Folder Title:	Country Files- Nicaragua - Correspondence - Volume 1
Folder ID:	1779825
Series:	Country Files
Dates:	09/10/1984 - 06/28/1991
Subfonds:	Records of President Barber B. Conable
Fonds:	Records of the Office of the President
ISAD Reference Code:	WB IBRD/IDA EXC-11-49S
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NICARAGUA

X

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

BARBER B. CONABLE
President

June 28, 1991

Dear Mr. Minister:

I have learned of your appointment as Alternate Governor for Nicaragua on the Boards of Governors of The World Bank Group. I realize this is incident to your responsibilities in your own Government, but I hope you will be in a position to actively participate in the affairs of the Bank Group, as well.

The Executive Directors, Officers and Staff of The World Bank Group believe very strongly in its development mission and in the battle against poverty. We look forward to working with you to make the Bank Group even more effective during the coming years. Congratulations on your appointment and thank you for your willingness to take on this additional responsibility.

I look forward to meeting you in the near future, and send my best personal wishes.

Sincerely,

(Signed) Barber B. Conable

Su Excelencia
Dr. Silvio De Franco
Ministro de Economia y Desarrollo
Edificio Malaga, 2o piso
Managua, DN
Nicaragua

cc: Mr. Naim
Mr. Steckhan
Mr. Paul

ETSanidad:se

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

BARBER B. CONABLE
President

28 de junio de 1991

Señor Ministro:

Me ha sido comunicada su designación como Gobernador Suplente por Nicaragua en las Juntas de Gobernadores del Grupo del Banco Mundial. Estoy consciente de que este nombramiento es inherente al cargo que desempeña en el Gobierno de su país, pero confío en que podrá estar en condiciones de participar también de forma activa en los asuntos del Grupo del Banco.

Los Directores Ejecutivos, los altos funcionarios y el personal del Grupo del Banco Mundial están firmemente dedicados a la misión de desarrollo de la institución y a la lucha contra la pobreza. Esperamos con sumo interés colaborar con usted en la tarea de hacer que el Grupo del Banco sea aún más eficaz en los años venideros. Permítame que le exprese mis felicitaciones por su designación para ocupar este cargo, así como mi agradecimiento por su disposición a asumir esta responsabilidad adicional.

En espera de verlo en un futuro cercano, le envío mis mejores deseos personales.

Lo saluda muy atentamente,

Excmo. Señor
Silvio De Franco
Ministro de Economía y Desarrollo
Edificio Málaga, 2º piso
Managua, D.N., Nicaragua

MINISTERIO DE LA PRESIDENCIA

Managua, 14 de Junio, 1991
MP-191

Sr. Barber B. Conable
Prsidente
Banco Mundial
1818 H. Street, N.W.
Washington, D.C. 20433

Estimado Sr.Conable:

Por instrucciones de Doña Violeta Barrios de Chamorro, Presidente de Nicaragua, le comunico que para el propósito de facilitar todas las relaciones entre el Banco y la República de Nicaragua concernientes a los programas de ajuste estructural ha sido nombrado como Gobernandor Alterno de su Institución el Dr. Silvio De Franco, Ministro de Economía y Desarrollo, sustituyendo al Dr. Raúl Lacayo, Presidente del Banco Central.

Este nombramiento es efectivo a partir de esta fecha.

Con atentos saludos,

Ing. Antonio Lacayo
Ministro de la Presidencia

MINISTERIO
DE LA
PRESIDENCIA

ROUGH TRANSLATION:

In accordance with instructions by Dona Violeta Barrios de Chamorro, President of Nicaragua, and in order to facilitate all relations between the Bank and Nicaragua concerning structural adjustment programs, Dr. Silvio De Franco Minister of Economy and Development, has been named Alternate Governor of the Bank for Nicaragua, replacing Dr. Raul Lacayo, President of the Central Bank. This appointment is effective as of this date.

DISTRIBUTION

TO- Executive Director
~~Executive Vice President, MIGA~~
Country Director, Bank
Investments Director, IFC
File Credential

FROM - E. T. Sanidad
SECRETARY'S DEPARTMENT

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

BARBER B. CONABLE
President

June 28, 1991

Dear Mr. Minister:

Thank you for your letter dated June 14, 1991, informing us of the appointment of His Excellency Dr. Silvio De Franco, Minister of Economy and Development, as Governor for Nicaragua on the Boards of Governors of the World Bank Group. Our records have been amended accordingly.

We very much look forward to working closely with the Minister in the coming years.

Sincerely,

(Signed) Barber B. Conable

Su Excelencia
Senor Antonio Lacayo
Ministro de la Presidencia
Managua, D.N.
Nicaragua

cc: Mr. Naim

ETSanidad:se

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

BARBER B. CONABLE
President

28 de junio de 1991

Señor Ministro:

Deseo acusar recibo y agradecerle su carta de fecha 14 de junio de 1991 por la que nos comunicó la designación del Excmo. Sr. Silvio De Franco, Ministro de Economía y Desarrollo como Gobernador Suplente por Nicaragua, en las Juntas de Gobernadores del Grupo del Banco Mundial. Hemos hecho las modificaciones correspondientes en nuestros registros.

Será un gran placer para nosotros poder colaborar estrechamente con el Sr. Ministro en los años venideros.

Lo saluda atentamente,

Excmo. Señor
Antonio Lacayo
Ministro de la Presidencia
Ministerio de la Presidencia
Managua, D.N., Nicaragua

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

CAK
SS
BBC
co. file

DATE: April 15, 1991

TO: Files

FROM: Rainer B. Steckhan, Director, LA2 Steckhan

EXTENSION: 38074

SUBJECT: NICARAGUA - Mr. Barber B. Conable's Meeting with President Violeta de Chamorro

1. Mr. Conable, accompanied by Mr. S. Shahid Husain and the writer, met with President Violeta de Chamorro on Monday, April 15. On the Nicaraguan side, Foreign Minister Enrique Dreyfuss, Minister of the Presidency Antonio Lacayo, Minister of Economy Silvio de Franco, Minister for External Aid Erwin Kruger and others attended.

2. Mr. Conable expressed his pleasure at meeting President Chamorro and assured her that the Bank would do what it could to provide economic advice, technical assistance, and some IDA financing as a catalyst to mobilize resources from other donors. He also emphasized the importance of continued leadership by the United States in galvanizing support from various bilateral sources for sound economic and social development in Nicaragua.

3. In this context, Mr. Conable emphasized the importance for the Government to stay the course of fiscal austerity and to strengthen the financial sector, the privatization program, clarity of property rights and improved absorptive capacity.

4. Both sides agreed on the vital importance of the upcoming May 16/17 Consultative Group meeting in Paris as the occasion to decide on a financing plan for arrears clearance and mobilization of additional development funds. The Nicaraguan Minister of the Presidency said that Nicaragua would take care of ensuring bridge financing of $60 to $75 million each from Venezuela, Mexico, and Spain.

5. In reply to a question on the amount of IDA resources destined for Nicaragua, Mr. Conable said he could not give a figure. IDA certainly would not be able to put up in the first two years the equivalent of the arrears amount, but Nicaragua could count on a sizable IDA contribution in relation to the financing gap and to the quality and depth of continued economic reforms.

Cleared with and cc. Mr. Husain

CC. Mr. Conable, Mr. Qureshi
Mr. Voljc, Mr. Tuncer, Mr. Clifford

WORLD BANK OFFICE TRACKING SYSTEM
OFFICE OF THE PRESIDENT
Routing and Action Transmittal Sheet

File
Nicaragua

TO:	DATE:
Mr. B. Conable (E-1227)	4/11/91

SUBJECT:

Document From: M. Qureshi
To: bbc
Dated: 4/10/91

Reference No.: EXC910411002

Topic: NICARAGUA: Meeting with Mrs. Violeta B. CHAMORRO, President, on MONDAY, APRIL 15 @ 4:30 (Blair House).

ACTION INSTRUCTIONS: | DUE DATE:

_______ HANDLE
_______ REVIEW AND RECOMMEND
_______ FOR YOUR INFORMATION
_______ DISCUSS WITH ____________
_______ AS WE DISCUSSED
_______ PREPARE RESPONSE FOR ______ SIGNATURE
_______ FOR YOUR FILES
_______ RETURN TO ____________
_______ OTHER: ____________

Remarks: cc: BBC (original), Sandstrom, Khanna

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

4/13
4:30 pm

DATE: April 10, 1991

TO: Mr. Barber B. Conable

THROUGH: Mr. Moeen A. Qureshi

FROM: S. Shahid Husain

EXTENSION: 39001

SUBJECT: Briefing for your meeting with Mrs. Violeta B. Chamorro, President of Nicaragua

1. On Sunday, April 14, President Chamorro 1/ will be on a state visit to Washington, where she will be meeting with President Bush, and, among others, the leaders of the three international financial institutions. Though not originally scheduled to coincide with the arrears clearance process, President Chamorro's visit is now critical to put in place the elements needed to bring the arrears problem to a successful completion. This includes possible additional funds from the USA, an agreement that the USA should urge cofinancing from Japan, and support by the USA of bridge financing, from Spain, Mexico and Venezuela.

2. At the recent informal meeting of the Consultative Group on March 25-26 the Nicaragua delegation, headed by Mr. Antonio Lacayo, Minister of the Presidency, described the very far reaching reforms announced by the government on March 3. These included a 400% devaluation of the cordoba oro, and a cessation of monetary emission by the Central Bank, both aimed at eliminating hyperinflation, which had reached 13,500% in 1990. Also, included in the reform package were planned reductions in government expenditures, greater fiscal control over state owned enterprises, tax reforms, and negotiations towards free trade agreements with countries such as Mexico, Venezuela and the United States. On the legislative front a financial sector law, including both a regulatory framework and the authorization of privately owned banks, was recently approved unanimously by the National Assembly. Additional legislation is expected soon on direct foreign investment, free trade zones and privatization of the huge state owned apparatus.

3. The government noted that the reform program had widespread support from the Nicaraguan people, the opposition, the labor unions and private sector groups. Indeed, only one dissenting vote was cast against the program in the National Assembly. This was without doubt a major

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1/ President Chamorro took office on April 25, 1990 following the electoral victory of her fourteen party coalition (UNO) over the Sandinistas (FSLN). Her political career has its origins in the assassination of her husband, allegedly by persons associated with the Somoza government. President Chamorro was part of the first Sandinista governing junta but resigned within a year of its formation. Her most trusted advisor in her current government is Antonio Lacayo, Minister of the Presidency and her son-in-law. President Chamorro is not comfortable in speaking English.

benefit of the national reconciliation in which President Chamorro had staked her personal prestige since taking office in April 1990.

4. The international financial institutions all support the government's stabilization and adjustment efforts. The IMF, which had helped to design the program, indicated its intention to work with the government in monitoring progress. (This is not, however, an IMF "shadow program".) A stand-by program by August 1991 is a possibility and ESAF eligibility is being discussed by the Fund. The President of the IDB made a strong statement of support, and representatives of the IDB announced that $200 million in concessionary lending would be undertaken over the next three years, subject to arrears clearance. The Bank also indicated strong support, with IDA lending directed centrally to a quick disbursing Economic Recovery Credit in support of a sound adjustment program.2/ This could be followed initially by sector based lending, most likely in agriculture, education, health and nutrition, and then with project lending in infrastructure. The Bank also raised the possibility of establishing a Resident Representation in Managua.

5. Though the donors all expressed support of the Government's efforts, insufficient funds have so far been raised towards arrears clearance. Of the $380 million in arrears (assuming clearance in September 1991), the expectation is that these would be paid through a bridge loan of $230 (repaid from first tranche disbursements from the IDB, IMF, IDA and bilateral cofinancing from Germany, Japan and others), and cash donations of $150 million. On the latter, funds have been pledged from the USA ($50 million), Sweden ($10 million), France ($4 million), and Netherlands ($6.5 million). This leaves some $80 million yet to be raised.

6. During the March meeting, and immediately after it, a number of issues arose concerning the arrears clearance process. First, the government of Japan, indicated an unwillingness to provide cofinancing, until after the larger issues of debt relief proposals for highly indebted LDCs are discussed within the G-7 and the Paris Club. This could effectively remove Japan from any arrears clearance in September and could derail the entire effort by making it impossible for Nicaragua to re-pay the bridge loan. Second, cash donations offered so far are clearly short of the required level, and the government of Nicaragua hopes that the USA can increase its announced contribution beyond $50 million. Throughout the several consultative group meetings over the past nine months, the very strong sentiment has been that the USA must do more. Third, and most problematic is that the bridge financing may be in jeopardy. It was originally expected that the USA would provide the bulk of the funds, with additional support from Latin American countries and Spain. That arrangement may not materialize, and the bridge loan may come exclusively from Spain, Mexico and Venezuela. We have begun to talk to these countries about their possible participation. Even if the USA cannot provide bridge

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2/ Since December 1984 Nicaragua has been in non-accrual status to the World Bank. Cumulative lending to Nicaragua totalled $290 million for 33 projects, of which 28 were loans and 5 were credits. The last IBRD loan was approved in January 1982 for $16.0 million for municipal development. The last IDA credit was provided in December 1980 for $45.0 million to support a preinvestment fund.

financing, it still has a considerable role in working with other governments to convince them to do more.

7. President Chamorro's visit is primarily to galvanize U.S. support on all three of these issues, and secondarily to obtain support from the international financial institutions in her efforts to influence the U.S. government.

8. The Bank should indicate that it supports her efforts. Bank staff are travelling to Mexico, Venezuela and Europe to garner support, and are working closely with the Nicaraguans to develop a realistic financing proposal that would include bridge financing. We see Nicaraguan initiative - as demonstrated by President Chamorro's visit - and U.S. leadership as essential to a successful arrears clearance. The Bank has repeatedly stated that it wants to undertake a longer term program of development assistance in Nicaragua, and has taken the initial steps to begin that process. The next four weeks, leading up to the mid-May meeting of the Consultative Group, are, however, critical. Without the resolution of the three issues mentioned, the arrears clearance is likely to fail. The elements for success are nonetheless in place and merit the extra effort of the USA and the international financial institutions. President Chamorro should be encouraged to pursue her efforts to find a resolution of these issues.

Cleared with and cc.: Steckhan (o/r), Lee
cc.: Aiyer (LACVP); Knotter (LA2DR); Voljc, Clifford, Rivera (LA2C2)

RClifford/MVoljc:AR

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

BARBER B. CONABLE
President

March 28, 1991

The Honorable Jimmy Carter
The Carter Center Inc.
One Copenhill
Atlanta, Georgia 30307

Dear President Carter:

I was very pleased to receive your letter sharing with us your thoughts and observations at the end of your recent visit to Nicaragua. Thank you for acknowledging the contribution of my staff towards your preparations for the visit.

We also think that there has been genuine progress in Nicaragua during the last year towards restoring peace and achieving a consensus among the various political factions on the need and strategy for stabilizing the economy and paving the way for an equitable sustained growth. During the course of the year, the Bank staff has been in close communication with the authorities in identifying the underlying difficulties and designing appropriate economic policies. In our opinion, the measures recently taken by the Government constitute a major step in the stabilization and reactivation of the economy. We are also aware that the impact of these stringent policies on the poor will have to be cushioned through specific policies and programs for which we are coordinating with the authorities.

I would also like to point out that the Bank has been playing a leading role in the mobilization and coordination of donor support to the Government's program. Without a sizeable contribution from the donor community, the efforts for stabilization and adjustment have little chance to succeed. With this purpose, during the last year the Bank organized four donors' meetings, the last of which was held in Washington this week. It was encouraging that unanimously the donor representatives responded favorably to the Government's program and acknowledged the urgency of support both in terms of financial and technical assistance. We hope the consensus on the approval of Government policies will soon translate into concrete assistance. For our part, we are now preparing a major credit to support the Government's policies and programs, subject to clearance of arrears to the Bank.

Before closing, please allow me to express our appreciation of your personal efforts to achieve peace and economic recovery in Nicaragua with a particular focus on the needs of the most disadvantaged groups in the society.

Sincerely,

(Signed) Barber B. Conable

Barber B. Conable
President

cc: Messrs. S. Husain, S. Aiyer, M. Selowsky, R. Steckhan, P. Knotter,
M. Voljc, B. Tuncer, R. Clifford, R. Ground
File

BTuncer:maa

AK

WORLD BANK OFFICE TRACKING SYSTEM
OFFICE OF THE PRESIDENT
Routing and Action Transmittal Sheet

TO:	DATE:
Mr. M. Qureshi (E-1241)	3/19/91

SUBJECT:

Document From: President Jimmy Carter
To: bbc
Dated: 3/09/91 Reference No.: EXC910315006

Topic: Developments from his recent trip to Nicaragua. Thanking the Bank and staff for the assistance provided.

ACTION INSTRUCTIONS: | DUE DATE:

_______ HANDLE
_______ REVIEW AND RECOMMEND
_______ FOR YOUR INFORMATION
_______ DISCUSS WITH _______
_______ AS WE DISCUSSED
__XXX__ PREPARE RESPONSE FOR _BBC's SIGNATURE 3/29/91
_______ FOR YOUR FILES
_______ RETURN TO _______
_______ OTHER: _______

Remarks: note: please prepare a brief acknowledgment.

~~attn~~ cc: Mr. B. Tuncer, I-8-127

JIMMY CARTER

March 9, 1991

To Barber Conable

Thank you for sending Mr. Tuncer to provide the very helpful briefing in preparation for my trip to Nicaragua. Rosalynn and I returned from Managua last night, having made our first visit to the country since the election we helped to monitor a little more than a year ago. We were part of a delegation that included Dr. Robert Pastor and Dr. Jennifer McCoy from The Carter Center. Minister Beatrice Rangel represented President Perez and the Venezuelan government.

During the last year, the fragile peace has held, basic transition understandings between the UNO government and the Sandinistas have been honored, and almost 30,000 resistance fighters have been repatriated and disarmed. These notable achievements have been endangered, however, by the inability of President Violeta Chamorro and her government to bring hyper-inflation under control. Compounded at a rate of 30 to 40 percent per month, inflation during 1990 amounted to more than 13,000 percent. The Cordoba has become practically worthless as legal tender. This, plus capitulation to a series of strikes by public workers, seriously damaged the integrity and international reputation of the government and jeopardized needed foreign assistance and private investment.

Last month, Venezuela's President Carlos Andres Perez, Prime Minister Michael Manley of Jamaica, Prime Minister George Price of Belize and I, all members of the Council of Freely Elected Heads of Government, discussed the advisability of an effort to assist the troubled country.

Subsequently, President Violeta Chamorro and some of the Sandinista leaders asked us to visit Nicaragua to help garner support for a new plan of austerity and currency reform designed to bring inflation under control and to restore confidence in a new gold Cordoba, just devalued from one to five with respect to the U.S. dollar. After receiving a briefing on the plan from officials of the World Bank and the International Monetary Fund and other economists, we went to Managua and conducted two days of intensive meetings. While we were in the country, health workers were occupying some hospitals and conducting hunger strikes, and customs workers had to be forcibly removed by police from offices where they were holding up international traffic and preventing the collection of tariffs.

Our goals were to understand the economic stabilization program, to encourage support for its basic tenets, to assess unmet needs or legitimate concerns, to help explain its potential benefits to the country, and to reduce tensions that have arisen because of the stringent sacrifices that are being demanded from Nicaragua's citizens. Workers, for instance, are being asked to accept a reduction of more than 30% in immediate real wages, in anticipation of advantages expected to come from the new program.

Among others, we met with President Chamorro, Minister of the Presidency Antonio Lacayo, the Foreign Minister, the economic cabinet and the President of the Central Bank, leaders of eight major trade unions, both independent and affiliated with the Sandinistas, Cardinal Obando y Bravo, Contra leaders, directors of the business, agricultural and financial community, the U.S. Ambassador, army commander General Humberto Ortega, Daniel Ortega and other members of the Sandinista directorate, the Minister of Health, Vice President Virgilio Godoy, National Assembly President Alfredo Cesar, directors of the international agency responsible for repatriation of former resistance fighters, mayors of Managua, Matagalpa, Granada, San Pedro, and Chinandega, the Minister of Gobernacion (in charge of the national police), and twice with the national press corps.

After suggesting that the government spell out immediately a few special programs for the poorest citizens and some funding for the capitalizing of small businesses (both to be financed by funds already available), we attempted to promote support for the overall proposal. Such a consensus seemed to be building before we returned home, except for one trade union (FNT) associated with the Sandinistas. Despite our urging, the FNT leaders rejected our suggestion to allow a trial period of two or three months for the new plan. The forcible ejection of their workers from two of the customs houses further deterred them. The strong enforcement of the law by terminating an illegal occupation of the buildings demonstrated that the government was more serious about their current plan than had been indicated by past actions.

There is little doubt that government officials have the resolve necessary to maintain the reform program. Also, there seems to be an adequate level of support, including at least tacit agreement from Sandinista leaders. Although torn between acting responsibly during this economic crisis and demonstrating sympathy with the plight of their affiliated workers, they issued a satisfactory public statement on our first day in Managua. The next day, a resolution was passed by consensus in the National Assembly supporting the program, provided special provisions could be made for the very poor. Only one of the 39 Sandinista members (an FNT executive) voted against the proposal.

Further discussions, or negotiations, will continue among Nicaraguan leaders, but within the framework of the economic stabilization plan. At the same time, prices of a "basket" of basic commodities are being closely and continuously monitored.

Early reports are that they are stable, but it will take several weeks before it can be determined whether workers are better off than they would have been before the reforms were imposed.

Democratization of the country is surprisingly prevalent and cherished by all interest groups. It was especially encouraging to hear reports from the mayors and to witness both their lack of subservience to any central political parties and their ability to work with each other to achieve common goals. Also, the National Assembly has developed into a strong and independent body, demonstrating a gratifying harmony among the disparate political groups represented among its members. These changes, combined with financial assistance from the international community, can permit Nicaragua to demonstrate success in its long struggle for political and economic reform.

Beginning immediately, the National Assembly is committed to passing basic reform laws that will permit private banking, encourage foreign investment, expedite the privatization of many of the 400 business and service industries now owned by the Nicaraguan government, and establish free trade zones. President Chamorro promised to issue a final decree within a week to give full authority to the commission that can issue permanent land titles in the rural areas. These imminent steps should resolve most of the remaining legal questions that have continued to plague the country.

Although Nicaraguan leaders are obviously responsible for all the constructive steps being taken, it was also clear that our visit came at a propitious time and was beneficial in solidifying the commitments being made to joint action. We will be eagerly awaiting a forthcoming decision by the international financial community to acknowledge these courageous steps that have been taken in the country, and to assist in providing long term loans and grants needed to consummate the national plans.

Sincerely,

Jimmy Carter

The Honorable Barber Conable
President
The World Bank
1818 H Street, N.W.
Washington, D.C. 20433

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

~~AK~~
~~SS~~
~~BBC~~

MF— co. file

DATE: February 7, 1991

TO: Files

FROM: Marko Voljc, Chief, LA2C2

EXTENSION: 39546

SUBJECT: Mr. Conable's Meeting with the Nicaraguan Delegation, February 6, 1991

The Nicaraguan team was comprised of Messrs. Antonio Lacayo, Minister of the Presidency and head of the delegation, Silvio de Franco, Minister of Economy, Raul Lacayo, President of the Central Bank, Mariano Palacio, Nicaraguan Embassador to US, and Haroldo Montealegre, Economic Advisor to the Presidency. On the Bank's side, Ms. Silvia Charpentier (Alternate ED), and Messrs. Qureshi, Steckhan and Voljc attended.

Mr. A. Lacayo gave a brief summary of key developments since the new Government took office, emphasizing that the principal task of the first eight months of the Chamorro administration was to consolidate peace and political stability in Nicaragua. The Government is confident that this has now been achieved and the situation is right for a bold and comprehensive economic program which should effectively deal with the hyperinflation the economy is suffering from, strengthen the country's fiscal performance and set a stage for resumed relations with the IFIs. The authorities' immediate concern is to have such a program in place by March in order to get a supportive donors' response at a meeting late March to begin the process of clearing of arrears to the World Bank and to the IDB. In addition to the Bank's and IDB's active support in these endeavors, for which Mr. Lacayo expressed his appreciation, the IMF too should consider a program with the Government in support of their planned stabilization effort. The authorities are willing to heavily front load the program in order to get a quick response from the Fund in the form of a Stand-by program.

Mr. Conable welcomed the delegation and expressed his appreciation for the very difficult situation the new authorities had inherited and the achievements so far. The Bank would want to help in the Government's efforts to embark upon a stabilization and structural adjustment program, but IMF support will be critical. Given the very poor econmic performance of the past, the IMF will want to see a track record before entering into a stand-by program. For that reason, it is important that the measures to be introduced are fully convincing and front-loaded. In the arrears' clearance process, support of the US and other donor governments will be crucial. In reference to a possible IMF program, Mr. Qureshi emphasized that, given the expected IDA status that Nicaragua will in all likelihood get from the Bank, the authorities should seek access to the Fund's ESAF.

Mr. Lacayo, while agreeing with Mr. Conable on the importance of a far reaching economic program, stressed that fast response and strong support of the international financial community will be critical to make the reform process sustainable. In concluding, he thanked Mr. Conable for Bank's support to Nicaragua by chairing the Consultative Group and initiating the preparation of a possible fast disbursing adjustment operation once the arrears situation has been adequately addressed.

cc: Messrs. Conable, Qureshi, Husain (o/r), Steckhan, Tuncer, Clifford, Ground, LA2 Management Team.

MV

WORLD BANK OFFICE TRACKING SYSTEM
OFFICE OF THE PRESIDENT
Routing and Action Transmittal Sheet

TO:	DATE:
Mr. B. Conable (E-1227)	2/04/91

SUBJECT:

Document From: Mr. Steckhan (through MAQ)
To: BBC
Dated: 2/01/91 Reference No.: EXC910204019
NICARAGUA —
Topic: Briefing for Mr. Conable's Meeting with Mr. Antonio Lacayo
February 6, 1991 at 5:15 p.m.

ACTION INSTRUCTIONS: | DUE DATE:

_______ HANDLE
_______ REVIEW AND RECOMMEND
__XXX__ FOR YOUR INFORMATION
_______ DISCUSS WITH ______________________
_______ AS WE DISCUSSED
_______ PREPARE RESPONSE FOR ______ SIGNATURE
_______ FOR YOUR FILES
_______ RETURN TO __________________________
_______ OTHER: ____________________________

Remarks: ____

Mr. Conable:
Barber: Nicaragua is still suffering from hyperinflation. Before we can lend to them, especially adjustment loans, we will need to make sure that they make an adequate stabilization effort. This underscores the role of the Fund. It is not yet clear what the Fund will do — most likely work out a shadow program to establish a track record before any drawings are made. We must urge the Nicaraguans to work with and agree on a stabilization program with the Fund.
Moeen.

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: February 1, 1991

TO: Mr. Moeen A. Qureshi

FROM: Rainer B. Steckhan, Acting RVP, LAC Steckhan

EXTENSION: 38074

SUBJECT: Briefing for Mr. Conable's meeting with Mr. Antonio Lacayo February 6, 1991 at ~~4:30~~ 5.15 pm

1. Mr. Lacayo is visiting Washington D.C. for discussions with the U.S. government, the Bank, the IMF and the IDB on their possible support for stabilization and structural adjustment programs in Nicaragua.1/ In mid-February President Chamorro will visit Germany and Japan, two other key potential donors to Nicaragua. These visits follow seven months of Consultative Group work, under the leadership of the World Bank, aimed at reactivating the Nicaraguan economy and renewing international aid flows. Most recently parallel Bank, IDB and IMF missions were in Nicaragua from January 15-31 to review the stabilization and adjustment program and identify the outline of a possible SAL.

2. These visits are timed to coincide with a March donors meeting chaired by the Bank, during which the government's stabilization and arrears program will be discussed and a plan for the settlement of Nicaragua's IFI arrears of $350 million ($260m Bank) could be finalized.2/ The two issues are linked: the Consultative Group members have indicated that they would be willing to provide the financing necessary to clear the IFI arrears only if the IMF and the Bank provide a "green light" on the government's program.

3. Mr. Lacayo will explain the government's position on stabilization and adjustment, and seek a commitment from the Bank on a large IDA credit ($150.0-250.0 million) and access to other IDA instruments. He will present the government's achievements against the backdrop of war,

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1/ Mr. Lacayo is the Minister of the Presidency and acts as the de facto Prime Minister of Nicaragua. He is the son-in-law of the President and her most trusted adviser. Mr. Lacayo is a businessman with interests throughout Central America and Mexico. He remained in Nicaragua throughout the Sandinista years and is said to have developed a good relationship with several of their leaders. He is a graduate of M.I.T. and is fluent in English.

2/ Since December 1984 Nicaragua has been in non-accrual status to the World Bank. Cumulative lending to Nicaragua totalled $290 Million for 33 projects, of which 28 were loans and 5 were credits. The last IBRD loan was approved in January 1982 for $16.0 million for municipal development. The last IDA credit was provided in December 1980 for $45.0 million to support a preinvestment fund.

Sandinista mismanagement of the economy and a return to democracy, and will likely seek "exceptional" consideration for Nicaragua. Notable among the achievements are a new found political stability obtained through an agreement or concertacion with various groups, a reduction in the size of the army, new banking and foreign investment laws, the elimination of trade monopolies, public utility rate increases and tax reform.

4. In response, the Bank should commend the government but emphasize the need to build on the encouraging discussions of the recent mission. Without a comprehensive, coherent and appropriately sequenced stabilization and adjustment program along the lines discussed, the Bank will not be able to provide financial support. Our discussions with bilateral donors, particularly the U.S.A., Japan, and Germany indicate that their support requires the same. This makes the March meeting a critical and perhaps last opportunity to obtain broad international support. The Bank should also reject the notion of "exceptional" consideration if that means a muddle-through approach. We should point out that a strong and rapid stabilization and adjustment program, under conditions such as prevail in Nicaragua, has a merit of its own when viewed against the costs of alternative strategies. Also, our experience further indicates that the such a program is most successful when it is fully "owned" by the government.

5. In a different vein, the Bank should add that, provided the above conditions are met, the Bank is keenly interested in a long-term relationship with Nicaragua, involving policy dialogue, economic and sector work, and sector and investment lending. Also, internal discussions are underway on IDA eligibility and should be resolved before the March Consultative Group meeting. The size of the credit, assuming IDA eligibility is obtained, depends on the availability of IDA resources. Mr. Lacayo can be assured that the Bank will work within this constraint to ensure adequate financing and access to all IDA instruments. We will also continue to use the Consultative Group process to enlist other sources of assistance and ensure Nicaragua's successful re-entry into the international financial system.

6. Additional information on the efforts of the government and the Consultative Group, and on the economic and political situation is provided in Annex 1.

cc: Messrs Voljc, Tuncer, Ground, Clifford (LA2C2)

Annex 1

Additional briefing material for the visit of Mr. Antonio Lacayo
February 6, 1991

Background

1. The fourteen party coalition led by Violeta Chamorro that came to office in April 1990 inherited an economy beset by severe internal and external disequilibria. Under the Sandinistas total output had fallen every year since 1984 and by 1989 it was 10 percent lower than at the beginning of the decade. Exports had been falling since 1983 and were then at about half their 1980 level. When the new government took office, Nicaragua's external debt stood at $10.0 billion, 27 times annual exports, and total arrears were $3.5 billion, more than two times GDP. Also the financial sector was in a state of collapse, the currency overvalued, and the outgoing government had granted wage increases that would fuel inflation during 1990.

2. Nonetheless, even after capturing about 60% of the vote, the government felt constrained in its ability to introduce change. For example, it had little influence over key sectors such as the unions, agricultural cooperatives, the army, and the police, all of which remained under the control of the Sandinistas. As a result the government initially placed high priority on political stability and obtaining a consensus on the need for economic reform.3/

3. The government did seek to draw on its widespread international support. A donor meeting was held in Rome in June 1990 and a formal Consultative Group, under the Chairmanship of the World Bank, was formed. Subsequent joint IMF, IDB, IBRD economic missions and donor conferences assessed the situation and urged the government to develop a comprehensive stabilization and adjustment program.

4. In October the government submitted a detailed plan for discussion with the opposition, the unions and the private sector. It proposed a package of strong stabilization measures and an outward looking, market oriented structural adjustment. The resulting agreement or *concertacion* was signed in November. It is different from the original plan and sharply limits the scope of reform and the instruments available to achieve it. The agreement also calls on the international community to grant Nicaragua "exceptional" treatment in the clearance of arrears and the flow of aid in support of economic reform.

5. The Consultative Group met in December to review a new government program following the signing of the *concertacion*. Though the donors applauded the political consensus that made the *concertacion* possible, both the IFIs and the donors stated that reform program was not sufficiently comprehensive or coherent. As a result, the donors were unwilling to

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3/ President Chamorro's term officially began in January 1991. Her assumption of office in April 1990 was part of an agreement on the handover of power with the Sandinistas.

provide full financing for the clearance of IFI arrears and thus open the door to new sources of financial assistance.4/ Some donors said that in addition to a stronger program in Nicaragua they wanted to introduce greater burden sharing among donors, e.g. the provision of IDA and ESAF credits. Donors agreed that the IFIs should return to Nicaragua in January to review the situation with the authorities, analyze the planned stabilization and reform programs and report back at a March 1991 Consultative Group meeting. If the IFIs are able to report positive developments, then the arrears clearance could begin. Following that, the Bank's appraisal of an economic recovery credit (assuming IDA eligibility is granted) could be undertaken and a Board presentation could be made in the second half of 1991.

Current economic and political situation

6. Stabilization There were a number of specific achievements during 1990: increases in public utility rates, decreases in real wages, tax reform, and a reduction in the size of the military.5/ Inflation, however, reached 13,700% in 1990, significantly above the 1989 level of 1,600%. Additionally, inflation accelerated in the last quarter of 1990 after dropping from July to September. This was the result of a failure to control credit expansion as well as Central Bank financing of central government expenditures. The budget deficit reached $334 million, about 25% of GDP, partly as a result of excessive and uncontrolled off-budget financing. Hyper-inflation of the old cordoba led to a shift to cordoba oro (a newly introduced currency) and dollar denominated assets, which, coupled with the government's determination to maintain a 1:1 parity, resulted in an overvaluation of the cordoba oro. In the final two months of the year, the Central Bank utilized $20 million in reserves to defend the currency; by year end its gross reserves stood at $50 million.

7. Important issues thus still lay ahead and recent discussions with the government indicate that it is prepared to address them. One concern is the 1991 budget, including expectations on revenue growth, control of off-budget sources of funds and financing of the deficit. Another need is a highly disciplined monetary policy to choke off hyper-inflation, i.e. through reductions in credit expansion and Central Bank emissions.

8. Structural adjustment Policy measures introducing structural change have been more successful, largely because there is greater consensus on the need for change. In trade and commerce, for example, the state

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4/ Of the total estimated arrears of $350 million as of March 1991, the USA has indicated a willingness to provide a bridge loan of $150 million and a grant of $50 million to clear the arrears. France has pledged $4 million; no other donor has made a pledge though most have said in principle that they could make a donation for this purpose. Germany, Canada and Japan could provide cofinancing.

5/ The size of the military has decreased from 80,000 in April 1990 to 28,00 at the end of the year. Of these 5,000 were officers released under the demobilization agreement signed early in the year and the remainder were conscripts or reservists.

monopoly in marketing exports is being eliminated, effective protection is being reduced, quantitative restrictions are being phased out and tariff rates are being brought into line with the Central American Common Market neighbors. In addition, free trade zones are being established, a free trade agreement is being negotiated with Mexico, and one is proposed with the U.S.A.6/ Also, a Foreign Investment Law has been presented to the National Assembly.

9. Other aspects of structural adjustment are less advanced, though during the recent Bank mission the government indicated that it is willing to tackle these also. There is a critical need for financial sector reform, covering the regulatory framework, and the roles and responsibilities of the state and the private sector. A banking law providing for private commercial banks and a Superintendency of Banks is under discussion in the National Assembly but the regulatory framework is lacking, for example the process by which private bank applications will be reviewed, or what guidelines will be established by the Superintendency. In public finance, there is a need to enhance the budget process and reorient expenditures, giving greater weight to investment and social programs and less on recurring expenditures. This shift would likely call for a reduction in public sector employment and a drop in the size of the budget, which is now about one-third of GDP. Also critical are clear "rules of the game" for privatizing the 300 firms owned by the state. Without this, it will be difficult to attract new private investment or the return of flight capital. And, finally in agriculture, which the government looks to as a source of economic growth, there is an urgent need to restore competitiveness through macro economic policies as well as to devise a mechanism to ensure the flow of credit to efficient farmers. Over the longer term, land tenure, technology generation and environmental issues are major obstacles.

10. Political issues Political stability was shaken when the private sector refused to sign the concertacion in November, and then again in December, when the Vice-President Virgilio Godoy, ex-contras and several important mayors organized demonstrations to show displeasure with the pace of change. Mr. Lacayo was instrumental in defusing the latter situation, by bringing some ex-contras into high levels of government and obtaining support from the mayors, particularly the important mayor of Managua. More optimistically, the Sandinistas in the National Assembly have agreed on the need for structural changes and have made supportive statements to the donors, first in Rome in June and again in Paris in December last year. In Paris, however, they relied heavily on the terms of the concertacion and the "exceptional" treatment proposed in it. They have been reluctant to agree on a rapid stabilization effort, though very recent conversations with them hinted at a shift in their position. More troublesome is that the opposition members of the National Assembly may not be representative of the mood in the Sandinista controlled unions. This will undoubtedly be a critical factor in implementing a stabilization and adjustment program.

6/ The government has offered to drop its claim against the U.S.A. in the International Court of Justice in return for the free trade agreement.

WORLD BANK OFFICE TRACKING SYSTEM
OFFICE OF THE PRESIDENT
Routing and Action Transmittal Sheet

CP - F41
JENNY
SS + ALC
HAVE COPY
JW

TO: Mr. B. Conable (E-1227)	DATE: 2/04/91

SUBJECT:

Document From: Mr. Steckhan (through MAQ)
To: BBC
Dated: 2/01/91 Reference No.: EXC910204019

Topic: Briefing for Mr. Conable's Meeting with Mr. Antonio Lacayo
February 6, 1991 at 5:15 p.m.

ACTION INSTRUCTIONS:	DUE DATE:

_______ HANDLE
_______ REVIEW AND RECOMMEND
__XXX__ FOR YOUR INFORMATION
_______ DISCUSS WITH ____________________
_______ AS WE DISCUSSED
_______ PREPARE RESPONSE FOR ______ SIGNATURE
_______ FOR YOUR FILES
_______ RETURN TO ____________________
_______ OTHER: ____________________

Remarks: ____________________

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

Mr. Conable:
Barber: Nicaragua is still suffering from hyperinflation. Before we can lend to them, especially adjustment loans, we will need to make sure that they make an adequate stabilization effort. This underscores the role of the Fund. It is not yet clear what the Fund will do — most likely work out a shadow program to establish a track record before any drawings are made. We must urge the Nicaraguans to work with and agree on a stabilization program with the Fund.
Moeen

DATE: February 1, 1991

TO: Mr. Moeen A. Qureshi

FROM: Rainer B. Steckhan, Acting RVP, LAC Steckhan

EXTENSION: 38074

SUBJECT: Briefing for Mr. Conable's meeting with Mr. Antonio Lacayo February 6, 1991 at ~~4:30~~ 5:15 pm

1. Mr. Lacayo is visiting Washington D.C. for discussions with the U.S. government, the Bank, the IMF and the IDB on their possible support for stabilization and structural adjustment programs in Nicaragua.1/ In mid-February President Chamorro will visit Germany and Japan, two other key potential donors to Nicaragua. These visits follow seven months of Consultative Group work, under the leadership of the World Bank, aimed at reactivating the Nicaraguan economy and renewing international aid flows. Most recently parallel Bank, IDB and IMF missions were in Nicaragua from January 15-31 to review the stabilization and adjustment program and identify the outline of a possible SAL.

2. These visits are timed to coincide with a March donors meeting chaired by the Bank, during which the government's stabilization and arrears program will be discussed and a plan for the settlement of Nicaragua's IFI arrears of $350 million ($260m Bank) could be finalized.2/ The two issues are linked: the Consultative Group members have indicated that they would be willing to provide the financing necessary to clear the IFI arrears only if the IMF and the Bank provide a "green light" on the government's program.

3. Mr. Lacayo will explain the government's position on stabilization and adjustment, and seek a commitment from the Bank on a large IDA credit ($150.0-250.0 million) and access to other IDA instruments. He will present the government's achievements against the backdrop of war,

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1/ Mr. Lacayo is the Minister of the Presidency and acts as the *de facto* Prime Minister of Nicaragua. He is the son-in-law of the President and her most trusted adviser. Mr. Lacayo is a businessman with interests throughout Central America and Mexico. He remained in Nicaragua throughout the Sandinista years and is said to have developed a good relationship with several of their leaders. He is a graduate of M.I.T. and is fluent in English.

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Sandinista mismanagement of the economy and a return to democracy, and will likely seek "exceptional" consideration for Nicaragua. Notable among the achievements are a new found political stability obtained through an agreement or concertacion with various groups, a reduction in the size of the army, new banking and foreign investment laws, the elimination of trade monopolies, public utility rate increases and tax reform.

4. In response, the Bank should commend the government but emphasize the need to build on the encouraging discussions of the recent mission. Without a comprehensive, coherent and appropriately sequenced stabilization and adjustment program along the lines discussed, the Bank will not be able to provide financial support. Our discussions with bilateral donors, particularly the U.S.A., Japan, and Germany indicate that their support requires the same. This makes the March meeting a critical and perhaps last opportunity to obtain broad international support. The Bank should also reject the notion of "exceptional" consideration if that means a muddle-through approach. We should point out that a strong and rapid stabilization and adjustment program, under conditions such as prevail in Nicaragua, has a merit of its own when viewed against the costs of alternative strategies. Also, our experience further indicates that the such a program is most successful when it is fully "owned" by the government.

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10. Political issues Political stability was shaken when the private sector refused to sign the concertacion in November, and then again in December, when the Vice-President Virgilio Godoy, ex-contras and several important mayors organized demonstrations to show displeasure with the pace of change. Mr. Lacayo was instrumental in defusing the latter situation, by bringing some ex-contras into high levels of government and obtaining support from the mayors, particularly the important mayor of Managua. More optimistically, the Sandinistas in the National Assembly have agreed on the need for structural changes and have made supportive statements to the donors, first in Rome in June and again in Paris in December last year. In Paris, however, they relied heavily on the terms of the concertacion and the "exceptional" treatment proposed in it. They have been reluctant to agree on a rapid stabilization effort, though very recent conversations with them hinted at a shift in their position. More troublesome is that the opposition members of the National Assembly may not be representative of the mood in the Sandinista controlled unions. This will undoubtedly be a critical factor in implementing a stabilization and adjustment program.

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Record Removal Notice

File Title		Barcode No.
Country Files- Nicaragua - Correspondence - Volume 1		1779825
Document Date December 19, 1990	**Document Type** Letter	

Correspondents / Participants
To: Dr. Raul Lacayo S., Ministro Presidente, Banco Central de Nicaragua
From: President Barber B. Conable

Subject / Title
Appointment as Alternate Governor for Nicaragua

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

Translated letter in Spanish attached.

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Shiri Alon	March 08, 2022

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 5, 1990

TO: Memorandum for the Record

FROM: Rainer B. Steckhan, Director, LA2 Steckhan

EXTENSION: 38074

SUBJECT: NICARAGUA - Meeting with the Nicaraguan Delegation at the 1990 Annual Meetings on September 28, 1990

~~AK~~
~~SS~~
~~BBC~~
Co file

Delegation: Finance Minister Emilio Pereira (Governor); Central Bank President Francisco Mayorga (Alternate Governor); Economic Adviser to the President, Haroldo Montealegre; and the Economy and Development Minister, Silvio de Franco.

Bank Representatives: Barber B. Conable, Moeen A. Qureshi, S. Shahid Husain, William Stanton, David Bock, Sven Sandstrom, and Rainer B. Steckhan.

1. The Nicaraguan Delegation briefed Mr. Conable on Nicaragua's economic situation and on progress made on the emerging economic reform program. They emphasized that the Government was seeking commitment to the program from the trade unions and the Sandinista Opposition. The Delegation also thanked the Bank for its economic work and advice, and expressed the hope for World Bank Group lending.

2. In reply, Mr. Conable emphasized the importance of a sound stabilization and adjustment program of the Government, and political support for it as a basis for renewed growth and social development in Nicaragua. Provided such a program could be implemented, the Bank Group would be willing to support it and help the Government mobilize funds from other donors through the Consultative Group mechanism. Obviously, IMF support for a stabilization program would be a vital element of an international aid effort for Nicaragua. Bank Group lending would also be contingent on the settlement of Nicaragua's arrears to IBRD and IDA.

3. In response, Finance Minister Pereira reported that the World Bank, IDB, IMF, and Nicaragua had formed a working group which would formulate a long term debt workout and a plan for the settlement of arrears which would be submitted to the Consultative Group Meeting in Paris, scheduled for December 3 and 4. Mr. Pereira stated that discussions with the IMF were ongoing but had not yet led to the outline of a program.

cc. Mr. Conable's Office
Mr. Qureshi's Office
Messrs. Husain, Stanton, Bock, Sandstrom, Selowsky, Quijano, Knotter, Halperin, Binswanger, Lee, Voljc, Clifford (LA2)

September 20, 1990

NICARAGUA
ANNUAL MEETINGS BRIEF
September 28, 1990
10:45-11:15 a.m.

Since the Annual Meetings brief was submitted (August 31, 1990) we held a donors-only conference on Nicaragua on September 12, 1990. While the donors generally applauded the government's reform efforts to date they also shared the IBRD/IMF/IDB view that more needs to be done - particularly on the public sector deficit and credit expansion. We should stress therefore the importance of the Government moving ahead urgently with a strong, monitorable stabilization and economic adjustment program. In doing this we should note that the draft program that was recently provided to the Bank represented an improvement over previous plans but is still short on specific actions and targets.

Other items emanating from the donors' conference included: i) plans for a formal Consultative Group meeting December 5-7, 1990; ii) the formation of an external debt working group to come up with various alternatives for managing the external debt; and iii) the formation of a technical assistance working group under UNDP leadership. The Nicaraguans would participate in each of these meetings.

ANNUAL MEETING BRIEF
COUNTRY: NICARAGUA

Key Points for Mr. Conable

Although the government has initiated an economic adjustment effort and some progress has been made within a difficult political context, Nicaragua's economy faces severe and fundamental disequilibria that have not yet been adequately addressed, i.e., high fiscal deficit, overvalued exchange rate and highly expansionary credit policies which have fueled further very high inflation.

You should stress the critical importance of moving ahead urgently with a strong, monitorable stabilization and economic adjustment program and ask the delegation to comment on the key actions required to proceed with a structural adjustment loan:

i) development and implementation of a detailed economic reform program. The most recent plan is much better than previous ones but still lacks specific programs and targets. It must also include measures to alleviate the social costs of adjustment.

ii) agreement with the IMF on either a stand-by or shadow program. Without this a SAL cannot be approved.

iii) progress on external debt, including freezing the arrears with the IBRD as of June 15, 1990 as originally agreed, and the development of strategies with respect to other official and commercial debt. You should note that only one payment to the Bank has been received. If new arrears can be eliminated this would greatly facilitate the clearance of arrears and encourage donor support.

The Bank is committed to support Nicaragua's economic recovery efforts both as Chair of the Consultative Group and in working with the Government on a SAL. There have been a number of positive developments - the Rome conference, the joint IDB/IMF/IDB mission and the recent donor conference - but future progress depends greatly on the steps outlined above. To assist these efforts, a further Bank economic mission is planned for October, and a formal Consultative Group is scheduled for December.

In closing, you should impress upon the delegation the need to proceed expeditiously with their reforms. There is considerable international goodwill towards Nicaragua but this will dissipate rapidly if the reform process appears to be moving too slowly. Confidence in a credible program of reform is essential to return the country to a sustainable growth path.

CONFIDENTIAL

ANNUAL MEETINGS BRIEF

Name of Country: **NICARAGUA** Date: August 31, 1990

Meeting with: Emilio Pereira, Minister of Finance, Governor; Francisco Mayorga, Minister and President of the Central Bank, Alternate Governor; Haroldo Montealegre, Economic Adviser to the President.

Population: 3.7m (1989) Population Growth Rate: 3.3%
GNP per capita: US$263

Total Commitments to date: $290.2m
of which:
Bank: 28 loans $229.6m
IDA: 5 credits $60.6m
Total Undisbursed: $0.0m
Lending Program : FY91-92
(Preliminary Program under preparation)

FY90: Commitments: $0.0m
Disbursements: $0.0m
Amortization: $1.52m
Arrears: IBRD: $197.9m
IDA: $4.7m
(both as of 8/15/90)

Summary Data	Average 1985-89	1990 est.
GDP Growth	-4.0%	-2.0%
Export Growth	-3.2%	10.0%
Import Growth	-6.5%	-5.0%
Curr. Acc. Deficit (%GDP)	36.3% 1/	30.5% 2/
Gross Debt Service Ratio	159.3%	277.8%
Annual Inflation Rate	4180.0%	3222.0%

Aid Group Meeting: CG recently formed; First Meeting tentatively scheduled for November 1990.
IMF Status as of: Initial discussions with IMF underway.

1/ 1988-89; 2/ 11.5% paid

Background: The Nicaragua economy faces severe and fundamental disequilibria that have only been addressed partially by the new Chamorro government. A new economic recovery program has been announced but details are not yet available.

Issues likely to be raised by the delegation
- i) Size and timing of structural adjustment loan (SAL).
- ii) IDA eligbility

Issues to be raised by Bank Management
- i) Resolution of arrears to the Bank
- ii) Aid coordination

Attachments:
Preliminary Lending Program
Biographical Information
Capital Subscription Data

I. BACKGROUND

A. Political and Economic Situation

1. Nicaragua confronts fundamental economic disequilibria in the fiscal, trade and financial sectors that are compounded by a distorted state apparatus and a conflictive political situation. Total output has fallen every year since 1984, and by 1989 it was 10 percent lower than at the beginning of the decade. Inflation in mid-June 1990 stood at 880 percent on an annual basis, after having reached 1690 percent in 1989. The volume of exports has been falling since 1983 and stands now at about half the 1980 level. In addition, its total external debt stood at $10.0 billion, close to 4 times annual exports; of this amount $3.5b was in arrears as of mid-1990, 44% of it unpaid interest.

2. When the Chamorro government took office in April 1990 it faced a grossly overvalued exchange rate, depleted international reserves, a large increase in domestic credit and a swollen fiscal account that was largely absorbed by public sector wages. Its first 100 days in office were further marked by confrontations with the opposition. As a result economic recovery has not yet gotten underway in spite of a number of corrective measures that were taken, among them the gradual unification of exchange rates, tax reform, public utilities' rate increases (water and electricity) and the elimination of Central Bank exchange losses. The government has not been able to control the public sector deficit, which, together with highly expansionary credit policies of the nationalized credit system, has fueled a large expansion in the monetary base and resulted in inflation of 100 percent per month and an overvalued currency. This has contributed to continuing instability, has inhibited the return of expatriated capital and has put the recovery program in doubt. As a result the government has decided (on August 20) on a new economic program.

B. Bank Program

3. The Bank has supported a renewed dialogue with Nicaragua, with an initial emphasis on reviewing the economic situation and discussing steps to clear arrears. A joint Bank/IDB/IMF mission visited Nicaragua in August of 1990 and had extensive discussions on macroeconomic policy, privatization, external debt, and sectoral needs. As Chair of the newly formed Consultative Group, a donors only meeting will be held on September 12 to discuss the main findings of the August economic mission and expected financing needs. (This Brief may be updated following the meeting.) This is being followed by a formal CG meeting tentatively scheduled for November for which a Country Economic Memorandum is currently under preparation. A further economic mission is planned for October 1990. Its objective would be to review the Government's economic recovery program and indicate preparation of a SAL, assuming an adequate basis exists. Provided rapid progress in reaching agreement on the Government's adjustment program and key conditionality as well as satisfactory progress in working out

bridge financing and clearing arrears, the objective would be to have a SAL ready for Board consideration by February or March 1991. This assumes satisfactory progress in parallel IMF negotiations.

II. ISSUES LIKELY TO BE RAISED BY THE DELEGATION

Possible SAL

4. The Nicaraguans are seeking a Bank commitment to begin processing a large (perhaps on the order of $400m) structural adjustment loan now. They will argue that: a) theirs is a unique situation due to the recent hyper-inflation and the role of Nicaragua in the Central American peace process; b) they can go no further in their plans without external assistance. The delegation will argue that these two factors call for large levels of assistance from the international financial institutions and the speediest possible processing of a Bank SAL.

Suggested Response

5. Given the difficulties faced by the Chamorro government in tackling economic issues, the Bank cannot yet give a firm commitment for preparation of a SAL. We should also indicate that a SAL of the magnitude suggested by Nicaragua would not be feasible. The first SAL would most likely be on the order of US$80 million, although the total package could be much larger, assuming co-financing can be arranged. The actual amount of the program and the financing plan would need to be worked out during preparation. Recognizing the need to move quickly, the Bank is prepared to send a further economic mission in October to evaluate the Government's economic recovery program and seek agreement on the key elements of a SAL program.

6. The Government's program would have to include: i) a strong macroeconomic framework with clear objectives in regard to fiscal and monetary reform, public sector wages, financial sector reform, as well as specific actions to address external debt and arrears issues; ii) privatization of state enterprises; iii) a program to minimize the social costs of adjustment, including a safety net; and iv) sectoral components which address basic issues in agriculture, transport and the social sectors. Actual timing of the loan would depend on how quickly the key components of the program can be put together and agreed, including putting together the bridge financing package to clear arrears. Since a SAL would also require a strong macro-economic framework, rapid progress in parallel Nicaraguan discussions with the IMF on a standby would also be important as part of the overall financing package.

IDA Eligibility

7. The delegation will likely press for IDA terms given the severity of the situation and the country's falling per capita income.

Suggested Response

8. Based on the findings of the recent economic mission, Nicaragua's per capita income has fallen sharply and is therefore expected to meet IDA requirements. Regional management therefore plans to prepare a Board paper for Senior Management and the Board recommending IDA eligibility. We may want to stress, however, that IDA eligibility also requires satisfactory macro-economic management and the existence of a strong adjustment effort.

III. ISSUES TO BE RAISED BY THE BANK

Arrears

9. Amounts due to the Bank as of August 1990 totaled about $200 milion. For the present discussion we can assume that these (and $60 million in arrears to IDB) will be repaid using bridge funds. But the size, timing and conditions of any SAL will depend greatly on what the Nicaraguan government is able to renegotiate with other creditors. And of particular importance for future cash flows is how the mounting debt to the socialist countries (47% of the official debt of $6.7b) will be handled. Debt to the USSR, the largest single creditor ($2.5b), represents 80% of all debt to the socialist countries.

10. Clearance of arrears remains critical for the Bank since new lending requires this problem be resolved. Although we welcomed the Government's decision to freeze arrears at the June 15 level by remaining current on all future payments, we note that to date only the June 15 payment has been made. We would urge that subsequent payments be made, particularly since this effort by the Government would facilitate reaching an agreement on other arrears and encourage greater donor interest in helping the Government to sort out its debt problems.

Aid coordination

11. After a generally positive donors' meeting in Rome chaired by Italy, there has been little follow up by the government and many donors complained to the Bank about a lack of action on the part of the Nicaraguans. This was confirmed by mission members in August. The state of the economy requires that the Nicaraguan government work hard on the international front to ensure a flow of funds and scarce technical resources. The issue to be emphasized to the Nicaraguan delegation is that the entire recovery process would suffer severely if the country is unable to maintain and strengthen the considerable goodwill that now exists. The Bank is willing to work closely with the Nicaraguans in preparing for the CG planned for late November. However, we would also urge the Government to give higher priority to aid coordination matters when preparing the details of the economic recovery program, identifying external financing needs, and indicating technical assistance requirements.

Attachment 1

Preliminary Lending Program
FY91 - 93

FY 91	FY 92	FY 93
SAL 80 m.	Agr. SECAL 20 m.	Water Supply 20 m.
Soc. Sector 15 m.	Transport Rehab. 25 m.	

Biographical sketches:

Emilio Pereira is the Minister of Finance and Governor of the World Bank for Nicaragua. Prior to joining the government, Mr. Pereira was Dean at the Central American School of Business Administration (INCAE), the leading graduate school of its type in the region. He is an engineer in computing sciences, and is fluent in English.

Francisco Mayorga is Minister and President of the Central Bank of Nicaragua and Alternate governor for Nicaragua. During the Presidential campaign and the initial months of the administration he was the economic spokesman for Mrs. Chamorro and her UNO coalition. He was also the architect of the initial economic program which has recently been revamped. Mayorga was also formerly on the faculty of INCAE. He holds a PhD in Economics from Yale and is fluent in English.

Haroldo Montealegre is currently the Economic Adviser to the President (a cabinet level post) and is the driving force behind the newly announced economic program. He has well established connections with the private sector (including expatriates) and the opposition. In 1980 he was a minister in the Sandinista led Government of National Reconstruction, in which Mrs. Chamorro was a member of the Junta. Montealegre currently splits his time between his advisory position and his full service investment bank, Amerisecurities Capital Corp., located in Miami. He holds an MBA from the University of Chicago and is fluent in English.

Attachment 3

IBRD CAPITAL SUBSCRIPTION STATUS BY REGION

(AS OF JULY 31, 1990)

COUNTRIES	NO. OF SHARES			POT. VOTING POWER (%)	NATIONAL CURRENCY SUBSCRIPTION (US$ MIL EQ)		UNSUBSCRIBED SHARES					
	ALLOCATED	SUBSCRIBED	UNSUBSCRIBED		RELEASED	UNRELEASED	RES. NO	NUMBER OF UNSUB. SHARES	AMOUNT TO BE PAID ON SUBSCRIPTION (US$ MIL) US $	NATIONAL CURRENCY	TOTAL	SUBSCRIPTION PLANS OR STEPS TAKEN
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
LATIN AMERICA & THE CARIBBEAN COUNTRY DEPARTMENT 2												
COSTA RICA	233	131	102	.033	0.8	0,8	425	102	.037	.332	.369	None
EL SALVADOR a/	251	141	110	.034	0.4	1.1	425	110	.040	.358	.398	None
GUATEMALA a/	2001	1123	878	.154	0.8	7.7	425	878	.318	2.860	3.178	None
HONDURAS a/	641	360	281	.061	0.8	-0.4	425	281	.102	.915	1.017	None
MEXICO	18804	10553	8251	1.306	0.3	97.9	425	8251	2.986	26.875	29.861	Memorandum of Law received
NICARAGUA a/	608	341	267	.058	0.7	0.3	425	267	.097	.870	.966	None
PANAMA	385	218	169	.043	0.0	2.4	425	169	.061	.550	.612	None
TOTAL	22923	12865	10058	1.692	3.4	110.6		10058	3.640	32.760	36.400	

a/ IDA eligible countries

1990 ANNUAL MEETING BRIEF - IFC

NICARAGUA
(Member since 1956)

1. Representing Nicaragua

Mr. Emilio Pereira, Minister of Finance,and Bank Governor.
Mr. Francisco Mayorga, Minister and President of the Central Bank, Alternate Governor.
Mr. Haroldo Montealegre, Economic Adviser to the President.

2. Representing IFC

Mr. Helmut Paul, Director, CL1
Mr. Varel Freeman, Divisional Manager, CL1
Mr. Rolando Zosa, Manager, Special Operations Unit

3. Issues Likely to be Raised by the Delegation

(i) Desire for resumption of IFC activities.

4. Discussion Topic to be Raised by IFC

(i) Private Sector: The Government's specific plans to encourage private direct investment and its priorities.

(ii) Pipeline: IFC willing to consider new investments, subject to adequate economic outlook and resolution of IBRD arrears. CPDF assistance in pipeline development and finance from other sources available. CFS role in privatization possible. Advisory services not tied to clean up of arrears.

(iii) Nicaragua Sugar: Progress on compensation plan.

(iv) IFC's Capital Increase: Nicaragua has not subscribed to IFC's Capital Increase. IFC should ask the Government what is its position for subscribing to IFC's capital increase. The last date for repayment is July 30, 1991.

ANNEXES

1. Biographical Information.
2. 1990 Strategy Paper.
3. Statement of IFC's Investments in Nicaragua.

CL1 - September 12, 1990
(3682B)

NICARAGUA

BIOGRAPHICAL INFORMATION

Mr. Emilio Pereira, Minister of Finance, Governor

Mr. Francisco Mayorga, Minister and President of the Central Bank, Deputy Governor

Mr. Haroldo Montealegre, Economic Adviser to the President (Cabinet rank)

(details to follow)

CL1 - September 12, 1990
(3682B)

NICARAGUA

1990 STRATEGY PAPER

GENERAL CONTEXT

Economic Situation

1. Nicaragua confronts fundamental economic disequilibria in the fiscal, trade and financial sectors that are compounded by a distorted state apparatus and a conflictive political situation. Total output has fallen every year since 1984, and by 1989 it was 10 percent lower than at the beginning of the decade. Inflation in mid-June 1990 stood at 880 percent on a annual basis, after having reached 1690 percent in 1989. The volume of exports has been falling since 1983 and stands now at about half the 1980 level. In addition, its total external debt stood at $10.0 billion, close to 4 times annual exports; of this amount $3.5b was in arreas as of mid-1990, 44% of it unpaid interest.

2. When the Chamorro government took office in April 1990 it faced a grossly overvalued exchange rate, depleted international reserves, a large increase in domestic credit and a swollen fiscal account that was largely absorbed by public sector wages. Its first 100 days in office were further marked by confrontations with the opposition. As a result economic recovery has not yet gotten underway in spite of a number of corrective measures that were taken, among them the gradual unification of exchange rates, tax reform, public utilities' rate increases (water and electricity) and the elimination of Central Bank exchange losses. The government has not been able to control the public sector deficit, which, together with highly expansionary credit policies of the nationalized credit system, has fueled a large expansion in the monetary base and resulted in inflation of 100 percent per month and an overvalued currency. This has contributed to continuing instability, has inhibited the return of expatriated capital and has put the recovery program in doubt. As a result the government has decided (on August 20) on a new economic program but whose specifics are not yet known.

IBRD Priorities

3. The Bank is working closely with the new Government on economic matters. The Bank hopes to be in a position to make a structural adjustment loan sometime in the first half of CY 1991 providing Nicaragua can become current in its arrears. The Bank is also helping put together a donors' group which hopefully will be meeting during the autumm.

IFC Program and Country Strategy

4. IFC should move cautiously in light of the country situation. However, we could think of a relatively small operation with a good sponsor, perhaps with a project involving a privatization, provided IBRD arrears situation is satisfactory. A visit to the country in late autumm would be timely.

Portfolio (two projects - both with Special Operations Unit (SOU))

(a) Posada del Sol (a hotel). SOU is negotiating with the owners a price in which to buy out IFC's investment (loan and equity), both fully written-off.

Nicaragua Sugar Estates (NSE). SOU is discussing with the owners the development of a shrimp farm on the property with the objective of eventual export earnings with which to repay IFC.

CL1 - September 12, 1990
(3682B)

NICARAGUA

STATEMENT OF IFC INVESTMENTS (As of July 31, 1990)
(US$000's)

Investment Number	Year	Obligor	Type of Investment	Equity	Loan	Total	Total Held By IFC	Total Undisbursed Including Participants' Portion
130-NI	1968	*Textiles Fabricados de Nicaragua, S.A. (FABRITEX)	Textile Mill	1,071	1,000	2,071	-	-
345	1976	*Nicaragua Sugar Estates Limited (NSEL)	Sugar Mill	-	6,500	6,500	-	-
346-NI	1976	*Posada del Sol	Hotel	200	700	900	-	-
	Total			1,271	8,200	9,471	-	-

* Investments which have been fully cancelled, terminated, written off, sold, redeemed or repaid.

CL1 - September 12, 1990
(3682B)

Record Removal Notice

File Title Country Files- Nicaragua - Correspondence - Volume 1	**Barcode No.** 1779825
Document Date July 11, 1990	**Document Type** Letter

Correspondents / Participants
To: Senor Dr. Emilio Pereira A.
From: President Barber B. Conable

Subject / Title
Appointment as Governor for Nicaragua on the Boards of Governors of The World Bank Group

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

Translated letter in Spanish attached.

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Shiri Alon	March 16, 2022

Managua, 14 de Junio, 1990
MP-103

DISTRIBUTION

TO- Executive Director
Country Director, Bank
Investments Director, IFC
File Credential

FROM - E. T. Sanidad
SECRETARY'S DEPARTMENT

Sr. Barber B. Conable
Presidente
Banco Mundial
1818 H Street, N.W.
Washington, D.C. 20433

Estimado Sr. Conable:

Por instrucciones de Doña Violeta Barrios de Chamorro, Presidente de Nicaragua, le comunico que han sido nombrados Gobernador y Gobernador Alterno de su Institución las siguientes personas:

Gobernador : Dr. Emilio Pereira A.
Ministro de Finanzas de Nicaragua.

Cobernador Alterno : Dr. Francisco Mayorga B.
Ministro Presidente del
Banco Central de Nicaragua.

Los anteriores nombramientos son efectivos a partir del 25 de Abril de 1990.

Atentamente,

Ing. Antonio Lacayo O.
Ministro de la Presidencia

ROUGH TRANSLATION

Per instructions from Madam Violeta Barrios de Chamorro, President of Nicaragua, I wish to inform you that the following have been named Governor and Alternate Governor of your institution:effective April 25, 1990.

Governor: Dr. Emilio Pereira A.
Minister of Finance

Alt. Gov: Dr. Francisco Mayorga B.
Minister President
Banco Central de Nicaragua

MINISTERIO DE LA PRESIDENCIA

Record Removal Notice

File Title		Barcode No.
Country Files- Nicaragua - Correspondence - Volume 1		1779825
Document Date June 8, 1990	**Document Type** Letter	

Correspondents / Participants
To: Senor Francisco J. Mayorga
From: President Barber B. Conable

Subject / Title
Appointment as Governor for Nicaragua on the Boards of Governors of The World Bank Group

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

Translated letter in Spanish attached.

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Withdrawn by	Date
Shiri Alon	March 16, 2022

Banco Central de Nicaragua

PRESIDENCIA

28 de mayo de 1990.

DISTRIBUTION

TO- Executive Director
Country Director, Bank
Investments Director, IFC
File Credential

FROM - E. T. Sanidad
SECRETARY'S DEPARTMENT

Sr. Timothy Thahane
Vice-Presidente y Secretario
Banco Mundial
D- 11 -067
1818 -H. Street

Estimado Seño Vice-Presidente:

Pláceme informar a usted que en virtud de mi designación como Ministro Presidente del Banco Central de Nicaragua, estoy asumiendo la función de Gobernador por Nicaragua ante el Banco Mundial. Como Gobernador alterno fungirá el Doctor Silvio de Franco, Ministro de Economía y Desarrollo.

Cordiales saludos,

Francisco J. Mayorga
Ministro -Presidente

BANCO CENTRAL DE NICARAGUA - PRESIDENCIA - Managua, D. N. -

cc: Archivo.

ROUGH TRANSLATION:

Please be informed that I have been named as Minister-President of the Banco Central de Nicaragua and therefore assumes the function as Governor of The World Bank Group for Nicaragua. Dr. Silvio de Franco, Minister of Economy and Development will act as Alternate Governor

Record Removal Notice

The World Bank Group Archives & Records Management

File Title Country Files- Nicaragua - Correspondence - Volume 1	**Barcode No.** 1779825
Document Date June 8, 1990	**Document Type** Letter

Correspondents / Participants
To: Doctor Silvio de Franco, Ministro de Economia y Desarrollo
From: President Barber B. Conable

Subject / Title
Appointment as Alternate Governor for Nicaragua

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

Translated letter in Spanish attached.

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Shiri Alon	March 08, 2022

JV

10/30

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

Office of the President

October 16, 1989

Mr. Moeen A. Qureshi

Moeen:

Mr. Pinto asked for an appointment to follow up on Mr. Conable's reactions during the Governors' Luncheon on Nicaragua. Mr. Conable said that he would be happy to discuss with Nicaraguan authorities ways and means of cooperating in the future. He meant that we would be ready to develop a program if and when arrears could be cleared.

Could a briefing be prepared for Mr. Conable's consideration by c.o.b. Monday, October 23?

Marianne Haug

M. Haug

MH

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 89/10/19 DUE DATE : 00/00/00
LOG NUMBER : 891023008 FROM : Mr. Choksi (MAQ)
SUBJECT : BBRIEFING: Nicaragua - meeting with Mr. Jorge Pinto on Oct. 30, 1989 at 12 noon.
OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

- __________ APPROVED
- __________ PLEASE HANDLE
- ✓ FOR YOUR INFORMATION
- __________ FOR YOUR REVIEW AND RECOMMENDATION
- __________ FOR THE FILES
- __________ PLEASE DISCUSS WITH __________
- __________ PLEASE PREPARE RESPONSE FOR __________ SIGNATURE
- __________ AS WE DISCUSSED
- __________ RETURN TO __________

COMMENTS :cc: Mrs. Haug

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 19, 1989

TO: Mr. Barber B. Conable

THROUGH: Mr. Moeen A. Qureshi

FROM: Armeane Choksi, Acting RVP, LAC

EXTENSION: 31811

SUBJECT: NICARAGUA: Briefing For Your Meeting with Mr. Jorge Pinto

1. You will be meeting with Mr. Jorge Pinto, Executive Director for Central America at 12 p.m. on October 30, 1989. Mr. Pinto requested the meeting to follow up on your conversation with Mr. Cuadra Chamorro during the Governor's Luncheon regarding ways to restore the Bank/country relations.

Major Issues

2. As you are aware, the principal issue affecting the Bank's relationship with Nicaragua is the arrears problem. As of October 12, arrears totaled US$167 million. Nicaragua's portfolio was placed in non-accrual status in FY86 and we have been provisioning against the debt since FY87 at 20 percent per year. As a result of this situation, the Bank declined last May 1989 an invitation made by the Government of Sweden on behalf of the Government of Nicaragua, to participate in an international meeting of bilateral and multilateral agencies in Stockholm, where the country's economic prospects and financial needs were discussed.

3. During the meeting between Mr. Husain and the Nicaraguan delegation to the Annual Meetings headed by Mr. Cuadra-Chamorro, the President of the Central Bank, Mr. Cuadra-Chamorro noted that a solution to Nicaragua's arrears to the Bank required the participation of the entire international community. He indicated that following the elections of March 1990, a second international meeting to discuss Nicaragua's economic prospects and financial needs could be convened in Rome. He then expressed his Government's hope that the Bank would be able to attend this second international meeting. Mr. Cuadra-Chamorro also noted that Nicaragua remained prepared at any time to reopen a dialogue with the Bank to pave the way for working out a solution to the arrears after the elections.

4. In response, Mr. Husain expressed his hope that the situation would be clearer after the elections, but noted that the question of arrears had to be resolved before any discussion of future Bank assistance could be discussed. The Nicaraguan delegation, however, insisted in requesting that the Bank should begin some preliminary discussions now to pave the way for a more substantive effort by the Bank and other multilateral and bilateral agencies after the elections.

5. Mr. Pinto can therefore be expected to explore with you the possibilities for: i) a Bank mission to review Nicaragua's current economic situation and recent efforts by the country to adjust before the meeting in Rome; and ii) Bank participation in the Rome meeting.

Suggested Response

6. You may want to indicate to Mr. Pinto, that as has been expressed before, sending a Bank mission is precluded by the non-accrual condition of the country at a time when budgetary constraints have resulted in a very tight human and financial resource situation in the Central America Division.

7. Regarding Bank participation in the Rome meeting, you may want to indicate to Mr. Pinto that in principle the Bank is amenable to the idea, but that as Mr. Chamorro himself expressed during the Annual Meetings, an answer to such invitation to participate would have to wait until the event is confirmed after the Presidential elections of March 1990.

CONFIDENTIAL

BASIC COUNTRY DATA

Name of Country: Nicaragua   Date: October 19, 1989

Meeting with: Mr. Jorge Pinto, Executive Director

Population: 3.3 m (1986); Estimated Growth Rate -8.0% (1988)

GNP per capita: $790 (1986)

	($m)			($m)
Total Commitments to date:	290.2	FY89:	Commitments:	0.0
of which:			Disbursements:	0.0
Bank: 28 loans	229.6		Amortization:	0.0
IDA: 5 credits	60.6		Arrears to IBRD	
Total Undisbursed:	0.00		Arrears to IDA	
Lending Program: FY87-88:	0.00		Provisioning	

Summary Data(1)	Average 1984-88	1988 est.	
GDP growth (%)	-2.8	- 8.0	Aid Group Meeting:
Export growth	-10.0	1.5	No formal aid group
Import Growth	0.7	-2.0	functioning
Current Account Deficit (% of GDP)	10.8	28.3	IMF Status: No active program. They are presently current in their payments to the IMF.
Gross Debt Service Ratio	181.5	269.0	Last Article IV consultation
Annual Inflation Rate	312	5,000.0	mission May 1989.

(1) Data from information given by the Government of Nicaragua at the May 1989 Stockholm meeting of donor countries organized by the Government of Sweden

Record Removal Notice

The World Bank Group Archives & Records Management

File Title	Barcode No.
Country Files- Nicaragua - Correspondence - Volume 1	1779825

Document Date	Document Type
September 7, 1989	Letter

Correspondents / Participants
To: Senor Pedro Antonio Blandon Lanzas
From: President Barber B. Conable

Subject / Title
Reappointment as Alternate Governor for Nicaragua on the Boards of Governors of The World Bank Group

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

Translated letter in Spanish attached.

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Shiri Alon	March 16, 2022

Record Removal Notice

File Title	Barcode No.
Country Files- Nicaragua - Correspondence - Volume 1	1779825

Document Date	Document Type
August, 1989	Telex

Correspondents / Participants
To: Jorge Pinto, Director Ejecutivo
From: Joaquin Cuadra Chamorro, Ministro-Presidente

Subject / Title
Governor of The World Bank Group

Exception(s)
Communications of Executive Directors' Offices

Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Shiri Alon	March 16, 2022

Record Removal Notice

The World Bank Group Archives & Records Management

File Title Country Files- Nicaragua - Correspondence - Volume 1	**Barcode No.** 1779825
Document Date September 7, 1989	**Document Type** Letter

Correspondents / Participants
To: Joaquin Cuadra Chamorro, Ministro-Presidente
From: President Barber Conable

Subject / Title
Reappointment to a third term as Governor for Nicaragua on the Boards of Governors of The World Bank Group

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

Letter translated in Spanish attached.

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Shiri Alon	March 16, 2022

Record Removal Notice

The World Bank Group Archives & Records Management

File Title	Barcode No.
Country Files- Nicaragua - Correspondence - Volume 1	1779825

Document Date	Document Type
August, 1989	Telex

Correspondents / Participants
To: Senor Jorge Pinto, Director Ejecutivo
From: Joaquin Cuadra Chamorro, Ministro-Presidente

Subject / Title
Governor of The World Bank Group

Exception(s)
Communications of Executive Directors' Offices

Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Shiri Alon	March 16, 2022

Record Removal Notice

File Title	Barcode No.
Country Files- Nicaragua - Correspondence - Volume 1	1779825

Document Date	Document Type
August 25, 1989	Note w/attachments

Correspondents / Participants
To: President Barber Conable
From: Jorge Pinto, Executive Director

Subject / Title
Enclosed copies of letters exchanged with Shahid Husain.

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

Attachments:
March 29, 1989
April 21, 1989
May 9, 1989
July 13, 1989
Subject: Bank participation in Nicaragua Economic Mission

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Shiri Alon	March 16, 2022

FORM NO. 1663
(5-80)

THE WORLD BANK

ROUTING SLIP	DATE: Dec 16

FROM THE OFFICE OF THE
VICE PRESIDENT, EXTERNAL RELATIONS

NAME	ROOM NO.
BB Conable	

	APPROPRIATE DISPOSITION		NOTE AND RETURN
	APPROVAL		NOTE AND SEND ON
	COMMENT		PER OUR CONVERSATION
	FOR ACTION		PER YOUR REQUEST
✓	INFORMATION		PREPARE REPLY
	INITIAL		RECOMMENDATION
	NOTE AND FILE		SIGNATURE

REMARKS:

You were uncertain of
The numbers on Nicaraguan
loans at US News; This memo
Refreshes Them for you.

FROM: H Nicholas

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 16, 1987

TO: Barber B. Conable, EXC

FROM: Harry K. Nicholas, EXT HKN

SUBJECT: Nicaragua Loan Status

From information statement issued by the World Bank, September 18, 1987:

> For the fiscal year ended June 30, 1987, the Bank made a provision for losses of $41,000,000 on loans made to or guaranteed by Nicaragua with an aggregate principal balance outstanding of $213,328,000, of which $35,747,000 was overdue. These loans have been in nonaccrual status since December of 1984. Accumulated provisions for loan losses on these loans totalled $85,331,000 at June 30, 1987.

In the first quarter of Fiscal Year 1988 since then, up to September 30, 1987, the Bank has reserved for losses an additional $10,600,000, bringing the total to $95,896,000. Because of the sharp depreciation of the dollar, the reserve may have to be more than $20 million for this current quarter.

HKN:rlj

(1) MH
~~(2) BBC~~
(3) CP

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 7, 1987

TO: Files

FROM: Rainer B. Steckhan, Director, LA2DR Steckhan

EXTENSION: 61003

SUBJECT: NICARAGUA - Mr. Qureshi's Meeting with Government Delegates

On Wednesday, November 25, 1987 Mr. Joaquin Cuadra Chamorro, President of Nicaragua's Central Bank and World Bank Governor, accompanied by Mr. Silvio Conrado, Vice-President of Nicaragua's Central Bank, Mrs. Mercedes Rubio, Executive Director and Mr. Francisco Vannini, Alternate Executive Director came to visit with Mr. Moeen A. Qureshi. I was present.

Essentially the Nicaraguan delegation asked for technical assistance from the Bank to help Nicaragua prepare an economic adjustment program in conjunction with the technical assistance that the IMF was providing. The delegation asked, in particular, that World Bank staff accompany the upcoming annual consultation mission of the IMF. In reply Mr. Qureshi recalled the history of World Bank/Nicaragua relations and the damage Nicaragua had done by not paying the Bank while making some payments to other international institutions and creditors. For the first time in its history, the World Bank had to make provisions because Nicaragua had refused to give the Bank preferred creditor status. Nicaragua had thereby violated the principle of a cooperative institution which the World Bank represented.

In this situation, Mr. Qureshi felt that the Bank could not provide technical assistance to Nicaragua until Nicaragua took some concrete action to reflect the seriousness of its interest in the Bank. As a minimum, Nicaragua would have to reduce its arrears to the World Bank to below 2 years and propose a reasonable timetable on how to settle the remainder. The Nicaraguans said they could not make payments to the Bank at this stage.

Mr. Qureshi concluded that Nicaragua as a member of the World Bank had the right to a normal relationship, including economic discussions with Bank staff in Washington. Special assistance by the Bank would require the above concrete action by Nicaragua towards settling their arrears.

cc: Messrs. Conable
Stern
Thahane
Husain
Shihata
Corbo

Record Removal Notice

File Title	Barcode No.
Country Files- Nicaragua - Correspondence - Volume 1	1779825

Document Date	Document Type
July 21, 1986	Note

Correspondents / Participants
To: President Barber Conable
From: Ibrahim Shihata

Subject / Title
Relevant Bank policies regarding discussion on Nicaragua

Exception(s)
Attorney-Client Privilege

Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Shiri Alon	March 16, 2022

Record Removal Notice

File Title Country Files- Nicaragua - Correspondence - Volume 1	**Barcode No.** 1779825
Document Date June 10, 1986	**Document Type** Memorandum

Correspondents / Participants
To: President Mr. A.W. Clausen
From: Leonor Filardo de Gonzalez, Executive Director

Subject / Title
Provision for Losses on Loans to Nicaragua

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	**Date**
Shiri Alon	March 16, 2022

Conclusions Reached at the Executive Directors' Meeting of June 26, 1986 on

Provisions for Losses on Loans to Nicaragua

The Executive Directors decided that the Bank's FY86 financial statements would include provisioning in an amount equivalent to 20% of Nicaragua's loans outstanding unless before the completion of the audit of these statements, Nicaragua had no debt service payments more than two years in arrears.

A majority of the Executive Directors were against any relaxation of the conditions of payment on the Nicaraguan loans under or analogous to those provided for in Article IV, Section 4(c).

The Chairman confirmed that a mission would go to Nicaragua soon to look once again at the economic situation of the country, to review with the Government the measures that are needed to restore Nicaragua's creditworthiness and to discuss the expeditious payment of arrears.

The Chairman also noted that the Bank would have a disclosure problem in any borrowing prospectuses issued in July unless the Nicaraguan Government firmly committed ~~agreed~~ by June 30th to make the debt service payments referred to above.

6.26.86

OK

Background to Item 4

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International Bank for Reconstruction and Development

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FOR EXECUTIVE DIRECTORS' MEETING

For consideration on June ~~24~~, 1986
26

R86-158/1

FROM: Vice President and Secretary

June 13, 1986

PROVISIONS FOR LOSSES ON LOANS TO NICARAGUA

Scheduling of Item

The President's memorandum entitled "Provisions for Losses on Loans to Nicaragua" (R86-158) recommended the approval of the proposals contained in paragraph 13, in the absence of objection and/or request for discussion at a meeting, by close of business on June 17, 1986.

In compliance with a request from an Executive Director, this item will be included in the agenda for the meeting of the Executive Directors of the Bank to be held on Tuesday, June 24, 1986.

Distribution:

Executive Directors and Alternates
President
Senior Vice Presidents
Vice President and General Counsel
Vice President and Controller
Regional Vice President, Latin America
and the Caribbean

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International Bank for Reconstruction and Development

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R86-158

FROM: Vice President and Secretary

June 6, 1986

PROVISIONS FOR LOSSES ON LOANS TO NICARAGUA

1. Attached is a memorandum from the President entitled "Provisions for Losses on Loans to Nicaragua" dated June 6, 1986.

2. In the absence of objection and/or request for discussion at a meeting (to be communicated to the Vice President and Secretary or the Deputy Secretary by close of business on June 17, 1986), the provisioning as outlined in paragraph 13 of the memorandum will be deemed approved and so recorded in the minutes of a subsequent meeting.

3. In the event of an objection and a request for a meeting, this paper will be scheduled for consideration at the meeting of the Executive Directors to be held on Tuesday, June 24, 1986.

4. Mr. Steckhan (ext. 74621) will answer questions on operational matters and Mr. T. Hoopengardner (ext. 60121) on accounting aspects.

6-17-86

Distribution:

Executive Directors and Alternates
President
Senior Vice Presidents
Vice President and General Counsel

6-24-86

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

A. W. CLAUSEN
President

June 6, 1986

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: Provisions for Losses on Loans to Nicaragua

1. On May 20, 1986, the Executive Directors discussed Provisions for Losses on Loans (R86-94 dated April 15, 1986). They agreed that the Bank should begin to make provisions no later than when a borrower reaches two years of arrears on debt service to the Bank, unless there is overwhelming evidence to obviate the need for provisions. Accordingly, Management has now reviewed the case for provisions against loans to or guaranteed by Nicaragua. As of June 1, 1986, Nicaragua was in arrears to the Bank by two years with the total in arrears \$49 million on disbursed and outstanding loans of \$185 million.

2. In assessing whether the specifics of the present case argue against the strong presumption that provisions are necessary, Management has carefully considered the prospects of Nicaragua's economy and its attendant ability to meet its foreign obligations over the coming years. Management has also reviewed the history of relations between Nicaragua and the Bank to determine the existence of factors which might obviate the need for provisions.

3. Management's overall judgment is that, given the combination of protracted arrears and a steadily deteriorating economy with no near-term sign of improvement, financial prudence requires following the general policy accepted by the Board, i.e. that we begin to provision against Nicaragua's outstanding loans. There is no reason to support provisions being made at other than the normative rate of 20 percent per year discussed with the Joint Audit Committee and the Board. This will, of course, be kept under review. On the other hand, since the Nicaraguan Government has indicated its desire and intention to honor its World Bank debts, we therefore do not believe there is any need to consider write-downs at this time. The following paragraphs highlight the considerations bearing on this issue which were reviewed by Management.

Nicaragua's Economic and Financial Performance

4. For the past six years, the Government of Nicaragua has sought to rehabilitate productive units damaged during the 1979 civil war, increase rapidly the provision of social services, maintain high employment, accelerate investment, and increase defense expenditures. The Government nationalized the banking system and imposed significant direct control over trade, production and distribution, and investment.

5. This program was ambitious and highly expansionary. Although Government revenues grew very rapidly, they were outpaced by growth in expenditures, resulting in consolidated public sector deficits of one-third of GDP in 1983-85. These deficits have been financed almost entirely by the nation's banking system; consequently domestic credit to the public sector has more than doubled in each of the last three years. Expansionary fiscal and monetary policies amidst a severe foreign exchange shortage have led to a 220 percent rate of inflation in 1985. GDP declined by 19% in real terms between 1979 and 1985.

6. In 1985, exports of goods were only $300 million, less than half their 1978 level, while imports surpassed $880 million, 50 percent over their 1978 level. The current account deficit (including official grants) reached nearly $800 million in 1985, about 28 percent of GDP. Bilateral financing and external debt rescheduling were insufficient to finance the current account deficit which is undoubtedly made worse by a seriously overvalued currency. By the end of 1985, the monetary authorities had nearly $1 billion in external short-term liabilities, against only $30 million in usable reserves.

7. Since 1980, Nicaragua has benefitted from large amounts of foreign assistance, and from 1980-82 successfully restructured external debts amounting to about $678 million of principal and $116 million of interest on generous terms -- 12 years maturity and 5 years grace with some capitalization of interest. Since 1983, however, Nicaragua has been unable to make the revised interest payments and has renegotiated several extensions; to date it has been unable to meet its new obligations. In fact, in the last five years, Nicaragua has only paid about one-third of the total debt service it owed. In 1985, Nicaragua owed $299 million in interest (equivalent to total export earnings that year) and $197 million in principal payments. Of the interest due, only one-sixth was paid; one-third was rescheduled and the remainder was left in arrears. Of the principal due, only one-eighth was paid; one-fourth was rescheduled and the remainder was left in arrears. No payments of interest or principal were made to the World Bank. Arrears to external creditors at the end of 1985 were about $1 billion (equivalent to three and one-half years of current level exports). These figures do not include all debts on oil and other imports from Eastern Bloc countries.

8. Nicaragua is current with the International Monetary Fund. Until recently, Nicaragua was current with the Inter-American Development Bank (IDB), although the IDB presently reports very small amounts (less than $1 million) in arrears on payments due in May.

Bank's Dialogue with Nicaragua

9. In the two and one-half years following the current Government's assumption of power in 1979, the Bank supported Nicaragua's reconstruction efforts by lending US$107 million, including US$37 million of IDA credits. This was twice the total amount lent in the previous three year period and represents 36 percent of total Bank loans and credits (US$294 million) made to Nicaragua. Bank assistance also took other forms. Several loans were restructured to provide for more rapid disbursement.

10. Discussions between senior Nicaraguan Government and Bank officials based on the Bank's 1981 review of Nicaragua's economic situation and prospects showed that the policies being followed by the Government would result in further deterioration in the country's balance of payments situation over the medium to long term. Subsequent developments confirmed this assessment, as the management of the economy led to low rates of saving and investment, with export prospects weakening considerably. In consequence, the Bank has made no loans to Nicaragua since January, 1982. Since then the Bank has tried, without success, to reach agreement with Nicaraguan authorities on a feasible adjustment program as a prelude to further lending. The Bank signalled its willingness to work with Nicaragua to formulate a credible adjustment program. During 1985 it was agreed that the Bank would send an economic mission once Nicaragua had made an initial payment and established a plan for clearing the arrears. After several postponements at the request of Nicaragua, and the government's statement in April 1986 that it could not now make a payment or establish a plan, that mission is in abeyance. Indeed, at present, the prospects for substantive agreement on a viable development program seem remote.

11. In April 1986, senior Nicaraguan and Bank officials met to discuss Nicaragua's relationship with the Bank. The Nicaraguan officials reiterated their intention to honor their World Bank debts, but said that Nicaragua's foreign exchange position did not presently permit normal debt service. Nicaragua requested a rescheduling or permission to pay temporarily in Nicaraguan currency. The Bank had addressed the same question when Nicaragua was placed in non-accural status in December, 1984; it reaffirmed its policy against rescheduling and also against accepting service payments in local currency as a means of dealing with protracted arrears since, given the inconvertibility of the Nicaraguan currency, the latter would be tantamount to a rescheduling. In view of the fact that Nicaragua's total known arrears amount to three and one-half years exports, it would be unreasonable to expect it to repay the total amount of arrears of about US$49 million owing to the Bank in the near future;

however, since it has paid the IMF and is only slightly in arrears to the IDB, it could if it wished make a payment towards these arrears and propose a program for eliminating the balance. Nicaragua's unwillingness to follow this course suggests that the Government has made a conscious decision not to pay the Bank since, even though its foreign exchange position is tight, it is not giving the Bank preferred creditor status. This seems to confirm statements made by responsible Government officials to Bank missions that they would give priority to service debts only to those of their creditors that either extended new loans to Nicaragua or maintained a net resource transfer position.

Financial Consequences of Provisioning

12. The immediate financial risk to the Bank of not provisioning now is slight because the amounts are relatively small -- Nicaragua's obligation is less than one-half of one percent of total loans outstanding. There is a significant risk that judgments will be rendered by financial markets about the prudence of the Bank's financial practices and policies in relation to the standards now established in these markets. In the case at hand, based on deteriorating economic conditions, unsustainable external imbalance and the borrower's demonstrated inability to service its debt, it would be difficult to convince markets that a decision not to provision is consistent with the pattern of financial conservatism and prudence that the Bank has established over the years. Provisioning now underlines the Bank's willingness to manage its financial affairs in a manner which markets and its own creditors are able to accept as prudent and sound by the established standards which the marketplace applies.

Implications of the Decision to Provision

13. At the rate of 20% of outstanding balances, a charge of $37 million will be applied to the Bank's income in FY86. A special account for specific provisions against losses in this portion of the portfolio will be established. In no way is the borrower excused from its obligations by this action, and the Bank will continue to bill for interest and principal due as before.

International Bank for Reconstruction and Development

SecM86-660

FROM: Vice President and Secretary June 11, 1986

NICARAGUA: MEMORANDUM FROM MRS. GONZALEZ ON PROVISION FOR LOSSES ON LOANS TO NICARAGUA

1. Attached is a copy of a memorandum from Mrs. Gonzalez, the Executive Director for Nicaragua, entitled "Provision for Losses on Loans to Nicaragua", which is being circulated to the Executive Directors at her request.

2. The Management will circulate its comments on this matter shortly, after which the Secretary will consult with the Executive Directors on how best to proceed.

Distribution:

Executive Directors and Alternates
President
Senior Vice Presidents
Vice President and General Counsel
Vice President and Controller
Regional Vice President, Latin America

HE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE June 10, 1986

TO Mr. A. W. Clausen, President

FROM Leonor Filardo de González, Executive Director

EXTENSION 72231

SUBJECT Provision for Losses on Loans to Nicaragua

1. With regards to your memorandum dated June 6, 1986, on "Provision for Losses on Loans to Nicaragua", our Nicaraguan authorities have instructed me to submit their proposal for consideration of the management and the Board.

2. The proposal that I have received from the Governor of Nicaragua reads as follows:

"We refer to Nicaragua's arrears situation vis-a-vis the World Bank. As you know, these arrears cover a total of two years as of this June. The causes of this situation are as follows:

(a) The critical financial situation of the Nicaraguan economy results from external causes of which the world is well aware.

(b) The virtual paralyzation of World Bank activities in Nicaragua since the end of 1981, which has resulted in substantial negative net flows between our country and that institution, thus distorting the concept of a multilateral development finance institution and its relations with a developing country such as Nicaragua.

Nicaragua has for some time been making multiple efforts to solve the arrears situation. For one thing, we mentioned several times that we needed to have an analysis and programming mission come here to study our economic situation and our investment plan, with a view to reestablishing positive financing flows within a relatively short period of time. So far no progress has been made in this direction, in fact in March 1984 the World Bank decided to suspend disbursements to Nicaragua, stating that loans to our country were unproductive and that loan interest accumulation could not be permitted (non-accrual status).

Under these circumstances, in an attempt to normalize relations in a context that would expressly take account of the particular characteristics and critical financial situation of the Nicaraguan economy, Nicaragua officially asked the Bank in 1984 to provisionally agree to payment in local currency, pursuant to Article IV, Section 4 (c) of the Bank's Articles of Agreement. Our application was supported by reference to precedents regarding application of that clause and to the existence of the necessary conditions justifying our request. So far the Bank has rejected Nicaragua's application, stating that although the Articles may provide for the possibility of modifying (terms of) payment and using local currency with repurchase guaranteed over a given time period, it has been the policy of the Bank since 1968 not to accept such modifications. At a recent meeting with Bank staff members, I repeated our request, and was informed that it would be presented to the corresponding Committee without delay. So far we have not heard the outcome of this presentation, if it has in fact taken place.

In view of the foregoing, my Government now wishes first of all to confirm its determination and willingness to normalize its financial situation with the World Bank on appropriate terms that will take account of our difficult financial situation and facilitate the reestablishment of positive net flows within a reasonable period of time. To this end, I now repeat my Government's official request to use the facility offered in Article IV, Section 4 (c), i.e. to modify our payments and to make them in local currency, with repurchase over a reasonable period of time. In view of the long accumulation of arrears and future maturities, we have no other way of meeting these payments. As a gesture of our goodwill and determination to regularize Nicaragua's situation with the World Bank, an initial payment in foreign exchange could be symbolically included as part of the arrangement. Formalization of the arrangement should be the responsibility of a Bank mission that would come to Nicaragua to study our economy and confirm the existence of the conditions justifying our invocation of the above-mentioned clause, and to study the specific terms of the arrangement and the possibility of new loans to Nicaragua within a reasonable period of time.

As mentioned above, our application is based on real and objective conditions with precedent within the Bank, and on existing legal provisions. The Bank's Executive Directors being empowered to handle our request, we are asking you to present it to the Board and to Management. Prompt and favorable action on our request should serve to obviate the need to set up a reserve for loans to this country.

Lastly, I would mention that 1985 and 1986 have been years of major adjustment efforts in Nicaragua, years in which we have sought to reestablish external and internal economic equilibrium. The scope of these efforts will be expanded during the rest of this year and in 1987. Because of the extent of the current disequilibria, especially as a result of the embargo imposed on us, restoration of equilibrium has to be viewed as a medium-term proposition. The IMF has been analyzing our adjustment efforts, and its Board regards them as a step in the right direction, although as yet inadequate to correct the imbalances.

The Nicaraguan Government does not disagree with that opinion and will continue to expand its adjustment efforts.

Regards,

Joaquín Cuadra Chamorro
Minister, President
Banco Central de Nicaragua"

3. The Nicaraguan authorities have also verbally requested me to reiterate before management and the Board their willingness and their commitment to honor their obligations to the World Bank, and to avoid the necessity for the World Bank to make special provisions. In order to do so, they formally propose:

a) A Bank mission that would visit Nicaragua to study its economy, confirm the existence of conditions justifying its invocation of Article 4 (c), and to study specific terms of arrangement and the possibility of new loans to Nicaragua within reasonable period of time.

b) To use the facility offered in Article 4 (c), i.e. to modify their payments and make them in local currency with repurchase over a reasonable period of time.

c) As a gesture of their goodwill and determination to regularize Nicaraguan´s situation with the World Bank, an initial payment in foreign exchange that could be negotiated between the authorities and Bank, included as part of the arrangement.

4. Since the Nicaraguan authorities have asked me to circulate their official proposal, I kindly request that a copy of my memo be distributed to the Executive Directors.

Copies to Mr. Stern
Mr. Shehata
Mr. Shahane (original)

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE June 10, 1986

TO Mr. A. W. Clausen, President

FROM Leonor Filardo de González, Executive Director

EXTENSION 72231

SUBJECT Provision for Losses on Loans to Nicaragua

1. With regards to your memorandum dated June 6, 1986, on "Provision for Losses on Loans to Nicaragua", our Nicaraguan authorities have instructed me to submit their proposal for consideration of the management and the Board.

2. The proposal that I have received from the Governor of Nicaragua reads as follows:

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(b) The virtual paralyzation of World Bank activities in Nicaragua since the end of 1981, which has resulted in substantial negative net flows between our country and that institution, thus distorting the concept of a multilateral development finance institution and its relations with a developing country such as Nicaragua.

Nicaragua has for some time been making multiple efforts to solve the arrears situation. For one thing, we mentioned several times that we needed to have an analysis and programming mission come here to study our economic situation and our investment plan, with a view to reestablishing positive financing flows within a relatively short period of time. So far no progress has been made in this direction, in fact in March 1984 the World Bank decided to suspend disbursements to Nicaragua, stating that loans to our country were unproductive and that loan interest accumulation could not be permitted (non-accrual status).

Under these circumstances, in an attempt to normalize relations in a context that would expressly take account of the particular characteristics and critical financial situation of the Nicaraguan economy, Nicaragua officially asked the Bank in 1984 to provisionally agree to payment in local currency, pursuant to Article IV, Section 4 (c) of the Bank's Articles of Agreement. Our application was supported by reference to precedents regarding application of that clause and to the existence of the necessary conditions justifying our request. So far the Bank has rejected Nicaragua's application, stating that although the Articles may provide for the possibility of modifying

P-1866

(terms of) payment and using local currency with repurchase guaranteed over a given time period, it has been the policy of the Bank since 1968 not to accept such modifications. At a recent meeting with Bank staff members, I repeated our request, and was informed that it would be presented to the corresponding Committee without delay. So far we have not heard the outcome of this presentation, if it has in fact taken place.

In view of the foregoing, my Government now wishes first of all to confirm its determination and willingness to normalize its financial situation with the World Bank on appropriate terms that will take account of our difficult financial situation and facilitate the reestablishment of positive net flows within a reasonable period of time. To this end, I now repeat my Government's official request to use the facility offered in Article IV, Section 4 (c), i.e. to modify our payments and to make them in local currency, with repurchase over a reasonable period of time. In view of the long accumulation of arrears and future maturities, we have no other way of meeting these payments. As a gesture of our goodwill and determination to regularize Nicaragua's situation with the World Bank, an initial payment in foreign exchange could be symbolically included as part of the arrangement. Formalization of the arrangement should be the responsibility of a Bank mission that would come to Nicaragua to study our economy and confirm the existence of the conditions justifying our invocation of the above-mentioned clause, and to study the specific terms of the arrangement and the possibility of new loans to Nicaragua within a reasonable period of time.

As mentioned above, our application is based on real and objective conditions with precedent within the Bank, and on existing legal provisions. The Bank's Executive Directors being empowered to handle our request, we are asking you to present it to the Board and to Management. Prompt and favorable action on our request should serve to obviate the need to set up a reserve for loans to this country.

Lastly, I would mention that 1985 and 1986 have been years of major adjustment efforts in Nicaragua, years in which we have sought to reestablish external and internal economic equilibrium. The scope of these efforts will be expanded during the rest of this year and in 1987. Because of the extent of the current disequilibria, especially as a result of the embargo imposed on us, restoration of equilibrium has to be viewed as a medium-term proposition. The IMF has been analyzing our adjustment efforts, and its Board regards them as a step in the right direction, although as yet inadequate to correct the imbalances.

The Nicaraguan Government does not disagree with that opinion and will continue to expand its adjustment efforts.

Regards,

Joaquín Cuadra Chamorro
Minister, President
Banco Central de Nicaragua"

3. The Nicaraguan authorities have also verbally requested me to reiterate before management and the Board their willingness and their commitment to honor their obligations to the World Bank, and to avoid the necessity for the World Bank to make special provisions. In order to do so, they formally propose:

a) A Bank mission that would visit Nicaragua to study its economy, confirm the existence of conditions justifying its invocation of Article 4 (c), and to study specific terms of arrangement and the possibility of new loans to Nicaragua within reasonable period of time.

b) To use the facility offered in Article 4 (c), i.e. to modify their payments and make them in local currency with repurchase over a reasonable period of time.

c) As a gesture of their goodwill and determination to regularize Nicaraguan´s situation with the World Bank, an initial payment in foreign exchange that could be negotiated between the authorities and Bank, included as part of the arrangement.

4. Since the Nicaraguan authorities have asked me to circulate their official proposal, I kindly request that a copy of my memo be distributed to the Executive Directors.

International Bank for Reconstruction and Development

SecM86-660/1

FROM: Vice President and Secretary

June 18, 1986

NICARAGUA: MANAGEMENT'S COMMENTS ON THE MEMORANDUM FROM MRS. GONZALEZ ON PROVISION FOR LOSSES ON LOANS TO NICARAGUA

As indicated in paragraph 2 of the document (SecM86-660), issued on June 11, 1986, attached are Management's comments on the above.

Distribution:

Executive Directors and Alternates
President
Senior Vice Presidents
Vice President and General Counsel
Vice President and Controller
Regional Vice President, Latin America
and the Caribbean

June 16, 1986

1. By Memorandum from Mrs. Gonzalez, of June 10, 1986 (SecM86-660) the Nicaraguan Government has formally proposed:

a) A Bank mission that would visit Nicaragua to study its economy, to confirm the existence of conditions justifying its invocation of Article IV, Section 4(c), and to study specific terms of arrangement and the possibility of new loans to Nicaragua within a reasonable period of time.

b) To use the facility offered in Article IV, Section 4(c), i.e., to modify their payments and make them in local currency with repurchase over a reasonable period of time.

c) As a gesture of their goodwill and determination to regularize Nicaragua's situation with the Bank, an initial payment in foreign exchange that could be negotiated between the authorities and the Bank, included as part of the arrangement.

2. The Bank's Management proposes to respond along the following lines:

a) With respect to the need for a Bank mission to study Nicaragua's economic situation, the Bank has over the past few years continued to monitor developments in close consultation with the Nicaraguan authorities. Following an economic mission in the first half of 1984, the Bank conveyed to the authorities the mission's conclusions and recommendations for addressing the country's increasingly serious financial and economic problems. At that time the Bank also sent to the authorities, at their request, a report on food subsidy issues. In mid-1985, the Bank again conveyed to the authorities an up-to-date analysis of Nicaragua's current economic problems, which was discussed in detail with the Government in November, 1985. The Bank thus is well aware of Nicaragua's ongoing financial and economic difficulties, and indeed has discussed these repeatedly with the Government. Consequently, we do not believe that a mission to assess creditworthiness is needed at this time. In our discussions with the Government we have pointed out that economic work leading to the consideration of lending is premature in the absence of work on an effective stabilization program or on the other major policy issues previously identified. However, should Nicaragua put in place an effective stabilization program the Bank would be willing to send a mission to advise on growth and adjustment policies.

b) As regards the proposed payment of debt service in local currency under the provisions of Article IV, Section 4(c), it should be recognized that the Bank has not, heretofore, accepted local currency payments. In view of the current state of the Nicaraguan economy and its economic and financial performance (as set out in our memo R86-158 of June 6, 1986), the proposed conversion of the tendered local currency "over a reasonable period of time" could not be considered since acceptance of local currency payment would be the equivalent of a rescheduling of the debt service owed by Nicaragua to the Bank given Nicaragua's current circumstances. While the Nicaraguan economy is experiencing severe economic problems, there are many other Bank borrowers confronting difficult balance of payment situations and adjustment problems. We see no distinguishing criteria which would enable us to accept the proposed arrangement for Nicaragua without establishing a precedent for those other borrowers. In the context of the ongoing detailed monitoring of the quality of the Bank's portfolio by the rating agencies and by the financial houses who underwrite the Bank's bonds, any action by the Bank which could be perceived as a weakening of our policy against participation in debt rescheduling would have seriously adverse consequences for the operations of the Bank and of its members as a whole.

c) In the past, the Bank has repeatedly indicated to the authorities its willingness to accept a substantial downpayment on the amounts overdue to the Bank coupled with a tight program of payments in foreign exchange for the balance of the accumulated arrears. While we appreciate the authorities' commitment to honor their obligations to the Bank, a symbolic downpayment in foreign exchange would not suffice. Should there be a significant downpayment in foreign exchange we would be willing, as we have previously stated, to discuss a program for the settlement of the outstanding balance.

3. A detailed memorandum prepared by the General Counsel on the legal aspects is attached.

TREATMENT OF BANK BORROWERS IN CASES OF "ACUTE EXCHANGE STRINGENCIES" AND "DEFAULT"

Legal Memorandum on Article IV, Sections 4(c) and 7(a) of the IBRD Articles of Agreement

Ibrahim F.I. Shihata

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I. INTRODUCTION

1. The possibility of relaxing or otherwise modifying the terms of Bank loans in the cases where these loans cannot be serviced as agreed was very much in the minds of the framers of the Bank's Articles of Agreement. Such a possibility was discussed at length in the preparatory stages of the Articles and is explicitly mentioned in their text as something to be seriously considered under certain circumstances and with certain safeguards.

2. A memorandum from the Bank's General Counsel, distributed to the Executive Directors some sixteen years ago, maintained that modification of loan terms could also be made under the Bank's general powers as a lending institution and need not be limited to the cases explicitly provided for in the Articles.

3. The Bank's practice bears witness to the exercise by this institution of the broad discretion which its Articles confer on it in this and other areas. Incidents of relaxation of loan terms occurred in the Bank's practice where such action was deemed to be adequately justified, even in the absence of a formal request by the borrower concerned and regardless of whether or not such borrower was in default.1/ In every such incident, however, the Bank obviously was not performing an obligation dictated by the Articles. It was merely exercising a discretionary power, following what it felt to be the most sensible and appropriate course of action under the circumstances. The exercise of such power is limited by the Articles' requirement that the action taken by the Bank should not prejudice the interests of the borrower concerned, of the Bank's operations or of its members as a whole, as these interests are judged by the Bank.

1/ "Default" connotes failure of a debtor to discharge a legal obligation. It is used in the context of this paper to mean failure by the borrower to meet its financial obligations, i.e., non-payment of any amount due under the loan agreement at the time designated in or according to that agreement.

4. The Bank's Articles deal with the possibility of relaxation or modification of the terms of Bank financing in two places: Article IV, Section 4(c) which deals with the situation of a member suffering from an acute exchange stringency which seriously affects its ability to make service payments as originally agreed, and Article IV, Section 7(a) which deals with the situation of an actual default. These provisions read as follows:2/

Article IV, Section 4(c):

> Loan contracts under Section 1 (a) (i) or (ii) of this Article shall be made in accordance with the following payment provisions:
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> (c) If a member suffers from an acute exchange stringency, so that the service of any loan contracted by that member or guaranteed by it or by one of its agencies cannot be provided in the stipulated manner, the member concerned may apply to the Bank for a relaxation of the conditions of payment. If the Bank is satisfied that some relaxation is in the interests of the particular member and of the operations of the Bank and of its members as a whole, it may take action under either, or both, of the following paragraphs with respect to the whole, or part, of the annual service:
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> (i) The Bank may, in its discretion, make arrangements with the member concerned to accept service payments on the loan in the member's currency for periods not to exceed three years upon appropriate terms regarding the use of such currency and the maintenance of its foreign exchange value; and for the repurchase of such currency on appropriate terms.
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> (ii) The Bank may modify the terms of amortization or extend the life of the loan, or both.

2/ Compare Article V, Section 3 of IDA's Articles which covers the subject in one provision of a more general nature: "The Association may, when and to the extent it deems appropriate in the light of all relevant circumstances, including the financial and economic situation and prospects of the member concerned, and on such conditions as it may determine, agree to a relaxation or other modification of the terms on which any of its financing shall have been provided."

Article IV, Section 7(a):

> In cases of default on loans made, participated in, or guaranteed by the Bank:
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> (a) The Bank shall make such arrangements as may be feasible to adjust the obligations under the loans, including arrangements under or analogous to those provided in Section 4 (c) of this Article.

II. DRAFTING HISTORY

5. Each of the above provisions has a revealing, though different, history. The first (Article IV, Section 4(c)) was conceived before the U.S. published its first draft of the Articles, while the second emerged only at a late stage at the Bretton Woods Conference.

(i) Article IV, Section 4(c)

Early U.S. Drafts

6. Before the U.S. Treasury published in November 1943 its "Preliminary Draft Outline of a Proposal for a Bank for Reconstruction and Development of the United and Associated Nations",3/ a number of informal drafts were prepared and discussed by the Treasury Staff. An early draft, dated April 1943, envisaged that the Bank would declare the member which fails to pay in time to be in default and provided for severe sanctions against such

3/ See text in Proceedings and Documents of United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire, July 1-22, 1944 (hereinafter: Proceedings) (Washington, D.C. 1948), Vol. II, p. 1616 et seq.

member, not only by the Bank but also by all its members.4/ In later discussions among officials of the U.S. Treasury, in September 1943, it was recognized that such requirements would be "too strong" if not limited to members who willfully default. It was agreed, as a result, that the Articles should "permit reasonable action to be taken when members are in default through circumstances beyond their control".5/ The published Draft Outline of November 1943 thus required that Bank loans contain payment provisions to the effect that:

> "In the event of an acute exchange stringency the Bank may accept local currency in payment of interest and principal for periods not exceeding three years. The bank shall arrange with the borrowing country for the repurchase of such local currency over a period of years under appropriate terms that safeguard the value of the Bank's holdings of such currency."6/

4/ See Mr. H.D. White's draft of April 1943: "If the Bank shall declare any member in default, the member countries agree not to extend any financial assistance to that country, nor permit any of its nationals to extend any financial assistance to that country, until the country has paid sums due the Bank." The same language appeared in Mr. White's draft of August 2, 1943. An earlier draft, dated January 1943, included the first reference to sanctions in the case of default which were limited, however, to suspension from membership during the period of default by a majority decision. (Art. IV, Sec. 8.)

All unpublished documents referred to in this paper are available in the Bank's archives (Legal Department). Although they are not part of the official history of the Articles, they provide useful insights in understanding their evolution.

5/ Memorandum dated September 4, 1943. Meanwhile, the U.S. State Department's "Draft Proposal for an International Investment Agency", also dated September 4, 1943, provided for the power of the Agency to "make adjustments in debts owing it in cases where the debtor is in special difficulties". (Art. VII, Sec. 8).

6/ Op. cit., Note 3, at p. 1625 (Art. IV, 10(c). First reference to this provision appeared in a Treasury staff draft, dated September 16, 1943, which included also a provision allowing the Bank to declare in default the member which fails to meet its financial obligations and further allowing it to suspend the defaulting country from membership.

7. The above text spoke of the case of an "acute exchange stringency", without tying it to the inability of the borrower to service the debt or to an actual case of default. This latter case was covered by another provision whereby "a member country failing to meet its financial obligations to the Bank may be declared in default and may be suspended from membership during the period of its default, provided the majority of member countries so decide".7/

The U.K. Boat Draft

8. In a meeting held between the British delegation and European delegations, when they were considering revisions of the U.S. draft while en route to the United States for the Bretton Woods Conference, Lord Keynes commented on the "acute foreign exchange stringency" provision.8/ Conceding that it went some way in finding a solution which would "minimize the prospect of countries being forced into defaulting upon obligations to an international institution", he felt, however, that the U.S. draft left the Bank with only "one method of lessening the burden upon debtors in times of crises". He thought, therefore, that the provisions for relaxation of service charges ought to be extended and that some provision should be made for stabilization loans.9/ Lord Keynes' ideas were more clearly stated a few days earlier in a note to the Chancellor of the Exchequer:

> "... if the borrowing country is in difficulties about the service of the loan, for reasons beyond its own control, it should be the duty of the Bank to help it to retrieve its position and not to impose any penalties, except where the borrowing country is at fault. In particular, in the event of an acute foreign

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7/ Id, at p. 1628, Article V, Section 8. This text was dropped, for the first time, from the U.S. Treasury draft of May 1944, and later on from the draft submitted to the Bretton Woods Conference.

8/ Note of a meeting on the S.S. Queen Mary, June 22, 1944, U.K. Doc. I.M.C. (44) (General), 5th Meeting, 6/22/1944.

9/ Id.

exchange stringency, the Bank should accept local currency in paper for a limited period.

"The sanctions available to the Bank to be applied to countries defaulting unreasonably, would probably be limited to suspending them from membership, supported by an engagement by the other members of the Bank that they would not extend financial assistance to the defaulting country without approval of the Bank, until the country had been restored to membership, thus cutting it off substantially from outside financial assistance until it had mended its ways."10/

9. As a result, the "boat draft", which the U.K. delegation prepared while crossing the Atlantic, included the following provision which, while expanding the possible actions to be taken by the Bank, made it clear that they are to be considered only when the exchange problems of the country make it unable to service the loan as agreed:

"(c) In the event of the borrowing country suffering from an acute exchange stringency, so that it is unable to provide the service of the loan in the stipulated manner, it may appeal to the Bank for a relaxation of the conditions of payment. If the Bank is satisfied that some relaxation is in the interests of the borrowing country and of the operations of the Bank and the other member countries as a whole it may take action under all, or any, of the following headings in respect of the whole, or part, of the annual service:

(i) The Bank may in its judgment accept payments in respect of the service of the loan for periods not exceeding three years at a time in local currency. The Bank shall arrange with the borrowing country for the repurchase of such local currency over a period of three years on appropriate terms that safeguard the Bank's holdings of such currency. The Bank may also require that the whole, or part of such currency, may be transferred to another member country in whose hands it shall be freely available to make payments or to purchase exports in the borrowing country (see (9) below).

(ii) The Bank may re-arrange the installments of amortization so as to increase the amount due in later years or to prolong the life-time of the loan."11/

10/ Note and Memorandum from Lord Keynes to Chancellor of the Exchequer dated June 9, 1944.

11/ U.K. Doc. I.M.C. (44) B 5, dated June, 25, 1944.

Discussions in Atlantic City

10. The above provision of the U.K. draft served as the basis of further discussions of this part of the draft Articles. In Atlantic City where the Pre-Conference meeting was held in late June 1944, Lord Keynes stressed again that they were addressing a situation where, if the country was not properly assisted, it would have no choice but to default, a situation where the Bank should come to the aid of the borrowing country aiming at restoration rather than at enforcing penalties.12/ A U.S. delegate (Mr. Bernstein) commented on the provision allowing the transfer of the local currency service payments to another member country for payments to or in the borrowing country (which did not survive in the final text) suggesting that the Bank should exercise "great discretion" in exercising that particular option as it "could operate as a mild sanction against the borrowing country, forcing it to cut down imports and increase exports".13/ Lord Keynes also explained, in response to a suggestion that the period of repurchase be longer than three years, that "the three year period referred to was not the period of repurchase but the period during which the Bank may accept local currencies in respect of payments for service on a loan".14/ Both he and Mr. Varvaressos (Greece) considered as possible a suggestion by Mr. Bernstein that "some definite rate of repurchase, such as is provided for under the provision on liquidation of the Fund, might be provided for".15/ It was also suggested by Mr. Bernstein that the Bank

12/ U.S. Atlantic City Minutes 6/29/1944 p.m., p.l.

13/ Id. 6/30/1944 a.m., p. 2.

14/ Ibid.

15/ Ibid.

"might require member countries to take portions of this local currency instead of calling up guarantees [meaning callable capital]",16/ but the idea did not receive support.17/ The idea that the local currency paid by the country in difficulty may be used by the Bank to finance the local cost of projects in the same country through future Bank loans did not seem to have been mentioned. (There was nothing, however, in the original text, as there is nothing in the present text of Article IV, Section 4(c), which prevents the Bank and the country involved from reaching such an arrangement as part of the agreement on accepting payment in local currency.)

Discussions at the Bretton Woods Conference

11. The draft Articles submitted to the Bretton Woods Conference included a slightly revised text of the U.K.'s "boat draft" text of Article IV, Section 4(c).18/ The proceedings of the Conference do not record the deliberations of Committee II which discussed that provision. Successive reports of the Drafting Committee19/ and recorded discussions of the U.S. delegation to Bretton Woods20/ explain, however, the changes introduced to the draft and shed further light on the intended meaning. The changes introduced by the Drafting Committee included the following details: Reference to loans guaranteed by the Bank was added; the provision for

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16/ Ibid.

17/ Although an attempt was made to provide in the default provisions of the Articles that other members may purchase from the Bank the local currency paid by countries facing foreign exchange stringencies, in lieu of paying the call on callable capital, the provision was dropped in the first redraft of Article IV, Section 7, at the Bretton Woods Conference.

18/ See Doc. 169, July 6, 1944, Proceedings, pp. 199-200.

19/ See Doc. 495, July 20, 1944, id. p. 1025 and Doc. 505 July 21, 1944, id. pp. 1058-9.

20/ See Transcripts of Meetings held on July 11 (p. 39) and July 12, 1944 (pp. 11-13).

transfer of the local currency received by the Bank to another member was dropped; the "appropriate terms" of the repurchase of local currency by the country concerned were elaborated on to cover explicitly both use and maintenance of value of the local currency; and the modes of changing the loan terms were clarified to include modification of the terms of amortization, extension of the life of the loan or both.

12. In the meetings among members of the U.S. delegation to Bretton Woods, it was mentioned that the inclusion of the provision for accepting payment in local currency would partly eliminate an important source of default. It was also noted that if this arrangement helped to keep the Bank's losses moderate,21/ the income from guarantee fees would be sufficient to cover them, and "the American Government, for example, would not be called upon to put up any money because of losses."22/

13. The Proceedings of the Bretton Woods Conference do not show whether the implications of the language of Article 4, Section 4(c) were explored in detail. Important questions, such as those raised by the Bank's Executive Directors when they discussed in 1959 the corresponding provision in the IDA Articles, may still be raised: Why expressly provide for something which the institution as a lender has the power to do in any event? Is it wise to introduce in a document of this kind a clause which may encourage borrowers not to honor the terms of loan agreements? Shouldn't the application of such a clause be more carefully circumscribed? Does modification of loan terms include forgiveness of debt? etc.23/

21/ Mr. White mentioned that under the local currency payment arrangements "the losses are very likely to be less than ten percent" suggesting that that was an acceptable loss, recoverable through the Special Reserve. Transcript of July 12, 1944, p. 12.

22/ Intervention of Mr. White. *Id*. at p. 13

23/ See IDA/59-18, 11/20/1959; IDA/59-22, 11/27/1959 and verbatim transcript of the Executive Directors meeting.

(ii) Article IV, Section 7(a)

14. As has been mentioned, the November 1943 U.S. Draft Outline of the Bank's Articles stated that a "member country failing to meet its financial obligations to the Bank may be declared in default and may be suspended from membership during the period of its default provided the majority of member countries so decides".24/ This provision did not appear, however, in the draft Articles submitted to the Bretton Woods Conference which dealt with suspension of membership in general terms under another provision (now Article VI, Section 2).25/ The present Article IV, Section 7(a) was introduced during the deliberations at Bretton Woods as an introduction to a Section which otherwise dealt with the "methods of meeting liabilities of the Bank in case of defaults". Prior to its insertion, the relevant text in the U.S. and U.K. drafts concerned itself only with regulating the Bank's action towards its creditors in cases of default through

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24/ Para. 7 above. When the U.S. staff were asked by Czechoslovakian experts, in April 1944, for an explanation of the situation where a country "fails to meet its obligation", Mr. Bernstein stated "It was our understanding that a country had failed to meet its obligations if it had not come to an understanding with the Bank on meeting its obligation. Beyond that, it would rest entirely with the Bank to determine a country's specific obligation". Minutes of Meeting held on April 29, 1944.

25/ Article VI, Section 2:

"If a member fails to fulfill any of its obligations to the Bank, the Bank may suspend its membership by decision of a majority of the Governors, exercising a majority of the total voting power. The member so suspended shall automatically cease to be a member one year from the date of its suspension unless a decision is taken by the same majority to restore the member to good standing.

"While under suspension, a member shall not be entitled to exercise any rights under this Agreement, except the right of withdrawal, but shall remain subject to all obligations."

resort to reserves and calls on its members. Earlier, a U.S. staff memorandum of May 1944[26/] and the U.K. draft of June 1944[27/] suggested only that the provisions on meeting the Bank's liabilities on borrowings and guarantees applied both to the cases of default by borrowers and those arising from "temporary suspension of transfers" to the Bank, which include the cases where the Bank accepts local currency in lieu of service payment in foreign exchange.

15. The original proposal at Bretton Woods was to introduce at the beginning of Article IV, Section 7 a paragraph providing that:

> "In case of default on loans made by the Bank, it shall make such arrangements as may be feasible to adjust the obligations under the loan, including arrangements analogous to those provided in Section 4(c) of this Article."

Changes introduced by the Drafting Committee and later on by Commission II of the Conference resulted in the following alterations: The position of the first sentence was changed to make it applicable to all sub-sections of Section 7; the application of the text was extended also to loans participated in or guaranteed by the Bank; and reference to arrangements analogous to those provided in Section 4(c) of the Article was extended to include

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26/ Memorandum of U.S. Experts on the Bank for Reconstruction and Development, dated May 23, 1944 (which referred to Section IV-2 of the U.S. draft statement on the Establishment of a Bank for Reconstruction and Development, dated April 1944).

27/ I.M.C. (44) (B) 2, dated June 21, 1944 (Memorandum by Lord Keynes) distributed at Atlantic City as Doc. B.1., dated June 29, 1944. This document covered, in the section dealing with the order of meeting Bank's obligations (Article IV, Section 9) "any interruption in the service of a loan" guaranteed by the Bank.

arrangements under or analogous to such arrangements.28/ All those changes were basically stylistic.29/

16. The important question of the possible effect of default on Bank loans on the private capital market was discussed at the time of Bretton Woods by members of the U.S. Steering Committee. Although concern was expressed with the salability of bank bonds, U.S. officials seemed to have been content with the conclusion that the issue may better be decided by the Bank on a case by case basis.30/

III. BANK'S PRACTICE

Bank's Prospectuses

17. The first prospectus issued by the Bank contained detailed references to the Articles including a reference to Article IV, Section 4(c) as

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28/ See Doc. 419 (7/16/44), 452 (7/18/44), 468 (7/19/44), 469 (7/19)44), 495 (7/20/44) and 505 (7/21/44), Proceedings, Vol. I, pp. 701, 819, 847, 860, 1026 and 1060, respectively.

29/ Commenting on the last change listed above, Mr. A. Broches, former General Counsel of the Bank, noted that "since Section 7(a) sensibly provides that the Bank shall make such arrangements as may be feasible the mention of certain arrangements cannot be regarded as limitative". See Broches, IBRD Article IV, Section 4(c) and 7(a), IDA Article V, Section 3. Modification of Terms of Loans and Credits. (A Study prepared for the Bank's Legal Department in January, 1982.)

30/ Mr. Vinson, the Vice Chairman of the U.S. delegation raised the issue as follows: "... the argument is presented that they will look at your statement and see loans that are known to be impaired, loans in default, or if you take the extreme case, a loan that was worthless ... and you might have enough of those to affect the salability of subsequent issues". In answering him, Mr. Luxford, the lawyer of the delegation, who served later on as Assistant General Counsel of the Bank, made the following comment: "I haven't talked to the British about this, but I don't think they go so far as to say, 'in no case would we be willing to bury the dead'. What they say is 'we want the right to decide it at the time and not freeze it in this document'. In other words, the Board of Directors might well decide if you have a prosperous period and the loan goes sour. 'Well, let's take it up boys; the country is in good enough shape'. But don't freeze it into the document so they have to do that no matter what condition the country is in." Transcript of Meeting of the U.S. Steering Committee, July 13, 1944 at pp. 38-39.

providing that the Bank might in the circumstances defined in that Section in its discretion accept service payments in local currency.31/ No reference was made, however, to the members' right to apply for relaxation of loan terms in certain circumstances.32/ Nevertheless, it was generally understood in the Bank that such a right existed, with a corresponding obligation on the Bank to give serious consideration to such an application if made.33/

18. The Bank's second prospectus, issued in 1950 after the Bank's securities were exempted from the U.S. Securities Act of 1933 (subject to a seven days' prior notice of the issues and the prospectus used in their connection), was silent on the possibility of adjustment of loan terms. It mentioned only that the policies and procedures indicated in the prospectus were subject to change to the extent permitted under the Articles.34/ It was only in 1951 that the Bank, as a result of comments by the staff of the U.S. Securities and Exchange Commission (SEC),35/ stated for the first time in a prospectus that it "may also relax or modify contract requirements, reduce charges or otherwise waive rights under existing loan agreements, as may be appropriate in relation to changing Bank policies or as

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31/ See Prospectus dated July 11, 1947 for $100 million Ten-Year 2-1/4% Bonds and $150 million 25-year 3% Bonds, p.10.

32/ For details, see Broches, op. cit., p. 9.

33/ See Broches, op. cit., pp. 8-9, where he adds that the Bank "may not decline [the application] on the simple ground that it is entitled to insist on punctual performance of the loan agreement and to declare a default".

34/ Prospectus dated January 25, 1950 for $100 million 2% serial Bonds of 1950, due 1953-62, p. 9.

35/ See Broches, op. cit. at p. 10.

may appear advisable because of the economic situation of particular borrowers or guarantors".36/

19. The language of the February 1951 Prospectus, which in fact exceeded the scope of Article IV, Section 4(c) and seemed to state the implied general power of the Bank to adjust loan terms, was repeated with minor changes in all U.S. prospectuses until 1960. No reference was made in these prospectuses to the few cases of extension of amortization schedules made in the fifties [Loan 55-PA to Paraguay, Loan 109-IN to ICICI (India) and Loan 141-HA to Haiti] where rescheduling on project grounds was approved by the Executive Directors without reference to the Articles. In 1960, the Bank, after a two-year absence from the U.S. market, issued a new prospectus which contained no reference to the Bank's power to relax or modify loan terms referring only to the fact that "within the scope permitted by the Articles, [the Bank's] policies must necessarily be developed and adjusted in the light of experience and changing conditions".37/ This new attitude was probably influenced by the discussion of the IDA Articles in the Financial Policy Committee of the Bank's Board, referred to below, and by the doubling of the Bank's authorized capital which, according to Mr. Broches, made it "not difficult to persuade the underwriters to accept the deletion of most of the old language".38/ Subsequent prospectuses used this new language. No mention was made in the prospectuses of the second rescheduling of Loan 141-HA (Haiti) in 1963, which was recommended to the Board on the basis that, among other things, "the Haitian economy

36/ Prospectus dated February 28, 1951 for $50 million 3% 25-year Bonds, p. 9.

37/ Prospectus for the $125 million, 5% 25-year Bonds, 1960.

38/ Broches, *op. cit.*, p. 14

suffers from an acute exchange stringency" without reference to Article IV, Section 4(c), of Loan 129-LE to Lebanon and Loans 171-CH and 172-CH to Chile, which were rescheduled in 1963 and 1964, respectively, on project grounds, or of the third rescheduling of Loan 141-HA to Haiti in 1968 on the ground of the "overall position of the government", the "financial pressure upon it" and its "critical cash situation", again without reference to the Bank's Articles. Only the rescheduling of loans to India in 1968 was mentioned in the U.S. prospectus of that year, due perhaps to its size and to the debate in the Bank Board over it (unlike in the case of earlier reschedulings which were approved without discussion or objection).

20. In 1975, the Bank almost reversed the language used in the prospectuses of the 1960s and introduced the statement that "the Bank follows a policy of not taking part in debt rescheduling agreements".39/ This statement, which has since appeared in all Bank prospectuses, is made without further elaboration. When it was first introduced, it was preceded, however, by a statement on the "recent strains" on non-oil producing countries.40/ The statement is drafted in a careful manner. It does not introduce an absolute ban on any rescheduling of Bank loans, but only explains that the Bank does not take part in "debt rescheduling agreements" (where the reference, presumably, is to agreements entered into by commercial banks with developing countries). The policy itself was discussed several times in the Bank's Board in the preceding years (1970-75) where

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39/ Preliminary Prospectus for 5 and 10 year notes and 25 year Bonds of 1975 issued on November 18, 1975.

40/ More recent prospectuses include, in a separate paragraph, a reference to the fact that "a number of developing countries are experiencing serious strains as a result of continuing high interest rates and a slow recovery of international trade and commodity prices".

Management made its position clear.41/ Significantly, when a staff study on the "External Debt of Developing Countries"42/ was discussed in August 1971 and an Executive Director cited the Articles of Agreement in his comment on the paper's statement that Bank's direct participation in rescheduling was "not planned in the future", the chairman (Mr. McNamara) indicated that he would prefer not to make formal reference to the Articles.43/

Legal Basis of Loan Rescheduling - The Indian Rescheduling of 1968

21. The Bank's avoidance of invoking its Articles as a basis of rescheduling is noted in all the cases of rescheduling made by the Bank, both on project grounds and macro-economic grounds. The question became a bone of contention during the Board's discussion on February 27, 1968 of the President's recommendation to postpone payment of certain maturities of

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41/ More recently the "preferred status" of the Bank's loans was discussed at some length in Board meetings on January 11, 1983 and December 13, 1984 (discussion of the cofinancing program) and is often emphasized in Board discussions.

42/ R71-178 dated July 14, 1971.

43/ See SD71-29, August 10, 1971. The President's transmittal letter of the above-mentioned paper to the Bank's Governors, dated August 16, 1971, mentioned that "the views expressed in the paper were those of the staff and did not purport to represent the views of the Executive Directors of the Bank or the Governments which appointed or elected them".

Bank loans to India.[44] Several Directors, citing Article IV, Section 4(c), expressed the view that such action could be taken only after India had applied for relief, which was not the case. In addition, it was not clearly established that, serious as India's problem might have been, there was a case of an acute foreign exchange stringency which made it impossible for India to service its debt to the Bank. The chairman felt that there was no need for insisting on an application from India. He stated that, unless the General Counsel advised him otherwise, he would not subject India to "the indignity of a pauper's oath".

22. The General Counsel, who was not present in that meeting, later submitted a memorandum on the relevance of Article IV, Section 4(c) of the Articles to the proposed rescheduling.[45] In this memorandum, Mr. Broches stated that Section 4(c) did not apply in that particular case, since no application for relief has been made, and that in any event the rescheduling could be undertaken under the Bank's general powers to adjust loan terms. He added, however, that should, contrary to his view, Section 4(c) be held to apply, this would not create any problem since the proposed rescheduling was consistent with the limits of the debt relief defined by the

44/ See President's Memorandum: India - Proposed Participation in Indian Debt Relief Action, February 1, 1968 (R68-21). In the previous year the Bank's President (Mr. Woods) proposed that pending a decision on rescheduling the Indian debt, the Bank should make temporary deposits with the Reserve Bank of India to offset the first $50 million of repayments. The proposal was first opposed by some Executive Directors as a disguised rescheduling which did not meet the requirements of Article IV, Section 4(c). The acting General Counsel, Mr. L. Nurick, made a statement (SecM67-194) affirming the Bank's power to make the deposits and the Board finally approved the deposit, with one objection. See SM67-23, August 1, 1967.

45/ See President's Memorandum India - Participation in Indian Debt Relief Action, March 8, 1968 (R68-39).

Section. A number of Directors disagreed. One Director, insisting that the Section should apply, maintained that earlier contacts between the Bank and the Indian Government substituted for a formal application. Another contended that the Section did not require an application and that the Bank could act on its own motion if the requirements of the Section were met. As a result, he requested that the Minutes should show that in approving the rescheduling the Executive Directors were acting under Article IV, Section 4(c). He subsequently amended his request, after other Directors supported the view of the General Counsel, to state that the action was taken "in the light of Article IV, Section 4(c)". The Minutes so recorded the decision, adding that the Directors "agreed that within the next few months, they should further discuss the legal and policy implications of this decision".46/ Although such further discussions never took place, an Executive Director who felt that Article IV, Section 4(c) ought to have been applied sent a memorandum to the President and other Board members elaborating his views.47/ According to him, the Article's provision would be "superfluous and rather meaningless" if the Bank were free to adjust loan terms for balance of payments reasons in the absence of an acute exchange stringency or otherwise outside the scope of that provision. The General Counsel's view that the purpose of the provision was to explicitly accord a right to borrowers to apply for relief, rather than to grant a power to the Bank, was questioned. In addition to making the provision "superfluous", it was contended that that view would lead to the unreasonable result that a country applying for relief under Article IV, Section

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46/ SM68-14.

47/ Memorandum by Mr. Skjerdal dated April 10, 1968 (SecM68-96).

4(c) might be worse off than a country "referring only to balance of payments difficulties and to the Bank's general power to adjust the terms of its loans".

IV. LEGAL AND POLICY IMPLICATIONS

23. It is obvious from the above analysis that the framers of the Bank's Articles wanted to differentiate in the treatment of borrowers between those who default wilfully or due to their own faults and those who find themselves unable to service their debt to the Bank for reasons beyond their control. The Articles themselves differentiate between the cases where default is imminent but could still be avoided, and the cases of actual default where its adverse effect should be corrected, if at all possible. The framers wanted to minimize the cases of actual default where the Bank may, in order to meet its own obligations, be forced to call on its members to pay from the callable portion of their subscriptions. Accordingly, they explicitly authorized the members suffering from acute foreign exchange shortages which make them unable to meet their payment obligations in time, to apply to the Bank for relaxation of the conditions of payment and authorized the Bank to accept, in such circumstances, service payments in local currency subject to certain conditions and/or to modify the terms of loan amortization and extend the life of the loan (Article IV, Section 4(c)). In the cases of actual default, the Articles, recognizing the severity of the situation, instruct the Bank to make "such arrangements as may be feasible" and allow it greater freedom in the choice of the arrangements for adjusting the borrower's obligations. Any feasible arrangement, including the arrangements already mentioned or other arrangements analogous to them, may be adopted by the Bank in such cases (Article

IV, Section 7(a)). But the Bank's action in this regard is limited by considerations of feasibility including in particular its conviction that the relaxation of the loan terms is "in the interest of the particular member and of the operations of the Bank and of its members as a whole."48/

24. What is then the meaning of the right of a member to apply under Article IV, Section 4(c)? What is the Bank's corresponding obligation to this "right"? And does the Bank violate such a right or any provision in the Articles if it adopts, as its prospectuses now state, a policy against participation in rescheduling agreements?

25. The drafting history of the Articles shows that by providing that a member may apply for a relaxation of conditions of payment, they meant something beyond a statement of the obvious; that a borrower may apply to its lender for relaxation of payment terms and a lender may grant or withhold such relaxation need not be stated in so many words.49/ It is also clear that Article IV, Section 4(c), though requiring the applying member to have suffered from an acute exchange stringency so that the service of any loan contracted or guaranteed by it "cannot be provided in the stipulated manner", deals with situations which stand short of actual default, the latter being governed by the broader language of Section 7(a).50/

48/ Although the above quoted phrase appears only in Article IV, Section 4(c), it is obvious that it should guide all the Bank's decisions, including its decisions under Article IV, Section 7(a) where the arrangements to be adopted by the Bank would, otherwise, be hardly "feasible."

49/ _Accord_, Broches, _op. cit._, note 29, p. 8.

50/ _Accord_, Nurick, _op. cit._, note 44.

In fact, the purpose of the provision of Section 4(c) is to minimize the cases of default by giving the borrowers breathing spells to enable them to meet their obligations, recognizing that the alternative of such accommodation by the Bank would be the borrowers' default, with all its negative consequences on the borrower, the Bank and its members as a whole. Yet, no reasonable interpretation of these provisions would take them to mean that they may be applied in a manner detrimental to the interests they are meant to serve, i.e., those of the borrower, the Bank or its members as a whole. Attempts to accommodate a member in trouble should thus be tried but not at the expense of the Bank's financial integrity and credibility.

26. The discussions of the corresponding provision in the draft IDA Articles in late 1959 is revealing in this respect. In the Financial Policy Committee of the Bank's Board, an Executive Director asked whether "relaxation or other modification" would cover forgiveness of debt. The Bank's former General Counsel, Mr. Sommers, who was the Bank's Vice President in charge of the IDA project, replied that while the term relaxation could be stretched to include forgiving a debt, "it would not be a normal interpretation of the language."[51/] He also stated, in response to another question, that the provision does not give the institution the power to do anything it was unable to do in any event,[52/] thus suggesting, as Mr. Broches did in 1968, that the provision was meant more to emphasize the right of the member to apply for relaxation than the right of the institution to respond positively to such an application. I am inclined, however, to hold the view that, although the Bank as a lender has a general implied

51/ Doc. IDA/59-22, 11/27/1959.

52/ Verbatim transcript of the meeting of December 18, 1959.

power to adjust loan terms whether or not the borrower requests it, such adjustment, when made under the conditions provided for in Article IV, Section 4(c) or Section 7(a), has to be effected under the limitations provided for in these provisions, broad as these limitations may be. Such a view is not only based on the necessity of giving a significance to the provisions of the Articles, but also to ensure that the Bank's power in the adjustment of loan terms would not be exercised in an absolute manner, but would remain, as the text describes it, subject to the interests of the member, the Bank's operations and its members as a whole, all as judged by the Bank itself.

27. In the Bank's practice, the few cases of rescheduling loan payments reflect a correct understanding of its Articles as enabling it to assist its borrowers to avoid default situations and to lessen the debt burden on them whenever this can be done without detriment to the Bank. It is unfortunate therefore that no reference was made to the Articles in the cases where the Bank accepted rescheduling of loan payments or when it later announced a policy of non-participation in rescheduling agreements. The Articles are drafted in such a way as to ensure accommodation of the member's interest provided that it does not conflict with the continuity and viability of the Bank's operations or with the interest of other members who all have a stake in the Bank's financial viability, whether they are borrowers or not. It is interesting to note, however, that the Bank's practice does not include any case in which the Bank has accepted repayment in the local currency of the borrower, under article IV, Section 4(c) or otherwise. As such payment has to be made subject to the borrower's obligation to repurchase its local currency, this arrangement has

been seen as a de facto rescheduling which involves additional difficulties.[53/]

28. The Bank's declared policy of non-participation in rescheduling agreements has not been applied as an absolute and inflexible prohibition on any relaxation of loan terms. The consolidation of loans and credits to Bangladesh after its independence from Pakistan in 1975 took place a few months before the Bank introduced the statement in its prospectuses. When the Bank's President at the time (Mr. McNamara) was asked in the Board whether that consolidation amounted in fact to a form of rescheduling, he confirmed that it did. He refused to say that it would not be a precedent for the future. Hoping that there would never be another country dividing, he nevertheless acknowledged that should a similar situation occur, the Bank may have to consider this a precedent.[54/] Given such flexibility, an amply motivated and adequately flexible general policy against participation in rescheduling agreements cannot be properly described, under the

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53/ The issue was considered by Bank Management with respect to India in April 21, 1967 but the Management preferred to propose to the Board that the Bank make a deposit with the Reserve Bank of India instead. See note 44 supra. The reasons cited for this preference were the difficulties in working out the agreements necessary to cover reconversion of the local currency at the end of the agreed period, the problems involved to the extent that repayments represented 29 different local currencies of Bank members that had been loaned to India and the acceptability of this proposal to the Government of India and the other members of the India Consortium.

54/ Proceedings of Board Meeting, February 11, 1975. In that year, the Bank extended a 30-year loan to Bangladesh to finance repayment and prepayment of maturities of earlier Bank loans to Pakistan for projects visibly located in Bangladesh. See R75-24, January 24, 1975. Later on, in 1979, the Bank modified the conditions of three loans to Nicaragua "on technical grounds", following the events which affected the implementation of the projects financed by Loans 1244-NI, 1402-NI and 1496-NI (R79-264). As a result, it resumed disbursements on Bank loans to Nicaragua after the latter paid part of its arrears and undertook to settle the remainder over a period of a few months.

circumstances in which it was adopted, as against the Bank's Articles. Such a policy cannot, however, prevail over the Articles' requirements. If a member requests relaxation of payment terms under either of the provisions analyzed in this paper, the Bank must consider the request in the light of all the factors described above, recognizing that if the borrower is indeed unable to service the loan, the alternative to the adjustment of the terms of the loan would be the borrower's default. It has the right to relax the loan terms, but is under no obligation to exercise this right.55/ If the member involved has actually defaulted, the Bank should consider all feasible arrangements, but it cannot do so in a manner contrary to the interests of the operations of the Bank and of its members as a whole.

V. CONCLUSIONS

Two conclusions follow from the above analysis:

1. Within the important limitation mentioned below, the Bank may consider relaxing the payment terms for those members who, for no particular fault on their part, experience acute foreign exchange difficulties which make them unable to service their future payment obligations as originally agreed. All feasible arrangements, including relaxation of loan terms, should be considered in case the borrower actually defaults. In designing the measures to be adopted in each case, the Bank should attempt to minimize the cases of default while being careful not to prejudice the interests of its operations and of its members. It would thus consider such factors as the size of the loans involved, the effect of its accommo-

55/ Accord, Broches, op. cit., p. 21.

dating action on the financial market (compared to the effects of inaction) and the possible effects on the future behavior of other Bank borrowers. Such careful judgement will best be made on a case by case basis, after weighing the above factors under the special circumstances of each case.

2. In any case, the Bank should decline requests for relaxation of payment terms when such relaxation is judged by the Bank under objective criteria to be detrimental either to the Bank's borrowing and/or lending operations or to the interests of its members such as their interests in the continuity and sustainability of the Bank's activities and their interest in avoiding calls on the unpaid portions of subscriptions to meet the Bank's obligations to its creditors.

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

For MC Consideration June 16/86
Mr. Clausen E-1227

OPS/MC86-35

TO: Members of the Managing Committee June 13, 1986

FROM: Ernest Stern, SVPOP ES

SUBJECT: Nicaragua

Attached is a draft memo on the Nicaraguan request for payment of debt due us in local currency.

The draft contains contributions by Finance and Legal but is not yet finally cleared by any of us. However, in view of the urgency of the matter, I thought it best to forward the draft to get the MC's view on the proposed approach. Detailed drafting changes can be made later.

We believe it is essential that this memorandum be provided to the Board before our discussion of the provisioning issue. That the decision on these two issues do not depend on each other can be made clear in the cover memo from the Secretary. However, there is no doubt that the local currency proposal will be raised during the discussion on provisioning, and the Board should have the Management's views beforehand.

cc: Mr. Roberts

OPENS PANDORA'S BOX

where is Morples memo?

P-1867

June 13, 1986

There is no policy on local currency

1. By Memorandum from Mrs. Gonzalez, of June 10, 1986 (SecM86-660) the Nicaraguan Government has formally proposed that:

a) A Bank mission that would visit Nicaragua to study its economy, confirm the existence of conditions justifying its invocation of Article 4(c), and to study specific terms of arrangement and the possibility of new loans to Nicaragua within reasonable period of time.

This is a mission to establish creditworthiness

b) To use the facility offered in Article 4(c), i.e., to modify their payments and make them in local currency with repurchase over a reasonable period of time.

c) As a gesture of their goodwill and determination to regularize Nicaraguan's situation with the World Bank, an initial payment in foreign exchange that could be negotiated between the authorities and Bank, included as part of the arrangement."

2. The Bank's Management proposes to respond along the following lines:

C/ Bank would be ready to discuss rescheduling if there is a substantial down payment.

~~a)~~ With respect to the need for a Bank mission to study Nicaragua's economic situation, the Bank has over the past few years continued to monitor developments in close consultation with the Nicaraguan authorities. Following an economic mission in the first half of 1984, the Bank conveyed to the authorities the mission's conclusions and recommendations for addressing the country's increasingly serious financial and economic problems. At that time the Bank also sent to the authorities, at their request, a report on food subsidy issues. In mid-1985, the Bank again conveyed to the authorities an up-to-date analysis of Nicaragua's current economic problems, which was discussed in detail with the Government in November, 1985. The Bank thus is well aware of Nicaragua's ongoing financial and economic difficulties, and indeed has discussed these repeatedly with the Government. We have pointed out, in addition, that economic work leading to the consideration of lending is premature in the absence of work on an effective stabilization program or on the other major policy issues previously identified. A mission to assess creditworthiness is not needed at this time.

A ~~b)~~ As regards the proposed payment of debt service in local currency under the provision of Article IV Section 4(c), it should be recognized that the Bank has not, heretofore, accepted local currency payments. In view of the current state of the Nicaraguan economy and its economic and financial performance (as set out in our memo R86-158 of June 6, 1986), the proposed conversion of the tendered local currency "over a reasonable period of time" could not be considered since acceptance of local currency payment would be the equivalent of a rescheduling of the debt service owed by Nicaragua to the Bank given Nicaragua's current circumstances. While the Nicaraguan economy is experiencing severe economic problems, there are many other IBRD borrowers confronting difficult balance of payment situations and adjustment problems. We see no distinguishing criteria which would enable us to accept the proposed arrangement for Nicaragua without establishing a precedent for those other borrowers. In the context of the ongoing detailed monitoring of the quality of IBRD's portfolio by the rating agencies and by the financial houses who underwrite IBRD's bonds, any action by IBRD which could be perceived as a weakening of our policy against participation in debt rescheduling would have seriously adverse consequences for the operations of the Bank and of its members as a whole.

VM

B) In the past, the Bank has repeatedly indicated to the authorities its willingness to accept a substantial downpayment on the amounts overdue to the Bank coupled with a tight program of payments in foreign exchange for the balance of the accumulated arrears. While we appreciate the authorities' commitment to honor their obligations to the World Bank, a symbolic downpayment in foreign exchange would not suffice.

If they are prepared to make down payment

3. An opinion of the General Counsel on the legal aspects is attached.

There must be a stabilization program agreed upon before we can discuss adjustment program.

Discuss: How may the rest.
(1)
(2) Kind of program necessary

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

— **For MC Concurrence** by c.o.b. June 5/86
Mr. Clausen E-1227

OPS/MC86-32 and
FIS/MC86-36

DATE: June 4, 1986

TO: The Managing Committee

FROM: Ernest Stern, SVPOP and Moeen A. Qureshi, SVPFI

SUBJECT: Nicaragua -- Loan Loss Provisions

6-5
MYRA
FOR BOARD PRESENTATION

1. Attached is a recommendation from Mr. Knox, LCNVP, for provisioning against outstanding debt owed to the Bank by Nicaragua in pursuance of standard Bank policy. Also attached, is an analysis of Nicaragua's current economic and financial situation and prospects which concludes that the prospects for a turnaround in Nicaragua's circumstances are dim. A review of the dialogue between the Bank and Nicaraguan Government since 1981, is also attached.

2. In light of the assessment of economic prospects by Mr. Knox, in which Mr. Stern concurs, we recommend that we propose to the Board that we proceed to provision against our loans outstanding to Nicaragua. A draft memorandum to the Board is provided for consideration.

3. No payment had been received from Nicaragua as of June 2. Because we wish to reflect Nicaragua's status in the June 30 financial statements, should the Managing Committee wish to go ahead with provisioning, it is essential to circulate a paper to the Board by c.o.b. June 6, in order to allow time for the Board to consider the memorandum and for a Board meeting to be arranged should one prove necessary.

Attachments

DRAFT
June 6, 1986

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: Provisions for Losses on Loans to Nicaragua

1. On May 20, 1986, the Executive Directors discussed Provisions for Losses on Loans (R86-94 dated April 15, 1986). They agreed that the Bank should begin to make provisions no later than when a borrower reaches two years of arrears on debt service to the Bank, unless there is overwhelming evidence to obviate the need for provisions. Accordingly, Management has now reviewed the case for provisions against loans to or guaranteed by Nicaragua. As of June 1, 1986, Nicaragua was in arrears to the Bank by two years with the total in arrears $49 million on disbursed and outstanding loans of $185 million.

2. In assessing whether the specifics of the present case argue against the strong presumption that provisions are necessary, Management has carefully considered the prospects of Nicaragua's economy and its attendant ability to meet its foreign obligations over the coming years. Management has also reviewed the history of relations between Nicaragua and the Bank to determine the existence of factors which might obviate the need for provisions.

3. Management's overall judgment is that, given the combination of protracted arrears and a steadily deteriorating economy with no near-term sign of improvement, financial prudence requires following the general policy accepted by the Board, i.e. that we begin to provision against Nicaragua's outstanding loans. There is no reason to support provisions being made at other than the normative rate of 20 percent per year discussed with the Joint Audit Committee and the Board. This will, of course, be kept under review. On the other hand, since the Nicaraguan Government has indicated its desire and intention to honor its World Bank debts, we therefore do not believe there is any need to consider write-downs at this time. The following paragraphs highlight the considerations bearing on this issue which were reviewed by Management.

Nicaragua's Economic and Financial Performance

4. For the past six years, the Government of Nicaragua has sought to rehabilitate productive units damaged during the 1979 civil war, increase rapidly the provision of social services, maintain high employment, accelerate investment, and increase defense expenditures. The Government nationalized the banking system and imposed significant direct control over trade, production and distribution, and investment.

5. This program was ambitious and highly expansionary. Although Government revenues grew very rapidly, they were outpaced by growth in expenditures, resulting in consolidated public sector deficits of one-third of GDP in 1983-85. These deficits have been financed almost entirely by the nation's banking system; consequently domestic credit to the public sector has more than doubled in each of the last three years. Expansionary fiscal and monetary policies amidst a severe foreign exchange shortage have led to a 220 percent rate of inflation in 1985. GDP declined by 19% in real terms between 1979 and 1985.

6. In 1985, exports of goods were only $300 million, less than half their 1978 level, while imports surpassed $880 million, 50 percent over their 1978 level. The current account deficit (including official grants) reached nearly $800 million in 1985, about 28 percent of GDP. Bilateral financing and external debt rescheduling were insufficient to finance the current account deficit which is undoubtedly made worse by a seriously overvalued currency. By the end of 1985, the monetary authorities had nearly $1 billion in external short-term liabilities, against only $30 million in usable reserves.

7. Since 1980, Nicaragua has benefitted from large amounts of foreign assistance, and from 1980-82 successfully restructured external debts amounting to about $678 million of principal and $116 million of interest on generous terms -- 12 years maturity and 5 years grace with some capitalization of interest. Since 1983, however, Nicaragua has been unable to make the revised interest payments and has renegotiated several extensions; to date it has been unable to meet its new obligations. In fact, in the last five years, Nicaragua has only paid about one-third of the total debt service it owed. In 1985, Nicaragua owed $299 million in interest (equivalent to total export earnings that year) and $197 million in principal payments. Of the interest due, only one-sixth was paid; one-third was rescheduled and the remainder was left in arrears. Of the principal due, only one-eighth was paid; one-fourth was rescheduled and the remainder was left in arrears. No payments of interest or principal were made to the World Bank. Arrears to external creditors at the end of 1985 were about $1 billion (equivalent to three and one-half years of current level exports). These figures do not include all debts on oil and other imports from Eastern Bloc countries.

8. Nicaragua is current with the International Monetary Fund. Until recently, Nicaragua was current with the Inter-American Development Bank (IDB), although the IDB presently reports very small amounts (less than $1 million) in arrears on payments due in May which have resulted in suspension of disbursements.

Bank's Dialogue with Nicaragua

9. In the two and one-half years following the current Government's assumption of power in 1979, the Bank supported Nicaragua's reconstruction efforts by lending US$107 million, including US$37 million of IDA credits. This was twice the total amount lent in the previous three year period and represents 36 percent of total Bank loans and credits (US$294 million) made to Nicaragua. Bank assistance also took other forms. Several loans were restructured to provide for more rapid disbursement.

10. Discussions between senior Nicaraguan Government and Bank officials based on the Bank's 1981 review of Nicaragua's economic situation and prospects showed that the policies being followed by the Government would result in further deterioration in the country's balance of payments situation over the medium to long term. Subsequent developments confirmed this assessment, as the management of the economy led to low rates of saving and investment, with export prospects weakening considerably. In consequence, the Bank has made no loans to Nicaragua since January, 1982. Since then the Bank has tried, without success, to reach agreement with Nicaraguan authorities on a feasible adjustment program as a prelude to further lending. The Bank signalled its willingness to work with Nicaragua to formulate a credible adjustment program. During 1985 it was agreed that the Bank would send an economic mission once Nicaragua had made an initial payment and established a plan for clearing the arrears. After several postponements at the request of Nicaragua, and the government's statement in April 1986 that it could not now make a payment or establish a plan, that mission is in abeyance. Indeed, at present, the prospects for substantive agreement on a viable development program seem remote.

11. In April 1986, senior Nicaraguan and Bank officials met to discuss Nicaragua's relationship with the Bank. The Nicaraguan officials reiterated their intention to honor their World Bank debts, but said that Nicaragua's foreign exchange position did not presently permit normal debt service. Nicaragua requested a rescheduling or permission to pay temporarily in Nicaraguan currency. The Bank had addressed the same question when Nicaragua was placed in non-accural status in December, 1984; it reaffirmed its policy against rescheduling and also against accepting service payments in local currency as a means of dealing with protracted arrears since, given the inconvertibility of the Nicaraguan currency, the latter would be tantamount to a rescheduling. In view of the fact that Nicaragua's total known arrears amount to three and one-half years exports, it would be unreasonable to expect it to repay the total amount of arrears of about US$49 million owing to the Bank in the near future;

however, since it has paid the IMF and is only slightly in arrears to the IDB, it could if it wished make a payment towards these arrears and propose a program for eliminating the balance. Nicaragua's unwillingness to follow this course suggests that the Government has made a conscious decision not to pay the Bank since, even though its foreign exchange position is tight, it is not giving the Bank preferred creditor status. This seems to confirm statements made by responsible Government officials to Bank missions that they would give priority to service debts only to those of their creditors that either extended new loans to Nicaragua or maintained a net resource transfer position.

Financial Consequences of Provisioning

12. The immediate financial risk to the Bank of not provisioning now is slight because the amounts are relatively small -- Nicaragua's obligation is less than one-half of one percent of total loans outstanding. There is a significant risk that judgments will be rendered by financial markets about the prudence of the Bank's financial practices and policies in relation to the standards now established in these markets. In the case at hand, based on deteriorating economic conditions, unsustainable external imbalance and the borrower's demonstrated inability to service its debt, it would be difficult to convince markets that a decision not to provision is consistent with the pattern of financial conservatism and prudence that the Bank has established over the years. Provisioning now underlines the Bank's willingness to manage its financial affairs in a manner which markets and its own creditors are able to accept as prudent and sound by the established standards which the marketplace applies.

Implications of the Decision to Provision

13. At the rate of 20% of outstanding balances, a charge of $37 million will be applied to the Bank's income in FY86. A special account for specific provisions against losses in this portion of the portfolio will be established. In no way is the borrower excused from its obligations by this action, and the Bank will continue to bill for interest and principal due as before.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 4, 1986

TO: Mr. Ernest Stern, SVPOP

FROM: A. David Knox, LCNVP

SUBJECT: NICARAGUA: Provisions for Probable Losses

1. As you know, Nicaragua fell two years in arrears on its debt to the IBRD on June 1. I believe provision against a probable loss of part of this portfolio is appropriate. In support of this conclusion two background papers are attached for your information. One deals with Nicaragua's economic and financial performance and the other with the Bank's dialogue with the Nicaraguan Authorities since the Sandinista Government took office in July 1979.

2. As you know, we have made every effort to assist Nicaragua address its economic problems and have on a number of occasions offered to help the Government prepare a medium- to long-term growth strategy. We have also worked closely with the IMF in persuading Nicaragua to focus on its short-term problems by formulating a suitable stabilization program.

3. We succeeded in avoiding arrears in payments to the Bank until the middle of 1984 by restructuring our industrial rehabilitation loan to provide foreign exchange to cover debt service payments to the Bank. When that loan was fully disbursed and the total undisbursed amount of Bank loans to Nicaragua totalled only $2.4 million, of which $1.3 million was already committed, the Nicaraguan Government stopped servicing its debt to the Bank. Since then, we have tried to persuade it to become current on its payments and felt for some time that there was a chance that the Government would make some payment on the rapidly mounting arrears to the Bank. Earlier this year we concluded that the Government has made a conscious decision not to pay the Bank at this time.

4. Since it is the Bank's policy to provision against probable losses, and having concluded that Nicaragua has no present intentions of addressing its arrears, and that its creditworthiness is not likely to improve in the near future, I recommend that the Bank start provisioning against the loans outstanding to Nicaragua in accordance with its standard policy. From the analysis of Nicaragua's current economic and financial position and given the uncertain, but not terminated, state of the dialogue between the Bank and the Government, I see no reason to deviate from that policy.

cc: Messrs. Gillette, ACTDR
Steckhan, LC1DR
Hoopengardner, ACTDR
Park/Marques, LC1CA

HM:ms:sct

P-1867

NICARAGUA

ECONOMIC AND FINANCIAL PERFORMANCE

1. Sincé 1979, the Government of Nicaragua have pursued a multitude of objectives. The authorities have tried to: (i) rehabilitate the productive units damaged during the 1979 war; (ii) increase rapidly the provision of social services to the population; (iii) maintain high rates of employment; (iv) accelerate the rate of investment; and (v) increase defense expenditures. At the same time, the Goverment has carried out a profound reorganization of its operations. It nationalized the banking system and the properties of individuals who left the country; initiated a land reform; and introduced a significant degree of state control over external trade, distribution mechanisms, and production and investment decisions. In the process, the role of the private sector, whose nominal contribution to the value added in the economy is still estimated at 40 percent of total GDP, has not been completely defined, resulting in uncertainty among the remaining entrepreneurs. The Government's objective of creating a mixed economy that works, has thus far not been attained, and the lack of a transparent set of incentives and rewards has seriously undermined the efficiency of the economic system, and its potential for economic recovery.

2. At present, Nicaragua's economy is characterized by widespread shortages and controls. This is partly due to the intensification of the conflict during the last three years but also to the economic policies of the last six years. The Government has pursued expansionary fiscal and monetary policies amidst a general decline in production and exports and critical shortage of foreign exchange. These policies in turn have led to a sharp acceleration of inflation, and widening domestic and external imbalances. As a result the country's external debt increased more than four-fold in 1979-85, and debt-service payment is not being met.

3. Economic performance since 1979 has been poor. In 1985 real GDP was still 19 percent below its 1978 level. Agriculture, which accounts for about one-fourth of total output, three-fourths of total exports, and 40 percent of employment, has had an uneven performance. Production of basic grains expanded rapidly because of high support prices and abundant subsidized credit, while cotton and coffee, the principal export crops, remain at about 50 percent and 10 percent, respectively, below their historical peaks in the late 1970s. Manufacturing output is still about 15 percent below its 1978 level, owing partly to the acute lack of imported inputs. The service sectors stagnated, with the exception of Government services which increased by over 50 percent in real terms since the late 1970s. Sluggish economic performance has led to a continuous decline in private consumption, which as a percentage of GDP, fell from about 75 percent in the early 1980s to 56 percent in 1985, while public sector consumption doubled from 22 percent to 45 percent during the period. This rapid growth of public expenditures was partly due to defense which is estimated to absorb 40 percent of the Central Government budget. As a result of these trends, private consumption per capita remains at only about 50 percent of the 1977-1978 level; this is reflected in a much lower standard of living for most of the population.

4. Expansionary fiscal policies and lack of financial discipline in the nationalized sector have been at the root of the widening internal and external imbalances. Despite a strong increase in revenues, from 23 percent of GDP in 1981 to 32 percent in 1985, the overall deficit of the Central Government rose from 12 percent to 24 percent of GDP in 1985. Moreover, the consolidated public sector deficit including exchange losses of the Central Bank surpassed 32 percent of GDP in 1983-85, from 15 percent in 1981. These deficits have been financed almost entirely by recourse to the Central Bank, and consequently domestic credit to the public sector has more than doubled in each of the last three years.

5. External sector performance has worsened. In 1985, exports of goods declined below US$300 million, less than half their 1978 level. Imports, on the other hand, surpassed US$880 million, 50 percent over their 1978 level. The mounting current account deficit of the balance of payments (after official transfers) reached US$800 million in 1985, or about 28 percent of GDP. Bilateral financing and rescheduling of public sector and Central Bank external debt were insufficient to finance the current account, leading to an overall negative balance of US$407 million, which was financed by both an increase in arrears and a decline in reserves. As a result of these trends, the net foreign reserve position of the monetary authorities by the end of 1985 was highly negative at about US$500 million. Central bank short-term liabilites amounted to nearly US$1 billion, while gross reserves were half that amount. However, only about US$30 million of these reserves were liquid, since a large part consisted of gold pledged against foreign loans, other assets held as collateral against letters of credit, and claims on regional payments arrangements held against liabilites in the same clearing arrangements.

6. An unrealistic exchange rate policy has been a major cause of poor export performance. In 1985, the Government devalued the cordoba from C.10 to C.28 per US dollar. In early 1986, the cordoba was again devalued to C.70 per US dollar. In 1985 the Government also created an official parallel market for some invisible and part of some visible transactions, which de facto has been managed by the Central Bank. The parallel rate reached C.750 at the end of 1985. In early 1986, the black market rate had reached about C.1200 per US dollar. In spite of the massive devaluation, the traded weighted average of multiple exchange rates still remained overvalued in February 1986, by over 200 percent in real effective terms in relation to 1980, owing to accelerating inflation, which reached 220 percent in 1985.

7. In early 1980, Nicaragua benefitted from large amounts of foreign assistance as well as favorable rescheduling agreements with the commercial banks. In 1980-82, the authorities rescheduled about US$678 million of principal and US$116 million of interest. The maturity period was 12 years, including 5-years grace period, and part of the interest payments were to be capitalized. Since 1983, however, Nicaragua was unable to make the interest payments and renegotiated several extensions of payments, but was again unable to meet its new commitments. For these reasons Nicaragua loans have been declared value impaired by the U.S. Federal Reserve Board's National Bank Examiner (NBE). The current status of conversations with

commercial banks is unclear. Most of the bilateral debt has been rescheduled as well. At present the country is current in its obligations to the IMF and the IDB, although the IDB appears to be paying itself by means of disbursements on loans to Nicaragua.

8. In the last five years, Nicaragua only paid about one-third of the total debt service accrued. Nearly one-half of the debt service accrued was left unpaid, and the remaining was rescheduled. In 1985, debt service accrued amounted to US$496 million, of which US$197 million was principal and US$299 million interest. Interest payment obligations were equivalent to total export earnings. Only US$46 million were paid in interest, US$107 million were rescheduled, and US$146 million were left in arrears. As regards principal, US$24 million were paid, US$47 million were rescheduled and US$126 million were left in arrears.

9. Known arrears with external creditors at the end of 1985 were estimated at US$1 billion, equivalent to three and one-half years of current level exports. This estimate, however, is incomplete. Debts on oil and other imports from Eastern countries are unknown. Outstanding and disbursed external debt at the end of 1985 amounted to US$4.6 billion, excluding about US$1 billion of Central Bank short-term debt. Medium and long-term debt was equivalent to 160 percent of GDP and over 15 times the level of 1985 exports.

10. In light of this situation, Nicaragua is not creditworthy. In order to initiate a recovery of the economy and reestablish creditworthiness, the Government would have to implement a strong stabilization and restructuring program, including fundamental reforms of policy in the following areas: (i) private sector role in the economy; (ii) system of incentives in lieu of direct government controls; (iii) efficiency of public enterprises; and (iv) financial discipline in Government and state controlled institutions and cooperatives. Thus far the Government has not been willing to address these issues and, as a result, prospects for economic recovery are dim.

SELECTED MACROECONOMIC INDICATORS

	1981	1982	1983	1984	Estimates 1985
National Accounts (Annual Growth Rates)					
Gross domestic product (GDP)	5.4	-0.8	4.4	-1.4	-2.6
Consumption	-9.8	-2.7	-0.4	6.8	5.5
Private 1/	-15.6	-7.3	-8.6	-0.6	-15.2
Public	15.5	12.0	21.3	21.5	39.0
Gross domestic investment	65.7	-24.3	24.0	-10.2	-14.5
Private 1/ 2/	56.6	-32.9	-15.5	-0.3	-1.1
Public	83.7	-9.7	74.1	-16.3	-24.3
Central Government Accounts (percent of GDP)					
Current revenue	23.2	25.4	31.0	35.0	31.8
Current expenditure (-) 3/	29.0	33.1	38.5	41.6	48.4
Capital expenditure 3/ 4/	6.6	9.2	18.0	15.4	[illegible]
Current account deficit (-) before grants	-5.8	-7.6	-7.5	-6.6	-16.6
Overall deficit (-) before grants	-12.0	-15.5	-25.3	-21.8	-24.2
External financing (excluding grants)	2.6	4.7	2.3	3.2	0.8
Foreign grants	1.3	1.1	1.2	0.8	0.5
Internal financing	8.1	9.7	21.3	17.8	22.9
Money and Credit (percent change)					
Money	19.5	24.1	69.8	86.9	158.3
Quasi-money	-6.4	15.8	36.3	58.8	90.0
Credit 5/	-	60.6	125.5	98.3	176.3
Public sector	33.2	52.0	121.0	39.7	156.3
Private sector	11.6	3.5	4.5	9.6	19.5
Balance of payments (U.S. million)					
Exports of goods & non-factor services	514.7	419.8	439.0	393.6	302.6
Imports of goods & non-factor services	980.2	773.3	833.1	852.5	892.1
Resource Balance	-465.5	-353.5	-394.1	-458.9	-589.5
Factor services (net)	-141.0	-176.0	-176.9	-222.8	-297.4
of which: Interest payments accrued (official)	-169.3	-179.7	[illegible]	-227.4	-298.9
Transfers	70.0	52.0	79.0	39.9	94.9
Current account balance	-563.0	-505.0	-559.0	-631.0	-601.2
Capital Account, net	343.3	312.1	129.7	258.2	394.2
of which: Gross official disbursements	424.1	457.6	366.8	412.2	524.7
Amortization accrued	-97.2	-113.0	-157.0	-166.1	-197.1
Overall balance (deficit -)	-194.7	-189.9	-429.3	-372.8	-407.0
Net change in arrears	-264.9	-94.1	78.3	115.4	67.6
Increase of arrears during current year	37.4	82.5	227.6	207.8	272.4
Decrease of arrears of previous years	-302.3	-176.6	-149.3	-92.4	-204.8
Rescheduling 6/	357.6	176.6	407.8	263.2	229.9
Net change in reserves (increase -)	102.0	107.4	-56.8	-5.8	109.6
Net stock of reserves (end of period)	-331.5	-430.7	-394.2	-394.8	-500.6
External Debt M & LT (U.S. million) 7/					
Debt outstanding and disbursed (end of period)	2298.3	2867.7	3461.7	4065.7	4623.9
Debt service accrued	266.5	292.7	335.6	393.5	496.0
Debt service paid	191.7	203.0	99.5	79.0	69.3
Principal	70.7	59.3	39.8	28.4	23.7
Interest	121.0	143.7	59.7	50.6	45.6
Debt service unpaid	74.8	89.7	236.1	314.5	426.7
Rescheduled	37.4	7.2	8.5	106.7	154.3
Increase in arrears	37.4	82.5	227.6	207.8	272.4
Prices					
Consumer price index (average change)	23.8	24.9	31.0	35.4	219.4
Exchange rate: Official (C/US$)	10.0	10.0	10.0	10.0	28.0
Parallel market (end of period)	--	--	--	--	750.0
Black market (end of period)	--	--	--	--	1200.0

-- Not available.
1/ Includes APP enterprises.
2/ Includes changes in inventories.
3/ Expenditures are on cash basis.
4/ Excludes assumption by the Central Government of losses (C$ 2.4 billion in 1983 and C$ 1.3 billion in 1985) of the rest of the public sector incurred before 1980.
5/ In relation to the liabilities to the private sector at the beginning of the year.
6/ Includes rescheduling of arrears of previous years and conversion of Central Bank, short term liabilities into longer maturities.
7/ Public and publicly guaranteed debt with a maturity of one year and over, repayable in local and foreign currency.

Source: Central Bank, IMF and staff estimates.

NICARAGUA

Bank Group Financial Assistance

1. In the two and a half years following the new Government's assumption of power in 1979, the Bank supported its reconstruction efforts by lending US$107 million to Nicaragua (including US$37 million of IDA credits). This was twice the total amount lent in the previous three-year period and represents 36 percent of total Bank loans and credits (US$294 million) made to Nicaragua since 1951. Bank financial assistance also took other forms. Several loans were restructured to provide for more rapid disbursement soon after the new Government took office. Then after the May 1982 floods several other loans were restructured to accelerate disbursments. Details are in Annex I.

Economic Dialogue

2. The Country Economic Memorandum (CEM)--Nicaragua--The Challenge of Reconstruction was discussed with the Authorities in August 1981. The final report dated October 9, 1981 highlighted the need to improve economic management and to define a development strategy. It concluded that such a strategy would require the private sector to play a significant role in the economy, within the context of the mixed economic concept of the new Government, and to improve the efficiency of state enterprises. The Bank continued to prepare an agricultural project but was unable to pursue it, in the absence of agreement on policy measures to correct the deteriorating economic situation.

3. This CEM laid the basis for the subsequent dialogue between the Bank and the Nicaraguan Authorities but in spite of offers of technical assistance to address the key issues, the Government did not take appropriate corrective actions and the economic situation continued to deteriorate. The situation was further exacerbated by the periodic departure from the country of several key economic ministers.

4. Nevertheless, based on discussions with Bank staff the Government prepared a report entitled Outline of Economic Policies, 1983-88 and sent it to the Bank for comments in September 1983. These were given to Government representatives at the 1983 Bank Annual Meeting; the thrust of these comments was that the report was too general and that the key issues of private sector role in the economy and public enterprise management were not adequately addressed. Meanwhile, delays in servicing the debt to the Bank started becoming chronic. On a number of occasions responsible Government officials categorically stated to Bank missions that they would give priority to service debts to only those of its creditors that either extended new loans to Nicaragua or maintained a net resource transfer position. The Bank, however, was unable to proceed with new loans since Nicaragua's external balance of payments situation was rapidly deteriorating and prospects of repayment looked extremely slim. In addition, the management of the country's economy was such that the rates of saving and investment were low and there was little incentive to export, further exacerbating the country's tight foreign exchange situation.

5. The Bank continued to urge the Government to design a medium-term recovery program offering technical assistance towards this end and sending an economic mission to Managua in April 1984. The mission gave advice on suitable macroeconomic policies and a detailed proposal to phase out consumer subsidies. By June 1984, however, overdue payments started mounting. After numerous attempts to urge the Government to address this issue, the Bank suspended disbursements on September 28, 1984, when some payments were already overdue by about 120 days (as opposed to standard Bank policy of suspending disbursements when overdue payments reach 75 days). During the 1984 Annual Meetings, the Bank again urged the Government to take the necessary measures to set the economy on the path to restoring creditworthiness and to accept the importance of Nicaragua's becoming current on its obligations to the Bank. In response the Government proposed a freeze on all payments and disbursements on Bank loans until December 31, 1984, during which time it would prepare and submit to the Bank an economic recovery program to be implemented in 1985. In return for the submission of such a program, the Government expected the Bank to proceed with the preparation of an agricultural loan for presentation to its Board of Directors before June 30, 1985 at which point Nicaragua would repay all outstanding arrears to the Bank. Since a loan could not be prepared in the time frame proposed, even if Nicaragua's creditworthiness were not in question, the Government's proposal that the Bank agree to postponement of debt service payments was not accepted. The Bank, however, promised to review the proposed 1985 economic program and to assist in preparing a medium-term recovery program. In the absence of any progress on the settlement of overdue payments, Nicaragua was placed in non-accrual status on December 1, 1984. On this date some payments were overdue by more than 180 days.

6. In its telex of December 19, 1984 the Government, while reiterating its above proposal including resumption of lending by the Bank, cited the Articles of Agreement of the Bank to support its request for rescheduling of debt service payments and payment in local currency. In response, in its telex of January 9, 1985, the Bank explained the rationale for its publicly declared policy of not taking part in rescheduling agreements and confirmed that it did not consider the arrangements suggested by the Government feasible under Nicaragua's circumstances. In regard to resumption of lending the Bank reaffirmed that this would not be possible unless "firstly, there were in place an effective program to stabilize the economy and to set it clearly on the road to growth and to a restoration of creditworthiness; and secondly, Nicaragua had settled its arrears to the Bank."

7. The Government's 1985 program was received on March 11, 1985. It proved to be primarily a stabilization program and only partially addressed structural problems. A Bank mission visited Managua in April, gave its comments on the program but advised the authorities that the expertise in short-term stabilization measures lay with the IMF. It, however, agreed to organize a major economic mission to address the country's medium-term options. The Government in turn decided to ask the IMF to send a technical mission to review with it the short-term stabilization issues. The

Government also committed itself to make a substantial payment on the overdue amounts to the Bank, and present a plan to settle the remaining arrears, as soon as agreement was reached on the terms-of-reference for the economic mission and its timing. In July 1985, a Bank mission again visited Managua and submitted a paper on the issues to be covered by the proposed Bank economic mission, its timing and staffing. While the Government agreed in principle with the proposed terms and timing of the mission, it informed Bank staff that it was unable to make the agreed "substantial" payment on the arrears because the foreign exchange situation had deteriorated significantly since April. It hoped, however, that a payment could be made once the economic mission commenced its work, then scheduled for September 1985.

8. In September the Government asked the Bank to postpone the mission since most senior officials were expected to be away in Seoul for the Bank's Annual Meetings. During those meetings the Nicaraguan Delegation asked the Bank to send an interim mission in November to discuss in detail the issues to be covered by the proposed economic mission and to agree on another mutually acceptable time for its arrival. As regards the arrears, the Bank reaffirmed that it expected a payment on the overdue amounts not later than the arrival of the economic mission. The Government, on the other hand, then suggested that the Bank mission should also be asked to assess Nicaragua's capacity to repay the Bank.

9. During the November mission led by a senior staff member who was appointed to lead the economic mission, final agreement was reached on the terms of reference for the economic mission. The Bank also reiterated its position that a payment on arrears was expected upon the mission's arrival. It was agreed that the Bank would send an advance technical mission in February 1986 and that the full economic mission would follow in April.

10. During the February 1986 mission, the Government informed the Bank that it could not make any payment on the arrears as agreed either upon the arrival or during the April mission. Subsequently a high level Nicaraguan mission visited the Bank in Washington and reiterated their earlier requests for rescheduling debt service payments or making those payments in local currency. Both alternatives were not considered acceptable to the Bank.

11. Since it was becoming increasingly clear that a conscious decision had been taken by the Government not to make any payments to the Bank until it was first assured of new lending by the Bank, the Government was informed that the economic mission would be postponed until the authorities were ready to address the issue of overdue payments to the Bank in a satisfactory manner.

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PAYMENT OF ARREARS, 1979/80 AND RESTRUCTURING OF LOANS

1. The last Loan made before the end of the civil war in 1979 was for a water supply project in January 1978. From then until the end of 1979 the Bank made no loans to Nicaragua in view of major fiscal difficulties of the Government coupled with the disruptive effects of the civil war that had begun in late 1978. By mid-1979 the Bank concluded that meaningful project activities and adequate supervision of ongoing projects were no longer possible. It, therefore, suspended disbursements on existing loans and credits in mid-July and the Board was so informed. Soon, thereafter, the civil war ended and the current Government came into power. It immediately requested and received emergency assistance from the international community to facilitate recovery from economic disaster caused by wartime devastation and looting as well as from large outflows of capital. The Bank responded by sending a mission to Managua in September 1979. It reported:

(i) that the Government was prepared to recognize its debt to the Bank and to settle all arrears in debt service payments which had built up since before the end of the civil war.

(ii) that ongoing loans should be restructured to accelerate disbursements; and

(iii) that new project proposals be prepared aimed at providing emergency financing to assist the new Government.

Payment of Arrears

2. The Government recognized all the public external debt inherited from the previous Government and confirmed its intention to eliminate payment arrears to the Bank totalling US$3.7 million by making an initial payment of US$1.5 million before October 1, 1979 and successive payments through March 31, 1980; thus becoming current with the Bank and IDA. Consequently, the Bank resumed disbursements of existing loans and credits in November 1979. While the Government rescheduled Nicaragua's debt to private foreign banks and bilateral donors, it did not request, nor did the Bank even consider, to reschedule Bank loans.

Restructuring of Projects and Loans

3. On October 29, 1979 the Board approved restructuring of three ongoing projects to meet urgent reconstruction needs as well as to provide emergency financing of both foreign exchange and local currency costs. This was accomplished by redesigning these projects to meet the new situation and by providing 100% financing to utilize the substantial balances remaining undisbursed in the three loans. These were a US$22.0 million loan for a power project (US$16.2 million undisbursed); a US$10.1 million loan for a

water supply project (US$9.1 million undisbursed); and a US$11.0 million loan for an education project (US$10.6 million undisbursed). Revolving funds were set up in all three and Bank funds deposited in them to facilitate quick disbursement. Finally closing dates of all three Loans were extended. The Board was also informed that further assistance to Nicaragua's recovery process would be proposed in the form of new lending operations.

Project Financing

4. Between December 1979 and January 1982 the Bank approved four loans and three credits to finance Nicaragua's reconstruction program totalling US$70.0 million and US$37.0 million respectively. The last, a loan of US$16.0 million for a municipal development project was approved in January 1982. By then the Bank had conducted a review of Nicaragua's economic position and prospects and had concluded that the Government was not addressing the basic obstacles to growth. This subsequently led to the conclusion that the country was not creditworthy. Nevertheless, after the May 1982 floods the Bank restructured three ongoing loans to meet urgent foreign exchange needs to repair flood damage. The loan for the Municipal Development Project was amended to include reconstruction of six bridges (three in Leon and three in Chinandega), US$4 million was allocated for this purpose and a special account set up to expedite disbursements; in the loan for the Industrial Rehabilitation Project a revolving fund was set up to expedite disbursement of US$15 million 1/ and the loan for the Rural Sanitation Project was amended to provide US$0.45 million for a malaria control program in the flood affected areas.

1/ This loan was later further amended to provide foreign exchange to cover debt service payments to the Bank.

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DOCUMENT OF INTERNATIONAL MONETARY FUND
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FOR
AGENDA

EBS/86/82

CONFIDENTIAL

April 15, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Provisioning Against Loan Losses in the Context of the Fund

There is attached for consideration by the Executive Directors a paper on provisioning, which will be brought to the agenda for discussion on Monday, May 19, 1986.

Mr. Keuppens (ext. 7823) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Provisioning Against Loan Losses in the Context of the Fund

Prepared by the Treasurer's Department

Approved by W. O. Habermeier

April 15, 1986

Contents

I. Introduction

This paper reviews the widely observed commercial accounting practice of provisioning for contingent losses and the applicability of this practice in the context of the Fund. The issue of provisioning has been raised by the Executive Board in connection with its discussion of the midyear review of the Fund's income position (EBM/85/176, 12/6/85 and EBM/85/180, 12/13/85) and the recent special review (EBM/86/37 and EBM/86/38, 2/27/86) as well as during its discussion of the semiannual review of overdue financial obligations to the Fund (EBM/85/170, 11/25/85). Furthermore, last year's External Audit Committee (EAC) raised the issue of the treatment by the Fund of outstanding overdue financial obligations, including the need for periodic reviews to consider whether loss provisions for overdue obligations are necessary, and the establishment of a more comprehensive and structured approach to the evaluation of whether or not a material loss is probable with respect to members with protracted obligations to the Fund. (See Appendix II for an excerpt of the report of the EAC for FY 1985.) This paper considers the issues that bear on provisioning in the context of the Fund, and seeks guidance from the Executive Board as regards the various elements, including procedures, that could comprise an evaluation bearing on the probability of material loss from protracted overdue obligations.

The paper is organized as follows: in Section II the accounting principles that bear on provisioning for contingent losses are reviewed; Section III discusses the relevance of provisioning in the context of the Fund; Section IV provides an extended summary and makes some concluding remarks in which are outlined some of the issues that would need to be considered in the event the Fund decided that provisioning against contingent loss was necessary and desirable. Appendix I summarizes provisioning as practiced by commercial banks and by some intergovernmental international financial institutions--mainly development banks.

II. The Concept of Provisioning

While the Fund is not bound by national or international accounting principles, it has nevertheless followed their precepts as closely as possible, taking into account that its financial structure and mode of operation have many unique features which have no exact counterpart in national accounting presentations and standards. The following exposition of provisioning for contingent loss is based on generally accepted accounting principles, but the applicability of provisioning in the Fund, which is dealt with in Section III below, needs to be considered in the context of the objectives and practices of the Fund itself.

1. Definition and purpose of provisioning

The term "provisioning" in financial accounting means to reduce the value of an asset--its "book value"--to its estimated realizable value through the establishment of an allowance for future losses. 1/ The primary purpose of provisioning is thus to present a fair and accurate statement of the financial statements of an entity at a given time by valuing its assets at their expected realizable value instead of their nominal or book value. A second purpose of provisioning is to guard against an overstatement of the financial results of an entity for any given accounting period by making an appropriate charge against current income--i.e., by a reduction of income--to reflect anticipated losses on its assets.

If and when a loss occurs, the difference between the book value and realized value of the asset would have been provided for and the realized loss would reduce current income only to the extent that the provisions against the realized loss would have been insufficient. The process of making provision for bad or doubtful debts thus requires making a judgment that the historical cost of the asset exceeds the anticipated realizable value of the asset--i.e., that a loss is probable.

2. General accounting practice as regards provisioning

The rules established by nationally or internationally recognized accounting bodies provide broad guidelines to follow when considering the need for making loan-loss provisions. These guidelines must, however, be applied to the circumstances of particular cases. The final decision on whether or not to make provisions is a matter of judgment which is to be made by the management of an institution on the basis of all the relevant considerations.

The effect of provisioning is to increase expenditures and reduce income at the time the judgment is made that a loss is probable rather than at the time a loss is actually incurred. The provision would cover the whole credit if it appears probable that no part of it could be collected. Alternatively, the full amount of a loan could be provided for over a period of time on the assumption that, in the absence of settlement, the amount of probable loss increases pari passu with the passage of time.

1/ The Fund is unable to reduce the "value" of its holdings of currency ("loans") and it cannot make a presentation of net assets, as in the context for a provision for loan losses in commercial banks. In the context of the Fund, a provision would be shown as a liability to meet a loss on an asset if it is written off; the nominal value of the asset would remain unchanged until it is written off. The former method, of a reduction in value of the asset with parathentical disclosure of the amount of the provision is, however, the standard presentation.

The International Accounting Standards Committee concluded on the issue of provisioning as follows:

> "27. The amount of a contingent loss should be accrued by a charge in the income statement if:
>
> (a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability incurred at the balance sheet date, and
>
> (b) a reasonable estimate of the amount of the resulting loss can be made.
>
> 28. The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 27 is not met, unless the possibility of a loss is remote." 1/

The term "probable" in this context means that a future event is likely to occur, as contrasted to a remote--or slight--or even a reasonable, but less than probable, possibility. 2/

Generally accepted accounting principles thus call for provisioning when (i) a loss appears "probable", and (ii) its magnitude can be estimated. The amount to be provided against loss should reflect the best estimate of the loss; if the size of a loss cannot be estimated, though it is concluded that a loss is probable and the likely outcome is within a range, then at least the amount indicated by the lower end of the range should be provided for, which would be supplemented by additional information in the notes to the financial statements. When no reasonable estimates of loss can be made, no provision may be set up for the contingency, and this should be disclosed in the financial statements. In that event, the auditors may express a qualified opinion on the financial statements if the likely size of the loss, and taking into account the probability of loss if realized, would be material for the reporting entity.

1/ International Accounting Standards Committee, International Accounting Standard No. 10: Contingencies and Events Occurring After the Balance Sheet Date; London, 1978. Rules promulgated by national authorities, such as the Financial Accounting Standards Board (FASB) in the United States, the Institute of Chartered Accountants of England and Wales in the United Kingdom, or the EEC Accounting Directives are essentially similar.

2/ See, e.g., Financial Accounting Standards Board, Accounting Standards: Current Text (General Standards as of June 1, 1984), c 59.104; Stanford, Conn., 1984.

3. Methods of provisioning

The methods usually followed in making provision for contingent losses fall into two broad categories: (i) general provisioning, which usually refers to the establishment of a provision to meet a risk related to classes of assets with a common characteristic or a large number of small loans which make it impractical to assess each loan on its individual merits and to which it would be difficult to provide for each specific asset; and (ii) specific provisioning, which usually refers to the establishment of a provision to meet estimated probable losses on a specific credit of, usually, comparatively large size or on credits which are extended to creditors with unique characteristics and which may not be well captured in a broad aggregation of credit extended. A combination of both general and specific provisions is often used, though the alternative methods of provisioning can have significantly different effects on the financial statements.

General provisioning is based on past experience and the amount of provisioning is usually determined by establishing a ratio between past losses from bad debts to credit extended or to credit outstanding. A general provision will reflect some average of past experience (and the law of large numbers if numerous small loans are provisioned for). This approach leads to the establishment of adequate provisions to the extent that past experience properly reflects the expected loss on currently outstanding credit. Conversely, it will under- or overstate appropriate provisions if past experience is of limited relevance because of changes, for example, in the organization's credit policy or, in the economic environment which would affect the ability or willingness of debtors to discharge their obligations.

Special provisioning calls for an analysis of specific credits outstanding at the end of a reporting period, and the making of (usually difficult) judgments of whether loss on these individual credits is probable, as well as estimating the potential size of such losses in order to determine the amount of provisioning. It is the more usual form of provisioning by commercial enterprises.

4. Considerations in making provisions

Most kinds of risks can be reduced to some extent by increasing expenditures on precautions. The great difficulty is usually to know how large an increase in costs is justified in order to achieve an uncertain degree of reduction in an uncertain risk. Past experience can provide only an average probability of loss for the present. If the taking of certain precautions changes the timing of loss, and therefore the impact on income, an entity can decide whether precautions are worthwhile. A fundamental consideration in deciding whether or not to make provisions against loss involves a judgment on the probability of loss based on experience and current expectations. If there is uncertainty about a loss and precautions are not made, an important consideration would be the ability of an entity to absorb losses in the absence of provisioning--i.e., through fluctuations in income and reserves if a loss should materialize. In that event current income, and reserves if the loss exceeded income in the period, would have served effectively the same purpose as provisioning though the mechanism for financing losses would have been quite different as would the overall impact of losses on the financial position of the entity in the absence of provisioning.

Provisioning is a cost of conducting business and is, therefore, an item of expense. It also has an important consequence of protecting the income position of an entity against undue fluctuations in the event of losses being realized. The relative stability of income and the cost of provisioning are of particular relevance when attention focuses on current financial results, as usually is the case for profit-oriented enterprises, and may also be of importance for entities that, although not primarily aiming at profit generation, rely for financial resources on capital markets that may be sensitive to developments in an organization's financial results, such as, e.g., international development banks. Stability of income may not be an overriding concern for all financial enterprises and they would take a risk of absorbing realized losses through a reduction of income and, if need be, reserves. While the prospect of (unprovisioned) loss might be met directly by increasing reserves through an increase in income, this would not be in conformity with formal accounting theory nor could it be readily accommodated in the presentation of the financial statements which would need to indicate if a loss was probable.

5. Provisions and reserves

Provisions, which are a charge against operating income, are separate from equity reserves, which reflect the accumulation of net income in earlier years. However, both provisions and reserves serve to protect the entity from loan loss, though reserves also serve a wider purpose including meeting loan losses. 1/ Provisions are established when a loss is judged probable and the amount of the provision is determined irrespective of the level of reserves. Any realized loss is first charged against the provisions and affects current income only if the provision was inadequate to meet the loss. If the loan against which the provision has been established is fully repaid, or if a loss is judged less likely--the excess in existing provisions would be added to, and thus increase, current income.

1/ In this connection, the use of the term "reserves" to characterize provisions is gradually disappearing to avoid confusion with equity reserves, or more properly, retained earnings. Combinations of such terms as "allowance" or "provision" together with the terms "doubtful accounts," "bad debts" or "estimated losses" are found in practice. The trend in commercial banking is to refer to "Allowance for loan losses" in the balance sheet and to "Provisions for loan losses" in the income statement.

While provisioning protects the capital of an organization and its income position from the loss of nonrepayment, it does not afford protection from other forms of losses (e.g., from operational deficits or disaster). It is one of the purposes of retained earnings (reserves) to provide protection of the entity's capital against these more general risks. Reserves also differ from provisions in that they do not provide protection of income: general accounting rules prescribe that unexpected losses cannot be charged directly to reserves--retained earnings--but must be charged to current income and will reduce reserves only when the losses are in excess of current income.

Provisions and reserves thus serve different but related purposes. However, the relationship between provisioning and reserves is sufficiently loose that no presumption can be made as regards the need to change reserves policies because of changes regarding provisioning for bad debts, or vice versa; there is no basis for the automatic offsetting of one against the other. These matters are for decision after a review of all the circumstances.

III. Provisioning in Relation to the Fund

The External Audit Committee (EAC) for FY 1985 in its comments relating to overdue obligations that were addressed to the Managing Director and to the Treasurer (see Appendix II) noted that it is difficult to evaluate the extent of risk to which the Fund may be exposed, because the Fund extends credit only to its members, which constitute the organization, and past experience showed that obligations were eventually discharged. The EAC noted, however, that the probability of loss cannot be ruled out altogether. In the light of growing arrears, both as regards amount and number of members, the EAC emphasized the need for periodic reviews to consider whether loss provisions for overdue obligations are necessary. The EAC endorsed a proposal of the Treasurer to establish a more comprehensive and structured approach to the evaluation process as to whether or not a material loss is probable with respect to members with protracted overdue obligations to the Fund. This Section reviews the responses made by the Fund to the issue of overdue obligations and also discusses various issues, on which the Executive Board might give guidance, that might bear on the probability of loss with respect to protracted obligations.

1. The Fund's response to overdue obligations

Until the beginning of 1983, the Fund had experienced only comparatively few and isolated instances of late payments or prolonged overdue financial obligations by members. 1/ However, the amount of overdue obligations increased markedly since 1983 and the periods during which some members have remained in arrears to the Fund have lengthened considerably. In a number of instances there are no indications that prompt settlement of arrears can confidently be expected. In the face of these developments as regards overdue financial obligations, the Fund has taken a number of measures since late 1984 to encourage and assist members to meet their financial obligations to the Fund on time, and to safeguard the financial position of the Fund against uncertainties.

a. Measures to encourage settlement of overdue obligations

The economic and financial position of those members that are overdue in their obligations to the Fund for periods longer than could reasonably be considered mainly of a technical character is regularly reviewed by the Executive Board in accordance with agreed policies on the treatment of overdue obligations. 2/ Members are urged to discharge these obligations promptly. The Fund does not engage in discussions regarding the use by the member of the Fund's resources if the member has overdue obligations outstanding. Furthermore, the Executive Board reviews a member's overdue obligations in accordance with agreed procedures and this can lead and has led to the Fund declaring a member ineligible to use the general resources of the Fund. Such a declaration is made public by means of a press release issued by the Fund and reported in more detail in the Fund's Annual Report. The Fund's financial statements also contain information on overdue obligations. 3/

1/ It should also be noted that those countries that withdrew from membership and had outstanding financial obligations at the time of their withdrawal (Cuba, Indonesia and Czechoslavakia) settled their obligations in accordance with the terms of their withdrawal. However, a unique situation is presented by Kampuchea. This member began to incur overdue obligations in 1975 and in 1978 the Fund limited the member's right to use the General Resources of the Fund and suspended its right to use SDRs acquired after the date of suspension. In 1979 the Fund reclassified charges due from Kampuchea as deferred credit. In the context of the total amount of credit extended by the Fund, and by itself alone, the amount overdue by Kampuchea might be regarded as not material.

2/ See "Overdue Payments to the Fund - Experience and Procedures" (EBS/84/211, 3/9/84) and successive six-monthly reports to the Executive Board on overdue financial obligations (EBS/84/211, 10/11/84), (EBS/85/73, 3/27/85) and (EBS/85/245, 11/5/85).

3/ The Notes to the Financial Statements of the General Department contain information on the amounts receivable by the General Department of the Fund from members overdue in payments to the Fund for six months or more. The data include both the total amount of charges receivable and repurchases from members that are late by six months or more in discharging financial obligations to the Fund. Notes to the Financial Statements of the Trust Fund report similar information.

While a declaration by the Fund of a member's ineligibility to use the general resources of the Fund might raise issues about the payment performance of the member, it would not be proper to conclude from such a declaration that a loan loss is probable which would call for making provision against a loss. A declaration of ineligibility is, in the view of the staff, one possible indicator that might be taken into account in coming to a judgment on the probability of loss, but, of itself, it is not conclusive. The Fund maintains its relations with a member following a declaration of ineligibility. The Fund reviews a member's overdue position regularly, including the positions of members that have been declared ineligible. These reviews serve, inter alia, to keep the Fund informed on developments in the member's economy, but they also mean that the Fund remains prepared to discuss with and give assistance to the member on the elements of an economic program that the member could institute. Such a program would strengthen its external payments position and enable the member to reduce or eliminate its overdue obligations to the Fund. In this latter regard, the Fund may assist a member in helping to secure external financing from other sources in connection with the possible implementation of a stabilization program. The Fund also maintains close contact with the member through its periodic surveillance of members' economic, financial and exchange rate policies as part of the Article IV consultation process.

By these and related means, the Fund maintains an ongoing dialogue with members with overdue obligations which can be expected to help a member with overdue obligations to adopt measures that will assist it in discharging its overdue financial obligations to the Fund. On balance, it may reasonably be expected that ongoing contact between the member and the Fund would help to reduce to some extent the probability of loss with respect to the overdue obligations of the member. A declaration of ineligibility does not lessen dialogue between the member and the Fund.

b. Measures to protect the Fund's financial position

As regards the measures taken by the Fund to safeguard its financial position in the light of the increasing problem of overdue financial obligations, the Executive Directors will recall that:

(1) In March 1985, the Executive Board decided to exclude from current income unpaid charges due from members that were overdue in meeting financial obligations to the Fund for six months or more; 1/

1/ See "Overdue Financial Obligations to the Fund - Effect on Income and Treatment in Financial Statements" (EBS/84/231, 11/14/84), and "Overdue Financial Obligations to the Fund - Supplementary Notes" (EBS/85/32, 2/5/85).

(2) In June 1985, the Executive Board increased the net income target specified in Rule I-6(4)(a) from 3 percent to 5 percent of reserves at the beginning of a year; 1/

(3) In December 1985, the Fund decided, effective February 1986, to introduce a system of special charges aimed at recovering certain costs arising from overdue payments was introduced; 2/

(4) In December 1985, the Fund also raised the rate of charge on the use of its ordinary resources from 7 percent to 7.87 percent per annum, an amount that was projected to yield sufficient income to enable the Fund to meet its net income target for FY 1986, equivalent to 5 percent of its reserves at the beginning of the financial year. The Fund has also considered a reduction in the remuneration coefficient as a means of sharing the burden of reducing its operational expense as a means of carrying the cost of overdue financial obligations.

These measures, including the income-generating safeguard mechanism for the determination of the rate of charge and net income target under Rule I-6(4), emphasize the importance the Fund attaches to the protection of its overall financial position. These measures, which do not in any formal sense substitute for provisioning in the event of a probable loss on some of its lending, provide for some increased cover against the risk of financial loss, including the risk that repurchases are not made. In particular, the increase in the reserve target has to some extent served a similar purpose as provisioning to meet loan losses though the factors bearing on the size of the increase in the reserve target differ from those bearing on the amount of provisioning.

2. Evaluation of probability of loan losses

As noted earlier, any consideration of the possible need for making provisions by the Fund against repurchases becoming delinquent must be preceded by a judgment whether (i) a loss appears probable and (ii) an estimate of the magnitude of the loss. However, some of the traditional elements that might need to be considered in coming to a judgment whether a loss is probable not only raise a number of issues particular to the Fund but might also tend to increase the difficulty of coming to a view as regards the probability of loss.

The view might be taken that there is no inherent risk in lending by the Fund to its members because of the intergovernmental and cooperative nature of the institution, in which debtors and creditors collaborate to determine Fund policy, and in view of members' obligations

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1/ See "Factors Bearing on the Adequacy of Fund Reserves" (EBS/85/125, 5/14/85) and "Review of Income Position and Related Issues" (EBS/85/149, 6/18/85).

2/ See "Special Charges to Recover Costs and Losses Arising from Members' Overdue Financial Obligations to the Fund - Further Consideration" (EBS/85/242, 10/29/85).

under the Articles of Agreement. While these are arguments that are relevant for judging the risk of loss, they do not mean that the Fund is immune from probable loss. It would seem, that the Fund faces in practice two types of risks in its lending: the first is a political risk that the member will repudiate its indebtedness to the Fund or will indicate an explicit unwillingness to discharge its obligations to the Fund. The second type of risk the Fund faces is of an economic nature which fundamentally reflects a member's view that it is unable to service its obligations to the Fund because of its economic and financial circumstances.

a. Unwillingness to discharge debt

No member with overdue obligations to the Fund has given any indication of either a repudiation or unwillingness to discharge its overdue financial obligations to the Fund. On the contrary, all members with overdue financial obligations to the Fund have stated, though with differing degrees of emphasis, their intention to discharge overdue obligations as soon as circumstances permit. While a negative statement on intentions to repay must be taken at its face value, and would face the Fund with different issues, a difficult issue that arises in connection with any decision to provision is how much weight to give to a member's announced intention to actually discharge its overdue obligations when circumstances permit. The intention to repay must be seriously weighed because it indicates the continuing element of cooperation between the member and the Fund to find a solution to the member's financial difficulties. However, it cannot be regarded as a decisive element in the absence of some specific measure bearing directly on the repayment of debt.

b. Criteria to determine probable loss

The burden of coming to a view whether a loss is probable must depend on facts. Among the more relevant sets of facts would be those relating to the member's financial arrears, its economic performance, its policy actions, especially as they bear on the achievement of a viable balance of payments position in the medium term, the member's priorities in the discharge of arrears, the duration that the obligations have been outstanding as well as its expressed intentions to repay the Fund as soon as circumstances permit.

(1) Financial circumstances

Consideration would need to be given to the total of debt owed by the member and specifically the amount owed to the Fund, the member's record and priorities in discharging its debts as well as the length of time the debt has been outstanding, in particular in relation to the Fund. A member's debt profile and the order in which the debts are discharged, which could indicate the priorities in discharging debt, are generally observable facts, though a firm conclusion may not always be drawn from them as to the probability of loss. An "over-indebted" member will, of course, experience relatively greater difficulties in servicing its debt than others, but not necessarily to an extent that it will refrain from acknowledging the debt or taking steps to discharge it over time. Much would depend on the amount and distribution of debt that is outstanding to the Fund in relation, for example, to the member's quota, and in relation to other measures of the member's economic size and capacity to service debt.

(2) Economic performance

A major consideration to be taken into account is the willingness and ability of the borrowing member to implement a policy of economic adjustment and the establishment of possible special safeguards to secure the servicing of debt to the Fund, and also including structural reforms in order to help bring about a viable balance of payments position, and which would include the elimination of arrears towards the Fund. The absence of such an economic program in the face of a deteriorating economic and financial position might be regarded as an indication of a weakening intention by the member to discharge its obligations and, perhaps, a willingness to finance its balance of payments deficit through an accumulation of arrears, including arrears to the Fund. A weak economic performance by a member might well suggest a delay in the discharge of its overdue obligations to the Fund, though by itself the absence of an effective economic adjustment program would not of itself indicate that repayment will not be forthcoming at some time in the future. Circumstances may change, and perhaps change relatively quickly. A member may decide to institute an economic program and make other appropriate reforms, thereby improving the prospects, perhaps with the help of outside financial assistance, of the member discharging its overdue obligations to the Fund.

(3) Duration of overdue payments

While it may be difficult to draw firm conclusions as regards the bearing that a member's financial circumstances and its economic performance may have on a member's willingness and ability to discharge overdue obligations and hence their weight in the judgment as to the probability of loss, the length of time that obligations have been overdue may be regarded as a relatively specific indication of increasing probability of loss. It would be reasonable to presume that the longer an obligation has remained overdue the greater the probability of loss, unless there was specific evidence to the contrary. For example, protracted overdue obligations may be regarded as normally reflecting a lack of foreign exchange resources which could be used to discharge foreign indebtedness and would tend to reflect a decreasing probability that overdue obligations would be discharged. Furthermore, a shortage of foreign assets might well become more severe over time which might reflect an absence of corrective policies or changes in priorities. The argument that a prolonged failure to discharge overdue obligations might be interpreted as indicating a weakening of the particular relationship between the Fund and a member, and could indicate some impairment of the value of the asset, might also have some merit in the absence of an undertaking of an economic program despite declarations of the member of its intention to repay as soon as circumstances permit. In short, the length of time that obligations have remained overdue is a relatively significant indication that the issue of loss was increasingly likely in the absence of other action by the member to service its debt.

(4) Outside opinion

As indicated in Appendix I below, a number of outside bodies, in particular the major international commercial banks and various supervisory and regulatory authorities, make periodic evaluations of their debtors in accordance with the policies and procedures of these institutions regarding provisioning. Some aspects of these policies and procedures may not be altogether appropriate in the context of the Fund. For example, some of the methods are automatic in nature and do not provide for extenuating circumstances. Furthermore, some agencies, for example the Interagency Country Exposure Review Committee (ICERC) in the United States in its evaluation includes whether the country is in the process of adopting, or has adopted, a Fund program or is not adhering to such a program, or is not able to negotiate or unlikely to succeed in the scheduling of its debts. 1/ Thus, these criteria are not judged to be necessarily applicable to the Fund. The existence of arrears to the commercial banks would not appear to be a reason for doubting the obligations of a member which was meeting its payments to the Fund as they fell due or if a member that had fallen into arrears in the past had become current to the Fund.

While it would seem useful and desirable that the Fund take into account the evaluations by outside bodies in reaching its own judgment as to the probability of loss on the credit extended by it to its members, the Fund would, in many instances, not be safely guided by these judgments but would need to reach its judgment in the context of its functions and its relationship with the member. In this regard, it is worth noting that the Fund's judgment as to the probability of loss on loans to a member may have an impact on the judgments that other institutions may need to make on their loans to the same member. Nevertheless, a major consideration is the degree to which a member makes its payment on due time.

(5) Other considerations relevant in the context of the Fund

An assessment of the risks associated with lending by the Fund to its members is essentially an assessment of the overall credit-worthiness of each individual borrowing member, after taking into account its overall relations with the Fund. The case-by-case evaluation

1/ The ICERC evaluates the transfer risks associated with particular countries and, where appropriate, issues directives establishing reserves percentages that must be observed by U.S. banks for particular countries.

by the Fund of the creditworthiness of particular members, and also the Fund's lending in general, primarily reflect the Fund's own experience and responsibilities. The Fund's past experience as regards overdue payments is limited, and can be effectively dated from 1983. The increased incidence of overdue obligations has occurred against a background of difficult economic and financial conditions for many countries in the Fund, including in particular the poorer debtor countries, which may be temporary as economic recovery becomes more widespread. In making its assessments as to the probability of loss, the Fund would give due regard to the economic and financial conditions that might affect not only individual members but also the world economy in general.

The Fund has a particular responsibility in assisting its members both individually and collectively in accordance with its generally agreed policies. These responsibilities relate, for example, to the areas of conditional and unconditional liquidity and in its surveillance functions. They do not, in the view of the staff, relieve the Fund from making a judgment as regards the probability of loss on credit extended by the Fund. However, in the event that a relatively large number of countries found it difficult to service their debts to the Fund and to other creditors in view of general balance of payments difficulties, the issue might arise whether the Fund should not also consider action to meet a possible systemic difficulty as well as help individual members to overcome their difficulties before coming to a judgment whether a loss is probable. Any such general action, which would, of course, need to take into account the various elements influencing the working of the world economy, including the level and distribution of international liquidity, but would neither preclude nor obviate a detailed consideration of the position of individual members as regards their overdue obligations to the Fund.

(6) Summary

The probability of loss as regards the discharge of repurchases due to the Fund is a matter of judgment. This judgment has to be made in the special context of the Fund. As discussed above, certain criteria may be established which may help the Fund in arriving at its judgment. The factors discussed above, may sometimes be conflicting. However, when all, or most, of the relevant indications bearing on the probability of loss point in the same direction, some possible impairment in the value of the Fund's assets may be presumed to have occurred. Such indications bearing on the probability of loss could include the length of time that obligations have been overdue; the absence of a set of corrective measures or structural reforms in the debtor country; the existence of continuing, if not worsening, financial and economic imbalances in the country; and outside agencies have made a judgment as to the probability of loss as regards their loans to the country.

However, the Fund needs also to take into account wider considerations that touch on its broad responsibilities and functions in the world economy. In this regard, systemic issues might arise and indicate the possible need for general action, and not only with respect to individual members. Provisioning in the context of the Fund is not only an important accounting procedure. It raises significant issues bearing on the relationship between the Fund and its members and the international economic community in the sense of providing a signal regarding the relative performance, not necessarily confined to an individual member, but also of the performance of the international economy and the Fund itself.

Nevertheless, despite the real difficulties in assessing probable loss, the Fund may need to consider: (a) taking further protective measures when making its resources available and as long as they are outstanding and in improving its procedures in order to help prevent overdue obligations arising; (b) establishing a presumption as to a probability of loss based on the length of time that an obligation has been overdue, unless other indications or evidence of impending payment would strongly suggest otherwise, such as the introduction of an adequate economic adjustment program. In this regard, consideration may be given in coming to a conclusion as to the probability of loss if repurchase and other payment obligations to the Fund were overdue by, say, three years or more. The taking of such action would indicate that the Fund believed that by some future date the overdue debts from a member would not have been discharged, and that the prospects of settlement by the member had seriously diminished.

In the event that it was felt a judgment as regards the probability of loan losses was premature at the present time, consideration could be given to raise somewhat the reserve target. This approach would afford some protection to the Fund's financial position. It will be noted, however, that in the event it was decided later to make provision against probable loss, the Fund's reserves could not be used--or reclassified--to offset the cost of provisioning; though it would be reasonable to review the reserve target in the light of any decision to establish provisions.

3. Financial consequences of provisioning

As indicated earlier, the cost of making provision is a cost of conducting business. Provisioning is an item of expense which has implications for the net income position and, hence, the ability of an organization to retain earnings and increase equity capital. In the context of the Fund, particular issues arise regarding the means of financing provisions against doubtful or bad debt if it is determined that provisioning is necessary and desirable.

Given the Fund's net income target, the cost of provisioning would be met by increasing the Fund's income or reducing expenses. The main element in increasing income would be to raise the rate of charge on the use of the Fund's resources, while the main element of a reduction in expense would come from remuneration expense, i.e., from a reduction in the remuneration coefficient. 1/ Given the assumption in the last review of the Fund's income position for FY 1987 regarding the use of Fund credit and remunerated positions, each SDR 10 million of provisions in addition to the present target amount of net income would require an increase of the rate of charge of five basis points (0.05 percentage point), or a reduction of the remuneration coefficient of approximately 0.75 percentage point (e.g., from 94.99 percent prescribed by Rule I-10(b)(1)(i) for the period starting May 1, 1986 to 94.24 percent), or some combination of an increase in the rate of charge and reduction in the remuneration coefficient. 2/

As indicated above, the different types of provisioning that might be considered have differing effects on the Fund's income position. For example, a provision against total outstanding credit of, say, 0.5 percent (or somewhat below the lower range of provisioning apparently followed by most U.S. commercial banks) would amount to the order of SDR 176 million, or the equivalent of 0.9 percentage point on the rate of charge during one year. Alternatively, a provision allowance established on the basis of a rate of, say, 10 percent of all current overdue payments would amount to SDR 62 million; a provision for individual obligations that are overdue by, say, three years or more, would at present amount to SDR 25 million, though judgment as regards the remaining outstanding credits to such members with overdue obligations would also need to be considered. For example, if remaining loans would also be subject to doubt, it would be possible to provision in successive stages, over a period of, say, five years.

As already indicated, if a loss were no longer considered probable, a provision that had been made with respect to it would be dissolved. If a member had cleared its arrears, including those relating to the doubtful credit, a special provision would normally be dissolved unless other arrears existed and loss was judged probable about the remaining amounts of outstanding credits. The dissolution of general provisions would require a judgment that existing provisions were sufficient to meet probable losses in the light of changed circumstances. The resources that were released by the dissolved provisions would become part of current income, which would at that time allow a lower rate of charge, a higher remuneration coefficient, a faster reserve accumulation than otherwise would be the case, or some combination of these alternative courses of action. Under current procedures, an important consequence of provisioning would be greater instablity in the rate of charge and possibly in the remuneration coefficient because the Fund's income position would be further affected because of changes in the amount of provisioning that would be regarded as necessary or desirable.

1/ It might also be pointed out that the Fund may raise income to meet current expenses of the Fund through other means, such as making investments up to the total of the general and special reserve.

2/ A system of temporary, reversible surcharges, and temporary reversible discounts, has been suggested by the staff for consideration by the Executive Board; see "The Fund's Income Position for FY 1986 and Review of the Remuneration Coefficient" (EBS/86/81, 4/14/86).

IV. Overall Summary and Concluding Remarks

The following summarizes the points made in the analysis presented above, and presents some concluding remarks:

1. The concept of provisioning

(i) Provisioning in financial accounting means the establishment of an allowance to meet a probable loss on an asset or on a class of assets similar in character. The allowance for meeting losses is financed by making a charge against current income, and such an allowance is a cost of conducting business and is, therefore, an expense item.

(ii) Provisioning is intended to ensure a fair and accurate statement of the financial position of an entity (i.e., both its income and its assets), and thereby avoid an overstatement of income and of the equity of an entity, including reserves. Provisioning protects the capital (including equity reserves) of an entity against loss when an asset is written off as a loss is realized.

(iii) Provisioning becomes necessary when it is judged that a loss is probable and the amount of the loss can reasonably be estimated.

(iv) If the size of a loss cannot be estimated, though it is concluded that some loss is probable and the likely outcome is within a range, then at least the amount indicated by the lower end of the range should be provided for.

(v) There are two main methods or provisioning, which are not mutually exclusive. A general provision may be established to meet a risk related to classes of assets with a common characteristic, and when it is impractical to make specific provision because of the relatively large number of small loans being provisioned for. Under this method, the amount to be provided as a loss contingency generally is based on past experience and is determined by establishing a ratio of past losses from bad debts to new credit extended.

(vi) The more usual approach is to establish a special provision to meet an estimated probable loss on specific credits (usually on credits of comparatively large size or which are extended to creditors with unique characteristics).

(vii) Private financial institutions normally make provision against doubtful or bad debts in order to protect their income and equity capital from erosion in the event that losses would be realized. Institutions that do not make provision can experience wide fluctuations in income and, possibly in reserves, if they experience unexpected loss. Prudential requirements established by the supervisory and regulatory authorities may also require provisioning under certain circumstances.

(viii) As indicated in Appendix I, sovereign debt is usually treated separately from other types of debt, and the basis of judging the risks of such loans is generally the assessment of economic and financial factors that bear on the ability of the country to pay, and on the good faith and recent payments performance of the debtor.

(ix) The review of the practices followed by international financial organizations, and presented in Appendix I, shows that except for the International Finance Corporation (IFC), these institutions have not specifically provided against risk of loss or uncollectibility of loans, other than through the accretion of general reserves, largely on the grounds that they do not anticipate incurring losses on their loan portfolios which are composed of sovereign loans or loans guaranteed by their member governments. Nevertheless, though they have not concluded that a loss is probable on any of their overdue obligations, some of them are giving consideration to the issue of provisioning, and may reach the conclusion in the near future that it would be necessary for them to make a provision against doubtful loans. It may be presumed that any action by the Fund on provisioning would exercise considerable influence on their judgment.

2. Provisioning in the context of the Fund

(i) In view of the increasing amount of overdue obligations in the Fund, as well as the rising number of members with overdue payments, some Executive Directors and the FY 1985 External Audit Committee have raised the issue of the need for periodic reviews to consider whether loss provisions for such obligations are necessary.

(ii) Criteria for establishing probability of loss - The Fund has only limited experience of overdue payments and no experience of actual losses on income or principal. However, any change that might be introduced regarding the establishment of provisions would need to be systematically followed in the future, and it would therefore seem necessary to receive guidance from the Executive Board on various elements, including procedural matters, that would enter a judgment that a loan loss was probable.

(iii) Types of risk in Fund lending - While the view might be taken that there is no inherent risk in lending by the Fund to its members because of the intergovernmental, cooperative nature of the institution, the Fund is not judged to be completely free from the risk of loss on credit extended to its members. There appear to be essentially two types of risk the Fund faces: the first is a political risk of repudiation of debt, which would be an indication of unwillingness to repay the Fund, and the second type of risk is of an economic nature which fundamentally reflects a member's view that it is unable to service its obligations to the Fund in full or in part because of its economic and financial circumstances. The likelihood of either or both of these risks needs to be assessed in the light of certain standard criteria judged relevant in the context of the Fund.

(iv) Political risk (unwillingness to pay) - No member with overdue obligations to the Fund has indicated either a formal repudiation of debt to the Fund or unwillingness to discharge its overdue obligations to the Fund. However, while members with overdue obligations have generally indicated their intention to discharge their overdue obligations promptly, such declarations, although important, are of themselves insufficient, and the judgment regarding the probability of loss must be made on the basis of all the available facts bearing on the circumstances of the member.

(v) Economic risk (ability to pay) - An assessment of economic risk might be based on two sets of facts. The first set of facts are those relating to the financial aspects of the member's indebtedness, such as the total amount of external debt, including outstanding debt to the Fund, the volume and distribution of arrears and the order, if any, of debt repayments which may be indicative of the member's priorities in discharging its debt. The second set of facts on which the economic assessment might be based would include a review of a member's economic and financial policies, its willingness to implement a program of economic adjustment, and the extent and likelihood of external support that would be needed and forthcoming in its economic and financial rehabilitation. The absence of an economic program in the face of a deteriorating economic and financial position might be regarded as an indication of the weakening intention by the member to discharge its arrears. However, circumstances may change as regards a member's willingness to institute an adequate economic program, and the possibility of such change needs also to be taken into account.

(vi) Duration of overdue payments - An assessment of the economic and financial positions and policies of a member are not necessarily conclusive in coming to a judgment as to the probability of loss on overdue obligations. However, the longer an obligation has remained overdue the greater the probability of loss may become, particularly in the absence of evidence to the contrary which would lead to a conclusion that payment may be confidently expected. In this regard, it would be possible to establish a presumption for a period of time after which the probability of loss on the overdue obligations would increase to an extent that would call for making provisions unless the presumption is reversed by material evidence that loss is not probable. It would be a matter of judgment whether obligations should be overdue for, say, three years, before making provision.

(vii) Outside opinion - The Fund would also need to weigh fully the judgments reached by the international financial community and the various national supervisory and regulatory authorities in coming to its own judgment as to the probability of loss. The Fund would, of course, need to relate these judgments to its own experience and criteria which are governed by the purposes of the Fund, including its special role in the international monetary system in assisting its members in both adjusting and temporarily financing balance of payments deficits. Such assistance may, on occasion, be essential just at the time other sources of finance would dry up.

(viii) Role of the Fund - In making its assessment as regards the probability of loss on credits extended to members, the Fund also needs to take into account wider considerations that touch on its broad responsibilities and unique functions in the world economy, such as the policies attached to its lending, and its ability to respond to global shortages of conditional and unconditional liquidity and its function as an international lender of last resort. These responsibilities do not relieve the Fund of the duty to come to a judgment whether a loss is probable with respect to credits extended by it, but they could indicate some delay in a decision by the Fund that a loss appears probable until it is satisfied that the problem of overdue obligations is not one of generalized difficulty, for which general action might be needed. In that event, provisioning might be needed at a later stage than at most other financial institutions.

(ix) Overall judgment - When all, or most of the relevant indicators bearing on the probability of loss point in the same direction, it would seem reasonable to conclude that a presumption of loss has been established, unless developments in the international monetary system might indicate a generalized problem, and which would call for action by the Fund in fulfilling its role of safeguarding the global viability of the international monetary system.

(x) Review procedures - The judgment whether there is a need to establish provisions call for periodic reviews of individual members' indebtedness to the Fund, perhaps in addition to reviews that would otherwise be undertaken by the Fund in accordance with its procedures. In this connection, it would be necessary to consider (a) the frequency of the reviews on which the judgment on the probability of loss would need to be made, and (b) whether the Executive Board would have an ongoing involvement in making judgments regarding the probability of loss or whether the Executive Board would agree on broad guidelines and their application would be a matter for Management and staff.

(xi) Type of provisioning - In its consideration of the need for provisioning, the Executive Board would need to make a choice of whether to establish general or specific provisions, or to use a combination of the two. The establishment of a specific provision would involve making a judgment that a loss is probable with respect to the overdue obligations of a particular member. It would be for consideration whether the judgment as to probable loss should apply to all the obligations of the member to the Fund, or only to those obligations that are overdue at the time the judgment is made, or to those obligations that have been overdue for, say, three years or more. A system of specific provisioning does not depend on past experience of bad debts in the Fund nor does it imply a possible systematic or pervasive inability or unwillingness of members to repay the Fund.

(a) General provisioning - Such an approach would provide for a certain amount of provisioning which would be determined as a proportion, say, 0.5 percent of the amount of Fund credit outstanding or, say, 10 percent of the total amount of overdue obligations, or the amount of obligations that are overdue by, say, three years or more. The amount of the provision would be somewhat arbitrary in the sense that there is no past experience to call upon.

(b) Specific provisioning - In order to establish specific provisions for an individual member, it would not appear necessary for the Fund to conclude that loan loss is probable unless a member has already incurred prolonged overdue obligations with the Fund and unless most of the criteria, on which the judgment would be based, would point towards this conclusion.

(xii) Amount of loss - The amount of the provision to be established when it has been determined that a loss is probable will depend in part on whether general or specific provisioning is adopted and also whether the expectation of loss would cover a member's total obligations to the Fund or only that part of the obligations that are overdue or only the obligations that are overdue by, say, two years or more.

(xiii) Cost of provisioning - Provisioning is a cost of conducting business and is, therefore, an item of expense. It would be necessary to consider various options of financing an increase in the Fund's expense bearing in mind the issues relating to burden sharing.

(xiv) Provisioning and reserves - Provisioning against the probability of loss raises an issue regarding the relationship between provisions and the level of the Fund's reserves. If a loss is judged probable a provision must be established, irrespective of the level of reserves or the policy of the institution as regards the accumulation of reserves. It would, therefore, be appropriate for the Fund to review the reserve target, and consider whether an adjustment (upwards or downwards) in the target would be warranted in the light of all relevant circumstances, in the event the Fund adopted provisioning as a contingency against loss.

(xv) Interim action - In the event the Executive Board concludes that it is not possible to come to a judgment regarding the probability of loss, or that it would be appropriate to defer coming to a judgment at this time, consideration may be given to raise the reserve target in view of the rising volume of arrears to the Fund.

The Practice of Provisioning in Financial Organizations

The factors that influence the management of an organization in making judgments regarding the probability of a loss, and hence the possible need to make provision against a loss, are in part associated with the type, nature and purpose of business making the loans; the types of loans actually made and the maturity of the loans; past experience regarding doubtful or bad debts, including the length of time debts have been outstanding; the number of individual loans involved; and the economic and financial data available that bear on the financial position of the borrower. However, such factors have to be looked at within the operational context of the organization, and in particular, within the context of its relation with its clients and its general financial policies. A brief summary of the practices followed by some of the main types of financial institutions would seem helpful in clarifying some of the issues that relate to provisioning by the Fund. But this does not mean that these factors provide, in any way, conclusive guidance for the Fund.

1. Depository institutions

Financial institutions engaged in commercial lending operations have a long standing practice of provisioning for doubtful or bad debts in view of the risks normally associated with commercial lending. Banks and other depository institutions usually establish provisions in anticipation, and usually by quantitative estimation of loan losses, in order to protect their equity capital from erosion. Such institutions recognize that it is preferable to provision over time starting with the first signs of perception of loss, rather than when no further recovery is feasible and the entire loss has to be charged against earnings or reserves in one accounting period. The portion of estimated loan losses that is not covered by effectively realizable collateral is normally provided for by using various techniques of general and specific provisioning or by combining them.

Banks normally establish specific provisions by reviewing individual loans above a certain minimum amount and by ranking them according to risk category as good, substandard, doubtful or loss loans. Specific provisions are then made up to a specified percentage of the loan, amounting to 5 to 20 percent for "substandard loans", 50 percent for "doubtful loans" and 100 percent for "loss category loans." 1/

1/ "Substandard loans" are those loans with well-defined weaknesses that disrupt or jeopardize orderly repayment and that are inadequately protected by the current net worth and paying capacity of the obligor, while "doubtful loans" have the additional characteristic of making complete collection or liquidation improbable based on existing facts, conditions and collateral values. "Loss loans" are considered uncollectible and of such little value that their continuation as a bankable asset is unwarranted. The classification as a "loss loan" does not mean that the asset has absolutely no recovery or salvage value, but it is not considered practical and desirable to defer full loss recognition.

Following the calculation of these specific provisions, a general provision is calculated which represents further estimated losses which relates to that portion of the loan portfolio not covered by specific provisions.

In general, these policies of provisioning reflect a certain quantifiable risk, based in part on past experience, and they broadly relate to risks attached to relatively short to medium-term lending. Furthermore, a process of periodic evaluation and review of provisioning maintains the level of the provisions in accord with the perceived financial risk attached to the loan and the estimated magnitude of loss on the loan portfolio, while allowing losses to be absorbed without abrupt fluctuations in earnings. Typically, commercial banks in the United States allow for loan losses ranging in an amount equivalent to approximately 1-2 percent of loans outstanding, although there are significant fluctuations around this range which depend on portfolio composition (and the degree of quantifiable risk) and the write-off policy of each institution. 1/

In addition to the usual practice reflecting commercial risks, national regulatory or supervisory authorities typically have established additional requirements on banks which are especially aimed at the protection of the depositors and which are geared towards improving the solvency requirements of banks under their supervision. The regulatory requirements range from minimum equity or general reserve requirements to the detailed reporting of nonaccrual loans and recently the establishment of minimum provisions for certain categories of assets. Regulatory prescriptions on provisioning against loss on sovereign debt have increased markedly with the emergence of the debt crisis and the recent problems of some countries to service their government guaranteed debt. Prior to these difficulties, sovereign loans had by and large been considered risk-free as the concept of bankruptcy did not appear applicable to countries; recent events shifted the evaluation of such loans from virtually risk-free to risk-bearing assets and as a consequence certain minimum provisions have been made mandatory against lending to certain countries representing a varying degree of loss risk.

2. Sovereign debt

The regulatory accounting and reporting requirements in relation to sovereign debt vary from country to country, and often the issue of sovereign debt is treated separately from other types of debt because the lender usually has no control over the use of the proceeds received by the borrower and cannot normally monitor such use. The basis of judging the risk of such loans is the assessment of the credit standing of the debtor. The most stringent regulations have been adopted in the

1/ In the United States, where detailed disclosures are required, approximately 1.1 percent of loan principal was on average in 1983 provided against foreign loans by commercial banks. This percentage varied from 0.6 percent to 2 percent in the ten largest banks.

United States in the Sovereign Lending Act, which was passed in connection with the approval of the increase in the quota of the United States under the Eighth General Review. Under the prescriptions of this Act, countries are evaluated by the regulatory authorities and categorized using pre-established criteria. 1/

Classification in a "value impaired" or "loss" category requires provisioning at varying degrees with annual increments.

In the United Kingdom sovereign loans are not separately reported but are included in the balance sheet with other loans and, where appropriate, provision is made for a potential loss but not identified. There are no specific accounting and disclosure requirements or country classifications requiring specified provisions against sovereign risks although certain confidential information has to be provided to the Bank of England. Furthermore, specific provisions for sovereign exposure vary from one bank to another and depend in practice on their general provision policy.

The German Federal Banking Supervisory Authority has supported the effort of banks in setting up substantial country risk provisions. These provisions are not specifically identified as related to individual country debt but are included in the general provisions against loan losses. German banking law allows banks to set up provisions comprising an element of "hidden" reserves without describing this fact. In addition, banking authorities require statutory contingency reserves to be set up for all loans, reflected in the balance sheets among a bank's liabilities.

1/ Countries are classified as "substandard" when one of the following conditions is fulfilled: a country is not complying with its external service obligations as evidenced by arrears, forced restructuring, or rollovers; the country is not in the process of adopting a Fund program or other suitable economic adjustment programs or is not adhering to such a program, or is not able to negotiate or unlikely to succeed in the scheduling of its debts. This classification could deteriorate to a "value impaired" category when one or more of the following would apply and provisioning in varying degrees would start: the country has not fully paid its interest for six months, the country has not complied with Fund programs (and there is no immediate prospect for compliance); the country has not met rescheduling terms for over a year or the country has not shown a definite prospect for an orderly restoration of debt service in the near future. These two classification categories are in addition to a loss category for country debt, when the loan is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. An example would be an outright statement by a country which repudiates obligations to banks, the Fund or other lenders. According to the classification used by the Interagency Country Exposure Review Committee in the United States, sovereign lending to seven countries is classified as value impaired--Bolivia, Liberia, Nicaragua, Peru, Poland, Sudan and Zaire--and is subject to mandatory provisioning varying from 15 to 75 percent in the United States.

Japanese banks are required to establish provisions against specific overseas losses under the guidelines of the Ministry of Finance. These provisions are established against losses on loans to governments and private borrowers in specified problem countries. Periodic reports are required to be submitted to the Ministry of Finance of sovereign loan loss exposure and of specific reserves against them, and approval is required to have a provision allowed as a tax-deductible expense. The provision may be recorded as a charge to income or against retained earnings.

3. Public international financial organizations

To date, the international development banks have not specifically provided against risk of loss or uncollectibility of loans, other than through the accretion of general reserves. The notable exception is the International Finance Corporation which, by the nature of its activity as a partner in financing risk-bearing equity capital ventures, is confronted by risks normally absent in sovereign lending, and from its inception until 1974 followed a policy of allocating all of its net income to a provision called "reserve against losses". The Corporation changed this policy after 1974 when it began directly to charge against income an amount of provision for losses on investments, which was added to the "reserve against losses." The annual charge is based on the Corporation's historical loss experience, the amount of investments in respect of which a significant and relatively permanent decline in value is recognized and the amount of investments in respect of which losses cannot yet be identified.

The IBRD until 1964, allocated specified revenues 1/ directly to a special reserve against loan losses and held invested assets corresponding to this reserve. In addition, from 1951 to 1963, the Bank's net income was allocated automatically to a "supplemental reserve against losses on loans and guarantees", which was part of General Reserves. In 1975, the IBRD incorporated this reserve into the General Reserves, since accounting pronouncements in that year did not allow such an unspecified general business risk reserve to function as a provision account, to which losses could be charged in case of loss. The IBRD has to date, continued to indicate in its latest prospectus and S.E.C. filing that no material loss is expected as a result of payment delays. The staff understands tht the IBRD will soon consider the issue of provisioning in view of its overdue obligations.

1/ The Bank collected loan commissions to be added to the Special Reserve which was to be held in liquid assets and to be used only for the purpose of meeting liabilities on its borrowing and guarantees. This practice was discontinued in July 1961 in respect of subsequent loans.

4. Conclusion

As can be seen from this brief survey, private financial institutions that extend credit to commercial and official borrowers make provision with regard to their loan portfolio in anticipation of incurring some losses on their loans. Public international financial institutions such as the World Bank generally have not made provision for loan losses, largely on the grounds that they do not anticipate incurring a loss on their loan portfolios which is composed of sovereign loans or loans guaranteed by governments. 1/ However, with the increasing incidence of arrears, the IBRD will soon consider the issue of provisioning.

1/ The Notes to the Financial Statements of the IBRD, for example, note:

> It is the policy of the IBRD to place in nonaccrual status all loans made to or guaranteed by a member of the IBRD, if for any such loan interest, other charges or principal is overdue by more than six months, unless the IBRD's management determines that the overdue amount will be collected in the immediate future....
>
> It is not expected that these payment delays will result in any material loss to the IBRD. (IBRD, The World Bank Annual Report 1985, p. 206.)

A similar indication is found in the Notes to the Financial Statements of some of the regional development banks.

1985 EAC Comments to the Managing Director (excerpt)

Overdue financial obligations

We observe that there was a sharp increase in the amount of overdue financial obligations during the second half of FY 1985. The increase was not only in the matter of outstanding overdue obligations but also in respect of the number of countries and period of nonpayment. Deduction from operational income of deferred income relating to overdue charges resulted in a net loss of SDR 30 million in FY 1985 with a corresponding decrease in the reserves. This, coupled with the sharp increase in overdue financial obligations in the recent past, gives rise to the need for periodic reviews to consider whether loss provisions for such obligations are necessary.

Generally accepted accounting principles require that provisions be made when a loss is probable and the amount of loss can reasonably be estimated. Unlike other financial institutions, the Fund extends credit facilities only to sovereign Governments and past experience shows that the obligations were eventually discharged. It is therefore difficult to evaluate the extent of risk to which the Fund may be exposed. The probability of loss cannot, however, be ruled out altogether.

We understand that the Treasurer's Department is in the process of establishing a more comprehensive and structured approach to the evaluation of whether or not a material loss is probable with respect to members with protracted obligations to the Fund. We strongly endorse this effort.

1985 EAC Comments to the Treasurer (excerpt)

Overdue Financial Obligations

We observe that there was a sharp increase in the amount of overdue financial obligations during the second half of FY 1985. The total amount of overdues rose from SDR 138 million in September 1984 to SDR 224 million at the end of April 1985. The increase was not only in the matter of outstanding overdue obligations but also in respect of the number of countries and period of nonpayment.

(a) The overdue position had caused serious concern in the Fund. The Board, after due consideration, has taken certain measures, one of which is the adoption of the accounting practice of deferring the recognition as current income, charges receivable from members that are late by six months or more in discharging their financial obligations to the Fund unless such members have remained current in the payment of their charges. We believe that the application of this policy for FY 1985 was consistent with the generally accepted accounting principle which allows for the deferral of revenue recognition when there is uncertainty regarding the timing of collection. However, we believe that this policy could create some accounting presentation problems in the future. For example, if a member with outstanding obligations five months past due at April 30, 1985 delays in the payment of obligations beyond six months, under the present policy a portion of charges included as income in FY 1986 would be deducted as deferred income in 1986. However, is it logical that a deduction can be made from periodic charges in FY 1986 that do not include the amount being deducted? Accordingly, the Treasurer's Department needs to examine how to properly present,in accordance with generally accepted accounting principles, those amounts recognized as income in one year but because the member continues to be in arrears, are treated as a reduction of income in the succeeding year. The effect of amounts collected in the succeeding year should also be considered in this connection.

Also, there may be a potential conflict in the future between the strict application of the Fund's policy on charges relating to overdue obligations, and the requirements of GAAP. GAAP permits deferral of revenue recognition when there are uncertainties regarding collection. It is possible, however, that in strictly implementing the Board's decision, a deferral of revenue would be made even though, at the time of financial reporting, uncertainties may no longer exist (if material amounts, for example, were deferred as of a reporting date but collected before the report was released).

While we are satisfied that compliance with GAAP has occurred this year, we recommend that consideration be given by the Treasurer's Department to possible future conflicts to assure that the financial statement presentation, while reflecting the Executive Board Decision, will also be in accordance with GAAP.

(b) Deduction from operational income of deferred income relating to overdue charges resulted in a net loss of SDR 30 million in FY 1985 with a corresponding decrease in the reserves. This, coupled with the sharp increase in overdue financial obligations in the recent past, gives rise to the need for periodic reviews to consider whether loss provisions for such obligations are necessary. Although the Fund has so far not concluded that a material loss is probable with respect to these overdue obligations, the present situation indicates that the Fund's exposure to risk has considerably increased.

Generally accepted accounting principles require that provisions be made when a loss is probable and the amount of loss can reasonably be estimated. Unlike other financial institutions, the Fund extends credit facilities only to sovereign Governments and past experience shows that the obligations were eventually discharged. It is therefore difficult to evaluate the extent of risk to which the Fund may be exposed. The probability of loss, cannot, however, be ruled out altogether.

We understand that the Treasurer's Department is in the process of establishing a more comprehensive and structured approach to the evaluation of whether or not a material loss is probable with respect to members with protracted obligations to the Fund. We strongly endorse this effort.

EBS/86/82
Correction 1

CONFIDENTIAL

April 23, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Provisioning Against Loan Losses in the Context of the Fund

The following corrections have been made in EBS/86/82 (4/15/86):

Page 7, footnote 2, line 2: for "EBS/84/211, 3/9/84"
read "EBS/84/46, 3/9/84"

Page 9, footnote 1, line 3: for "EBS/85/149, 6/18/85"
read "EBD/85/149, 6/18/85"

Page 20, paragraph (xii), last line: for "two years or more"
read "three years or more"

Page 22, footnote 1, line 2: for "1.1 percent...in 1983"
read "1.2 percent...in 1984"

last line: for "0.6 percent to 2 percent"
read "0.8 percent to 2.1 percent"

Corrected pages are attached.

Att: (4)

financial obligations by members. 1/ However, the amount of overdue obligations increased markedly since 1983 and the periods during which some members have remained in arrears to the Fund have lengthened considerably. In a number of instances there are no indications that prompt settlement of arrears can confidently be expected. In the face of these developments as regards overdue financial obligations, the Fund has taken a number of measures since late 1984 to encourage and assist members to meet their financial obligations to the Fund on time, and to safeguard the financial position of the Fund against uncertainties.

a. Measures to encourage settlement of overdue obligations

The economic and financial position of those members that are overdue in their obligations to the Fund for periods longer than could reasonably be considered mainly of a technical character is regularly reviewed by the Executive Board in accordance with agreed policies on the treatment of overdue obligations. 2/ Members are urged to discharge these obligations promptly. The Fund does not engage in discussions regarding the use by the member of the Fund's resources if the member has overdue obligations outstanding. Furthermore, the Executive Board reviews a member's overdue obligations in accordance with agreed procedures and this can lead and has led to the Fund declaring a member ineligible to use the general resources of the Fund. Such a declaration is made public by means of a press release issued by the Fund and reported in more detail in the Fund's Annual Report. The Fund's financial statements also contain information on overdue obligations. 3/

1/ It should also be noted that those countries that withdrew from membership and had outstanding financial obligations at the time of their withdrawal (Cuba, Indonesia and Czechoslavakia) settled their obligations in accordance with the terms of their withdrawal. However, a unique situation is presented by Kampuchea. This member began to incur overdue obligations in 1975 and in 1978 the Fund limited the member's right to use the General Resources of the Fund and suspended its right to use SDRs acquired after the date of suspension. In 1979 the Fund reclassified charges due from Kampuchea as deferred credit. In the context of the total amount of credit extended by the Fund, and by itself alone, the amount overdue by Kampuchea might be regarded as not material.

2/ See "Overdue Payments to the Fund - Experience and Procedures" (EBS/84/46, 3/9/84) and successive six-monthly reports to the Executive Board on overdue financial obligations (EBS/84/211, 10/11/84), (EBS/85/73, 3/27/85) and (EBS/85/245, 11/5/85).

3/ The Notes to the Financial Statements of the General Department contain information on the amounts receivable by the General Department of the Fund from members overdue in payments to the Fund for six months or more. The data include both the total amount of charges receivable and repurchases from members that are late by six months or more in discharging financial obligations to the Fund. Notes to the Financial Statements of the Trust Fund report similar information.

While a declaration by the Fund of a member's ineligibility to use the general resources of the Fund might raise issues about the payment performance of the member, it would not be proper to conclude from such a declaration that a loan loss is probable which would call for making provision against a loss. A declaration of ineligibility is, in the view of the staff, one possible indicator that might be taken into account in coming to a judgment on the probability of loss, but, of itself, it is not conclusive. The Fund maintains its relations with a member following a declaration of ineligibility. The Fund reviews a member's overdue position regularly, including the positions of members that have been declared ineligible. These reviews serve, inter alia, to keep the Fund informed on developments in the member's economy, but they also mean that the Fund remains prepared to discuss with and give assistance to the member on the elements of an economic program that the member could institute. Such a program would strengthen its external payments position and enable the member to reduce or eliminate its overdue obligations to the Fund. In this latter regard, the Fund may assist a member in helping to secure external financing from other sources in connection with the possible implementation of a stabilization program. The Fund also maintains close contact with the member through its periodic surveillance of members' economic, financial and exchange rate policies as part of the Article IV consultation process.

By these and related means, the Fund maintains an ongoing dialogue with members with overdue obligations which can be expected to help a member with overdue obligations to adopt measures that will assist it in discharging its overdue financial obligations to the Fund. On balance, it may reasonably be expected that ongoing contact between the member and the Fund would help to reduce to some extent the probability of loss with respect to the overdue obligations of the member. A declaration of ineligibility does not lessen dialogue between the member and the Fund.

b. Measures to protect the Fund's financial position

As regards the measures taken by the Fund to safeguard its financial position in the light of the increasing problem of overdue financial obligations, the Executive Directors will recall that:

(1) In March 1985, the Executive Board decided to exclude from current income unpaid charges due from members that were overdue in meeting financial obligations to the Fund for six months or more; 1/

1/ See "Overdue Financial Obligations to the Fund - Effect on Income and Treatment in Financial Statements" (EBS/84/231, 11/14/84), and "Overdue Financial Obligations to the Fund - Supplementary Notes" (EBS/85/32, 2/5/85).

(2) In June 1985, the Executive Board increased the net income target specified in Rule I-6(4)(a) from 3 percent to 5 percent of reserves at the beginning of a year; 1/

(3) In December 1985, the Fund decided, effective February 1986, to introduce a system of special charges aimed at recovering certain costs arising from overdue payments was introduced; 2/

(4) I December 1985, the Fund also raised the rate of charge on the use of its ordinary resources from 7 percent to 7.87 percent per annum, an amount that was projected to yield sufficient income to enable the Fund to meet its net income target for FY 1986, equivalent to 5 percent of its reserves at the beginning of the financial year. The Fund has also considered a reduction in the remuneration coefficient as a means of sharing the burden of reducing its operational expense as a means of carrying the cost of overdue financial obligations.

These measures, including the income-generating safeguard mechanism for the determination of the rate of charge and net income target under Rule I-6(4), emphasize the importance the Fund attaches to the protection of its overall financial position. These measures, which do not in any formal sense substitute for provisioning in the event of a probable loss on some of its lending, provide for some increased cover against the risk of financial loss, including the risk that repurchases are not made. In particular, the increase in the reserve target has to some extent served a similar purpose as provisioning to meet loan losses though the factors bearing on the size of the increase in the reserve target differ from those bearing on the amount of provisioning.

2. Evaluation of probability of loan losses

As noted earlier, any consideration of the possible need for making provisions by the Fund against repurchases becoming delinquent must be preceded by a judgment whether (i) a loss appears probable and (ii) an estimate of the magnitude of the loss. However, some of the traditional elements that might need to be considered in coming to a judgment whether a loss is probable not only raise a number of issues particular to the Fund but might also tend to increase the difficulty of coming to a view as regards the probability of loss.

The view might be taken that there is no inherent risk in lending by the Fund to its members because of the intergovernmental and cooperative nature of the institution, in which debtors and creditors collaborate to determine Fund policy, and in view of members' obligations

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1/ See "Factors Bearing on the Adequacy of Fund Reserves" (EBS/85/125, 5/14/85) and "Review of Income Position and Related Issues" (EBD/85/149, 6/18/85).

2/ See "Special Charges to Recover Costs and Losses Arising from Members' Overdue Financial Obligations to the Fund - Further Consideration" (EBS/85/242, 10/29/85).

under the Articles of Agreement. While these are arguments that are relevant for judging the risk of loss, they do not mean that the Fund is immune from probable loss. It would seem, that the Fund faces in practice two types of risks in its lending: the first is a political risk that the member will repudiate its indebtedness to the Fund or will indicate an explicit unwillingness to discharge its obligations to the Fund. The second type of risk the Fund faces is of an economic nature which fundamentally reflects a member's view that it is unable to service its obligations to the Fund because of its economic and financial circumstances.

a. Unwillingness to discharge debt

No member with overdue obligations to the Fund has given any indication of either a repudiation or unwillingness to discharge its overdue financial obligations to the Fund. On the contrary, all members with overdue financial obligations to the Fund have stated, though with differing degrees of emphasis, their intention to discharge overdue obligations as soon as circumstances permit. While a negative statement on intentions to repay must be taken at its face value, and would face the Fund with different issues, a difficult issue that arises in connection with any decision to provision is how much weight to give to a member's announced intention to actually discharge its overdue obligations when circumstances permit. The intention to repay must be seriously weighed because it indicates the continuing element of cooperation between the member and the Fund to find a solution to the member's financial difficulties. However, it cannot be regarded as a decisive element in the absence of some specific measure bearing directly on the repayment of debt.

b. Criteria to determine probable loss

The burden of coming to a view whether a loss is probable must depend on facts. Among the more relevant sets of facts would be those relating to the member's financial arrears, its economic performance, its policy actions, especially as they bear on the achievement of a viable balance of payments position in the medium term, the member's priorities in the discharge of arrears, the duration that the obligations have been outstanding as well as its expressed intentions to repay the Fund as soon as circumstances permit.

(1) Financial circumstances

Consideration would need to be given to the total of debt owed by the member and specifically the amount owed to the Fund, the member's record and priorities in discharging its debts as well as the length of time the debt has been outstanding, in particular in relation to the Fund. A member's debt profile and the order in which the debts are discharged, which could indicate the priorities in discharging debt, are generally observable facts, though a firm conclusion may not always be drawn from them as to the probability of loss. An "over-indebted" member

(viii) Role of the Fund - In making its assessment as regards the probability of loss on credits extended to members, the Fund also needs to take into account wider considerations that touch on its broad responsibilities and unique functions in the world economy, such as the policies attached to its lending, and its ability to respond to global shortages of conditional and unconditional liquidity and its function as an international lender of last resort. These responsibilities do not relieve the Fund of the duty to come to a judgment whether a loss is probable with respect to credits extended by it, but they could indicate some delay in a decision by the Fund that a loss appears probable until it is satisfied that the problem of overdue obligations is not one of generalized difficulty, for which general action might be needed. In that event, provisioning might be needed at a later stage than at most other financial institutions.

(ix) Overall judgment - When all, or most of the relevant indicators bearing on the probability of loss point in the same direction, it would seem reasonable to conclude that a presumption of loss has been established, unless developments in the international monetary system might indicate a generalized problem, and which would call for action by the Fund in fulfilling its role of safeguarding the global viability of the international monetary system.

(x) Review procedures - The judgment whether there is a need to establish provisions call for periodic reviews of individual members' indebtedness to the Fund, perhaps in addition to reviews that would otherwise be undertaken by the Fund in accordance with its procedures. In this connection, it would be necessary to consider (a) the frequency of the reviews on which the judgment on the probability of loss would need to be made, and (b) whether the Executive Board would have an ongoing involvement in making judgments regarding the probability of loss or whether the Executive Board would agree on broad guidelines and their application would be a matter for Management and staff.

(xi) Type of provisioning - In its consideration of the need for provisioning, the Executive Board would need to make a choice of whether to establish general or specific provisions, or to use a combination of the two. The establishment of a specific provision would involve making a judgment that a loss is probable with respect to the overdue obligations of a particular member. It would be for consideration whether the judgment as to probable loss should apply to all the obligations of the member to the Fund, or only to those obligations that are overdue at the time the judgment is made, or to those obligations that have been overdue for, say, three years or more. A system of specific provisioning does not depend on past experience of bad debts in the Fund nor does it imply a possible systematic or pervasive inability or unwillingness of members to repay the Fund.

(a) General provisioning - Such an approach would provide for a certain amount of provisioning which would be determined as a proportion, say, 0.5 percent of the amount of Fund credit outstanding or, say, 10 percent of the total amount of overdue obligations, or the amount of obligations that are overdue by, say, three years or more. The amount of the provision would be somewhat arbitrary in the sense that there is no past experience to call upon.

(b) Specific provisioning - In order to establish specific provisions for an individual member, it would not appear necessary for the Fund to conclude that loan loss is probable unless a member has already incurred prolonged overdue obligations with the Fund and unless most of the criteria, on which the judgment would be based, would point towards this conclusion.

(xii) Amount of loss - The amount of the provision to be established when it has been determined that a loss is probable will depend in part on whether general or specific provisioning is adopted and also whether the expectation of loss would cover a member's total obligations to the Fund or only that part of the obligations that are overdue or only the obligations that are overdue by, say, three years or more.

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(xiv) Provisioning and reserves - Provisioning against the probability of loss raises an issue regarding the relationship between provisions and the level of the Fund's reserves. If a loss is judged probable a provision must be established, irrespective of the level of reserves or the policy of the institution as regards the accumulation of reserves. It would, therefore, be appropriate for the Fund to review the reserve target, and consider whether an adjustment (upwards or downwards) in the target would be warranted in the light of all relevant circumstances, in the event the Fund adopted provisioning as a contingency against loss.

(xv) Interim action - In the event the Executive Board concludes that it is not possible to come to a judgment regarding the probability of loss, or that it would be appropriate to defer coming to a judgment at this time, consideration may be given to raise the reserve target in view of the rising volume of arrears to the Fund.

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The factors that influence the management of an organization in making judgments regarding the probability of a loss, and hence the possible need to make provision against a loss, are in part associated with the type, nature and purpose of business making the loans; the types of loans actually made and the maturity of the loans; past experience regarding doubtful or bad debts, including the length of time debts have been outstanding; the number of individual loans involved; and the economic and financial data available that bear on the financial position of the borrower. However, such factors have to be looked at within the operational context of the organization, and in particular, within the context of its relation with its clients and its general financial policies. A brief summary of the practices followed by some of the main types of financial institutions would seem helpful in clarifying some of the issues that relate to provisioning by the Fund. But this does not mean that these factors provide, in any way, conclusive guidance for the Fund.

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Financial institutions engaged in commercial lending operations have a long standing practice of provisioning for doubtful or bad debts in view of the risks normally associated with commercial lending. Banks and other depository institutions usually establish provisions in anticipation, and usually by quantitative estimation of loan losses, in order to protect their equity capital from erosion. Such institutions recognize that it is preferable to provision over time starting with the first signs of perception of loss, rather than when no further recovery is feasible and the entire loss has to be charged against earnings or reserves in one accounting period. The portion of estimated loan losses that is not covered by effectively realizable collateral is normally provided for by using various techniques of general and specific provisioning or by combining them.

Banks normally establish specific provisions by reviewing individual loans above a certain minimum amount and by ranking them according to risk category as good, substandard, doubtful or loss loans. Specific provisions are then made up to a specified percentage of the loan, amounting to 5 to 20 percent for "substandard loans", 50 percent for "doubtful loans" and 100 percent for "loss category loans." 1/

1/ "Substandard loans" are those loans with well-defined weaknesses that disrupt or jeopardize orderly repayment and that are inadequately protected by the current net worth and paying capacity of the obligor, while "doubtful loans" have the additional characteristic of making complete collection or liquidation improbable based on existing facts, conditions and collateral values. "Loss loans" are considered uncollectible and of such little value that their continuation as a bankable asset is unwarranted. The classification as a "loss loan" does not mean that the asset has absolutely no recovery or salvage value, but it is not considered practical and desirable to defer full loss recognition.

Following the calculation of these specific provisions, a general provision is calculated which represents further estimated losses which relates to that portion of the loan portfolio not covered by specific provisions.

In general, these policies of provisioning reflect a certain quantifiable risk, based in part on past experience, and they broadly relate to risks attached to relatively short to medium-term lending. Furthermore, a process of periodic evaluation and review of provisioning maintains the level of the provisions in accord with the perceived financial risk attached to the loan and the estimated magnitude of loss on the loan portfolio, while allowing losses to be absorbed without abrupt fluctuations in earnings. Typically, commercial banks in the United States allow for loan losses ranging in an amount equivalent to approximately 1-2 percent of loans outstanding, although there are significant fluctuations around this range which depend on portfolio composition (and the degree of quantifiable risk) and the write-off policy of each institution. 1/

In addition to the usual practice reflecting commercial risks, national regulatory or supervisory authorities typically have established additional requirements on banks which are especially aimed at the protection of the depositors and which are geared towards improving the solvency requirements of banks under their supervision. The regulatory requirements range from minimum equity or general reserve requirements to the detailed reporting of nonaccrual loans and recently the establishment of minimum provisions for certain categories of assets. Regulatory prescriptions on provisioning against loss on sovereign debt have increased markedly with the emergence of the debt crisis and the recent problems of some countries to service their government guaranteed debt. Prior to these difficulties, sovereign loans had by and large been considered risk-free as the concept of bankruptcy did not appear applicable to countries; recent events shifted the evaluation of such loans from virtually risk-free to risk-bearing assets and as a consequence certain minimum provisions have been made mandatory against lending to certain countries representing a varying degree of loss risk.

2. Sovereign debt

The regulatory accounting and reporting requirements in relation to sovereign debt vary from country to country, and often the issue of sovereign debt is treated separately from other types of debt because the lender usually has no control over the use of the proceeds received by the borrower and cannot normally monitor such use. The basis of judging the risk of such loans is the assessment of the credit standing of the debtor. The most stringent regulations have been adopted in the

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1/ In the United States, where detailed disclosures are required, approximately 1.2 percent of loan principal was on average in 1984 provided against foreign loans by commercial banks. This percentage varied from 0.8 percent to 2.1 percent in the ten largest banks.

Office Memorandum

TO: Mr. Thahane

May 5, 1986

FROM: Leo Van Houtven

SUBJECT: Provisioning Against Losses in the Context of the Fund - Transmittal of Document

As requested, the following document is enclosed for the information of the World Bank Executive Directors: "Provisioning Against Losses in the Context of the Fund" (EBS/86/82 and Correction 1).

cc: Mr. Habermeier

action Reading

CONFIDENTIAL

December 21, 1984

Mr. Qureshi

Moeen,

Re: Nicaragua

Please note that we now have a formal request from the Nicaraguan Minister of Finance (copied to Mr. Stern and Ms. Gonzalez) for loan scheduling and/or acceptance of payments in local currency.

As I understand it, this is designed to set in train the following moves:

- Request by Board for legal opinion regarding reschedulings and other options including review of any precedents. Informally I understand that such a request has already been made by Mr. Mayorga to Mr. Shihata;

- JAC and Board discussion about these options relative to Management's statement that it is the policy of the Bank not to participate in reschedulings. As you know, this "discussion" has already commenced in the JAC;

- Board discussion on how to respond to Nicaragua's request as a test case for the application of the policy options set out in the Articles.

Even if the policy as stated in our borrowing prospectus were to be reconfirmed as the result of these discussions, we are very concerned that protracted, indecisive and devisive discussions on this subject hold substantial danger for our market image and for our borrowing activities.

Therefore it is urgent that Management formulate and agree on its position and on a course of action which is designed to contain the risks that this issue holds for our shareholder relations and market standing. Recent discussions in the JAC would suggest that it is essential that staff know where Management stands on this matter and what marching orders staff are expected to follow.

Heinz Vergin

cc: Mr. Stern
Mr. Rotberg
Mr. Steckhan
Mr. Southworth

HV:di

9

STRICTLY CONFIDENTIAL

December 19, 1984

Messrs. Gillette
Scott
Vergin

Re.: Nicaragua

We have just received a reply from Nicaragua to our suspension and non accrual cables.

The reply reiterates the requests made by Nicaragua at the Annual Meeting (scheduling repayment of arrears for the second half of FY85, with parallel preparation and appraisal by the World Bank of recovery program and project for Board presentation before the end of the fiscal year). In addition, Nicaragua requests loan rescheduling and/or loan repayment in local currency.

Finally, Nicaragua requests a meeting with World Bank representatives to discuss temporary suspension of the World Bank's cable of October 16, and Nicaragua's request for rescheduling and local currency payments.

In conclusion, Nicaragua reaffirms its "great interest to resolve pending problems with the World Bank."

RBS

Rainer B. Steckhan

Attachment

cc. Mr. Mirza

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

For MC Consideration Oct. 23/84
Mr. Clausen E-1227

FIS/MC84-53

CONFIDENTIAL

(1) When stop accruing interest?
(2) When charge off?

2.2

Mike Gillotti

DATE: October 19, 1984

TO: The Managing Committee

FROM: Moeen A. Qureshi, SVPFI MAQ

EXTENSION: 73665

SUBJECT: Nicaragua

1. As you are aware, Nicaragua is currently in arrears on a number of loans, two of which were due June 1, 1984. If we have not received payment by December 1, Nicaragua will pass the threshold established by the Managing Committee of 180 days of arrears, for which a specific analysis of collectability of interest and principal is required. We thus need a recommendation from the Regional Vice President as to the collectibility of loans to Nicaragua by December 1.

2. Following the Managing Committee's last discussion of this subject, a working group under the direction of Mr. Knox was established to develop specific guidelines for regional managers in making determinations as to loan collectibility. This working group is chaired by Peter Scherer with members from the Finance Complex and the Legal Department. Work is still in progress but the general outline is as follows.

3. The region would complete an analysis of the ability of Nicaragua to become current on its obligations to the Bank within a reasonable time frame. The region's analysis would be reviewed by the OPSC and submitted to the Managing Committee for discussion. If, in the judgement of the region, it is not probable that Nicaragua will be able to become current within two years from the original due date (e.g. June 1, 1986), we would put all[1/] loans to Nicaragua on non-accrual status in our December financial statements. The impact would be that (1) we would reduce net income by the amount of accrued interest on loans to Nicaragua, and (2) we would begin recording interest income on the loans to Nicaragua only to the extent of cash payments received from Nicaragua. The effect on reported net income for the second quarter would be a reduction of approximately \$10 million; for the year, the effect would be a reduction of approximately \$16 million, assuming we receive no further payments.

1/ The decision to stop accrual of interest on loans is based on judgment about the probability of collection of interest. There are few cases in which we could legitimately assert that the probability of collection of interest on the specific loans reaching the 180-day trigger is any different than that for the rest of the country's portfolio. Therefore, unless the region can make a case that there are borrowers in the country whose repayment prospects differ from that of the country itself, all loans to a country would be placed on non-accrual status simultaneously.

4. Similarly, if in the judgment of the region, it is not probable that Nicaragua will be able to become current within four years, we would need reserves against the principal. Given the size of total outstanding loans to Nicaragua ($149 million), however, the special reserve of $293 million would be adequate to cover any such provisions for loss. There would, consequently, be no impact on reported net income of a judgment to provide reserves against loans to Nicaragua.

5. Our financial statements for December would include disclosure of the amount of loans outstanding that have been placed on non-accrual status and of the resultant reduction of net income. We would need to take steps to minimize the reaction in the financial markets to the disclosure of our first non-accrual status loans. As soon as a decision is made to place Nicaragua on a non-accrual status, we would inform our underwriters of the impending effects on our December financial statements. We would state that we are continuing to hold discussions with the Nicaraguan government in order to reach a solution, but because of uncertainty as to when Nicaragua will resume debt service, we are being conservative and prudent in placing them on non-accrual. We would also stress the insignificant impact on our net income.

6. While we will proceed as indicated above, I must emphasize to this committee once again the gravity of this unfolding scenario for the Bank. It is hard for me to predict the seriousness of the impact that the first default would have on our credit standing in the financial markets in the current evironment. We would obviously try to do all we can to minimize it. I must once again stress the importance and urgency of our undertaking yet another effort to prevent the Nicaragua case from becoming our first default.

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

R1

398

DATE December 27, 1984

TO Files

FROM Hans C. Hittmair, CTRVP

EXTENSION 61051

SUBJECT Loans to Nicaragua

1. The accounting policy for non-accrual approved by the Managing Committee is to place in non-accrual status all loans made to or guaranteed by a member who has any loan for which the payment of interest or principal is 180 days or two payment periods past due, unless the Regional Vice President requests a waiver of such action, on the basis that collection of all amounts past due is assured in the immediate future.

2. As of December 1, 1984, two of the Bank loans to Nicaragua were two service payments past due. We received a memorandum from Mr. Rainer B. Steckhan dated November 29, 1984, indicating that in the judgment of the region, no waiver was justified for Nicaragua. We also received a memorandum from Mr. Jean De Boeck confirming that the Cashier's Department did not receive any payments from Nicaragua on the loans in question, as of December 3, 1984, the first business day following the December 1, 1984 due date.

3. In accordance with the approved accounting policy, we have placed all loans to Nicaragua in non-accrual status effective December 3, 1984. This means that interest and charges on loans to Nicaragua will be included in the Bank's income only when received in cash, and that interest and charges accrued prior to December 3, 1984 but not yet paid will be deducted from the Bank's net income for the current quarter. As of December 3, 1984, interest and charges accrued but not paid totalled about $8.4 million equivalent, and Nicaragua's overdue service payments totalled approximately $11 million equivalent.

cc: Messrs. Clausen
Stern
Qureshi
Knox
Rotberg
Shihata
Wood
De Boeck
Gillette
Lee
Steckhan
Vergin

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1984 DEC 28 PM 3: 54
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WORLD BANK / INTERNATIONAL FINANCE CORPORATION

R1

OFFICE MEMORANDUM

CONFIDENTIAL

TO: Mr. Moeen Qureshi, SVPFI

DATE: September 10, 1984

FROM: Ernest Stern, SVPOP ES.

SUBJECT: Nicaragua

315

This is to alert you that there is a high probability that, prior to the closing of the accounts on September 30, we will have suspended disbursements to Nicaragua, with no prospects of early resumption of their debt servicing to the Bank.

As you know, as of now almost $ 6.7 million are outstanding in overdues from Nicaragua. Some of these payments are overdue by more than the normal 90 days. We have exceeded the normal deadline because of the sensitivity of the situation and because it has taken time to implement the suggestion that we enlist the support of some of the Contadora countries to exercise their influence on Nicaragua. The reception of these countries to our request was very good and we know that there have been high level contacts between Mexico and Colombia and Nicaragua. Early indications were, so we were told, that payments might be expected in the near term. However, to date no payments have been received. As a final step, Mr. Steckhan is leaving tomorrow for Nicaragua to make one more attempt to obtain the resumption of service payments. However, despite the high level political support we have received from other countries, I would judge that the prospect of obtaining these payments is very slim. By the end of this month, some of these payments will be overdue by more than 120 days.

I want to draw your attention to these developments so that we can consider how to handle this matter in our financial statements.

cc: Mr. Clausen

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