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8/12

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

File
Nicaragua

DATE: August 12, 1992

TO: Mr. A. Karaosmanoglu

FROM: S. Shahid Husain

EXTENSION: 39001

SUBJECT: NICARAGUA: Proposed Debt Reduction Operation under the Debt Reduction Facility for IDA-Only Countries

1. Attached is a Memorandum and Recommendation of the President informing the Executive Directors of the Association's plans to allocate US$25 million under the Debt Reduction Facility for IDA-Only countries. The proposed allocation is higher than the norm of US$10 million due to the extraordinary scale of Nicaragua's indebtedness. Nicaragua is one of the most heavily indebted countries in the world, with total external debt about 6.5 times GDP. The share of commercial bank debt within that total is also very high (about 17% of total). The amount of commercial bank debt that would be treated under this operation (US$1.7 billion) is more than ten times that of the two actual operations under the Facility. The proposed allocation has been discussed and cleared with the concerned departments in Finance, Cofinancing and Legal.

2. The Memorandum and Recommendation of the President also informs the Executive Directors of the Association's plans to make a grant, at this time, of US$750,000 for financing of financial and legal advisors to assist in the preparation of the operation. Though relatively large, this grant would still be less than the US$1 million in expenses incurred in the preparation of the Mozambique operation.

3. I intend to authorize distribution of the Memorandum and Recommendation of the President to the Executive Directors if you agree.

Agreed.
AK.
8/12

Attachment

cc: Mr. S. Sandstrom (o/r), EXC

8/12

THE WORLD BANK/IFC/MIGA

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2. The Memorandum and Recommendation of the President also informs the Executive Directors of the Association's plans to make a grant, at this time, of US$750,000 for financing of financial and legal advisors to assist in the preparation of the operation. Though relatively large, this grant would still be less than the US$1 million in expenses incurred in the preparation of the Mozambique operation.

3. I intend to authorize distribution of the Memorandum and Recommendation of the President to the Executive Directors if you agree.

Attachment

cc: Mr. S. Sandstrom (o/r), EXC

FROM: Vice President and Secretary

NICARAGUA: Allocation of Resources of the Debt Reduction Facility for IDA-Only Countries for a Proposed Debt Reduction Operation
and
Grant from the Facility for Preparation of the Proposed Operation

1. Attached is the President's Memorandum and Recommendation (P-_____-NI) on the allocation of resources of the Debt Reduction Facility for IDA-Only Countries for a Proposed Debt Reduction Operation for Nicaragua and a proposed grant from the Facility to the Republic of Nicaragua for the initial financing of financial and legal advisors for the preparation of the proposed program.

2. A draft Grant Agreement (Preparation of Commercial Debt Reduction Program) between the Republic of Nicaragua and the Association as Trustee of the Debt Reduction Facility for IDA-Only Countries is available on request from the Secretary's Department Documents Office (ext. 80213).

3. Questions on these documents should be referred to Mr. Dennis Flannery (ext. 31226) or Mr. Richard Clifford (ext. 38909).

Distribution:

Executive Directors and Alternates
Office of the President
Executive Vice Presidents, IFC and MIGA
Vice Presidents, Bank, IFC and MIGA
Directors and Department Heads, Bank, IFC and MIGA

'E WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

APPROVED FOR DISTRIBUTION TO THE
BOARD OF EXECUTIVE DIRECTORS

S. Shahid Husain, RVP, LAC

DATE: August 11, 1992

TO: Mr. S. Shahid Husain, LACVP

FROM: Rainer B. Steckhan, Director, LA2 Steckhan

EXTENSION: 38074

SUBJECT: NICARAGUA: Proposed Debt Reduction Operation under the Debt Reduction Facility for IDA-Only Countries

1. I attach for your approval the Memorandum and Recommendation of the President informing the Executive Directors of the Association's plans to allocate up to US$25 million under the Debt Reduction Facility for IDA-Only countries towards the financing of a proposed commercial debt reduction operation and to make a grant, at this time, for the initial financing of financial and legal advisors to assist in the preparation of the operation. Also attached for your approval is the draft Grant Agreement (preparation of Commercial Debt Reduction Program) between Nicaragua and the Association as Trustee of the Facility.

2. Nicaragua meets the conditions for receipt of funds from the Facility. It has a medium-term adjustment program acceptable to the Association. It also has a debt management strategy that will materially enhance the country's growth and development prospects. The strategy includes a program for resolving the commercial bank debt problem, and substantial debt relief from bilateral creditors.

3. Obtaining significant debt relief and regaining access to sources of new funds are the critical elements of Nicaragua's external debt strategy. Renewing relations with the international financial institutions, and obtaining very favorable terms from the Paris Club, Mexico, Venezuela and Colombia are evidence of the success that the Government has had in the past two years. Though the next phase of negotiations with the commercial banks and bilateral creditors in Central America, Argentina and Brazil, and especially the former USSR, promises to be difficult, the potential payoff is significant. Resolving the commercial bank debt will substantially improve creditworthiness, facilitate expanded trade credits, and improve the climate for private investment, particularly from the large Nicaraguan expatriate community. These are fundamental to the Government's goal of a market based, outward oriented economy.

4. Two items, however, are noteworthy in this operation: (i) the use of the Facility for legal and financial advisors and (ii) the size of the proposed allocation. Following the new guidelines for the Facility, we are proposing a grant of up to $750,000 for legal and financial advisors. Little attention has been given to the commercial bank debt by the Government for the better part of a decade, and as a result the legal and financial documentation is in disarray. The consultants will play a key role in analyzing and classifying debt, reviewing options for the Government and assisting in communications with creditors and others, such

as the Paris Club and London Club. One critical issue that needs to be resolved is the precise level of debt: $1.7 billion as claimed by the Government or $2.2 billion as claimed by Bank of America (one of the four agent banks). These first steps must be taken before serious negotiations can take place.

5. The proposed US$25 million allocation from the Facility is well above the maximum assistance of US$10 million contemplated in the initial guidelines for the Facility. These same guidelines indicate, however, that the precise amount of Facility resources to be made available is determined on a case by case basis. We believe that a strong case exists for the proposed allocation of US$25 million due to the unprecedented nature and magnitude of the operation. Even with a discount greater than 90%, the resources that will need to be mobilized for this operation are much greater than previous ones. Nicaragua is one of the most heavily indebted countries in the world (total external debt is about 6.5 times GDP). The share of commercial bank debt within that total is also very high (about 17% of total), and much higher than that of other actual or proposed recipients of the Facility (Mozambique, 7%; Niger, 8%; Guyana, 4%). In absolute terms, the commercial bank debt that would be treated under this operation (US$1.7 billion) is more than ten times that of the two actual operations under the Facility (Mozambique, US$124 million; Niger, US$107 million), each of which was granted the maximum of US$10 million. The US$10 million maximum is also envisaged for other, smaller operations under preparation, i.e. Bolivia, Guyana, and Uganda.

6. For the success of the debt reduction operation, substantial donor support will be required. We expect the proposed allocation to have a catalytic effect among other donors. In previous Consultative Group meetings for Nicaragua, a number of donors (e.g. the Nordic countries, Switzerland) have expressed interest in participating in a commercial bank debt operation. This would largely be in addition to their on-going development assistance programs. Subject to the Executive Directors' approval of the proposed allocations from the Facility, we plan on convening a meeting of potential donors by the end of the year. This will give sufficient time for the legal and financial consultants to initiate their work and the Government to weigh various options for presentation to donors and creditors. It must be noted, however, that at this time there can be no assurance that sufficient donor funding can be mobilized to provide adequate financing for a debt reduction operation. Nevertheless, we believe it is prudent to provide the grant for the advisors. Until this work is completed, it will be difficult to obtain donor commitments.

7. A condition for completion of the proposed operation will be the elimination of a substantial portion of the debt on highly concessional terms (i.e. less than $0.10 per dollar of principal). There are many uncertainties yet to be resolved, given the huge size of the commercial debt, the extensive work that needs to be done by the legal and financial advisors, and the critical need for cofinancing. It is impossible, at this stage, to provide a definitive timetable for the operation, though we hope to conclude it within twelve to eighteen months.

8. Once the proposed operation has been satisfactorily prepared, we will present a staff appraisal report setting out the details of the operation for submission by Management and approval by the Executive Directors.

9. As of July 31, 1992, Nicaragua was current in its payments to the Bank and the Association. The attached draft Grant Agreement has been approved by the Government of Nicaragua.

10. This memorandum and the accompanying documents have been cleared by the Departments concerned.

11. We propose to submit the Memorandum of the President to the Board for approval on a non-objection basis, following which, the required legal and financial advisors would be appointed.

12. If you agree, please initial this memorandum as suggested above.

Attachment

Cleared with and cc: Messrs: Flannery (CFSPS); Duvall (LEGMN); Katz (FRM)

cc: Messrs. LA2 Management Team; Rivera, Sapelli, Clifford, (LA2C2); Lachler (LA2NI)

RLC/mcs

International Development Association
FOR OFFICIAL USE ONLY

IDA/R92-115

FROM: Vice President and Secretary

August 14, 1992

NICARAGUA: Allocation of Resources of the Debt Reduction Facility for IDA-Only Countries for a Proposed Debt Reduction Operation and Grant from the Facility for Preparation of the Proposed Operation

1. Attached is the President's Memorandum on the allocation of resources of the Debt Reduction Facility for IDA-Only Countries for a Proposed Debt Reduction Operation for Nicaragua and a proposed grant from the Facility to the Republic of Nicaragua for the initial financing of financial and legal advisors for the preparation of the proposed program.

2. A draft Grant Agreement (Preparation of Commercial Debt Reduction Program) between the Republic of Nicaragua and the Association as Trustee of the Debt Reduction Facility for IDA-Only Countries is available on request from the Secretary's Department Documents Office (ext. 80213).

3. In the absence of objections (which should be communicated to the Vice President and Secretary or the Deputy Secretary by the close of business on September 2, 1992) the recommendation contained in paragraph 40 of the memorandum will be deemed approved and so recorded in the minutes of a subsequent meeting of the Executive Directors.

4. Questions on these documents should be referred to Mr. Dennis Flannery (ext. 31226) or Mr. Richard Clifford (ext. 38909).

Distribution:

Executive Directors and Alternates
Office of the President
Executive Vice Presidents, IFC and MIGA
Vice Presidents, Bank, IFC and MIGA
Directors and Department Heads, Bank, IFC and MIGA

FROM: The President August 13, 1992

ON THE ALLOCATION OF RESOURCES OF THE DEBT REDUCTION FACILITY FOR IDA-ONLY COUNTRIES FOR A PROPOSED DEBT REDUCTION OPERATION FOR NICARAGUA

AND

A PROPOSED GRANT FROM THE FACILITY TO THE REPUBLIC OF NICARAGUA FOR PREPARATION OF THE PROPOSED OPERATION

I. SUMMARY AND OVERVIEW

1. I submit the following Memorandum and Recommendation for the allocation of up to US$25 million from the Debt Reduction Facility for IDA-Only Countries (the Facility) for a proposed commercial bank debt reduction operation for the Republic of Nicaragua, and for a proposed grant of up to US$750,000 from the Facility to engage financial and legal advisors to assist in the preparation of the proposed operation.

2. The Republic of Nicaragua wishes to reduce substantially its commercial bank debt, as part of its debt management strategy. As of December 31, 1991, total commercial bank debt amounted to approximately US$1.7 billion[1/], which consisted of about US$1.0 billion in principal and US$0.7 billion in past due interest. The Government has requested the Association to provide grant resources from the Facility to support such an operation. Grants from bilateral donors would also be an essential part of the operation, although, to date, only tentative indications of support have been discussed in the context of Consultative Group meetings for Nicaragua.

3. Nicaragua is expected to meet the eligibility criteria set out in the operational guidelines for the Facility.[2/] It has a medium-term adjustment program acceptable to the Association and an external debt strategy that should materially enhance the country's growth and development prospects. It has already received substantial debt relief from official bilateral creditors, e.g. through agreements with its Paris Club creditors on enhanced "Toronto Terms" as well as with the Mexican, Venezuelan and Colombian Governments, and is seeking similar relief from its other bilateral creditors. A comprehensive solution to the commercial bank debt problem as contemplated in this operation is a fundamental part of the Government's overall external debt strategy. With this solution in hand, Nicaragua's creditworthiness would be enhanced significantly, facilitating expanded trade financing, and its investment climate made more attractive to private investors, particularly the large Nicaraguan expatriate community. Both are essential to achieving the Government's goal of a market based, outward oriented economy.

1/ Estimates of the total amount due range up to US$2.2 billion. The initial work of the legal and financial advisors will be directed, in part, towards resolving this discrepancy.

2/ "Operational Guidelines and Procedures for the Use of Resources of the Debt Reduction Facility for IDA-Only Countries" (R89-156, IDA/R89-103, July 13, 1989); "Review of Progress under the Debt Reduction Facility for IDA-Only Countries" (R92-33, IDA/R92-96, March 9, 1992).

4. An allocation of US$25 million is proposed from IBRD's contribution from FY89 net income to the Facility for the operation. The operational guidelines for the Facility state "Facility resources available to any country should not exceed US$10 million unless there are exceptional circumstances providing strong justification for a greater level of support." A US$25 million allocation is essential given the unprecedented nature and magnitude of the proposed operation. Nicaragua is one of the most heavily indebted countries in the world, with a total external debt of about 6.5 times GDP. Given this severe debt overhang, and the size and share of commerical bank debt (17%) within the total external debt, an agreement on highly concessional terms, i.e., less than $0.10 per dollar of principal, will be required to complete the operation. Even with this deep discount, the proposed allocation of US$25 million is essential to ensure that sufficient funds are mobilized to permit a comprehensive solution. The proposed allocation is expected to have a catalytic affect on other donors' resources. At this stage, however, no donor commitments have been made and there is no assurance that sufficient funds can be mobilized to provide adequate financing for the operation. Once the operation has been prepared and determined by staff to be satisfactory, including the availability of sufficient cofinancing resources to support the operation, the Executive Directors will be asked to approve a grant from the Facility to finance the operation on the terms and conditions to be set forth in a Memorandum of the President to the Executive Directors.

5. As to the availability of resources under the Facility, the US$10 million limitation is designed, in part, to ensure that Facility resources would be available for operations in a number of countries. To date, out of the US$100 million contributed to the Facility by the Bank, approximately US$14 million has been disbursed for the completed operations for Niger and Mozambique. Another US$20 million has been allocated for proposed operations in Bolivia and Guyana. An allocation of up to US$25 million for the proposed operation in Nicaragua would leave a balance of US$41 million for operations elsewhere. Management believes this amount to be adequate to finance the remaining operations under preparation.

6. It is further recommended that the Executive Directors approve at this time a grant of up to US$750,000 from the Facility to Nicaragua for the financing of financial and legal advisory services necessary to assist the Government in preparing the proposed operation. Management believes such a grant is appropriate even though there are no assurances from donors at this time that sufficient financing for the operation. Until preparation of the operation has been substantially completed, it is difficult to accurately determine resource requirements and obtain donor commitments. There is a substantial amount of work to be done, due to the virtual absence of any commercial bank relationship or debt service in the past ten years. The advisors would be retained by Nicaragua in accordance with Bank guidelines for the recruitment of consultants.

II. THE ECONOMY

Economic Structure

7. Nicaragua, with 3.86 million inhabitants and a per capita GDP of approximately US$400 in 1991, is one of the poorest countries in Latin America. Economic deterioration has been dramatic in the last 15 years. After a big drop, due to the civil strife that brought the Sandinistas to power in 1978, the GDP deteriorated continuously until, in 1990, it reached its 1965 level. Given the fast population growth during that period (3.4% p.a.), the GDP per capita in 1990 was below its 1950 level.

8. The Sandinista Government that came to power in 1979 increased rapidly government participation in production and trade, gave priority to the social sectors in central government expenditures and practically eliminated the market allocation mechanism in international trade and the financial sector. The fast growth of the public sector's scope and influence resulted in heavy government

deficits, raised price increases to hyper-inflationary levels and increased external debt to levels that were impossible to service.

9. The current Government, which took office in April 1990, inherited a centralized command economy with a small and over-regulated private sector. Market institutions were extremely weak or had completely disappeared after a decade of central planning. International trade was reserved for the State and was mainly in the hands of state trading companies. In 1989, 98% of exports and 56% of imports were carried out by these enterprises, with the remaining foreign trade activities performed by the private sector in an environment characterized by multiple exchange rates and heavy exchange controls. The financial and public utility sectors were completely state-owned, as were the most important enterprises in agriculture, manufacturing and mining. These enterprises worked under soft budgets, directly financed with subsidized credit from the Central Bank. By the most conservative estimates, the State controlled 40% of GDP in production, trade, finance, and public utility services by 1989.

The Economic Reform Process

10. Based on a domestic political consensus and in consultation with the IMF, the Government launched a stabilization program in early March 1991. After establishing a track record, the program was supported by an IMF Stand-By Agreement approved in September 1991. Its main components have been: (i) a 400% devaluation of the Cordoba, followed by a fixed exchange rate policy and adjustment of public sector prices and tariffs; (ii) a restrictive fiscal policy targeted at eliminating domestic financing of the overall public sector deficit; and (iii) restrictive credit policies aimed at reducing inflation to low monthly levels and halting the contraction of international reserves.

11. Nicaragua had observed all the IMF performance criteria for end-March 1992. After corrective price increases in March and April of 1991, inflation has stayed, on average, below one percent per month. The cumulative rate of inflation from January-June 1992 was 1.7%. Net international reserves have been in line with program targets, and gross reserves are now at about 3.6 months of imports. Contrary to initial expectations, GDP declined only slightly in 1991, despite a drought that affected agricultural production. Growth of about 1-2% is now expected for 1992. Foreign aid has played a key role in achieving these positive results by: (i) filling the gap between absorption and production without much pressure on foreign reserves; and (ii) buffering the economic costs and social tensions of the stabilization effort.

12. Fiscal policy has been the key ingredient for achieving the above results. Central Government current expenditures decreased from 46% of GDP in 1990 to 26% of GDP in 1991, and are expected to reach 21% in 1992. The non-financial public sector balance shifted from a deficit of 15% in 1990 to a surplus of about 5% GDP in 1991. A deficit of 1.5% of GDP is projected for 1992, mainly as a result of an increase in capital expenditure on infrastructure. The fiscal adjustment has been achieved mainly by a large reduction (12% of GDP) in defense expenditures, and a recovery (5% of GDP) in tax revenues of the Central Government. Supported by these strong fiscal results, the extremely fast reduction in inflation and the stabilization of the exchange rate, monetary policy has remained largely on track without crowding out private sector credit.

13. As part of a national reconciliation effort begun in late 1990, there was broad consensus on the necessity of launching a structural adjustment program in March 1991 to move Nicaragua toward a competitive market economy. IDA helped the Government prepare the structural adjustment program, and subsequently approved an Economic Recovery Credit (ERC I) in September 1991 (with cofinancing from IDB, Japan, Germany and Switzerland), focussing on trade liberalization and domestic deregulation, financial reform, and fiscal reform.

14. Implementation of the ERC I was successful, and approval for disbursement of the second and final tranche of the ERC I was given in 1992.[3/]. In the trade regime, barriers to private sector entry were eliminated and a liberalization program, including agricultural trade, was implemented. Maximum import protection was reduced to 40% in March 1992. To reduce import protection dispersion, a 10% tariff floor on imports was also instituted in August 1991. In the financial sector, a new Banking Superintendency Law was passed to permit entry to new private banks. Seven private bank entry licenses have been approved and six banks are now in operation. A program for the state banks' restructuring and downsizing, including work force reduction and sale of assets, and the redefinition of the role of state-owned banks has been approved. The Central Bank is also being reorganized and strengthened, with technical assistance from the IMF. In the area of fiscal reform, an overhaul of the tax system was undertaken. Particularly successful has been a recently created "large taxpayers' unit," which now accounts for 70% of all collections. On the expenditure side, substantial reductions in the defense budget have been achieved. The initial phase of a work force reduction program is largely complete, with 12% of the central government employees, approximately 8,500, having opted to participate in the voluntary employment reduction program. Progress in privatization has also been significant; state control of productive activities was reduced to less than 30% of GDP by the end of March 1992. Almost half of the enterprises comprising the holding company for state-owned firms (CORNAP) have now been privatized.

III. MEDIUM TERM OUTLOOK

Agenda for Sustained Economic Growth and Poverty Alleviation

15. Notwithstanding the important improvements in economic performance and policies over the past year, the economy remains fragile and highly vulnerable to external shocks. Capacity to design, implement, and monitor government policies and programs is very limited. Economic growth needs to recover to help improve living standards after seven years of GDP decline. While inflation is presently under control, the fiscal situation is fragile, and the balance of payments is still very weak and highly dependent on exceptional financing.

16. The Government's 1992-95 economic program aims at setting the stage for sustainable growth and advancing toward external viability. The key objectives of the program are: (i) continued strict implementation of the fiscal reforms begun under ERC I; (ii) continued tight credit policy; (iii) a strengthening of external finances through a reduction in the current account deficit and sustained progress in rebuilding international reserves. Central to the implementation of this program will be the development of an economic environment conducive to the growth of domestic savings and investment. Emphasis will also be given to improving the institutions for public sector management, and orienting them to a new role for the state in a market economy. The impact of these changes will lead to greater efficiency in the allocation of public resources and permit the expansion of private sector activity.

17. Financial reform is central to increasing private savings, to enhancing the quality of investment and to fostering prudent monetary and credit policies. The rediscount policy of the Central Bank needs to be streamlined. Rediscounts are the main source of funds to finance economic activities and are still being allocated without established criteria to state-owned banks which show very low loan recovery. The Government is committed to implementing a competitive and transparent rediscount policy, including competitive pricing of resources, strict lending rules to avoid the repetition of past allocation errors, and

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3/ IDA/SecM92-230

giving equal access to resources to the private banks. The Government is also committed to gradually phasing out directed credit to agriculture.

18. The deepening of trade liberalization is a key step that the Government is committed to implement in the 1992-95 period. Nominal import protection will decline to a range of 10-20%. Remaining non-tariff barriers on imports and exports will also be eliminated. Domestic trade will also be further liberalized by privatizing the state-owned agricultural trading agency.

19. To increase private sector participation in the economy and increase its efficiency and flexibility the Government is committed to take a number of measures. First, the Government plans to substantially complete the privatization process by the end of 1993. Second, it is also committed to resolving insecurities on land tenure and assure enforcement of land rights. Lastly, labor market rigidities will be addressed, and clear regulations will be established for natural resources exploitation and private sector participation in public utility services.

20. Poverty, which is pervasive in Nicaragua, is being addressed through a two-pronged strategy. A social investment fund created in 1991 is being used as a transitory mechanism to attack the most urgent poverty problems. Structural reforms in the line ministries are being undertaken to reallocate resources toward preventive health care and primary education as well as to improve the delivery of these services.

21. Assuming stabilization remains on track, growth will originate in the short-term, from the reduction in distortions in production, from an increase in capacity utilization, and from an increase in public investment in physical and social infrastructure. Thereafter, the deepening of structural adjustment, the strengthening of government institutions and technical capabilities, and the rebuilding of market institutions, supported by IDA, IDB, and IMF, would accelerate growth to higher levels. Over the medium-term, this would be supported by increased private investment and an improved quality of overall investment, as total factor productivity rises as a result of structural adjustment policies and institutional strengthening.

22. To sustain these growth rates, higher levels of savings would be required. Foreign savings are expected to play a critical role in financing investment, particularly in the early part of the 1992-95 period. Required savings are expected to come from abroad via grants, concessional credits and substantial debt reduction/rescheduling, and from an increase in public savings. In the short-term the public sector would begin to have a surplus on current account, due to the very strict fiscal policy required to consolidate stabilization, and would thereby generate resources for public investment in infrastructure reconstruction.

External Resource Requirements

23. Substantial debt reduction/rescheduling is essential for medium-term growth. Even after taking account of the achievements in paying arrears to the international financial institutions, and renegotiations with the Paris Club and selected bilateral creditors, the average annual financing gap is projected to be $1.9 billion - about the same size as GDP - over the period 1992-95. With wide ranging debt relief on the part of official creditors, a comprehensive commercial debt solution, and extraordinary support from the Consultative Group (about US$600 million per year) the gap could be reduced to about US$200 million per year during 1993-95 (Table 1).

TABLE 1: NICARAGUA

1992-95 - PROJECTED FINANCING PLAN
(IN MILLIONS OF U.S. DOLLARS)
1992-1995

	1992	1993	1994	1995
Gross financing needs	4124	3344	2137	1761
Resource balance	555	571	554	589
Debt service (accrued)	1364	1090	1558	1133
Public	1270	1026	1493	1066
Private	94	64	65	67
Build-up reserves	15	27	25	39
Clear. of arrears to off. crd.	2190	0	0	0
Clear. of arrears to banks	0	1656	0	0
Sources of financing	821	825	869	905
Private	78	85	98	122
Transfers	15	30	40	60
Loan disbursements	50	30	31	33
Private sector net factor income	13	25	27	29
Bilateral a/	600	610	622	643
Official transfers	403	414	427	442
Loan disbursements	197	196	195	201
Multilateral	143	130	149	140
Financing gap	3303	2519	1268	856
Rescheduling of current payments	895	0	0	0
Possible resched. of current payments b/	0	658	1053	620
Possible commercial bank relief	0	1656	0	0
Resched. of moratorium interest	122	0	0	0
Change in arrears to commercial banks	110	0	0	0
Resched. arrears w/offic. creditors	2170	0	0	0
Residual financing gap	6	205	215	236

Source: IMF balance of payments medium-term scenario with continuous rescheduling (March 1992)

a/ Includes cofinancing of ERC by bilateral creditors in 1992. Estimates for 1993-1995 are based on known commitments, and recent levels of aid, not all of which are formally committed.

b/ Assumes continuous rescheduling of debt to former USSR and East Block, Paris Club, and other Latin America countries.

IDA Support

24. The IDA country strategy supports the development agenda and financing requirements described above through lending, economic and sector work, and institutional support. Emphasis is placed on IDA leadership of the Consultative Group, as a forum for both resource mobilization and monitoring the policy framework. Over the five-year period FY92-96, IDA credits totalling US$285 million are planned (including the ERC of US$110 million already approved), to help deepen the adjustment process, strengthen the private sector, and address both the transitional and structural aspects of poverty. IDA reflow credits of about US$10 million per year are also projected, and grants from the new Institutional Development Fund (IDF) are expected to help strengthen key ministries and public sector functions. Finally, the Resident Mission, opened in Nicaragua in January 1992, would continue to play a major role in strengthening the policy dialogue.

IV. EXTERNAL DEBT SITUATION AND STRATEGY

Structure

25. As of December 31, 1991, Nicaragua's total external debt amounted to US$10.3 billion, of which US$7.2 billion (70%) was owed to bilateral creditors, US$1.0 billion (10%) to multilaterals, about US$1.7 billion (17%) to commercial banks, US$238 million (2%) to suppliers, and US$81 million (1%) to other creditors (Table 2). This external debt burden was 6.5 times the value of GDP and 39 times the value of exports. In comparison, the average debt stock of severely indebted low-income countries was 1.1 times the size of GDP and approximately 4 times their exports. Debt per capita was approximately US$2,635 in 1991 in Nicaragua, compared to an income per capita of about US$400. In 1992 contractual debt service is estimated to amount to US$1.3 billion, about 5 times exports. Contractual interest payments in 1992 amount to about one quarter of GDP and 150% of exports.

TABLE 2: NICARAGUA

TOTAL EXTERNAL PUBLIC DEBT
OUTSTANDING BALANCES BY CREDITOR

(IN MILLIONS OF U.S. DOLLARS)

AS OF DECEMBER 31, 1991

CREDITOR TYPE	OUTSTANDING BALANCE	INTEREST ARREARS a/	TOTAL	STRUCTURE PERCENT OF TOTAL
Multilateral	1,039.4	17.4 b/	1,056.4	10.3
Bilateral	6,509.6	682.0	7,191.6	70.0
- Paris Club	710.0	172.3	882.3	9.0
- Non-Paris Club c/	5,799.6	509.7	6,309.3	61.0
Commercial Banks	1,058.2	653.2	1,711.4	16.6
Suppliers	217.4	20.5	237.9	2.3
Others d/	64.7	16.3	81.0	0.8
TOTAL	8,889.3	1,389.0	10,278.3	100.0

Source: Central Bank of Nicaragua, May 1992

a/ Does not include late interest.

b/ Includes CABEI and OPEC Fund. There are no arrears to IMF, IDB, or Bank/IDA.

c/ Includes 1.1. billion rubles, converted to US dollars at the exchange rate prevailing at the time of the borrowing.

d/ Includes obligations to private insurance companies and mining companies, among others.

Strategy

26. Obtaining significant debt relief and regaining access to sources of new funds are the fundamental elements of the Government's external debt strategy. Its first step upon taking office was to clear arrears

with the IBRD/IDA and the IDB (there were no arrears to the IMF) and thus open the way to new credits. Since then it has followed a multi-pronged approach focussing on: (i) key bilateral donors that would likely provide new sources of funds (Paris Club, selected Latin American creditors); (ii) commercial banks that could support the recovery of private investment; and (iii) other bilateral creditors not likely to provide new funds but which account for a large part of the overhang (e.g. the former USSR).

Multilateral creditors

27. In September 1991, arrears amounting to US$315 million to the IBRD/IDA and the IDB were cleared through a major effort of the Consultative Group. The arrears were cleared in three months using grants from donors, bridge loans and Government funds following an intensive effort on the part of the Government to introduce economic reform. Total IBRD/IDA arrears cleared amounted to US$223 million, about half of which was past due interest.

Bilateral creditors

28. Paris Club (US$710 million excluding debt of the former East Germany of about US$700 million). In December 1991, Nicaragua was the first country to be granted enhanced "Toronto Terms" by the Paris Club. Since then, a bilateral agreement has been signed with the United States, which also agreed to forgive official debt amounting to US$260 million. Sweden, France, Holland, United Kingdom and Spain has also reached bilateral agreements. Other countries, including Norway and Switzerland, have also indicated a willingness to forgive at least a portion of Nicaragua's debts, and the signing of bilateral agreements is expected shortly.

29. Mexico, Venezuela, and Colombia (US$1.3 billion). These countries reached agreement with the Nicaraguan Government for the restructuring of the total amounts due (principal, past due interest and late interest). The eligible debt was exchanged for 40-year zero coupon bonds issued by the United States Treasury, which effectively reduced the outstanding debt to 5% of its face value.[4/] The Mexican and Venezuelan Governments granted a grace period of 6 years for interest payments, after which interest would only be paid if Nicaragua's annual exports reached US$1,400 million calculated at 1990 constant prices. (Exports of goods and services in 1991 were US$268 million.) Once interest payments begin, the interest rate may rise to a ceiling of 6 percent, in line with an export related indicator.

30. Argentina and Brazil (US$158.2 million). Preliminary negotiations have begun, with the Nicaraguan Government proposing a restructuring along the lines agreed with Mexico, Venezuela and Colombia. Brazil has offered a proposal based on restructuring principal with a 30-year zero coupon bond and repaying interest with Brazilian debt purchased in the secondary market, which would be accepted by Brazil at par. Argentina has not made a counter-proposal but is considering freezing debt service obligations for four years.

31. Central America (US$794 million). The Nicaraguan Government has proposed to the Central American Presidents a debt reduction along the lines of that agreed with Venezuela, but negotiations are pending.

4/ Mexico included 50 percent of its eligible debt in this arrangement. The remaining 50 percent is expected to be used to promote Mexican investments in Nicaragua.

32. Former USSR and Eastern Block Countries (US$2.6 billion) The main creditor is the former USSR (US$2.2 billion). In March 1992, the Government met with officials of the Russian Federation to discuss a possible rescheduling. No agreement was reached, but both sides agreed to appoint a technical commission scheduled to meet in August 1992. According to the Government, about eighty percent of the debt is denominated in rubles, but negotiators for the Russian Federation say that many of these agreements have maintenance of value clauses.

33. Other bilateral creditors This diverse group of creditors (e.g. Iran, Libya, India, North Korea) will not likely be future providers of funds. The Government has initiated contact with most of these creditors and requested debt relief along Venezuelan terms.

Commercial Bank Creditors

34. Nicaragua's commercial bank debt dates largely to the late 1970s. Portions of it were restructured in 1980, 1981, 1982 and 1984. American banks accounted for about 60% of debt at the time of the 1980 restructuring, with the remainder spread evenly across Canadian, Japanese, British, Swiss and German banks. The current distribution will not be known until after a review by the legal and financial advisors for the Government.

35. Comprehensive commercial debt relief would provide long-term benefits in the form of enhanced creditworthiness and an improved investment climate. Combined with maintenance of a sound macroeconomic framework, a resurgence of a favorable investment climate, and a wealth of natural resources, the restoration of international commercial bank relations could have a significant impact on private investment flows, particularly from the Nicaraguan expatriate community, and expanded trade finance in the medium term.

V. THE PROPOSED OPERATION

36. The Government wishes to use up to US$25 million from the Facility for a commercial debt reduction of unprecedented nature and magnitude. The total resources that will need to be mobilized from all multilateral and bilateral sources for this operation are much greater than previous ones. In absolute terms, the commercial bank debt that would be treated under this operation (US$1.7 billion of principal and interest arrears) is more than ten times that of the two previous operations (Mozambique, US$124 million; Niger, US$107 million).

37. The proposed operation is envisioned as a multi-donor undertaking with the funds from the Facility having a catalytic role in resource mobilization. In previous Consultative Group meetings, a number of donors (e.g. the Nordic countries, Switzerland) have expressed interest in participating in a commercial bank debt operation, largely in addition to their on-going development assistance programs. These and other potential donors would be approached to assist the Government in putting together the resources necessary to reach a comprehensive solution to the problem. At this time, however, no donor commitments have been made and there is no assurance that sufficient funds can be mobilized to prvide adequate financing for the operation.

38. The Government has not discussed the proposed operation in detail with its commercial creditors. Before it can do so, the Government must engage financial and legal advisors to assist it in verifying the

commitments have been made and there is no assurance that sufficient funds can be mobilized to prvide adequate financing for the operation.

38. The Government has not discussed the proposed operation in detail with its commercial creditors. Before it can do so, the Government must engage financial and legal advisors to assist it in verifying the actual level of claims and subsequently in designing and preparing an operation. The proposed grant from the Facility of up to US$750,000 would provide the financing of such advisors. The grant agreement provides that the qualifications, experience and terms and conditions of employment of such advisors be satisfactory to the Association. The Association's normal procedures will be followed in the selection of advisors.

39. The objective of the operation is to discharge the total amount of eligible debt at a very substantial discount. The speed with which the operation can be concluded will depend in large measure on the difficulties encountered by the legal and financial advisors in sorting out claims that have gone unattended for the better part of a decade and also on securing sufficient cofinancing resources for the operation. Nevertheless, it is hoped that the operation will be completed within eighteen months.

VI. RECOMMENDATION

40. To support the proposed commercial debt reduction operation in Nicaragua, I recommend an allocation of up to US$25 million from the Facility and that the Executive Directors approve an initial grant from the Facility of up to US$750,000 to the Government to provide financing for financial and legal advisors to assist the Government in the preparation of the proposed operation. The eventual grant of $25 million from the Facility for the program will be contingent on:

(a) continued adherence by the Government to its medium-term adjustment program;

(b) the terms of the debt reduction program being satisfactory to the IDA;

(c) agreement by the Government's commercial creditors to extinguish their claims through the program on highly concessional terms; and

(d) availability of sufficient cofinancing resources to support the operation.

41. As and when the details of the proposed operation are known, a staff appraisal report will be prepared seeking the approval of the Executive Directors for a further grant from the Facility to support the implementation of the operation.

Lewis T. Preston
President