita fell by 8 percent during 1990-93 and official estimates indicate unemployment may currently approach 20 percent. On the other hand, private consumption per capita grew by 12 percent over 1990-93, made possible by the large inflow of foreign aid that began in early 1991. At the same time, real wages expanded by 23 percent per annum during 1991-92 and fell slightly in 1993. In any case, poverty is widespread and basic social services are inadequate. The Government has made considerable efforts to protect the poor during adjustment, through the establishment of targeted safety net mechanisms, and by attempting to protect allocations to the social sectors from fiscal stringency. Social conditions and IDA's strategy are discussed in greater detail in Section C below.

B. THE EXTERNAL ENVIRONMENT

9. Nicaragua's small and weak economy is highly vulnerable to external conditions. Three areas are particularly important: (i) external aid; (ii) export prospects for its primary commodities; and (iii) external debt. In addition, Nicaragua's trade reform effort is framed within the context of the ongoing regional integration process in Central America.

10. **Aid Prospects.** Since the mid 1970s, Nicaragua has become increasingly dependent on foreign aid. This dependence became especially pronounced during 1990-92, when exceptional volumes of foreign assistance became available to support the Government's stabilization and structural adjustment program. During 1990-92, gross disbursements of grants and loans averaged about US$600 million annually, equivalent to about US$150 per capita. This placed Nicaragua among the three top aid per capita recipients in the world. Recent indications suggest that Nicaragua can no longer count on such large aid inflows, as key donors continue to face increasingly tight aid budgets and rearrange priorities in response to the emergence of new aid claimants. In addition, as a result of cutbacks in assistance from some key donors, total aid to Nicaragua will decline even more abruptly than would be expected on account of global trends. In 1993, gross disbursements of grants and loans fell to US$390 million, 35 percent below the average for 1990-92, and a drop equivalent to about 12 percent of GDP. The extent to which international financial institutions can make up for these lower flows will remain limited by the country's creditworthiness and the availability of concessional funds. This poses two types of problems for Nicaragua. First, the economy has no option but to adjust to this decline in aid, but given Nicaragua's small economy even relatively small aid shortfalls require considerable domestic adjustments. For this reason and the country's heavy foreign debt burden, external financing needs remain large. (External financing requirements and sources are discussed in para. 54.) Second, the problem is exacerbated by the unpredictability of the pace of decline. The urgent task now facing the Government is to adopt domestic policies which can offset the prospective decline in foreign savings and, over the medium term, reduce the economy's aid dependence. This will necessarily involve increasing domestic savings and reducing consumption.

11. The Government's stabilization and adjustment program, supported by the IMF and IDA, aims to gradually render the economy less dependent on aid by increasing domestic savings and exports. The adjustment program supported by ERC II, especially the public sector reform component, is a critical element in the Government's strategy to raise public savings through a structural transformation of the State and to improve conditions for private sector development. In addition, through the Consultative Group (CG) process and its donor coordination activities, IDA will continue efforts to mobilize donor support for Nicaragua's development programs, especially by encouraging donors to make the decline in aid smoother and more predictable.

12. **Export Prospects.** Two factors have contributed to Nicaragua's high dependance on aid—the lack of supply response in the export sector, especially agriculture, and a decline in commodity prices for its main exports. Except for a brief surge during 1989-90, total exports have followed a declining trend since the late 1970s. Six commodities (coffee, cotton, sugar, beef, bananas, and shrimp) account

for about 70 percent of total merchandise exports. All but shrimp suffered international price declines between 1990 and 1992, with those of coffee and cotton particularly severe. These adverse price movements account for about 40 percent of the US$107 million fall in total exports observed over the period, while the rest was due to lower output and yields. The performance of merchandise exports improved somewhat in 1993, but at US$267 million, they were still only 60 percent of the nominal level achieved in 1980.

13. Nicaragua's weak export base and lack of supply response are symptomatic of the constraints affecting private sector development, especially in agriculture. The Government's efforts have focused on liberalizing markets, improving incentives, removing the State from production and trading activities, and improving property rights and security in rural areas. These efforts need to be continued and deepened, especially in the agriculture sector, where there is considerable potential for a quick supply response without substantial additional investments. In addition to supporting the next phase of the Government's adjustment program through ERC II, IDA's recently approved Agricultural Technology and Land Management project aims to increase agricultural productivity and improve land property rights.

14. **External Debt.** Nicaragua's total external debt of US$11.8 billion at end-1993 makes it one of the most severely indebted countries in the world. Total external debt is more than six times its GDP and the ratio of total debt to exports is more than 3,000 percent. About 80 percent of the total is long-term debt, of which about 37 percent was contracted with the Russian Federation, former Eastern Block countries and the former German Democratic Republic, about 19 percent is owed to Latin American countries, about 16 percent to commercial banks, about 12 percent to international financial institutions and 9 percent to Paris Club members. This enormous debt overhang contributes to an acute and unsustainable external situation, which Nicaragua has only been able to manage by incurring substantial arrears on debt servicing.

15. The Government has made considerable efforts to regularize its situation with external creditors. In December 1991, Nicaragua was the first country to be granted "enhanced Toronto terms" by the Paris Club. The Government and the Paris Club reached an agreement that effectively cut debt service in half over the period 1992-94 and left open the possibility of reducing the stock of debt at the end of this period. The Government also renegotiated its debt with Mexico, Colombia and Argentina on highly favorable terms. The treatment of debt to the Russian Federation, the former German Democratic Republic and the terms of debt forgiveness from Germany remain to be addressed. In August 1992, the Board approved an allocation of up to US$25 million from the Debt Reduction Facility for IDA-only Countries for a proposed commercial bank debt reduction operation, and a grant from the Facility of up to US$750,000 to engage financial and legal advisors to assist in preparing the debt reduction operation. It was expected that IDA's allocation would act as a catalyst to mobilize additional cofinancing from bilateral donors. So far only a small number of donors have expressed interest in cofinancing the proposed debt reduction operation and although efforts are continuing the prospects for mobilizing sufficient cofinancing appear extremely limited.

16. Nicaragua's longer-term prospects will depend critically on reaching a comprehensive solution to its debt overhang. Given the magnitude of the problem and the country's limited prospects for a rapid reactivation of growth, this will necessarily entail substantial debt forgiveness. Until the debt problem can be comprehensively resolved, Nicaragua's fragile external position will critically constrain Government efforts to promote private investment, especially foreign. Over the medium term, Nicaragua will continue to face very high exceptional financing needs.

17. **Regional Integration.** Nicaragua is a member of the Central American Common Market (CACM), together with Costa Rica, El Salvador, Guatemala and Honduras. In recent years the CACM has transformed itself into an outward-oriented institution, reinforcing national policies to liberalize trade and encourage exports to third markets. In 1993, the CACM was expanded and deepened into a General Treaty of Central American Economic Integration, covering not only trade but coordination of

macroeconomic policies, financial and other services and, eventually, free factor mobility. Under the Treaty, there is free trade between members and a Common External Tariff (CET). The CET has been gradually reduced—by December 1993, except for Nicaragua it was within a range of 5-20 percent with a few relatively minor exceptions. However, in accordance with the "Guatemala Protocol", signed in September 1993 by the Economic Cabinets of all CACM members, Nicaragua was granted preferential treatment reflecting its special circumstances. In particular, a more gradual reduction in protection from imports originating outside CACM is allowed, and Nicaragua has the ability to impose selective consumption taxes on goods originating in Central America. Under the trade reform program supported by ERC II, Nicaragua would reduce its tariff structure gradually to reach a ceiling of 20 percent by 1999. Although given the structure and level of Nicaragua's exports, the CACM would have little immediate impact on the economy, its membership does provide an important source of support and encouragement to maintain outwardly oriented policies. The country's special treatment does not mean it is deprived of the wider benefits of CACM membership, including the interchange of policy experience, support in developing a national consensus on reform, and a common front in facing external developments, such as the European Union's banana policy and the impact of NAFTA. Both IDA and IDB are involved in strengthening CACM and Treaty institutions. Among ongoing IDA initiatives is a study examining the impact of NAFTA on Central America, especially possible trade and investment diversion effects.

C. GOVERNMENT DEVELOPMENT POLICIES AND IDA ASSISTANCE STRATEGY

Government Strategy and Growth Prospects

18. The basic aims of the Government's development strategy have been to: (i) maintain a stable economy; (ii) achieve a massive economic transformation—away from a centralized command economy to a market and private sector-driven system; (iii) revive growth in a sustainable and equitable manner; and (iv) render the economy less dependent on foreign aid. Although these aims have been clear and the Government has not wavered in its commitment, there has been less clarity and consensus on specifics of the strategy. This reflects, first and foremost, Nicaragua's deep political divisions, which make it difficult to build a national consensus on detailed elements of the strategy. With a volatile political environment, coupled with difficult economic and social problems, the Government's attention is frequently focused on extinguishing short-term political and economic fires. These difficult circumstances are compounded by the Government's weak institutional capacity and by acute impatience in the country with the lack of growth and pervasive social problems. As a result, the Government is often on the defensive, taking a reactive stance instead of proactively articulating a longer-term development agenda.

19. Nicaragua can achieve sustained growth in the second half of the 1990s. In the short run, however, a rapid reactivation of growth appears difficult due to tight macroeconomic constraints. The best that can be hoped for is annual growth averaging about 3.2 percent over the next three years, until the economy's structural transformation is further advanced and the private sector has acquired enough confidence to step up its investment activities. Such a structural transformation and renewed private sector confidence are contingent on: (i) consolidation of the stabilization process and deepening of the structural adjustment program; (ii) a major reduction of the external debt burden; (iii) a strengthened institutional capacity of the State; and (iv) significant progress in resolving property rights disputes and improving law and order conditions. The main sources of growth over the medium term are expected to be: (i) a recovery of production and exports in the agriculture, fishing and mining sectors toward levels reached in the late 1970s; and (ii) productivity improvements stemming from a more efficient utilization of existing capacity. The recovery of agriculture and the natural resource sectors will be driven mainly by the removal of policy distortions and price controls, while commodity prices improve modestly over the projection horizon. Productivity improvements would result from more efficient financial intermediation, the elimination of price distortions, improved security in rural areas, more efficient management of privatized enterprises and public utilities, and the rehabilitation of economic infrastructure. Over the longer term, growth is expected to arise primarily from increased private investment, especially in agriculture-based export activities. Gross domestic savings are expected to

increase substantially during 1994-97, through reductions in public and private consumption, which would contribute to growth by releasing more resources for investment.

IDA's Objectives and the Development Agenda

20. **IDA's Strategy.** The central aim of IDA's assistance strategy is to support the Government in its efforts to complete the transformation toward a market economy capable of sustaining growth and reducing poverty. An overriding priority is to revive economic growth. Although the other aspects of the development agenda (described below) are also important and clearly complement the aim of sustainable development, without a revival of growth there would be little chance that progress could be made in meeting these other challenges, especially in terms of reducing poverty, or that Nicaragua could successfully complete the transition to a democratic and more equitable society.

21. Limited resources require that IDA's strategy be highly selective. In this light, our assistance strategy over the FY95-99 period will adopt a two-track approach. On the one hand, we will maintain a sharp focus on stabilization and structural adjustment, in order to lay the foundations for a sustained and private sector-led economic recovery. Adjustment lending, through the proposed ERC II and a subsequent ERC III, would be the centerpiece of this effort but would also be reinforced by an intensive policy dialogue, analytical work and donor coordination, including resource mobilization. The second track would concentrate on equity and sustainable development, focusing on: (i) capacity building; (ii) poverty alleviation and human resource development; (iii) restoration of physical and social infrastructure; and (iv) improved environmental management. An overarching objective of the assistance strategy will be to build up the Government's capacity to manage, not only the structural reform program, but also the country's longer-term development agenda.

22. **The Development Agenda.** IDA's assistance strategy then seeks to address four key aspects of Nicaragua's development challenge: (i) reviving growth; (ii) reforming the public sector and strengthening institutional capacity; (iii) alleviating poverty and investing in human capital; and (iv) improving environmental and natural resource management. The objectives and instruments of IDA's assistance strategy, and their relationship to Nicaragua's development agenda are discussed below. Annex B summarizes the objectives and instruments of IDA's country assistance strategy over FY95-99.

Reviving Growth

23. Reviving growth is critical. Within this overall framework, four interrelated issues need to be addressed: (i) maintaining a stable economy and deepening the structural adjustment process; (ii) developing a broad-based political consensus to underpin the reform effort; (iii) removing constraints to private sector development; and (iv) rebuilding the country's social and physical infrastructure base to increase productivity and living standards.

24. **The Need to Maintain Stabilization and Deepen Adjustment.** When the second tranche of ERC I was disbursed in June 1992, Nicaragua's economy appeared to have stabilized and to be on the way to recovery. Instead, output growth became negative again in 1993 and the subsequent loss of reserves has left the economy in a precarious position. The need for a continuing stabilization effort is also rendered urgent by the anticipated decline in foreign aid inflows (discussed in Section B above). While these developments have once again placed stabilization at the forefront of the economic agenda, they have also underscored the need to deepen structural reforms so that they reinforce and complement the stabilization effort.

25. Over the short run, strong macroeconomic measures need to be taken to restore an adequate foreign reserve cushion and reduce the danger of renewed instability. Credit availability was very tight in 1993, so the stabilization effort needs to focus on further fiscal compression in order to increase public savings. The fiscal adjustment, however, needs to be sustained and focus on a structural improvement

in the public sector's savings performance. Since capital expenditures and the public investment program are almost entirely donor financed, the key fiscal stability indicator is public savings. A sustained improvement in public savings over 1994-97, will be required to both permit private sector expansion and to ensure an orderly economic adjustment to the expected decline in foreign savings.

26. Although stabilization issues are critical, the need to restore growth is also urgent—especially in view of Nicaragua's high population growth (an estimated 3.2 percent, among the highest in Latin America). In the absence of faster growth, the country's already dismal poverty conditions and fragile social peace will rapidly deteriorate. On the other hand, restoring growth will be extremely difficult under the currently weak economic conditions. In order to improve conditions for private sector-led growth, attention needs to be placed on: (i) reorienting the role of the State, to increase its efficiency and allow more room for private sector expansion, while contributing to longer-term fiscal stability; (ii) improving the efficiency of financial intermediation; and (iii) reducing key barriers to private sector confidence. The Government's reform program, to be described in Part II, seeks to address these issues.

27. IDA is supporting the Government's stabilization and adjustment effort in two major ways. First, the need to ensure a stable macroeconomic framework, especially through tight fiscal policies, has underpinned our policy dialogue with the Government. IDA has made a major effort, in coordination with the IMF, to analyze the critical macroeconomic situation and explore with Government possible adjustment options. This has been done through the recently-completed CEM, a background document for the last CG meeting, and through a broad-based policy dialogue in the country. Second, the proposed ERC II, especially its public sector reform component, is designed to underpin the Government's fiscal adjustment effort, and to establish conditions for the revival of private sector-led growth.

28. **Political Consensus.** Nicaragua's economic and political situation remains difficult. The stabilization gains are fragile and the lack of growth, combined with a serious poverty and unemployment problem, exacerbate political and social tensions. The continuation of the stabilization and adjustment policies, essential to revive growth, will be difficult unless the Government is able to forge a sustained political consensus to underpin the reform effort. In order to contribute to the process of building such a consensus, IDA has widened its policy dialogue on stabilization and adjustment to include non-government representatives. As well as extensive informal discussions, IDA has also supported a process of constructive economic debate through, for instance, seminars reviewing economic options to deal with declining foreign aid prospects, attended by Government representatives and selected academic and opposition economists. As discussed above (para. 7), there are now indications that consensus-building efforts are beginning to yield fruit. Recent political developments have created a propitious moment for a series of important actions on the economic front which the Government is anxious to seize. Bilateral donors are also looking to IDA and the IMF to provide the overall stabilization and adjustment framework that would enable them to continue supporting Nicaragua and to permit a more gradual reduction in overall bilateral aid flows.

29. **Private Sector Development.** The private sector, which is the key to sustained growth, especially in the agriculture sector, has been slow to respond to recent reforms due to the high risk of doing business in Nicaragua. One important source of risk is the possibility of future policy reversals created by an unstable political climate and fragile macroeconomic situation. The restoration of stronger macroeconomic control while deepening the structural reform effort, therefore, will be essential to strengthen investor confidence. Other important sources of risk are the ongoing property rights disputes, severe uncertainties created by the absence of adequate property rights guarantees, sudden and unpredictable changes in tax and economic policies, the uneven application of selected incentives, and unclear labor market and sector policies. To reduce these uncertainties and provide a more attractive environment for private investment, clear rules of doing business need to be established and transparently applied, and property disputes need to be settled as quickly as possible.

30. In addition to the market liberalization measures taken during the first phase of its structural adjustment program, the Government is making efforts to improve the security situation in rural areas and has set up a number of institutional mechanisms to adjudicate property rights disputes (Box 2). Improving the private sector environment remains a key priority of IDA's assistance strategy. The theme of the recent CEM and CG background document was the revival of private sector activity, and a recent report on the public utilities and natural resource sectors analyzed and recommended a set of measures to encourage private sector participation and the adoption of market-based regulatory mechanisms. The Agricultural Technology and Land Management project is supporting a major land titling, registration and cadastre effort, as well as a program to privatize extension services. Under the project, it is expected that about 50,000 land titles will be issued over five years, which would provide the basis for the establishment of a credible system of land property rights. ERC II will support measures to increase transparency in the application of economic policies and improve incentives for private activity, measures to improve the administrative dispute resolution process and options to increase the value of the compensation bonds.

Box 2: THE PROPERTY RIGHTS PROBLEM

Why is there a property rights problem? The lack of property rights guarantees represent a long-standing problem, aggravated during the Sandinista Administration, which confiscated many urban and rural properties that, until the closing days of the administration, were not formally nationalized as State property. Shortly before leaving office, the Sandinistas legalized the possession of these properties by their occupants in what became known as the *piñata* (a bag of gifts that shower down on children at a party). This situation confronted the incoming Government with an intractable problem.

What is the extent of the problem? The property rights problem is of truly Gordian complexity. It is estimated that there are about 5,400 claimants, involving more than 16,000 disputed properties. Lack of clear title affects over 10,000 agricultural holdings, over 10,000 urban houses and over 90,000 urban plots. About 30 percent of total cultivable land is currently without clear titles or claimed by different owners.

What is being done? In 1992 the Government put in place an administrative process to resolve the 5,400 disputed claims, and title/register properties of legitimate owners. This involves an accelerated review of disputes by a National Review Commission, which can lead to return of improperly confiscated property or to confirmation of legal title to occupants and compensation to previous owners. The Ministry of Finance determines compensation and has established an arbitration system for cases where the Government's valuation is not accepted. Alternatively, claimants can pursue their case through the judicial system, but this is problematic due to the weakness and politicized nature of the judiciary. Compensation is being financed through 20-year Córdoba denominated bonds indexed to the dollar, with 3 percent capitalized interest, to be redeemed from the proceeds of the privatization of state enterprises. Bonds are transferable and can be sold on the secondary market but at a deep discount. As of March 1994, about 1,000 of the 5,400 claimant cases had been resolved.

31. An important constraint on private sector growth during 1993 was the lack of credit for productive activities, especially in agriculture, which is the key to reviving growth in the short run. However, any credit expansion made possible by further fiscal compression in 1994 will only succeed in promoting growth if the banking sector can operate more efficiently and prudential supervision is strengthened. Despite significant progress made in removing policy distortions in the financial sector and the emergence of 7 private banks during the last two years (2 more are expected to open in 1994), the financial system remains underdeveloped and dominated by the two largest, loss-making state banks. This has resulted in high costs and inefficiency in financial intermediation, misallocation of financial resources and a potential fiscal burden. At the same time, the private banks are small and extremely cautious in their lending activities. Over the medium-term, the Government's strategy is to avoid any further recapitalization of the state banks, subject them to prudential regulations, and require them to shift their larger, more established clients to the private banking system. In this way, state banks could only increase their lending room by improving collections and transferring part of their portfolio to the private sector. Over the longer term, and with a more developed private banking system, the Government could consider partial or full privatization of the state banks. IDA is supporting this approach through ERC II, which also includes measures to strengthen the Superintendency of Banks. In addition, IDA is exploring with other donors the scope for developing

community-based approaches to banking in rural areas, which could help to relieve credit constraints for smallholders.

32. **Rebuilding Infrastructure.** After a decade of civil war, Nicaragua's physical infrastructure is in bad shape. Services are inadequate and of poor quality, provided inefficiently, and unequally distributed. Transport infrastructure is in need of urgent rehabilitation or reconstruction. Telecommunications coverage is inadequate, with a telephone density of only 1.2 lines per 100 inhabitants—some estimates calculate unsatisfied demand as twice the level of supply. The energy sector is in critical condition. Less than one half of the population has access to electricity, with frequent service interruptions and low reliability. The energy deficit is estimated at 10-15 percent of consumption and system losses reach almost one quarter of electricity supply. The water and sanitation sector faces similar problems. Coverage is low, with potable water available to slightly more than half of the population, and sewerage and sanitation available to about one quarter. In Managua, water losses reach about one half of total production.

33. The Government initially set out an ambitious public investment program to rehabilitate and expand infrastructure, but fiscal realities combined with institutional bottlenecks and limited external support have forced it to scale down planned investments. In FY94, IDA prepared a report on Deregulation of Public Utilities and Natural Resources which presented a set of recommendations to improve the performance and regulation of major public utilities. IDB plans to assist the Government improve the management and regulatory framework for public utilities through a proposed Public Utilities Sector Loan in 1995. IDA's support for FY95-97 would focus on social infrastructure in the water and sanitation sector, in close collaborations with IDB. IDA's proposed operation would fit within a comprehensive sector policy framework and investment priorities developed jointly with the Government and IDB. IDA's project would focus on increasing the access of low-income groups to water and sanitation services and improving environmental management in the sector. The Government's public sector reform program, including privatization of the telecommunications company, would also contribute to improving the delivery of infrastructure services by strengthening the public sector's institutional and managerial capacity. An Infrastructure Recovery report, planned for FY95, would assist the Government define investment and policy reform priorities in the sector and would enable us to consider an Infrastructure Rehabilitation project, possibly focusing on rural areas.

Public Sector Reform and Capacity Building

34. The public sector still accounts for over 40 percent of GDP, is weak and inefficient, and continues to be involved in activities that could be more efficiently undertaken by the private sector. The costs of maintaining such an oversized state are reflected in the high overall tax burden—at 24 percent of GDP, it ranks among the highest in Latin America and discourages private sector expansion. To permit a stable response to lower aid inflows and create more room for the private sector, a major effort is needed to comprehensively downsize the State. At the same time, available public resources need to be allocated more efficiently toward priority areas—particularly a better provision of basic social services, the expansion of social safety net mechanisms and improved infrastructure support for private productive activities. Finally, as the State withdraws from economic activities that can be more efficiently undertaken by the private sector, it has to establish uniform and transparent rules for the private sector to operate. IDA will support the Government's public sector reform efforts through ERC II and a proposed Technical Assistance Credit (TAC).

35. The public sector's institutional capacity is weak, reflecting its inefficiency and overextension. Large scale technical assistance will continue to be required over the medium term, but this support needs to be well coordinated and framed within a comprehensive and longer-term effort to reform and modernize the public sector. A key priority in IDA's assistance strategy is to assist the Government develop and implement a longer-term public sector reform program, designed to improve its efficiency and strengthen its institutional capacity. IDA is currently preparing a TAC, expected to be presented to

the Board in FY95. The proposed TAC would aim to assist the Government design and begin implementation of the public sector reform program supported through ERC II and, extending beyond the ERC II implementation period, provide a longer-term framework to guide further reforms and ensure continuity in institutional strengthening efforts. It would provide the overall policy umbrella for the coordination of capacity-building efforts and the linkage between the first phase of the Government's public sector reform program and the preparation of policies and measures to deepen the reform program beyond the ERC II implementation period. The second phase of the public sector reform program would be supported through a proposed ERC III, which would most likely be prepared with a new Administration in early 1997. To maintain momentum in the reform effort and avoid a gap in the event that preparation of ERC III is delayed, IDA will begin work on an Institutional Development Credit (IDC) designed to assist the Government sustain progress in implementation of its public sector reform program and widen capacity building initiatives. The IDC would seek to go beyond the strategy formulation and diagnostic work of the TAC by focusing on the implementation and sustainability of capacity building efforts. In addition, IDA is considering expanding and redefining the scope of the Managua Resident Mission to better support our capacity building objective.

Alleviating Poverty and Investing in Human Capital

36. Nicaragua is a very poor country with a high degree of inequality and a weak human capital base. A recent IDA Poverty Profile found that slightly more than one half of the population is poor and close to one fifth live in extreme poverty. Poverty is primarily a rural phenomenon. Three quarters of all rural inhabitants live in poverty compared to 36 percent of urban dwellers. Extreme poverty is even more concentrated in rural areas—78 percent of the extremely poor live in rural areas. Inequality is also quite high, with the bottom 40 percent of the population accounting for 12 percent of total monthly expenditures while the top 20 percent has a share of 55 percent. A Gini coefficient of 0.5 reflects this high level of inequality. Over 28 percent of children under 5 suffer from some form of malnutrition—it is almost double that of the rest of the population among extremely poor children, and is most severe in the poor Northern and Segovia regions (49 and 46 percent, respectively).

37. Nicaragua's low human capital base is not the result of insufficient social expenditures. Social spending increased from 3.5 percent of GDP in 1970 to about 11 percent in 1993, which is relatively high for a low income country. Rather, problems stem from inadequate policies, inefficient resource allocation and low institutional capacity, compounded by high population growth. For more than a decade, Nicaragua has made a major effort to improve the health status of the population. Despite a considerable expansion of health facilities and public spending, health gains have been limited. In recent years, tight resource constraints combined with an overly-centralized system and misallocation of resources have led to a substantial deterioration in the quality of care at the primary and secondary levels, severe shortages of medicines and supplies, and overcrowding at higher-level facilities.

38. Although there was a major expansion of the primary school system during the 1980s, educational quality and attainment are extremely low. The average level of education attainment is 4 years of schooling, and 1.6 years for the extremely poor. Primary school graduates take an average of 10.2 years to complete the six year cycle. Over 20 percent of the population is illiterate (almost 50 percent of the extremely poor). An inadequate curriculum, late entrance and high repetition and dropout rates, scarcity of teaching materials and trained teachers contribute to poor quality. About 45 percent of primary teachers do not meet national qualification standards, and about 9,000 primary classrooms out of 12,000 in existence, do not meet minimum standards. Overcrowding at the primary level is serious, with an average classroom size of 57 students. While about 80 percent of children in the 7-12 age bracket are enrolled in primary schools, secondary enrolment is only about 21 percent in the 13-17 age bracket. Although education expenditures have increased rapidly in recent years, almost all resources (98 percent) go to meet teacher salaries.

39. Nicaragua's deep-seated poverty presents an added challenge for women: rapid population growth resulting from a high fertility rate (5.5 children per woman of childbearing age); 6 percent contraceptive prevalence rate, the lowest in Central America; and low birth spacing. In 1990, maternal mortality was 159 per 100,000 live births and access to pre- and post-natal care remains limited. Female-headed households represent 29 percent of all households. Although female heads have somewhat less schooling, are less likely to participate in the labor market, and have higher unemployment, the Poverty Profile found there was no evidence that these households are at a significantly greater risk of poverty.

40. The Government's poverty alleviation strategy has three key elements. First and foremost is creating the conditions for the reactivation of sustained economic growth. Second, the Government is aware that while growth is critical, safety net mechanisms are necessary to protect the poor during the period of adjustment. Third, the Government aims to improve the provision of basic social services, both to help mitigate some of the more immediate effects of poverty and, over the longer term, to rebuild its devastated human capital base. Past Government efforts have been hampered by the lack of a comprehensive and consistent strategy. With donor support, the Government is currently completing a Social Sector Strategy and Action Plan, which should lay the basis for better coordination and improved targeting of Government and donor efforts. At the same time, the Government has placed greater emphasis on safety net programs by expanding the FISE and the creation of a temporary employment program administered by the newly-created Social Action Ministry. In addition, the Government has endeavored to protect social spending from fiscal austerity (para. 77).

Box 3: DECENTRALIZING HEALTH

The recently approved Health Sector Reform project supports an innovative decentralization program, focusing on improving the quality and access of disadvantaged groups to basic health. The project also offers important lessons on building commitment and capacity where the Government has a weak institutional base.

Under the project, the Ministry of Health (MOH) has begun to allocate 20 percent of its budget to health units at the department level (SILAIS). MOH is entering into performance contracts with the SILAIS, including specific and monitorable service delivery targets which will allow MOH to evaluate and reward the SILAIS. The ultimate aim will be to allow the SILAIS to hire and fire their staff, and greater autonomy in procuring drugs and supplies.

During project preparation a major effort was made to develop support for the reforms by: (i) assisting the Government to define a comprehensive health sector strategy to provide the overall framework for the reforms; (ii) undertaking a major dissemination effort through public seminars and meetings, which generated broad support across the political spectrum; (iii) intensive coordination with the decentralized units that will carry out the project; (iv) the adoption of a flexible and phased approach, which would enable building up capacity and demonstrating results before implementing broader reforms; and (v) creation of a Project Preparation Unit that coordinated several working groups and directly managed consultants during project preparation.

As a result of these efforts, there is broad commitment and ownership for the reforms, not only within the Government but also at the community and beneficiary level, and the public at large. The Government is interested in replicating this experience, with IDA support, in the education sector.

41. A key priority of IDA's assistance strategy is to begin to alleviate directly the causes of acute poverty in Nicaragua. In addition to assisting the Government lay the conditions for a reactivation of growth, IDA is building a lending program heavily concentrated on poverty alleviation and the social sectors. Ongoing operations supporting improved primary health care, the FISE and the transfer of technology to small and medium-sized agricultural producers, will be supplemented by projects in the primary education, and water and sanitation sectors. In the social sectors, the Government has initiated a program to reorganize and strengthen the Health and Education Ministries to improve the provision of basic health and primary education. The effort in health is well underway and supported by IDA's Health Sector Reform project. Work has started in the education sector, following the successful project preparation approach followed in health (Box 3), to be supported through a Basic Education project in FY95. In addition, a Living Standards Measurement Survey was completed in June 1993 with IDA support, and a Poverty Assessment is under preparation. The results of this work would assist the Government to refine its strategy and

develop more accurate social targeting mechanisms. Future IDA support for the social sectors during FY98-99 would include a second operation to support FISE and a Health and Nutrition project.

42. The Government is concerned to meet the special needs of women. Within the context of its health sector policy, it is introducing intensive family planning education programs and improving the ability of the health system to meet demand for family planning services and maternal/child care. About half of the beneficiaries of the primary school subcomponent of the IDA-supported FISE are expected to be girls, and women are expected to be the main users of the health posts and centers slated for rehabilitation. About 20 percent of FISE resources have been earmarked for social services subprojects which would be largely directed at women, especially household heads. The recently-approved Health Sector Reform project, with its primary health care focus, is designed to directly benefit the health and nutritional status of pregnant and lactating women. It also supports the Government's efforts to strongly promote family planning as an integral part of its primary health care model, by making modern contraceptives widely available and improving the quality of outreach services. The proposed Basic Education project would assess the need to place particular emphasis on improving the quality and coverage of primary education for girls.

Environmental and Natural Resource Management

43. Nicaragua faces serious environmental problems. Its natural resource base has suffered considerable damage due to political upheavals and economic deterioration. Relocation programs, nationalization of forests and fisheries and land redistribution by the previous Government, eroded incentive systems which would encourage sustainable natural resource use. Between 1960 and 1980, Nicaragua experienced the highest rate of deforestation in Central America—forest cover was reduced by about 2 million hectares (about one third of total forest area). Current farming practices, hillside cultivation, and agriculture expansion to marginal areas have contributed to high rates of soil erosion. Among the more pressing environmental problems is the worsening condition of major watersheds surrounding Lakes Managua and Nicaragua, as well as others emptying directly into marine areas in the Pacific coast. Siltation due to soil erosion, agrochemical runoffs and industrial contaminants, have led to the biological death of Lake Managua. Siltation is an immediate threat to the hydroelectric sector, which accounts for about 50 percent of generating capacity. Water and waste treatment is infrequent and uncontrolled, and raw sewage is openly discharged. Net migration due to the turmoil of the 1970s and 1980s relieved much of the pressure on the environment and actually reversed the habitation patterns of the Atlantic region that had predominated since the 1950s. However, the quarter million refugees that fled to Honduras and Costa Rica are now returning and resettlement programs are stretched to the limit. Although the forest areas of the Atlantic coast remain relatively untouched, returning migrants are increasingly encroaching on forested areas, which are incapable of supporting traditional agriculture for more than a few years.

44. The Government has prepared a National Environmental Action Plan (NEAP), which was presented to IDA in December 1993 and has been adopted as Nicaragua's official environmental strategy. It identifies soil conservation, water resource management and the forestry sector as the priority areas in need of attention and proposes a set of actions to be implemented over the next five years. The NEAP, which was prepared with the support of Sweden, Denmark and IDA through an IDF Grant, benefitted from an extensive process of consultation which included over 1,400 representatives of municipalities and all major social, economic and political groups in the country. Given the nature of Nicaragua's environmental problems, the priorities articulated in the NEAP, and the urgent need to increase agricultural output and productivity, IDA's priority will be to support green issues through a proposed Natural Resource Management project, focusing on soil conservation and water management. IDB is actively involved in the forestry sector and plans to support the NEAP's forestry priorities through an Agroforestry project in 1994 focusing on the Pacific region, and a Forestry Conservation project in 1995 aimed at strengthening the regulatory framework in the sector. USAID is assisting the Government in the preparation of a new Forestry Law, a draft of which is currently under discussion. IDA's

Agricultural Technology and Land Management project is supporting improvements in sound pesticide management and studies related to the demarcation of indigenous lands and natural reserves. Water pollution would be addressed through a proposed Water and Sanitation project.

Lending Levels and Composition

45. **Past Lending.** Cumulative Bank/IDA lending as of end-March 1994 totals US$503 million for 28 loans, 11 credits and 2 supplementary credits under the IDA Reflows facility. Of these, 28 loans and 7 credits were approved and fully disbursed by FY80, and 4 credits and the 2 supplementary credits were approved during FY92-94. The first Economic Recovery Credit (US$110 million equivalent) was approved in September 1991 and fully disbursed by June 1992. The Board also approved credits to support the Social Investment Fund (US$25 million equivalent) in November 1992, an Agricultural Technology and Land Management project (US$44 million equivalent) in July 1993, and a Health Sector Reform project (US$15 million equivalent) in December 1993. The two supplementary credits were approved during FY92-93 for a total of US$18.8 million. In August 1992, Nicaragua qualified for a grant under IDA's Debt Reduction Facility to prepare a commercial debt reduction operation (para. 15).

46. **Proposed Lending.** The proposed lending program for the period FY95-97 would include 4-5 operations for an amount in the range US$100-130 million equivalent, in line with the current IDA country allocation. Lending for FY98-99 would depend on the Government's performance in implementing its reform program and the project portfolio, and on the corresponding IDA country allocation. The proposed lending program over the next five years would support implementation of the Government's public sector reform program and wider capacity building efforts, improved coverage and decentralization of basic education, adoption of an appropriate policy framework for the water and sanitation sector, coupled with investments to improve access by low-income groups, expansion of social safety nets through the FISE, improved natural resource management, infrastructure rehabilitation, and strengthening of health services and nutrition programs. The lending program would be complemented by studies and technical support on the priority areas identified above. Provided eligibility criteria are met, Nicaragua would also be eligible to access IDA Reflows under the Fifth Dimension and the IDA Debt Reduction Facility. Over the period 1994-96, IDA disbursements would account for about 9 percent of bilateral and multilateral disbursements of grants and loans. Given Nicaragua's severe indebtedness and low income, continued lending on IDA terms is expected over the medium term.

47. A marked deterioration in macroeconomic management and/or lack of Government progress in implementation of the structural adjustment program would trigger a shift to a low case lending scenario. Provided portfolio implementation remained satisfactory, the lending program would be adjusted by postponing ERC III while project lending in the areas proposed above would be maintained. This approach would enable IDA to continue playing a catalytic role in assisting the Government to strengthen its capacity to deal with economic problems and in providing a more solid foundation for the sustainability of the development effort.

ESW Program

48. The overall aims of IDA's ESW program are to support Government efforts to revive growth and to provide the analytical underpinnings for a well focussed lending program in line with the objectives of the country assistance strategy. A Poverty Assessment will be completed in 1994, which would assist the Government develop a comprehensive poverty alleviation strategy and improve social targeting mechanisms. An Infrastructure Recovery report is scheduled for FY95, which would seek to develop a medium-term strategy for rebuilding the country's devastated infrastructure and examine the rationale for future IDA lending support in the sector. A CEM in FY96 will analyze progress in structural adjustment, the remaining reform agenda, and place particular emphasis on private sector development. In FY97, a Decentralization of Social Services study will be prepared to review progress and lessons learned in implementation of the Government's decentralization strategy in health and education. An

Agriculture and Poverty report scheduled for FY97 will extend the work of the Poverty Assessment by examining the prospects for increasing agricultural productivity and linkages with the Government's poverty alleviation efforts. In addition to formal ESW, IDA will continue the practice of preparing informal reports and policy notes, to guide our policy dialogue with the Government, non-government representatives, and to inform donors on the evolving stabilization and structural adjustment agenda.

Portfolio Implementation

49. Only three projects are currently under implementation—FISE, which became effective in June 1993, the Agricultural Technology and Land Management project, which became effective in December 1993, and the Health Sector Reform project, which became effective in March 1994. Our limited portfolio implementation experience thus far suggests that auditing has not been a major problem, although an audit assessment mission found that the country's internal accounting and auditing practices need to be improved. Portfolio problems mainly concern delays in disbursements due to lack of familiarity with procurement procedures, especially at the subproject level, incomplete disbursement applications, delays in forwarding legal documents to IDA, and duplication of requests due to lack of intra-government coordination. These problems are largely the result of the Government's lack of familiarity with IDA procedures, compounded by its weak institutional capacity.

Table 1: Projects under Implementation

PROJECT NAME	NUMBER	APPROVAL	EFFECTIVE	AMOUNT	DISBURSED	OVERALL RATING
Social Investment Fund	2434	11-17-92	06-18-93	25.0	4.5	1
Agric. Tech. & Land Mngmt.	2536	20-07-93	11-24-93	44.0	2.5	1
Health Sector	2556	17-12-93	15-03-94	15.0	0.0	nr

nr = not rated.

50. Implementation of the FISE project is satisfactory, but bottlenecks in the contracting of subprojects have slowed disbursements, which as of end-1993 were 58 percent of appraisal estimates. The last supervision mission (February 1994) found that the number of requests for small projects has been larger than anticipated so there may be a need to readjust some of the aggregate limits for different methods of procurement under the credit. The mission also agreed with the Government on the need for FISE to provide assistance to sponsors who are not familiar with procurement procedures. Based on the mission's recommendations, it is expected that by end-1994, disbursement performance would improve. Despite the lag in disbursements, FISE is meeting its development objectives. The quality of subprojects is good, FISE approved almost 1,000 subprojects in 1993 for US$26 million (90 percent of target) and has built a pipeline for 1994 of US$32 million. Early experience with implementation of the Agricultural Technology and Land Management project is satisfactory.

51. As the portfolio grows, IDA will intensify its efforts to strengthen the Government's implementation capabilities, placing particular emphasis on country ownership of projects and increased involvement in project preparation and design. A Country Procurement Assessment and a Country Program Portfolio Review are planned for 1994. In addition to support from the Regional Project Management Office in Costa Rica, the Managua Resident Mission will continue to play a key role in efforts to strengthen project implementation and Government capacity (para. 35). In terms of Government ownership and involvement, we will seek to build on the successful approach followed in the preparation of the Health Sector Reform project.

IFC and MIGA Activities

52. IFC's last investment was in FY76. In late 1992, IFC undertook a major promotion effort in Nicaragua. Initial results appeared quite promising but, largely due to the political instability that has

prevailed since, IFC's project preparation efforts have not progressed. While IFC remains interested in supporting private sector development in Nicaragua, it does not plan to renew promotion activities until the political climate improves sufficiently. Nicaragua is a member of MIGA, having joined the Agency in December 1992. Because of the short period since Nicaragua joined, the Agency has not been able to issue guarantees, but it is expecting to do so in the near future.

Cooperation with Other Institutions

53. IDA is working closely with the IMF, IDB and other key donors to ensure consistency in the country policy dialogue. Given Nicaragua's difficult economic problems and its high dependence on aid, the need for donor coordination has been particularly critical. Preparation of the Government's stabilization program has been and will continue to be coordinated with the IMF through the PFP process. The annual CG process provides the overall framework for donor coordination, but IDA has also intensified donor contacts through formal as well as informal discussions, including periodic meetings with headquarters staff of key donors, regular updates of country developments, and various in-country meetings organized by the Resident Mission. The latter have included Government representatives as well as key leaders outside Government. The Resident Mission holds regular meetings with local donor representatives to report on progress in the preparation and implementation of the adjustment program. Coordination with IDB, USAID and UNDP has been, and will continue to be, particularly important given their large lending programs and extensive technical assistance activities, especially in terms of coordinating support for the Government's public sector reform program and related capacity-building efforts. In addition, IDA has strongly encouraged the Government to be more active in strengthening its own donor coordination efforts. At a time of declining aid flows, it becomes particularly important for the Government to prioritize and maximize the effectiveness of donor support.

Table 2: External Financing Requirements and Sources, 1993-97
(US$ million)

	1993	1994	1995	1996	1997
Requirements	1,397	1,923	1,274	1,144	1,183
Current account deficit[1]	430	399	379	348 326	338
Debt service	1,068	1,455	817	725 715	813
Increase in gross reserves	-100	69	78	71	32
Sources (net)	1,397	1,923	1,274	1,144	1,183
Official grants	243	211	177	172	172
Medium long-term loan disbursements	144	352	344	329	329
Other capital[2]	139	133	150	150	150
Use of Fund resources	--	24	43	46	27
Change in arrears	779	-2,976	--	--	--
Exceptional financing	92	4,179	560	447	505
Current obligations	--	1,217	560	447	505
Arrears	--	2,962	--	--	--

1/ Excludes interest payments due and official transfers.
2/ Includes net errors and omissions.

External Financing Needs

54. External financing requirements and sources are presented in Table 2. The projections, which are based on the current ESAF program, indicate that the current account deficit (excluding interest obligations and official transfers) would fall gradually, from US$430 million in 1993 to about US$340 million in 1997. Total gross disbursements of official grants and loans are projected to average about US$520 million annually over 1994-97. Other capital, mainly private capital inflows, would add about US$145 million annually over the period. Given Nicaragua's heavy external debt burden, the exceptional financing needs will remain substantial over the medium term. For 1994 these would amount to about US$1,220 million, excluding the rescheduling of arrears with official bilateral creditors and the resources

that would be needed for a buyback of commercial bank debt. Exceptional financing needs for 1995 would amount to US$560 million, and to US$475 million on average in 1996-97, even before considering debt service payments to commercial banks and payments to non-Paris Club creditors prior to the conclusion of debt negotiations with these creditors. The exceptional financing needs for 1994-95 would be met, among other ways, through the concessional rescheduling of debt service obligations to Paris Club creditors and the rescheduling of arrears and current obligations to non-Paris Club creditors on terms comparable to those obtained from certain Latin American countries, which provided for debt cancellation equivalent to 90-95 percent in present value terms.

D. AGENDA FOR BOARD CONSIDERATION

55. Nicaragua's economic and social situation remains very difficult. A weak economy coupled with an uncertain external environment and a fragile political consensus confront the Government with an enormous challenge. Despite these difficulties, the Government has not wavered in its commitment to reform and has successfully resisted pressures to backtrack on past efforts. IDA's assistance strategy is designed to assist the Government complete the complex transition to a market economy and to begin addressing the longer-term issues of sustainable and equitable development. The Government is in broad agreement with IDA's assistance strategy and the thrust of the development agenda presented above. Recent discussions with the Government have confirmed agreement on the level and composition of the proposed lending program, the priorities of the proposed ESW program and donor coordination efforts.

56. IDA will focus on the following criteria to evaluate progress. **First**, a key criteria would be the Government's ability to maintain a stable economy and deepen its structural reforms, especially the public sector reform program. The latter is a critical element in IDA's strategy. In the event that the economy were to destabilize markedly due to inappropriate macroeconomic policies and/or the Government proved unable to effectively implement its structural adjustment program, IDA would reduce its lending by postponing future adjustment lending, while maintaining the proposed investment lending program. **Second**, within the base and low case lending program, progress would be judged on the quality of portfolio implementation as well as the continuation of the Government's commitment to sustainable development, particularly institutional strengthening and poverty alleviation.

57. The **main** risk is political—the Government needs to forge a broad-based consensus to maintain the course of its stabilization and adjustment efforts, while at the same time adopting a longer-term view of the country's development challenges. The absence of sufficient consensus would result in increased political turmoil that could undermine the Government's reform agenda, threaten the reactivation of private sector growth, and stall progress in addressing longer-term development issues. A **second** important risk concerns institutional capacity—the Government's development agenda is comprehensive, but its implementation capacity is weak and spread out over many activities. To compensate for this risk, the assistance strategy and reform program focus on the adoption of simple policy rules and the withdrawal of the State from functions that can be better performed by the private sector or effectively decentralized. This should enable the Government to focus its limited institutional capacity on priority areas. Also, IDA plans to help reduce this risk through the proposed TAC and IDC operations, designed to underpin the public sector reform program and expand capacity-building efforts. The **third** important risk concerns future foreign aid contributions. While the overall reform program aims to reduce Nicaragua's aid dependency, abrupt aid reductions or protracted delays could rapidly destabilize the economy and lead to a reversal of the structural adjustment measures. Donor coordination efforts and successful implementation of the Government's stabilization and adjustment program would help to reduce this risk.

Part II. THE GOVERNMENT'S ADJUSTMENT PROGRAM

58. The second phase of the Government's structural adjustment program seeks to address Nicaragua's main challenge—resuming growth while maintaining macroeconomic stability in the face of

decreasing external assistance. The Government's immediate priority is to restore and maintain macroeconomic stability. To do this, it will need to downsize the public sector sufficiently to increase public savings, restore a safer foreign reserve level and permit expansion of credit to the private sector. The main elements of the Government's structural adjustment program are: (i) the development and implementation of a comprehensive and longer-term public sector reform program, designed to refocus the role of the State, improve its efficiency and contribute to sounder fiscal policies; (ii) a deepening of reforms in the financial system, including major restructuring of the state banking system and strengthened prudential supervision; and (iii) improving the private sector business environment by reducing discretionality in economic policy management, implementing a trade reform and export development program, and improving labor market policies. To complement this policy reform program, the Government is making efforts to resolve outstanding property disputes, improve law and order conditions, especially in rural areas, and strengthen the public sector's administrative and regulatory capabilities.

A. MACROECONOMIC FRAMEWORK

59. In collaboration with the IMF, the Government has prepared a program to ensure external viability in line with reduced foreign aid prospects. The stabilization and medium-term adjustment program is reflected in the Government's PFP for the period 1994-97. The stabilization program for 1994 envisages GDP growth of 2 percent, inflation of 10 percent and accumulation of gross official reserves to 1.7 months of imports. The main fiscal target underlying this program is an increase in public sector savings of 2.3 percent of GDP in 1994 (3.2 percent of GDP excluding net interest paid). As public investment is projected to increase by about 2 percent of GDP, the overall cash deficit of the public sector (before grants and including Central Bank losses) would decline slightly to 9.7 percent of GDP in 1994. To achieve this increase in public savings, the Government will: (i) further reduce import duty exemptions; (ii) implement administrative measures to increase the sales tax base; (iii) adjust petroleum prices to maintain their values in dollar terms; (iv) restrain public sector wage growth; (v) further reduce military personnel and public sector employment; and (vi) reduce Central Bank losses through increased onlending rates. For 1995-97, public savings are targeted to increase by an additional 3.5 percent of GDP, inflation would fall to about 5.5 percent by 1997, and gross official reserves would reach about 3.8 months of imports by end-1997. The envisaged fiscal adjustment coupled with the onlending of external resources, to be provided mostly by the Central American Bank for Economic Integration, would allow for an expansion in credit to the private sector of about 10 percent a year in real terms during 1994-95.

B. REFORM OF THE STATE

60. The fiscal adjustments required to face the decline of external aid flows present a challenge but also an opportunity to carry out a major reform of the State in Nicaragua. The Government's program to downsize and modernize the State has three major components: (i) labor mobility to reduce public sector employment; (ii) privatization and divestiture of the majority of remaining state-owned enterprises; and (iii) a comprehensive, longer-term Public Sector Reform Program designed to achieve a small, efficient and modern public sector.

61. **Public Sector Labor Mobility.** Reducing public sector employment will be critical to achieve a sustained improvement in public savings. The Government has prepared an Action Plan to implement its Labor Mobility Program, which targets the reduction of 13,569 positions in the public sector (about 13 percent of total public sector employment) through voluntary retrenchments during 1994-96 **[Board presentation condition; para. 80(i)]**. As part of the Labor Mobility Program, the Government has eliminated about 800 positions as of March 1994, and will have eliminated a total of 5,000 positions by end-1994 **[second tranche release condition; para. 81(i)]**. Due to severance payments, this labor force reduction would only yield modest savings in the first year of implementation, but result in significant permanent gains thereafter. IDA plans to assist the Government in the implementation of this program

through the proposed TAC. The action plan includes safeguards to ensure that the public sector does not lose its most productive employees and mechanisms to prevent the rehiring of displaced employees. The Government would maintain satisfactory progress in implementing and meeting the Program targets, including the cumulative elimination of 7,000 positions by mid-1995 **[third tranche release condition; para. 82(i)]**.

62. **Divestiture of State-Owned Enterprises.** A key element in the Government's strategy to streamline the State has been the divestiture of enterprises controlled by the state holding company, CORNAP. Under ERC I, the Government divested 233 of the 351 CORNAP enterprises, by selling them to workers and cooperatives, returning some to their original owners and closing others. Since release of the ERC I second tranche, the Government has divested an additional 46 enterprises. The Government plans to largely complete the process by divesting at least 66 of the remaining 72 CORNAP enterprises by end-1994. In addition, in 1994 the Government also plans to divest an oil and a gas enterprise, LUBNICA and ENIGAS, and 9 out of 17 enterprises currently incorporated under the Ministry of Construction and Transport (MCT), and some operations of the state-owned oil company (PETRONIC), including gasoline distribution activities, by mid-1995. The Government has also decided to privatize the international and domestic telecommunications operations of the state telecommunications and postal institute (TELCOR). In accordance with its program, as of May 1994, the Government has: (i) brought to the point of sale, liquidation or offered concessions for 33 of the remaining 72 CORNAP enterprises, 8 enterprises under MCT, and LUBNICA and ENIGAS; and (ii) prepared an action plan and drafted legislation to divest a 40 percent share of TELCOR's telecommunications operation, together with a management contract, and publicly announced the calendar of steps in the bidding process for TELCOR **[Board presentation condition; para. 80(ii)]**. By end-1994, the Government would: (i) bring to the point of sale or liquidate at least 33 of the remaining CORNAP enterprises, and one additional MCT enterprise; and (ii) implement satisfactorily the TELCOR privatization plan, including bringing to the point of sale at least 40 percent of TELCOR's shares together with the offer of a management contract to the successful bidder **[second tranche release condition; para. 81(ii)]**. By mid-1995, the Government will complete the administrative process of transferring ownership for all the CORNAP and MCT enterprises that were sold, and liquidate or bring to the point of sale some of PETRONIC's operations, including gasoline distribution activities, and shall have defined PETRONIC's regulatory functions, if any, in view of the planned liberalization of the hydrocarbons sector **[third tranche release condition; para. 82(ii)]**.

63. **Public Sector Reform Program.** Sustained fiscal adjustment will require a substantial downsizing of the State. This will need to be based on a fundamental redefinition of the role and functions of the public sector, which in turn would provide the basis for the institutional reordering of public sector activities. In addition, remaining public sector institutions need to be strengthened, with the objective of creating an efficient, transparent, accountable and service-oriented State. This is needed both to increase the State's capacity to deliver those services that remain within its purview and to improve private sector confidence in the State's ability to maintain stable rules of the game. In the Executive branches of government, institutions and agencies need to be restructured, merged and, in some instances, abolished. In addition, the role and functions of different ministries need to be redefined and strengthened in all areas but especially in financial management, tax and customs administration, and management of the civil service. As the State shrinks and the private sector takes up new activities, the public sector's role needs to focus increasingly on ensuring an enabling environment for the private sector to function. Where feasible and appropriate, central government services would be devolved to local governments and community organizations, and the Judicial and Legislative branches need to be significantly strengthened.

64. Implementation of a comprehensive public sector reform program is a difficult task for any country, but especially for Nicaragua where the public sector has a very weak institutional base. The process of reforming Nicaragua's public sector will be a long-term undertaking. Donors are working with the Government in a number of areas, either through self-standing technical assistance or as part of

their project activities. IDB for example is supporting improved tax and customs administration, developing a regulatory framework for public utilities, and plans to support the strengthening of the Judicial and Legislative branches. IBRD is supporting improved public sector management through an IDF grant. USAID has developed a program of integrated financial management and is supporting the strengthening of local governments through greater administrative decentralization. These efforts will necessarily progress at different speeds, depending on the actions of donors and the Government's own institutional capacity. A key aim of ERC II is to assist the Government define and begin the process of implementing a coherent and comprehensive public sector reform program, while being realistic on the time that the process will take in Nicaragua and allowing flexibility for differences in the implementation pace of each component. The process of public sector reform would continue beyond the implementation period of ERC II and would be supported and deepened through a proposed ERC III.

65. While the Government has initiated steps with donor support to diagnose and formulate reforms in a number of areas, these efforts have often lacked a coherent framework and strategy. To address this issue, the Government has: (i) prepared a policy statement outlining the overall strategy and broad elements of a comprehensive Public Sector Reform Program; and (ii) created within the Ministry of Finance a Reform of the State Program Management Unit (PMU), with agreed terms of reference and charged with designing and coordinating implementation of the Public Sector Reform Program **[Board presentation conditions; para. 80(iii)]**. The Government has requested IDA assistance through the proposed TAC to support PMU's work. PMU's mandate will be to develop and begin implementing by end-1994 a comprehensive and time-bound Public Sector Reform Program and Action Plan to be implemented over the next three years **[second tranche release condition; para. 81(iii)]**. The Public Sector Reform Program and Action Plan would cover: (i) institutional restructuring in line with the redefinition of the role and functions of the State, including the identification of proposed steps to restructure, merge and abolish public sector institutions; (ii) civil service reform, including an improved incentives system, the monetization of benefits, and an improved personnel management system; (iii) budgetary and expenditure management reform, including implementation of an integrated financial management system; (iv) improved tax and customs administration, including measures to expand the tax base, and streamline administrative procedures; (v) administrative decentralization, including increased local autonomy and accountability, extending the successful effort underway in health to the education sector; and (vi) strengthening of the Judicial and Legislative branches, including training and the development of management information systems. The Government would maintain satisfactory progress in implementation of the agreed Program, including the restructuring of at least two major public institutions **[third tranche release condition; para. 82(iii)]**.

C. FINANCIAL SECTOR REFORM

66. **Banking Sector Reform.** The Government recognizes the urgent need to improve the financial intermediation process and to establish conditions for a more rapid expansion of private banking. The two largest state banks, BANADES and BANIC, still dominate Nicaragua's financial market and constitute a major source of resource misallocation. Despite a major recapitalization in mid-1992 and significant reductions in personnel and branch offices, BANADES and BANIC have high operating losses, a declining deposit base and loan recovery rates of only 65-75 percent. Both banks rapidly expanded their loan portfolio relying on rediscounted credit lines at below market rates from the Central Bank and the second-tier National Investment Fund (FNI). The private banks, on the other hand, have experienced steady growth in their deposit base (accounting for 47 percent of total deposits in October 1993), but their credit portfolio has expanded more slowly (accounting for about 22 percent of total commercial credit). The private banks' capital-asset ratio averages 15 percent, reflecting extremely cautious lending policies. Private bank lending is almost exclusively directed to short-term commercial activities. Because loan repayment is less strictly enforced, all borrowers (including the best potential clients) prefer to take credit from the state banks, even though they consider the private banks as safer institutions in which to place their deposits.

67. Due to the large size of the state banks in the financial system and the cautious approach exhibited by the private banks, the Government considers that privatization or liquidation of the state banks is not feasible over the short- to medium-term. Also, there currently exists a legal (Constitutional) constraint to the partial or full privatization of the state banking system. Nonetheless, the Government recognizes the need to improve the efficiency of the state banks and prevent the use of fiscal resources to prop up the banks. To achieve this objective, the Government has eliminated the earlier practice of preassigning funds to specific economic activities and, as of December 1993, established a policy whereby interest rates on Central Bank rediscount lines are set quarterly based on the average market rate offered by commercial banks on 30-day deposits plus a 0.25 percent margin and indexed to the US dollar (as is the practice with virtually all commercial deposits). In addition, it intends to reform the state banks while at the same time subjecting them to a hard budget constraint—by precluding any future recapitalization with public sector funds and enforcing compliance with prudential norms established by the Superintendency of Banks. Moreover, any revaluation of non-financial assets would only be used to cover a deficit in loan provision requirements—when the level of earnings is insufficient to cover the required provisions and the capital adequacy level requirements are at their stipulated minimum—and/or to cover future severance incentives to encourage workforce reductions. Under this policy regime, the state banks would only be able to grow by raising their operating efficiency. To help the state banks become more efficient, the Government has prepared with IDB support a program to reform and restructure BANADES into a multi-purpose institution, oriented toward small and medium-sized agricultural producers, and lending at market rates. Also, the Government took the important step of replacing BANIC's management and several of its Directors in early 1994. This new management team is expected to prepare and implement an action plan designed to reform and downsize BANIC into a more efficient institution that could be eventually privatized. As part of its reform program, the Government stated its policy of: (i) not recapitalizing state banks, either through new capital from the public sector or the revaluation of non-financial assets; (ii) enforcing compliance by all banks with prudential norms established by the Superintendency of Banks; and (iii) not preassigning own rediscount funds to specific activities **[Board presentation condition; para. 80(iv)]**. Government compliance with this policy would be monitored throughout the program period **[second and third tranche release conditions; paras. 81(iv) and 82(iv)]**.

68. **Prudential Supervision.** To promote the development of a sound, private sector-based financial system, the Government has taken important steps to strengthen the Superintendency of Banks, including: (i) revision of prudential norms on loan classification, capital adequacy, asset-liability regulations and lending to related parties; (ii) identification of functions to be transferred from the Board of the Superintendency to the Superintendent to grant him increased autonomy to supervise banks; (iii) design of a new chart of accounts and an accounting manual that conforms with international standards; and (iv) modernization of managerial and financial information systems, reflected in improved monthly and quarterly Superintendency reports. Also the Superintendency has formally requested the Central Bank to issue instructions that establish the eligibility of foreign banks as recipients of deposits and investments from domestic banks. The current banking law requires all commercial banks to have an external audit at least once a year and the Superintendency must clear the auditors' reports before banks can declare dividends. The Government recognizes that further actions are needed to strengthen prudential supervision and improve the transparency of financial information. These actions have been incorporated in the agreed Action Plan to Improve Prudential Supervision (see Annex C for details of the Action Plan). Satisfactory implementation of the Action Plan will be monitored throughout the program period. In line with this Plan, the Superintendency has issued revised prudential norms **[Board presentation condition; para. 80(iv)]**, and by November 1994 will have: (i) instructed all banks to implement the new chart of accounts; (ii) designed a centralized management information system of debtors in the financial system; and included FNI and INISER (the Insurance Company) in the Superintendency's inspection program. Also by November 1994, the Government will have issued a Presidential Decree or, if necessary, presented legislation to the Assembly that increases the ceiling on penalties and fines for non-compliance with prudential norms or instructions by the Superintendency **[second tranche release conditions; para. 81(iv)]**. By mid-1995, the Superintendency will have: (i) reviewed and enforced compliance by banks

with the new chart of accounts; (ii) implemented the centralized management information system; and (iii) included the Stock Exchange in the Superintendency's inspection program, unless and until a separate regulatory agency has been created **[third tranche condition; para. 82(iv)]**.

D. PRIVATE SECTOR DEVELOPMENT

69. **Property Rights Guarantees.** The lack of a comprehensive land title and registration system has been a long-standing source of property conflicts and land-tenure uncertainty in Nicaragua. This problem was exacerbated by the land reforms and urban property transfers carried out during the past decade. These transfers were characterized by incomplete ownership titles, the coexistence of mutually conflicting laws, and frequent abuses, both in terms of illegal confiscations and transfers to ineligible land reform beneficiaries. The consequence is that about 1.7 million hectares of cultivable land (of a total of 5.7 million) and a substantial number of houses and urban lots are currently without title or are claimed by different owners. The lack of clear ownership relations, in turn, has encouraged land invasions and violent confrontations. The uncertainty created by these unresolved property conflicts and resulting climate of violence arguably constitutes the most important obstacle to investment in agriculture, with major negative spillover effects on the rest of the economy.

70. Following a major information-gathering effort during 1992, the Government set up an administrative process to speed up the resolution of outstanding property disputes and clarify ownership relations. To address the claims of dispossessed property owners, a Commission was established to review all outstanding claims. If a claim is considered justified, the Commission can recommend either compensation or, when possible, the return of properties. Compensation is to take place in the form of 20-year dollar-indexed bonds, backed by the proceeds from the sale of public assets, including TELCOR and possibly the electric utility company. Also, an Office was created to review the legitimacy of past land assignments and grant clear titles if found to be legitimate. Both institutions have been operating since early 1993 and the Government has established a timetable to resolve through administrative means all cases of disputed land by mid-1995. (If a claimant remains dissatisfied with a particular administrative resolution, he/she retains the right to pursue the claim through the judicial system.) These efforts to clarify property ownership relations are being complemented by stronger law enforcement efforts to prevent land invasions.

71. Throughout preparation of the proposed ERC II, IDA has reviewed the Government's efforts to resolve property rights disputes, and considered designing conditionality to monitor progress according to an agreed timetable. The property disputes resolution process, however, is complex, slow and politically controversial—in and outside the country. IDA is encouraging the Government to make every effort to resolve the problem to the satisfaction of all parties concerned. The Government has indicated in its **Letter of Development Policy** (Annex E) its intention to speed up the process and take all reasonable measures to satisfy the legitimate claims of all parties in dispute. To support these efforts, IDA has agreed with the Government on a set of measures to strengthen the administrative process for the resolution of property disputes and to raise the value of compensation bonds in order to increase acceptability of the compensation process. In particular, agreement was reached on: (i) the establishment of a mechanism in the Ministry of Finance to carry out random inspections to verify compliance with established procedures to resolve property conflicts and to report any deviations from established procedures for their correction; and (ii) commissioning of a study to analyze potential uses of the Compensation Bonds, with the objective of raising their value **[Board presentation condition; para. 80(v)]**. Satisfactory progress in implementing the verification process, and the design and implementation of agreed recommendations of the study would be monitored throughout the program period **[second and third tranche release conditions; paras. 81(v) and 82(v)]**.

72. **Discretionality in Economic Policy Management.** The Nicaraguan Constitution gives the President of the Republic powers to revise taxes and impose non-tariff barriers (NTBs) on trade. The President delegated these powers to different Government Ministries in order to share the large task of

eliminating the gross policy-induced distortions inherited from the previous Administration and to enable a quick response needed to maintain stability in the face of exogenous shocks. The exercise of these powers by different Ministries, however, also has generated uncertainty in the private sector, which perceives a lack of clarity in the rules of business. Moreover, the public was often not informed about such policy changes in a clear and timely manner. During this second phase of the adjustment program, and given that many of the previous policy distortions have been eliminated, it will be important to render the rules of the game more transparent and predictable in the interest of promoting greater private sector confidence. As part of this process, the Government issued Presidential Decrees that: (i) state that any change in tax and fiscal policies has to be published in the Official Gazette to be legally binding, except in cases of *force majeure*, in which case it must be published in at least one daily newspaper of broad circulation; (ii) abrogate and elevate to the Presidential level the powers of ministries and government agencies to change tax and fiscal policies; and (iii) abrogate the powers of ministries and government agencies to create new commercial enterprises **[Board presentation condition; para. 80(vi)]**.

73. **Trade Reform and Export Development.** Nominal import protection rates, including tariffs and specific import consumption taxes, currently range between 10 and 40 percent (with a few exceptions below 10 percent) and virtually all NTBs applied with protectionist intent have been abolished. In its Letter of Development Policy submitted for ERC I, the Government stated its intention to reduce the range of nominal import protection to 10-20 percent by December 1993. In view of the decline in foreign aid and consequent need for increased public savings, however, the Government is concerned that further tariff and import tax reductions now would undermine the required stabilization effort. Furthermore, to reach the desired objective of promoting export growth, tariff reductions need to be accompanied by compensatory devaluations of the real exchange rate. The economy's ability to respond to exchange rate adjustments is constrained by considerable dollar indexation. Under these circumstances, major tariff reductions would tend to expand the external deficit and depress domestic production. In the absence of a demand-switching response, the entire adjustment would have to take place through the compression of aggregate demand, which would jeopardize the desired reactivation of growth.

74. The Government intends to implement its tariff adjustment program more gradually and, instead, focus its efforts on improving the transparency of the trade regime and removing the rigidities that currently prevent real exchange rate adjustments. To render the trade regime more transparent, the Government has issued two Presidential decrees, effective as of July 1, 1994, that eliminate the Selective Consumption Tax (ISC) and the Luxury Goods Tax, replacing them with a Temporary Protection Tariff (ATP) applicable only to imports, and a Special Consumption Tax (IEC) applicable to domestic and imported products. The ATP now applies to only 750 import items (at the 8-digit Central American import classification code) of the 1,451 items previously subject to the ISC, while the remaining items are only subject to the IEC. Under the revised tariff adjustment program, the nominal protection ceiling, including import duties and the ATP, would gradually reach 20 percent by end-1999 (see **Letter of Development Policy** in Annex D for the Government's tariff adjustment schedule). This more gradual tariff adjustment program has been agreed under the Central American Common Market framework (para. 17). The Government has prepared a phased tariff reduction program to reach a maximum of 37 percent (including the Central American CET, ATP and the 5 percent flat rate) by mid-1995 **[Board presentation condition; para. 80(vii)]**. The Government would implement satisfactorily the agreed tariff program, including attainment of a maximum nominal protection ceiling of 37 percent by mid-1995, with the exception of 8 products (designated "fiscal industries") subject to a review of the fiscal impact of lower protection before third tranche release **[third tranche release condition; para. 82(vi)]**.

75. To improve the transparency of the trade regime, the Government plans to simplify the bureaucratic procedures and charges currently required for import and export transactions under a program to strengthen the "single window" at the Central Bank. A temporary export promotion mechanism was introduced in 1992, which grants relatively high subsidies for a limited set of non-traditional exporters, depends on complex administrative and control mechanisms that lend themselves to abuse, and may violate the GATT agreements to which Nicaragua is a signatory. Since the current

export promotion mechanism is imbedded in contracts between the Government and exporters, the Government is scrutinizing the application and eligibility of all new contracts to avoid abuse, and intends to allow this mechanism to expire as scheduled in 1997. The current mechanism will be replaced by an export promotion system that is more transparent and applicable to all exports. By mid-1995, the Government would prepare an agreed action plan to replace the current export promotion mechanism by a duty drawback system or a temporary admission regime **[third tranche release condition; para. 82(vi)]**. Moreover, the Government intends to offer exporters that benefit from the current system the choice of transferring to the new export promotion system as soon as it is implemented.

76. **Labor Market Policy.** Although the current Labor Code is not unduly restrictive, a small segment of the labor force, comprising employees in the public sector and the recently-privatized state enterprises, benefits from overly generous collective agreements that inhibit labor mobility and discourage productivity improvements. Modifications to the Labor Code have been under discussion in the Assembly for the past 12 months. Initially, it appeared that the Assembly would approve reforms that threatened to extend several key features of the collective bargaining agreements to the rest of the labor force in the formal sector, including tight restrictions on the ability of employers to hire and fire labor. This could seriously impede the structural adjustment process by reducing labor mobility and constrain the private sector's ability to become internationally competitive. Recent indications, however, suggest that a more moderate position is likely to prevail in the Assembly and that any reforms would not be overly restrictive. In any event, the Government is prepared to veto any modifications to the existing Labor Code agreed within the Assembly that would impose stronger restrictions on labor mobility. This commitment is reflected in the Government's **Letter of Development Policy**. As a parallel effort and to guide any future labor reform initiatives, the Government has clarified its policy and objectives concerning the functioning of labor markets that are reflected in a Letter of Labor Policy (Annex F) **[Board presentation condition; para. 80(viii)]**.

E. SOCIAL IMPACT

77. Over the short term, the reactivation of growth, especially in rural areas, would have the most immediate impact on reducing poverty. The main adverse effect of the Government's adjustment program will be in terms of displaced labor resulting from the Labor Mobility Program and privatization of state enterprises. To minimize the social impact of its Labor Mobility Program, the Government has included a relatively generous compensation package which, while limiting the immediate fiscal gains, it deems essential given the high levels of unemployment and poverty in the country. Displaced public sector employees will continue to draw their full salary for up to three years, depending on length of service in the public sector, and will retain their full pension rights. The Government expects that while privatized enterprises will initially shed some redundant labor, as their management and efficiency improve they will gradually expand output and employment. In addition, the Government plans to protect the social sectors from budget cuts undertaken as part of the reform program. Reflecting this commitment, the share of the total ordinary central government budget allocated to the social sectors increased from 36 percent in 1992 to 46 percent in 1993 and would remain at 45 percent in 1994. These allocations have allowed the Government to maintain social sector expenditures constant in real terms throughout the adjustment period. The Government is also making efforts to mobilize additional donor funding for its social safety net programs, including additional support for the FISE planned by IDB in 1995. As a result, in 1994-96 FISE is expected to double its expenditures and create about 20,000 jobs.

Part III. THE PROPOSED CREDIT

A. BACKGROUND

78. The proposed ERC II and IDA Reflows Credit will support implementation of the Government's structural adjustment program. IDA and the Government have maintained an active policy dialogue since

the completion of ERC I on the need to continue and deepen the process of structural adjustment. The political volatility which the country experienced in 1993, compounded by the interruption of important bilateral aid inflows, forced the Government to focus its attention on political matters and emergency macroeconomic measures to prevent destabilization of the economy. During 1993, little progress was achieved in the policy dialogue and preparation of the proposed ERC II. In early 1994, as the political and security climate improved, the Government refocussed its attention on the need to set in place macroeconomic and structural reform policies to permit an orderly economic adjustment to the decline in aid. Substantial progress was achieved during two pre-appraisal mission in the first quarter of 1994. On the basis of this progress, appraisal of ERC II took place during April 4-8, 1994. As discussed in Part I, the proposed ERC II is fully consistent with IDA's assistance strategy for Nicaragua.

B. CONDITIONS FOR TRANCHE RELEASE

79. The measures contained in the Government's program aim to improve balance of payments prospects, in line with the expected reduction in net aid inflows. Nevertheless, the balance of payments support provided by the proposed ERC II and eventual donor cofinancing is needed to compensate in part for the decline in overall aid inflows and, thereby, permit a more orderly adjustment until reforms achieve their full effects. A credit of US$60 million equivalent is proposed, to be supplemented by an IDA Reflows Credit for SDR 5.36 million (US$7.6 million equivalent) from the FY94 IDA Reflows allocation.[2] The credit would have three tranches. The first tranche of US$30 million, supplemented by the FY94 IDA Reflows Credit, would be available upon effectiveness, expected to take place in July 1994. Provided the program is implemented on schedule, the second tranche of US$15 million would be disbursed in December 1994 and the third tranche of US$15 million in August 1995. In addition to the actions specified below, each tranche release would be contingent on the maintenance of an appropriate macroeconomic framework and satisfactory overall progress in implementation of the adjustment program, as described in the attached Matrix of Policy Actions (Annex C) and the Government's Letter of Development Policy (Annex E).

80. The following policy actions have been taken before **Board presentation**:

(i) prepared a satisfactory action plan to implement the Public Sector Labor Mobility Program, including time-bound employment reduction targets (para. 61);

(ii) brought to the point of sale, liquidation or offered concessions for 33 of the remaining 72 CORNAP enterprises, 8 MCT enterprises, and LUBNICA and ENIGAS; and prepared an action plan and drafted legislation to divest a 40 percent share of TELCOR's telecommunications operation, including the offer of a management contract to the successful bidder, and publicly announced the calendar of steps in the bidding process for TELCOR (para. 62);

(iii) prepared a policy statement outlining the strategy and broad elements of the Government's Public Sector Reform Program, and established within the Ministry of Finance a Reform of the State Program Management Unit (PMU) with agreed terms of reference (para. 65);

(iv) stated its policy of: (i) not recapitalizing state banks, either through new capital from the public sector or revaluation of non-financial assets, (ii) enforcing compliance by all banks with prudential norms established by the Superintendency of Banks, and (iii) not preassigning own rediscount funds to specific economic activities (para. 67); and prepared an agreed Action Plan to Strengthen Prudential Supervision, and issued revised prudential norms (para. 68);

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2. The proposed Supplemental Credit for Nicaragua was contained in the President's Memorandum of January 4, 1994 entitled "Distribution of FY94 Annual Allocations from IDA Reflows—Proposed Supplemental Credits for Bolivia, Ethiopia, Ghana, Guyana, Honduras, Kenya, Malawi, Mauritania, Senegal, Sierra Leone, Uganda and Zambia" (IDA/R94-1) approved by the Board on January 14, 1994.

(v) agreed on the establishment of a mechanism in the Ministry of Finance to carry out random inspections to verify compliance with established procedures to resolve property conflicts, and the commissioning of a study to analyze potential uses of the Compensation Bonds, with the objective of raising their value (para. 71);

(vi) issued Presidential Decrees that: (i) state that any change in tax and fiscal policies has to be published in the Official Gazette to be legally binding, (ii) abrogate and elevate to the Presidency the powers of ministries and government agencies to change tax and fiscal policies, and (iii) abrogate the powers of ministries and government agencies to create new commercial enterprises (para. 72);

(vii) presented an agreed phased tariff reduction program to reach a maximum of 37 percent by mid-1995 (para. 74); and

(viii) presented a satisfactory Letter of Labor Policy (para. 76).

81. The following actions would be second tranche release conditions:

(i) satisfactory progress in implementing and meeting the targets of the Public Sector Labor Mobility Program, including the elimination of 5,000 positions by end-1994 (para. 61);

(ii) bring to the point of sale or liquidate at least 33 of the remaining CORNAP enterprises and one additional MCT enterprises; and implement satisfactorily the TELCOR privatization plan, including bringing to the point of sale a 40 percent share of TELCOR's telecommunications operation, together with the offer of a management contract to the successful bidder (para. 62);

(iii) develop and begin implementing by end-1994 a comprehensive and time-bound Public Sector Reform Program and Action Plan to be implemented over the next three years (para. 65);

(iv) compliance with stated policy toward state banks (para. 67), and satisfactory implementation of Action Plan to Improve Prudential Supervision (para. 68); and

(v) satisfactory progress in implementation of the verification process and the design and completion of the study on potential uses of the Compensation Bonds (para. 71).

82. The following actions would be third tranche release conditions:

(i) satisfactory progress in meeting the targets of the Public Sector Labor Mobility Program, including the cumulative elimination of 7,000 positions by mid-1995 (para. 61);

(ii) complete the administrative process of transferring ownership for all the CORNAP and MCT enterprises that were sold, and liquidate or bring to the point of sale some of PETRONIC's operations, including gasoline distribution, while defining PETRONIC's regulatory functions, if any, in view of the planned liberalization of the hydrocarbons sector (para. 62);

(iii) satisfactory implementation of the Public Sector Reform Program and Action Plan, including the restructuring of at least two major public institutions (para. 65);

(iv) compliance with stated policy toward state banks (para. 67), and satisfactory implementation of Action Plan to Improve Prudential Supervision (para. 68);

(v) satisfactory progress in implementation of the verification process, and the design and implementation of agreed recommendations of the study to increase the value of the Compensation Bonds (para. 71); and

(vi) satisfactory implementation of tariff reduction program, including attainment of a maximum nominal protection ceiling of 37 percent by mid-1995 for all imports with the possible exception of 8 products ("fiscal industries") subject to a prior review of the fiscal impact of lower protection (para. 74); and preparation of an agreed action plan to replace the export promotion mechanism by a duty drawback system or a temporary admission regime (para. 75).

C. PROCUREMENT, DISBURSEMENT AND AUDITING

83. Credit proceeds from ERC II and the Supplemental IDA Reflows Credit would be used to finance the foreign exchange cost of general imports (goods and relevant foreign services), excluding goods financed by other bilateral and multilateral agencies, luxury goods, military equipment and other goods specifically prohibited in the negative list defined under the Standard International Trade Classification or equivalent classification. Retroactive financing not exceeding one-third of the credit amount (SDR 14.17 million equivalent), would be allowed for eligible expenditures incurred since February 1, 1994. The increase in retroactive financing and extension of the eligible period by one month would assist the Government in smoothing out foreign exchange reserve flows. Debt service obligations and domestic credit needs for the agricultural cycle reach a peak toward the middle of the year. External flows, on the other hand, are bunched toward the second half of the year. The retroactive financing would allow the Government to meet its external obligations without constraining domestic credit, which would jeopardize the economic reactivation supported by ERC II. The IDA reflows complement the first tranche.

84. Experience under ERC I with procurement has been fully satisfactory, with all disbursements made against imports supported by documentation compiled by the Central Bank. Audits of the first and second tranche confirmed the completeness and adequacy of the relevant documentation compiled by the Central Bank. The audits also confirmed that the supporting documentation, together with internal controls and procedures applied, conformed with IDA procedures. The following procurement procedures—agreed with the Borrower during negotiations—would be applied:

(i) Goods imported by public and private sector entities valued at US$3 million equivalent or more would be procured through simplified international competitive bidding (ICB) procedures, using IDA's standard bidding documents, in accordance with IDA guidelines, except for petroleum imports being supplied under existing contracts. These petroleum expenditures would qualify for reimbursement under the credit for up to 50 percent of the credit amount and in an amount not to exceed on a per unit basis the reference average FOB price published in the Platt's Oilgram for the US Gulf Coast or the Caribbean, as applicable, on the date of loading and adjusted for the type and quality of crude or product. Freight and insurance related to such procurement purchases would qualify for reimbursement provided they are procured on a competitive basis from a source eligible under IDA guidelines. Any financing provided under such contracts would be deducted from the expenditures to be reimbursed under the credit, and any petroleum imports procured after the existing petroleum contracts expire would need to meet the standard provisions of simplified ICB procedures, conforming with IDA guidelines, to be eligible for reimbursement. A similar criterion would apply to the reimbursement of expenditures under existing contracts for other commodities for which the reference unit price would be the average price posted by a recognized commodity exchange; and

(ii) Imports valued at below US$3 million equivalent would be procured in the case of: (a) public sector entities, in accordance with the procedures applicable to them as governed by the law; and (b) private imports, in accordance with established commercial practices, including price quotations from at least two eligible suppliers, except where direct contracting may be appropriate under IDA procurement guidelines.

85. Disbursement of each tranche would be made against import documentation received by the Central Bank, which would be responsible for collecting the relevant documentation and submission of withdrawal applications. For contracts valued at less than US$3 million equivalent each, IDA would reimburse the Central Bank on the basis of Statement of Expenditures prepared from standard supporting documentation compiled by the Central Bank. The Central Bank would retain supporting documentation for review by IDA supervision missions and for subsequent audits by external auditors acceptable to IDA. It would also be responsible for preparing the calculations and adjustments vis-a-vis the market prices indicated in Platt's Oilgram [see para. 84(i)] before submitting withdrawal applications. An audit report would be submitted to IDA within 90 days from the date of full disbursement of each tranche or not later than four months after the end of each fiscal year, and compliance with the audit covenant would be a condition for disbursement of each subsequent tranche. A special provision would be included in the auditor's terms of reference to verify the Borrower's petroleum price calculations. Withdrawal applications should be consolidated and submitted in amounts not less than US$250,000 equivalent. Import contracts valued under US$5,000 would be ineligible for financing under the credit. The closing date for ERC II is December 31, 1995 and for the IDA reflows one year after the date of the agreement.

D. RELATIONS WITH OTHER FINANCIAL ORGANIZATIONS AND DONORS

86. IDA staff are working closely with the IMF, IDB and key bilateral donors to coordinate support for the Government's structural adjustment and stabilization program. Together with the IMF, IDA has assisted the Government prepare a PFP, to serve as the basis for a proposed ESAF program with the IMF. The IDB is providing technical assistance to reform BANADES and will assist the Government develop an appropriate regulatory framework for the infrastructure sector through a proposed Public Utilities Reform project. IDB also plans to assist the Government in its efforts to strengthen the Judicial and Legislative branches. All these efforts are being coordinated by IDA to ensure consistency with the reforms supported by ERC II. The Resident Mission in Managua periodically hosts meetings with local donor representatives to inform them of progress made in the preparation and implementation of the adjustment program. A CG meeting chaired by IDA is scheduled for mid-June 1994, which will assist the Government to firm up donor support for its reform program.

E. COFINANCING

87. The Government and IDA are exploring the possibility of cofinancing for the proposed ERC II with several bilateral donors. During the last CG meeting in April 1993, Germany expressed the intent to cofinance ERC II with DM 20 million (US$12 million). Sweden and Switzerland have also expressed interest in cofinancing ERC II with US$9 million equivalent and US$6 million equivalent, respectively. The Government has requested cofinancing of US$60 million equivalent from the Government of Japan.

F. TECHNICAL ASSISTANCE

88. The main technical assistance needs to implement the adjustment program lie in the following areas: (i) development of the overall strategy and action plan to begin implementation of the public sector reform program; (ii) implementation of the labor mobility program; (iii) civil service reform; (iv) budget and expenditure control processes; and (v) completion of the study to increase the value of Compensation Bonds. The proposed TAC, to be implemented through the PMU, would support preparation and initial implementation of the Public Sector Reform Program, and cover those needs not included in other donor efforts. The TAC would play a key role in coordinating technical assistance provided by other donors, especially IDB, USAID and UNDP, and in providing the link with a proposed follow-on ERC III, which would continue and deepen the process of public sector reform. The proposed IDC would focus on

implementation of the second phase of the public sector reform program, to be supported by ERC III, and seek to broaden overall capacity-building efforts in the country.

G. PROGRAM BENEFITS AND RISKS

89. **Benefits.** The main benefits of the program would be to help the Government adjust to lower foreign resource inflows and to improve the conditions for resuming sustained private sector-led growth. Approval of ERC II would enable the Government to mobilize additional balance of payments support which would permit a more gradual and predictable economic adjustment path to reduced aid inflows. More importantly, to the extent that implementation of the proposed reform program succeeds in reviving economic growth within a stable macroeconomic environment, the Government would be in a stronger position to resist political pressures for more populist and interventionist policies. Even a modest improvement in living standards would allow the Government to take a longer-run view of the country's development agenda.

90. **Risks.** Potential external risks and general country risks are discussed in Part I (paras. 9-17 and 57, respectively). This operation faces two types of risks. **First**, a breakdown of the consensus-building process now underway could lead to a political impasse as occurred in 1993. Under these circumstances, the Government could find it politically difficult to implement the stabilization and adjustment measures in its reform program. While Nicaragua's political situation remains a source of concern and there will certainly be outright opposition to some elements of the program, especially the public sector reform component, this is tempered by a realization across the political spectrum, that the country has no option but to adjust to the decline in foreign aid and that this adjustment must involve a reduction in the size of the public sector. **Second**, the Government's weak institutional capacity could delay implementation of several components of the program. To reduce this risk IDA has: (i) included considerable flexibility in the design of the reform program and its conditionality, relying to a great extent on the implementation of agreed action plans, which allow for the monitoring of overall program implementation while leaving sufficient room for variability in the pace of implementation of different components; and (ii) prepared a TAC to support institutional strengthening and implementation of the reforms included in ERC II.

Part IV. RECOMMENDATION

91. I am satisfied that the proposed credit would comply with the Articles of Agreement of the Association and recommend that the Executive Directors approve the proposed credit.

92. I am also satisfied that the proposed Supplemental credit would comply with the articles of Agreement of the Association and recommend that the Executive Directors approve the Supplemental credit.

Lewis T. Preston
President

Attachments

Washington, D.C.
May 27, 1994

ANNEX A

STATISTICAL APPENDIX

ANNEX A

Statistical Appendix

NICARAGUA – Selected Indicators of Bank Portfolio Performance and Management

Indicator	FY 1993	FY 1994 (as of March)
Portfolio Performance		
Number of projects under implementation	1	2
Average implementation period (years)	-	-
Average ratings a/		
Development objectives b/	nr	1
Overall status c/	nr	1
Percent of projects rated 3 or 4	0	0
Development objectives b/	0	0
Overall status c/	0	0
Cancelled during FY	0	0
Disbursement ratio (%) d/	0	11.9
Disbursement lag (%) e/	-	55.1
Memorandum item: % completed projects rated unsatisfactory f/	0	0
Portfolio Management		
Supervision resources (total staff-weeks)	-	23.5
Average supervision (staff-weeks/project)	-	11.8
Supervision resources by location (in %)	-	100.0
Percent headquarters	-	57.0
Percent resident mission	-	43.0
Supervision resources by rating category (staff-weeks/project)		
Projects rated 1 or 2	-	11.8
Projects rated 3 or 4	-	-
Memorandum item: date of last/next CPPR	-	Oct. 94

a. Average of points in the Bank's country portfolio.
b. Extent to which the project meets its development objectives (see OD 13.05, Annex D2).
c. Assessment of overall performance of the project based on the ratings given to individual aspects of project implementation (e.g. management, availability of funds, compliance with legal covenants) and to development objectives. The overall status is not given a better rating than that given to project development objectives.
d. Ratio of disbursements during the year to the undisbursed balance of the Bank's portoflio at the beginning of the year (*investment projects only*).
e. For all projects comprising the Bank's country portfolio, the percentage between actual cumulative disbursements and the cumultative disbursements estimates as given in the " Original SAR/PR Forecast" or, if the loan amounts have been modified, in the "Revised Forecast." The country portfolio disbursement lag is effectively the weighted average of disbursement lags for projects comprising the Bank's country portfolio where the weights used are the respective project shares in the total cumulative disbursement estimates.
f. For current FY only: from the OED database.

Note: The one project under implementation in FY93 was the FISE, which only became effective in June 1993. The Health Sector Reform project became effective in March 1994 and is therefore not included as a project under implementation for FY94.

NICARAGUA -- Bank Group Fact Sheet, FY91-97

	Past			Current	Planned		
Category	FY 91	FY 92	FY 93	FY 94	FY 95	FY 96	FY 97
Commitments (US$m)	0.0	120.3	33.5	12[illegible]	[US$ 100-130 million] a/		
Sector (%)	0.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture	0.0	0.0	0.0	34.5	0.0	0.0	0.0
Infrastructure and urban development	0.0	0.0	0.0	0.0	0.0	100.0	36.6
Human Resources	0.0	0.0	74.6	11.8	100.0	0.0	0.0
Multisector	0.0	100.0	25.4	53.7	0.0	0.0	63.4
Lending Instrument (%)	0.0	100.0	100.0	100.0	100.0	100.0	100.0
Adjustment Loans	0.0	100.0	25.4	50.4	0.0	0.0	100.0
Specific Investment Loans and Others	0.0	0.0	74.6	49.6	100.0	100.0	0.0
Disbursements (US$m)	0.0	125.4	3.2	26.4	82.5	40.9	46.7
Adjustment Loans	0.0	125.4	3.2	8.5	45.0	15.0	27.0
Specific Investment Loans and Others	0.0	0.0	0.0	17.9	37.5	25.9	19.7
Repayments (US$m)	2.0	121.4	18.8	18.3	16.3	15.4	11.7
Interest (US$m)	3.3	144.5	10.6	9.6	8.2	7.0	5.7

a/ Planned FY95-97 program.

NICARAGUA -- IFC and MIGA Program, FY91-93

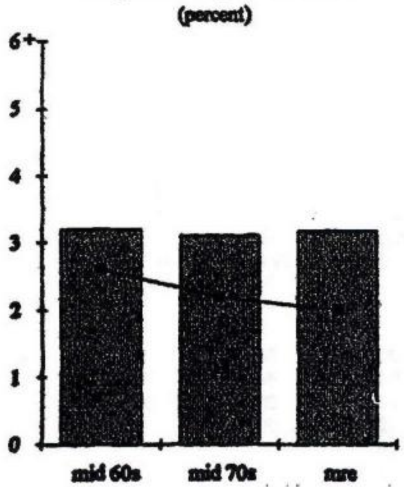
Category	Past		
	FY 91	FY 92	FY 93
IFC approvals (US$m)			
Sector (%)			
Agribusiness			
Capital Markets			
Chemicals/fertilizers			
Infrastructure			
Manufacturing			
Oil/Mining			
TOTAL			
Investment instrument (%)			
Loans			
Equity			
Quasi-Equity			
TOTAL			
MIGA guarantees (US$m)			
MIGA commitments (US$m)			

Note: IFC's last operation with Nicaragua was approved in FY76. MIGA has not issued guarantees to Nicaragua.

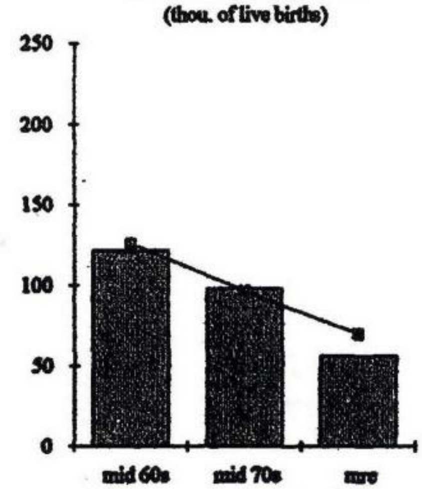
Nicaragua: Priority Poverty Indicators

Indicator	Unit of measure	25-30 years ago	15-20 years ago	Most recent estimate (mre)	Same region/income group: Latin America Caribbean	Same region/income group: Low-income	Next higher income group
POVERTY							
Upper poverty line	local curr.	..	..	..	..	..	..
Headcount index	% of pop.	..	..	..	..	..	..
Lower poverty line	local curr.	..	..	..	..	..	..
Headcount index	% of pop.	..	..	..	..	..	..
GNP per capita	US$	310	630	460	2,410	350	1,610
SHORT TERM INCOME INDICATORS							
Unskilled urban wages	local curr.	..	..	..	..	..	..
Unskilled rural wages	"	..	..	..	..	..	..
Rural terms of trade	"	..	..	..	..	..	..
Consumer price index	1987=100	..	0	10,305	..	..	..
Lower income	"	..	..	..	..	..	..
Food	"	..	..	100	..	..	..
Urban	"	..	..	..	..	..	..
Rural	"	..	..	..	..	..	..
SOCIAL INDICATORS							
Public expenditure on basic social services	% of GDP	..	..	..	..	..	..
Gross enrollment ratios							
Primary	% school age pop.	69	82	98	107	113	100
Male	"	68	80	94	..	122	106
Female	"	69	85	101	..	106	98
Mortality							
Infant mortality	thou. live births	121	98	56	43	70	40
Under 5 mortality	"	..	..	66	53	98	53
Immunization							
Measles	% age group	..	..	82	78	73	70
DPT	"	..	..	65	77	81	74
Child malnutrition (under-5)	"	..	..	..	..	..	..
Life expectancy							
Total	years	51	57	66	68	63	67
Females/males	ratio	1.06	1.07	1.07	1.09	0.95	1.08
Total fertility rate	births per woman	7.3	6.6	5.1	3.1	3.7	3.5
Maternal mortality rate	100,000 live births	..	..	300	..	..	..

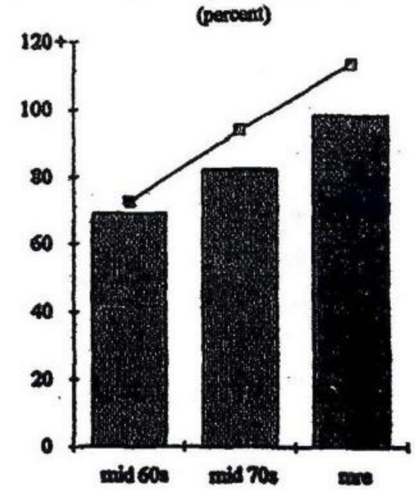
Population growth rate
(percent)



Infant mortality rate
(thou. of live births)



Primary enrollment
(percent)



Nicaragua
— Low income

Nicaragua: Resources And Expenditures

Indicator	Unit of measure	25-30 years ago	15-20 years ago	Most recent estimate (mre)	Same region/income group: Latin America Caribbean	Same region/income group: Low-income	Next higher income group
HUMAN RESOURCES							
Population (mre=1991)	thousands	1,758	2,426	3,794	445,450	3,127,265	773,803
Age dependency ratio	ratio	1.05	1.01	0.94	0.67	0.66	0.71
Urban	% of pop.	42.7	50.3	60.0	72.3	40.1	53.9
Population growth rate	annual %	3.2	3.1	3.2	1.7	1.9	1.7
Urban	"	4.6	4.4	3.5	2.9	5.2	3.1
Labor force (15-64)	thousands	535	722	1,256	162,042	1,448,104	302,448
Agriculture	% of labor force	57	49	..	..	..	..
Industry	"	16	16	..	..	..	..
Female	"	19	21	26	27	33	32
Female per 100 males							
Urban	number	..	..	..	106	..	..
Rural	"	..	..	..	88	..	..
NATURAL RESOURCES							
Area	thou. sq. km	130	130	130	20,507	38,828	23,990
Density	pop. per sq. km	14.0	19.0	28.0	21.0	77.0	31.0
Agricultural land	% of land area	44.5	49.1	55.8	40.5	47.4	41.8
Change in agricultural land	annual %	1.0	0.9	0.8	0.2	0.0	0.0
Agricultural land under irrigation	%	0.3	1.1	1.3	3.2	13.7	12.6
Forests and woodland	thou. sq. km	62	51	35	9,553	9,197	5,396
Deforestation (net)	annual %	-1.8	-2.1	-3.1	..	..	..
INCOME							
Household income							
Share of top 20% of households	% of income	..	65	..	..	..	..
Share of bottom 40% of households	"	..	9	..	..	..	..
Share of bottom 20% of households	"	..	3	..	..	..	..
EXPENDITURE							
Food	% of GDP	..	..	..	..	..	..
Staples	"	..	..	..	..	..	..
Meat, fish, milk, cheese, eggs	"	..	..	..	..	..	..
Cereal imports	thou. metric tonnes	94	58	177	21,698	36,008	44,418
Food aid in cereals	"	..	3	37	1,783	6,669	4,047
Food production per capita	1979-81=100	99	113	62	104	122	101
Fertilizer consumption	kg/ha	25.0	16.0	43.0	63.7	47.5	94.2
Share of agriculture in GDP	% of GDP	25.1	22.4	30.0	9.4	28.7	..
Housing	% of GDP	..	..	..	..	..	..
Average household size	persons per household	6	..	..	..	..	..
Urban	"	6	..	..	..	..	..
Fixed investment: housing	% of GDP	..	..	..	..	..	..
Fuel and power	% of GDP	..	..	..	..	..	..
Energy consumption per capita	kg of oil equiv.	172	293	257	1,061	350	1,249
Households with electricity							
Urban	% of households	..	..	..	..	..	..
Rural	"	..	..	..	..	..	..
Transport and communication	% of GDP	..	..	..	..	..	..
Fixed investment: transport equipment	"	..	..	..	..	..	..
Total road length	km	..	..	14,997	..	..	..
INVESTMENT IN HUMAN CAPITAL							
Health							
Access to health care	% of pop.	..	..	..	..	..	..
Population per physician	persons	2,570	2,114	1,492	..	..	..
Population per nurse	"	1,396	..	..	..	..	..
Population per hospital bed	"	..	403	538	510	1,048	509
Access to safe water	% of pop.	..	56.0	53.0	73.4	70.6	..
Urban	"	..	100.0	76.0	83.6	79.3	..
Rural	"	..	14.0	18.0	66.9	62.8	..
Oral rehydyration therapy (under-5)	% of cases	..	..	38	51	32	..
Education							
Gross enrollment ratio							
Secondary	% of school-age pop.	14	24	38	48	44	56
Female	"	13	24	44	53	37	..
Pupil-teacher ratio: primary	pupils per teacher	34	39	33	25	39	25
Pupil-teacher ratio: secondary	"	17	41	29	..	20	..
Pupils reaching grade 4	% of cohort	..	48	56	64	..	..
Repeater rate: primary	% of total enroll	..	13	17	14	..	..
Illiteracy	% of pop. (age 15+)	50	..	..	15	39	..
Female	% of fem. (age 15+)	..	..	..	17	52	..
Newspaper circulation	per thou. pop.	46	38	47	..	..	..

Source: World Bank International Economics Department, April 1993

NICARAGUA - Key Economic Indicators

Indicator	Actual				Estimated	Projected		
	1989	1990	1991	1992	1993	1994	1995	1996
NATIONAL ACCOUNTS (% GDP) a/								
Gross Domestic Product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture	32.0	31.1	29.8	30.3	30.3	..	..	..
Industry	21.3	20.0	20.3	19.5	20.2	..	..	..
Services	46.8	48.9	50.0	50.2	49.5	..	..	..
Total Consumption	105.1	99.2	109.7	113.8	107.5	101.9	100.5	100.2
Gross Domestic Fixed Investment	27.6	19.3	20.1	18.0	17.4	21.5	21.4	21.2
Non Fin. Public Sector	2.7	1.3	4.4	8.6	8.2	10.4	10.8	11.1
Private b/	24.9	18.0	15.7	9.5	8.9	11.1	10.6	10.1
Exports (GNFS)	32.5	25.0	21.2	16.4	20.2	22.1	24.6	25.4
Imports (GNFS)	65.2	43.5	51.0	48.5	45.3	45.8	46.9	46.4
Gross National Savings	-26.0	-11.7	-34.6	-40.0	-31.5	-26.6	-11.8	-11.7
Gross Domestic Savings	-5.1	0.8	-9.7	-13.8	-7.5	-1.9	-0.5	-0.2
Memorandum Items								
GDP (US$m)	1,563.6	1,321.8	1,398.5	1,749.5	1,748.4	1,770.6	1,768.8	1,874.9
GDP Per Capita (US$)	438.8	448.5	443.1	449.7	413.1	405.4	392.5	403.1
REAL ANNUAL GROWTH (%)								
Gross Domestic Product	-1.7	-0.3	-0.2	0.4	-0.9	2.0	3.0	4.5
Gross Domestic Income	-4.1	-3.1	1.3	-7.6	-1.7	4.6	3.0	4.4
REAL ANNUAL PER CAPITA GROWTH (%)								
Gross Domestic Product	-4.8	-3.4	-3.2	-2.7	-3.9	-1.2	-0.2	1.3
Total Consumption	-15.8	-7.1	5.0	-6.6	-10.0	-4.3	-1.8	0.4
Private Consumption	-12.3	-17.7	29.5	-6.4	-7.6	-1.8	-2.2	1.5

Notes: a/ At current market prices.
b/ Includes changes in stocks.

NICARAGUA - Key Economic Indicators

Indicator	Actual			Estimated		Projected		
	1989	1990	1991	1992	1993	1994	1995	1996
Balance of Payments (US$m)								
Exports (GNFS) a/	332.6	390.4	350.2	309.3	366.6	392.0	436.0	475.5
Merchandise f.o.b.	310.7	330.6	272.4	223.1	266.5	291.0	330.0	368.3
Imports (GNFS) a/	666.5	678.9	842.6	895.2	817.0	811.0	830.1	870.6
Merchandise f.o.b.	547.3	567.4	668.7	750.8	659.4	658.0	690.0	714.0
Resource Balance	-333.9	-288.5	-492.4	-585.9	-450.4	-419.0	-394.1	-395.1
Net Current Transfers	0.0	0.0	15.0	10.0	20.0	19.0	15.0	47.0
Current Account Balance (after official grants)	-369.8	-303.9	-436.9	-745.1	-612.4	-640.0	-410.1	-444.1
Net Private Direct Investment	..	..	..	..	..	..	..	..
Long-Term Loans (net)	589.9	469.1	310.3	298.9	143.8	352.2	343.9	328.9
Official	589.9	469.1	310.3	298.9	143.8	352.2	343.9	328.9
Private	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other capital (net) b/	-287.7	-363.0	1,368.9	441.3	368.7	332.8	101.2	140.2
Change in Reserves c/	67.6	197.8	-1,242.3	4.9	99.9	-45.0	-35.0	-25.0
Memorandum Items								
Resource Balance/GDP	-21.4	-21.8	-35.2	-33.5	-25.8	-23.7	-22.3	-21.1
Current Acc. Bal./GDP d/	-34.4	-38.2	-65.7	-61.2	-48.9	-48.1	-33.2	-32.9
Real Growth Rates (%)								
Merchandise Exports	30.3	10.6	-14.4	-9.6	11.4	-3.6	8.8	7.3
Primary e/	17.4	24.4	-15.5	-5.4	-14.8	16.5	10.0	9.2
Other	62.7	-13.0	-12.3	-28.7	105.0	-8.7	6.0	4.2
Merchandise Imports	-23.1	-1.9	15.4	5.9	-12.8	-0.8	-0.7	2.2

Sources: Central Bank of Nicaragua and Bank staff estimates.

Notes: a/ "GNFS" denotes goods and non factor services.
b/ Includes errors and omissions.
c/ Includes use of IMF resources.
d/ Before official grants.
e/ Includes the major traditional primary commodities.

NICARAGUA - Key Economic Indicators

Indicator	Actual 1989	1990	1991	1992	Estimated 1993	1994	Projected 1995	1996
Public Finances (% of GDP) a/								
Current Revenues	27.1	19.0	24.8	28.6	28.9	30.8	31.3	31.4
Current Expenditures	29.3	46.4	27.1	27.2	25.6	25.7	25.2	24.2
Cur. Acc. Balance	-2.2	-27.4	-2.3	1.4	3.3	5.1	6.1	7.2
Capital Expenditures (net)	3.7	2.1	5.3	10.1	11.8	13.9	12.9	13.5
Overall Balance	-5.9	-29.4	-7.6	-8.7	-8.5	-8.8	-6.8	-6.3
Foreign Financing b/	3.3	14.3	12.6	15.1	9.7	14.9	8.0	7.3
Monetary Indicators								
M2/GDP	27.0	24.3	12.3	11.9	10.7	10.9	11.2	13.6
Growth of M2 (%)	2,192.6	7,841.6	414.8	21.0	3.2	10.0	12.2	10.5
Private Sector Credit Growth/ Total Credit Growth (%)	77.1	68.2	225.2	82.3	69.7	204.4	201.9	177.0
Annual Credit Flows (% of GDP)								
To Non Fin. Public Sector (net)	13.5	64.4	12.9	-9.3	0.8	-5.5	-5.6	-4.4
To Private Sector	45.6	99.1	34.6	2.6	5.1	8.3	7.8	7.1
Price Indices (1980=100)								
Merchandise Exports	94.8	91.2	87.8	79.6	85.0	96.0	101.3	104.7
Merchandise Imports	131.5	139.0	141.9	148.0	148.8	153.8	158.2	163.1
Merchandise Terms of Trade	72.1	65.6	61.9	53.8	57.2	62.4	64.0	64.2
Real Exchange Rate (US$/CO$) c/	59.7	100.0	97.5	100.1	98.0	93.2	87.8	82.1
Consumer Price Index (% change, end of year)	1,689.1	13,490.2	865.6	3.5	19.5	10.0	7.7	6.0
GDP deflator (% change)	4,709.2	7,700.5	2,948.6	23.7	20.4	7.2	8.4	6.8

Notes: a/ Data refer to the Non-Financial Public Sector as percentage of GDP at current market prices.
b/ Includes net foreign borrowing and official grants.
c/ CO$ denotes Cordobas. An increase in US$/CO$ denotes appreciation. Index 1990=100.

NICARAGUA - Key Exposure Indicators

Indicator	Actual			Estimated		Projected		
	1989	1990	1991	1992	1993	1994	1995	1996
Debt Indicators (US$m) a/								
Total Debt Outstanding and Disbursed (TDO)	9,652.6	10,623.2	10,445.6	10,995.1	11,832.7	12,624.7	12,421.7	12,718.2
Net Disbursements	64.4	-737.3	-851.7	-290.5	-499.2	-630.1	-228.8	-89.9
Total Debt Service (TDS)	825.3	1,620.8	1,605.4	925.0	1,077.5	1,459.9	830.7	736.3
Interest	299.8	414.4	420.1	335.6	434.5	453.6	210.1	269.6
Principal	525.5	1,206.4	1,185.3	589.4	643.0	1,006.3	620.6	466.7
Debt and Debt Service Indicators (%)								
TDO/XGS b/	2,901.8	2,721.4	2,983.1	3,555.0	3,236.5	3,237.6	2,848.8	2,674.6
TDO/GDP	617.3	803.7	746.9	628.5	657.3	699.2	688.8	699.8
TDS/XGS b/	248.1	415.2	458.5	299.1	294.7	374.4	190.5	154.8
TDS/GDP	52.8	122.6	114.8	52.9	59.9	80.8	46.1	40.5
Total Interest/XGS b/	90.1	106.2	120.0	108.5	118.8	116.3	48.2	56.7
Total Interest/GDP	19.2	31.4	30.0	19.2	24.1	25.1	11.7	14.8
IBRD Exposure Indicators (%)								
IBRD DS/Public DS	0.0	0.1	15.5	2.8	3.3	3.6	3.9	3.6
Preferred Creditors DS/ Public DS c/	0.0	0.1	15.5	3.0	3.5	4.3	6.1	5.6
IBRD DS/XGS b/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IBRD portfolio share	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IFC (US$ m)								
Loans								
Equity and quasi-equity d/								
MIGA								
MIGA Guarantees (US$m)								

Notes:
a/ Includes public and publicly guaranteed debt, private non-guaranteed debt, use of IMF credits, and net short-term capital.
b/ "XGS" denotes exports of goods and services, including worker remittances.
c/ Preferred creditors refers to multilateral lenders and IMF. Public debt service includes IMF.
d/ Includes equity and quasi-equity types of both loan and equity instruments.

STATUS OF BANK GROUP OPERATIONS IN NICARAGUA

A. STATEMENT OF BANK LOANS AND IDA CREDITS

(As of March 31, 1994)

Credit/ Loan No.	Fiscal Year	Borrower	Purpose	Amount in US$ million (less cancellation) Bank	IDA	Undisbursed
28 loans and 8 credits fully disbursed				229.61	189.40	
Of which SECALs, SALs, and Program Loans a>						
Cr. 2302-NIC	1992	Nicaragua	Economic Recovery Credit		110.00	
Cr. 2302-1-NIC	1992	Nicaragua	Economic Recovery Credit		10.30	
Subtotal					120.30	
Cr. 2434-NIC	1993	Nicaragua	Social Investment Fund		25.00	18.29
Cr. 2536-NIC	1994	Nicaragua	Agric. Technology & Land Magn		44.00	41.38
Cr. 2556-NIC	1994	Nicaragua	Health Sector Project		15.00	15.25 b>
Total				229.61	273.40	74.92
Of which has been repaid				175.31	5.73	
Total now held by Bank and IDA				54.30	267.67	
Amount sold :		5.62				
Of which has been repaid:		5.62				
Total undisbursed				0.00	74.92	74.92

a> Approved after FY80.
b> Difference due to exchange rate fluctuation between the SDR and the US$.

NICARAGUA
SUMMARY OF IFC INVESTMENTS

as of March 31, 1996

(US$ Millions)

Fiscal Year Committed	Obligor	Type of Business	Original Gross Commitments: IFC Loan	IFC Equity	Partici- pant	Total	Held by IFC	Held by Partici- pants	Undisbursed (including) Participants
1968	Textiles Fabricato de Nicaragua, S.A. (FABRITEX)	Textile Mill	0.07	1.07	0.93	2.07	–	–	–
1976	Nicaragua Sugar Estates Ltd. a/	Sugar Mill	6.50	–	–	6.50	–	–	–
1976	Posada del Sol a/	Hotel	0.70	0.20	–	0.90	–	–	–
	Total Gross Commitments b/		7.27	1.27	0.93	9.47			
	Less: Cancellations, Terminations, Repayment & Sales		7.27	1.27	0.93	9.47			
	Total Commitments Now Held c/		0.00	0.00	0.00	0.00	–	–	–
	Total Undisbursed Commitments		0.00	0.00	0.00	0.00	–	–	–

a/ Investments which have been fully cancelled, terminated, written-off, sold, redeemed or repaid.

b/ Gross Commitments consist of approved and signed projects.

c/ Held Commitments consist of disbursed and undisbursed investments.

ANNEX B

OBJECTIVES AND INSTRUMENTS OF THE COUNTRY ASSISTANCE STRATEGY, FY95-99

OBJECTIVES AND INSTRUMENTS OF THE COUNTRY ASSISTANCE STRATEGY, FY95-99

OBJECTIVES	PAST ACTIONS	FUTURE ACTIONS/INSTRUMENTS
Macroeconomic Stability	ERC I and policy dialogue supported Government efforts to stabilize the economy. The FY94 CEM analyzed macro situation.	Future adjustment lending (ERC II and III) will require maintenance of appropriate macro framework, to be monitored jointly with IMF through PFP process. Next CEM will analyze in depth sustainability of macro adjustment effort.
Deepening Adjustment	ERC I supported first phase of Government's structural adjustment program. FY94 CEM and 1993 CG paper reviewed progress and remaining agenda. Continuous policy dialogue on adjustment issues.	The second and third phases of the adjustment process to be supported through ERC II and III. Progress in adjustment and the remaining agenda to be reviewed in next CEM and would be a regular theme of the CG process. Informal policy notes to be produced as warranted.
External Environment	CG process and donor coordination are vehicles for Government to mobilize donor support. Stabilization and adjustment program supported by IDA and IMF assisted Nicaragua obtain favorable terms from Paris Club. IDA reflows providing additional resources to meet external debt obligations. Board approved eligibility for a US$25 million grant from the Debt Reduction Facility; IDA organized meeting in Berne to explore cofinancing possibilities for the facility. Structural reforms in ERC I designed to improve export incentives, to increase diversification.	Stabilization and adjustment program supported by ERC I is designed to help the economy adjust to lower aid inflows. Continued donor coordination efforts, through the CG process and individual contacts, to help Nicaragua mobilize external financing for its reform program. Agreement on stabilization and adjustment program would pave the way for further debt reschedulings from the Paris Club. ERC II would further improve incentives to reactivate growth and exports. Continue efforts to mobilize cofinancing for the Debt Reduction facility, in order to resolve the commercial debt problem.
Consensus Building	Widened the economic policy dialogue to include representatives outside Government. Organized a two-day workshop in Managua on Economic Policy Options under Declining Foreign Aid Prospects, attended by IFIs, Government, and selected academic and opposition economists. Encouraged donors to assist in the consensus building process.	Continue an active and broad economic policy dialogue, which can assist leaders and economic actors in Nicaragua better understand the need for stabilization and adjustment. Continue to rely on seminars, workshops, informal policy notes and contacts to disseminate key economic messages.
Public Sector Reform and Capacity Building	The first steps toward public sector reform were taken under ERC I, particularly in terms of a major downsizing of the State and an ambitious privatization program. The Government also removed the State from most production and trading activities. The Agriculture project is helping to reform the extension system and providing institutional support to improve land titling. The Health project is supporting an innovative effort to decentralize basic health services.	ERC II will support implementation of the next phase of the Government's public sector reform program. The proposed TAC will underpin this effort and provide the linkage between ERC II and a proposed ERC III. A key objective of ERC I and the TAC is to provide an overall framework for the public sector reform effort and better coordinate technical assistance. ERC III would concentrate heavily on deepening of the public sector reform and capacity building effort. We will continue to rely selectively on the use of IDF grants to help strengthen the Government's institutional capacity. A proposed Basic Education project would extend the decentralization efforts underway in health.

OBJECTIVES AND INSTRUMENTS OF THE COUNTRY ASSISTANCE STRATEGY, FY95-99

Private Sector Development	ERC I made an important beginning in improving the climate for the private sector. The Agriculture project is supporting a mechanism to privatize extension services. The FY94 CEM and the 1993 CG background paper focused on constraints to private sector growth.	Private sector development will continue to be a key priority of the reforms supported by ERC II and III, as well as our formal and informal analytical work, including the next CEM.
Protecting the Poor and Investing in People	A project to support the FISE is under implementation and is showing good results. In late 1993 IDA completed a Poverty Profile and approved the Health project. The latter aims to improving basic health in rural areas, target disadvantaged groups and assign increasing responsibility and accountability to the departmental and community level.	IDA will complete a Poverty Assessment in FY95, which would be followed up by an Agriculture and Poverty report, focusing on linkages between agricultural productivity and poverty alleviation. A proposed Basic Education project would follow a similar approach as in Health and focus on decentralization, targeting poor communities and rehabilitating the large stock of dilapidated schools. A proposed report on Decentralization of Social Services would review progress and lessons in health and education, and recommend steps to improve the process and its replicability in other sectors. In later years we would also consider further support for FISE and a Health and Nutrition project. A proposed Water and Sanitation project would aim to improve coverage for low-income groups.
Rebuilding Infrastructure	An FY94 report on Deregulation of Public Utilities and Natural Resources included a set of recommendations to improve the management and regulatory framework of the utilities sector.	ERC II supports the privatization of the Telecoms company. The public sector reform program, supported by adjustment lending and the TAC, aims to strengthen the Government's capacity to manage those services that will remain in State hands. The proposed Water and Sanitation project will be prepared in collaboration with IDB to ensure a common sector strategy and agreement on investment priorities. An Infrastructure Recovery report will review the policy framework and investment priorities. This would enable IDA to prepare in later years an Infrastructure Rehabilitation project, most likely focusing on rural areas.
Environmental Management	With IDA assistance, the Government completed its National Environmental Action Plan (NEAP) in December 1993. The ongoing Agriculture project is supporting improvements in sound pesticide management and is financing studies related to the demarcation of indigenous lands and natural reserves.	It is expected that donors will be actively involved in assisting the Government implement the NEAP. IDA will focus on agriculture through a proposed Natural Resource Management project.

ANNEX C

MATRIX OF POLICY ACTIONS

SECOND ECONOMIC RECOVERY CREDIT: MATRIX OF POLICY ACTIONS

OBJECTIVES	ACTIONS TO BE TAKEN BEFORE: BOARD PRESENTATION	SECOND TRANCHE RELEASE	THIRD TRANCHE RELEASE
I. MACROECONOMIC FRAMEWORK			
Ensure an appropriate macroeconomic framework.	Maintain supportive macroeconomic framework.	Maintain supportive macroeconomic framework.	Maintain supportive macroeconomic framework.
II. REFORM OF THE STATE			
A. Public Sector Labor Mobility. Achieve permanent cost reductions to strengthen fiscal balances through a reduction of the public sector workforce.	Presented a satisfactory action plan to implement the Labor Mobility Program, including time-bound employment reduction targets, to reduce the public sector labor force by 13,569 positions during 1994-96.	Satisfactory progress in implementing and meeting the employment reduction targets of the Labor Mobility Program, including the reduction of 5,000 positions.	Satisfactory progress in implementing and meeting the employment reduction targets of the Labor Mobility Program, including the cumulative reduction of 7,000 positions.
B. Privatization Program. Promote more efficient resource allocation and reduce the fiscal burden on the State by completing the divestiture of state enterprises.	Brought to the point of sale or closed at least 33 of the remaining 72 CORNAP enterprises. Brought to the point of sale or closed: LUBNICA, ENIGAS, and 8 enterprises under the Ministry of Construction and Transport (MCT).	Bring to the point of sale or close at least 33 of the remaining CORNAP enterprises, so that no more than 6 enterprises remain in CORNAP. Bring to the point of sale or close 1 MCT enterprise.	Complete the administrative process of ownership transfer or liquidation of all divested CORNAP and MCT enterprises. Bring to the point of sale or liquidate some of PETRONIC's operations, including gasoline distribution, while defining PETRONIC's regulatory functions, if any.
Improve the efficiency and coverage of services by promoting private sector participation in the telecommunications sector.	Prepared action plan and drafted legislation to divest TELCOR. Announced publicly the calendar of steps in the bidding process for TELCOR.	Satisfactory implementation of TELCOR privatization plan, including bringing to the point of sale a 40 percent share of TELCOR's telecommunications operation, including the offer of a management contract to the successful bidder.	

SECOND ECONOMIC RECOVERY CREDIT: MATRIX OF POLICY ACTIONS

OBJECTIVES	ACTIONS TO BE TAKEN BEFORE: BOARD PRESENTATION	SECOND TRANCHE RELEASE	THIRD TRANCHE RELEASE
C. Public Sector Reform. Create an efficient, smaller and modern public sector.	Presented policy statement outlining the strategy and broad elements of the Government's Public Sector Reform Program, covering: institutional restructuring, civil service reform, budgetary and expenditure management, tax and customs administration, decentralization, and strengthening of the Judicial and Legislative branches. Created and initiated staffing of a Reform of the State Program Management Unit (PMU), with agreed terms of reference, which will design and coordinate the Reform of the State Program.	Prepare and begin implementing a detailed and agreed three-year Public Sector Reform Program and Action Plan in line with the Government's agreed policy statement on public sector reform.	Satisfactory progress in implementation of the agreed Public Sector Reform Program and Action Plan, including the restructuring of at least two major public institutions.
III. FINANCIAL SECTOR REFORM			
A. Banking Sector Policy. Promote the development of an efficient financial intermediation system, with increased participation of the private sector.	Stated policy of: (i) not recapitalizing the state banks, either through new funds from the public sector or revaluation of non-financial assets; (ii) enforcing compliance with prudential norms and instructions issued by the Superintendency of Banks; and (iii) not preassigning Central Bank rediscount funds to specific activities. Any revaluation of non-financial assets can only be used to cover a deficit in loan provision requirements—when the level of earnings is insufficient to cover the required provisions and the capital adequacy level requirements are at their stipulated minimum—or to cover future severance incentives to encourage workforce reductions.	Maintain policy.	Maintain policy.

SECOND ECONOMIC RECOVERY CREDIT: MATRIX OF POLICY ACTIONS

OBJECTIVES	ACTIONS TO BE TAKEN BEFORE:		
	BOARD PRESENTATION	SECOND TRANCHE RELEASE	THIRD TRANCHE RELEASE
B. Superintendency of Banks. Strengthen prudential regulation, financial information and accounting systems.	Presented an agreed action plan to modify or introduce new prudential norms and to improve the functioning of the Superintendency of Banks (See Annex D for details of action plan).	Satisfactory implementation of the action plan.	Satisfactory implementation of the action plan.
IV. PRIVATE SECTOR DEVELOPMENT			
A. Property Rights. Resolve property rights disputes in order to improve security of land tenure and improve private sector climate.	Agreed on: (i) establishing a mechanism in the Ministry of Finance to carry out random inspections to verify compliance with established procedures to resolve property conflicts and to report any deviations from established procedures for their correction; and (ii) commissioning a study to analyze potential uses of the Compensation Bonds, with the objective of raising their value.	Satisfactory implementation of the verification process. Complete study on potential uses of the Compensation Bonds.	Satisfactory implementation of the verification process. Implement agreed recommendations of the study.
B. Discretion in Economic Policy. Provide a more stable and transparent policy environment for the private sector by reducing ministerial discretionality in changing tax and fiscal policies, and the creation of new commercial enterprises.	Issued Presidential Decree stating that any change in tax and fiscal policies has to be published in the Official Gazette to be legally binding, except in cases of *force majeure*, in which case it must be published in at least one daily newspaper of broad circulation. Issued Presidential Decree abrogating and elevating to the Presidency the powers of ministries and government agencies to change tax and fiscal policies. Issued Presidential Decree abrogating the powers of ministries and government agencies to create new commercial enterprises.		

SECOND ECONOMIC RECOVERY CREDIT: MATRIX OF POLICY ACTIONS

OBJECTIVES	ACTIONS TO BE TAKEN BEFORE: BOARD PRESENTATION	SECOND TRANCHE RELEASE	THIRD TRANCHE RELEASE
C. Trade Reform. Promote export growth and efficient import substitution by reducing the level and dispersion of nominal protection and creating a more transparent and effective export incentive system.	Presented an agreed phased import tariff reduction program designed to reach a nominal protection ceiling (including Temporary Protection Tariffs) of 37 percent by mid-1995, and 20 percent by 1999.		Satisfactory progress in implementing import tariff reduction program, including the attainment of a nominal protection ceiling of 37 percent, with the exception of 8 products ("fiscal industries") subject to prior review of fiscal impact of reducing protection. Complete preparation of action plan to replace existing export promotion mechanism by a duty drawback system or a temporary admission regime.
D. Labor Market Reform. Promote greater labor productivity and reduce the incentives toward informal activities by ensuring flexibility in the operation of the labor market.	Submitted to IDA an acceptable Letter of Labor Policy (see Annex F).	Compliance with Letter of Labor Policy.	Compliance with Letter of Labor Policy.

ANNEX D

ACTION PLAN TO IMPROVE PRUDENTIAL SUPERVISION

ACTION PLAN TO IMPROVE PRUDENTIAL SUPERVISION

OBJECTIVE	ACTIONS TAKEN	ACTIONS BEFORE SECOND TRANCHE	ACTIONS BEFORE THIRD TRANCHE
Improve the performance of the Superintendency of Banks and financial information flows, in order to strengthen prudential supervision of the financial system.	Revision of prudential norms by an external consultant. Issued the revised prudential norms. Managerial and financial information systems have been implemented, including quarterly and monthly reports. Analysts have been trained to participate in bank inspection teams, thereby raising the number of inspectors to 12. A chart of accounts and an accounting manual conforming with Nicaraguan tax laws and international standards have been issued and distributed to banks. The Superintendency has identified functions that its Board should transfer to the Superintendent to grant him increased autonomy in superivising banks. The Superintendency has formally requested the Central Bank to issue instructions that establish the eligibility of foreign banks (according to international credit ratings) as recipients of deposits or investments from domestic banks.	Implement the new chart of accounts in all banks. Design a centralized management information system of debtors in the financial system. Include FNI and INISER in the Superintendency's inspection program. Issue Presidential Decree or, if necessary, present legislation to the National Assembly that increases the ceiling on penalties/fines for non-compliance with prudential norms or instructions by the Superintendency.	Review and enforce compliance by banks with the new chart of accounts. Implement the centralized management information system. Include the Stock Exchange in the Superintendency's inspection program until a separate Stock Market Superintendency is created.

ANNEX E

GOVERNMENT LETTER OF DEVELOPMENT POLICY

REPUBLICA DE NICARAGUA

Ministerio de Finanzas

LETTER OF DEVELOPMENT POLICY

SECOND ECONOMIC RECOVERY PROGRAM

Managua, Nicaragua

Ministerio de Finanzas
Despacho del Ministro

LETTER OF DEVELOPMENT POLICY
SECOND ECONOMIC RECOVERY PROGRAM

Managua, May 5th, 1994

Mr. Lewis T. Preston
President
The World Bank
Washington, D.C. 20433

Dear Mr. President:

1. In April 1990, when the Government of Mrs. Violeta Barrios de Chamorro took office, the economy was devastated and performing at extremely depressed levels compared to a decade earlier. Private sector participation in the economy was minimal due to extensive public sector intervention through ownership, monopoly, and regulation of economic activities, as well as heavy use of domestic and external resources. This, coupled with mismanagement of economic policy, resulted in major inefficiencies of resource allocation and production, and depressed domestic savings and investment. Additionally, the economy was highly unstable, with hyper-inflation reaching over 33,000 percent p.a. in 1988. As the public sector registered large and increasing imbalances, the country relied heavily on foreign assistance and incurred large arrears on external debt service obligations. In 1988, the Sandinista Administration embarked on a stabilization and adjustment program, which was abandoned in early 1990 when the Government was defeated in the presidential elections.

2. From the beginning of its regime the new Government has pursued a reform strategy which emphasizes the importance of establishing and maintaining price stability and structural adjustment as crucial steps toward achieving sustained growth. The main focus of the strategy has been to reduce the size of the public sector, to realign relative prices, and to achieve the preconditions of a market economy. In line with this strategy, over the past four years the Government has been implementing a set of policies in the areas of expenditure reduction, privatization of state assets, tax reform, monetary and exchange rate policies, and trade liberalization.

3. Upon assuming office, the new Government took measures to stabilize the economy. However, the implementation of the economic program was interrupted, as efforts focused on obtaining peace through the demobilization of the military and guerrilla groups, and establishing a process of dialogue and concertation with the different political and social groups to achieve a national consensus regarding the urgent need of structural adjustment measures targeted at correcting macroeconomic imbalances. In March 1991, this attempt was followed by a more comprehensive stabilization effort involving a major devaluation of the Cordoba (from C$1 to C$5 per U.S. dollar), flexible public sector pricing policies, and tight wage and credit policies. The stabilization program was supported by an 18 month stand-by arrangement with the International Monetary Fund (IMF). In parallel with the stabilization program, the Government embarked on a structural adjustment program aimed at eliminating distortions and reducing state intervention, facilitating private sector development through economic deregulation, reforming the financial system, and liberalizing foreign trade. The Government program of structural reform was supported by an IDA Economic Recovery Credit and by a Trade and Finance and Adjustment Loan from the Interamerican Development Bank (IDB), approved in September 1991.

4. Economic performance improved markedly under this program. The rate of inflation decelerated from 13,500 percent at end-1990 to less than 780 percent by end-1991, and less than 5 percent by end-1992. The Government also advanced significantly in the implementation of its structural adjustment program, especially in liberalizing production and financial markets, privatization of state assets and reducing levels of protection. Moreover, Nicaragua has reestablished relations with international financial institutions and external creditors. However, economic activity remained weaker than originally envisaged. Real GDP dropped slightly in 1991, in part because of a severe drought, and in 1992 increased only 0.5 percent, reflecting a slump in the international prices of some major export-crops, short falls in external assistance, disputed land rights in the country side, the eruption of the Cerro Negro volcano, and a tidal wave.

5. The Government of Nicaragua is proud of its success in achieving economic stabilization. It is the only country to have gone so rapidly from hyper inflation to single-digit inflation in the post-World War II period. The Government's goals now are to advance rapidly with growth, investment and employment creation without jeopardizing stabilization.

THE GOVERNMENT'S STRUCTURAL ADJUSTMENT PROGRAM

6. In spite of the Government's achievements, the external situation remains fragile and highly dependent on concessional financing. To set the stage for sustainable economic growth and to move further toward external viability, the Government has formulated a program for 1994-96 which aims at consolidating the stabilization gains made in 1991-93 and intensifying the process of structural reform required for the efficient functioning of a competitive economy. The program puts particular emphasis on re-establishing basic macro-economic balances and in preparing conditions for sustained growth. To accomplish this goal, it will be necessary to develop an appropriate climate for private investment which will be the main source of growth and expansion of the country's export capacity over the medium-term and to improve the living conditions of the poorest segments of the population. The Government of Nicaragua wishes to request support from IDA for implementation of this program through a second Economic Recovery Credit.

7. Under the next phase of the Government's structural adjustment program, the immediate priority is to sustain macroeconomic stability. To do this, the public sector needs to be reduced sufficiently to generate higher public savings, restore foreign reserves to more prudent levels, and permit expansion of credit to finance productive activities in the private sector. The main elements of the Government's structural adjustment program are: (i) the development and implementation of a comprehensive and longer-term public sector reform program, designed to redefine the role of the State, improve its efficiency and contribute to sounder fiscal policies; (ii) a deepening of reforms in the financial system, including major restructuring of the state banking system and strengthened prudential supervision; and (iii) improving the conditions affecting private businesses by reducing discretionality in economic policy management, implementing a trade reform and export development program, and improving labor market policies. To complement this policy reform program, the Government is making efforts to resolve outstanding property disputes, improve law and order conditions, especially in rural areas, and strengthen the public sector's administrative and regulatory capability.

i) Maintaining a Stable Macroeconomic Framework

8. Nicaragua's macroeconomic balances have become very fragile as foreign reserves were nearly depleted at the end of 1993. In collaboration with the IMF, the Government has elaborated a macroeconomic program to ensure external viability in a manner consistent with reduced external aid

prospects. This program will be supported by the ESAF program of the IMF and its major elements are outlined in the Government's three-year Policy Framework Paper, prepared in collaboration with the IMF and IDA. The program is designed to achieve output growth of 2 percent in 1994, an inflation rate of 10 percent, and the accumulation of net international reserves by $45 million. Under this program, public sector savings (including Central Bank losses) are expected to increase by 2.3 percent of GDP, which represents a strong fiscal adjustment (net of interest payments) of 3.2 percent of GDP. To achieve this increase in public savings, the Government will: (i) further reduce import duty exemptions; (ii) implement administrative measures to increase revenues from the sales tax; (iii) adjust the prices of petroleum derivatives; (iv) freeze public sector wages; (v) introduce fees for certain education and health services for those able to pay; (vi) further reduce military personnel; (vii) improve the operating position of public utilities through tariff adjustments; and (viii) reduce Central Bank losses through increases in its interest rate structure. The resulting decrease in public sector borrowing requirements will allow the expansion of credit to the private sector by about 10 percent per annum in 1994-95 in real terms. For 1995-96, public savings are targeted to increase by an additional 1.5 percent of GDP each year, inflation would fall to single digits by 1996 and international reserves would reach over 3 months of imports by end 1996.

ii) Reducing the Size and Redefining the State

9. The Government is conscious that the fiscal adjustments required to face the prospective declines of external aid flows are only possible through major public sector reforms. In this respect, the Government intends to: (i) carry out a permanent reduction of public sector employment; (ii) privatize and divest state-owned enterprises that do not conform with our new vision of the State; and (iii) introduce a comprehensive, longer-term Public Sector Reform Program designed to achieve a small, efficient and modern public sector.

10. **Public Sector Labor Mobility Program.** Reducing public sector employment will be critical to achieve a sustained improvement in public savings. The Government has prepared a Labor Mobility Program to reduce the number of public sector positions by almost 13,600 persons (or about 15 percent of public sector staff) during 1994-96. The Labor Mobility Program is voluntary and includes generous incentives to encourage public sector employees to seek alternative employment in the private sector. Employees that volunteer for the Program may continue to draw their salaries for up to 36 months depending on length of service and will maintain their pension rights upon retirement from the program. The Government believes that these incentives are necessary not only to encourage public sector employees to participate in the Program but to help mitigate the social impact of the reforms. We are confident that with the reactivation of growth, most of the displaced employees will be able to find gainful employment in the private sector.

11. Since the Labor Mobility Program is voluntary, the labor reduction targets can only be specified in indicative terms. The indicative targets of this plan include a reduction of up to 7,000 public sector positions in 1994, 4,000 in 1995 and 2,600 in 1996. Due to severance payments, this labor force reduction will yield only limited fiscal savings in the first year of implementation, but result in significant permanent gains thereafter. In order to carry out this reduction in public sector employment efficiently and without adverse effects on the quality of public services, the Government has developed mechanisms to ensure that the more productive functionaries do not leave and that those that leave do not re-enter the public sector. The Government is working with IDA assistance on the development of these mechanisms and we have requested support for their implementation through a Technical Assistance Credit.

12. **Divestiture of State-Owned Enterprises.** A key element in the Government's strategy to streamline the State has been the divestiture of enterprises controlled by the state holding company, CORNAP. During 1990-92, the Government divested 233 of the 351 CORNAP enterprises. An

additional 46 enterprises were divested in 1993. The Government will largely complete the process by divesting the remaining 72 CORNAP enterprises by end-1994, of which 33 have been brought to the point of sale or leasing to the private sector, or closed by May 1994. Two companies, LUBNICA and ENIGAS, that were incorporated under the electric utility company, INE, will also be divested in May 1994. Finally, the Government plans to liquidate or divest some PETRONIC operations, including gasoline distribution, by June 1995, and to separate the regulatory functions currently under PETRONIC's responsibilities from any operational responsabilities. To achieve this objective, the Government has requested support from IDB to improve the regulatory framework for the public utilities sector and hydrocarbons sector, in particular.

13. In addition, the Government has privatized or liquidated 8 of the 17 enterprises that were incorporated under the Ministry of Construction and Transport (MCT), while the remaining enterprises have been substantially downsized in terms of personnel and equipment. These enterprises, essentially, have the function of carrying out MCT's road maintenance and rehabilitation programs. By November 1994, the Government will divest one further MCT enterprise, but keep the remaining enterprises under state control, in order to maintain a minimal road and building maintenance capacity, especially in remote areas that are not easily accessible to private entrepreneurs. If at any time the Government receives indications from the private sector that they would be interested in any of the remaining MCT enterprises and would be prepared to enter into contracts for road rehabilitation and maintenance in the remote areas served by the MCT enterprises, the Government would consider further divestiture of the remaining 7 MCT enterprises.

14. The Government has also decided to privatize the domestic and international telecommunications operations of the state telecommunications institute (TELCOR). The Government intends, as a first step to sell a 40 percent share of TELCOR to an established international telecommunications firm, which will also include the granting of a management concession. The company will be managed by the foreign company and enjoy autonomy from the Government. All interested potential buyers were contacted and, as a result, nine reputable international companies were pre-qualified. The Government will make the offer for sale of 40 percent of the shares of TELCOR, including a management contract, by October 1994. In parallel, with the divestiture process, the Government is also creating a regulatory agency for the telecommunications sector with support from IDB and USAID. The proceeds from the privatization of TELCOR will be used to back the bonds given to former owners of confiscated properties.

15. As further step to consolidate the privatization program and transmit a clear signal to the private sector, the Government is committed to avoid the creation of new commercial state enterprises. To this end, the Government well issue a Presidential Decree which abrogates the powers of Government ministries and agencies to create new commercial enterprises.

16. **Public Sector Reform Program.** The Government's capacity to ensure the maintenance of appropriate fiscal policies will depend on its ability to substantially reduce the size of the Nicaraguan State. The Government believes that the reduction in public sector staff is not an end in itself but is one key instrument to reach the goal of creating an efficient, transparent, accountable and service-oriented State. This is needed, both to increase the State's capacity to deliver those services that remain in its hands and to improve private sector confidence in the State's ability to maintain an environment in which private initiative can thrive and be the engine of growth. As staff are reduced, there will also be a need to strengthen the capacity of the State, particularly its management and policy-making capabilities. The role and functions of different ministries need to be redefined and strengthened in all areas but especially in financial management, tax and customs administration, and management of the civil service. As the State contracts and the private sector expands into new areas, the public sector has to increasingly devote attention to the provision of a proper business environment for the private sector to function. The Government also wishes to strengthen

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administrative capacity in local governments and community organizations, which can be more responsive to the needs of the people. As the public sector is strengthened and made more efficient, there is also a parallel need to strengthen the other two powers of a modern, democratic State; the Judiciary and Legislature.

17. The Government is fully cognizant of the fact that effective implementation of a comprehensive public sector reform program will be an especially difficult and long-term undertaking for Nicaragua. Although the Government commitment is strong, Nicaragua's public sector, reflecting the social disruption of more than a decade of civil conflict, has a weak institutional base. For this reason we have requested IDA and other donors for their support in implementing this ambitious reform program. In this context, the Government has: (i) prepared a policy statement outlining the overall strategy and broad elements of a comprehensive Public Sector Reform Program; and (ii) created within the Ministry of Finance a Project Management Unit (PMU) charged with designing and coordinating implementation of the Public Sector Reform Program. The Government has requested IDA assistance through a Technical Assistance Credit to support the PMU's work. Its mandate is to develop a comprehensive Public Sector Reform Program and Action Plan, including a timetable for its implementation over the next three years.

18. The Program covers: (i) institutional restructuring in line with the redefinition of the role and functions of the State, including the identification of proposed steps to restructure, merge and abolish public sector institutions; (ii) civil service reform, including an improved incentives system, the monetization of benefits, and an improved personnel management system; (iii) budgetary and expenditure management reform, including implementation of an integrated financial management system; (iv) improved tax and customs administration, including measures to expand the tax base, and streamline and computerize administrative procedures; (v) administrative decentralization, including increased local autonomy and accountability; and (vi) strengthening of the Judicial and Legislative branches, including training and the development of management information systems. Work is underway to define each of these components and the external technical support that will be required. The Action Plan to implement the Reform Program will be completed by end-1994. By mid-1995, the Government expects to have advanced substantially in implementation of the Program and will have completed the institutional restructuring of at least two major public sector institutions.

iii) Financial Sector Reform

19. **Reform of the State Banks.** The Government's economic strategy for 1994-96 envisages a strong increase in public savings, thereby releasing more resources that will permit the expansion of credit to the private sector. This constitutes a key ingredient for reviving economic growth. To succeed in reaching this objective, however, it is important that the commercial banking system be able to intermediate these increased financial resources in an efficient manner. Despite a major recapitalization in mid-1992 and significant reductions in personnel, the two largest state banks, BANADES and BANIC, continue to have high operating losses and low loan recovery rates. They need to be urgently reformed to improve the financial intermediation process and to establish the conditions for a more rapid expansion of a private-sector-based commercial banking system. While the private banks have grown rapidly, with seven new banks established and operating since August 1991, they have remained very cautious in their lending policies and lend mainly for short term commercial activities. Therefore, as these banks continue to develop and diversify into productive activities, which takes some time, it will be important to improve the efficiency of the state banks and reorient their activities toward the productive sectors that currently are not being attended to by the private banking system. In pursuit of this objective, the Government is implementing a program to reform and restructure BANADES with support from IDB. It has also renewed BANIC's management, which has prepared an action plan to transform BANIC into an efficient and viable intermediary. We have requested IDA's support for implementing this action plan.

20. To promote a sound financial sector development, the Government will not recapitalize the state banks further from public sources, while requiring that they comply with the prudential norms established by the Superintendency of Banks on a par with the private sector banks. This is expected to force the state banks to redouble their efforts in improving their operating efficiency, which may entail a significant downsizing of operations, and to remove sources of potential fiscal losses. Also, it is the Government's policy not to permit any capital increases through a revaluation of non-financial assets, except to cover a deficit in loan provision requirements when earnings are insufficient to cover the required provisions and capital adequacy levels are at their stipulated minimum or to create reserves for future payments of incentive and separation packages required to reduce staff. In no event will asset revaluations be permitted to increase the banks' lending capacity which, under this policy, will only be possible to the extent that the state banks generate externally audited operational profits (excluding gains through exchange rate adjustments). Finally, to promote a more efficient allocation of financial resources through both the state-owned and private banking system, the Central Bank will continue to maintain its policy of not pre-assigning its own rediscount funds for specific economic activities and maintain a policy, established in December 1993, by which interest rates on Central Bank loans to financial institutions are set quarterly on the basis of an average of rates offered by commercial banks on 30-day deposits plus a spread of 0.25 percent. External lines of credit will continue to be made available to both state and private banks.

21. **Prudential Supervision.** The development of a sound and efficient private-sector-based commercial banking system will require an effective superintendency of banks. The Superintendency of Banks was created in 1991 as an autonomous institution. Since then, with technical assistance from various donors, the Superintendency has advanced significantly in the preparation of prudential norms and has strengthened its capacity to carry out its monitoring and supervision functions. To date, the Superintendency has issued prudential norms on capital adequacy, loans to related parties and loan provisions, which conform with best international practices. It has also designed a chart of accounts and accounting manual conforming with Nicaraguan tax laws and international standards, which all banks will be required to use in the second half of 1994. All banks are required to submit externally audited reports at least once a year. The Government recognizes that further actions are still needed to strengthen the Superintendency's capacity to supervise the banking system and to improve the transparency of financial information in the financial system. To achieve these objectives, the Government intends to increase the Superintendency's capacity to enforce prudential norms by raising the ceiling on penalties for non-compliance with norms and instructions issued by the Superintendency and by introducing a management information system to cover the major financial debtors (by November 1994). Also, continuing efforts in training and qualification of Superintendency staff will be made to ensure that supervision capacity remains adequate for an expanding private-sector based financial system. Finally, the second-tier state bank, FNI, and the state insurance company, INISER, will be included in the Superintendency's inspection program by November 1994, and the stock market by June 1995.

iv) Improving the Private Sector Business Environment

22. The private sector represents the most promising source of investment and future growth for Nicaragua. Not with standing the re-establishment of macro-economic stability and a social market-based system, a key barrier to private sector development is the uncertainty originated by problems of insecurity and disputed property rights in the country side, the potential discretional application of economic policies, and unclear labor market and sector regulations. To reduce this uncertainty and promote private sector investment, clearer rules of the game need to be established in each of these areas.

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23. **Property Rights Guarantees.** Inadequate property rights guarantees have been a long-standing problem in Nicaragua, that was exacerbated by the land reforms and property transfers carried out by the previous Administration. To address this problem, the Government has taken important steps since September 1992 by establishing a National Review Commission to review claims by previously confiscated owners, determine their legitimacy and recommend the return of property (when possible) and an Office of Territorial Ordering to review the legitimacy of past assignments of urban houses (Ley 86), urban lots (Ley 85), and rural properties that took place during the period of government transition in February-April 1990. To determine the amount of just compensation for confiscated properties that cannot be returned, the Government established an Office of Quantification of Compensation and introduced a 20-year bond (with maintenance of value and backed by the proceeds from the sale of certain public assets, including TELCOR) to serve as a compensation mechanism. This administrative process is intended to speed up the resolution of property conflicts, but it does not negate a claimant's right to seek recourse through Nicaragua's Judicial system.

24. The Government has already advanced substantially in the resolution of outstanding property disputes, having by March 1994 resolved 1,009 cases involving the return or compensation for previously confiscated properties; representing the resolution of 18.6 percent of 5,420 originally outstanding cases. Also, of the 10,382 cases involving the review of rural properties transferred during February-April 1990, 6,600 (58 percent) have been resolved; of the 10,229 cases under Ley 85, 6,814 (67 percent) have been resolved; and of the 90,264 cases under Ley 86, 30,531 (31 percent) have been resolved. The Government is committed to resolving all outstanding property disputes through this administrative process by June 1996 according to the following timetable:

Cumulative percentage of property cases to be resolved by:

	Dec., 1994	June, 1995	Dec., 1995	June, 1996
Nature of Case				
Agricultural Land Holdings	85%	100%	--	--
Ley 85	70%	100%	--	--
Ley 86	50%	--	80%	100%
Compensation (return)	25%	--	75%	100%

25. The Government wants to ensure that these targets can be achieved and also to increase the legitimacy of the compensation mechanism. The Government has taken a number of steps for this purpose. In early 1994, it created an office to provide the holders of compensation bonds with necessary information to participate in the bidding of state-owned assets to be privatized. In this context, the Government intends to devote the proceeds from the sale of TELCOR and the former Banco de America building to redeem compensation bonds in periodically held public auctions. Also, all ministries and autonomous institutions have been instructed (Decreto Presidencial 56-92) to place all assets that are not indispensable at the disposal of this Bond Compensation System. The Government will also establish by November 1994 in the Ministry of Finance an administrative mechanism to carry out random inspections to verify compliance with the established procedures (described in the letter to IDA dated April 29, 1994) to resolve property conflicts and to report any deviations from established procedures for their correction. This verification process will concentrate primarily on the cases involving the assignment of rural properties made during the period of February through April 1990. In addition, the Government will commission a study by September 1994 to analyze additional financial mechanisms that could render the compensation bonds more attractive to holders without jeopardizing fiscal stability. Among the mechanisms to be considered are

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the use of bonds to finance environmental conservation projects. The Government will seek the support of IDA and other donors to help design and carry out this study, which would be completed by end-1994. Implementation of the study's recommendations would begin before mid-1995.

26. **Discretionality in Economic Policy Management.** The Nicaraguan Constitution gives the President of the Republic ample powers to revise taxes and economic regulations. The Presidency had delegated many of these powers to different Government Ministries, which have needed to rely on these discretionary policy powers in the past due to the magnitude of the task of eliminating the policy-induced distortions inherited from the previous Administration and the need to respond quickly to maintain stability in the face of exogenous shocks. Nevertheless, the exercise of these powers has generated considerable uncertainty in the private sector, which perceives a lack of clarity in the rules of doing business. With attainment of greater macro-economic stability and the correction of the most obvious distortions inherited from the past, the Government believes that the time is right to reduce its discretionary powers to modify taxes and economic regulations, in the interests of improving the business climate. For this purpose, it will issue a Presidential Decree that elevates all powers to change tax and fiscal policies from the Ministerial levels to the Presidential level. The same Decree, furthermore, also establishes that any such changes have to be published in the Gazeta Oficial, except in cases of 'force majeure', in which case they must be published in at least one daily newspaper of broad circulation, for them to be legally binding.

27. **Trade Reform and Export Development.** The Government made great advances in liberalizing foreign trade since 1990. Nominal rates of protection to domestic industries provided by Nicaragua's import tariff structure currently range between 10 and 40 percent (with a few exceptions below 10 percent), and virtually all non-tariff barriers (NTBs) have been abolished. It was the Government's intention to have reduced the levels of nominal protection even further by December 1993, as described in our Letter of Development Policy, dated July 25, 1991, submitted to the President of the World Bank for the first Economic Recovery Credit. As a result of the unanticipated decline in foreign aid and consequent need to increase public savings, however, the Government is concerned that tariff and import tax reductions now as originally planned would undermine the required stabilization effort. Furthermore, to reach the desired objective of promoting export growth, tariff reductions need to be accompanied by compensatory devaluations of the real exchange rate. While the Government has decided to accelerate modestly the rate of devaluation, the ability to restore greater competitiveness through this mechanism is limited by the existence of significant financial indexation.

28. In view of these circumstances, the Government intends to implement its tariff adjustment program in a more gradual manner than previously planned and to focus particularly on improving the transparency of the trade regime and on removing the rigidities that currently prevent real exchange rate adjustments. Under the revised tariff adjustment program, which has been negotiated with the other member countries of the Central American Common Market, the nominal protection ceiling, including import duties and selective import consumption taxes, would be reduced to 37 percent in June 1995, 35 percent in January 1996, and 32 percent in January 1997, with the objective of reaching 20 percent by January 2000. All imports will be subject to this general reduction in the nominal protection ceiling with the possible exception of 8 products denoted 'fiscal industries', pending a review of the overall fiscal situation at the time this measure is to be implemented.

29. To improve the transparency of the trade regime, the Government has taken a major step to simplify bureaucratic procedures required for export transactions by creating, in the first quarter of 1994, a one-stop export processing window (ventanilla unica) at the Central Bank. Also, by June 1995, the Government will have completed an action plan to implement a new export promotion mechanism to replace the existing temporary mechanism designed to promote non-traditional exports. The new mechanism will be less complex to administer and less vulnerable to potential abuse than the

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existing, while its purpose will be to promote all exports, rather than just those defined as non-traditional. Moreover, exporters still benefitting from the current export promotion system will be given the option of cancelling their export contracts before these expire in December 1997 in exchange for being allowed to benefit from the new system. Until the current export promotion system expires, the Government will review all benefits granted under existing contracts carefully and apply strict eligibility criteria in awarding any new contracts in order to prevent unnecessary fiscal losses.

30. **Labor Market Policy.** Nicaragua's unemployment rate currently approaches 20 percent and sub-employment rates are equally high, and deserve the urgent attention of the Government. To address this problem, faster output growth will be essential, together with measures that will permit the labor market to function more flexibly. The topic of reforms to the Labor Code is currently under discussion in the Legislative Assembly. To assist the current debate and provide a framework for any current or future reforms that might be considered, the Government has prepared a Letter of Labor Policy (attached) which sets out the key parameters that we believe would be essential to maintain. As described in that letter, the Government would exercise its constitutional powers to insist in abrogating any legislation that would be inconsistent with these principles and that would impose stronger restrictions on labor mobility or act as a brake on the process of structurally transforming our economy into a more internationally competitive system.

v) Social Sector and Poverty Alleviation Policies

31. The expected reduction of external aid in the coming years will require strong fiscal adjustments and a significant reduction in overall private consumption, given that the country will no longer be able to live beyond its means. This poses a major threat for the poor, who do not have resources to withstand a further deterioration of living standards. The Government considers that the promotion of faster growth, as intended by the present program, represents the key vehicle for bringing about a sustained improvement in living standards for all Nicaraguans. Without growth, it will not be possible to meet our people's aspiration for a better quality of life. Also, the Labor Mobility Program includes generous incentives to cushion the social impact of the necessary labor displacement. At the same time, we also understand that we cannot simply wait for growth to take care of our poverty problem and inadequate social services. For this reason, our Government is also taking actions to improve social services and to expand the coverage of safety nets targeted to the poor segments of the population. Our efforts in this direction have to fit within the overall fiscal constraints imposed by the need to maintain a stable economy. The Government firmly believes that any resurgence of macro-economic instability, especially a re-emergence of high inflation, would not only have a devastating effect on productive activity but also severely impact the poor, who are least able to protect themselves from the ravages of inflation.

32. A major project to strengthen the provision of basic health services and improve hospital care has been recently launched with the support of IDA and other donors. A similar effort is underway in the education sector, with primary emphasis on improving primary education. In 1991, the Government created an Emergency Social Investment Fund (FISE), as the Government's most important safety net mechanism. The FISE's activities have been expanding at a rapid rate and are expected to generate almost 20,000 jobs in 1994-95. To complement this effort, the Government created the Ministry of Social Action in January 1993 to coordinate the Government's social sector activities and to administer temporary communal employment generating programs supported by donor funds.

vi) Environmental Policy

33. The Government has prepared a National Environmental Action Plan (NEAP), which was presented to IDA in December 1993. The NEAP identifies soil conservation, water resources and the forestry sectors as priority areas in need of attention and outlines the main actions to begin to deal with problems in these areas. The reform measures which constitute the Government's structural adjustment program, and which have been described above, are not expected to create negative environmental effects. Rather, the reduction of land tenure uncertainties and Government efforts underway to establish a clear regulatory framework for the fishing, forestry and mining sectors will contribute toward a more rational use of depletable and renewable natural resources than is now taking place. In addition, the Government has taken steps to reverse the country's environmental deterioration through several donor-supported programs. These include the design and implementation of a Forestry Action Plan with support from Sweden, the alleviation of water pollution problems through an IDB and IDA-supported water project, the incorporation of soil conservation and pesticide management practices in the IDA-supported agricultural research/extension program and the institutional strengthening of the Ministry for Environment and Natural Resources (MARENA) with support from various donors.

CONCLUSIONS

34. Mr. President, the Government believes that Nicaragua has made enormous strides over the past three years but our task is not finished. We cannot be satisfied until we see a vigorous economic recovery, led by the private sector and capable of offering the promise of a brighter future for the people of Nicaragua. The Government has maintained its commitment to reform and to carrying out a dramatic transformation of Nicaragua's economy, often in the face of severe external and domestic pressures. We have the will but require the technical and financial support of the international donor community. It is in this context that we request the World Bank's support for the implementation of our stabilization and structural adjustment program. We are confident that with the World Bank's support, and that of other donors, we can make further progress in the difficult road ahead.

Dr. Emilio Pereira Alegria
Minister of Finance

ANNEX F

GOVERNMENT LETTER OF LABOR POLICY

REPUBLIC OF NICARAGUA

MINISTRY OF FINANCE

LETTER OF LABOR POLICY

Managua
NICARAGUA

Republic of Nicaragua
Ministry of Finance
Office of the Minister

Managua, April 14, 1994

Mr. Lewis T. Preston
President
The World Bank
1818 H Street, N.W.
Washington, D.C. 20433

Dear Sir:

As the Government of Nicaragua is engaged in a major Bank-financed structural reform program, and as labor reforms will be part of the program, we believe it to be of interest to set out below the principles on which the Government's general labor policy is based, and particularly its specific policies on promoting labor-market flexibility and enacting a Labor Code that is consistent with the pursuit of that flexibility.

I. Key Labor-Market Problems in Nicaragua

It is estimated that in 1994 Nicaragua will have a labor force of 1.5 million, of which roughly 23.5% will be unemployed. Of the 76.5% of individuals working (a total of 1,181,200), 45% are employed in the formal sector and the other 55% are employed or under-employed in the informal sector.

The public sector, one of the players in the formal sector, employs 83,000 individuals, providing 16% of all formal-sector employment. The number of government workers has been falling since the 1990 Occupational Conversion Plan was initiated, and further reductions involving 13,569 workers are expected in 1994-96 under the voluntary Manpower Mobility Program launched at the beginning of 1994.

The relatively small group of workers in the formal sector, which (depending on how it is defined) appears to employ some 531,500 persons, is highly unionized, as approximately 300,000 of these individuals are estimated to belong to unions.

Labor matters are governed by a series of laws, decrees, collective bargaining agreements and case law associated with the 1945 Code of Labor (*Código del Trabajo*), which went through several revisions; at the present moment, a draft of a new Labor Code (*Nuevo Código Laboral*) is being debated.

During the early part of 1990, between the elections and the new Government's entry into office, salaries in the public sector were increased exponentially. Immediately after the new

Administration was inaugurated, labor disputes and strikes broke out, increasing significantly in both demands and intensity throughout 1990 and 1991. Although trade unions are regulated by the Labor Code, the majority of the strikes, whether legal or illegal, resulted in greater concessions to the unions and the workers they represent. Many of these concessions went beyond the reasonable, doubtless because of the very intensity of the conflict, accompanied as it was by excessive demands on the part of labor — some of them approved against a background of civil disturbance. Inevitably, there was an increase in manpower costs in the public sector, particularly for the public enterprises.

The report issued by the committee of the National Assembly, which is now examining the draft Labor Code, attempts to reconcile the principles the Executive Branch is advocating in its efforts to deregulate the labor market.

In response to the committee's report, the Executive Branch has recommended that certain articles be reconsidered, while new amendments, approved by consensus among the various social sectors after 1992, have been introduced. Discussions on the remaining articles are still in progress.

Nicaragua needs a labor market that allows the best possible allocation between workers and employers, so that the productivity of labor can be maximized and the welfare of the entire Nicaraguan population increased. It is extremely important that the labor laws serve these two ends, and that they do away with the paternalistic mechanisms inherited from previous Administrations. Without a deregulated labor market, a growth strategy based on private investment and expansion in the export sector would not be possible.

The dynamic forces that affect the labor market in any economy, but particularly an economy like Nicaragua's which is undergoing far-reaching restructuring, requires labor mobility and conditions favorable to vocational training and worker retraining.

Similarly, if there is to be real adjustment in both the production apparatus and the labor market, employers who rely on special skills in their labor force and are offering special compensation packages need to be able to find productive workers with precisely those skills in the market.

For these reasons, the Executive Branch in Nicaragua is committed to including labor market flexibility as a key element in the country's structural adjustment program.

II. Labor Policy of the Government of Nicaragua: Underlying Principles

Nicaragua's labor policy emphasizes actions designed to make the authorities facilitators rather than central planners, limiting their interventions to those arenas in which public-sector participation is essential if equality and promptness of access to manpower and to employment are to be assured.

At the same time, that policy is also focused on radically transforming the paternalistic environment which is the legacy left by earlier Administrations and is responsible for today's over-regulated labor market.

In order to achieve these objectives, the Government is making a concerted effort to develop a coherent labor policy framework designed to make the allocation of manpower to different activities more efficient, and thereby to promote employment and to discourage unemployment and reliance on the informal sector.

In keeping with the overall direction of the Government's general labor policy, the Ministry of Labor has formulated the principles which will guide its implementation of new labor policies and of the labor laws that will be enacted. The following are some of those principles:

(a) Equality of opportunity to work and to apply for any legal employment available.

(b) Workers' inalienable rights: every individual has the right to work and to be protected against employment abuses.

(c) Flexibility of the labor market: in order to promote efficient allocation of labor resources, the Government will guarantee the freedom of workers to move freely in the labor market. Labor market regulations will allow free access to least-cost manpower, plus freedom to dismiss personnel, subject to labor-contract conditions. The terms and conditions of a labor contract, and rescission of it, should be guided by the private agreement between employer and employee.

(d) Labor laws and social security will be kept separate, as the purpose of labor legislation is to regulate the relations between the parties to labor contracts with certainty and exactness.

(e) A free labor market, in which the intentions of the parties to individual labor contracts take priority, will be guaranteed.

The Government is aware of the urgent need to improve the functioning of the labor market, and therefore not only firmly supports the reform project the Ministry of Labor is proposing, but will also incorporate very explicit labor reforms in the country's overall economic reform program.

III. Labor-Market Policies

In exercising its responsibility for implementation of the policy to create a more flexible labor market, the Ministry of Labor has formulated the following minimum requirements which should be met by any new Labor Code or new labor legislation:

<u>Labor legislation should treat employers and employed even-handedly</u>: Labor laws should ensure that the labor contract facilitates the employer/employee relationship efficiently. The parties to a labor contract, whether it is implied or explicit, are equal before the law.

<u>Flexibility in manpower contracting</u>: Nicaragua's labor legislation should ensure that any person who desires to work legally for a given wage is not prevented from doing so by statutory requirements if there are employers willing to pay the wage sought, provided the minimum wage is respected. It should also ensure that contract duration and terms are negotiated freely by the parties. In view of the labor practices the present Administration has inherited from its predecessors, and assuming that the political difficulties created if labor contracting practices were deregulated entirely would be restrictive, the Ministry of Labor, as a minimum, is committed to extending temporary, fixed-term, probationary and apprenticeship labor contracts, so that the majority of persons willing to work may find employment. Temporary, fixed-term, probationary and apprenticeship contracts will

not enjoy the benefits of the collective bargaining agreement. In addition, steps will be taken to ensure that temporary, fixed-term, probationary and apprenticeship contracts written as part of privatization and individual contracting arrangements do not automatically create obligations to pay social security contributions.

Freedom to rescind labor contracts: The country's labor legislation should eliminate all difficulties surrounding the dismissal of workers who perform unsatisfactorily or whose services — for business reasons (technical, financial) — are no longer necessary. The maximum severance payment provided for in the Code consists of remuneration for time worked, the 13th month of salary and vacation time, and a maximum of two months' wages in lieu of notice.

Monetization of social benefits: So that the link between wages and productivity can be clearly reflected, we are committed to promoting the monetization of existing social benefits and their full-scale inclusion in employees' wages, and to avoiding any new change that goes beyond minimum international practice in this arena. We are also working to ensure that social benefits currently provided are laid down by mutual agreement between the parties to a labor contract. The initial steps toward this monetization of social benefits will be taken within the government sector itself. Social benefits will not be dealt with in the Labor Code.

Labor legislation governing trade unions: The labor laws should guarantee the right of the worker to become a member of the trade union of his/her choice. Payment of union dues should be strictly voluntary. Unions should have at least 25 members, and employers should be under no obligation to cover any trade union expenditure.

The Government will advocate retention in the country's labor legislation of the restrictions on strikes prescribed in the present Labor Code (Article 227) in connection with public services or services in the general interest, and also of the requirement that conflicts be resolved according to obligatory rules of arbitration. All labor disputes and strikes declared illegal should be penalized, and the function of declaring strikes legal or illegal should belong to the Ministry of Labor.

In particular, takeover and occupation of the workplace by striking workers should be prohibited and be liable to appropriately severe penalties. Employers in these cases should not be obligated by law to pay lost wages.

The Labor Code should give priority to free individual contracting and should guarantee the rescission, suspension, or termination of contracts, despite the existence of collective bargaining agreements.

Elimination of non-labor provisions from Code: The Government is committed to promoting a new Labor Code free of provisions not strictly connected with labor matters. For instance, co-management of enterprises could be regulated according to the will of the parties involved; under the terms of Article 81 of the Constitution, it should be regarded as a field calling for special legislation.

Other regulations: The labor laws should not declare additional compensation payments or payments proportional to wages to be obligatory. Nor should they increase vacation periods beyond what is prescribed in the Labor Code now in force.

IV. Key Strategies for Implementation of Labor Market Policy

The main obstacle to the efficient operation of Nicaragua's labor market has been identified as the labor legislation in force, and which is currently under examination in the National Assembly. In general terms, the results of this examination process bear out the principles discussed in this Letter. However, the Executive Branch would make use of the power vested in it by Article 142 of the Constitution to counteract any articles of the new Labor Code or other legislation that ultimately prove to be inconsistent with the labor policy principles expounded here.

Volumes Nos. 6, 7, 9 and 13 of the Summary Proceedings of the Joint Technical Committee set up on the recommendation of the National Assembly Committee on Labor and Trade Union Matters and the Ministry of Labor, and on which all social interest groups are represented, are particularly relevant.

Volume No. 6 provides an extremely clear and straightforward description of temporary labor hiring practices in Nicaragua (Article 26).

Volume No. 7 deals with fixed-term labor contracts (Article 27).

Volume No. 9 deals with probationary contracts. This is a type of labor contract which includes a clause that provides for a trial period. Thus the relationship being inaugurated is given a temporary character, and can be rescinded if, in the judgment of the employer, the worker has not proved satisfactory.

Volume No. 13 provides a thorough review of all aspects of the cancellation of labor contracts.

Attached is a photocopy of the letter that it is planned to send to all members of the National Assembly, as well as a copy of all articles approved so far in the Assembly.

The above are the key points on which the Ministry of Labor is focusing its efforts, and for which the Government hopes to obtain the full support of the World Bank.

The policies outlined in this letter, and the actions being taken with a view to their implementation, are the manifestation of the Government's firm intentions as far as the labor market is concerned. The Government is committed to these policies, which afford the best means of improving the functioning of the labor market in Nicaragua.

Yours truly,

Emilio Pereira Alegría

Governor of the World Bank
for Nicaragua

Francisco Rosales

Minister of Labor

ANNEX G

SUPPLEMENTARY CREDIT DATA SHEET

NICARAGUA
SECOND ECONOMIC RECOVERY CREDIT

SUPPLEMENTARY CREDIT DATA SHEET

Section I: Timetable of Key Events

(a) Time taken by the country to prepare the credit: 12 months
(b) Operation prepared by: Ministry of Finance and the Central Bank
(c) First presentation to IDA: June 1993
(d) Departure of Appraisal Mission: April 4, 1994
(e) Completion of Negotiations: May 6, 1994
(f) Planned date of effectiveness: July 1994

Section II: Special Implementation Actions

None

Section III: Special Conditions

Actions taken before Board presentation:

(i) prepared a satisfactory action plan to implement the Public Sector Labor Mobility Program, including time-bound employment reduction targets;

(ii) brought to the point of sale, liquidation or offered concessions for 33 of the remaining 72 CORNAP enterprises, 8 MCT enterprises, and LUBNICA and ENIGAS; and prepared an action plan and drafted legislation to divest a 40 percent share of TELCOR's telecommunications operation, including the offer of a management contract to the successful bidder, and publicly announced the calendar of steps in the bidding process for TELCOR;

(iii) prepared a policy statement outlining the strategy and broad elements of the Government's Public Sector Reform Program; and established within the Ministry of Finance a Reform of the State Program Management Unit (PMU), with agreed terms of reference;

(iv) stated its policy of: (i) not recapitalizing state banks, either through new capital from the public sector or revaluation of non-financial assets, (ii) enforcing compliance by all banks with prudential norms established by the Superintendency of Banks, and (iii) not preassigning own rediscount funds to specific economic activities; and prepared an agreed Action Plan to Strengthen Prudential Supervision, and issued revised prudential norms;

(v) agreed on the establishment of a mechanism in the Ministry of Finance to carry out random inspections to verify compliance with established procedures to resolve property conflicts, and the commissioning of a study to analyze potential uses of the Compensation Bonds, with the objective of raising their value;

(vi) issued Presidential Decrees that: (i) state that any change in tax and fiscal policies has to be published in the Official Gazette to be legally binding, (ii) abrogate and elevate to the Presidential level the powers of ministries and government agencies to change tax and fiscal policies, and (iii) abrogate the powers of ministries and government agencies to create new commercial enterprises;

(vii) presented an agreed phased tariff reduction program to reach a maximum of 37 percent by mid-1995; and

(viii) presented a satisfactory Letter of Labor Policy.

Second tranche release conditions: satisfactory progress in implementation of the Government's structural adjustment program, including maintenance of a supportive macroeconomic framework, and the following actions:

(i) satisfactory progress in implementation and meeting the targets of the Public Sector Labor Mobility Program, including the elimination of 5,000 positions by end-1994;

(ii) bring to the point of sale or liquidate at least 33 of the remaining CORNAP enterprises and one additional MCT enterprises; and implement satisfactorily the TELCOR privatization plan, including bringing to the point of sale a 40 percent share of TELCOR's telecommunications operation, together with the offer of a management contract to the successful bidder;

(iii) develop and begin implementing by end-1994 a comprehensive and time-bound Public Sector Reform Program and Action Plan to be implemented over the next three years;

(iv) compliance with stated policy toward state banks, and satisfactory implementation of Action Plan to Improve Prudential Supervision; and

(v) satisfactory progress in implementation of the verification process and the design and implementation of agreed recommendations of the study to increase the value of the Compensation Bonds.

Third tranche release conditions: satisfactory implementation of the Government's structural adjustment program, including the maintenance of a supportive macroeconomic framework, and the following actions:

(i) satisfactory progress in meeting the targets of the Labor Mobility Program, including the cumulative elimination of 7,000 positions by mid-1995;

(ii) complete the administrative process of transferring ownership for all the CORNAP and MCT enterprises that were sold, and liquidate or bring to the point of sale some of PETRONIC's operations, including gasoline distribution, while defining PETRONIC's regulatory functions, if any, in view of the planned liberalization of the hydrocarbons sector;

(iii) satisfactory implementation of the Public Sector Reform Program and Action Plan, including the restructuring of at least two major public institutions;

(iv) compliance with stated policy toward state banks, and satisfactory implementation of Action Plan to Improve Prudential Supervision;

(v) satisfactory progress in implementation of the verification process, and the design and implementation of agreed recommendations of the study to increase the value of the Compensation Bonds; and

(vi) satisfactory implementation of tariff reduction program, including attainment of a maximum nominal protection ceiling of 37 percent by mid-1995 for all imports with the possible exception of 8 products ("fiscal industries") subject to a prior review of the fiscal impact of lower protection; and preparation of an agreed action plan to replace the export promotion mechanism by a duty drawback system or a temporary admission regime.

END

END

CR 2302-NI

Report No. P-5598-NI

Privatization of APP and Financial Sector Reform were cornerstone to the program.

REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL DEVELOPMENT ASSOCIATION

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED ECONOMIC RECOVERY CREDIT

OF SDR 83.5 MILLION

(US$110 MILLION EQUIVALENT)

TO THE

REPUBLIC OF NICARAGUA

September 3, 1991

CURRENCY EQUIVALENTS
(as of August 30, 1991)

Currency Unit - Cordoba

US$1.0 = C$5
US$0.20 = C$1

FISCAL YEAR

January 1 - December 31

ABBREVIATIONS

AGROEXCO	=	Agriculture State Export Company
AFA	=	Rice, Beans and Sugar Food Package
APP	=	People's Property Area
BANIC	=	Nicaraguan Industry and Commerce Bank
BIN	=	Nicaraguan Mortgage Bank
BND	=	Nicaraguan Development Bank
BP	=	People's Bank
CAFENIC	=	Nicaraguan Coffee State Trading Company
CIT	=	Corporate Income Tax
CO	=	Cordoba Oro
CORFIN	=	Nicaraguan Financial Corporation
CORNAP	=	State-owned Corporations Holding Company
CPAR	=	Country Procurement Assessment Report
ENABAS	=	State Agricultural Marketing Company
ERC	=	Economic Recovery Credit
FASO	=	Fund for Assistance to the Oppressed
FISE	=	Social Emergency Investment Fund
FNI	=	Nicaraguan Investment Fund
GVT	=	General Value Tax
ICB	=	International Competitive Bidding
IDB	=	Inter-American Development Bank
INAA	=	Nicaraguan Institute for Water and Sewerage
HATONIC	=	Nicaraguan Cattle/Slaughtering Holding Company
MDP	=	UNDP Management Development Program
OECD	=	Organization for Economic Cooperation and Development
PMA	=	Mother-Children Nutrition Program
PTI	=	Personal Income Tax
RUTA	=	UNDP/IBRD Regional Unit for Technical Assistance
SCT	=	Selective Consumption Tax
SOE	=	Statement of Expenses
UNDP	=	United Nations Development Program
USAID	=	United States Agency for International Development

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NICARAGUA

ECONOMIC RECOVERY CREDIT

PRESIDENT'S REPORT

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NICARAGUA

ECONOMIC RECOVERY CREDIT

CREDIT AND PROGRAM SUMMARY

Borrower:	Republic of Nicaragua
Amount:	SDR 83.5 million (equivalent to US$110 million)
Executing Agencies:	Ministry of Finance and Ministry of Economy and Development
Terms:	Standard IDA terms with repayment in 40 years, and ten years of grace.
Description:	The proposed loan would support the Government's structural adjustment program, which is designed to (i) downsize and restructure the public sector, including the privatization of state-owned companies; (ii) reform the financial system to improve resource allocation/ mobilization through establishment of a competitive environment with private sector participation; and (iii) reform the incentives systems by eliminating barriers to private sector entry to production and trade, liberalizing trade, domestic price controls and other regulations.
Benefits:	The implementation of the structural adjustment program would promote growth through increased private sector participation, improved incentives for production and a more efficient allocation of domestic resources. It would also increase employment opportunities and help alleviate poverty. In addition, it would facilitate the flow of external financing and foreign investment.
Risks:	The principal risks are weaknesses in institutional capacity to carry out the program, resistance on the part of organized groups to fiscal and financial restructuring, slow private sector response due to uncertainty regarding the property rights, and shortfalls in timely donor support.

<u>Disbursements</u>: The proceeds of the loan would be disbursed in two equal tranches of SDR 41.75 million (US$55 million equivalent) each: the first tranche upon effectiveness (with retroactive financing of up to SDR 41.75 million), the second tranche after a satisfactory performance review expected around March 1992.

**REPORT AND RECOMMENDATION OF THE PRESIDENT
OF THE
INTERNATIONAL DEVELOPMENT ASSOCIATION
TO THE EXECUTIVE DIRECTORS ON
A PROPOSED ECONOMIC RECOVERY CREDIT
OF SDR 83.5 MILLION
TO THE REPUBLIC OF NICARAGUA**

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1. I submit this report and recommendation on a proposed credit in the amount of SDR 83.5 million (US$110 million) to the Republic of Nicaragua. The credit would be on standard IDA terms, with repayment in 40 years, including a 10 year grace period. The credit would support an economic recovery program aiming to achieve economic stabilization and renewed sustainable economic growth, as well as an improvement in living standards. The credit proposal follows the recent decision to declare Nicaragua eligible for IDA credits (IDA/Sec. M 91-131, dated April 16, 1991). The proposed operation would be co-financed with concessionary funds from the Inter-American Development Bank (IDB), the Japanese Government, the German Government, and the Swiss Government (para. 103).

2. The IDA credit would be the first to Nicaragua since 1980. Following the past decade of Sandinista rule, the February 1990 elections brought the Chamorro Government to power. The new Administration approached the Bank and IDA to support its stabilization and recovery efforts after a six-year interruption in relations between the two institutions. Since April 1990, Bank staff visited Nicaragua on several occasions, assessed the economic situation, and discussed with the authorities the elements of a program for stabilization and adjustment. The Bank and IDA also coordinated donor support, including Consultative Group meetings in Paris on December 3-4, 1990, and May 16-17, 1991. In the latter meeting, the donors agreed on a financial package to clear the arrears to the World Bank and the IDB. The Government resumed debt service payments and froze the World Bank arrears at the May 1991 level. The International Monetary Fund (IMF) is helping the Government to monitor a Stabilization Program launched on March 3, 1991. A stand-by arrangement, based on a track record of program implementation, is expected to be presented to the IMF Board during the first half of September 1991. The Government is also requesting Paris Club assistance for debt relief.

I. ECONOMIC ISSUES, POLICIES, AND IDA ASSISTANCE STRATEGY

Background

3. The Chamorro administration inherited from the Sandinistas a devastated economy. Production was well below 1980 levels, exports ran at

about half of the pre-1980 level, hyperinflation was about 4,700 percent in 1989, international reserves were depleted, and debt had accumulated to around US$9 billion by late 1989. The administration has also inherited an oversized and extremely inefficient public sector which has crowded out private sector participation through a deep involvement in economic activities, and ownership of productive means. Many skilled technicians and managers had left the country. The tasks of achieving stability, economic revival, and the other prerequisites for sustained growth appeared daunting. Moreover, the economic agenda had to be pursued in the environment of a fragile political peace.

4. During the preceding decade, the Sandinista government tried to establish a centrally controlled economy. Many privately-owned undertakings were confiscated or expropriated. The financial and external trade sectors were nationalized. The small remaining private sector was heavily regulated. Inappropriate macroeconomic policies and price controls distorted resource allocation. Gross inefficiencies in resource use resulted. Public sector expenditures trebled over the decade, reaching an average of 57 percent of GDP in 1983-87. The Government's resort to Central Bank financing fueled an inflation level which reached 14,300 percent in 1988. The contra war and a United States trade embargo compounded problems. Consequently, the GDP grew only moderately at the beginning of the 1980s, and declined every year beginning in 1984. Table 1 illustrates the economic deterioration of the 1980s.

Table 1: NICARAGUA - GENERAL MACROECONOMIC INDICATORS, 1979-1990

	1979-83 1/	1984	1985	1986	1987	1988	1989	1990
Annual Real Growth Rates:								
GDP	-2.5	-1.6	-4.1	-1.0	-0.7	-15.0	-2.8	-4.4
Total Consumption per capita	-6.2	0.2	-4.9	-3.7	-2.6	-19.1	-9.9	-6.2
Average Domestic Inflation Index	33	35	220	682	912	14,316	4,770	7,485
Dec. to Dec. Domestic Inflation Index	35	50	333	747	1,347	33,657	1,689	13,490
Imports of Goods & NFS	-9.6	-1.5	0.6	-14.3	3.5	-5.7	-15.2	3.0
Exports of Goods & NFS	-2.4	-20.8	-11.7	-17.6	-1.0	-10.6	7.5	9.9
Ratios to GDP (%):								
BOP Current Account (incl. off. grants)	-15.2	-21.1	-25.9	-20.6	-22.1	-51.9	-32.8	-33.3
Resource Balance	-12.2	-15.0	-20.7	-19.4	-19.6	-47.7	-29.5	-31.1
Debt Indicators, excl. Interest Arrears (US$Mls):								
Debt Outstanding	2,644	4,546	5,255	5,945	6,984	7,488	8,267	8,819
Medium Long-Term DOD	2,151	3,900	4,618	5,321	6,262	6,773	7,546	8,064
Short-Term DOD 2/	493	646	637	624	722	715	722	755
Total DOD/Exports GNFS (percent)	520	986	1,526	2,070	2,152	2,378	2,427	2,358
Total DOD/Current GDP (percent)	109	161	188	210	240	659	752	796
Non-Financial Public Sector (As % of Curr. GDP): 3/								
Total Revenues	26.2	40.8	37.0	36.5	29.8	23.3	24.6	17.2
Total Expenditures 4/	38.8	62.6	59.8	51.6	47.9	49.8	29.9	42.8

Sources: BCN, IMF and Bank staff estimates
Notes:
1/ Annual average.
2/ Includes US$185 Million of estimated commercial debt.
3/ Consolidated nonfinancial public sector (NFPS) includes general government and public utility enterprises.
Figure for 1979 includes Central Govt. only.
4/ In 1990 extrabudgetary expenditures equivalent to 12 percent of GDP are included.

Recent Economic Developments

5. The Sandinista Government launched an emergency stabilization package to curb hyperinflation in 1989. The program significantly reduced the public sector deficit by halving Central Government expenditures, dramatically cutting credit to the public sector, and frequently devaluing to create a 90

percent real depreciation of the Cordoba in 1989. The program failed, although inflation was temporarily reduced to 4700 percent in 1989 and the current account deficit was slightly narrowed. In early 1990, a lame duck government abandoned the program and pursued highly expansionary policies. In only three months, public sector wages were increased by 800 percent in nominal terms, while public sector prices remained fixed. The Central Bank financed resulting deficits and the Cordoba appreciated by 45 percent in real terms, as inflation accelerated.

February 1990

6. The Chamorro administration has emphasized the importance of stabilization through a combination of fiscal and monetary policies, and the reduction of the size and role of the government as well as reliance on market forces. Central Government expenditures rose only by 2 percentage points of GDP in 1990 despite a doubling of the wage bill, mainly due to the Sandinista-inspired wage increases prior to the new Government's term. The financial performance of the public utilities improved dramatically after prices were increased and then indexed to the US dollar. However, the measures taken in 1990 by the Chamorro government fell significantly short of achieving stabilization. Mainly due to a decline in government revenue by 7 percentage points of GDP, the overall public sector deficit widened to 43 percent of GDP. Domestic bank credit increased rapidly because of deficits in state enterprises.

May 1990 Cordoba Oro

7. In May 1990, the Government introduced a second currency, the Cordoba Oro (CO). It was pegged to the US dollar. Initially, the CO was used as a unit of account. However, subsequently it was used to pay a part of public sector wages. Loans and deposit rates were indexed to the CO and interest rates became less negative in real terms because the Cordoba continued devaluing against the US dollar (and the CO) on a weekly basis. Nonetheless, non-market criteria continued to determine credit allocation. The introduction of the CO in an inflationary environment also complicated monetary management. The fact that transactions were denominated in CO and effected in Cordobas, sped circulation of the Cordoba. Lax financial policies combined with enforcement of parity to the US dollar also depleted scarce international reserves.

8. Economic performance continued to worsen throughout 1990. This was exacerbated by political volatilities and persisting macroeconomic imbalances. The GDP dropped further by 4.4 percent. Inflation accelerated to over 7,400 percent due to unchecked monetary expansion and a large fiscal deficit. Despite improvement in export performance, the current account deficit remained high.

October 1990 Agreement

9. The most significant achievements of the Government in 1990 were the moves toward establishing peace and reaching broad national consensus on the main thrust of its economic policies, after an initial period of prolonged strikes. The consensus-building efforts culminated with an October 1990 agreement. The "Concertación Económica y Social" between the Government and representatives of workers and employees secured a formal consensus on the need to implement structural reforms, including: liberalizing trade, removing state monopolies in the financial and foreign trade sectors, and returning expropriated properties to their rightful owners. The Chamorro administration

demobilized and worked to reintegrate armed groups. In addition, the Government enacted significant policy changes in the areas of tax reform, tariff reform, and deregulation of the economy.

March 1991
Stabilization Program.

10. In 1991, the Government focused on stabilization and structural change. An extensive stabilization program was initiated on March 3. The Government sharply devalued the exchange rate and placed strict ceilings on expenditures and credit expansion (paras. 22-24). The early results of the stabilization program are encouraging in terms of drastic declines in the rate of inflation (para. 26). The scanty available figures regarding output levels indicate that the economic decline has been arrested and that moderate growth may have ensued in 1991, though no trend can be confirmed yet.

Need for Adjustment and Constraints

11. The severely distorted economy requires rapid transformation of the whole economic system away from centralized management, regulations, public ownership and resource use, and controls to a free-market orientation with increased private sector participation. This economic transformation has to occur under the restraint of a major stabilization effort. Before structural adjustment efforts can bear fruit, sustainable relative price stability has to be established.

12. While the Government demonstrates commitment to stabilization and adjustment through the March 3, 1991 program and a number of steps toward structural adjustment, the economic agenda continues to face strong challenges. Some of these challenges are not in the domain of straightforward economic policy. The effort to maintain consensus behind economic policies has consumed the Government's attention and required concessions by all economic actors regarding the content of policies. The Government, however, has achieved consensus to date in support of the main thrust of its economic policies.

13. The Government faces many constraints which will continuously test its political will and capability to implement its program for reforms. In an environment of hyperinflation, the restoration of macroeconomic stability necessitates drastic fiscal and monetary measures. Major expenditure cuts are required in the public sector. This will necessitate a decline in the wage bill with consequences for real wages and the level of public sector employment. Also, special care has to be taken that essential government services and social sector needs are not adversely affected. The government's revenue raising capability has to be improved significantly. Moreover, credit for all types of activities will have to be severely constrained. The authorities are working to achieve the stabilization targets without curtailing the supply response and worsening the position of poverty-ridden groups. Failure in this respect would erode support for Government policies and disturb the recently acquired social and political peace.

14. Reducing the role and share of the public sector in the economy constitutes a major challenge to the Government's adjustment efforts. First, the central government spends almost one third of GDP. This exceeds public

revenues, resulting in a fiscal imbalance. Second, government ownership of economic assets in all sectors and heavy public sector use of resources crowds out the private sector. The public sector monopolizes the financial system, owns a majority of the manufacturing firms, and participates in agricultural production by owning state farms. State enterprises operate inefficiently, are afflicted by highly politicized excess labor, and depend on financial resource transfer to cover operational deficits. Third, little room for private initiatives remains because the government heavily controls and regulates the economy, as well as monopolizes trade and services. Public sector cutbacks meet resistance from strong pressure groups opposing change.

15. Although the central government pervades the economy, its policy formulation, implementation and monitoring capabilities are limited. The deteriorated political climate has caused significant personnel losses in key areas over the last several years. Similarly, institutional capabilities have eroded. Implementing demanding stabilization and structural adjustment programs will strain public sector capabilities. Without substantial and immediate technical assistance, program implementation could fail.

16. The absence of a functioning financial system presents a major challenge to adjustment. The ineffective publicly owned financial institutions serve merely to channel Central Bank credit to the state. Formerly, the lack of credit discipline led to unchecked credit expansion and almost complete noncompliance with repayment requirements. The Central Bank has ineffectively used traditional monetary policy instruments. In addition, there is no effective supervisory agency nor prudential regulations. While a program to restructure the financial sector has been initiated recently, establishment of a functioning financial sector will take time.

17. The uncertainty surrounding property rights, land ownership, and land tenure, unless remedied quickly, could endanger the Government's ability to implement an adjustment program to obtain the necessary supply response. Since sympathizers of the previous regime retain control of many law enforcing offices, including the police, settling existing conflicts and enforcing property ownership rights may prove to be difficult. The privatization of properties confiscated or expropriated under the previous regime and agricultural production are especially sensitive to the property rights issue.

18. High unemployment and strained labor relations also cause concern. While economic adjustment and restored sustained growth would increase employment in the medium to long-term, stabilization and adjustment will require reduced public sector employment in the short-term. Decreased employment levels and declining real wages could meet with strong resistance from the highly politicized organized labor groups. This would cause interruptions in production and a slowing down of economic recovery.

The Government's Strategy and Program for Stabilization and Adjustment

19. Strategy for Renewed Growth. The Government's strategy, recognizing the interrelation between stabilization and structural adjustment,

requires carefully coordinated and sequenced actions to achieve the two goals. Achieving macroeconomic stability in an unstable macroeconomic environment is a precondition for successful adjustment, the authorities realize. In turn, economic stabilization, without a significant supply response through structural adjustment, would be short-lived.

20. The authorities recognize that structural adjustment entails immediate and simultaneous actions in several areas. However, proper policy sequencing is essential not to overextend the weak administrative capability of the Government across many areas. The authorities have sequenced their adjustment policies such that measures which can be implemented immediately with a relatively quick pay-off are given priority. Some examples are deregulating the economy, removing government monopolies in domestic and international trade, and abolishing intricate licensing practices. These changes, coupled with the maintenance of competitive interest and exchange rates, will encourage private sector participation.

21. Policy measures eventually will have to be supplemented by investment projects in productive and infrastructural sectors such as energy and communications. Meanwhile, the Government has initiated programs to cushion the impact of adjustment on the most vulnerable low-income groups (para. 91) and to address the immediate needs of the poor segments of the population.

22. The Stabilization Program. With IMF staff assistance, the authorities prepared a stabilization program to reduce inflation drastically. Implementation began on March 3,1991. In the area of fiscal policy, the program aimed to reduce the public sector deficit to a level that can be financed by external grants and concessionary assistance, without recourse to domestic credit. This required deep cuts in the recurrent expenditures from the budget compared to 1990, and a major increase in the tax effort. No extra-budgetary spending would be allowed in 1991. According to the program, all public entities are denied access to net domestic bank credit in 1991.

23. The stabilization program calls for strict constraints on domestic bank credit. The Government has instructed the Central Bank not to extend net domestic credit to the economy beyond available loanable funds. Monthly ceilings on Central Bank credit have been established. Also, the program aims to simplify the interest rate structure and indexes deposit and lending rates to the dollar.

24. The March 3, 1991 program devalued the exchange rate of the Cordoba Oro by 400 percent, from 1CO$ per US$ to 5CO$ per US$. The Government also announced increases in: (i) public utility tariffs ranging from 150 percent for telephone services to 350 percent for electricity; (ii) prices of petroleum products by about 350 percent; liquor, cigarette, and soda water prices by 300 percent; and (iii) prices of primary food products (rice, beans, corn, sugar, oil, milk) and soap, produced and marketed by state enterprises, by about 300 percent. An average 200 percent wage and salary increase was granted to public sector employees to partially offset the impact of price increases.

25. The ultimate success of the stabilization program will depend on the authorities' ability to achieve demanding expenditure and revenue targets. Through May 1991, expenditures have been limited to the targeted levels, which are compatible with current revenue and foreign grants. Tax receipts increased by more than 40 percent during the first five months of 1991 and will reach the target for 1991 easily. Thus, the drop in the tax revenue in 1990 proved a transitional phenomenon, resulting from the unusual political circumstances.

26. During the first five months of 1991, total Central Bank credit to the public sector and domestic financial institutions- the key factor behind high inflation in recent years- declined. This fact and the disbursements of foreign loans and grants led to a net increase in international reserves of US$93 million. In addition, the consumer price index dropped by 6 percent in May 1991 compared to April, indicating a moderation in price levels since the initial post-devaluation upsurge of March.

27. The Structural Adjustment Program. Section II details the Government's structural adjustment program. However, a broad outline of the program is given in this section. The comprehensive program for structural adjustment was finalized recently in consultation with IDA staff. The program aims at a radical reorientation of the economy toward competitive markets and improving incentives to the private sector.

28. Fiscal policy aims to balance revenue and expenditures through selective current expenditure cuts and improved revenue gathering by the tax administration. To avoid fiscal account imbalances, the authorities will continue to use cash budgeting, continuously adjusting monthly expenditures to revenue. To achieve price and external reserve targets, monetary policy will try to balance money supply with demand for real money balances. The authorities will continue to constrain the Central Bank's stock of net domestic credit. Both deposit and lending interest rates will be kept positive in real terms. After the primary objectives of stabilization are achieved, interest rates will be approximated to market rates (para. 76). The Government exchange rate policy will be flexible in order to maintain competitiveness in the tradeable sector and to stimulate export diversification. To ensure a competitive exchange rate, while adhering to tight monetary, fiscal, and wage policies, the authorities will monitor developments closely in order to act immediately due to changes in domestic and external factors.

29. The Government's program highlights reforms for the public sector, the financial sector, and the incentives system. Public sector reforms aim to reduce the government's size and economic involvement, while increasing efficiency in public services. Regarding public sector expenditures, the Government has controlled 1991 budgetary expenditures after an unsuccessful attempt in 1990. The authorities have targeted to cover all non-interest current expenditure with current revenue by FY93. To this end, the Government intends to reduce non-interest current expenditures by around 7 percent in FY92. Military expenditures are marked to bear the biggest burden

of adjustment, since they are perceived to be excessive. In addressing the public sector employment issue, the program initiated for employment reduction through voluntary retirement in 1991, will be continued in 1992 along with external assistance. The Government targets the privatization of some 350 state-owned companies. Already, several companies have been privatized mostly by returning them to their legal owners. The Government has a time-bound action plan to privatize about 90 percent of state-owned companies by end 1993.

30. The Government is moving to improve the tax administration, in order to enhance the buoyancy of the tax system and to ensure the reliability of tax revenues. Some measures, such as those against tax evasion, would produce short-term results. Other measures target long-term institutional improvements, including the training of staff.

31. Financial sector reforms comprise a major share of the adjustment program. The authorities are planning to introduce competition into the financial system by including the private sector. The state-owned banks will be either liquidated, merged, restructured or rechartered as institutions providing services and credit to small agricultural producers and micro enterprises. In addition, a modern and comprehensive Law of Banking and Financial Institutions is going to be drafted to establish prudential regulations and facilitate the use of modern banking and financial instruments.

32. The third component of the adjustment program aims to restore a system of incentives conducive to private sector participation in a market-oriented environment. Trade liberalization measures include the gradual lowering of nominal tariff protection to a range of 10-20 percent by end 1993. Steps are being taken to completely open foreign trade to the private sector, and remaining restrictions on imports are being removed and the foreign exchange allocation mechanism is being liberalized. The discretionary, complex, and distorted tax system was changed significantly in the second half of 1990. Distorting domestic regulatory practices would be erased by reducing the extent of the government's involvement in the economy and changing the regulatory framework for state-owned enterprises. Moreover, the authorities will eliminate the remaining agricultural support prices.

Medium Term Prospects

33. The Nicaraguan economy has the potential to achieve fairly rapid economic growth over the next decade. This expectation is supported by Nicaragua's rich agricultural resources and considerable unused capacity, indicated by a much lower than recent historical average overall output. Also, the external markets of the last decade can be regained, particularly in the US, now that the embargo has been lifted. Successful implementation of the stabilization and structural adjustment policies, to be supported under the proposed credit, would achieve recovery and sustained growth. Another prerequisite of resumed growth is the maintenance of national peace and the resolution of the property rights issue. The Government has intensified efforts to resolve the potentially explosive property rights issue. With

private sector confidence, price stability, competitive exchange rates, and reformed fiscal, financial and incentives systems, quick recovery and respectable economic growth are attainable.

34. A base case scenario has been developed which assumes that structural adjustment measures would be implemented fully. GDP growth is expected to turn positive in 1991 and then gradually increase to reach 5 percent annual levels by 1995 and then stabilize at around 4.5 percent annually for the remainder of the decade. Despite positive per capita GDP growth rates by 1993, however, private consumption per capita would recuperate more slowly. In the transition from stabilization to the resumption of sustained growth, public investment would play the dual role of buffering initial slow growth and of improving infrastructural activities to encourage private investment. Even with this growth performance, real GDP would only reach early 1970s levels by 1996. More strikingly, GDP per capita levels would not reach 1950s levels before 2000. Table 2 shows the projected macroeconomic scenario.

Table 2: NICARAGUA - KEY INDICATORS, 1991-2000

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Annual Real Growth Rates:										
GDP	1.0	3.0	4.0	4.5	5.0	5.0	4.5	4.5	4.5	4.5
GDP per capita	-2.0	-0.1	1.0	1.5	1.9	2.0	1.7	1.7	1.7	1.7
National Accounts (As % of Curr. GDP):										
Total Consumption	113.2	107.7	105.7	104.5	102.5	100.5	98.8	97.4	96.1	94.7
Public Consumption	21.8	20.7	16.6	15.9	15.1	14.4	13.8	13.5	13.1	13.1
Private Consumption	91.4	87.0	89.1	88.6	87.3	86.1	85.0	83.9	83.0	81.6
Total Investment	12.0	15.0	16.0	16.0	16.5	16.5	16.3	16.0	16.0	16.0
Public Investment 1/	8.0	9.3	7.4	7.5	6.5	5.5	4.7	4.6	4.6	4.5
Private Investment	4.0	5.7	8.6	8.5	10.0	11.0	11.6	11.4	11.4	11.5
Exports of Goods & NFS	28.0	30.7	32.1	32.6	33.7	35.1	36.6	37.8	38.7	39.6
Imports of Goods & NFS	53.2	53.4	53.7	53.1	52.6	52.1	51.7	51.2	50.7	50.3
Gross Domestic Savings	-13.2	-7.7	-5.7	-4.5	-2.5	-0.5	1.2	2.6	3.9	5.3
Non Financial Public Sector (As % of Curr. GDP):										
Total Current Revenues	22.4	23.5	23.7	23.9	23.3	23.0	22.7	22.5	22.0	22.0
Total Current Expenditures	27.8	24.9	21.7	20.8	19.8	18.8	18.0	17.5	17.0	16.8
Capital Expenditures	7.0	7.7	7.6	7.7	6.7	5.7	4.9	4.8	4.8	4.7
Overall Balance	-12.2	-8.9	-5.4	-4.4	-2.9	-1.3	0.0	0.3	0.5	0.7
Balance of Payments:										
(Real Growth Rates)										
Exports of Goods & NFS	2.9	8.7	8.0	8.9	8.5	8.8	7.7	7.6	6.4	6.4
Imports of Goods & NFS	2.6	6.1	3.9	3.0	3.9	3.3	3.0	3.0	3.0	3.0
(As % of Current GDP)										
Resource Balance	-25.2	-22.7	-21.6	-20.5	-18.9	-16.9	-15.0	-13.3	-12.0	-10.7
Current Account - interest paymts 2/	13.0	-18.2	-17.5	-16.7	-15.5	-13.9	-12.3	-11.0	-10.0	-9.0
MEMO: GDP in US$ Mln.	1,421	1,489	1,578	1,714	1,888	2,065	2,236	2,444	2,666	2,909

1/ Includes APP enterprises.
2/ Includes official grants in 1991.
Source: WB staff estimates.

35. As shown in the table, modest growth is expected for 1991. This growth estimate is based on the predicted rapid reduction in inflation, existence of significant excess capacity, and new opportunities in the external sector. The stabilization program launched in early March 1991, has produced positive results already. The public sector carries the burden of adjustment, leaving room for increasing credit to the private sector even in the short run. Structural policy measures encouraging private sector participation in production and trade have been initiated. Foreign trade was

opened to the private sector in early 1991, and currently private traders are participating. Moreover, a full year's effect of the removal of the US trade embargo in 1990 will be felt in 1991. The agricultural frontier has grown since the end of the war, and there has been a massive transfer of idle agricultural land to ex-military personnel and former resistance fighters. The authorities expect a 25 percent increase in the production of basic grains this year.

36. The effects of structural reforms to improve resource allocation/mobilization and increase production of tradeables will take time. Moreover, private investment is expected to grow slowly. Although Nicaragua, a small economy, can be integrated rapidly into world markets, structural reform implementation will cause a lag in growth. Structural change will occur quickly in the trade and domestic deregulation areas because the main task there is to eliminate policy imposed barriers to production and trade. These reforms are expected to be installed by the end of 1993. However, financial sector reform will be more complex. It involves the difficult task of restructuring the state-owned banks. Similarly, the supervisory institutions and the privately-owned banks require time to be fully functional. Therefore, relatively high, stable GDP growth is not expected until 1995.

37. Maintaining a competitive exchange rate, in addition to far reaching trade liberalization and elimination of entry barriers to the private sector, will alleviate the anti-export bias and allow for a significant increase in exports in the medium-term. Overall exports of goods and non-factor services are expected to reach approximately US$660 million by 1996, growing at an real average annual rate of 8.6 percent between 1992 and 1996. This would be realized mostly through an increase in traditional exports, mainly coffee, cotton, and beef, products that will account for nearly half of total exports throughout the nineties. Coffee exports are expected to grow 10 percent annually, as a consequence of a slight increase in the cultivated area, and considerable increases in yields, reaching levels observed in other countries of the region. However, only in 1996 will the export volumes of the seventies be reached again. Cotton exports are expected to grow at high rates due to an increase in the cultivated area. Even with these favorable prospects, by the year 2000, export volumes would still be 20 percent below the 1970s' levels. Beef exports should grow steadily at a slow pace, given the small number of cattle for slaughter. On account of less favorable outlook in world markets, sugar will lose its 14 percent share of exports in 1992 to 11 percent in 1996. Export volumes of bananas will grow fast, due to favorable price prospects and the possibility of entering the American and European markets. An expansion in the cultivated area for banana is expected both in the short and long run. The seafood sector has good export prospects, since almost all exports are based on fishing rather than on shrimp and lobster aquaculture. However, because of overexploitation in some areas, export volumes will continue to be below levels twenty years earlier. With measures to increase profitability, non-traditional exports, especially agro-industrial products, are expected to increase at an annual rate of nearly 10 percent. In the case of imports, trade liberalization will not imply a massive increase, provided that the Government maintains a competitive exchange rate.

<u>IDA Assistance Strategy</u>

38. The present crisis, with its political, economic and social roots, presents formidable challenges to the implementation of a viable economic recovery and adjustment program. Like most IDA only countries, Nicaragua faces extreme poverty, a host of policy shortcomings, and weak institutions as it attempts to pre-condition sustained growth. However, Nicaragua faces three additional problems that compound the difficulty of its reform effort and argue for an exceptionally high level of concessionary support from multi- and bilateral donors. The first is that Nicaragua is emerging from a ten year military conflict that destroyed the country's physical and institutional infrastructure, diverted a high percentage of government expenditures to military uses, and contributed to a significant brain drain - amounting to some 10 percent of the population - mostly of professional and skilled labor. The war left large numbers of displaced and handicapped people that will strain government services for many years. The second additional difficulty is that the Chamorro Government is trying to dismantle completely the command economy from the 1980s. This means breaking down the state monopolies in internal and external commerce, rebuilding the insolvent financial sector, restoring property rights, returning businesses and agricultural holdings to the private sector, enacting major legislative and judicial reforms, and reducing the size of the state. Finally, the Government faces an extraordinarily high external debt burden and financing requirements over the next decade. Also, as of early 1991, Nicaragua's accumulated total arrears stood at $3.2 billion, more than twice the 1990 GDP. Though the Government has taken important steps to renegotiate its debt, this debt overhang remains constraining.

39. IDA must play a decisive role in both providing direct assistance and in mobilizing and coordinating adequate levels of donor support. Drawing on its comparative advantage, IDA will focus its assistance on: (i) helping first to address key macroeconomic and structural policy issues through quick disbursing operations; (ii) consolidating the reform process through a gradual shift to sector operations to support the Government's objectives of increasing the efficiency of resource use in the public sector, rehabilitating physical infrastructure and human resource development, and strengthening the private sector; and (iii) using the special IDA facilities to help improve creditworthiness and thereby contribute to restoring private capital flows. In leading the Consultative Group, IDA will seek to complement its financial support by: (i) helping organize and direct urgently needed technical assistance to support the Government's adjustment efforts; and (ii) assisting the Government to mobilize additional concessional resources. In order to enhance both these efforts, a Resident Mission will be established in Nicaragua later in 1991. This will back the Government in its implementation of the program and provide a direct line of communication in Nicaragua for the donor community.

40. This assistance addresses strategic issues critical to the realization of the government's economic development goals. Most importantly, there is a need to: (i) develop and implement an appropriate mix and sequence of adjustment and investment actions, including those for urgent infrastructure rehabilitation; (ii) strengthen the enabling environment for

private sector activities to ensure progress in the ongoing process of privatization; (iii) define and implement policies to address the structural causes of poverty; (iv) overcome the limited implementation capacity of the public administration through efficient use of external technical assistance and measures to attract qualified expatriates back to Nicaragua; and (v) promote the efficiency and effectiveness of external resource mobilization, given the likely dependence of Nicaragua on external aid in the medium term.

41. Given the need for profound structural reforms and to ensure a rapid transfer of resources, the bulk of the IDA funds initially will be made available through quick disbursing, policy-based credits. These policy-based operations will be designed to attract cofinancing or parallel financing in order to maximize external resource mobilization. The magnitude of the base case IDA lending program is determined by the amount of available IDA resources. In consideration of the special circumstances facing the country, Nicaragua has obtained a special allocation from IDA under the Ninth Replenishment, for the three year period FY92 - FY94. For FY95 and FY96, the requirement for IDA funds would be reduced, as the external balance of the country is expected to improve.

42. Upon successful implementation of the proposed Economic Recovery Credit (ERC), a follow-up structural adjustment credit is proposed for early FY93 to help the Government to deepen the adjustment process. Like the proposed ERC, this second IDA credit is expected to be supported through cofinancing and/or parallel lending from other donors on concessionary terms. Based on an intensive and well-focussed economic and sector work program (see para. 44), sectoral operations also would be prepared for Board presentation as soon as basic macroeconomic reform had occurred and the adjustment process was in place. Depending on the size of the available IDA resources, pivotal operations in the social sector, agriculture and infrastructure are being considered for the period FY92-FY94. The former is essential to poverty alleviation and human resource development, and the latter two credits are critical to achieving sustained growth and a resurgent private sector. For FY95 or FY96, an environmental project is envisaged. Both the "fifth and sixth dimension" IDA facilities could be utilized to broaden the assistance program, encourage greater concessionary flows from other donors, and strengthen burden sharing.

43. This IDA credit strategy is designed both to support the Government's objective of economic reform and to marshall the external resources needed to carry out this demanding agenda. It is critical, however, that the program "stay on track." Should significant policy slippages occur, a reassessment would be made of IDA's assistance role in Nicaragua. Under such circumstances, IDA might be able to consider a much reduced level of core credit operations focussing on the alleviation of poverty and on the environment.

44. To establish a sound analytical framework for the proposed future operations and continuation of the policy dialogue, an expanded economic and sector work program will restore the Bank's knowledge of the Nicaraguan economy following the lapse in relations in the early 1980s. A Public Sector Expenditure Review is currently being undertaken which will be followed later

in FY92 by reviews of the social sector, agriculture and infrastructure issues. In FY92-FY96, work would focus on (i) the mix and sequence of adjustment actions (through studies on the financial sector, public sector decentralization and the regulatory framework); (ii) reactivation of the private sector; (iii) poverty issues; and (iv) the environment.

45. For the past year, the Consultative Group has focussed on emergency assistance, the government's economic recovery effort, and mechanisms for clearing arrears to the International Financial Institutions. In the medium-term, the donor community faces the difficult tasks of supporting the reform effort, and helping to close the financing gap of about US$425 million per year (see para. 123). Recent bilateral support has focussed on balance of payment support, but will shift in the future to areas such as private sector development, education, municipal development, and natural resources.

46. Currently, IFC has two investments in Nicaragua, a sugar plantation and a hotel in Managua. The corporation is exploring, with both local and foreign private sector sponsors, the possibility of developing projects primarily in mining, aquaculture, and private energy generation.

II. THE GOVERNMENT'S STRUCTURAL ADJUSTMENT PROGRAM

47. The proposed ERC would support the Government's policies contained in the Structural Adjustment Program, which was designed in close cooperation with IDA. The program aims to reorient the economy toward competitive markets and improving incentives for private sector participation. The policies to be supported under the ERC are mainly in three specific areas, including: (i) public sector size and efficiency, (ii) the financial system; and (iii) the system of incentives. The program is described in the Government's Letter of Development Policy (Annex C). The details of the program in each general area are given below.

Public Sector Reforms

48. The Government's overall strategy toward organizing the economy and economic growth necessitates a major change in the public sector's role. While the state sector is expected to reduce its involvement in the economy in terms of ownership and regulatory responsibilities, the resources channeled through the public sector also must be reduced. Under the public sector reform, the program addresses issues that relate to public expenditures and revenue, public sector employment, and privatization.

49. The resources used in public sector expenditures are considerably higher than international and regional norms and are inconsistent with the Government's adjustment strategy. In 1990, for example, central government expenditures, excluding interest payments and activities of public utilities and other public enterprises, were around one third of GDP. As a result, the

potential growth of the private sector was crowded out, the public sector was burdened by large management responsibilities, and the resulting fiscal balances were unsustainable due to shortfalls in revenue performance.

50. The distribution of public expenditures between current and capital expenditures raises additional issues. For 1991, approximately 88 percent of projected budgetary expenditures are recurrent, leaving only about 12 percent for capital expenditures. Personnel-related expenditures comprise nearly 50 percent of current expenditures.

51. The authorities already have reduced the size of current budget expenditures. Cuts were effected in the 1991 budget compared to the (budgeted and non-budgeted) expenditures of the central government in 1990 (para. 22). The objective is to establish a balance between the revenue and non-interest current expenditures of the Central Government by 1993. Beginning in 1994, the central government is expected to be a net saver in its non-interest current account transactions. As a first step, the authorities have prepared, prior to Board presentation, a FY92 budget which reduces current expenditures to US$325 million equivalent in 1992 (para. 97 A.(i)). This corresponds to a current expenditure budget which is about 7 percent lower in current dollar terms in 1992. The level of current expenditures will be reduced by another 9 percent in 1993. The implied deficit of the central government is entirely consistent with anticipated donor grants and balance of payments assistance. Therefore, the envisaged fiscal adjustment would support the objective of price stability. The authorities are prepared to make further downward adjustments in expenditures to maintain the fiscal balance if there is a downfall in anticipated resources.

52. In the FY92 budget to be adopted by the Government, non-interest current expenditures would not exceed US$325 million equivalent (<u>second tranche release condition</u>; para. 97 B.(i)), compared with US$338 million equivalent in FY91. (This latter figure represents a major reduction in the FY91 budget adopted by the Assembly, and is in line with the targets of the stabilization program.) The budget reductions should be through carefully targeted expenditure cuts rather than across-the-board cuts. Therefore, savings will have to come through selected reductions in government activities. In the current budget, the projected expenditures in 1991 indicate a 45 percent decline in real terms in military spending and a 25 percent reduction in spending on internal security, compared to 1990. In the FY92 budget, with further cuts in the military expenditures, the share of civilian expenditures is expected to be around 87 percent of the non-interest current expenditures. While this corresponds to a 1 percent increase in the relative share of civilian expenditures, these are being reduced by the equivalent of US$16 million between 1991 and 1992. Expenditure reductions on vehicle maintenance and operation, water and utilities, and other areas will affect all spending units. Also, certain transfers from the budget, such as salary supplements, will be reduced. To achieve a more comprehensive expenditure restructuring, the authorities are undertaking a public expenditure review, with IDA assistance. The size, sectoral composition and distribution, and the institutional aspects of public expenditures will be reviewed. Agreement on implementing the recommendations of the public

expenditure review will provide the basis for the further restructuring of public expenditures (second tranche release condition; para. 97 B. (i)).

53. The Government will also undertake medium-term measures to strengthen the institutional capabilities of the line ministries and central ministries for better expenditure planning. Shortcomings exist in the current expenditure planning and monitoring practices. For example, links between the Ministry of Finance and the spending ministries in budget collaboration are unclear. A relevant macroeconomic framework for the preparation of a given year's budget is also missing. Moreover, the Ministry of Finance does not sufficiently monitor expenditures, except for ad hoc decisions on cuts. Other institutional issues involve the inadequacy of budgetary formats, the lack of public expenditures coverage other than of the central government, and the process of project selection in the public sector. These issues will be addressed in the context of the public expenditure review (para. 44).

54. Public sector employment requires particular attention. Without a significant reduction in employees, expenditure restructuring objectives cannot be fully met. As a result of political pressures stemming from strong unionization under the previous administration, public sector employment swelled, particularly in low skill areas. As of end 1990, approximately 69,000 people were employed by the central government and more than 75,000 workers were employed in state enterprises. Public sector salaries are high for unskilled workers and relatively low for technical levels. This has induced a substantial outflow of skilled workers, leaving the public sector with an extremely large over-paid and unskilled labor force. Though unionization is illegal for public employees, this restriction was circumvented by the previous Government with the formation of the National Association of Employees, a de facto union. This Association obtained extremely generous wage increases in the last months of the former regime and exerts strong political pressure for wage increases. The Association has also extracted a concession in the Concertacion Agreement which restricts the dismissal of government employees (para. 9).

55. To surmount labor market rigidities, the Government has introduced an Employment Reconversion Program (with direct funding from the USAID) to release about 9,000 of the 69,000 central government employees, with an additional reduction of 3,000 in the defense sector during 1991. A reduction of this size would reduce the share of the central government budget in GDP by about two percent. The initial reaction of the employees to this voluntary retirement program has been encouraging. The processing of voluntary employment reduction in the public sector for 8,000 personnel has been completed prior to Board presentation (para. 97 A. (ii)). The Government has now agreed with USAID to include the general public sector, including the banking sector, in the Employment Reconversion Program. The Government plans to continue the Employment Reconversion Program in 1992, with a stronger focus on state-owned financial institutions, public utility companies, and state enterprises. This second phase of the program to be implemented in 1992, which is also expected to be funded by the USAID, aims to reduce public sector employment by an additional 10,000 people. At the same time, the Government will implement a freeze on hiring new employees to replace those who leave the

services through retirement and resignation. It will continue also to gradually raise the work day to eight hours in the public sector.

56. The recovery and maintenance of government revenue will play a key role in the feasibility of attaining the stabilization targets, as well as in assuring non-inflationary financing of the government programs. Major improvements are necessary to overcome the weakness of tax administration. The General Directorate of Revenues and the General Directorate of Customs lack the organizational structure and the human capital base to implement a much-needed modernization program for tax administration. The high concentration of tax collections demonstrates tax administration weakness. In 1989, 84 percent of total tax collection was concentrated in 125 taxpayers. 92 percent of Selective Consumption Tax (SCT) collection was from 10 taxpayers mainly in fiscal industries, such as cigarettes and liquor. Tax collection is still heavily dependent on ad-hoc applications of SCT and the General Value Tax (GVT).

57. The Government has been working on a program to improve tax administration which will include organizational and procedural changes, as well as the formation of a team of well-trained specialists in tax administration, improving the judiciary process, and raising penalties for tax evasion. The Government has initiated an action plan, satisfactory to IDA, to improve tax administration (para. 97 A. (iii)). The Government has set up a separate unit within the General Directorate of Revenue to administer closely the taxes collected from the 280 largest taxpayers. This separate unit, will serve as a pilot project for the development of a modernized tax administration system. The experience from this operation will be extended to the entire system. Also, several customs posts recently have been relocated closer to the frontiers in order to improve collection.

58. The program for improving tax administration and enforcement includes both short and long-term steps. The authorities are planning by October 1991 to distribute and implement simplified tax declaration/payment forms and procedures, decree stricter sanctions for tax evasion and delinquent practices of businesses, and to revise the penalty structure for tax evasion and delayed tax payments based on the fiscal cost of the infraction and the lateness of payments. All tax administration and enforcement measures, as well as the full operation of the unit for large taxpayers, form a second tranche release condition (para. 97 B. (ii)). The customs valuation lists will be revised to reflect the changes in value, and will be updated on a monthly basis.

59. The above measures will provide a more reliable basis for tax assessment and enforcement. These short to medium-term measures will be supplemented by measures addressing the main institutional weaknesses in tax administration. To this end, the authorities are trying to develop automated management control systems and a computerized taxpayer identification system. Also, programs are being designed to train Internal Revenue and Customs personnel. A project for technical assistance is under negotiation with the IDB. The Government will finalize the arrangements for technical assistance by March 1992, hire consultants, and start implementing the project to improve

tax administration. Initiation of these long-term programs is a second tranche release condition (para. 97 B. (ii)).

60. In addition to 15 public utilities, the new Government inherited approximately 350 companies engaged in various activities ranging from agricultural production to manufacturing, and from mining to trade services. These companies are collectively known as the Area de Propiedad del Pueblo (APP). The larger enterprises in APP were expropriated from the Somoza family while others were acquired as a result of the agrarian reform, the confiscation of assets "abandoned" by their owners, and through other means. The Government's strategy is to privatize APP companies, but retain ownership of public utilities.

61. There is considerable scope for improvement in the performance of public utilities. Since they lack an overall regulatory framework, piecemeal distortional interventions are the norm. Public utilities have been given autonomy to set the tariffs for the services they provide, without having a framework to define their operation as natural monopolies. This allows them to pass on their inefficiencies and to realize monopoly rents at the expense of consumers and producers. They are also exempted from income taxes and from taxes on goods and services, including trade taxes. Organized power structures and political agendas in these enterprises still remain highly influential. In addition, management capabilities and technical skills are scarce and capital stock is run-down.

62. The necessary major restructuring of the public utilities will be based on the recommendations of a study to be conducted by the Government with grant funding and IDA support. The recommendations would help establish a regulatory framework defining the relations between the government and enterprises based on the principles of autonomy and accountability. The review would cover the establishment of efficient pricing practices for natural monopolies and would investigate the possibilities of competitive contracting-out alternatives to improve accountability in the operation of public utilities. Other areas include upgrading of management capabilities, improving the human capital base of public utilities, assessing production capabilities to create a minimum investment program for upgrading them, and preparing action plans for implementation. The study is expected to be initiated before March 1992. Its conclusions and recommendations may be included in the follow-up structural adjustment credit (para. 42).

63. In addition to public utilities, the core economic activities in the country were nationalized by the former government, and put under APP. State control of production led to heavy political intervention, contraction of production, technological backwardness and excessive employment in both manufacturing and agriculture. By conservative estimates, more than 30 percent of GDP was produced by state enterprises, excluding those in the financial sector. The state controlled 45 percent of value added in manufacturing, 70 percent in mining, and a smaller portion in agriculture.

64. The privatization of the APP enterprises is a major component of the Government's strategy for structural adjustment. Privatization involves the sale of companies legally owned by the government, the return of

confiscated companies to their legal owners, and liquidation. By divesting these entities, the Government aims to reduce the share of the public sector in the economy, lessen its administration and management responsibilities, and earn additional revenue for the budget. The combination of a smaller role for the state and a reinvigorated private sector in a competitive framework is expected to create efficiency gains and employment. One of the earlier steps taken by the new Government was to set up Junta General de Corporaciones Nacionales del Area Pública (CORNAP) and charge it with carrying out the privatization process.

65. The process of preparing these companies for privatization has proven to be difficult and time consuming due to legal, technical, political, and financial considerations. A major obstacle to privatizing the non-agricultural companies has been the procedure for determining whether the Government legitimately owns a company. The former administration established de facto ownership of a number of companies without going through channels that are now regarded as legitimate. Consequently, the legal ownership status of each company has to be determined before CORNAP can either dispose it or return it to its former owner. This task, together with the work required to establish a data base on the companies under its umbrella, have occupied most of CORNAP's management time and resources. In addition, the Government's sensitivity to the demands of the labor employed by these companies has been a factor slowing down the process.

66. After a lengthy preparation period, CORNAP has developed a broad privatization strategy which has been adopted by the Government (para. 97 A. (v)). Out of about 350 companies covered by this strategy, 152 are candidates for privatization through sale to private parties. Of the remaining companies, around 70 are to be returned to their legal owners, 50 are to be liquidated, more than 30 are to be assigned to some government departments, and the rest are to be partly privatized and partly returned to private owners. To date, 86 companies have been divested, of which, 23 given back to previous owners, 34 partly privatized and partly returned to owners, 26 either liquidated or assigned to ministries, and 3 fully privatized. The most important action completed involved privatization of three large-scale agricultural corporations, including the HATONIC (the largest cattle operation), AGROEXCO (agricultural export company), and CAFENIC (coffee growing and processing). The properties of these corporations were distributed among the previous owners, workers, army retirees, and the demobilized resistance forces, based on agreement between the parties involved and the Government.

67. The Government's program will include 90 percent of state-owned companies in the privatization process by end-1993. The authorities have identified interim targets for mid-March 1992. By that date the process of divestiture will be completed in an additional 75 companies, out of which 25 companies will be fully privatized, while devolution or liquidation will be completed in the remaining 50 companies. Finally, another 30 companies will also have been prepared for sale by the same date (second tranche release condition; para. 97 B. (iii)). Once these interim targets are achieved, the relative importance of the state-owned companies in total GDP will decline from about 30 percent to less than 10 percent.

Financial Sector Reform

68. The Government considers financial sector reform to be central to the adjustment process and the stabilization effort because it has implications for resource allocation and money creation. Changes in production incentives implemented through the structural adjustment polices will create a demand for financial services that the existing state owned financial system cannot meet. A stronger and more diversified financial system concentrated in the private sector must develop based on free-market principles.

69. By 1979, Nicaragua had one of the most advanced financial systems in Central America. A mix of state, private national, and foreign subsidiary banks offered many financial services, including sight deposits, term deposits, transfers, and insurance. Even the inefficient state institutions earned positive rents during the period, while barriers to entry in the financial system created high rents for the more efficient private sector. After taking power in July 1979, the Sandinista government progressively changed the structure of the financial system by eliminating private sector financial institutions, transferring control of state bank operations to a holding company (which evolved into the Corporación Financiera de Nicaragua, CORFIN), and progressively reducing to five, the number of financial institutions: Banco Nacional de Desarrollo (BND), Banco Nicaragüense de Industria y Comercio (BNIC), Banco Popular (BP), Banco Inmobiliario (BIN), and the investment lending institution Fondo Nicaragüense de Inversión (FNI).

70. The state-owned banks were also functioning in specific sectors. BND serviced the agriculture and livestock sectors, BNIC the industrial and commercial sectors, BP the small scale sector, and BIN the housing sector. The complete specialization of the banks in 1985 further reduced management incentives to improve the quality or efficiency of their operations. Managers rolled over poor or nonperforming loans to maintain the flow of financial resources to targeted sectors. Moreover, periodic Government forgiveness or rescheduling of overdue loans and persistently negative real interest rates on loans eliminated any incentive for management to seek high return projects for their investments.

71. A cornerstone of the Government's program to reform the financial system is a restructuring of the state owned banks, along with the cessation of Central Bank subsidies and discounts. The Government initiated an evaluation of the state banks to outline a restructuring program, which has been adopted (para. 97 A. (vii)). The plan includes the following objectives: (i) a rechartering of BND and BP to noncommercial institutions within two years; (ii) the liquidation or merger of BIN with BNIC (second tranche release condition; para. 97 B. (iv)); (iii) the downsizing and restructuring of BNIC as a commercial banking institution; (iv) the restoration of FNI to a second tier institution; and (v) the dissolution of CORFIN (second tranche release condition; para. 97 B. (iv)). The rechartered BND and BP institutions would be financed by external grants and domestic resources, and would deliver technical and financial services for agricultural development and small scale industry, respectively. Initiation of these steps is a second tranche release condition (para. 97 B. (iv)). The Government is aware of the importance of

eliminating special support to the public banks to attract competitive and universal private sector banks to Nicaragua in the short-term.

72. The Government has emphasized laying the legal and regulatory groundwork for a new Superintendency of the banking system. In April 1991 a law to create the Superintendency and Financial Institutions was passed. Regulations recently adopted address the shortcomings in that law by reducing the discretionary powers of the Superintendency. The regulations will also reduce potential political interference in the functions of the Superintendent stemming from the role of the Superintendency Board (mainly composed of Cabinet Ministers) in the decision-making process. A Superintendent was appointed and operations of the Superintendency were initiated, both satisfactory to IDA, prior to Board presentation (para. 97 A. (vi)). According to the Government's plans, by October 1991, the Superintendent will have issued normatives to initiate private banking operations, and by December 1991, the Superintendent will have approved at least two applications for private banks (second tranche release condition; para. 97 B. (iv)).

73. The legal framework to establish a private sector financial system will be completed by creating a modern and comprehensive Law of Banking and Financial Institutions. This law will replace the outdated 1963 banking law and will authorize the privatization of state-owned banks. Until the law is drafted and implemented, the Superintendent will have to issue provisional and partial prudential regulations in order to issue licenses in the financial sector. The Government recognizes the urgency of completing the law as soon as possible. A draft law will be presented to the national assembly early next year (second tranche release condition; para. 97 B. (iv)).

74. The Government recognizes that prolonging the current system of interest rate controls both precludes development of strong and diversified private sector banking institutions and major improvement in resource allocation. However, an immediate liberalization of interest rates while the economy is stabilizing, could disrupt economic activity and discourage the evolution of stable financial institutions. Therefore, the Government plans to pursue an interest rate reform with the following objectives: (i) maintenance of positive real interest rates in the short-term; (ii) introduction of a flexible interest rate policy by March of 1992; and (iii) gradual liberalization of interest rates for all financial institutions with the development of a multibank system under Superintendency supervision.

75. The Government introduced a new interest rate policy in April 1991. At that time, deposit rates were established at 12 percent and indexed to the US dollar. Short-term lending rates were unified and indexed to the dollar at 18 percent. A second 30-day deposit instrument was introduced without indexation at 25 percent interest. The rate of interest has been progressively reduced since that time. Between April 11 and April 30, 1991, the Government attracted 47 million cordobas oro through the 30-day deposit instrument. The interest rate on this window of operations will continue to be reduced on a monthly basis as the rate of inflation declines.

76. Until stabilization is achieved and a fully functioning system is completed, the authorities will continue to manage interest rates, but with

greater flexibility. By March of next year, the Government intends to implement the next stage of its interest liberalization policy. This stage includes completely freeing deposit rates, maintaining a band on lending rates equivalent to interest rates on loans of similar maturity in the US adjusted for country and currency risk, and pursuing a rediscount policy which maintains a uniform rate on rediscounts higher than the average financial system interest rate prevailing on deposits. These measures will encourage banks to compete for deposits and borrowers.

<u>Reforms of System of Incentives</u>

77. The Government strategy will also focus on the system of incentives. Policy changes in the areas of trade regime, tax structure, and the domestic regulatory framework are needed. The Government inherited a <u>trade regime</u> under which foreign trade was practically closed to the private sector. Incentives were significantly biased toward import substitution. The old incentives system, coupled with exchange controls and arbitrary variations in the real exchange rate, has caused a decrease in the production of tradeables and a reduction of exports to 50 percent of their 1978 level. During the past decade, most international trade was performed by the state trading companies. These companies monopolized exports of traditional products (coffee, cotton, sugar, bananas, cattle, precious metals, seafood and forestry products), and accounted for up to 98 percent of exports in some years.

78. On the import side, state-owned trading companies administered trade with the Eastern block and imports of international donations. In 1989, these companies accounted for 56 percent of total imports, including a monopoly on imports of oil and fertilizers. Import quotas and prohibitions existed only for basic grains and related products, while some export quotas and prohibitions applied to forestry, fisheries, and cattle. Private parties were marginally involved in foreign trade under discretionary allocation/retention of foreign exchange within a system of multiple exchange rates and arbitrary trade credit rationing. Private importers had to register officially at the Ministry of External Trade and had to get specific import permits from the Central Bank. Nominal import protection was nontransparent and widely differentiated. It ranged from 4 percent to 253 percent, averaging 48 percent.

79. The Government has moved boldly to liberalize and deregulate trade. After the drastic devaluation of the exchange rate, beginning March 3, 1991, foreign exchange allocation mechanisms were liberalized significantly. Importers need neither ministerial nor Central Bank permits to have access to foreign exchange. All exporters, except cotton and coffee exporters, have full access to the foreign exchange that they generate. The state trading monopolies, which controlled virtually all export and most import trade during the 1980s, were eliminated by a decree in January, 1991, opening trade to private sector participation.

80. The authorities have also reduced trade protectionism and increased trade regime transparency. The ceiling on tariffs was reduced to 20

percent, and most of the administratively granted import tariff exemptions were eliminated. Transparency was increased by eliminating the SCT for domestic production and keeping it as an import surcharge for most imports. These measures lowered the nominal protection range to 3-143 percent and the average protection to 18 percent, the second lowest in Central America. The dispersion was also lowered. Now 66 percent of tariff positions vary between 3 percent and 40 percent.

81. The Government recently announced the next steps for a coherent medium-term program of trade liberalization and deregulation. In accordance with this program, the Government has reduced nominal import protection to a 10-60 percent range, by a combination of changes in the SCT and tariffs prior to Board presentation (para. 97 A. (viii)). Only medicines, newsprint and books will be exempted from the 10 percent tax/tariff. Also, prior to Board presentation: (i) the Government has made a public announcement specifying that, by December 1993, nominal import protection will be reduced to 10-20 percent range, while the SCT and the stamp tax will be eliminated (para. 97 A. (viii)); (ii) the Government has approved regulations to ensure automatic registration for imports and exports (para. 97 A. (ix)). According to the program, by March 1992, nominal import protection will be further reduced to the range of 10-40 percent. This will be a second tranche release condition (para. 97 B. (v)); and (iii) to lower nominal import protection dispersion and increase tax collections, the Government has established a timetable, satisfactory to IDA, to eliminate indirect tax exemptions including import tax exemptions and has removed income tax exemptions (para. 97 A. (iv)).

82. Regarding agricultural trade liberalization, the authorities have designed a price-based mechanism with variable levies for rice, yellow corn, and white maize (para. 97 A. (x)). The mechanism will be implemented before March 1992. Simultaneously, all remaining quantitative restrictions on food and grain imports will be eliminated prior to second tranche release (para. 97 B. (vi)). The Government's trade liberalization program will establish free-trade status for exporters by exempting them from import and domestic indirect taxes through a decree on export promotion which will be fully applied by March 1992. To liberalize the foreign exchange market, the same decree will eliminate foreign exchange surrender requirements for exporters.

83. The new Government inherited a highly discretionary, complex, and severely distorted tax system that compounded distortions in the trade regime. The Corporate Income Tax (CIT) had highly differentiated and high marginal rates, *ad hoc* exemptions, and incentives. The Personal Income Tax (PIT) system compounded the above distortions through multiple bases, excessive brackets, extremely high marginal rates, double taxation of dividends, and exemptions for interest income. The GVT aimed to be a value added tax, but because of its multiple exemptions, multiple rates, and weak administration, arbitrary distortions throughout the economic system resulted. The SCT exacerbated distortions because it was applied to about 700 goods with differential (higher) rates for imports and extremely high rates for the fiscal industries (soft drinks, beers, rums, cigarettes, and oil derivatives).

84. During the second half of 1990, the new Government enacted a broad tax reform to address most of the above distortions. It rationalized the

income tax regime by eliminating some tax exemptions and most fiscal incentives. To do this, the Government unified the CIT rate and equalized it to the maximum PIT rate at 38.5 percent. The PIT was simplified and changed to a global base. To increase the income tax base, the Government implemented new presumptive income tax collection methods. The GVT base was extended to additional services and the rate was raised and unified at 15 percent. The SCT was eliminated for all but the fiscal industries and the tax on imports was retained as a temporary surcharge. Indexing the tax system to the Cordoba Oro was an appropriate transitory solution to avoid the impact of high inflation on tax yields. In addition, by the end of 1990, the Government improved the withholding and advancement system of income tax collection to minimize the lag between accruals and collections. This improvement aimed to avoid the possible negative effects of accelerated inflation on collections. In June 1991, the Government reduced the maximum rate of PIT and the flat rate of CIT to 35.5 percent. Gradually, the Government will continue lowering it to approximately 33 percent. This internationally competitive rate would not deter foreign investment nor the repatriation of capital from Nicaraguans abroad. The tax system currently conforms to international standards and has the basic safeguards to avoid lagging collections in the presence of accelerated inflation. Currently, no major additional change in the tax system is required.

85. The third aspect of the policies to improve incentives entails changes in domestic regulatory practices. Some state-owned enterprises have had a *de facto* monopoly in production and trade, for example, the sugar, bananas, and slaughtering house sectors. State-owned enterprises in natural resource sectors have regulatory powers to limit market entry and exports of private sector firms. The Government has also inherited a system of generalized price controls, closed markets, and interventions by the ENABAS in regulating agricultural products and derivatives. In addition to the measures to liberalize imports (para. 80), the Government has lifted domestic price controls, with the exception of fiscal industries, and petroleum and public utilities. However, for a reduced group of basic staples, the authorities set prices in government-owned retail outlets as part of the strategy to alleviate inflation.

86. Though ENABAS intervenes much less in the market, it still dominates the domestic and foreign trade of basic grains. ENABAS has privileged access to the import permits that regulate basic grains. This enables it to control the domestic supply of basic grains and to establish its price support policy for domestic grains producers. This intervention has caused wide fluctuations in nominal protection for basic grains. The Government is aware of the negative effects of ENABAS' market intervention. Policy changes being introduced are designed to encourage competition in the international and domestic trade of basic grains.

87. The Government will eliminate *de facto* state production and trade monopolies via the privatization of state-owned enterprises in sugar, bananas, and slaughtering houses. The state institutes for mining and fisheries will be transferred to the Ministry of Economy, after separating its production and trade activities. The Ministry of Economy is studying ways to regulate natural resources.

88. The Government plans to eliminate transitory price setting adopted for selected products in Government owned stores before March 1992. Prior to March 1992 the Government intends to present an action plan to phase out price controls of the fiscal industries and reformulate the SCT, thereby confining it to luxury and sin goods regardless of origin. The legal framework permitting generalized price controls will be abrogated by the same date.

89. As part of its overall development policy, the Government's plan to reduce and change the role of ENABAS calls for support prices for all to be eliminated by August 1991. ENABAS will buy grains at market prices and offer storage and related services to private traders and producers for a fee. It may also rent out part of its facilities. In addition, ENABAS will offer private traders the service of importing on their behalf (bundling orders). ENABAS will stop trading in all but basic grains. A program for privatizing its retail and wholesale outlets will be prepared by the end of 1991. According to the Government's plan, at least 20 percent of its assets will be sold to wholesalers or distributed as part of severance payments to ENABAS employees by March 1992. The remainder will be divested before the end of 1992. The Government is designing a medium-term strategy and an action plan for redefining the future role of ENABAS. ENABAS' intervention in regional grain markets will be restricted to markets where private competition is insufficient and ENABAS' facilities will be privatized and/or leased where competitive private participation is ensured.

Social Sector Requirements and Poverty Alleviation

90. The recent economic decline has caused sharp deterioration in nutrition standards and the provision of basic services. Since 1985, calorie and protein intake per capita fell by 30 percent. They were 14 percent and 25 percent, respectively, below minimum recommended levels in 1989. The infant mortality rate, at 61 per thousand, is high by Latin American standards. Education coverage also remains poor; 24 percent of the children 10 years or older are not enrolled in school. An even greater percentage attend school irregularly. The dropout rate is high, especially at the primary level.

91. Nicaragua, with one of the lowest per capita incomes in Latin America and years of deterioration in the provision of basic services, cannot afford to wait until the end of adjustment to address the needs of the vulnerable segments of the population. Moreover, these groups will be affected adversely by the implementation of the stabilization program, which includes cuts in public sector employment and spending, as well as price adjustments. The Government has already taken initial steps to attack poverty. In November 1990 it created the Social Emergency Investment Fund (FISE) as a mechanism to channel donor funds toward urgently needed social projects. FISE operates directly under the Office of the Presidency and serves as a financial intermediary with auditing responsibility, but not as a project executing agency. It channels resources for primary health care, primary nutrition, retraining and micro-enterprise credit. It tries to stimulate local governments, private sector grass-roots organizations, and NGOs to participate in projects.

92. FISE has identified areas of critical poverty and targeted resources toward these most critical areas. The fund started its operations, mobilizing US$15 million from the external and local donors. It has committed US$4.5 million in the first quarter of 1991; 32 projects are already underway with an additional 62 projects scheduled for the rest of 1991. For FISE to continue, additional donor funding is required once the available resources are exhausted.

93. The Fund for Assistance to Oppressed Sectors (FASO), a more recent government creation, will provide immediate relief to poverty groups. Some pledges have been made to FASO by nine OECD member governments, but no program has yet begun operations. For now, the Vice Ministry of Social Affairs, an integral part of the Office of the Presidency which is managing FASO during its initial phase, has received UNDP and bilateral assistance. This will help strengthen social sector management, monitoring, and evaluation to prepare for efficient use of donor assistance.

94. The Government also needs to address severe nutrition problems of the poorest segments of the population. In 1985, 31 percent of the population was classified as poor and 23 percent were living under extreme poverty. The poverty status is certainly worse today, after two failed attempts at stabilization and continuous deterioration in production and employment opportunities since 1985. The authorities are addressing nutrition needs by: (i) retargeting eligibility to AFA (a food delivery program) to reach the poorest segments of the population; (ii) gradually eliminating food distribution in the work place and increasing distribution through health centers, NGOs, and churches where the poor can be reached; (iii) improving the logistics of the World Food Program sponsored mother/child program (PMA); (iv) increasing the nutritional content and improving targeting of the "glass of milk program" by introducing a solid enriched food or cookie to accompany the glass of milk; and (v) developing a weaning food to replace the currently used food ("atole") that has very low nutritional content.

95. Despite relatively high public spending in the past on health and education, the quality of services remains low. IDA is preparing a social sector operation which would support social sector rehabilitation and improve sector management, human resource development, basic infrastructure needs for classrooms, health posts, and health equipment (para. 42).

XII. THE PROPOSED ECONOMIC RECOVERY CREDIT

Objective and Size of the Credit

96. The proposed ERC aims to support the Government of Nicaragua in its endeavors to arrest the ongoing decline in the economy, to achieve lasting price stability, and to revive economic growth on a sustained basis. This is to be achieved with deep structural reforms that would help reorient the economy toward a competitive free-market. This will necessitate changes in macroeconomic policies, the public sector, financial sector, and the system of

incentives. The proposed ERC focuses on the most important areas of reform as described in previous sections and summarized in the Matrix of Actions (Annex D). As shown in Annex D, the Government has taken considerable up front action to implement its program. The size of the Credit is relatively large at SDR 83.5 million (US$110 million equivalent) in order to respond to the Government's demonstrated initiative, play an important catalytic role in mobilizing external assistance for the clearance of arrears to the international financial institutions, and provide sufficient program support. The operation will also receive significant co-financing (para. 103).

Conditions for Tranche Release

97. The Credit proceeds will be disbursed in two tranches, each tranche being SDR 41.75 million (US$55 million equivalent). The closing date will be end-December 1992. The first tranche will be available for disbursement upon credit effectiveness (para. 98), and the second tranche will be available for disbursement after six to eight months and the completion of the second tranche conditions. A summary of the proposed actions to be supported by each tranche release is presented below. In addition to the monitorable actions specified below, the release of both tranches will be contingent upon the maintenance of an appropriate macroeconomic framework and satisfactory performance in overall program implementation as outlined in the Letter of Development Policy (Annex C) attached.

A. Policy actions taken before Board presentation:

(i) Central Government non-interest current expenditures in the proposed FY92 budget were reduced to US$325 million equivalent; agreement with IDA on the composition of the proposed budget of the Central Government for FY92 (paras. 51, 52);

(ii) The processing of voluntary employment reduction in the public sector was completed for 8,000 personnel (para. 55);

(iii) The Government initiated an action plan, satisfactory to IDA, to improve tax administration with specific emphasis on General Value Tax (GVT) and income tax collection (para. 57);

(iv) Income tax exemptions were removed, and a satisfactory timetable was approved to phase out indirect tax exemptions including import tax exemptions (para. 81);

(v) The Government has adopted an action plan satisfactory to IDA, to privatize CORNAP enterprises (para. 66);

(vi) Regulations for the implementation of the Superintendency Law were adopted, the Superintendent was appointed and the

Banking Superintendency activities have been initiated, all satisfactory to IDA (para. 72);

(vii) The Government adopted an action program, satisfactory to IDA, on restructuring of state-owned banks, along with cessation of Central Bank subsidies and discounts (para. 71);

(viii) The Government lowered nominal protection in the trade sector to a range of 10-60 percent through a combination of reductions in the levels of tariffs, SCT, and stamp tax; and it announced a target tariff range of 10-20 percent and elimination of SCT and stamp tax on imports by the end-1993 (para. 81);

(ix) Arrangements for automatic registration for importers and exporters were approved (para. 81); and

(x) A proposal was presented to IDA for a price-based mechanism with variable levies for rice, yellow corn and white maize (para. 82).

B. Policy actions to be taken before second tranche:

(i) Adoption of (a) FY92 budget with reduced Central Government non-interest current expenditures less than US$325 million equivalent and (b) agreement on implementing the recommendations of the joint Government-IDA public expenditure review (para. 52);

(ii) Implementation of measures to strengthen tax administration, including (a) full operation of unit for large taxpayers; (b) issuing of decrees on sanctions applying to delayed payment and non-compliance; and (c) initiating programs on automated management control system, computerized taxpayer identification system, and training programs for Internal Revenue and Customs personnel (paras. 58-59).

(iii) Implementation of privatization of CORNAP state-owned companies through (a) completion of privatization of additional 25 state-owned companies; (b) finalization of devolution, liquidation, or assignation of another 50 companies; and (c) initiation of concrete steps towards the preparation of an additional 30 companies for privatization (para. 67).

(iv) Carrying out financial sector reforms including, (a) liquidation or merger of Banco Inmobiliario with Banco Nicaragüense de Industria y Comercio, (b) dissolution of Corporación Financiera de Nicaragua (CORFIN), (c) initiation of steps towards the restructuring of Banco Nicaragüense de

Industria y Comercio, Banco Nacional de Desarrollo, and Banco Popular according to agreed action plan, (d) submission to the National Assembly of a draft law, satisfactory to IDA, on Banking and Financial Institutions, and (e) issuance of at least two licenses to private banks (paras. 71,72,73).

(v) The protection resulting from combined tariffs and taxes that apply to imports in Nicaragua will be reduced to a minimum of 10 percent and a maximum of 40 percent, except with respect to medicines, books and newsprint which may be exempt from such tariffs and taxes or subject to tariffs and taxes at a combined rate lower than the minimum rate referred to above (para. 81).

(vi) Replacement of import quotas on rice, yellow corn and white maize for a price based mechanism with variable levies, satisfactory to IDA, and elimination of remaining quantitative restrictions on food grain imports (para. 82).

Procurement, Disbursement and Auditing

98. The proposed ERC of US$110 million would be disbursed to reimburse the CIF cost of general imports (goods and services), excluding goods and services financed by other multilateral or bilateral sources, luxury goods, miliary equipment and other goods specifically prohibited in a negative list defined under the Standard International Trade Classification (SITC). In view of the large number of policy actions taken up front by the Government, and based on the financing requirements of the program, retroactive financing not exceeding SDR 41.75 million (US$55 million equivalent; 50 percent of the Credit amount) is recommended for eligible imports made after November 1, 1990, and before the date of the Agreement.

99. Because of the lack or inadequacy of procurement procedures, a conservative cut-off limit of US$3 million equivalent has been adopted for International Competitive Bidding (ICB). Therefore, imports made by public and private importers valued at the equivalent of US$3 million or more would be procured under simplified ICB procurement procedures in accordance with IDA's procurement guidelines. Public sector imports valued below US$3 million equivalent and above US$1 million equivalent would be procured on the basis of advertised competitive procedures satisfactory to the Association. Public sector imports valued at US$1 million equivalent or less may be procured through comparison of price quotations from at least two suppliers eligible under the Guidelines.

100. Import contracts by private importers, valued at below US$3 million equivalent, shall be awarded in accordance with established commercial practice, requiring comparison of price quotations obtained from at least two eligible suppliers, except in cases where direct contracting is considered appropriate under para. 3.5 of the Guidelines for procurement. Alternatively, such contracts will be subject to pre-shipment verification of quantity,

quality and price by an independent inspection firm acceptable to the Association.

101. Applications for disbursement corresponding to all import contracts paid after November 1, 1990 and before March 1, 1992, below US$3 million equivalent each, shall be supported by a certification by an independent inspection agency acceptable to IDA on the reasonability of the price paid. In the case of crude oil imports, expenditures under ongoing supply contracts entered into by Nicaragua would qualify for reimbursement under the Credit of an amount not to exceed, per unit, the reference price per unit established in commodity markets as reflected in Platt's Oilgram for the relevant shipping date and type of oil.

102. The Central Bank would administer the ERC and be responsible for the collection and review of relevant procurement documentation, ensuring that only imports that meet the eligibility criteria and agreed procurement procedures are included in withdrawal applications. To assist in this work, the Central Bank will retain an experienced procurement consultant. Disbursements against contracts valued under US$1.0 million would be made on the basis of statements of expenditure (SOE). The procurement documentation would be retained by the Central Bank for review by IDA as required and by the auditors to be appointed for the auditing of expenditures at the completion of each tranche. The submission to IDA of an audit report on the first tranche would be a condition of disbursement of the second tranche. Full procurement documentation would be required with withdrawal applications for individual contracts valued at US$1.0 million equivalent or more. Withdrawal applications would be consolidated and submitted in amounts not less than SDR 190,000 (US$250,000 equivalent). Contracts for imports valued under US$5,000 equivalent would be ineligible for financing under the loan.

Co-financing and Aid Coordination

103. As indicated in para. 2, since the new Government assumed office in April 1990, IDA has played a lead role in aid coordination for Nicaragua. Five donor meetings were convened, including the Consultative Group meeting in Paris on May 16-17, 1991. Seventeen bilateral donor representatives and eight international organizations attended the meeting in which agreement on arrears clearance was obtained. The IDB will co-finance the proposed ERC with a US$110 million credit to be disbursed in two tranches. The Governments of Japan (US$70 million), Germany (US$17 million) and Switzerland (US$ 5 million) will co-finance the program. The US Government has pledged more than US$500 million in 1990 for a two-year support, of which some US$300 million has already been disbursed. Other bilateral support will come from, among others, the Nordic countries, Germany, Canada, France, the Netherlands, and Austria. Mexico, Spain, Colombia, and Venezuela are supporting Nicaragua's reform program through bridge financing for arrears clearance.

Relations with International Financial Organizations

104. IDA has worked closely with the IMF and IDB staff in carrying out a policy dialogue with the authorities and toward the preparation of this credit. Regular meetings were held at Headquarters and joint field missions were organized. IDB staff participated in IDA missions for the preparation of ERC, including the June 1991, appraisal mission. IMF staff have also overlapped with IDA missions. The IMF has helped the authorities to design the new stabilization program and to monitor implementation. The track record established on implementation will provide the basis for a stand-by arrangement with the IMF to be presented to the IMF Board during the first half of September. The IMF has also been asked to consider Nicaragua for ESAF eligibility. The anticipated stand-by and ESAF arrangements would provide important additional financing for the Government's program.

Technical Assistance

105. Technical assistance for implementing the program is crucial. Though IDA will not finance the provision of technical assistance, through its leadership in the Consultative Group and its oversight of the adjustment process, it will help organize and direct technical assistance. To facilitate IDA's policy dialogue, ERC implementation, and technical assistance coordination, IDA will set up a Resident Mission in Nicaragua later this year. The Resident Mission will provide support as the Government implements its reform program and help identify institutional weaknesses and human resource requirements. A number of initiatives have already been underway, to address the immediate shortcomings in implementing and monitoring the reform programs and strengthening the institutional framework. To meet the short- term requirements of supporting the stabilization and adjustment program the Government has followed a two-track approach. It has been working through the Consultative Group to identify a minimum set of actions for which short term technical cooperation can provide a useful basis for decision making. Additionally, recognizing that this approach only addresses the immediate gaps, the Government has been working with the UNDP, IDB, selected bilateral agencies, and the international financial institutions to strengthen key ministries.

106. A number of critical tasks will be carried out using, to the extent feasible, the short-term resources that have been made available in recent months. To support the reconstruction of the financial sector, for example, technical cooperation funds will be used to design the banking regulatory framework, and organize the Superintendency of banks. An evaluation of the loan portfolios of the two major state owned banks, as an input for financial sector reform, has already been completed. An external debt management strategy and a related accounting system are being developed. The IDA Public Sector Expenditure Review is expected to recommend, <u>inter-alia</u>, reforms in the 1992 budget cycle. In agriculture, the UNDP/IBRD Regional Unit for Technical Assistance (RUTA) is tackling the issue of property rights by reviewing a cadastral system. It will also evaluate the Government's proposals for developing and disseminating agricultural technology. In the public utilities, a management audit has been completed in the water company

(INAA), where initial efforts in infrastructure rehabilitation are likely to take place.

107. The UNDP and USAID currently are providing longer term technical cooperation funds to staff key ministries. As the implementation of reform programs gets underway, however, ministries will need to add other functions and skills. The Government has entered into consultations with the UNDP Management Development Program (MDP) to provide funds for additional staff. It expects to have these staff in place within six months. In the Ministry of the Presidency, the staff would serve as a small secretariat to the Economic Cabinet to improve coordination across various ministries in the implementation of the program. Other staff would be assigned to the Ministry of Finance to implement budget reforms, and improve expenditure planning, disbursement controls and project evaluation. Other staff would be assigned to customs and revenue offices. In the Ministry of Economy and Development, additional staff are needed to improve the data collection and processing capabilities of key economic indicators, such as price indexes and other short-term indicators of economic activity. The Ministry also needs to strengthen its regulatory capabilities, in particular in the area of natural resources. In the Ministry of External Cooperation, staff are needed to coordinate the technical cooperation process, negotiate with donors, and ensure that conditionality on these grants is met. Finally, the IDB and the IMF have joined together to provide longer term technical cooperation resources to the Central Bank to support macroeconomic policy and to develop accounting and management information systems.

108. Over the longer term, the Government will need to deepen institutional strengthening by developing a merit-based civil service reform and more efficiently utilizing new analytical skills. This is essential to the recruitment and retention of a highly professional civil service, staffed by Nicaraguans. As a first step toward these goals, the Government plans to revitalize the Public Administration Institute under the proposed UNDP Management Development Program (MDP).

Benefits and Risks

109. Economic Benefits. The proposed ERC and the associated co-financing will enable the Government of Nicaragua to implement vital structural adjustment policies, at a time when domestic resource mobilization and foreign exchange to finance are inadequate. These international resources, the adjustment program of in Government, and the re-opening of the U.S. market will permit a rapid, but modest, supply response in the short-run. Without such recovery in supply, stabilizing prices would be impossible without recourse to massive external resource transfers.

110. Implementing the policies supported by the Credit can streamline resource mobilization and use in the medium-term. Reducing the size of the public sector, reforming of the financial system, and deepening trade reform, will reorient Nicaragua's productive structure toward activities with comparative advantage. Establishing an encouraging climate for investment

through sustained stabilization and deregulation/liberalization will induce large-scale private sector participation in the economy. Increased economic activity, coupled with properly functioning markets will alleviate unemployment. Finally, maintaining a sound macroeconomic environment and fully implementing structural adjustment measures would prompt external financing, and private foreign investment for long-term sustained growth.

111. <u>Poverty Alleviation Effects</u>. The Government's reform program should contribute significantly to reducing poverty. In the short-term, eradication of hyperinflation, would arrest the erosion and wild fluctuation of real incomes of the poor. The price stabilization since March has created according to preliminary estimates of the cost of living a relatively less expensive minimum consumption basket, in real terms than before the stabilization package. Land distribution to ex-militia, ex-contras, and workers will also improve the standard of living of these groups. FISE is targeting public work programs to the poorest segments of the population, easing the burden of adjustment.

112. In the medium-term, the structural adjustment program, will also alleviate poverty. The real devaluation, by impacting the profitability of agricultural production, will benefit many low-income rural groups. Trade liberalization and deregulation will reorient the productive structure toward labor intensive activities. Thus labor demand will rise. Moreover, an overall resumption of efficient growth in line with Nicaragua's comparative advantage, will create productive employment.

113. <u>Environmental Effects</u>. The main environmental issue in Nicaragua is the erosion of forests and woodlands. Erosion is rampant in the heavily populated Pacific slopes. The topography and the nature of the soil there make the land very vulnerable to inappropriate agricultural practices. Between 5 and 10 percent of all agricultural land is estimated to be "seriously eroded" or "degraded". The rate of deforestation is high, as forests and woodlands are disappearing at a rate of 2.2 percent per year, well above average for the Central America region. Primary tropical forest is being cleared at an even higher rate. In addition, widespread and uncontrolled use of pesticides, particularly in cotton production, and the serious chemical contamination of Lake Managua challenge the environment. The project will have an indirect positive impact on the environmental issues. The regulatory framework for the administration of natural resources will consider restrictions on the exploitation of natural resources, specifically of forests. Also, realigning relative prices to their international levels will avoid excess use of pesticides and damaging chemicals in agriculture.

114. <u>Risks</u>. Given the actions taken to date, little doubt remains about the Government's commitment to the program of stabilization and adjustment. A far-reaching stabilization effort has been in place since March 3, 1991, and important steps have been taken towards structural adjustment. Nonetheless, given the magnitude of problems, the Government's limited implementation capability, and the fragile nature of the peace among the opposing political forces, the proposed operation faces a number of serious risks. Politically strong groups, including the military, may resist deep

cuts in budgetary allocations and slow down fiscal adjustment. Organized labor, highly politicized by the opposition party, may resort to strikes and work stoppages to obtain higher salaries and resist cuts in public sector employment. If the issue of property rights is not resolved, the private sector may be slow in making new investments, or expanding and modernizing the existing capacities. In the area of privatization, domestic and foreign investors may prove reluctant to tender offers for state enterprises if employees continue to exercise effective control over them. Also, established political/economic interest groups and the employees working in state-owned banks may resist financial sector reforms.

115. However, the Government has established a consensus behind the program, as demonstrated by the statements of the ruling coalition and the opposition party representatives in recent donor meetings. This support is expected to continue, as long as the Government can demonstrate early success with the program. At the same time, the authorities have demonstrated their resolve to establish property rights and the rule of law. This would promote private sector trust in the economy and in the system of incentives.

116. The success of the program also depends on the timely availability of donor support. Given the large financing requirements and the huge external debt to be rescheduled, mobilization of donor assistance is challenging. Any major shortfall in the size and timing of this effort could prove extremely damaging to the program's success. However, the donors' response to Nicaragua's program in recent meetings has been encouraging. The authorities are now taking a very active posture in soliciting donor support. IDA will continue to play a key role in the coordination of such efforts.

117. Another potential risk to the timely implementation of a difficult program is weakness in the administration at a technical level. To alleviate shortcomings in the implementation capacity of the administration, technical assistance programs are being designed and put into place by bilateral and multilateral organizations (paras. 105-106). This will allow the authorities to implement the reforms more speedily and effectively. The Government is expected to assemble programs to alleviate managerial and administrative problems in the medium to long term, again with the help of technical assistance programs.

V. EXTERNAL FINANCING REQUIREMENTS

118. Nicaragua's economic recovery and medium-term growth will depend critically on adequate external financing. After having addressed the arrears problem (para. 119), Nicaragua needs to reduce its external debt overhang problem so that it can begin to manage its annual debt servicing and mobilize external financing for its program. The country's resource balance deficit as well as debt and debt servicing burden are expected to remain high by international standards through the remainder of the 1990s. Under the projected base case scenario (Table 2), Nicaragua's resource gap would be 20.1

percent of GDP during 1992-96, and then fall to an average 12.7 percent of GDP per annum in the 1997-2000 period.

IFI Arrears Clearance

119. Notwithstanding the magnitude of the debt burden, arrears to the World Bank, IDA and the IDB represent the immediate constraint to the flow of international assistance. As of April 1991, arrears to both institutions were approximately US$340 million. Beginning in May 1991, Nicaragua resumed debt service to both institutions. With the arrears effectively "frozen" as of May 1991, the clearance process is expected to be finalized by September 1991. Clearing the arrears to the international financial institutions is part of the overall financing program. The process will consist of three parts: (i) a relatively short-term bridge loan of approximately US$195 million, provided by Mexico, Colombia, Spain and Venezuela that would be repaid from the first tranche disbursements of the IDA, IMF, and IDB fast disbursing operations, and other cofinanciers (Japan, Switzerland, and Germany); (ii) some US$30 million in longer-term loans to be provided by Venezuela and Spain; and (iii) specific contributions made by bilateral donors for the purpose of arrears clearance for the remaining US$115 million from the USA, the Netherlands, Germany, France, Canada, Switzerland, Norway, Korea and Denmark.

External Debt Overhang

120. At the end of 1990, Nicaragua's total external debt amounted to US$10,585 million (including US$4,110 million in principal and interest arrears) of which US$7,081 million (67 percent) was owed to bilateral creditors, US$1,300 million (12 percent) to multilaterals, US$1,867 million (18 percent) to commercial banks, US$71 million (0.7 percent) to suppliers, and US$267 million (2.3 percent) to other creditors. To illustrate the gravity of the situation, if Nicaragua does not get debt relief on favorable terms, the outcome is illustrated in Tables 3 and 4. Under the assumptions that all arrears are cleared in 1991 and all debt service as due is paid to all creditors, the 1991 financing gap is projected at US$3.2 billion (Table 3); of this, US$2.5 billion is payment of non-multilateral arrears. Assuming further, that Nicaragua would service its external debt obligations as due throughout the 1990s, the country's external financing requirements would grow from US$887 million in 1992 to US$1.8 billion by the year 2000 (Table 3); the average annual financing gap would reach a staggering US$1.3 billion (63 percent of GDP on average) in the 1992-2000 period. The foreign debt would be on average five times the country's GDP for the remainder of the 1990s (Table 4). Gaps of this size are obviously unsustainable and cannot realistically be financed. Measures to significantly and drastically reduce Nicaragua's debt burden will have to be found.

121. The Government has taken a number of steps to address this situation. It has renegotiated its debt with Mexico and Venezuela (totalling some US$1.3b) on highly favorable terms (including substantial debt reduction) and hopes to reach a similar agreement with the USSR and Eastern Bloc countries (US$3.7b). It expects to begin negotiations with the Paris Club

donors later in 1991 as part of its debt management program. At this stage it is not possible to predict the outcome of these discussions. Commercial bank negotiations have also not yet begun and are unlikely to occur before 1992.

Table 3: Projected Financing Plan, 1991-2000
(US$ Millions)
(Debt Service as due)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Gross Financing Requirements	(3,962)	(1,035)	(1,010)	(1,330)	(1,290)	(1,492)	(1,544)	(1,692)	(1,834)	(2,026)
Resource Balance	(357)	(338)	(342)	(351)	(357)	(350)	(336)	(326)	(321)	(311)
Net Non-Interest Factor Income	10	16	16	15	14	13	11	8	4	(1)
Interest Payments a/	290	414	490	693	656	735	814	896	989	1,086
Amortization Payments a/	3,325	282	174	278	270	406	390	462	532	610
Buildup of Reserves	0	(18)	(21)	(24)	(22)	(14)	(13)	(16)	(17)	(18)
Sources	3,962	1,035	1,010	1,330	1,290	1,492	1,544	1,692	1,834	2,026
Private Transfers	50	50	50	50	50	50	50	50	50	50
Official Capital Grants	482	0	0	0	0	0	0	0	0	0
Net Direct Investment	10	30	40	50	60	75	90	105	120	135
Pipeline Disbursements	188	68	0	0	0	0	0	0	0	0
Financing Gap b/	3,232	887	920	1,230	1,180	1,367	1,404	1,537	1,684	1,841

a/ Includes debt service on arrears & existing debt, on pipeline disbursements, and on gap financing.
b/ Accounts for clearance of arrears to all creditors, except East Bloc and oil exporters, in 1991. Financing gap terms are 20 years maturity, 5 years grace, and 8% p.a. interest rate.

Table 4: FINANCING GAP AND CREDITWORTHINESS RATIOS, 1991-2000
(US$ Millions)
(Debt Service as due)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Financing Gap	3,232	887	920	1,230	1,180	1,367	1,404	1,537	1,684	1,841
Total Debt a/	6,275	6,948	7,694	8,646	9,557	10,518	11,531	12,606	13,738	14,990
Total Amortization Payments	3,325	282	174	278	270	406	390	462	532	610
Total Interest Payments	290	414	490	693	656	735	814	896	989	1,086
Total Debt Service Payments	3,615	696	664	970	926	1,141	1,205	1,357	1,521	1,696
Debt/GDP	442	466	487	505	506	509	516	516	516	515
Debt/Exports	1,539	1,462	1,464	1,491	1,447	1,398	1,360	1,317	1,289	1,260
Interest/GDP	20	28	31	40	35	36	36	37	37	37
Interest/Exports	71	87	93	119	99	98	96	94	93	91
Debt Service/GDP	254	47	42	57	49	55	54	56	57	58
Debt Service/Exports	886	147	126	167	140	152	142	142	142	142

a/ Excludes East Bloc and Oil Exporters.
Source: World Bank estimates.

External Resource Requirements

122. Two debt reduction and debt management scenarios have been developed to illustrate the impact of debt and debt servicing rescheduling/reduction on Nicaragua's external financing requirements during the 1990s. Both scenarios assume that arrears to the IFIs (IBRD, IDA, IDB) will be cleared and debt servicing to those institutions resumed in 1991. Under the "Toronto like" scenario, principal and interest on bilateral debts (excluding Mexico, Venezuela and the former Eastern Bloc countries for which negotiations have been completed or are nearing completion) are assumed to be

rescheduled approximating Toronto terms.[1/] The external financing gap is reduced to an average US$648 million per annum for the 1992-2000 period. While this is less than half of the "payment as due" scenario, it is extremely high considering the level of external finance likely.

Table 5: FINANCING GAP AND CREDITWORTHINESS RATIOS, 1991-2000
(US$ Millions)
("Toronto-like" Scenario)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Financing Gap	14	507	628	657	679	666	669	675	676	678
Total Debt a/	6,141	6,716	7,324	8,083	8,740	9,384	10,018	10,647	11,282	11,918
Total Amortization Payments	357	71	73	72	70	60	62	69	62	61
Total Interest Payments	40	245	299	325	354	380	408	427	450	471
Total Debt Service Payments	397	316	372	398	425	440	470	496	513	533
Debt/GDP	432	451	464	472	463	454	448	436	423	410
Debt/Exports	1,506	1,414	1,394	1,393	1,323	1,247	1,182	1,112	1,057	1,001
Interest/GDP	3	16	19	19	19	18	18	17	17	16
Interest/Exports	10	52	57	56	54	51	48	45	42	40
Debt Service/GDP	28	21	24	23	22	21	21	20	19	18
Debt Service/Exports	97	66	71	69	64	59	55	52	48	45

a/ Excludes East Bloc and Oil Exporters.
Source: World Bank estimates.

123. The second alternative debt reduction scenario (called "Beyond Toronto Terms") incorporates debt forgiveness on the order of two-thirds of the bilateral debt stock (again excluding Mexico, Venezuela and the former Eastern Block countries). That brings the projected financing gap down to some US$425 million per annum for the 1992-2000 period (from US$450 million in 1993 to US$405 million in 2000). Table 6 shows the details of this scenario. The debt forgiveness element lowers the debt/GDP ratio to some 210 percent on average in the 1992-2000 period. Interest payments are reduced drastically to some 10-20 percent of exports during the decade.

Table 6: FINANCING GAP AND CREDITWORTHINESS RATIOS, 1991-2000
(US$ Millions)
("Beyond Toronto" Terms)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Financing Gap	14	326	450	463	468	441	431	426	415	405
Total Debt a/	6,141	2,837	3,233	3,683	4,098	4,493	4,872	5,237	5,596	5,947
Total Amortization Payments	357	89	92	91	89	79	81	88	81	80
Total Interest Payments	40	65	101	113	125	136	151	159	170	180
Total Debt Service Payments	397	154	193	204	214	215	232	247	252	260
Debt/GDP	432	190	205	215	217	218	218	214	210	204
Debt/Exports	1,506	597	615	635	620	597	575	547	524	500
Interest/GDP	3	4	6	7	7	7	7	6	6	6
Interest/Exports	10	14	19	19	19	18	18	17	16	15
Debt Service/GDP	28	10	12	12	11	10	10	10	9	9
Debt Service/Exports	97	32	37	35	32	29	27	26	24	22

a/ Excludes East Bloc and Oil Exporters.
Source: World Bank estimates.

1/ Bilateral debt is rescheduled, with 14 years maturity, 8 years grace and 3.5% interest p.a.. Nicaragua's interest payments would approximate those under an application of Toronto terms to all bilateral debt.

124. While the above two scenarios (particularly the last one) represent a significant improvement over the "debt service as due" case, it is evident that Nicaragua's economic program will depend heavily on additional external financial assistance for the foreseeable future. The donor community has already expressed a considerable interest in supporting Nicaragua. It has been demonstrated that aid flows of around US$400 million per annum realistically may be mobilized through the Consultative Group mechanism, if the Government stays on course with stabilization and adjustment program targets. Therefore, it appears possible to finance a gap on the order implied by the "beyond Toronto-terms". Since the first year's external financing requirements are basically met, timely efforts are needed to ensure the availability of external resources in 1992 and beyond. IDA will continue to play a key role in this process through the Consultative Group mechanism.

V. RECOMMENDATION

125. I am satisfied that the proposed credit would comply with the Articles of Agreement of IDA and recommend that the Executive Directors approve the proposed credit.

Lewis T. Preston
President

Attachments

Washington, D.C.
September 3, 1991

NICARAGUA -- Key Indicators

(In percentages unless otherwise noted)

Base Case Projection a./

ANNEX A
Page 1 of 1

	Actual				Est.	Projected				
	1980	1987	1988	1989	1990	1991	1992	1993	1995	2000
Real Growth Rates:										
Gross Domestic Product (GDP)	4.6	-0.7	-15.0	-2.8	-4.4	1.0	3.0	4.0	5.0	4.5
Gross Domestic Income (GDY)	..	..	..	..	-6.7	1.3	5.0	3.9	4.9	4.[illegible]
Real per Capita Growth Rates:										
Gross Domestic Product (GDP)	1.2	-4.1	-17.8	-5.9	-7.3	-2.0	-0.1	1.0	1.9	1.7
Total Consumption	16.7	-2.6	-19.1	-9.9	-6.2	-0.9	-2.8	-1.2	-0.2	0.[illegible]
Private Consumption	13.9	-6.5	2.2	-10.7	-5.1	1.7	-2.8	3.1	0.3	-0.[illegible]
Debt and Debt Service (LT+IMF+ST): b./										
Total DOD (US$M)	1,964	6,984	7,488	8,267	8,819	6,275	6,948	7,694	9,557	14,99[illegible]
DOD/GDP	163.7	464.7	546.3	624.9	658.4	441.7	466.5	487.5	506.3	515.3
Debt Service (US$M)	..	..	..	..	..	3,615	696	664	926	1,696
Debt Service/Exports	..	..	..	..	..	886.5	146.5	126.3	140.2	142.5
Debt Service/GDP	..	..	..	..	..	254.5	46.7	42.1	49.1	58.3
Interest Burden (LT+IMF+ST): b./										
Interest Paid (US$M)	..	..	..	..	..	290	414	490	656	1,086
Interest/Exports	..	..	..	..	..	71.2	87.2	93.3	99.4	91.3
Interest/GDP	..	..	..	..	..	20.4	27.8	31.0	34.8	37.3
Gross Investment/GDP c./	16.8	15.8	15.0	13.0	13.0	12.0	15.0	16.0	16.5	16.[illegible]
ICORs (one year lag)	..	..	..	..	..	..	..	3.7	3.2	3.6
Domestic Savings/GDP c./	-2.3	13.8	-24.6	-11.7	-12.8	-13.2	-7.7	-5.7	-2.5	5.3
BOP Resource Balance/GDP	-36.0	-37.9	-39.6	-24.7	-25.8	-25.2	-22.7	-21.6	-18.9	-10.7
National Savings/GDP	..	..	-28.1	-16.5	-14.7	2.8	-27.7	-28.8	-31.5	-28.5
BOP Current Account Balance/GDP d./	-46.2	-51.8	-56.9	-40.3	-42.7	-39.6	-39.3	-41.6	-45.3	-42.5
Government Investment/GDP e./	4.5	..	4.7	2.7	1.3	6.2	7.5	7.4	6.5	4.5
Government Savings/GDP	..	..	-36.8	-17.7	-29.9	-5.4	-1.4	2.0	3.6	5.2
Private Investment/GDP e./	10.1	..	10.3	10.3	11.7	5.8	7.5	8.6	10.0	11.5
Private Savings/GDP	..	..	-5.0	-9.5	0.2	-25.8	-26.3	-30.8	-35.1	-33.8
Government Revenues/GDP	..	29.8	23.3	24.6	17.2	22.6	23.7	23.9	23.5	22.2
Government Expenditures/GDP	..	47.9	49.8	29.9	42.8	34.8	32.6	29.3	26.5	21.5
Budget Deficit (-) or Surplus/GDP	..	-18.1	-26.5	-5.3	-25.6	-12.2	-8.9	-5.6	-2.9	0.7
Consumer Price Index (% growth rate)	35.0	912.0	16316.0	4770.0	7485.0	2850.1	40.9	20.3	11.2	10.0
GDP Deflator (% growth rate)	37.0	523.0	13233.0	5897.0	7485.0	2850.1	40.9	20.3	11.2	10.0
Real Exchange Rate (1989=100)	42	3,395	167	100	163	132	132	132	132	132
Terms of Trade Index (1989=100)	..	..	..	100	91	92	99	99	96	96
Exports (GNFS) Volume Growth Rate	-40.6	-1.0	-10.6	7.5	9.9	2.9	8.7	8.0	8.5	6.4
Exports (GNFS)/GDP	41.0	21.6	23.0	25.7	28.0	28.0	30.7	32.1	33.7	39.6
Imports (GNFS) Volume Growth Rate	81.6	3.5	-5.7	-15.2	0.3	2.6	6.1	3.9	3.9	3.0
Imports (GNFS)/GDP	77.0	59.5	62.6	50.4	53.8	53.2	53.4	53.7	52.6	50.3
BOP Current Account Balance (US$M) d./	-554.0	-778.1	-779.4	-532.7	-571.6	-562.8	-585.7	-656.4	-855.5	-1246.2
Net Reserves (US$M)	-208.5	-814.3	-800.9	-869.6	-1087.8	-1087.8	-1070.2	-1049.5	-1004.0	-925.9
Gross Reserves (months imports)	..	..	0.8	2.1	1.3	1.3	1.3	1.7	2.0	2.0

a./ Estimated and projected data are based on RNSM estimates, except for debt data.
b./ Figures for projected years based on Financing Scenario "As Due". This scenario excludes debt to former Eastern Bloc countries and Latin American Oil Exporters.
c./ Official data on gross domestic investment for 1988-90 were adjusted due to overestimation in the national accounts.
d./ Figures for projected years based on RNSM Financing Scenario (Annex A6). Excludes official grants.
e./ Public Investment refers to Non-Financial Public Sector only, i.e. excludes APP enterprises. Private Investment makes up for the difference.

NICARAGUA - NATIONAL ACCOUNTS

ANNEX A1
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Part A: Current Price Data
(As Percentage of GDP)

Base Case Projection
Per Capita GNP in US$: ca. 500 (1990)
Mid-year Population: 3.86 millions

	Actual				Est.	Projected				
	1980	1987	1988	1989	1990	1991	1992	1993	1995	2000
Gross Domestic Product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Imports (GNFS)	43.3	13.8	62.6	50.4	53.8	53.2	53.4	53.7	52.6	50.3
Exports (GNFS)	24.2	11.8	23.0	25.7	28.0	28.0	30.7	32.1	33.7	39.6
Resource Balance	-19.0	-2.0	-39.6	-24.7	-25.8	-25.2	-22.7	-21.6	-18.9	-10.7
Total Expenditures	119.0	102.0	139.6	124.7	125.8	125.2	122.7	121.6	118.9	110.7
Total Consumption	102.3	86.2	124.6	111.7	112.8	113.2	107.7	105.7	102.5	94.7
Government	19.7	34.2	35.3	23.3	24.0	21.8	20.7	16.6	15.1	13.1
Private	82.5	52.0	89.3	88.4	88.8	91.6	87.0	89.1	87.3	81.6
Gross Domestic Investment 1/	16.8	15.8	15.0	13.0	13.0	12.0	15.0	16.0	16.5	16.0
Government	..	..	19.4	16.9	6.1	8.0	9.3	7.4	6.5	4.5
Private	..	..	-4.4	-3.9	6.9	4.0	5.7	8.6	10.0	11.5
Memorandum Item:										
Domestic Saving	-2.3	13.8	-24.6	-11.7	-12.8	-13.2	-7.7	-5.7	-2.5	5.3

1/ Official data for 1988-90 were adjusted due to overestimation in the national accounts. Private investment includes increase in stocks for historical years.

Part B: Constant Price Data
(Millions of Cordobas, 1980=100)

	Actual				Est.	Projected				
	1980	1987	1988	1989	1990	1991	1992	1993	1995	2000
Gross Domestic Product	20,799	21,100	17,936	17,433	16,666	16,833	17,338	18,031	19,785	24,774
Imports (GNFS)	8,999	6,430	6,063	5,142	5,296	5,435	5,768	5,993	6,414	7,456
Exports (GNFS)	5,039	3,250	2,907	3,125	3,434	3,533	3,839	4,146	4,897	6,986
Resource Balance	(3,960)	(3,180)	(3,156)	(2,017)	(1,861)	(1,902)	(1,929)	(1,847)	(1,517)	(470)
Total Expenditures	24,759	24,280	21,092	19,450	18,528	18,735	19,267	19,879	21,302	25,244
Total Consumption Expenditures:	21,269	19,617	16,415	15,316	14,770	15,232	14,757	14,875	15,641	18,370
Government	4,103	10,222	6,480	6,156	5,811	5,377	5,376	4,472	4,421	4,756
Private	17,166	9,395	9,935	9,160	8,959	9,855	9,381	10,403	11,220	13,614
Total Investment Expenditures:	3,490	4,663	4,678	4,134	3,757	3,503	4,510	5,003	5,661	6,874
Government	..	..	..	..	..	..	..	..	..	..
Private	..	..	..	..	..	..	..	..	..	..
Terms of Trade (TT) Effect	..	..	..	..	..	..	..	..	..	..
Gross Domestic Income	..	..	..	..	..	..	..	..	..	..
Domestic Savings (TT Adjusted)	..	..	..	..	..	..	..	..	..	..

Note: Preliminary and projected data are based on MHSM estimates.

NICARAGUA - NATIONAL ACCOUNTS

Part C: Value Added by Sector
(Sectoral Shares in Percent)

ANNEX A1
Page 2 of 3

Base Case Projection

	Actual				Est.	Projected				
	1980	1987	1988	1989	1990	1991	1992	1993	1995	2000
Agriculture	23.2	28.9	29.1	31.0	31.3	..	..	..	..	..
Industry, of which:	29.3	22.2	21.9	20.4	20.2	..	..	..	..	..
Mining	0.7	0.4	0.5	1.1	0.8	..	..	..	..	..
Manufacturing	25.6	18.7	17.8	16.1	16.3	..	..	..	..	..
Services	47.5	48.9	49.0	48.6	48.5	..	..	..	..	..
Total	100	100	100	100	100	100	100	100	100	100

Part D: Long-Term Growth Rates
(Average Annual Growth Rates)

	Actual				Est.	Projected	
	1970-75	1975-80	1980-84	1984-89	1990	1990-95	1995-2000
B. National Accounts Growth (Constant Prices)							
Gross Domestic Product m.p.	5.1	-4.2	1.9	-4.3	-4.4	3.5	4.6
Agriculture	4.9	-4.7	3.0	-5.1	-3.4	..	..
Industry	6.0	-4.1	1.9	-6.3	-4.8	..	..
(of which Manufacturing)	5.9	-0.9	2.3	-7.3	-3.3	..	..
Services 1/	4.6	-3.9	1.2	-2.8	-4.7	..	..
Exports of GNFS	8.0	-5.6	-2.7	-9.5	9.9	7.4	7.4
Imports of GNFS	5.4	9.0	-5.4	-5.7	3.0	3.9	3.1
Total Expenditures	4.5	-0.1	0.3	-3.7	-4.7	2.6	3.0
Total Consumption	4.7	0.4	-1.2	-4.0	-3.6	1.8	2.8
Private Consumption	4.5	-1.9	-9.5	-4.6	-2.2	3.5	3.0
General Government	6.7	15.9	20.8	-3.1	-5.6	-5.3	1.5
Gross Domestic Investment	3.3	-2.8	8.4	-2.4	-9.1	8.5	4.0
Fixed Investment	8.4	-7.4	8.4	-2.3	-10.2	15.1	4.0
Capacity to Import	..	..	..	..	..	..	..
Gross Domestic Income	..	..	..	..	-6.7	3.7	4.6
Gross National Income	..	..	..	..	-8.6	0.5	3.0
Gross National Product 2/	..	..	..	..	-5.9	0.3	3.1

1/ Includes electricity, gas & water.
2/ Excludes current transfers.

NICARAGUA - NATIONAL ACCOUNTS

Part E: Annual Growth Rate

Base Case Projection

	Actual				Est.	Projected				
	1980	1987	1988	1989	1990	1991	1992	1993	1995	2000
GDP at Market Prices:	4.6	-0.7	-13.0	-2.8	-4.4	1.0	3.0	4.0	5.0	4.5
Agriculture	-19.0	-3.2	-10.5	2.7	-3.4	..	..	..	..	..
Industry	18.1	-0.8	-25.9	-7.2	-4.8	..	..	..	..	..
Services	12.8	0.5	-10.1	-3.1	-4.7	..	..	..	..	..
Gross Domestic Income	..	..	..	..	-6.7	1.3	5.0	3.9	6.9	4.4
Total Investment	-376.2	-1.5	0.3	-11.6	-9.1	-6.8	28.8	10.9	8.3	4.5
Total Consumption	20.7	0.9	-16.3	-6.7	-3.6	2.2	0.2	1.8	2.8	2.9
Population	3.4	3.6	3.4	3.3	3.1	3.1	3.1	3.0	3.0	2.8
Per Capita:										
GDP at Market Prices	1.2	-4.3	-18.4	-6.1	-7.5	-2.0	-0.1	1.0	1.9	1.7
Total Consumption	17.3	-2.7	-19.7	-10.0	-6.7	-0.9	-2.8	-1.2	-0.2	0.1
Private Consumption	14.6	-6.8	2.4	-11.1	-5.3	1.7	-2.8	3.1	0.3	-0.1

Part F: Price Indices
(National Accounts Deflators, 1989=100)

	Actual				Est.	Projected				
	1980	1987	1988	1989	1990	1991	1992	1993	1995	2000
GDP Deflator	0.10	12.51	1.67	100	7585	223766	315298	379338	480495	775034
Imports (GNFS)	0.06	3.28	1.67	100	5403	220831	303230	367350	467697	773766
Exports (GNFS)	0.12	11.76	1.32	100	9201	205067	300421	363243	449840	767119
Total Expenditures	0.08	9.08	1.72	100	6631	227117	313755	378322	483989	785869
Consumption	0.08	9.24	1.65	100	6413	227548	313668	378332	484783	788117
Investment	0.09	8.13	2.00	100	7563	223117	314384	378258	479101	772786
Agriculture	0.08	12.95	1.65	100	7591	..	..	..	..	..
Industry, of which:	0.12	11.35	1.71	100	7539	..	..	..	..	..
Mining	0.07	8.23	1.20	100	7587	..	..	..	..	..
Manufacturing	0.13	11.68	1.77	100	7590	..	..	..	..	..
Services	0.10	13.28	1.68	100	7586	..	..	..	..	..

Part G: Other Economic Indicators

-	1974-81	1981-90	1990-95	1995-2000	1974	1981	1990
Import Elasticity based on Imports (GNFS)	..	..	..	0.7	..	..	-0.1
Marginal Saving Rates:							
Gross Domestic Saving	..	..	..	..	..	..	..
Gross National Saving	..	..	..	..	..	..	..
ICOR (period averages)	..	..	..	3.5	..	..	..
Labor Force (%):							
Agriculture	..	..	..	..	..	..	..
Industry	..	..	..	..	..	..	..
Services	..	..	..	..	..	..	..
Total	100	100	100	100	100	100	100

NICARAGUA - EXTERNAL TRADE

A: Volume, Value, and Prices

ANNEX A2

Base Case Projection

	Actual				Est.	Projected				
	1980	1987	1988	1989	1990	1991	1992	1993	1995	2000
Volume Indices 1980=100										
Merchandise Exports:										
Coffee	100.0	81.4	67.4	73.2	81.6	66.9	76.9	84.6	102.3	153.1
Cotton	100.0	235.7	177.2	124.8	122.9	135.8	163.7	198.9	281.6	499.2
Sugar	100.0	81.0	55.7	125.6	187.8	225.1	225.1	225.1	229.7	253.6
Shrimp	100.0	29.2	30.7	40.7	28.5	41.1	47.2	54.3	69.9	119.9
Beef	100.0	33.4	46.6	99.0	144.4	143.2	147.5	151.9	161.1	186.8
Bananas	100.0	70.0	67.8	68.1	84.8	98.2	112.9	129.8	171.7	278.7
Gold	100.0	46.3	51.9	94.0	63.2	79.9	82.3	84.8	90.0	104.3
Non-Traditional & Other	100.0	..	..	..	..	..	..	..	..	..
Total Merch. Exports (FOB)	100.0	..	..	..	..	..	..	..	..	..
Value-Current Prices (US$ Millions)										
Merchandise Exports:										
Coffee	166	133	85	90	68	59	71	81	116	262
Cotton	30	46	53	28	37	41	50	63	95	200
Sugar	20	20	5	17	35	37	56	54	44	65
Shrimp	27	12	9	12	10	14	17	20	28	58
Beef	59	15	19	41	65	65	66	74	87	129
Bananas	8	[illegible]	15	21	23	27	31	36	48	86
Gold	32	[illegible]2	13	21	14	18	19	20	24	34
Non-Traditional & Other	103	43	37	61	71	82	90	99	130	233
Total Merch. Exports (FOB)	445	[illegible]95	236	290	321	342	400	447	572	1,071
Volume Indices 1988=100										
Merchandise Imports:										
Food	..	..	100.0	86.2	141.5	141.1	143.6	147.1	155.6	179.1
Other Consumer Goods	..	..	100.0	57.6	94.7	94.6	96.1	98.4	104.1	119.8
POL and Other Energy	..	..	100.0	77.2	90.5	107.3	109.2	111.8	118.3	136.1
Intermediate Goods n.e.i.	..	..	100.0	73.9	52.6	52.4	53.5	55.0	58.8	69.4
Capital Goods	..	..	100.0	76.2	67.8	67.6	81.2	87.4	95.4	110.0
Total Merch. Imports CIF	..	..	100.0	77.8	78.2	80.2	85.1	88.3	94.7	110.1
Value-Current Prices (US$ Millions)										
Merchandise Imports:										
Food	215	88	93	80	140	146	152	158	182	258
Other Consumer Goods	43	35	27	16	27	29	30	31	36	50
POL and Other Energy	174	123	109	84	114	120	103	113	135	231
Intermediate Goods n.e.i.	340	336	256	190	143	150	155	163	189	276
Capital Goods	110	242	234	178	168	176	215	236	280	398
Total Merch. Imports CIF 1/	881	824	720	548	592	620	655	700	823	1,213
Terms of Trade Indices 1989=100										
Merchandise Export Prices	..	..	..	100.0	97.7	100.5	107.1	109.8	116.9	148.7
Merchandise Import Prices	..	..	..	100.0	107.7	109.4	108.0	111.0	121.7	154.9
Merchandise Terms of Trade	..	..	..	100.0	90.6	91.9	99.2	99.0	96.0	96.0

1/ Imports valued at f.o.b. for 1988-2000

NICARAGUA - EXTERNAL TRADE

ANNEX A2
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B: Shares of Total, and Growth Rates

Base Case Projection

	Share of Merchandise Exports and Imports (in current prices)				Export and Import Volume Growth Rates			
	Actual	Est.	Projected		Actual	Est.	Projected	
	1980	1990	1995	2000	1980-89	1990	1990-95	1995-2000
Merchandise Exports (%, % p.a.):								
Coffee	37.2	21.0	20.2	24.5	-3.6	11.4	6.6	8.4
Cotton	6.8	11.4	16.7	18.7	2.5	-1.5	18.0	12.1
Sugar	6.6	10.8	7.7	6.1	2.6	49.5	4.1	2.3
Shrimp	6.0	3.1	4.8	5.4	-9.5	-30.0	19.7	11.4
Beef	13.2	20.1	15.2	12.0	-0.1	45.8	2.2	3.0
Bananas	1.9	7.2	8.4	8.0	-4.2	24.5	15.2	10.2
Gold	7.2	4.4	4.2	3.1	-0.7	-32.8	7.3	3.3
Non-Traditional & Other	23.1	22.0	22.8	22.2	..	12.7	10.1	8.3
Total Merch. Exports (FOB)	100.0	100.0	100.0	100.0	..	13.4	8.3	8.0
Merchandise Imports (%, % p.a.):								
Food	24.4	23.6	22.2	21.3	..	64.3	1.9	2.8
Other Consumer Goods	4.9	4.6	4.3	4.2	..	64.3	1.9	2.8
POL and Other Energy	19.8	19.3	16.4	19.0	..	17.3	5.5	2.8
Intermediate Goods n.e.i.	38.5	24.1	23.0	22.7	..	-28.9	2.2	3.4
Capital Goods	12.4	28.3	34.1	32.8	..	-11.0	7.1	2.9
Total Merch. Imports (CIF) 1/	100.0	100.0	100.0	100.0	..	0.4	4.2	3.3

1/ Imports valued at f.o.b. for 1990-2000

C: Trends in Nonfactor Services

	Actual				Est.	Projected				
	1980	1987	1988	1989	1990	1991	1992	1993	1995	2000
Volume Indices 1989=100:										
Exports of Nonfactor Services	..	..	..	100	100	102	106	110	119	145
Imports of Nonfactor Services	..	..	..	100	101	102	104	107	114	135
US$ Price Indices 1989=100:										
Exports of Nonfactor Services	..	..	..	100	106	111	113	115	126	155
Imports of Nonfactor Services	..	..	..	100	106	111	113	115	126	155

NICARAGUA - BALANCE OF PAYMENTS

(US$ Millions)

ANNEX A3
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Base Case Projection

	Actual				Est.	Projected				
	1980	1987	1988	1989	1990	1991	1992	1993	1995	2000
A. Exports of Goods & NFS:	492	325	315	341	375	398	457	506	637	1,15:
1. Merchandise (FOB)	445	295	236	290	321	342	400	447	572	1,07:
2. Non-Factor Services	47	30	79	51	53	56	57	59	64	81
B. Imports of Goods & NFS:	924	895	858	667	720	755	795	848	994	1,462
2. Merchandise (FOB)	816	734	720	548	592	620	655	700	823	1,213
3. Non-Factor Services	108	161	138	119	128	135	140	147	171	249
C. Resource Balance	(433)	(570)	(543)	(326)	(345)	(357)	(338)	(342)	(357)	(311:
D. Net Factor Income:	(122)	(208)	(237)	(206)	(226)	(255)	(298)	(365)	(549)	(985:
1. Factor Receipts	19	1	2	7	10	10	18	19	24	39
2. Factor Payments 1./	161	209	239	213	236	265	316	384	572	1,02-
a. Total Interest payments	120	209	239	213	236	265	314	381	563	98-
E. Net Current Transfers :	2	..	..	..	0	50	50	50	50	50
1. Current Receipts	..	..	..	..	..	..	..	..	..	..
a. Workers' Remittances	..	..	..	..	..	..	..	..	..	..
b. Other Current Transfers	..	..	..	..	..	..	..	..	..	..
2. Current Payments	..	..	..	..	..	..	..	..	...	..
F. Current Account Balance: 1./										
1. Before Official Grants	(552)	(778)	(779)	(533)	(572)	(563)	(586)	(656)	(856)	(1,246:
2. Official Capital Grants	122	135	189	169	202	482	0	0	0	0
3. After Official Grants	(430)	(643)	(590)	(364)	(370)	(81)	(586)	(656)	(856)	(1,246:
G. Long-Term Capital Inflows n.e.i.:	64	537	382	241	216	150	603	677	877	1,265
1. Net Direct Investment	(138)	76	106	(37)	(1)	10	30	40	60	135
2. Net LT Borrowing	94	90	2	(101)	(225)	(647)	573	637	817	1,130
a. Disbursements 2./	295	490	286	286	221	169	1,404	1,265	1,411	1,735
b. Repayments 1./	(201)	(400)	(284)	(387)	(446)	(816)	(831)	(627)	(594)	(605:
3. Other LT Inflows (net)	108	372	273	379	441	787	(0)	(0)	0	0
H. Total Other Items (net)	149	(14)	222	55	(63)	(69)	(0)	(0)	(0)	(0)
1. Net Short Term Capital n.e.i. 3./	13	193	227	206	224	(69)	(0)	(0)	(0)	(0)
a. Interest Arrears	..	..	..	..	..	..	..	..	..	..
b. Other Net ST Capital	..	..	..	..	..	..	..	..	..	..
2. Capital Flows n.e.i.	75	8	20	0	0	0	0	0	0	0
3. Errors and Omissions	61	(215)	(25)	(150)	(287)	0	0	0	0	0
I. Change in Net Reserves [() indicates increase]	217	120	(13)	68	218	0'	(18)	(21)	(22)	(18)
1. Net Credit from the IMF	..	..	..	..	..	..	..	..	..	..
2. Reserve Changes n.e.i.	..	..	..	..	..	..	..	..	..	..
3. Escrow Account	..	..	..	..	..	..	..	..	..	..

1./ Based on RMSM financing scenario (Annex A4), thus may differ from Key Indicators table as well as text tables.
2./ Includes unidentified financing for projected years. Based on RMSM financing scenario.
3./ Includes US$315 Mls. of payment of multilateral arrears in 1991.

NICARAGUA - BALANCE OF PAYMENTS

(US$ Millions)

Base Case Projection

	Actual				Est.	Projected				
	1980	1987	1988	1989	1990	1991	1992	1993	1995	2000
J. As Shares of GDP (current US$): 1./										
1. Resource Balance	-36.0%	-37.9%	-39.6%	-24.7%	-25.8%	-25.2%	-22.7%	-21.6%	-18.9%	-10.7%
2. MLT Interest Payments	10.0%	13.9%	17.5%	16.1%	17.6%	18.7%	21.1%	24.1%	29.8%	33.8%
3. Current Account Balance	-46.0%	-51.8%	-56.8%	-40.3%	-42.7%	-39.6%	-39.3%	-41.6%	-45.3%	-42.8%
4. LT Capital Inflow (line G)	5.3%	35.7%	27.9%	18.2%	16.0%	10.6%	40.5%	42.9%	46.5%	43.5%
5. Net Credit from the IMF	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
K. Foreign Exchange Reserves:										
1. Gross Reserves (excluding gold)	..	..	..	..	..	..	..	..	..	..
2. Gold (end-year London price)	..	..	..	..	..	..	..	..	..	..
3. Gross Reserves (including gold)	0.0	0.0	58.7	116.9	75.2	81.8	99.4	120.1	165.6	243.7
4. Net Res. in Months Imports	..	..	0.8	2.1	1.3	1.3	1.5	1.7	2.0	2.3
L. Exchange Rates:										
1. In Nominal Terms 2./										
(C$/US$):										
a. Primary (Official) Rate										
Annual Average	0.01	0.07	191	15655	689819	4.33	7.50	8.86	10.29	13.49
End-of-Year	0.01	0.07	920	38150	3000000	..	..	..	..	..
b. GDP Conversion Factor	0.02	1.79	223	13463	964602	5.42	7.50	8.86	10.29	13.49
2. In Real Terms										
(base 1989=100):										
a. MUV (PAC estimates)	76	94	101	100	106	111	113	115	126	155
b. Index Real Exchange Rate (US$/C$) (increase = app.)	42	3395	167	100	163	132	132	132	132	132
M. Memorandum Item:										
GDP (US$ Million) 3./	1200	1503	1371	1323	1339	1421	1489	1578	1888	2909
GDP curr. cordobas 4./	0.021	2.696	306	17812	1291602	7697	11171	13978	19426	39235

1./ Based on RMSM financing scenario (Annex A4), thus may differ from Key Indicators table as well as text tables.

2./ Amounts in New Cordobas which were introduced with the monetary reform in 1988; and in Cordobas Oro for 1991-2000. The GDP conversion factor is set equal to the implicit nominal exchange rate.

3./ The 1980 US$ GDP was converted from the local currency with the parallel market exchange rate. In subsequent years, US dollar GDP is a product of that year's change in real GDP, the change in the G-5 MUV LDC weights for that year, and the previous year's US dollar GDP.

4./ In billion New Cordobas thru 1990; in million Cordobas Oro for 1991-2000.

NICARAGUA - EXTERNAL CAPITAL AND DEBT 1./

(US$ Millions)

ANNEX A-
Page 1 of 2

Base Case Projection

	Actual				Est.	Projected				
	1980	1987	1988	1989	1990	1991	1992	1993	1995	2000
A. Disbursements:										
1. Public & P.Guar. LT	..	..	285.9	286.3	221.0	188.0	67.9	0.0	0.0	0.0
Official Creditors	..	..	284.6	281.2	220.8	188.0	67.9	0.0	0.0	0.0
Multilateral	..	..	11.2	4.0	1.8	16.0	0.0	0.0	0.0	0.0
of which IBRD	..	..	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
of which IDA	..	..	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bilateral	..	..	273.4	277.2	219.0	172.0	67.9	0.0	0.0	0.0
Private Creditors	..	..	1.3	5.1	0.2	0.0	0.0	0.0	0.0	0.0
Suppliers	..	..	0.0	3.1	0.0	0.0	0.0	0.0	0.0	0.0
Financial Markets	..	..	1.3	2.0	0.2	0.0	0.0	0.0	0.0	0.0
2. Private Non-Guar. LT	..	..	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3. Total LT Disbursements	..	..	285.9	286.3	221.0	188.0	67.9	0.0	0.0	0.0
4. IMF Purchases	..	..	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
5. Net Short-Term Capital	..	..	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6. Unidentified Sources	..	..	0.0	0.0	-0.0	-18.9	1336.1	1264.5	1411.4	1734.7
7. Total (all sources)	..	..	285.9	286.3	221.0	169.1	1,404.0	1,264.5	1,411.4	1,734.7
B. Repayments:										
1. Public & P.Guar. LT	..	..	283.8	387.0	438.1	809.0	826.6	623.2	590.0	228.4
Official Creditors	..	..	120.9	132.4	270.5	621.0	720.6	617.6	586.7	228.4
Multilateral	..	..	34.5	36.6	36.5	40.9	47.9	76.0	70.5	44.5
of which IBRD	..	..	13.1	8.6	7.4	11.1	11.3	11.4	9.6	4.5
of which IDA	..	..	0.3	0.2	0.3	0.7	0.7	1.1	1.1	1.7
Bilateral	..	..	86.4	115.7	234.0	580.1	672.7	541.6	516.1	183.9
Private Creditors	..	..	162.9	234.6	167.5	188.0	105.9	5.5	3.3	0.0
Suppliers	..	..	0.6	6.7	5.2	31.4	11.1	5.3	3.3	0.0
Financial Markets	..	..	162.3	227.9	162.4	156.6	94.8	0.3	0.0	0.0
2. Private Non-Guar. LT	..	..	0.0	0.0	8.3	6.7	4.2	4.2	4.3	0.4
3. Unidentified Sources	..	..	0	0	0	0	0	0	-0	376
4. Total LT Repayments	..	..	283.8	387.0	446.4	815.7	830.8	627.4	594.2	605.2
5. IMF Repurchases	..	..	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6. Amortization Arrears	..	..	278.4	378.7	440.9	786.8	(0.0)	(0.0)	0.0	0.0
C. Interest:										
1. Public & P.Guar. LT	..	..	239.3	212.9	227.2	261.4	258.6	221.1	164.0	65.7
Official Creditors	..	..	126.1	118.3	165.0	230.1	245.2	219.5	163.4	65.7
Multilateral	..	..	44.6	36.9	37.0	23.9	22.5	43.8	32.6	13.3
of which IBRD	..	..	21.5	20.1	20.5	7.8	6.8	5.5	3.9	0.7
of which IDA	..	..	0.4	1.4	0.4	0.3	0.3	0.3	0.2	0.2
Bilateral	..	..	81.6	81.3	128.0	206.2	222.7	175.7	130.9	52.4
Private Creditors	..	..	113.2	94.6	62.2	31.4	13.4	1.5	0.5	0.0
Suppliers	..	..	1.0	5.6	2.4	7.9	5.4	1.5	0.5	0.0
Financial Markets	..	..	112.2	89.0	59.8	23.5	8.0	0.0	0.0	0.0
2. Private Non-Guar. LT	..	..	0.0	0.0	7.0	2.3	1.6	1.3	1.2	0.1
3. Total LT Interest	..	..	239.3	212.9	234.2	263.7	260.0	222.4	165.1	65.8
4. IMF Service Charges	..	..	0.0	0.0	1.9	2.4	2.4	2.4	2.4	2.4
5. Interest Paid on ST Debt	..	..	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6. Unidentified Sources	..	..	0	0	0	-1	52	156	395	916
7. Total (all sources)	..	..	239.3	212.9	236.2	265.4	314.3	380.8	562.8	984.3
8. Interest Arrears	..	..	229.2	205.6	224.2	245.8	(0.0)	(0.0)	(0.0)	(0.0)
Memo: Tot. Arrears (Amort.+Int.):	..	..	507.6	384.3	665.1	1032.6	-0.0	-0.0	0.0	0.0

1./ Based on RMSM financing scenario. This scenario includes debt to all creditors, and assumes arrears clearance in 1991 to IBRD, IDA and IDB only, and debt service payments to all creditors for 1992 and beyond.

NICARAGUA - EXTERNAL CAPITAL AND DEBT 1./

ANNEX A-
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Base Case Projection

(US$ Millions)

D. External Debt (DOD)	1980	1987	1988	1989	1990	1991	1992	1993	1995	2000
	Actual				Est.	Projected				
1. Public & P.Guar. LT	..	..	6,705	7,479	7,999	7,378	6,619	5,996	4,565	3,0[illegible]
Official Creditors	..	..	5,370	6,130	6,632	6,199	5,544	4,929	3,506	1,95[illegible]
Multilateral	..	..	881	976	1,045	1,020	972	896	733	499
of which IBRD	..	..	159	159	159	148	136	125	104	71
of which IDA	..	..	59	59	59	58	57	56	54	48
Bilateral	..	..	4,489	5,154	5,587	5,179	4,574	4,032	2,734	1,652
Private Creditors	..	..	1,335	1,349	1,367	1,179	1,073	1,067	1,058	1,05[illegible]
Suppliers	..	..	30	43	61	29	18	13	4	(0)
Financial Markets	..	..	1,305	1,307	1,306	1,149	1,055	1,054	1,054	1,05[illegible]
2. Private Non-Guar. LT	..	..	68	67	65	59	54	50	42	29
3. Total Long-Term DOD	..	..	6,773	7,546	8,064	7,436	6,673	6,046	4,606	3,03[illegible]
4. IMF Credit	..	..	0	0	0	0	0	0	0	0
5. Short-Term Debt	..	..	715	722	735	735	735	735	735	735
6. Unidentified Sources	..	..	0	0	-0	-19	1317	2582	5646	12133
7. Total (all sources)	..	..	7,488	8,267	8,819	8,172	8,745	9,382	11,007	15,918
8. Accumulated Arrears	..	..	2,556	3,087	4,034	4,751	4,751	4,751	4,751	4,751
A. Interest	..	..	1,184	1,330	1,767	1,824	1,824	1,824	1,824	1,82[illegible]
B. Amortization	..	..	1,373	1,758	2,267	2,927	2,927	2,927	2,927	2,927
9. Total Debt + Acc. Arrears	..	..	8,671	9,597	10,586	9,996	10,570	11,207	12,831	17,743
Share of Public LT DOD:										
1. On Concessional Terms	..	..	..	..	..	..	..	..	..	..
2. With Variable Int. Rates	..	..	..	..	..	..	..	..	..	..
E. Bank and IDA Ratios										
1.IBRD to total LT DOD (line 3)	..	..	2.3%	2.1%	2.0%	2.0%	2.0%	2.1%	2.3%	2.3%
2.IDA to total LT DOD (line 3)	..	..	0.9%	0.8%	0.7%	0.8%	0.9%	0.9%	1.2%	1.6%
4.IBRD to total LT DS (line 3)	..	..	9.0%	9.4%	8.8%	2.9%	2.6%	2.5%	2.4%	1.0%
5.IDA to total LT DS (line 3)	..	..	0.2%	0.6%	0.2%	0.1%	0.1%	0.1%	0.2%	0.3%
F. DOD-to-Exports G&S										
1. Long-Term Debt	..	..	2136.3%	2171.9%	2096.0%	1823.7%	1404.6%	1150.7%	697.4%	523.0%
2. IMF Credit	..	..	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
3. Short-Term Debt	..	..	225.4%	207.7%	196.1%	185.1%	158.8%	143.6%	114.2%	130.1%
4. LT+IMF+ST DOD	..	..	2361.7%	2379.7%	2292.2%	2008.8%	1563.4%	1294.4%	811.6%	653.1%
5. Total Debt + Arrears	..	..	2735.0%	2762.4%	2751.4%	2451.6%	2224.7%	2133.0%	1942.6%	3058.7%
G. DOD-to-current GDP										
1. Long-Term Debt/GDP	..	..	494.0%	570.4%	602.2%	523.5%	448.0%	383.0%	244.0%	177.0%
2. IMF Credit/GDP	..	..	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
3. Short-Term Debt/GDP	..	..	52.1%	54.6%	56.4%	53.1%	50.7%	47.8%	40.0%	44.0%
4. LT+IMF+ST DOD/GDP	..	..	546.1%	624.9%	658.6%	576.6%	498.7%	430.8%	284.0%	221.0%
5. Total Debt + Arrears	..	..	632.5%	725.4%	790.6%	703.7%	709.6%	710.0%	679.7%	1035.3%
H. Debt Service/Exports G&S										
1. Public & Guaranteed LT	..	..	165.0%	172.7%	172.9%	262.5%	228.4%	160.7%	114.1%	50.7%
2. Private Non-Guaranteed LT	..	..	0.0%	0.0%	4.0%	2.2%	1.2%	1.1%	0.8%	0.1%
3. Total LT Debt Service	..	..	165.0%	172.7%	176.9%	264.7%	229.6%	161.7%	115.0%	115.7%
4. IMF Repurchases+Serv.Chgs..	..	..	0.0%	0.0%	0.5%	0.6%	0.5%	0.5%	0.4%	0.4%
5. Interest Only on ST Debt	..	..	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
6. Total (LT+IMF+ST Int.)	..	..	165.0%	172.7%	177.4%	265.3%	230.1%	162.2%	115.3%	116.1%
I. Interest Burden Ratios										
1. Total Interest/current GDP	..	..	17.5%	16.1%	17.6%	18.7%	21.1%	24.1%	29.8%	57.4%
2. Total Interest/Exports G&S	..	..	75.5%	61.3%	61.4%	65.1%	66.2%	72.5%	85.2%	169.7%

1./ Based on RMSM financing scenario. This scenario includes debt to all creditors, and assumes arrears clearance in 1991 to IBRD, IDA and IDB only, and debt service payments to all creditors for 1992 and beyond.

NICARAGUA - PUBLIC FINANCE

Base case Projection

ANNEX A5
Page 1 of 1

I. Consolidated Non-Financial Public Sector	Actual				Est.	Projected				
	1985	1987	1988	1989	1990	1991	1992	1993	1995	2000
As percent of Current GDP:										
A. Total Current Receipts	36.8	29.7	23.2	24.3	17.1	22.4	23.5	23.7	23.3	22.[illegible]
1. Tax Revenue	33.5	28.5	21.7	21.7	14.7	18.7	19.6	19.6	19.3	18.3
2. Non-Tax Current Receipts	2.5	2.1	1.4	2.4	1.2	2.1	2.1	2.1	2.1	2.[illegible]
3. Op. Surplus of Pub. Ent.	0.8	-0.9	0.1	0.2	1.2	1.6	1.8	2.0	2.0	1.6
B. Total Current Expenditures a./	47.7	41.5	42.6	26.0	41.3	27.8	24.9	21.7	19.8	16.5
1. Consumption	39.3	36.2	33.5	22.6	35.9	21.8	20.7	16.6	15.1	13.[illegible]
2. Transfers	..	..	..	..	5.4	6.0	4.2	5.1	4.6	3.7
3. Interest b./	..	..	..	..	..	..	..	..	..	..
C. Budgetary Savings	-10.9	-11.8	-19.4	-1.7	-24.2	-5.4	-1.4	2.0	3.6	5.2
D. Capital Exp. & Net Lending	12.1	6.5	7.2	3.9	1.4	7.0	7.7	7.6	6.7	4.7
1. Budgetary Investment	10.3	5.5	4.7	2.7	1.3	6.2	7.5	7.4	6.5	4.5
2. Capital Transfers	1.8	1.0	2.5	1.2	0.1	0.8	0.2	0.2	0.2	0.2
E. Capital Revenue	0.2	0.1	0.1	0.2	0.1	0.2	0.2	0.2	0.2	0.2
F. Overall Balance Financed by:	-22.8	-18.2	-26.5	-5.4	-25.5	-12.2	-8.9	-5.4	-2.9	0.7
1. Official Capital Grants	0.6	0.5	0.6	2.9	13.2	12.2	8.9	5.4	2.9	0.3
2. External Borrowing (net)	0.1	0.1	0.7	0.1	0.0	0.0	0.0	0.0	0.0	-0.7
3. Domestic Financing	22.0	17.5	25.2	2.2	12.4	0.0	0.0	0.0	0.0	0.0
G. GDP (curr. Cordobas) c./	0.115	2.696	306	17,810	1291602	7,697	11,171	13,978	19,426	39,235
II. Total Public Sector d./										
Overall Balance (deficit -)	-44.0	-37.2	-54.4	-38.9	-55.9	-28.2	..	..	..	..
Non-Financial Public Sector	-22.8	-18.2	-26.5	-5.4	-25.5	-12.2	-8.9	-5.4	-2.9	0.7
Rest of public sector	-13.1	-9.4	-3.2	-4.9	-14.8	-2.0	..	..	..	..
Central Bank losses	-2.8	-5.0	-8.5	-11.9	-1.8	-0.4	0.0	0.0	0.0	0.3
Unpaid foreign interest	-5.3	-4.6	-16.2	-16.7	-13.8	-13.6	..	..	..	..
Financing	44.0	37.2	54.4	38.9	55.9	28.2	..	..	..	..
External Financing e./	..	18.7	22.1	24.1	19.1	15.7	..	..	..	..
Domestic Financing	..	18.0	31.7	11.9	23.6	-1.1	..	..	..	..
Foreign Grants (civilian)	0.6	0.5	0.6	2.9	1.2	13.6	9.5	5.5	2.6	0.0
Foreign Grants (military)	..	..	..	..	12.0	0.0	0.0	0.0	0.0	0.0

./ In 1990 includes 12 percent of GDP in extrabudgetary military outlays financed with grants from Eastern European countries.
./ To be determined.
./ Amounts in billion New Cordobas which were introduced with the monetary reform in 88; and in million Cordobas Oro for 91-2000.
./ Excludes expropriated productive enterprises (APPs). Rest of the public sector includes the state oil company, foreign trade enterprises, and expenditures financed by external lines of credit.
./ Includes the counterpart of unpaid foreign interest.

NICARAGUA - MONEY AND CREDIT

Base case Projection

ANNEX A6
Page 1 of 1

	Actual a./				Estimated
	1986	1987	1988	1989	1990
A.As percent of Current GDP:					
Money Supply (34)	47.5	3.3	62.6	21.8	21.1
Money + Quasi-Money (34+35)	64.5	3.8	65.7	26.7	26.1
Total Net Domestic Credit	77	3	86	52	91
To Government (net) (32an)	45.0	1.0	70.0	42.6	68.6
To Official Entities (32b)	..	..	..	..	..
To Private Sector (32d)	32.3	1.8	15.8	9.7	22.2
Net Foreign Assets (31n) b./	-56.9	-0.5	-826.0	-546.5	-598.2
All Other Items (net)	-39.1	-1.1	805.9	519.0	533.5
B.Offsets to expansion of MQM :					
Net Foreign Assets b./	-104.4%	-2.2%	..	-2256.2%	-2292.5%
Credit to Government	58.3%	22.4%	..	175.4%	264.2%
Credit to Official Entities	..	..	..	..	..
Credit to Private Sector	40.6%	48.1%	..	39.9%	89.6%
Net Other Assets & Liabilities	105.5%	31.7%	..	2141.0%	2042.8%
Increase in Money + Quasi-money	100.0%	100.0%	..	100.0%	100.0%

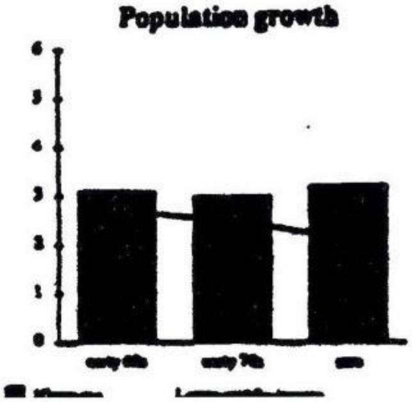
a./ Beginning 1988 there is a break in the comparability of the data.
b./ Includes Long-Term Foreign Liabilities.

Social Indicators of Development, 1990

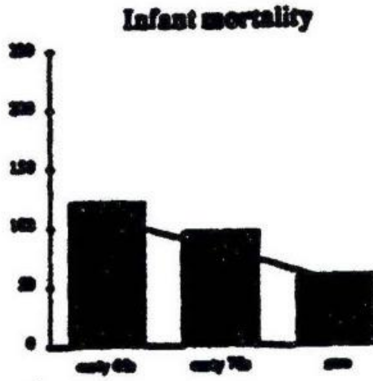
Nicaragua

	Unit of measure	25-30 years ago	15-20 years ago	Most recent estimate (mre)	Same region / income group: Latin America, Caribbean	Same region / income group: Lower-middle-income	Next higher income group
HUMAN RESOURCES							
Size, growth, structure of population							
Total population (mre = 1989)	thousands	1,750	2,408	3,740	422,417	666,815	422,994
14 and under	% of pop.	48.8	47.9	46.0	36.5	37.9	33.6
15-64	"	48.8	49.7	51.2	58.9	57.6	60.8
Age dependency ratio	unit	1.05	1.01	0.95	0.70	0.73	0.64
Percentage in urban areas	% of pop.	42.7	50.3	59.2	73.6	59.2	68.2
Females per 100 males							
Urban	number	..	116	..	104	..	..
Rural	"	..	94	..	..	..	..
Population growth rate	annual %	3.1	3.0	3.2	2.0	2.1	1.8
Urban	"	4.6	4.3	4.3	2.9	3.0	2.9
Urban/rural growth differential	difference	2.5	2.6	2.6	3.0	1.9	3.1
Projected population, 2000	thousands	..	..	5,148	514,043	831,021	510,348
Stationary population	"	..	..	13,908	..	..	..
Determinants of population growth							
Fertility							
Crude birth rate	per thou. pop.	49.2	46.1	40.0	27.9	30.0	25.5
Total fertility rate	births per woman	7.19	6.47	5.33	3.45	3.87	3.27
Contraceptive prevalence	% of women 15-49	..	..	27.0	..	..	..
Child (0-4) / woman (15-49) ratios							
Urban	per 100 women	..	64	..	..	..	..
Rural	"	..	91	..	..	..	..
Mortality							
Crude death rate	per thou. pop.	15.7	12.2	7.2	7.1	8.1	8.0
Infant mortality rate	per thou. live births	121.4	95.8	58.5	51.7	52.7	45.2
Under 5 mortality rate	"	..	..	69.5	61.6	81.5	54.4
Life expectancy at birth: overall	years	50.4	55.7	64.1	67.0	65.2	67.4
female	"	51.6	56.7	65.4	70.0	67.6	69.9
Labor force (15-64)							
Total labor force	thousands	535	722	1,162	148,480	243,588	159,186
Agriculture	% of labor force	56.7	49.1	..	..	..	..
Industry	"	15.7	15.6	..	..	..	..
Female	"	18.8	20.6	24.9	26.6	30.2	30.7
Females per 100 males							
Urban	number	..	128	..	106	..	..
Rural	"	..	94	..	88	..	..
Participation rate: overall	% of labor force	30.6	30.0	30.9	35.1	38.8	38.7
female	"	11.4	12.3	15.4	18.5	22.6	23.5
Educational attainment of labor force							
School years completed: overall	years	..	4.4	..	..	..	..
male	"	..	..	..	..	..	..
NATURAL RESOURCES							
Area	thou. sq. km	130	130	130	20,308	21,088	16,264
Density	pop. per sq. km	13	19	27	20	30	25
Agricultural land	% of land area	40.7	44.8	50.1	36.5	36.9	31.9
Agricultural density	pop. per sq. km	33	41	54	45	82	79
Forests and woodland	thou. sq. km	62	51	38	9,703	6,084	6,887
Deforestation rate (net)	annual %	-1.8	-2.1	-2.8	-0.5	-0.7	-0.4
Access to safe water	% of pop.	..	56.0	48.0	73.2	63.5	79.7
Urban	"	..	100.0	76.0	83.6	77.2	90.4
Rural	"	..	14.0	11.0	52.6	46.8	63.2

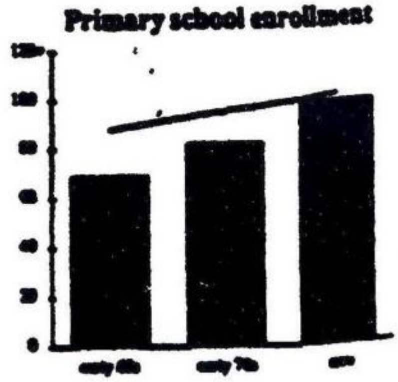
Population growth



Infant mortality



Primary school enrollment



Social Indicators of Development, 1990

Nicaragua

	Unit of measure	25-30 years ago	15-20 years ago	Most recent estimate (mre)	Same region / income group: Latin America Caribbean	Same region / income group: Lower-middle-income	Next higher income group
INCOME AND POVERTY							
Income							
GNP per capita (mre = 1987)	US$	320	630		1,950	1,320	3,810
Total household income							
Share to top 10% of households	% of income	..	..	..	..	..	..
Share to top 20% of households	"	..	65	..	..	..	..
Share to bottom 40% of households	"	..	9	..	..	..	..
Share to bottom 20% of households	"	..	3	..	..	..	..
Poverty							
Absolute poverty income: urban	US$ per person	..	..	..	..	..	..
rural	"	..	..	..	..	..	..
Pop. in absolute poverty: urban	% of pop.	..	..	..	..	..	..
rural	"	..	..	..	..	..	..
Prevalence of malnutrition (under 5)	% of age group	..	..	22.1	..	..	..
EXPENDITURE							
Food	% of GDP	..	..	..	..	..	..
Staples	"	..	..	..	..	..	..
Meat, fish, milk, cheese, eggs	"	..	..	..	..	..	..
Cereal imports	thou. metric tonnes	54	58	129	17,357	40,386	36,788
Food aid in cereals	"	..	3	87	..	7,767	..
Food production per capita	1979-81=100	98.7	115.3	58.5	103.8	99.9	102.9
Share of agriculture in GDP	% of GDP	25.1	22.5	29.6	10.1	15.2	13.1
Daily calorie supply	calories per person	2,398	2,374	2,361	2,728	2,741	2,980
Daily protein supply	grams per person	69	69	57	69	71	77
Housing	% of GDP	..	..	..	..	..	
Average household size	persons per household	6	..	..	..	..	
Urban	"	6	..	..	..	..	
Fixed investment: housing	% of GDP	..	..	..	..	..	
Fuel and power	% of GDP	..	..	..	..	..	..
Energy consumption per capita	kg of oil equivalent	172.1	293.4	255.8	967.1	843.7	1,537.7
Households with electricity							
Urban	% of households	..	..	..	..	..	..
Rural	"	..	..	..	..	..	..
Transport and communication	% of GDP	..	..	..	..	..	..
Population per passenger car	persons	135	66	84	17	30	15
Fixed investment: transport equipment	% of GDP	..	..	..	..	..	..
Total road length	km	..	..	..	..	..	..
Population per telephone	persons	..	67	61	12	17	8
INVESTMENT IN HUMAN CAPITAL							
Medical care	% of GDP	..	..	..	..	..	..
Population per: physician	persons	2,498	2,098	1,498	938	1,551	1,020
nurse	"	1,390	..	534	879	..	601
hospital bed	"	..	400	400	..	..	..
Access to health care	% of pop.	..	..	..	..	..	..
Immunized (under 12 months): measles	% of age group	..	..	44.0	52.7	62.9	..
DPT	"	..	..	43.0	62.4	63.2	..
Oral Rehydration Therapy use (under 5)	% of cases	..	..	23.0	33.6	27.5	..
Education	% of GDP	..	..	..	..	..	..
Gross enrollment ratios							
Primary: total	% of school-age group	69.0	82.0	99.0	106.8	102.0	102.6
female	"	60.0	85.0	104.0	105.4	101.1	99.7
Secondary: total	"	14.0	24.0	43.0	47.9	51.1	55.9
female	"	13.0	24.0	58.0	51.3	52.4	56.5
Tertiary: science/engineering	% of tertiary students	9.7	..	20.2	..	..	..
Pupil-teacher ratio: primary	pupils per teacher	34	39	32	24	26	23
secondary	"	17	41	33	..	17	..
Pupils reaching grade 4	% of cohort	..	47.9	60.9	60.3	..	75.4
Repeater rate: primary	% of total enrollment	..	13.7	14.6	19.6	8.6	..
Illiteracy rate: overall	% of pop. (age 15+)	50.4	42.5	..	16.7	25.4	..
female	% of females (age 15+)	..	..	..	19.0	31.6	..
Newspaper circulation	per thou. pop.	46.3	37.8	46.5	81.7	78.9	83.0

Source: World Bank International Economics Department, September 1990.

MINISTERIO DE LA PRESIDENCIA

LETTER OF DEVELOPMENT POLICY

Managua, July 25, 1991 (9:26am)

Mr. Barber B. Conable
President
The World Bank
Washington, D.C. 20433

Dear Mr. Conable,

1. After free elections in February 1990, the Chamorro Government took office in April 1990 inheriting a devastated economy which was performing at extremely depressed levels compared to a decade earlier. Private sector participation in the economy was minimal due to extensive public sector intervention through ownership, monopoly, and regulation of economic activities as well as heavy domestic and external resource use. This, coupled with mismanagement of economic policy, resulted in major inefficiencies of resource use and production, and reduced domestic savings and productive investment. Additionally, the economy was highly unstable, with hyper-inflation reaching about 34,000 percent p.a. in 1988.

2. From the beginning of its regime the new Government has pursued a reform strategy which emphasizes the importance of establishing and maintaining price stability and structural adjustment. The main focus of the strategy has been to reduce the size of the public sector, to realign relative prices, and to achieve the preconditions of a market economy. In line with this strategy, the Government has adopted a set of policies in the areas of expenditure reduction, tax reform, monetary and exchange rate policy, and trade liberalization.

3. After achieving some initial success in reducing the rate of inflation in 1990, the Government's economic policies came under pressure from extended strikes and other political difficulties. Under more relaxed fiscal and monetary practices, inflationary pressures increased and the year was closed with a decline in output and more than 7,000 percent annual rate of inflation. Nonetheless, the Government was successful in restoring peace to the country and in formally achieving a consensus among the different groups in the society. A "concertación" agreement was successfully concluded among the Government, labor, business, and the Sandinista opposition in October 1990, which would pave the way for successful implementation of the Government's economic policies.

I. THE STABILIZATION PROGRAM

4. After consultation with international organizations including the IMF and the World Bank, the Government announced a far reaching stabilization program on March 3, 1991. The main elements of the stabilization program included:

Changing the official parity of the córdoba (oro) from 1 C$ to 5 C$ per dollar. Convertibility at that rate for trade purposes will be progressively increased with the aim of achieving free convertibility by year's end. The old córdoba was taken out of circulation completely by April 30, 1991.

Committing, from March 4 onward, to refrain from emitting any new money that is not backed by international reserves. The Central Bank will not extend credit to finance the public sector deficit, and it will give credit to the banking system only to the extent that it is backed by corresponding foreign currency inflows.

Pursuing public sector wage policies which are consistent with reducing inflation and maintaining fiscal discipline. Revenues will be increased primarily by widening the tax base. Expenditures will be strictly limited to tax revenues plus actual receipts from foreign grants and loans, and the government payroll will be gradually reduced through a voluntary program of job reconversion.

5. This stabilization program has been closely scrutinized by the international community. In various fora the IMF, the World Bank, and the IDB, and bilateral donors have strongly endorsed the program and have acknowledged the Government's decisiveness in implementing such a program under strenuous economic, social, and political circumstances.

6. The results of the implementation of the stabilization program are very encouraging. After eleven months of weekly inflation rates ranging from 6 to 20 percent, the rate of inflation declined quickly after the corrective shock following the March 3 devaluation, and amounted to only 12 percent from end-March to end-April, becoming negative in May. Industrial sales recovered significantly from February to May and were at higher levels than a year before.

II. THE STRUCTURAL ADJUSTMENT PROGRAM

7. The Government considers that stabilization and structural adjustment are preconditions to economic recovery after many years of depression, and that they also pave the way to sustained growth with equity. It is our conviction that, without economic recovery, stabilization will not last very long, and without stabilization and establishment of a supporting macroeconomic environment, our adjustment efforts will be unproductive. Consequently, the Government is now poised to intensify its efforts toward structural adjustment. The main elements of this program have been discussed with the World Bank staff, and the final design of the program has benefitted from these discussions.

<u>Medium Term Macroeconomic Framework</u>

8. The Government attaches primary importance to maintaining macroeconomic policies which support the objectives of structural adjustment. To this end, we are committed to pursuing the following:

Fiscal policy which maintains the proper balance between revenues and expenditures, and which avoids recourse to Central Bank financing. While the need for external financing will continue in decreasing magnitudes, the objective is to achieve a balance between Government revenues and non-interest current expenditures by 1993 through expenditure rationalization and improvements in revenue performance.

Monetary policy which encourages financial resource mobilization and improves the efficiency of resource allocation. Together with financial sector reforms, this will be achieved through the maintenance of positive real interest rates and eventual interest rate liberalization. The Government will ensure the consistency of the monetary program with the objectives of stabilization and adjustment, which will put tight constraints on increases in the Central Bank stock of net domestic credit.

Exchange rate policy that helps to maintain competitiveness and profitability in the tradeables sector and encourages the diversification of the country's exports. While implementing tight fiscal, monetary and income policies, we will also monitor developments closely and take actions promptly, when warranted, to account for changes in domestic and external factors.

Public Sector Reform

9. The Government's structural adjustment policies will have a particular focus on public sector reforms, financial sector reform, and reforms in the system of incentives. In the area of public sector reform, the reduction of the size of the public sector is one of our priorities. During the previous decade, the public sector sharply expanded its share in resource use as the deficit of the public sector peaked at 54 percent of GDP in 1988.

10. **Expenditures.** In line with our stabilization objective, we plan to keep Central Government expenditures under US$ 390 million in 1991, with US$ 338 million represented by current expenditures. This represents 63.2 percent of the current expenditures of the previous year. This drastic cut is to be achieved through the continuous rationalization of the public sector, with particular emphasis on military expenditures. The Government's objective is to ensure that in the medium term the Central Government will be a net saver, in contrast with its performance during the previous decade. To this end: 7

Non-interest current expenditures will be reduced by another 7 percent in 1992 from the level programmed in 1991 at US$ 330 million. To ensure this outcome, the FY1992 budget will accommodate no more than US$ 315 million of non-interest current expenditures. This outcome will be partly achieved through an approximate 15 percent cut in military expenditures.

By FY93 we will target another restructuring in the budget which will aim at reducing non-interest current expenditures by an additional 9 percent in that year, a level which we expect will correspond to Government revenue.

Beyond 1993, we will aim to cover recurring interest payments expenditures from the current budget with domestic resources, and the Central Government to produce a net savings in funds.

The Government will carry out a public expenditures review in 1991-1992, jointly with the World Bank, which will provide a basis for the restructuring of the size and composition of public expenditures. We expect to incorporate some of the resulting recommendations in FY92.

11. As part of our public sector restructuring effort, the Government has implemented an employment reconversion program which aims at voluntarily reducing the size of public sector employment. With funds from USAID, we are targeting more than 10,000 public sector employees to be retired in 1991. The program has been very successful in that more than 8,000 employees applied to take advantage of the retirement scheme. During the year, we extended the program to cover the financial public sector and state economic enterprises. We plan to continue with the program, targeting an additional 10,000 employees in the public sector, if we can obtain additional external funds in 1992.

12. Privatization. Another important aspect of our public sector restructuring efforts is the privatization of state owned corporations and companies. There were some 350 such entities when this government came to office. Their activities ranged from agricultural farming, to manufacturing, and to trade and other services. Some of these companies were monopolies in their respective areas of operation, while others acted as regulatory agencies. The Government aims to drastically reduce public ownership in economic activities, dismantle state monopolies, and eliminate undue regulations. After having set up an umbrella organization (CORNAP) to assume the responsibility for privatization, we formulated a strategy for divestiture. Some $\boxed{86}$ enterprises have already been either returned to previous owners whose properties were illegally confiscated under the previous regime, liquidated, or privatized. Our goal is to accomplish the objectives of privatization rapidly. The plan is to finalize divestiture or complete preparations for privatization for at least 90 percent of enterprises by the end of 1993. In line with this objective, the Government will complete the following by March 15, 1992: 86

Finalize the privatization of at least 25 additional companies.

Finalize devolution, liquidation or assignation of an additional 50 companies.

Take concrete steps toward the preparation of an additional 30 companies for privatization.

13. Public Utilities. During the previous year, the Government was successful in eliminating the deficits of the public utilities through adjustments in their tariffs and rates. There is still a need, however, to improve their overall efficiency in operations. This will require changes in areas such as organization, incentives, autonomy and accountability of management, and decision making. To provide a framework for such changes, the Government plans to undertake, with support from the World Bank, a comprehensive study covering the various aspects of public utilities operations. This study will commence before March 1, 1992.

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14. **Tax Administration.** The Government has already taken important steps to revise the overall tax rate structure. We believe that these rate adjustments will yield their full effects, in the form of higher revenues and improved incentives, as a result particularly of the implementation of major improvements in tax administration and enforcement. The Government, therefore, has prepared a plan of action to reform the customs and internal revenue services. In accordance with this plan, the Government has already created a separate unit within the General Directorate of Revenue to improve the administration of taxes collected from the 280 largest taxpayers. Several customs posts have been relocated to improve customs control. The separate taxation unit for large contributors will serve as a pilot project for the development of a modernized tax information system and streamlined tax administration procedures. It will be extended subsequently to the entire system, and it is expected to be fully operative by August 1, 1991. Other actions that will be completed before October 1991 include:

The distribution and implementation of simplified tax declaration/payment forms and procedures.

The publication of a decree establishing stricter sanctions for tax evasive or delinquent practices.

The publication of a second decree revising the penalty structure for tax evasion and delayed tax payments in accordance with the fiscal cost of the infraction and the lateness of payments.

The relocation of all customs posts identified in the action plan.

The revision of customs valuation lists, which will be updated on a monthly basis.

15. In addition to these short term measures, the Government aims to address the main institutional weaknesses in tax administration in the context of a medium to long term strategy. Toward this end, the Govenment is planning to take steps to: (i) develop automated management control systems and a computerized taxpayer identification system, and (ii) train Customs and Internal Revenue personnel, especially in the areas of auditing and the use of computers. By March 1992, the arrangements for technical assistance to implement actions in these areas will be finalized, consultants will have been hired, and program implementation will have started.

<u>Financial Sector Reform</u>

16. The plan for reform of the financial sector is consistent with the overall economic reform strategy in other sectors. Through a series of regulatory changes the role of the public sector in financial intermediation activities will diminish, in such a way as to create the conditions that allow a greater private sector participation in the financial sector. The ultimate goal of the plan is to improve the efficiency of financial intermediation and resource allocation through the establishment of a competitive, free entry, private sector oriented financial system.

17. **Restructuring the State Owned Banks.** A restructuring of the state owned banks will form the cornerstone of the reform program for the financial sector. This is not only essential to attract viable private sector financial institutions to the economy, but also to eliminate the enormous cost to the Government and the economy of the current state bank system. To initiate the restructuring program the Government will adopt an action program by July 15, 1991 which incorporates the following measures:

The recharter, within 24 months, of the Banco Nacional de Desarrollo and Banco Popular to provide financial and technical assistance services for rural and agricultural development and small scale enterprise. During the transition process, BND will be transferring its commercial operations to the private banks in step with the capacity of those banks to provide these services. Both BND and BP will be funded exclusively through foreign grants and domestic resources which have been budgeted for in the Central Government. During the transition process before adoption of the new charters, both institutions will operate under competitive conditions with private sector financial institutions.

The liquidation or merger of Banco Inmobiliario with Banco Nicaragüense de Industria y Comercio (BANIC) within 6 months.

The restructuring of BANIC as a public financial institution subject to exactly the same conditions as any competing private sector financial institution, including redimensioning it to be compatible with financial viability.

The measures required for the Fondo Nicaragüense de Inversiones (FNI) to become a second-tier banking institution.

And the dissolution of the Corporación Financiera de Nicaragua (CORFIN) by March 1992.

18. By March 1992, the Government will have completed all administrative and regulatory requirements needed to implement the action plan in its entirety. Additionally, financial sector employment will have been reduced to levels compatible with financial viability and the minimum investment required to restore solvency to BANIC will have been determined. All banking functions of CORFIN will have been consolidated into the appropriate state owned banking operation, with the elimination of CORFIN.

19. **The Superintendency.** Creating and implementing a strong Superintendency is a critical element of the plan to develop a well functioning private banking system. The Superintendency has the responsibility to society at large to monitor banking activities and to enforce their compliance with established norms. Owing to the importance of this aspect of the financial sector program, a law has already been passed for The Creation of Superintendency and Financial Institutions. By July 15, 1991, additional measures will be taken:

A qualified Superintendent will be designated.

The Superintendent will be housed and at least partially staffed and equipped to assume operations.

Regulations acceptable to IDA will be issued to execute the Superintendency Law.

A financing source for any technical assistance required to prepare normatives through the Superintendency will be identified.

By October 1991, the Superintendent will have issued normatives to permit the initiation of private banking operations, and by December 1, 1991, will have approved applications for private sector financial institutions.

20. **Law of Banking and Financial Institutions.** The Government recognizes that a modern and comprehensive Law of Banking and Financial Institutions is necessary, to complete the legal framework to establish a financial market with free access that encourages competition, to authorize the privatization of state owned banks, and to develop modern prudential regulations.

21. By end-July 1991, the Government will produce a terms of reference for developing and implementing the new Law of Banking and Financial Institutions. The terms of reference should identify a team, a technical assistance financing source, and a timetable for the development of the new law.

22. By March 1992, a modern Law of Banking and Financial Institutions will have been developed and submitted to the National Assembly.

23. **Monetary and Interest Rate Policy.** Appropriate monetary and interest rate policies are not only necessary to maintain price stability, they are also crucial for the development of domestic savings and an efficient and competitive financial system. The Government has already introduced a transitional interest rate structure which indexes deposit and lending rates to the US dollar. Interest rates on domestic lines of credit have been increased to 3 percentage points above the deposit rate, also indexed to the dollar. Monetary policy is conducted with an objective of achieving price stability and reserves targets, where corresponding ceilings established for net domestic assets are met.

24. By March 1992, the Government will have introduced a new interest rate policy which completely liberalizes deposit rates and maintains only a band of control around lending rates. The band of lending rates will be sufficiently wide to allow the possibility of lending interest rates equivalent to rates in the US adjusted for currency and country risk. The rediscount rate will be uniform for all borrowers, and will lie above the average deposit rate prevailing in the financial system.

Trade Liberalization and Market Reforms

25. Private-sector driven economic growth and Nicaragua's efficient insertion into world trade require not only the retreat of the state from direct control over GDP, but also the elimination of obstacles to the functioning of internal and external markets. The Government has launched a far-reaching program of liberalization and promotion of foreign trade across all products and sectors of the economy. Measures have already been taken, and will continue to be directed, toward the elimination of entry and exit barriers to economic activities and (domestic and foreign) markets, the achievement of a neutral

foreign-trade regime, and the provision of services necessary for market transparency.

26. State Trading Monopolies. The state trading monopolies that controlled virtually all of export and most of import trade during the 1980's have been eliminated by Legislative Decree in January 1991 and substituted by a system of commercial registration at the Ministry of Economic Affairs and Development. Regulations, passed in June 1991, ensure complete automaticity, non-discretionality and transparency of the registration process. Additionally:

De facto trading monopolies, due to the dominant position and forward-integration of state-owned enterprises in certain product markets (e.g. meat and sugar), will be dealt with in the context of the government's privatization plan. Specifically, CANSA's monopoly on domestic purchases and distribution of sugar will be eliminated by March 1, 1992.

The government will take further steps to improve the legal basis of free private sector participation in foreign trade during the remainder of 1991.

27. Quantitative Restrictions. The 1980's were characterized by pervasive non-price restrictions on foreign trade. Over the past year, most of these restrictions have been eliminated. At present, and apart from currency convertibility, quantitative restrictions remain only on exports of some natural resources, basic grains, sugar and capital goods, and on imports of basic grains, sugar and products of the poultry industry. In addition:

Export permits for precious metals, timber, fish, crustacea and live cattle will be dealt with in the context of controls on exploitation (see below). Trade in basic grains will be subjected to a price band (see below).

In the case of products subject to quotas in international markets (currently: sugar), quota access conditions imply the necessity of distributing such quotas among exporters. By March 1, 1992, access to the quota will be based on a bidding system to exclude non-price rationing and minimize government discretionality.

All other quantitative restrictions on non-petroleum imports and exports (but those of basic grains) will be completely eliminated by March 1, 1992.

28. Tariff Reform. Trade liberalization and thus tariff reform is at the core of the Government of Nicaragua's program of structural adjustment and of the fundamental shift from an economic philosophy of import substitution toward incentive neutrality as the basis for Nicaragua's insertion into world markets. Even though substantial advances have already been made to reduce nominal protection and render it more uniform, a high rate dispersion and a certain lack of transparency persist.

29. Duties on imports to Nicaragua include the basic tariff (DAI) applied to imports from outside the Central American region as well as the Selective Consumption Tax (ISC) on selected imports and a flat 3 percent stamp tax on imports from all origins. Nominal protection currently ranges from 3 percent to 143 percent and averages 18 percent, the second lowest level in Central America.

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The Government of Nicaragua is committed to reduce nominal import protection and rate dispersion according to the following schedule:

By August 1991, nominal import protection (NIP) will be lowered by Decree and its dispersion reduced to a 10%-60% range. The Decrees -- and widely published public announcements to this effect -- will further include a timetable according to which, by December 1991, the NIP range will be reduced to 10%-50%, and progressively in well-defined steps to reach a tariffs-only range of 10%-20% by December of 1993. The only exceptions to this rule will be medicines and books.

By March 1992, according to the NIP reduction program, the NIP rates will have been lowered to a 10%-40% range.

So as to avoid exemptions to this regime and thus unnecessary distortions, the government will negotiate with the respective foreign agencies that in-kind donations should reach local markets under competitive conditions, and will remove income tax exemptions as well as prepare a program to phase out indirect tax exemptions, including import tax exemptions.

30. Decontrol of Foreign Exchange. Restrictions on access to foreign exchange for current account purposes are among the most damaging of quantitative restrictions. The Government of Nicaragua's move toward free trade and efficient markets therefore implies a rapid process of decontrol of foreign exchange.

Foreign exchange allocation under the Sandinista government was highly centralized and discretional. Exporters did not have guaranteed access to the foreign exchange generated by their operations. Foreign exchange retention of export proceeds by the government is not currently enforced, with the exception of the foreign exchange revenue generated by cotton and coffee exports.

Legally, the Export Promotion Decree, to be passed in August 1991, will provide exporters with unrestricted access to own-generated foreign exchange for current account operations. Similarly, the Investment Promotion Law, enacted in June 1991, guarantees foreign investors access to foreign exchange for transfers of dividends and profits as well as for the repatriation of principal.

Although the government is committed to achieve full current account convertibility of the Córdoba by March 1992, the allocation of foreign exchange from official external credit lines and donations will continue to be regulated by the Central Bank for reasons of compliance with donor and creditor restrictions. Nevertheless, the allocation process will be drastically simplified and its transparency increased, and steps will be taken to ensure that allocation will not entail rationing of eligible demand by means of non-price criteria by March 1992.

After July 1991, foreign exchange operations will be progressively transferred to the commercial banking sector.

31. Agricultural Trade. With the objectives of reducing Government intervention, barriers to private sector participation, and incentive distortions in the production and trade of basic food grains (rice, beans, maize and sorghum), an action plan has been approved that contains the following elements:

Support prices for all four products will be eliminated by August 1991. ENABAS will buy grains at prevailing market prices. ENABAS will also offer to private traders and producers storage and related services for a fee. It may also rent out part of its facilities.

Payments in kind to public sector employees (AFA package) will be monetized as part of the salary before October 1991.

A price band system with variable levies for rice, yellow corn, and white maize will be designed before August 1991, and implemented before March 1992.

Any remaining quantitative restrictions on food grain imports will be eliminated by March 1992. ENABAS will offer to private traders the service of importing on their behalf (bundling orders). An action plan for the elimination of quantitative restrictions on exports will be prepared by the same date.

ENABAS will refrain from trading in all but basic grains before March 1992. A program for privatizing its retail and wholesale outlets will be prepared by the end of 1991. At least 20 percent of its corresponding assets will be sold to wholesalers or distributed as part of severance payments to ENABAS employees, before March 1, 1992; the rest will be divested before the end of 1992.

A medium-term strategy and action plan for redefining the future role of ENABAS, restricting ENABAS intervention in regional grain markets to such markets where private competition is insufficient, and privatizing and/or leasing its facilities whenever competitive private participation can be ensured, will be prepared before March 1992.

32. **Export and Investment Promotion.** The thrust of the government's export and investment promotion policies is the elimination of the anti-export bias inherent in Nicaragua's history of controls and protection, and the provision of a clear legal framework for property rights, as illustrated by the following:

The new Export Promotion Decree, to be passed by September 1991, provides for the exemption of inputs for export production from import duties and indirect taxes. As part of the Decree, non-traditional exports will receive additional temporary incentives, in the form of negotiable tax credit certificates, to compensate for the economy's anti-export bias during the adjustment phase. The by-laws of the Decree will be elaborated by the same date and implementation is to be completed by March 1992.

The Foreign Investment Law, adopted by the National Assembly in June 1991, guarantees the foreign investor's right to profit and dividend transfers as well as the repatriation of his capital.

The Decree on Duty-Free Export Processing Zones, to be adopted before Board presentation, specifies further stimuli to exporters who meet certain minimum criteria.

Finally, one-stop administrative procedures will be in place by the end of 1991, simplifying current needs for the exporter to deal with a diverse array of government institutions.

33. Domestic Deregulation. A very significant reduction of government intervention in the economy, and the development of open and competitive markets, are necessary conditions both for a more efficient use of resources and for creating a favorable climate for the reactivation of private economic activity. Where government intervention is necessary on social or economic grounds, it will be done under transparent and equitable rules, while simplifying bureaucratic procedures to the greatest extent possible. In this context, the following actions will be taken:

The legal framework permitting price controls, except for natural monopolies, will be abrogated before March 1992.

Transitory price setting adopted for selected products in Government-owned stores will be eliminated before March 1992.

An action plan to phase out price controls of the fiscal industries and to reformulate the Selective Consumption Tax, confining it to luxury goods regardless of origin, will be prepared before March 1992.

The state institutes in charge of regulating exploitation in mining (INMINE) and fisheries (INPESCA), after separating from them their corresponding production and trade activities, will be transferred from CORNAP to MEDE before August 1991.

Terms of reference for studies to design the regulatory framework for the management of natural resources will be prepared by September 1991. This regulatory framework will be implemented before March 1992.

Any regulatory entry barriers to the private sector in other activities still remaining under CORNAP production monopolies (sugar mills, export slaughtering houses, bananas for export) will have been eliminated before August 1992.

Social Sector Programs

34. Two programs have been established to ensure that the burden of stabilization and structural adjustment does not fall most heavily on the poor.

The Emergency Job Creation program is administered by the Emergency Social Investment Fund (FISE) that was created in November, and a campaign for social protection of the most vulnerable groups (will be administered by the Fund for Attention to Oppressed Sectors (FASO):

Emergency Job Creation. The emergency job creation program (FISE) is expected to generate the equivalent of 30,000 man-years of temporary employment at a total cost of US$ 62 million in 1991, and 40,000 man-years at a cost of US$ 83 million in 1992.

Protection to Most Vulnerable Groups. The campaign for social protection (FASO), with a projected budget of US$ 87 million in 1991 and US$ 103 million in 1992, will create additional social safety nets for the most vulnerable of the society:

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Emergency feeding programs will be directed toward rural and urban child care centers, homes for invalids and the elderly indigent, and orphans of war victims. A total of 46,598 persons are expected to participate in the feeding program.

Occupational training for the unemployed will target 20,000 workers laid-off as of March 1991 and will provide them with training, free transportation and foodstuffs during the duration of the training.

A microenterprise credit program for 10,050 people will promote and protect micro-entrepreneurs working in the informal sector. The small business people will receive technical and managerial training programs and credit through the Micro-fund of the Banco Popular.

A special health support program will be added in 1992.

III. CONCLUSIONS

35. The Government of Nicaragua is committed to pursuing policies which lead to renewed and sustainable growth and an improvement in living standards for the citizens of Nicaragua. The actions and policies outlined in this letter of development policy will support both of these objectives. Since taking office in April 1990, the Government led by President Chamorro has demonstrated its commitment and political will to initiate both stabilization and adjustment measures under extremely difficult conditions. To ensure the successful completion of these programs, however, adequate financial and technical assistance from the international community are needed. In this context, we request the World Bank's fina ial support for the implementation of our program for economic recovery and adj stment.

Ministro de Economia y Desarrollo

MACROECONOMIC POLICIES AND PROGRAM IMPLEMENTATION

ISSUES AND OBJECTIVES	ACTIONS ADOPTED		ACTIONS TO BE ADOPTED
	BEFORE NEGOTIATIONS	BEFORE BOARD PRESENTATION	BEFORE MARCH 1992 [1]
Achieve and maintain a macroeconomic policy framework consistent with the objectives of price stability, trade and exchange rate liberalization, and balance of payments equilibrium.	A stabilization program has been initiated; Cordoba was devalued by 400 percent. Expenditures targeted in line with expected revenue. Adopted cash-budgeting procedures for expenditures. Monthly credit ceilings for Central Bank credits established.	Maintenance of an appropriate macroeconomic framework, including fiscal deficit and domestic credit ceilings consistent with stabilization objectives (Board Presentation condition). Maintenance of exchange rate policy which is consistent with export competitiveness, and which reflects changes in monetary, balance of payments, and trade and foreign exchange reserve indicators. Satisfactory program implementation (Board Presentation Condition).	Maintenance of an appropriate macroeconomic framework (Second tranche condition). Satisfactory program implementation (Second tranche condition).

[1] Tentative date for second tranche release.

PUBLIC EXPENDITURES

ISSUES AND OBJECTIVES	ACTIONS ADOPTED		ACTIONS TO BE ADOPTED
	BEFORE NEGOTIATIONS	BEFORE BOARD PRESENTATION	BEFORE MARCH 1992
Large size of public sector with high total expenditures/GDP ratio and current expenditure/GDP ratio	Budgetary expenditures for FY91 have been restrained, including a significant reduction in military expenditures.	Reduction of Central Government non-interest current expenditures in the proposed FY92 budget to less than US$325 million equivalent (Board Presentation condition).	Adoption of: (a) FY92 Budget with reduced Central Government non-interest current expenditures less than US$325 million equivalent; (Second tranche condition) and (b) An action plan, satisfactory to IDA, based on recommendations of the joint Government-IDA public expenditure review (Second tranche condition).
Weak institutional capacity to plan and monitor public expenditures.			

PUBLIC SECTOR EMPLOYMENT

ISSUES AND OBJECTIVES	ACTIONS ADOPTED		ACTIONS TO BE ADOPTED
	BEFORE NEGOTIATIONS	BEFORE BOARD PRESENTATION	BEFORE MARCH 1992
Excessive public sector employment and large wage bill. Reduce public sector work force and facilitate reallocation of redundant labor to productive employment in the private sector, especially in tradeables.	Government demobilization of 35,000 military draftees and milita and retiring of 5,000 military officers. Institution of a hiring freeze in Central Government.		
	Introduction of an externally funded "employment reconversion program" to relocate 9,000 of 69,000 central government employees, including an additional 3,000 military personnel during 1991.	Completion of the processing of voluntary employment reduction in the public sector for 8,000 personnel (Board Presentation condition).	
		Preparation of an action plan to extend employment reconversion program to the entire public sector with a target of 10,000 employees including CORNAP, public utilities, and the banking sector.	Satisfactory progress in implementing the action plans for employment reconversion program.

PUBLIC UTILITIES

ISSUES AND OBJECTIVES	ACTIONS ADOPTED		ACTIONS TO BE ADOPTED
	BEFORE NEGOTIATIONS	BEFORE BOARD PRESENTATION	BEFORE MARCH 1992
Major restructuring of public utilities is needed to improve efficiency in their operations and responsiveness to the demands of a growing and competitive economy.	Elimination of indiscriminate price subsidies for the goods and services supplied by most state enterprises. Creation of an informal oversight central government committee for public utilities.		Initiation of a study, with IDA support, on Public Enterprise rationalization.

PRIVATIZATION

ISSUES AND OBJECTIVES	ACTIONS ADOPTED		ACTIONS TO BE ADOPTED
	BEFORE NEGOTIATIONS	BEFORE BOARD PRESENTATION	BEFORE MARCH 1992
Major reduction of the size of state enterprise sector. Quick sales of state enterprises to reduce the structural deficit of the public sector, to encourage private sector participation, and to generate revenue. Clarify and guarantee private property rights to remove uncertainty and foster private investment and growth.	Established CORNAP and endowed it with responsibility for both managing and privatizing about 350 state enterprises. Study completed on privatization strategy. Strategy for divestiture is worked out. 86 companies have already been returned to previous owners, liquidated or privatized, including one large group of agricultural enterprises -Hatonic-)	Adopt an action plan, satisfactory to IDA, to privatize CORNAP enterprises (Board Presentation condition).	Implementation of privatization plan including: completion of privatization of an additional 25 state-owned enterprises; devolution, liquidation or assignation of another 50 enterprises; and having already taken concrete steps toward the preparation of 30 additional enterprises for privatization (Second tranche condition).

PUBLIC REVENUE

ISSUES AND OBJECTIVES	ACTIONS ADOPTED		ACTIONS TO BE ADOPTED
	BEFORE NEGOTIATIONS	BEFORE BOARD PRESENTATION	BEFORE MARCH 1992
Increase and maintain tax revenue to ensure objectives of stabilization and non-inflationary finance of medium-term government program.	Tax reform measures were implemented, including reduction in the number of brackets in personal income tax, and reduction of top rates for personal and corporate income taxes.		
	Withholding provisions were improved, and new presumptive methods were introduced for both of above taxes.	Removal of income tax exemptions, and approval of a program to phase out indirect tax exemptions including import tax exemptions (Board Presentation condition).	Satisfactory progress in implementing the action plan to phase out indirect tax exemptions.
	The General Value Tax base was expanded and the rate increased to 15 percent.		
	Administratively granted tax exemptions were eliminated.		
Simplify and strengthen tax administration	Adoption of a plan, satisfactory to IDA, to improve tax administration with emphasis on GVT and Income Tax Collections. Preparation of a pilot project to register and collect taxes from large tax payers.	Initiation of an action plan, satisfactory to IDA, to improve tax administration with specific emphasis on GVT and income tax collections (Board Presentation condition).	Implementation of measures to strengthen tax administration including: (a) full operation of unit for large taxpayers; (b) issuance of decrees on sanctions applying to delayed payers and non-compliance; (c) relocation of customs posts indicated in the action plan; and (d) initiation of programs on automated management control, computerized taxpayer identification system, and training programs for Internal Revenue and Customs personnel (Second tranche condition).

GVT = General Value Tax

FINANCIAL SECTOR

ISSUES AND OBJECTIVES	ACTIONS ADOPTED		ACTIONS TO BE ADOPTED
	BEFORE NEGOTIATIONS	BEFORE BOARD PRESENTATION	BEFORE MARCH 1992
Improve the allocation of financial resources by rationalizing regulations on banking activities and by strengthening instruments of monetary control	Established deposit interest rates at 12 percent and lending rates at 18 percent and tied both to dollar. Introduced a monthly deposit rate for non-indexed deposits.		Adoption of an interest rate policy which approximates rates to market rates, by setting up a band for lending rates and freeing the deposit interest rates.
Improve the efficiency of financial intermediation through the development of a profit oriented, private sector based financial system.	Assembly approved a bill for setting up a Superintendency.	Adoption of regulations, satisfactory to IDA, for the implementation of the Superintendency law. Appointment of a superintendent and start-up of Superintendency activities (Board Presentation condition). Adoption of an action program, satisfactory to IDA, for the restructuring of state-owned banks, along with cessation of Central Bank subsidies and discounts except for agriculture and micro enterprises (Board Presentation condition). Preparation of terms of reference for developing and implementing the new Law for Banking and Financial Institutions which identifies a team, a technical assistance financing source, and a timetable.	Preparation of transitory normatives to establish necessary prudential regulations. Carrying out of financial sector reforms including, (a) liquidation or merger of Banco Inmobiliario with Banco Nicaraguense de Industria y Comercio; (b) dissolution of Corporacion Financiera de Nicaragua (CORFIN); (c) demonstration of concrete steps toward the restructuring of Banco Nicaraguense de Industria y Comercio, Banco Nacional de Desarrollo, and Banco Popular according to agreed plan; (d) submission to the National Assembly of a bill, satisfactory to IDA, on Banking and Financial Institutions; and (e) issuance of three licenses to start-up private financial institutions (Second tranche condition).

TRADE REGIME

ISSUES AND OBJECTIVES	ACTIONS ADOPTED		ACTIONS TO BE ADOPTED
	BEFORE NEGOTIATIONS	BEFORE BOARD PRESENTATION	BEFORE MARCH 1992
Increase output and diversification of tradables by increasing private sector participation in trade.	Trade Deregulation Decree opens import and export trade to the private sector.		Consolidate the legal framework to ensure permanence of minimum government intervention in foreign trade.
	After the devaluation of the Cordoba, foreign exchange allocation mechanisms were significantly liberalized, eliminating ministerial and Central Bank permits for importers, and giving de-facto full access to foreign exchange to exporters (except cotton and coffee exporters).	Allow full foreign exchange retention for exporters under an Export Promotion Decree.	Achieve full current account convertibility of the Cordoba.
Move to a more uniform, transparent, and lower nominal protection structure.	Reduction in the dispersion and average "basic" tariff rates. Elimination of selective consumption tax on a number of imports. Conclusion of a free trade agreement with Mexico to become fully operational by 1996.	Lowering nominal protection in trade sector to a range of 10%-60% through a combination of reductions in the levels of tariffs, SCT, and stamp tax; and announcement of a target tariff range of 10%-20% and elimination of SCT and stamp tax on imports by the end of 1993; and approval of arrangements for automatic registration for imports and exports (<u>Board Presentation condition</u>).	Lowering of nominal protection in the trade sector, to a range of 10%-40% through a combination of reductions in levels of tariffs, SCT and stamp tax (<u>Second tranche condition</u>).
		Develop action plan to provide free trade status, i.e., exemption of tariffs and indirect taxes, for exporters.	Satisfactory progress in the implementation of the action plan for giving free trade status to exporters.
		Design a price-based mechanism with variable levies for rice, yellow corn and white maize (<u>Board Presentation condition</u>).	Replacement of import quotas on rice, yellow corn and white maize for a price based mechanism with variable levies, satisfactory to IDA, and elimination of remaining quantitative restrictions on food grain imports (<u>Second tranche condition</u>).

DEREGULATION

ISSUES AND OBJECTIVES	ACTIONS ADOPTED		ACTIONS TO BE ADOPTED
	BEFORE NEGOTIATIONS	BEFORE BOARD PRESENTATION	BEFORE MARCH 1992
Curb and eventually minimize static and dynamic welfare losses occasioned by pervasive state intervention	Elimination of most domestic price controls other than those of public utilities and the fiscal industries		Abrogation of the legal framework permitting price controls, except for natural monopolies. Removal of transitory price setting adopted for selected products in government-owned stores. Present an action plan, satisfactory to IDA, to remove price controls of the fiscal industries and to reformulate the ISC extending it to luxury goods.
	Abrogation of legal export monopolies for several products by allowing private sector access to export licenses.		
		Elimination of barriers to entry to natural resource exploitation by transferring licensing regulations from state enterprises to the Ministry of Economy. Prepare terms of reference for studies on the regulatory framework of natural resources.	Implementation of the study's findings on a regulatory framework for the management of natural resources.
		Elimination of support prices for basic grains. ENABAS to begin offering services (storage, bundling import orders) and to rent facilities to private entrepreneurs.	Disallow ENABAS to trade in all but basic grains. Present a program for privatizing ENABAS retail and wholesale outlets, such that at least 20% of its corresponding assets will be sold to private parties or to laborers by March 1992 and the remainder will be divested by the end of 1992. Present an action plan to redefine the future role of ENABAS.

NICARAGUA - Economic Recovery Credit

Supplementary Credit Data Sheet

Section I. Timetable of Key Events

(a) Time taken by the Country to prepare project: 7 months

(b) Project prepared by: Ministries of Economy, Finance, and the Central Bank.

(c) First Presentation to the Bank: January 1991

(d) Departure of Appraisal Mission: June 1991

(e) Completion of Negotiations: July 1991

(f) Planned date for Effectiveness: September 1991

Section II: Special Bank Implementation Action:

None

Section III: Special Conditions:

Release of the second tranche would be contingent on satisfactory progress in the implementation of the Government's structural adjustment program, including the maintenance of a supportive macroeconomic framework, and fulfilling the following conditions:

(i) Adoption of (a) FY92 budget with reduced Central Government non-interest current expenditures less than US$325 million equivalent, and (b) agreement on implementing the recommendations of the joint Government-IDA public expenditure review;

(ii) Implementation of measures to strengthen tax administration, including (a) full operation of unit for large taxpayers; (b) issuing of decrees on sanctions applying to delayed payment and non-compliance; and (c) initiating programs on automated management control system, computerized taxpayer identification system, and training programs for Internal Revenue and Customs personnel.

(iii) Implementation of privatization of CORNAP state-owned companies through (a) completion of privatization of additional 25 state-owned companies; (b) finalization of devolution, liquidation, or assignation of another 50 companies; and (c) initiation of concrete steps toward the preparation of an additional 30 companies for privatization.

(iv) Carrying out of financial sector reforms including, (a) liquidation or merger of Banco Inmobiliario with Banco Nicaragüense de Industria y Comercio, (b) dissolution of Corporación Financiera de Nicaragua (CORFIN), (c) initiation of steps toward the restructuring of Banco Nicaragüense de Industria y Comercio, Banco Nacional de Desarrollo, and Banco Popular according to agreed action plan, (d) submission to the National Assembly of a draft law, satisfactory to IDA, on Banking and Financial Institutions, and (e) issuance of at least two licenses to private banks.

(v) The protection resulting from combined tariffs and taxes that apply to imports in Nicaragua will be reduced to a minimum of 10 percent and a maximum of 40 percent, except with respect to medicines, books and newsprint which may be exempt from such tariffs and taxes or subject to tariffs and taxes at a combined rate lower than the minimum rate referred to above.

(vi) Replacement of import quotas on rice, yellow corn and white maize for a price based mechanism with variable levies, satisfactory to IDA, and elimination of remaining quantitative restrictions on food grain imports.

STATUS OF BANK GROUP OPERATIONS IN NICARAGUA

A. STATEMENT OF BANK LOANS AND IDA CREDITS

(As of March 31, 1991)

Credit/ Loan No.	Fiscal Year	Borrower	Purpose	Amount in US$ million (less cancellation) Bank	IDA	Undisbursed
28 loans and 5 credits fully disbursed				229.61	59.74	
Total				229.61	59.74	
Of which has been repaid				72.50	0.88	
Total now held by Bank and IDA				157.11	58.86	
Amount sold :		5.62				
Of which has been repaid:		5.62				
Total undisbursed				0.00	0.00	0.00

EBArevalo:LA2C2
File: NIC0391 (a1..o60)
May 09, 1991

NICARAGUA

B. Statement of IFC Investments
As of March 31, 1991
(US$ million)

Fiscal Year	Obligor	Type of Business	-----Original Approvals----- Loan	Equity	Total
1968	Textiles Fabricato de Nicaragua, S.A. (FABRITEX)	Textile Mill	1.00	1.07	2.07
1976	Nicaragua Sugar Estates Limited (NSEL)	Sugar Mill	6.50	0.00	6.50
1976	Posada del Sol	Hotel	0.70	0.20	0.90
	Total gross commitments		8.20	1.27	9.47
	Less cancellations, terminations, repayments and sales		8.20	1.27	9.47
	Total commitments now held by IFC		0.00	0.00	0.00

IFC Investments:NIC0391
EBArevalo:LA2C2
June 11, 1991

END

END