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Nicaragua: First and Second Reviews Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver and Modification of Performance Criteria—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Nicaragua

In the context of the first and second reviews under the three-year arrangement under the Poverty Reduction and Growth Facility and request for waiver and modification of performance criteria, the following documents have been released and are included in this package:

- the staff report for the first and second reviews under the three-year arrangement under the Poverty Reduction and Growth Facility and request for waiver and modification of performance criteria, prepared by a staff team of the IMF, following discussions that ended on **May 2, 2003,** with the officials of Nicaragua on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 3, 2003**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **June 18, 2003** updating information on recent developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its June 18, 2003 discussion** of the staff report that completed the review.

- a statement by the Executive Director for Nicaragua.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Nicaragua*
Supplementary Memorandum of Economic and Financial Policies by the authorities of Nicaragua*
Supplementary Technical Memorandum of Understanding by the authorities of Nicaragua*

*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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NICARAGUA

First and Second Reviews Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver and Modification of Performance Criteria

Prepared by the Western Hemisphere Department
(In consultation with other departments)

Approved by Markus Rodlauer and Michael Hadjimichael

June 3, 2003

Discussions. Discussions on issues for the first and second reviews were held in Managua in March and April and at headquarters in February and April. The staff met with President Bolaños; Minister of Finance Montealegre; President of the Central Bank Alonso; Superintendent of Banks and Other Financial Institutions Sacasa; other senior government officials; members of the National Assembly; leaders of the opposition; and representatives of the donor community and NGOs. The staff closely coordinated its work with World Bank and IADB staff.

PRGF. A three-year PRGF arrangement amounting to SDR 97.5 million (75 percent of quota) was approved in principle by the Executive Board on December 4, 2002 (Country Report No. 03/24). Because of the high program risks, the first annual program features quarterly reviews.

Reviews. The first and second reviews were scheduled for March and June 2003, respectively. Because the first review has been delayed (owing to difficulties with the 2003 budget, which have now been resolved), it is proposed to complete it together with the second review. Upon completion of the reviews, two disbursements totaling an amount equivalent to SDR13.93 million would be made available.

Last Board Discussion. In the December 2002 Board meeting, Directors stressed the need to broaden domestic political consensus on the government's economic program. They saw adoption of an appropriate 2003 budget and implementation of a second round of tax reform as key priorities. Directors also urged vigorous implementation of the central bank's asset recovery program, further strengthening of bank supervision, and strict enforcement of prudential regulations.

Staff team. The staff team comprised Marco Piñón (head), Cecilia Mongrut, Oscar Melhado, Monica Perez dos Santos (all WHD) and James Walsh (PDR). The missions were assisted by Luis Breuer, the Fund's resident representative in Nicaragua. Isaias Coelho (FAD) joined the March mission to assist in the design of tax reform, and Mr. Oyarzábal (OED) participated in some of the policy discussions.

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Abbreviations and Acronyms

BCN	Central Bank of Nicaragua
BM	Structural Benchmark
DGA	General Directorate of Customs
DGI	General Directorate of Internal Revenue
ENEL	Nicaraguan Electricity Company
ENITEL	Nicaraguan Telecommunications Company
ESAF	Enhanced Structural Adjustment Facility
FOGADE	Deposit Guarantee Fund
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
HIPC	Enhanced Heavily Indebted Poor Countries Initiative
IDB	Inter-American Development Bank
IMF	International Monetary Fund
LOI	Letter of Intent
MEFP	Memorandum of Economic and Financial Policies
MHCP	Ministry of Finance
NFPS	Nonfinancial Public Sector
NIR	Net International Reserves
PC	Performance Criterion
PCs	Performance Criteria
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
PSIA	Poverty and Social Impact Assessment
SB	Superintendency of Banks and Other Financial Institutions
SMEFP	Supplementary Memorandum of Economic and Financial Policies
TA	Technical Assistance
TMU	Technical Memorandum of Understanding
VAT	General Sales Tax

Executive Summary

Background

Economic performance has been broadly in line with the program. Despite some early setbacks and delays in program implementation, the macroeconomic framework remains intact: growth declined to 1 percent in 2002 and is expected to recover moderately in 2003 (to 3 percent); inflation fell to 4 percent in 2002 and is projected at 6 percent in 2003 (in line with the exchange rate crawl); and the external position has improved somewhat faster than programmed. Performance criteria for end-December 2002 and end-March 2003 have been observed, with two exceptions for which waivers are being proposed.

The program has been implemented in a difficult political situation and against strong resistance from vested interests. Domestic political consensus on key program policies remains weak, partly because of a continuing rift within the ruling Liberal party. Pressures have been intense, in particular, to relax fiscal policy and against the central bank's asset recovery program. While this has forced the authorities to modify some elements of the program, key program objectives have been preserved. Nevertheless, the program continues to face major risks, especially from the domestic political situation.

Policy discussions

The fiscal program has been brought back on track, after some difficulties, in early 2003 (which led to a delay in completing the first review). Intense pressures to raise spending resulted in some increase in budgeted outlays for 2003, but this has now been fully offset by higher taxes. Moreover, a second round of comprehensive tax reforms passed in May will significantly improve the quality of the tax system.

While a start has been made in strengthening the banking sector, significant further work is needed. All banks are reported in compliance with prudential norms, following stepped-up supervision efforts. On-site inspections of all banks are planned for 2003, and the authorities intend to comprehensively upgrade the regulatory framework in line with Basel Core Principles. The authorities have requested an FSAP for 2003.

The central bank's asset recovery plan is being implemented, despite strong opposition from vested interests. An international firm has been hired to carry out the recoveries, and conducted the first auction in late May. Intense pressures forced the government to grant a preferential scheme for coffee-related debts and postpone the auction of small debts, but these accommodations have so far been limited and the overall thrust of the asset recovery program remains intact.

The authorities reaffirmed their commitment to their growth and poverty-reducing strategy presented in the December 2002 PRSP progress report. The implementation and tracking of poverty-reducing programs is being strengthened, and implementation of HIPC completion point triggers is on track (toward reaching the completion point by end-2003).

I. Background and Recent Developments

1. **Soon after taking office in early 2002, the new government of President Bolaños moved to arrest the severe economic deterioration that had taken place during the previous two years.** Faced with a large fiscal deficit and a near balance of payments crisis, the authorities implemented measures to reduce the fiscal deficit, tightened monetary policy, stepped up the enforcement of prudential rules for banks, and took steps to address corruption and governance problems. In particular, the assembly reduced the 2002 expenditure budget and passed tax reform measures, cutting last year's deficit by over 5 percent of GDP compared with 2001. These measures succeeded in stabilizing the official reserves position and laid the groundwork for the comprehensive reform program supported by the PRGF arrangement approved in December 2002.

2. **The adjustment and reform effort has been carried out in a difficult political situation and against strong resistance from vested interests (Box 1).** In addition to the historical divisions between the governing coalition, led by the Liberal Party, and the Sandinista opposition, policy implementation has been complicated by a growing rift within the Liberal party, following government charges of corruption against former President Alemán. As a result, the government does not have a stable voting majority in the assembly. Moreover, the government's reform agenda intrudes on entrenched vested interests (including, for example, delinquent debtors and beneficiaries of tax concessions) whose opposition needs to be overcome.

3. **Nevertheless, a year and a half into its term of office, the government has persevered in implementing the program.** Despite some setbacks and delays in program implementation, the macroeconomic framework remains intact and the broad thrust of the government's reform effort has been maintained. By the same token, the broader domestic consensus that the government had hoped to achieve in support of the program has so far failed to materialize, posing a continuing risk to the program.

4. **Economic developments through the first quarter of 2003 have been broadly in line with the program (Figure 1).** In particular:

- Real GDP growth was 1 percent in 2002, and is expected to recover moderately to 3 percent in 2003 (as assumed in the program). Available indicators of activity in early 2003 are consistent with this outlook; in particular, the construction sector as well as exports (both coffee and noncoffee) have shown early signs of a recovery during the first quarter.

- Inflation declined to 4 percent last year (reflecting weak domestic demand and low import prices), and is projected at 6 percent in 2003 (in line with the exchange rate crawl).

- The external position strengthened, with a marked decline in the current account deficit and higher-than-programmed "augmented NIR" (NIR minus the domestic dollar and dollar-indexed debt of the central bank). In addition to lower imports and higher workers' remittances, the reserve position was helped in late 2002 by official donor support as well

Box 1. Political Situation

Background

Although social conditions improved during the 1990s, Nicaragua remains the second-poorest country in Latin America. About half of the population lives below the poverty line, with 15 percent in extreme poverty (down from 20 percent in 1993). Although most social indicators have improved, progress has been uneven and, for example, only moderate in health.

Nicaragua remains a polarized society with deep political divisions, reflecting decades of armed conflict, weak institutions, and widespread poverty. Despite a peaceful transition to a democratic regime in the early 1990s, the divisions and vested interests of previous epochs persist in today's political landscape.

Property issues have contributed to the domestic debt, fostered social tensions, and affected the investment climate. The *Sandinista*-era confiscations of properties have resulted in the compensation of some former owners with government bonds (amounting to about US$800 million to date), with still-pending claims of around US$600 million. Property issues also arise from conflicting titles issued by different public institutions.

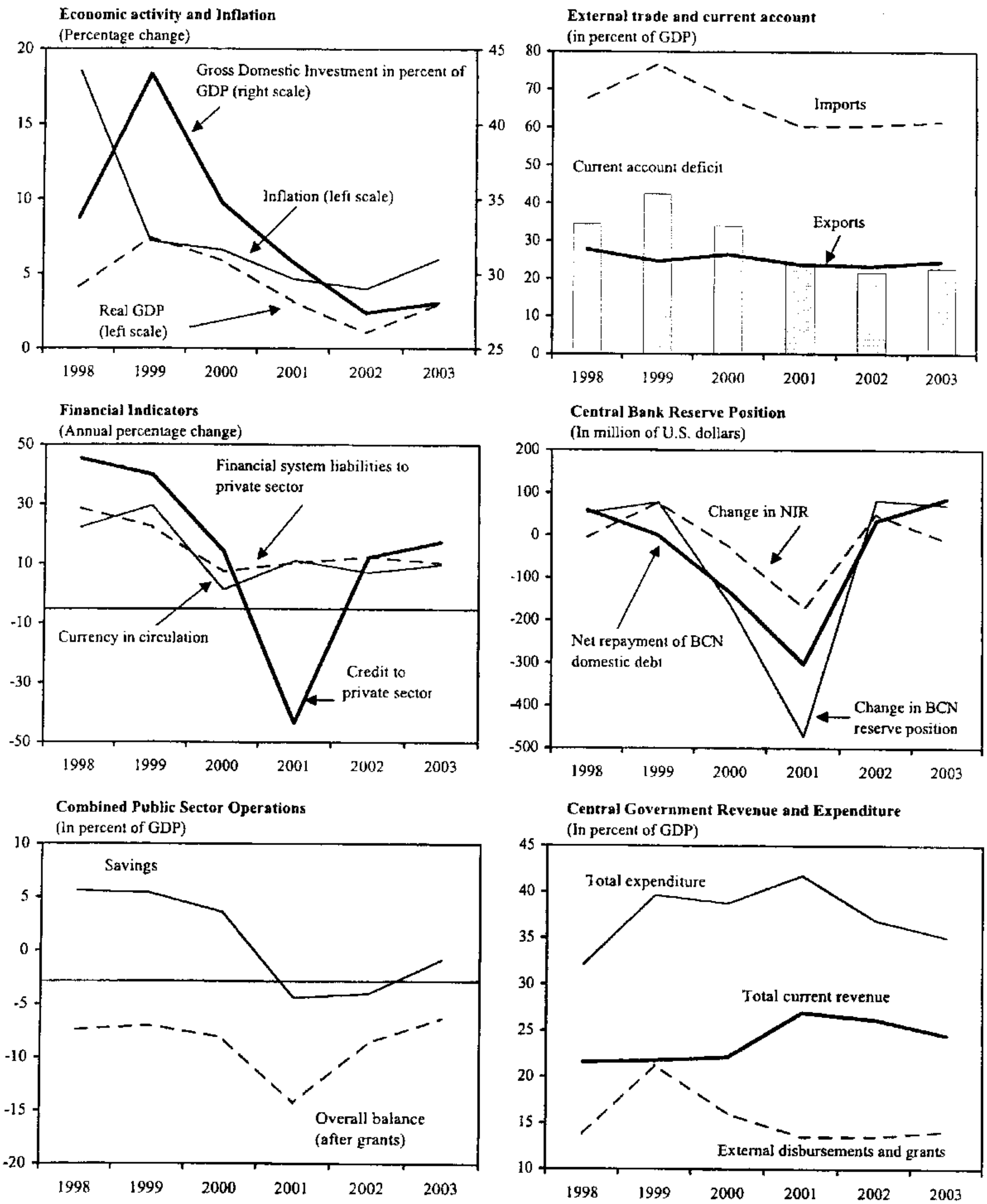
Despite the historical divisions, there has been some movement in political alliances. The country has traditionally been split into two main political camps. The *Sandinistas* control about 40 percent of the electorate (mainly in the urban population). The anti-*Sandinista* coalition, led by the *Partido Liberal Constitucional* (PLC) that helped elect President *Bolaños* in 2001, represents about 55 percent of the electorate (mainly the rural population and business community). However, since the prosecution and subsequent house arrest of former President and PLC leader *Alemán* (on corruption charges), the PLC has split with the majority of its deputies now in opposition to the government.

Governance has been a major problem that has contributed to a lack of trust in public institutions. There is a widespread perception that key public institutions are under the influence of a few and that the large domestic debt (60 percent of GDP) is a result of corruption. There are also significant problems with the rule of law and judicial uncertainty.

Political support for the program

Although broadly supported by the public, mainstream media, and the international community, key program policies are opposed by important constituencies. Focused on fighting corruption and reducing economic imbalances and barriers to growth, the agenda intrudes on major vested interests. Some of these have exerted intense pressures to increase public wages and protect other areas of nonpoverty-reducing outlays (such as relatively high transfers to universities), while others have resisted the central bank asset sales (coffee growers) or the elimination of tax benefits (selected private sector groups). In addition, the split within the ruling *Liberal* party has forced the government to seek alliances for each important measure. This situation poses significant risks for the program, particularly as municipal elections (scheduled for November 2004) approach.

Figure 1. Nicaragua: Main Economic Indicators



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

as private capital inflows and increases in bank deposits following the approval of the PRGF arrangement.[1] In early 2003, however, there were sizable (albeit temporary) shortfalls in foreign loans disbursements (see below), which led the central bank to opt for lower domestic debt reduction (and correspondingly higher reserves accumulation) compared with the program.

- The real effective exchange rate of the cordoba declined by 11 percent in the 12 months to February 2003, mainly as a result of the depreciation of the U.S. dollar (Figure 2).

- Program financing was on track through December 2002, but a sizable temporary shortfall occurred in the first quarter of 2003. Following approval of the PRGF, US$50 million in loans and grants were received from the IDB and bilateral donors. Paris Club creditors granted Nicaragua a rescheduling agreement under Cologne terms. In March 2003, the World Bank approved a new Country Assistance Strategy and a Programmatic Structural Adjustment loan, with annual disbursements of US$15 million. However, two disbursements (totaling US$40 million) programmed for the first quarter were delayed to the second quarter. A Consultative Group meeting is planned for September 2003 in Managua.

- All performance criteria (PCs) for end-December 2002 and end-March 2003 were observed, with two exceptions for which the authorities are requesting waivers. The PC on approval of an appropriate 2003 budget was not observed in December 2002, but a budget that is in line with the program was passed in February 2003. The PC on domestic credit to the government for March was missed by a small margin (US$2 million), owing to the delay in external disbursements, which is expected to be reversed in the second quarter.[2]

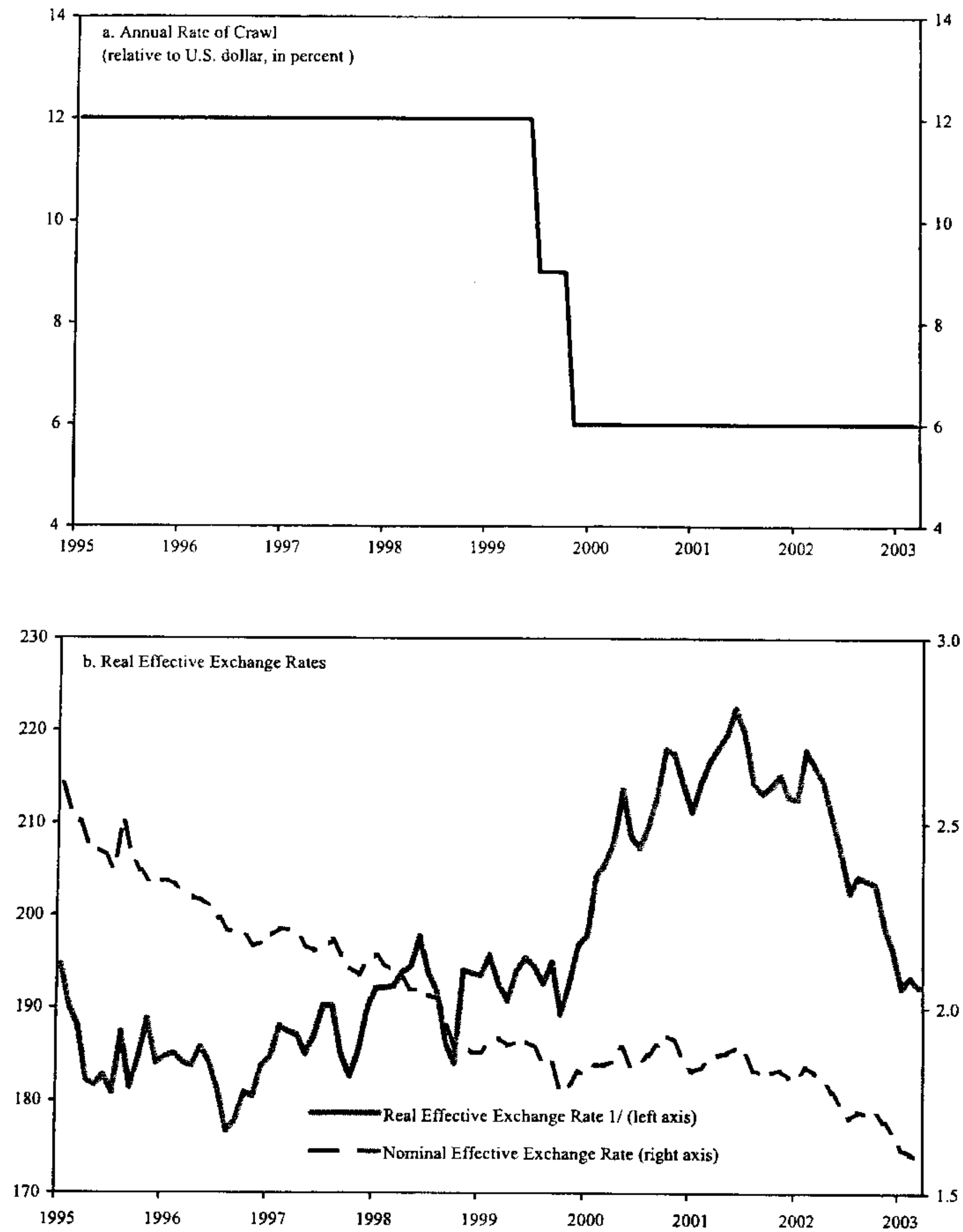
II. Policy Discussions

5. **The discussions focused on the immediate policy challenges (mainly related to the budget and asset recoveries) and how best to keep the program on track amidst the difficult political, social, and economic situation.** Despite the difficulties encountered in implementing the program—and the consequent delay in completing the first review—the authorities explained that they remained fully committed to the program. Successful program implementation, they emphasized, required some flexibility on details while preserving the critical program goals, with continuing efforts to broaden the domestic political consensus on

[1] Part of the reserve increase in late 2002 was because of temporary factors, including an accumulation of excess reserve deposits of commercial banks and a spike of government floating debt (resulting in a lower use of central bank credit) at the end of the year.

[2] The shortfall in external loan disbursements (US$40 million) exceeded the limit provided for the automatic adjuster to the PC (by US$15 million)—see paragraphs 9 and 16 of the Technical Memorandum of Understanding of November 19, 2002 (Country Report No. 03/24; Attachment III).

Figure 2. Nicaragua: Exchange Rate Developments, 1995-2003



Sources: IMF Information Notice System; Fund staff estimates; and Central Bank of Nicaragua.

1/ Trade-weighted index of nominal effective exchange rates deflated by seasonally adjusted relative consumer prices. An increase (decrease) indicates appreciation (depreciation).

reforms. The authorities also noted that some of the most difficult program issues had been faced right at the start (the budget for 2003, tax reform, and asset recoveries) and that once these were addressed, they intended to broaden the agenda to other medium-term issues such as a comprehensive financial sector reform, tax administration, and further trade liberalization.

6. **The macroeconomic framework for 2003 has been broadly maintained, with some strengthening of quantitative program targets to lock in part of the better outcome in recent months.** The main economic objectives for 2003 are as follows:

Selected Economic Indicators

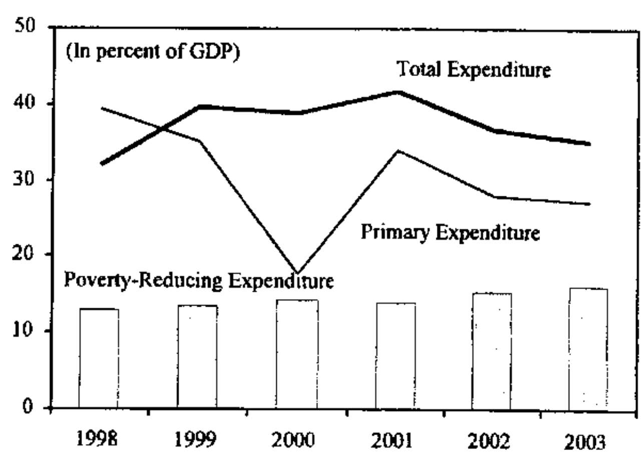
	2002		2003	
	Prog.	Prel.	Prog.	Rev. Prog.
Real GDP growth (in percent)	1.0	1.0	3.0	3.0
Consumer prices (eop)	6.0	4.0	6.0	6.0
External current account balance (in percent of GDP)	-28.2	-27.3	-24.0	-24.4
Gross international reserves (in millions of US$)	355.0	454.0	417.0	449.0
Change in augmented BCN reserve position (in millions of US$)	20.0	82.0	100.0	70.0
Net repayment of BCN debt (+)	33.0	33.0	70.0	85.0
Increase in NIR (+)	-13.0	49.0	30.0	-15.0
Combined public sector deficit after grants (in percent of GDP)	-9.2	-8.6	-6.3	-6.3

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

Fiscal policy

7. **Despite strong pressures to relax fiscal policy, the authorities have maintained the broad thrust of the fiscal program.** The consolidated public sector deficit (after grants) declined from 14.3 percent of GDP in 2001 to 8.6 percent of GDP in 2002. This was 0.6 percent of GDP below the program target, on account of lower spending and higher grants. Poverty-reducing spending, at 15.4 percent of GDP, fell slightly short of the 15.6 percent of GDP target, owing to implementation difficulties, which the authorities are working to address (Figure 3). Performance in the first

Figure 3: Nicaragua: Central Government Expenditure and Poverty-Reducing Spending



quarter of 2003 has remained broadly in line with the program.[3] The fiscal program for 2003 was predicated, in particular, on approval by the assembly of an appropriate budget (a PC for end-December)[4] and a second round of tax reforms to be implemented by midyear (yielding additional revenues of ½ percent of GDP in 2003, or 1 percent of GDP on an annual basis). In the event:

- Soon after the program started, the assembly in mid-December passed a budget with 0.9 percent of GDP higher spending than programmed (mainly for salaries). Following a presidential veto, a revised budget was approved in February that provides for 0.3 percent of GDP higher spending (mainly for salaries in health and education), financed by additional tax measures (on automobiles, cigarettes, and commercial banks)—thereby bringing the deficit back on track.

- In the course of preparing the tax reform, the authorities, in response to social and political pressures, decided to augment and accelerate the implementation of the package in order to finance some additional spending. They explained that this was necessary to reduce social tensions and achieve the required consent of the opposition (given the split in the ruling Liberal party). The staff, consulted closely by the authorities in every phase of the process, emphasized the need to keep the spending increases moderate and focused on anti-poverty and growth enhancing programs.

- The tax reform package approved by the assembly in late April has a net revenue yield of 1.2 percent of GDP in 2003, which covers the additional spending and allows for a net gain of 0.5 percent of GDP, as required under the program (Text table).[5] The tax reform (Box 2) entails a significant improvement in the quality of the tax system, including the elimination of the zero-VAT rate (except for exports),[6] streamlining VAT exemptions, a new minimum corporate income tax, and taxation of interest on bank accounts and

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[3] The deficit before grants was 2.4 percent of annual GDP, 0.2 percent of GDP lower than programmed; the deficit after grants was 1.6 percent of annual GDP, 0.2 percent of GDP higher than programmed owing to delays in HIPC-related grants (made up in the second quarter).

[4] The government had submitted a budget for 2003 in October 2002 that was consistent with the programmed deficit target of 6.3 percent of GDP (a prior action for the PRGF).

[5] This includes a 1.2 percent of GDP revenue yield of the tax reform, increased spending by 0.8 percent of GDP, and an upward 0.1 percent of GDP revision to external grants.

[6] Previously, 53 products were zero-VAT rated. Elimination of zero-rating is important because it closes an important potential leakage in tax administration. While a number of products remain "VAT exempt", this exemption typically applies only to the final stage (in contrast to the complete exemption, including for all inputs, under a "zero-rate"). For eight basic products a limited "quasi-zero-rate" regime is being maintained by exempting most of their inputs.

Box 2. Tax Reform

During 2002–03, Nicaragua has taken important steps to raise revenues and improve the tax system. Prior to the reforms, the system was inefficient and inequitable, difficult to administer, lacked transparency, and relied on few taxes and taxpayers.

A first stage of a tax reform was approved in 2002, with an estimated net annual revenue yield of 2.1 percent of GDP. Key measures included: reducing substantially import tariff exonerations, limiting VAT exemptions, gradually eliminating preferential VAT rates, removing ad-hoc tax exemptions for the financial system, increasing withholding rates on several activities, and enlarging the tax base for excise taxes on beverages. At the same time, however, the assembly also increased the list of zero-rated VAT products from 19 to 53, against the government's proposal to eliminate or reduce the list.

In February 2003, new tax measures were approved to offset a higher-than-programmed spending budget. Specifically, tax rates on automobiles and cigarettes were raised, and a new tax on commercial banks (based on the level of deposits) was approved, with a total revenue yield of 0.3 percent of GDP.

A second stage of tax reform in April 2003 entailed a major overhaul of the system, completing the comprehensive reform initiated in 2002. The program had assumed that the reform would raise additional revenues of 1 percent of GDP on an annual basis (0.5 percent of GDP in 2003). The package approved is estimated to yield 1.7 percent of GDP on an annual basis (1.2 percent of GDP in 2003). A larger-than-programmed package was needed to finance additional spending that was approved by the assembly at the same time. Key tax reform measures include elimination of the VAT zero-rating (except for exports), while allowing eight products to have selected VAT-exempt inputs; creation of a minimum corporate income tax via a 1-percent of assets withholding; limiting accelerated depreciation to exporters; streamlining of VAT exemptions; modification of excise taxes on luxury goods; and taxing interest earned on bank deposits and private sector securities.

Revenue Yield of the Second Stage of the Tax Reform
(In percent of GDP)

	May–December 2003	Annual
Elimination of zero VAT rate	0.35	0.42
Minimum corporate income tax (1 percent of assets[1])	0.27	0.45
Reducing and streamlining VAT exemptions	0.16	0.23
Excise tax on luxury goods	0.09	0.13
Taxing agricultural stock transactions	0.07	0.10
Taxing interest on bank deposits	0.06	0.09
Other measures	0.20	0.32
Total	**1.20**	**1.74**

Source: Ministry of Finance.
[1] In the case of banks, 0.6 percent of deposits.

securities. Implementing regulations have been issued, including a definition of eight basic products[7] for which most inputs will remain VAT-exempt (a prior action for issuing this staff report).

- The additional spending totals 0.8 percent of GDP, with 0.4 percent of GDP in current spending (mostly wages for health workers, teachers, and security forces, and transfers to universities) and 0.4 percent of GDP for investment (about 0.2 percent for poverty-reducing programs). As a result, poverty-reducing outlays are expected to reach 16.1 percent of GDP in 2003, 0.3 percent of GDP higher than originally programmed. The authorities intend to set up a high-level commission to review the quality of public spending and make recommendations on improving further the poverty-reducing and growth-enhancing orientation of the 2004 budget. Creation of the commission with suitable terms of reference is a structural benchmark (BM) for June, and presentation of its recommendations is a BM for September. The authorities are planning to request technical assistance for this commission from the World Bank.

Consolidated Operations of the Public Sector, 2003
(In percent of GDP)

	Program	Approved Budget	After Tax Reform
Total current revenue	32.4	32.7	33.4
Of which			
Second stage of tax reform	0.5	0.5	1.2
February measures		0.3	0.3
Total current expenditure	33.5	33.8	34.2
Combined public sector savings	-1.0	-1.0	-0.8
Capital expenditure and net lending	12.2	12.2	12.6
Grants (including HIPC)	7.0	7.0	7.1
Combined public sector balance (after grants)	6.3	6.3	6.3
Memo item:			
Poverty spending	15.8	15.9	16.1

Sources: Ministry of Finance; and Central Bank of Nicaragua.

8. **The authorities are committed to embark on a comprehensive effort to strengthen tax and customs administration.** They agreed with the staff on the importance of this effort, given the high degree of tax evasion and to derive the full benefits from the just completed tax reform. An action plan will be adopted by September 2003 (BM).

Monetary and exchange rate policies

9. **Monetary policy remains anchored on the crawling peg of the exchange rate.** The authorities intend to maintain the current rate of crawl in 2003 (6 percent). The authorities

[7] Rice, chicken, sugar, eggs, milk, cooking oil, coffee, and soap.

reiterated their view that the crawling peg has been helpful in containing inflation, while recognizing that it is a source of vulnerability especially in combination with the high degree of financial dollarization. They plan to conduct a study of the exchange rate system, in consultation with the staff, during the second half of 2003.

10. **The staff agreed with the authorities that the present stance of monetary policy is consistent with the crawl and the external program targets.** In setting the "augmented NIR" targets for the remainder of 2003, the authorities agreed to preserve part of the overperformance registered since the start of the program.[8] Specifically, the targets for NIR and domestic debt reduction were raised, with higher debt repayments during the rest of 2003 expected to more than make up for the delays in the first quarter. Interest rates have declined in recent months, supported by the fiscal adjustment and improved confidence.[9] The growth of credit to the private sector rose to 17 percent (year-on-year) in February 2003, partly reflecting a low base following a sharp contraction of credit in 2001.

Banking sector and asset recovery

11. **Further efforts to strengthen the banking system and reduce its vulnerabilities will be made in 2003 (Box 3).** The authorities confirmed that all banks complied with the existing regulatory framework as of December 2002, including the key capital adequacy requirements (a small bank that was found nearly insolvent in late 2002 was recapitalized by its owners). Comprehensive on-site inspections of banks will start in 2003, and the staff urged the authorities to implement those inspections rigorously and insist on prompt corrective actions where necessary. The authorities reaffirmed their commitment to improve banking supervision, including through strict enforcement and upgrading prudential norms, where necessary. In particular:

- The legal framework of the banking system will be revised, in line with Basel Core Principles;
- A new norm for liquidity mismatches will be introduced by September 2003;[10]
- The public deposit insurance agency will be strengthened; and

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[8] About half of the US$60 million NIR margin at end-2002 is estimated to reflect a better underlying performance (with the remainder due to the temporary or historically volatile factors noted in footnote 1). Most of this was "locked-in" by raising the NIR targets for June and September 2003 and in setting the targets for December 2003.

[9] Interest rates on one-year dollar-denominated central bank paper (CENIS) have dropped from about 16 percent in November 2002 to below 9 percent in April.

[10] The norm will limit risks derived from maturity mismatches between assets and liabilities. The original date (March 2003) was postponed because of the need to receive TA to address technical problems with the draft norm.

Box 3. Strengthening the Financial Sector

Strengthening the financial sector is a key element of the program. Key objectives in this area are to strictly enforce prudential norms, strengthen the Superintendency of Banks (SB), upgrade the bank resolution process, and strengthen the legal framework in line with Basel Core Principles of Banking Supervision. During 2002, the authorities formally ended regulatory forbearance on nonperforming loans, upgraded asset classification and provisioning norms, and ensured that all banks met the capital adequacy requirement.

In 2003, the SB will take a number of steps to further strengthen supervisory practices. In particular, it will conduct comprehensive on-site inspections of all banks; strictly enforce existing prudential norms; and further strengthen those norms where necessary, including by approving a new norm on liquidity mismatches. In addition, the SB will establish incentives to comply with existing regulations and introduce automatic penalties for not compliance; provide technical training to inspectors, and include Information Technology systems' audits in the inspections.

To strengthen procedures for resolving distressed banks, the public deposit insurance agency (FOGADE) will be modified. A unit will be formed within FOGADE that will be responsible for managing and liquidating the assets of future distressed banks; legislation to this effect is to be submitted to the assembly by September 2003. The new unit should establish: (i) an adequate framework for bank intervention; (ii) regularization plans with time limits, clear objectives, and triggers for intervention for banks with capital deficiencies; and (iii) laws and regulations needed to implement such a framework.

The legal framework of the banking system will be upgraded in line with Basel Core Principles of Banking Supervision. Legislative changes to the banking law and the law of the superintendency are to be submitted to the assembly by September 2003. They will include better legal protection to the Superintendent and supervisors, a more restrictive definition of bank secrecy, and the ability to undertake consolidated supervision.

The authorities have requested an FSAP to comprehensively evaluate the vulnerabilities and development needs of Nicaragua's financial sector. The FSAP is tentatively scheduled to start in the second half of 2003.

- The authorities have requested an FSAP which is tentatively scheduled for the second half of 2003.

12. **The authorities remain committed to the central bank's asset recovery program, despite strong opposition from vested interests.** As anticipated in the program, a contract to carry out asset recoveries was signed with an international firm in December 2002. The plan worked out by the firm was to have a first auction of assets on May 21, 2003, and to finish the entire process by September 2003. The authorities explained that the plan has been subject to major resistance from the affected delinquent debtors, in the form of legal challenges, political pressures, and most recently a (nonbinding) resolution by the assembly calling for postponement and modification of the plan.

13. **The authorities' strategy has been to maintain the thrust of the asset recovery plan, while adapting it where necessary to make it legally robust and sustain minimum political consensus.** In this context, coffee-related debtors (many of which are small coffee growers) were permitted, for a limited time, to repay their debts with government bonds (which can be acquired at a discount in the market). However, in order to minimize moral hazard concerns, the authorities limited the period for such repayment to end in mid-May and did not extend similar concessions to other sectors. In mid-May, the authorities decided to postpone the sale of small loans,[11] originally scheduled for the first auction of May 21, to the second auction in late June. This change allowed the first auction, which included all real estate and large loans, to proceed as scheduled.

Debt management and program financing

14. **The authorities are continuing their efforts to address the vulnerabilities arising from the large domestic and external debt.** A draft law on domestic and external indebtedness of the public sector, which is in line with international best practices, was submitted to the assembly in December 2002, and is expected to be approved in the coming months. On external debt, most Paris Club creditors have offered full debt forgiveness, and the authorities expect to conclude bilateral negotiations with all Paris Club members during 2003. In addition, the authorities are pursuing Paris Club-comparable agreements with non-Paris Club creditors. On the domestic side, to ease the bunching of maturities in 2004,[12] the central bank is working on a program to retire debts (in the secondary market) ahead of maturity. In addition, to facilitate the rollover of remaining maturities and to lower interest costs, the authorities (1) have started discussions with commercial banks (the main holders of central bank paper) on voluntary and market-based refinancing agreements, to lengthen repayment periods and distribute maturities more evenly, and (2) are preparing to launch new debt instruments from mid-2003 that are standardized with those of other Central American countries and should therefore find greater market acceptance.

15. **After some delays in the first quarter of 2003, external program financing is broadly back on track.** In particular, program loan disbursements delayed in the first quarter have been made up in April–May. The main elements of the program financing in 2003 are as follows:

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[11] Representing some 40,000 debtors, or 10 percent of the value of total loans to be auctioned.

[12] Domestic maturities in 2004 total some US$350 million, or close to 80 percent of projected gross reserves at end-2003; maturities during April–December 2003 are about US$170 million, most of them due in the fourth quarter.

Key Elements of Program Financing in 2003
(In millions of U.S. dollars)

	January–March		April–December		2003	
	Prog.	Actual	Prog.	Revised Prog.	Prog.	Revised Prog.
BOP support loans	40	0	35	68	75	68
Untied grants	1	9	27	22	28	31
Privatization receipts	0	0	41	41	41	41
Asset recovery proceeds	0	1	45	44	45	45

Sources: Ministry of Finance; and Central Bank of Nicaragua.

PRSP and HIPC issues

16. **The authorities reaffirmed their commitment to their growth and poverty-reducing strategy presented in the December 2002 PRSP progress report.** They were confident that the poverty-reducing spending levels programmed for 2003 would be achieved, and expected to be able to further improve the implementation of these programs. The authorities emphasized that reaching the HIPC completion point by year-end remains a key objective, noting the progress being made in the implementation of the HIPC completion point triggers (Table 15). A new progress report on the second year of PRSP implementation is expected to be completed in late 2003. In addition, the authorities intend to conduct a Poverty and Social Impact Analysis (PSIA), with assistance from the World Bank, initially covering the areas of tax reform, the proposed free trade agreement with the United States, and the education program.

17. **The tracking and implementation of poverty-reducing programs is being strengthened,** as evidenced by two recent reports on the use of HIPC relief in 2001 and 2002 as well as the approval of supplementary social fund regulations in late 2002.

Other issues

18. **Improving governance remains an overarching priority of the government.** The authorities emphasized their continuing full commitment to fighting corruption and improving transparency, including in the fiscal accounts. In addition, they stressed the importance of judicial reform for strengthening investor confidence, the functioning of markets, and domestic consensus on their economic reform program. Accordingly, they intend to prepare and make public an initial draft of a judicial reform initiative by September 2003, with the aim of launching a national consultation process toward draft legislation that could be submitted to the assembly in 2004.

19. **The authorities expressed their commitment to further trade liberalization.** They saw the initiative for a free-trade agreement between the Central American countries and the United States as crucial to raising Nicaragua's medium-term growth prospects, and hoped that the negotiations could be completed during 2004. The authorities are revising and improving their customs methodology and database, and have requested technical assistance from the Fund in this area. Nicaragua recently eliminated the 35-percent surcharge on imports from Honduras.[13]

20. **New national accounts for 1994–2000 were officially adopted in March 2003** (Box 4). This entailed an upward revision in the average level of GDP in 1994–2000 by about 70 percent. Nevertheless, Nicaragua remains the country with the lowest per capita income in Central America (US$770 in 2000), and thus PRGF/IDA eligible. Preliminary revised estimates for 2001–02 will be finalized by end-June, which should allow incorporation of the revised national accounts into the macroeconomic framework of the program at the next review. The authorities expressed hope that the improved quality of the data and their transparency in presenting the new national accounts would not lead donors to reduce their support to Nicaragua, given the country's large development and social needs.

21. **The authorities will continue to implement the safeguards assessment recommendations**. They confirmed that there were no discrepancies between the central bank balance sheet data for end-2002 and the data reported to the Fund for program purposes on international reserves, and that all overdue loans to the central government had been written off. The authorities committed to identify the differences between International Accounting Standards and the central bank reporting standards (under which the 2002 balance sheet was prepared) and to submit to the assembly a draft amendment of the central bank law to clarify provisions for the removal from office of its board members. Moreover, the central bank will report quarterly on the internal audit department's review of the reconciliation of international reserves.

III. Program Risks and Monitoring

22. **The program remains subject to considerable risks**. The main risk remains political: when the program started late last year, the authorities expected domestic consensus on the program to firm up progressively with the government consolidating its support in the assembly. As noted, however, so far this has not materialized. The staff expressed concern that the unsettled political situation could force the government to compromise on every important legislative initiative, with potentially escalating economic and fiscal costs. The authorities recognized this risk, but noted that the intense public debate in recent months on key elements of the program had served to strengthen public understanding and support of the program. They were hopeful that gradually this would lead to growing support for the government's reform initiatives in the assembly as well. The staff also noted the continuous

[13] The surcharge was introduced in 1999 following a territorial dispute with Honduras. A similar surcharge on imports from Colombia remains in place.

Box 4. The New National Accounts

In March 2003, the central bank officially adopted a new series of national accounts for the period 1994–2000, based on the United Nations System of National Accounts (1993). This represents an important step that enhances the quality and international comparability of Nicaragua's macroeconomic data. The old system used 1980 as the base year and had significant deficiencies in its coverage and estimation methods. Preliminary GDP estimates for 2001 and 2002 will be available by end-June 2003.

The level of GDP during 1994–2000 has been revised upward by about 70 percent, but Nicaragua remains classified as a low-income country. The revision is attributable mainly to a broader coverage of economic activities, changes in estimation methods (such as introducing estimates for nonremunerated income), and the update of relative prices (from 1980 to 1994). While the estimate for per capita GDP in 2000 was raised to US$771 from an earlier estimate of US$478, Nicaragua remains the poorest country in Central America and eligible for World Bank (IDA) concessional lending.

While overall growth estimates for 1994–2000 remained unchanged, the revised GDP series depicts a different structure of the economy (see Table below). Real growth during 1994–2000 averaged 5.2 percent per year. On the supply side, the most significant change is a sharp reduction in the relative importance of the primary sector (from 34 percent of GDP to about 19 percent of GDP) and an increase in the share of the secondary sector (from 22 percent of GDP to 33 percent of GDP). The increase in the contribution of the secondary sector reflects a better coverage of small and medium enterprises, the inclusion of free trade zones, and better estimation methods. A slight increase of the tertiary sector is explained by broader coverage of transport and communication firms and real estate and housing, as well as the inclusion of all regional governments. On the expenditure side, most of the upward revision is explained by higher private consumption and investment (on domestically produced goods), largely as the result of a broader use of surveys. External trade statistics in dollar terms remained broadly unchanged.

Shares to Nominal GDP in 2000 by Sectors and Expenditures
Before and After GDP Revision

Expenditure Side	Before Revision	After Revision	Supply Side	Before Revision	After Revision 1/
	In percent			In percent	
GDP	100.0	100.0	GDP	100.0	100.0
Consumption	111.2	93.4	Primary sector	33.9	18.8
Public	18.6	17.3	*Of which:* Agriculture	25.4	10.6
Private	92.6	76.1	Secondary sector	21.5	33.0
Investment	35.0	33.8	*Of which:* Manufacturing	14.2	22.7
Public	13.6	7.4	Construction	6.2	7.0
Private	21.4	26.4	Tertiary sector	44.6	48.2
Exports	35.8	24.1	*Of which:* General government	8.5	9.7
Imports	82.0	51.4	Transportation and communication	3.3	4.7

Source: Central Bank of Nicaragua.

1/ Based on data provided by the BCN and Fund staff calculations.

efforts of vested interests to obstruct key reforms, such as the asset recovery program. The authorities emphasized the need to remain firm on the overall reform objectives while maintaining flexibility on details to sustain minimum political consensus. This strategy had proven successful with the recent tax reform and the earlier budget debate.

23. **Given the high risks, close monitoring remains essential**. The program continues to feature quarterly reviews for the rest of 2003. Quantitative and structural performance criteria and benchmarks are being proposed through December 2003 as shown in Table 1 of the Supplementary Memorandum of Economic and Financial Policies (SMEFP). Approval of the tax reform and implementing regulations was a prior action for issuance of this staff report. New benchmarks were added related to the commission on the quality of fiscal spending, an action plan to strengthen tax and customs administration, and judicial reform. A summary of structural conditionality under the program is presented in Box 5.

IV. Staff Appraisal

24. **Economic performance has been broadly in line with the program, although policy implementation has been difficult.** The macroeconomic framework for 2003 remains broadly unchanged, with prospects for a moderate recovery of growth, continued low inflation, and a further strengthening in the external position. The fiscal program, after some difficulties that have caused a delay in the first review, is back on track; the key asset recovery plan is proceeding, albeit with some modifications; and a start has been made with banking reforms.

25. **The staff commends the authorities for their determination and commitment to implement the program, but also notes the continued risks from the weak domestic political consensus.** The government does not have a stable voting majority in the assembly, and entrenched vested interests have put up strong resistance to key reforms. The staff commends the authorities for overcoming these obstacles and persevering with their reform agenda. Nevertheless, the unsettled political situation continues to pose major risks to the program, as the government needs to seek alliances for every important reform initiative. The staff urges the authorities to continue to work toward strengthening the domestic consensus on Nicaragua's medium-term growth and poverty reduction strategy and the key policies necessary to achieve its objectives.

26. **Reducing the fiscal deficit while strengthening the poverty-reducing impact of the budget remains at the heart of the program.** The staff welcomes the approval in early 2003 of a budget in line with the program, and supports the recent tax reform package as it will significantly improve the quality of the tax system. While the spending increases associated with both of these measures may have been necessary to secure domestic political consensus, the staff cautions that the room for further such accommodations is extremely limited. The staff also would have preferred the additional spending to be more focused on poverty-reducing and growth-enhancing programs. Further improving the implementation and monitoring of poverty-reducing programs is an important program objective, and the

Box 5. Structural Conditionality

Structural conditionality in the current program. Structural conditionality under the first year of the PRGF Arrangement (2002–03) focuses on (Table 2, SMEFP):

- ***Fiscal consolidation:*** On the revenue side, the tax reform (see Box 2) entails a significant improvement in the quality of the tax system (even though some deficiencies remain). On the expenditure side, a high-level commission is to review and recommend steps to further improve the composition of spending with the aim at increasing its growth enhancing and anti-poverty orientation; and adoption of a public sector restructuring plan aims at increasing efficiency and a permanent reduction in current spending. Privatization will continue and the remaining shares of the telecommunication company will be sold.

- ***Financial system*:** Strengthening the prudential framework and enforcement of existing provisioning and capital requirements are key program elements. Implementation of a plan for regular on-site inspections, setting up of a new unit at the public deposit insurance agency (FOGADE) as well as necessary legal amendments for effective bank supervision (in line with Basel Core Principles) are also envisaged during the first year of the program.

- ***Governance and transparency*:** Successful implementation of a plan for asset recoveries will contribute to the health of the financial system, lessen moral hazard and reduce pressures on public finances. Changes to the legal framework of the banking system will include better protection and safeguard for the superintendent and supervisors. Action plans to strengthen the customs and internal tax agencies are expected to reinforce tax administration. A high-level commission will be established to advise the government on the quality of public spending and further increase its orientation toward poverty reduction and enhancing growth. Judicial reform will support the government's efforts in fighting corruption, strengthen creditor protection and pave the way for foreign investment. The approval of a law on domestic and external indebtedness will signal a commitment to a sustainable debt position over the long term. Adoption of the revised national accounts will allow a better assessment of economic policies and prospects.

Status of structural conditionality from earlier programs. A three-year ESAF arrangement was approved in March 1998. The first and second reviews under the second annual arrangement of the program were completed in December 2000, including waivers for nonobservance of structural performance criteria relating to the approval of the social security reform law and issuance of final bid documents for the public electricity company's generation and distribution units and for 40 percent of the public telecommunication company's assets. By end-2001, those structural reforms were implemented. Discussion on the third annual PRGF could not be completed because of significant policy slippages, particularly in the fiscal area.

Structural areas covered by World Bank and IDB lending. Disbursements of ***World Bank*** program loans are conditioned on strengthening the policy and regulatory environment in the telecommunications sector and rural electricity sector; pension reform to create a more equitable and sustainable system of old-age income security for workers; reforming the public sector management system and civil service; improving the efficiency and soundness of financial intermediaries that serve small productive units in rural and peri-urban areas, and strengthening the Superintendency of Banks; strengthening rural municipalities; addressing constraints to private sector development; developing human capital; reviving agriculture and strengthening natural resource management; rehabilitating road infrastructure and improving the road maintenance system; improving land administration and strengthening land rights; supporting the social safety net and combating rural poverty; and improving protection from natural disasters. ***IDB*** lending operations support strengthening of the financial system, the General Comptroller and the judicial system; pension reform; credit to small enterprises and rural cooperatives; reform of the electricity sector; rural productive reactivation; decentralization and transportation infrastructure; social protection, focusing on child care; water supply modernization; health and education reforms; and improvement in transparency and control of government procurement.

Other relevant structural conditions. Seven floating HIPC completion point conditions are set out in Table 15. Additionally, the government has submitted to the assembly legislation on a new judicial career system.

staff welcomes the establishment of a high-level commission on the quality of fiscal spending and looks forward to its recommendations. After completing the tax reform, the authorities should now focus on strengthening tax and customs administration, and the staff urges early formulation of an action plan as envisaged under the program. Another important priority in the coming months will be the preparation of the 2004 budget in line with the authorities' medium-term program of fiscal consolidation.

27. **Monetary policy remains anchored on the crawling peg of the exchange rate.** The staff considers the present stance of monetary policy as appropriate, and welcomes the proposed modification of performance criteria for June and September that aims at consolidating the recent good performance under the financial program as indicated in Table 2 of the SMEFP. The staff looks forward to the planned study of the exchange rate system and urges the authorities to consider carefully the vulnerabilities associated with the crawling peg, especially given the high level of financial dollarization.

28. **While progress has been made, much work remains to be done in strengthening the financial sector.** The staff commends the authorities for tightening bank supervision since last year, and urges continued rigorous implementation of all existing prudential norms. In particular, on-site inspections should be carried out for all banks as planned this year, and followed up with appropriate prompt corrective actions where necessary. The staff looks forward to the planned revamp of the legal framework for banking in Nicaragua to bring it fully in line with Basel Core Principles. The forthcoming FSAP will be a welcome opportunity to take stock of the situation in the financial sector after the major changes of recent years and to identify remaining vulnerabilities and key developments needs.

29. **The staff strongly urges the authorities to complete the asset recovery plan as programmed.** It is an essential part of the program, both for its financing and as a crucial step to address governance problems and moral hazard in the banking system. The staff regrets that the plan had to be modified by easing terms for coffee-related debtors and by delaying the auction of small loans. It is now crucial that the plan go forward without further significant changes.

30. **The new national accounts published recently are a major improvement in Nicaragua's economic statistics.** The staff encourages the authorities to complete the accounts for 2001–02 as soon as possible, which will allow the program to be re-based on the revised estimates. The staff urges continued efforts to address the remaining data deficiencies, in particular in the areas of monetary and balance of payments statistics.

31. **Close monitoring remains essential given the program risks.** The authorities deserve to be commended for their continuous and close consultation with the staff on all important policy issues. The structure of program monitoring, including quarterly reviews, performance criteria, benchmarks and prior actions, has proven adequate and will continue at least through the rest of 2003.

32. **Based on the overall satisfactory performance to date and the authorities' continued commitment to the program, the staff recommends completion of the first and second reviews.** Economic developments have been in line with or somewhat better than programmed. Although the domestic political consensus remains weak, the authorities have shown determination in implementing the program and have found ways to build alliances, even if fragile ones that allowed them to press ahead with key measures and reforms. Thus, the staff also supports the authorities' requests for two waivers (paragraph 4 of this report) and modifications of PCs to strengthen the financial program for the rest of 2003 (Table 4 of SMEFP).

Table 1. Nicaragua: Selected Economic and Financial Indicators

	1999	2000	2001	2002 Prog. 1/	2002 Prel.	2003 Prog. 1/	2003 Rev. prog.
(Annual percentage change; unless otherwise indicated)							
National income, prices, and unemployment							
GDP at constant prices	7.4	5.9	3.2	1.0	1.0	3.0	3.0
Consumer prices (end of period) 2/	7.2	6.6	4.7	6.0	4.0	6.0	6.0
Consumer prices (period average) 2/	11.2	7.4	7.4	4.4	4.0	6.0	5.9
Unemployment rate (percent)	10.7	9.9	10.5	...	...	...	...
External sector							
Exports, f.o.b.	-4.9	18.3	-8.1	1.0	1.9	10.8	9.4
Export volume	3.2	15.1	7.3	1.1	4.3	5.5	6.1
Imports, f.o.b.	21.6	-3.0	-1.1	-4.2	-4.6	2.4	4.0
Import volume	18.3	-9.7	3.1	-4.7	-4.7	1.0	1.6
Terms of trade (deterioration -)	-12.5	-4.0	-11.2	-0.6	-2.8	3.0	0.8
Nominal effective exchange rate end of period (depreciation -)	-2.7	2.1	-2.9	...	-8.1	...	...
Real effective exchange rate end of period (depreciation -)	1.6	8.8	-0.6	...	-7.9	...	...
Money and credit							
Net domestic assets of the central bank 3/	-39.3	22.7	141.7	16.6	-28.5	-12.0	20.6
Net credit to nonfinancial public sector 3/	-75.6	-36.2	161.7	-40.7	-68.2	-81.7	-78.7
Net credit to financial institutions 3/	-2.6	95.4	-54.0	-19.8	-35.8	-16.3	-1.8
Currency in circulation	29.5	1.2	11.1	7.0	7.0	9.7	9.7
Financial system liabilities to private sector	22.4	7.3	7.2	7.1	13.6	9.8	10.3
Financial system credit to private sector 4/	40.0	14.2	-43.5	15.0	12.2	19.7	17.4
Money income velocity (GDP/M3)	1.5	1.6	1.7	1.7	1.6	1.7	1.6
Interest rate on deposits (percent per annum) 5/	11.5	11.2	10.5	...	6.9	...	...
(In percent of GDP)							
Public sector 6/							
Combined public sector saving 7/	5.4	3.6	-4.4	-4.2	-4.0	-1.0	-0.8
Combined public sector primary balance (before grants) 7/	-10.1	-10.0	-11.9	-5.3	-5.1	-2.8	-2.9
Combined public sector overall balance (before grants) 8/	-15.7	-15.4	-21.0	-16.5	-16.4	-13.2	-13.4
Combined public sector overall balance (after grants) 7/ 8/	-7.0	-8.1	-14.3	-9.2	-8.6	-6.3	-6.3
Nonfinancial public sector saving	7.1	5.1	-2.4	-1.1	-0.9	2.2	2.4
Nonfinancial public sector overall balance (before grants)	-14.1	-13.9	-19.0	-13.5	-13.3	-10.0	-10.2
Central bank operational results (deficit -)	-1.7	-1.5	-2.0	-3.1	-3.0	-3.2	-3.2
Savings and investment							
Gross domestic investment	43.3	34.7	30.8	27.3	27.4	27.8	28.1
Public	21.1	18.9	16.2	12.3	12.4	12.2	12.6
Private	22.2	15.8	14.6	15.0	15.0	15.6	15.4
National savings	1.4	2.6	-2.7	-1.2	-0.3	3.0	3.0
Public	5.4	3.6	-4.4	-4.2	-4.0	-1.0	-0.8
Private	-4.0	-1.0	1.7	3.0	3.7	4.0	3.8
External savings 9/	41.9	32.1	33.5	28.5	27.7	24.8	25.1
External sector							
External current account balance	-47.7	-38.3	-38.1	-28.2	-27.3	-24.0	-24.4
(Excluding interest obligations)	-37.5	-27.7	-25.7	-26.0	-22.3	-18.7	-19.4
Trade balance (deficit -)	-52.1	-41.2	-40.7	-37.4	-37.0	-35.1	-35.9
Outstanding external public debt (end of year) 10/	289.0	278.0	250.3	184.5	247.4	128.8	132.3
(In percent of exports of goods and nonfactor services)							
Contractual interest obligations, before debt relief	47.1	45.3	38.5	43.4	45.1	33.1	34.6
Gross international reserves (in months of imports)	3.3	3.2	2.3	2.2	2.8	2.5	2.6

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

1/ As stated in EBS/02/194 (11/20/2002).

2/ For 2000, staff estimates using the new consumer price index adopted in 2001.

3/ In relation to currency in circulation at the beginning of the year.

4/ Excludes credit held by liquidation boards.

5/ Six-month deposits, end of period.

6/ From 2001 onward, the interest cost of bank resolution on accrual basis is included in the central government operations.

7/ Includes central bank operational balance.

8/ For 2001–03 HIPC interim debt relief from multilaterals is recorded as grants.

9/ External current account deficit, excluding interest on debt to bilateral creditors that is eligible for debt rescheduling on terms comparable to those of the Paris Club.

10/ For 2002–03, preliminary projections based on aggregate data.

Table 2. Nicaragua: Consolidated Operations of the Public Sector

(In percent of GDP)

		2002		2003 1/	
	2001	Prog. 2/	Prel.	Prog 2/	Rev prog.
Total current revenue	**30.8**	**31.7**	**31.6**	**32.4**	**33.4**
Current revenue of the general government	30.3	31.3	31.3	32.0	33.1
Operational surplus of public utilities	0.5	0.4	0.3	0.4	0.3
Total current expenditure	**35.2**	**35.9**	**35.6**	**33.5**	**34.2**
Consumption and transfers	25.5	23.9	23.6	22.4	23.1
Nonfinancial public sector interest payments 3/	7.7	8.9	8.9	7.8	7.8
Central bank operating deficit	2.0	3.1	3.0	3.2	3.2
Combined public sector savings	**-4.4**	**-4.2**	**-4.0**	**-1.0**	**-0.8**
Excluding interest payments	4.6	7.0	7.3	9.4	9.7
Capital expenditure and net lending (net of capital revenue)	**16.6**	**12.3**	**12.4**	**12.2**	**12.6**
Combined public sector primary balance (before grants)	**-11.9**	**-5.3**	**-5.1**	**-2.8**	**-2.9**
Combined public sector balance (before grants)	**-21.0**	**-16.5**	**-16.4**	**-13.2**	**-13.4**
Grants	**6.7**	**7.3**	**7.7**	**7.0**	**7.1**
Interim debt relief: HIPC 4/	1.9	3.2	3.1	2.9	2.9
Other 5/	4.8	4.1	4.6	4.1	4.2
Combined public sector balance (after grants)	**-14.3**	**-9.2**	**-8.6**	**-6.3**	**-6.3**
Financing	**14.3**	**9.2**	**8.6**	**6.3**	**6.3**
Privatization and external financing, net 4/	7.4	7.3	7.2	9.0	9.0
Domestic financing, net	6.8	1.9	1.4	-2.7	-2.6
Of which : central bank	8.5	-2.7	-4.1	-4.7	-4.6
Memorandum items:					
Total expenditure of the combined public sector	51.8	48.2	48.0	45.7	46.8
Total interest of the combined public sector	9.0	11.2	11.2	10.5	10.5
Total primary expenditure	42.7	37.0	36.8	35.2	36.3
Total primary current expenditure	26.2	24.6	24.4	23.0	23.7
Total poverty-reducing expenditure 6/	14.1	15.6	15.4	15.8	16.1
GDP (in millions of cordobas)	34,242	36,646	36,646	40,204	40,204

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

1/ Assumes that private pension funds initiate operations in July.
2/ As stated in EBS/02/194 (11/20/2002).
3/ Includes the interest cost of bank resolution on accrual basis.
4/ Interim debt relief from multilaterals creditors is recorded as grants.
5/ Mainly project-related grants from bilateral donors.
6/ Excluding post-Hurricane Mitch reconstruction expenditure.

Table 3. Nicaragua: Summary Operations of the Central Government

(In percent of GDP)

	Prel.	2002		2003	
	2001	Prog. 1/	Prel.	Prog. 1/	Rev. Prog.
Total current revenue	**22.3**	**23.4**	**23.4**	**25.1**	**26.3**
Tax revenue	21.5	22.0	22.2	24.2	25.4
Nontax revenue and current transfers	0.9	1.4	1.2	1.0	0.9
Total current expenditures	**27.0**	**26.2**	**26.2**	**23.7**	**24.5**
Consumption and transfers	19.3	17.3	17.3	15.9	16.7
Of which : wages and salaries	6.2	6.8	6.8	6.3	6.9
Interest payments 2/	7.7	8.9	8.9	7.8	7.8
Savings	**-4.6**	**-2.8**	**-2.8**	**1.4**	**1.8**
Capital expenditure and net lending (net of capital revenue)	14.7	10.2	10.7	10.2	10.6
Primary balance before grants	**-11.7**	**-4.1**	**-4.5**	**-1.0**	**-0.9**
Balance before grants	**-19.4**	**-13.0**	**-13.4**	**-8.8**	**-8.7**
Grants	5.7	6.7	7.0	6.3	6.4
Of which: HIPC interim relief 3/	1.9	3.2	3.1	2.9	2.9
Balance after grants	**-13.7**	**-6.3**	**-6.4**	**-2.5**	**-2.3**
Financing	**13.7**	**6.3**	**6.4**	**2.5**	**2.3**
Privatization and external (net) 3/	6.8	6.5	6.4	8.3	8.2
Domestic (net)	6.9	-0.2	0.0	-5.9	-5.9
Memorandum items:					
Total expenditure	41.8	36.4	36.9	33.9	35.1
Total primary expenditure	34.1	27.6	28.0	26.2	27.3
Total primary current expenditure	19.3	17.3	17.3	15.9	16.7

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

1/ As stated in EBS/02/194 (11/20/2002).

2/ Includes the interest cost of bank resolution on accrual basis.

3/ HIPC interim debt relief from multilaterals is recorded as grants.

Table 4. Nicaragua: Consolidated Operations of the Public Sector - Quarterly

(In millions of cordobas)

	2002		2003 1/									
	Q-4		Q-1		Q-2		Q-3		Q-4		Total	
	Prog. 2/	Prel.	Prog. 2/	Prel.	Prog. 2/	Rev Prog.	Prog. 2/	Rev Prog.	Prog. 2/	Rev Prog.	Prog. 2/	Rev Prog.
Total current revenue	**2,981.5**	**2,964.5**	**3,329.1**	**3,275.7**	**3,199.3**	**3,316.9**	**3,227.8**	**3,472.4**	**3,289.6**	**3,361.5**	**13,045.8**	**13,426.6**
Current revenue of the general government	2,955.7	2,957.7	3,295.4	3,261.9	3,159.4	3,277.6	3,175.5	3,432.6	3,252.8	3,332.2	12,883.1	13,304.4
Operational surplus of public utilities	25.7	6.8	33.7	13.8	39.9	39.4	52.2	39.8	36.8	29.3	162.7	122.2
Total current expenditure	**3,268.7**	**3,189.1**	**3,437.3**	**3,352.4**	**3,222.1**	**3,223.7**	**3,351.0**	**3,689.8**	**3,445.3**	**3,470.9**	**13,455.6**	**13,736.9**
Consumption and transfers	2,596.0	2,534.7	2,134.7	2,087.6	2,177.1	2,249.5	2,178.2	2,341.4	2,515.5	2,612.4	9,005.5	9,291.0
Nonfinancial public sector interest payments 3/	639.7	628.0	991.1	967.7	621.1	654.7	1,002.1	970.9	540.4	559.1	3,154.7	3,152.3
Central bank operating deficit	33.1	26.4	311.5	297.1	423.8	319.6	170.7	377.5	389.4	299.4	1,295.4	1,293.6
Combined public sector savings	**-287.3**	**-224.7**	**-108.2**	**-76.7**	**-22.8**	**93.2**	**-123.2**	**-217.4**	**-155.7**	**-109.4**	**-409.8**	**-310.3**
Excluding interest payments	309.1	353.1	1,134.9	1,131.0	963.4	1,008.4	994.2	1,075.3	705.7	681.4	3,798.2	3,896.1
Capital expenditure and net lending (net of capital revenue)	**1,361.8**	**1,372.2**	**959.3**	**894.1**	**1,270.6**	**1,278.9**	**1,322.8**	**1,478.7**	**1,360.2**	**1,423.8**	**4,912.8**	**5,075.4**
Combined public sector primary balance (before grants)	**-1,052.7**	**-1,019.1**	**175.6**	**236.9**	**-307.2**	**-270.5**	**-328.6**	**-403.4**	**-654.5**	**-742.3**	**-1,114.6**	**-1,179.4**
Combined public sector balance (before grants)	**-1,649.1**	**-1,596.9**	**-1,067.5**	**-970.8**	**-1,293.4**	**-1,185.7**	**-1,446.0**	**-1,696.1**	**-1,515.9**	**-1,533.2**	**-5,322.6**	**-5,385.7**
Grants	**754.9**	**893.0**	**493.6**	**347.6**	**631.3**	**720.4**	**913.0**	**856.4**	**770.4**	**917.5**	**2,808.3**	**2,841.8**
Interim debt relief: HIPC 4/	178.0	149.4	293.5	101.7	242.4	380.2	399.3	477.7	226.4	204.5	1,161.7	1,164.2
Other	577.0	743.6	200.1	245.9	388.9	340.1	513.6	378.6	544.0	712.9	1,646.6	1,677.6
Combined public sector balance (after grants)	**-894.2**	**-703.9**	**-573.9**	**-623.2**	**-662.0**	**-465.3**	**-533.0**	**-839.8**	**-745.5**	**-615.7**	**-2,514.4**	**-2,543.9**
Financing	**894.2**	**703.9**	**573.9**	**623.2**	**662.0**	**465.3**	**533.0**	**839.8**	**745.5**	**615.7**	**2,514.4**	**2,543.9**
Privatization and external financing, net	1,194.8	1,064.8	1,090.6	676.9	414.9	914.6	1,173.6	1,571.8	934.7	924.3	3,613.8	3,599.8
Domestic financing, net	-300.6	-361.0	-516.7	-53.6	247.1	-449.3	-640.6	-732.0	-189.2	-308.6	-1,099.4	-1,055.9
Of which : central bank	-169.1	-626.9	-560.5	-397.9	-168.6	-614.8	-769.4	249.3	-391.5	-120.0	-1,890.1	-1,864.7

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

1/ Assumes that private pension funds initiate opertions in July.

2/ As stated in EBS/02/194 (11/20/2002).

3/ Includes the interest cost of bank resolution on accrual basis.

Table 5. Nicaragua: Summary Operations of the Central Government - Quarterly

(In millions of cordobas)

	2002		2003									
	Q-4		Q-1		Q-2		Q-3		Q-4		Total	
	Prog. 1/	Prel.	Prog. 1/	Prel.	Prog. 1/	Rev. Prog.	Prog. 1/	Rev. Prog.	Prog. 1/	Rev. Prog.	Prog. 1/	Rev. Prog.
Total current revenue	**2,245.0**	**2,248.8**	**2,444.8**	**2,452.8**	**2,383.6**	**2,501.7**	**2,609.1**	**2,852.0**	**2,669.1**	**2,759.3**	**10,106.6**	**10,565.8**
Tax revenue	2,056.0	2,136.5	2,313.9	2,382.6	2,297.2	2,429.6	2,523.4	2,773.7	2,581.6	2,615.8	9,716.0	10,201.7
Nontax revenue and current transfers	188.9	112.3	130.9	70.2	86.4	72.1	85.7	78.3	87.5	143.5	390.5	364.1
Total current expenditures	**2,483.0**	**2,462.8**	**2,523.0**	**2,483.9**	**2,174.8**	**2,278.7**	**2,549.0**	**2,680.9**	**2,287.3**	**2,417.7**	**9,534.2**	**9,861.2**
Consumption and transfers	1,847.2	1,834.8	1,534.6	1,516.9	1,556.8	1,624.5	1,549.6	1,710.4	1,750.0	1,859.1	6,391.0	6,710.9
Of which : wages and salaries	819.3	813.5	583.0	600.5	581.4	636.5	581.4	683.3	793.7	862.8	2,539.4	2,783.1
Interest payments 2/	635.7	628.0	988.4	967.0	618.0	654.2	999.4	970.5	537.3	558.6	3,143.2	3,150.3
Savings	**-238.0**	**-214.0**	**-78.2**	**-31.0**	**208.7**	**223.0**	**60.1**	**171.1**	**381.7**	**341.5**	**572.4**	**704.6**
Capital expenditure and net lending (net of capital revenue)	1,141.0	1,174.1	783.2	796.3	1,008.5	1,031.1	1,108.2	1,185.2	1,213.3	1,231.4	4,113.2	4,244.1
Primary balance before grants	**-743.3**	**-749.4**	**127.0**	**142.2**	**-181.7**	**-153.1**	**-48.6**	**-39.0**	**-294.3**	**-317.4**	**-397.6**	**-367.4**
Balance before grants	**-1,379.0**	**-1,377.4**	**-861.5**	**-824.8**	**-799.7**	**-807.4**	**-1,048.0**	**-1,009.5**	**-831.6**	**-876.0**	**-3,540.8**	**-3,517.7**
Grants	712.5	807.4	430.1	301.2	565.9	630.2	827.6	785.5	725.2	865.5	2,548.8	2,582.3
Of which: HIPC interim relief 3/	178.0	149.4	293.5	101.7	242.4	380.2	399.3	477.7	226.4	204.5	1,161.7	1,164.2
Balance after grants	**-666.5**	**-570.1**	**-431.3**	**-523.6**	**-233.8**	**-177.2**	**-220.4**	**-224.0**	**-106.4**	**-10.6**	**-992.0**	**-935.4**
Financing	**666.5**	**570.1**	**431.3**	**523.6**	**233.8**	**177.2**	**220.4**	**224.0**	**106.4**	**10.6**	**992.0**	**935.4**
Privatization and external (net)	1,091.2	941.7	1,041.1	645.3	304.5	848.9	1,109.7	983.3	891.8	834.5	3,347.1	3,312.0
Domestic (net)	-424.8	-371.6	-609.8	-121.7	-70.7	-671.7	-889.3	-759.4	-785.4	-823.9	-2,355.2	-2,376.6

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

1/ As stated in EBS/02/194 (11/20/2002).

2/ Includes the interest cost of bank resolution on accrual basis.

3/ HIPC interim debt relief from multilaterals is recorded as grants.

Table 6. Nicaragua: Summary Accounts of the Central Bank

(Flows in millions of cordobas; unless otherwise stated)

	Actual	Prel.	2002		2003	
	2000	2001	Prog. 1/	Prel.	Prog. 1/	Rev. Prog.
Exchange rate (cordobas/U.S. dollars)	12.7	13.4	14.3	14.3	...	...
Net international reserves	**-374**	**-2,290**	**-188**	**691**	**453**	**-227**
(in millions of U.S. dollars)	-29	-171	-13	49	30	-15
Net domestic assets	**393**	**2,485**	**324**	**-555**	**-250**	**430**
Net credit to nonfinancial						
Public sector (NFPS) 2/	-627	6,690	-794	-1,329	-1,705	-1,642
Public sector (NFPS) 3/	-627	2,837	-794	-1,329	-1,705	-1,642
Operational losses	461	680	1,121	1,115	1,296	1,294
Net credit to the financial system 4/	1,656	-947	-387	-697	-340	-37
CENIS, BOMEX, and TELs 5/	-1,274	-4,130	308	407	841	1,057
Foreign liabilities						
(Medium- and long-term)	161	174	170	142	284	263
Other 4/	16	18	-93	-193	-626	-505
Currency	**19**	**195**	**137**	**136**	**203**	**203**
Memorandum items:						
Currency (stock)	1,754	1,949	2,086	2,086	2,289	2,288
Currency (annual change; in percent)	1.2	11.1	7.0	7.0	9.7	9.7
Strengthening of BCN reserve position						
(in millions of U.S. dollars) 6/	-163	-472	20	82	100	70
Net repayment of BCN domestic debt (+)	-134	-301	33	33	70	85
Increase in NIR (+)	-29	-171	-13	49	30	-15

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

1/ As stated in EBS/02/194 (11/20/2002).
2/ Includes bonds issued to recapitalize weak banks.
3/ Excludes bonds issued to recapitalize weak banks.
4/ From 2002 onward, asset recovery of closed banks is included in "other."
5/ Certificados Negociables de Inversion (CENIS), Bonos en Moneda Extranjera (BOMEX), and Titulos Especiales de Liquidez (TELs).
6/ Defined as the sum of the net repayment of BCN domestic debt and the change in NIR.

Table 7. Nicaragua: Summary Accounts of the Central Bank-Quarterly

(Flows in millions of cordobas; unless otherwise stated)

	2002		2003									
	Q-4		Q-1		Q-2		Q-3		Q-4		Total	
	Prog. 1/	Prel.	Prog. 1/	Prel.	Prog. 1/	Rev. Prog.	Prog. 1/	Rev. Prog.	Prog. 1/	Rev. Prog.	Prog. 1/	Rev. Prog.
Net international reserves	**0**	**878**	**159**	**-113**	**130**	**42**	**169**	**27**	**-6**	**-183**	**453**	**-227**
(In millions of US$)	0	62	11	-7	9	3	11	2	0	-12	30	-15
Net domestic assets	**367**	**-514**	**-233**	**-68**	**-267**	**-138**	**-220**	**-43**	**470**	**680**	**-250**	**429**
Net credit to nonfinancial public sector (NFPS)	-63	-598	-560	-345	-31	-556	-722	-673	-392	-67	-1,705	-1,642
Net credit to the financial system	264	-49	-137	159	-106	-83	-92	-83	-5	-30	-340	-37
CENIs, BOMEX and TELs 2/	46	145	88	-193	82	250	233	584	438	416	841	1,057
Foreign liabilities (medium- and long-term)	36	0	53	53	27	22	174	164	30	24	284	263
Other	85	-12	324	258	-240	228	187	-35	398	338	670	789
Currency	**367**	**364**	**-73**	**-182**	**-137**	**-97**	**-51**	**-16**	**464**	**497**	**203**	**203**
Memorandum items:												
Currency (stock)	2,086	2,083	2,013	1,905	1,876	1,808	1,825	1,792	2,289	2,289	2,289	2,737
Currency (annual change; in percent)	7.0	7.0	2.3	-3.3	7.2	3.3	6.2	4.0	9.7	9.7	9.7	9.7
Change in BCN reserve position (in millions of U.S. dollars)	11	73	16	-23	25	23	30	47	29	22	100	70
Net repayment of BCN domestic debt	11	62	6	-15	17	20	19	46	29	34	70	85
Change in NIR	0	11	11	-7	9	3	11	2	0	-12	30	-15

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

1/ As stated in EBS/02/194 (11/20/2002).

2/ Certificados Negociables de Inversion (CENIS), Bonos en Moneda Extranjera (BOMEX), and Titulos Especiales de Liquidez (TELs).

Table 8. Nicaragua: Operations of the Central Bank and the Financial System

(Stocks in millions of cordobas)

	2001 1/	2002 2/ Prog. 3/	2002 2/ Prel.	2003 Prog. 3/	2003 Rev. Prog.
I. Central Bank					
Net international reserves	**213**	**39**	**914**	**494**	**742**
(In millions of U.S. dollars)	16	3	64	33	49
Net domestic assets	**1,736**	**2,048**	**1,171**	**1,795**	**1,546**
Net credit to NFPS	34,467	34,798	33,725	33,421	32,395
Net credit to the financial system	207	-82	-675	-354	-660
CENIs, BOMEX and TELs 4/	-7,456	-7,603	-8,654	-7,219	-8,117
Medium- and long-term foreign liabilities	-23,806	-25,073	-25,477	-26,295	-26,745
Other	-1,676	8	2,252	2,241	4,672
Currency	**1,949**	**2,086**	**2,086**	**2,289**	**2,288**
II. Consolidated Financial System					
Net international reserves	**3,014**	**2,917**	**4,684**	**4,088**	**6,093**
(In millions of U.S. dollars)	224	205	329	271	403
Net domestic assets	**16,366**	**18,667**	**17,142**	**19,607**	**17,940**
Net credit to nonfinancial public sector	30,445	34,077	33,072	32,273	31,635
Credit to the private sector	13,576	10,894	10,830	13,042	12,693
Medium- and long-term foreign liabilities	-24,475	-25,950	-26,624	-27,074	-27,959
Other net assets	-3,179	-353	-136	1,366	1,571
Liabilities to the private sector	**19,380**	**21,584**	**21,826**	**23,695**	**24,034**

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

1/ From 2001 onward, monetary accounts are prepared using a better sectorization and classification.
2/ In 2002, credit held by the liquidation boards is assumed to be sold to the private sector or written off.
3/ As stated in EBS/02/194 (11/20/2002).
4/ Certificados Negociables de Inversion (CENIS), Bonos en Moneda Extranjera (BOMEX), and Titulos Especiales de Liquidez (TELs).

Table 9. Nicaragua: Balance of Payments

(In millions of U.S. dollars; unless otherwise indicated)

			Prel.	2002		2003	
	1999	2000	2001	Prog. 1/	Prel.	Prog. 1/	Rev. prog.
Current account	-1,059	-931	-971	-726	-702	-640	-651
Excluding interest obligations	-835	-674	-724	-593	-573	-499	-515
Trade balance	-1,157	-1,003	-1,037	-963	-951	-935	-956
Exports, f.o.b.	545	645	593	598	604	663	661
Of which: coffee	135	171	105	73	73	80	72
Imports, f.o.b.	-1,703	-1,648	-1,630	-1,561	-1,555	-1,598	-1,617
Nonfactor services (net)	-42	-32	-26	-6	-25	17	3
Receipts	293	311	328	339	313	371	351
Payments	-335	-343	-354	-345	-338	-354	-348
Official interest obligations	-225	-257	-247	-133	-130	-141	-135
Other current transactions (net)	364	361	339	376	403	420	438
Factor services receipts	31	31	15	8	8	13	12
Other factor services payments	-62	-69	-77	-85	-69	-89	-78
Private transfers	396	400	402	453	464	496	504
Capital account	876	627	558	532	540	523	481
Official (net)	415	346	366	254	241	299	335
Official transfers	307	308	346	329	316	266	291
Public sector consolidated	192	176	125	106	115	109	114
Other	115	132	173	150	130	80	100
HIPC Interim Relief from Multilaterals 2/	0	0	49	73	71	77	77
Disbursements 3/	274	220	217	194	203	226	250
Amortization 3/	-168	-171	-177	-269	-278	-193	-207
Other (net) 4/	2	-11	-20	0	0	0	0
Other Capital (private)	460	282	193	278	300	224	147
Foreign Direct Investment	300	265	132	201	144	256	192
Commercial Banks	110	17	-85	18	-25	-46	-90
Other (net)	221	-13	166	59	169	14	44
Commercial Credits			70	20	34	0	0
Errors and omissions	-175	12	-20	0	12	0	0
Overall balance	-184	-304	-413	-194	-162	-117	-169
Change in net international reserves (- increase)	-77	29	170	13	-49	-30	15
Of which: IMF (net)	104	21	-5	4	4	20	20
Net change in arrears (decrease -) 5/	151	64	-285	-1,944	-574	0	-1,798
Exceptional financing	110	211	526	2,124	785	0	1,953
Paris Club rescheduling	91	98	31	56	228		18
Non-Paris Club Rescheduling 5/	19	113	495	2,068	557		1935
Remaining financing gap	0	0	0	0	0	0	0
Memorandum items:							
Current account (in percent of GDP)	-47.7	-38.2	-38.2	-28.2	-27.3	-24.0	-24.4
Excluding interest obligations (in percent of GDP)	-37.5	-27.7	-28.5	-23.1	-22.3	-18.7	-19.4
Gross reserves (in millions of U.S. dollars)	513	497	383	355	454	417	449
Gross reserves (in months of imports)	3.3	3.2	2.3	2.2	2.8	2.5	2.6
Net international reserves (in millions of U.S. dollars)	357	187	16	3	64	33	49
Debt service ratio 6/	47	45	38	43	45	33	35
Debt service ratio, after debt relief 6/	34	33	27	17	17	11	12
Debt service ratio, actual payments 6/	20	20	22	17	17	11	12
Gross official grants and loans (in percent of GDP)	31	23	20	21	21	20	21
Net official grants and loans (in percent of GDP)	22	17	17	16	16	15	17
Interim HIPC Debt Relief	0	0	49	0	71	0	77
GDP (millions of US$)	2,213	2,435	2,544	2,571	2,571	2,661	2,661

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

1/ As stated in EBS/02/194 (11/20/2002).
2/ Include interim HIPC assistance from multilaterals.
3/ Medium and long term.
4/ Short-term debt, and private debt due to official creditors. As of 2002, short-term debt is included in total interest and amortization payments.
5/ In 2002 this represents arrears cleared under bilateral agreements at terms comparable to those offered by the Paris Club. Clearance in 2003 is of debt remaining to other non-Paris Club creditors, with whom agreements have not yet been finalized.
6/ In percent of exports of goods and nonfactor services.

Table 10. Nicaragua: Public Sector Domestic Debt (Stocks; Accrual Basis)

(In millions of US dollars)

	Prel.	2002		2003	
	2001	Prog. 1/	Prel.	Prog. 1/	Rev. Prog.
BCN liabilities	**697**	**671**	**676**	**578**	**562**
Certificados Negociables de Inversiones (CENIs)	610	585	595	578	555
Auctioned	187	178	185	280	264
Coffee-related	10	9	9	8	8
Bank resolution (from Interbank onward)	413	398	402	290	283
Bonos en Moneda Extranjera (BOMEX)	21	24	10	0	0
Titulos Especiales de Inversion (TEIs)	27	16	22	0	7
Titulos Especiales de Liquidez (TEIs)	39	46	48	0	0
MHCP liabilities	**832**	**913**	**896**	**909**	**898**
Indemnization bonds (BPIs) 2/	763	850	806	850	850
Other paper	69	62	90	59	48
Bonds (held by the Social Security Institute)	23	18	56	17	30
Other	46	44	34	42	18
Combined Public Sector Domestic Debt	**1,529**	**1,583**	**1,572**	**1,487**	**1,459**
In percent of GDP	59.8	61.6	61.1	55.9	54.9
Memorandum Items:					
Debt reduction on accrual basis (+)	**-533**	**-59**	**-43**	**96**	**112**
Central Bank	-408	24	21	93	114
Central government	-125	-83	-64	4	-2
Net Repayment of BCN Domestic Debt (+)	**...**	**52**	**33**	**81**	**90**
Central bank	...	33	33	70	70
Central government	...	19	0	11	20

Sources: Central Bank of Nicaragua; and Ministry of Finance.

1/ As stated in EBS/02/194 (11/20/2002).

2/ Increase in 2002 reflects previously awarded court claims on properties confiscated during the Sandinista government.

Table 11. Nicaragua: Public Sector External Debt and Debt Service

	2000	Prel. 2001	2002 1/ Prog. 2/	2002 1/ Prel.	2003 Prog. 2/	2003 Rev. Prog.
	(In millions of U.S. dollars; end of period)					
Total debt	6,660	6,374	4,745	6,363	3,429	3,521
Bilaterals	4,124	3,740	...	3,555	...	1,117
Multilaterals	2,260	2,243	...	2,563	...	2,397
Commercial banks	235	243	...	207	...	0
Other	41	48	...	37	...	5
	(In percent of GDP)					
Total debt	274	251	185	247	129	132
Bilaterals	170	147	...	138	...	42
Multilaterals	93	88	...	100	...	90
Commercial banks	10	10	...	8	...	0
Other	2	2	...	1	...	0
	(In millions of U.S. dollars)					
Total debt service obligations	422	429	407	413	342	350
Principal	164	182	274	284	200	214
Interest	257	248	133	130	141	135
Debt service paid 3/	188	257	155	158	118	118
Principal	111	127	114	120	54	68
Interest	77	130	41	37	64	50
Debt service not paid 4/	234	173	252	255	224	232
Principal	53	55	160	163	146	147
Interest	180	118	92	92	77	85
	(In percent of GDP)					
Total debt service obligations	17	17	16	16	13	13
Principal	7	7	11	11	8	8
Interest	11	10	5	5	5	5
Debt service paid 3/	8	10	6	6	4	4
Principal	5	5	4	5	2	3
Interest	3	5	2	1	2	2
Debt service not paid 4/	10	7	10	10	8	9
Principal	2	2	6	6	5	6
Interest	7	5	4	4	3	3
	(In percent of exports of goods and nonfactor services)					
Total debt service obligations	44	47	45	45	34	35
Principal	17	20	30	31	20	21
Interest	27	27	15	14	14	13
Debt service paid	20	28	17	17	12	12
Principal	12	14	12	13	5	7
Interest	8	14	4	4	6	5
Debt service not paid	24	19	28	28	22	23
Principal	6	6	18	18	15	15
Interest	19	13	10	10	8	8

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

1/ The large difference between programmed and actual end-2002 stock is due to delays in reaching agreement with non-Paris Club creditors on Paris Club comparable term.

2/ As stated in EBS/02/194 (11/20/2002).

3/ Debt service paid by authorities after traditional and HIPC relief.

4/ Debt service covered by traditional and HIPC relief.

Table 12. Nicaragua: Phasing of IMF Disbursements and Reviews

Date of Disbursement	Amount (Millions of SDRs)	Conditions
December 2002	6.965	Executive Board approval of PRGF arrangement and first-year program.
June 2003	13.930	Completion of first and second reviews; observance of end-December and end-March performance criteria.
September 2003	6.965	Completion of third review, observance of end-June 2003 performance criteria.
January 2004	13.930	Completion of fourth review and observance of end-September 2003 performance criteria and approval of second-year program.
March 2004	13.930	Completion of fifth review and observance of end-December 2003 performance criteria.
September 2004	13.930	Completion of sixth review and observance of end-June 2004 performance criteria and approval of the third-year program.
March 2005	13.930	Completion of seventh review and observance of end-December 2004 performance criteria.
September 2005	13.920	Completion of eighth review and observance of end-June 2005 performance criteria.
Total	**97.500**	

Source: IMF, Finance Department.

Table 13. Nicaragua: Indicators of Financial Obligations to the Fund (as of March 31, 2003)

(In millions of SDRs; unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Outstanding Fund credit (end of period)	118.6	128.3	143.5	173.4	182.3	159.2	136.1	112.0	90.4	71.0	51.5	32.0
Poverty Reduction and Growth Facility (PRGF) disbursements	0.0	7.0	20.9	39.1	27.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total debt service to the Fund	5.1	4.6	6.6	13.1	20.2	24.3	24.2	25.2	22.4	20.1	20.1	20.0
Principal	4.0	4.0	5.7	11.9	19.0	23.1	23.1	24.2	21.6	19.4	19.5	19.5
Charges and interest	1.1	0.6	0.9	1.2	1.2	1.2	1.1	1.0	0.8	0.7	0.6	0.5
Total debt service to the Fund after HIPC assistance	5.1	0.6	4.6	8.2	7.6	9.5	9.4	10.6	13.0	16.6	19.2	19.1
Outstanding Fund credit (end of period)												
In percent of quota	91.2	98.7	110.4	133.4	140.2	122.5	104.7	86.2	69.5	54.6	39.6	24.6
Debt service to the Fund (in percent of total debt service due after rescheduling) 1/	4.2	0.5	5.3	11.5	9.6	9.8	9.2	10.8	14.4	16.2	17.4	15.4
Total debt-service ratio (after rescheduling) 1/	16.3	17.3	11.3	8.4	8.5	9.7	9.5	8.4	7.0	7.1	6.9	7.0
Of which: IMF	0.7	0.1	0.6	1.0	0.8	1.0	0.9	0.9	1.0	1.2	1.2	1.1
Repayment to IMF/reserves (in percent)	1.7	0.2	1.4	2.1	1.6	2.0	1.9	2.1	2.4	2.8	3.0	2.9

Source: IMF, Finance Department.

1/ IMF service net of delivery of HIPC assistance based on indicative drawdown schedule specified in the decision point document (Table 11 of EBS/00/259) in all cases.

Table 14. External Financing Requirements and Sources

(In millions of U.S. dollars)

	Prel.	2002		2003	
	2001	Prog. 1/	Prel.	Prog. 1/	New Prog.
Gross financing requirements	**-976.4**	**-990.7**	**-1,038.0**	**-890.9**	**-873.0**
External current account deficit (excluding official transfers)	-971.1	-725.9	-702.4	-639.9	-653.4
Debt amortization	-176.9	-269.0	-278.2	-193.3	-206.7
Gross reserves accumulation	176.8	9.3	-52.3	-50.1	-5.4
IMF repurchases and repayments	-5.2	-5.2	-5.2	-7.5	-7.6
Available financing	**976.4**	**990.7**	**1,038.0**	**890.9**	**873.0**
Foreign direct investment (net)	132.3	201.0	144.2	256.0	192.4
Debt financing from private creditors	80.9	77.0	143.5	-31.9	-43.7
Trade pre-financing	69.7	20.0	33.5	0.0	0.0
Commercial banks' reserves	-84.8	18.4	-25.0	-45.9	-89.7
Other private capital (including CENIS)	96.0	38.6	135.0	14.0	46.0
Official transfers	346.0	329.4	316.1	266.0	291.3
Disbursements (medium- and long-term loans)	216.6	193.6	202.7	226.3	250.0
Of which : balance of payments financing	34.5	43.0	34.9	75.0	83.0
Of which : expected new commitments	...	15.0	15.0	30.0	30.0
IMF disbursements	0.0	9.0	9.0	27.7	28.0
Net change in arrears	-284.6	-1,943.6	-573.8	0.0	-1,798.4
Other flows 2/	-40.4	0.0	12.0	0.0	0.0
Exceptional financing 3/	525.7	1,945.0	784.6	0.0	1,953.0
Financing gap 4/	0.0	179.2	-0.3	146.8	0.5

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

1/ As stated in EBS/02/194 (11/20/2002).

2/ Includes all other net financial flows, and errors and omissions.

3/ Includes only traditional debt rescheduling.

4/ Could be covered by debt relief under the enhanced HIPC Initiative.

Table 15: Nicaragua. Status of Poverty Reduction and Structural Measures for Reaching the HIPC Floating Completion Point

1. **Nicaragua's annual PRSP progress report.** The full PRSP was submitted to the Board of the Fund in September 2001 and a report of the first year of its implementation was presented in December 2002.

2. **Use of budgetary savings resulting from the interim relief under the HIPC Initiative.** A reliable tracking mechanism of poverty reducing expenditures was approved. The mechanism is already operating and it was consulted with the NGOs, donors and civil society.

3. **Stable macroeconomic framework and satisfactory performance under a program supported by a PRGF arrangement.** A request for a new three-year PRGF arrangement was approved by the Board in December 2002. First and second reviews under the three-year PRGF arrangement is presented for Board approval.

4. **Human capital development and social protection**

   a. **Approval of a satisfactory school autonomy law and its implementation.** A law considered satisfactory by the World Bank was approved in February 2002. Implementing regulations are pending.

   b. **Approval of a satisfactory general health law and its implementation.** A law deemed satisfactory by the World Bank was approved and published in May 2002, and became effective in November 2002. Implementing regulations were approved and published in January 2003.

   c. **Introduce an effective system of social protection.** A pilot program was concluded in 2002. Design and adoption of an effective social protection program based on the findings of the pilot program is in process. The government is working on the definition of an integrated social protection policy.

5. **Governance**

   a. **Approval and advance in implementation of a satisfactory civil service law.** A draft of the law was submitted to the Assembly in December 1999. Approval is pending.

   b. **Introduction of a satisfactory system of management and inspection of public sector procurement.** Implementation of the program agreed with the IDB started in October 2002.

   c. **Satisfactory progress in implementation of a plan to strengthen and improve the efficiency of the Comptroller's Office.** Program agreed with the IDB started in December 2002.

   d. **Approval of the law on penal procedures and initiation of training programs and technical preparations for its implementation.** A law on penal procedures (Law nr. 411) was approved and published in December 2001. Implementation of the law started at the end of 2002. Training programs and technical preparations are advanced.

   e. **Approval of the law on public prosecutors and initiation of training programs and technical preparations for its implementation.** A law on public prosecutor (Law nr. 342) was approved in May 2000 and published in October 2000. Implementing regulations are pending.

6. **Pension system: Restructuring of the social security institute and introduction of a satisfactory private pension system.** A new Pension Law and the Pension Superintendence Law were approved in 2000. New law on the social security institute including pending parametric reforms is expected to be approved in 2003. Nomination of the Superintendent of Pensions is still pending. Award of licenses to private fund managers is expected by end 2003 and transfer of all eligible social contributors to the new pension system is expected within the first quarter of 2004.

7. **Divestment of ENITEL**: 40 percent of ENITEL's share and its management were awarded in August 2001. 1 percent of the shares were donated to workers, and 10 percent offered for sale to workers. The sale of the government's share is expected to be completed by end 2003.

8. **Divestment of all electricity generating units of ENEL**. The sale of the hydroelectric (Hidrogesa) and one thermal plant (Gecsa) is expected during 2003–04.

NICARAGUA—FUND RELATIONS
(As of April 30, 2003)

I. Membership Status: Joined: 03/14/1946; Article VIII since 7/30/1964.

II. General Resources Account:

	SDR Million	Percent of Quota
Quota	130.00	100.00
Fund Holdings of Currency	130.01	100.01

III. SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	19.48	100.00
Holdings	0.12	0.60

IV. Outstanding Purchases and Loans:

	SDR Million	Percent of Quota
ESAF/PRGF arrangements	128.29	98.69

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	12/13/2002	12/12/2005	97.50	6.97
ESAF/PRGF	03/18/1998	03/17/2002	148.96	115.32
ESAF	06/24/1994	06/23/1997	120.12	20.02

VI. Projected Obligations to Fund (with Board-approved HIPC Assistance): (SDR million; based on existing use of resources and present holdings of SDRs)

	Overdue	Forthcoming				
	12/31/2002	2003	2004	2005	2006	2007
Principal	...	4.46	11.85	19.03	23.06	23.06
Charges/Interest	...	0.89	0.93	0.84	0.74	0.62
Total	...	5.35	12.78	19.87	23.80	23.69

VII. Implementation of HIPC Initiative:

	Enhanced Framework
Commitment of HIPC assistance	
Decision point date	December 2000
Assistance committed	
by all creditors (US$ million)[1]	3,267.00
Of which: IMF assistance (US$ million)	81.47
(SDR equivalent in millions)	62.98
Completion point date	Floating
Disbursement of IMF assistance (SDR million)	
Assistance disbursed to the member	1.888
Interim assistance	1.888
Completion point balance	--
Additional disbursement of interest income[2]	--

VIII. Safeguards Assessments:

The Central Bank of Nicaragua (BCN) is subject to an update safeguards assessment which is currently underway. The BCN was subject to a safeguards assessment under Nicaragua's previous financial arrangement with the IMF, which expired in March 2002. The initial safeguards assessment was completed in December 2001, and the report concluded that an on-site assessment was not necessary. However, certain weaknesses were identified, and staff recommended that (i) the BCN strengthen financial reporting by either adopting IAS, or disclosing any differences between the BCN's accounting principles and IAS in its financial statements; (ii) the BCN implement an action plan to collect the overdue receivables or to write them off as nonrecoverable; and (iii) the Internal Audit Department (IAD) should review the process of reconciliation of reserves data to ensure that net reserves are properly valued, that there are no encumbrances, and that they are consistent with the audited financial statements. The update assessment will include monitoring of the status of implementation for the above recommendations.

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[1] Assistance committed under the original framework is expressed in net present value (NPV) terms at the completion point, and assistance committed under the enhanced framework is expressed in NPV terms at the decision point.

[2] Under the enhanced framework, an additional disbursement is made at the completion point corresponding to interest income earned on the amount committed at the decision point but not disbursed during the interim period.

IX. Exchange Rate Arrangements:

In December 1995, the Monetary Board of the central bank approved the **unification of the exchange rate system** effective January 1, 1996. With the unification of the exchange rate, all previous exchange restrictions on payments and transfers for current international transactions and multiple currency practices were eliminated. The central bank buys/sells any amount of foreign currency from/to financial institutions at the official exchange rate, and implements a crawling peg system. In November 1999, the monthly crawl was reduced from an annual rate of 9 percent to 6 percent.

As of May 12, 2003, the exchange rate in the official market was C$14.98 per U.S. dollar.

X. Article IV Consultation:

The last consultation was completed by the Executive Board on November 19, 2002 (IMF Country Report No. 03/24). It is expected that the next Article IV consultation with Nicaragua will be held on a standard 24–month cycle subject to the provisions of the decision on consultation cycles approved by the Board on July 15, 2002.

XI. Technical Assistance:

Dept.	Purpose	Time of Delivery
FAD	Tax Reform	March 2003
FAD	ROSC Fiscal Transparency Module	November 2001
FAD	Mission to review energy taxation and advise on the system of exemptions, exonerations, tax holidays, and other incentives with regard to the major indirect taxes major indirect taxes	January 2000
MFD	Bank Supervision	October 2002
MFD	Bank Restructuring	November 2001
MFD	Assessing CBN's debt sustainability and streamline its open market operations, with special focus on providing liquidity to CBN's securities and increase their marketability.	July 2001
MFD	Workshop on payments system.	January 27–29, 1999
MFD	Consultancy on introducing an exchange rate band.	October 1999
OIA	Mission to assess the management, organizational structure, and internal control systems and procedures of the Superintendency of Banks and Other Financial Institutions.	February 2000

Dept.	Purpose	Time of Delivery
STA	National accounts	November 2001
STA	Monetary and finance statistics	November 2001
STA	Monetary and finance statistics	September 2001
STA	Mission on money and banking statistics.	June–July 1999

XII. Resident Representative:

Mr. Breuer assumed the position of Resident Representative in Nicaragua in August 2002.

NICARAGUA—RELATIONS WITH THE WORLD BANK GROUP
(As of April 30, 2003)

I. FINANCIAL RELATIONS

A. Bank Loans and IDA Credits
(In millions of U.S. dollars)

	Bank	IDA	Undis-bursed
Thirty one loans and 24 credits fully disbursed	229.6	873.2	
Credits/Loans currently committed		476.1	235.6
Total	**229.6**	**1,349.3**	**235.6**
Of which:			
Repaid	224.1	22.0	
Borrower obligations	**0**	**859.4**	
Amount sold and repaid	5.6		

B. World Bank/IDA Loan Commitments and Disbursements

1. As of April 30, 2003, total loans/credits disbursed and currently committed from the Bank/IDA amounted to US$1,579 million, of which US$236 million remain to be disbursed. In view of its low income and high indebtedness, Nicaragua has been an IDA-only country since lending resumed in the early 1990s. The evolution of IDA gross disbursements exhibits a progressive decline since 1999. This pattern reflects the return to a normal lending program following the exceptional financing induced by emergency reconstruction needs in the aftermath of hurricane Mitch in October 1998. These needs triggered a rapid response on the part of IDA, which more than doubled gross disbursements from US$51 million in 1997 to US$120 million in 1999. The decline of gross disbursements since then mirrors the winding down of reconstruction activities.

2. Nicaragua reached the HIPC Decision Point on December 21, 2000, qualifying for IDA debt relief assistance equal to US$379 million. Since January 1, 2001, IDA has provided Interim HIPC assistance equivalent to a 90 percent reduction on Nicaragua's debt service to IDA.

II. RECENT NONLENDING IDA ASSISTANCE

3. During 2002 IDA delivered the following products: Investment and Income Effects of Land Regularization: The Case of Nicaragua (January 2002, Policy Research Paper No. 2752); Promoting Competitiveness and Stimulating Broad-based Growth in Agriculture (October 2002, Report No. 25115-NI); and PRSP Annual Progress Report Joint IDA/IMF Staff Assessment (November 2002, Report No. 25104-NI).

III. Plans for the Next Twelve Months

4. IDA has prepared a new Country Assistance Strategy (CAS) and Programmatic Structural Adjustment Credit (PSAC), which were presented to the Board in March 2003. Future projects being considered for IDA support include an Off-Grid Rural Electrification Project, and a Rural Micro-Finance Development Project.

Nicaragua—Relations with the Inter-American Development Bank
(As of May 12, 2003)

I. Financial Relations

A. Statement of IDB Loans
(In millions of U.S. dollars)

Year	Purpose	Amount
2003	Public Sector Modernization and Fiscal Reform	25.0
	Support to the Technical Secretariat of the Presidency (SECEP)	6.0
	Multiphase Roads Program	50.0
	Modernization of Agricultural Health Services	16.0
2004	Program of road integration PPP	30.0
	Social Sector Program II (PBL)	25.0
	Basic Education for Young and Adults	30.0
	Citizen's Security	7.0

B. IDB Loan Commitments and Disbursements

As of May 12, 2003, there are 34 projects in the Bank's portfolio for a total amount of US$772.1 million, and an available balance of US$500.4 million. As of this date and for the next twelve months, there are eight more operations—for a total of US$189.0 million—being considered in the 2003 pipeline. During 2002, Nicaragua received US$45.7 million of HIPC interim debt relief from the IDB. For 2003 it is estimated that the relief will amount to US$39.1 million.

II. Recent Technical Assistance

The Bank's program also includes 17 new non-reimbursable technical cooperation for a total of US$6.0 million.

III. Recent Agreements

Nicaragua's Country Strategy for years 2002–05 was approved by the Board in February 2003.

IV. Plans for the Upcoming Months

The Bank will prepare the Consultative Group for Nicaragua, to be held in Managua by September 2003.

REPUBLICA DE NICARAGUA

Managua, Nicaragua
June 3, 2003

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

Dear Mr. Köhler:

1. Attached you will find the Supplementary Memorandum of Economic and Financial Policies (MEFP) that reviews economic developments and policy implementation through March 2003 under the PRGF arrangement approved in December 2002, and sets out specific objectives and targets for June–December 2003. Based on the good track record and the policies adopted, we request the completion of the first and second reviews under the PRGF and the approval of the revised performance criteria for June 2003 and September 2003 that reflect the strong performance under the program. We also request waivers for the nonobservance of two performance criteria (PCs).

2. Nicaragua's economic performance through March 2003 has been consistent with the program. Macroeconomic policies have been in line with the PRGF, and progress was made in key structural areas. As a result, all quantitative and structural PCs for end-December 2002 and end-March 2003 were met, with two exceptions that were subsequently corrected. The structural PC related to the approval of the 2003 budget was not met in December 2002, but a presidential veto led to a modified budget in February 2003 and brought it back in line with the program. In March 2003, the quantitative PC for the net domestic financing of the consolidated public sector was exceeded by only a small amount (about US$ 2 million), which is fully explained by delays in disbursements of balance of payments support that had been expected for March but were received in the second quarter of 2003.

3. It is worth mentioning that as a prior action for the completion of the first and second reviews, we secured approval by the National Assembly (assembly) of a tax reform package in April 2003, two months earlier than envisaged in the program. The package is designed to significantly improve the efficiency and equity of the tax system, while raising tax revenues by at least 1.7 percent of GDP on an annual basis. In addition, structural benchmarks have been added with the aim of strengthening the quality of public spending and improving bank resolution procedures.

4. The Government of Nicaragua believes that the policies and measures set forth in the MEFP are adequate to achieve the objectives of the reform program supported by the PRGF

Arrangement. However, we stand ready to take, in consultation with the Fund, additional measures that may be appropriate for the achievement of the program's objectives. We will continue consulting with the Fund on relevant economic and financial policies, and providing the Fund all necessary data on a timely basis for monitoring purposes. Consistent with our intention to keep the public informed about our policies and objectives, the government will publish the MEFP and will report periodically on progress under the program.

5. We propose that the IMF carry out reviews under the program in September 2003 and December 2003 based on the observance, respectively, end-June 2003 and end-September 2003, quantitative and structural performance criteria established in Tables 1 and 2 of the attached memorandum.

6. We assure you that the government of Nicaragua remains fully committed to the implementation of the program.

Sincerely yours,

/s/	/s/
Mario B. Alonso I. President Central Bank of Nicaragua	Eduardo Montealegre Rivas Minister of Finance

SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. The PRGF arrangement approved last December supports the government's economic and financial program, which we began to implement soon after taking office in January 2002. We remain firmly committed to the strategy embodied in our Poverty Reduction Strategy Paper (PRSP), as updated in the 2002 PRSP first progress report, and the program supported by the PRGF. This memorandum supplements our letter and memorandum of economic and financial policies of November 19, 2002, and outlines the key next steps that we envisage in implementing this program.

2. Economic performance has been consistent with the program and all performance criteria (PCs) for end-December 2002 (first review test date) and end-March 2003 (second review test date) were met, with the exception of one structural and one quantitative PC that were subsequently corrected. Real GDP growth in 2002 was 1 percent, and 12-month inflation declined to 4 percent. Between 2001 and 2002, the combined public sector deficit before grants fell from 21 percent of GDP to 16.4 percent of GDP, while the deficit after grants fell from 14.3 percent of GDP to 8.6 percent of GDP. Poverty-reducing spending increased to 15.4 percent of GDP in 2002, slightly short of the 15.6 percent of GDP target.

3. The fiscal program for 2003 targets a reduction in the combined public sector deficit (after grants) to 6.3 percent of GDP. While the end-December 2002 PC related to the 2003 budget was not observed due to changes made by the assembly to the proposal submitted by the Executive Branch, a presidential veto led in February 2003 to a revised budget that brought the fiscal program back on track. The revised budget allowed 0.3 percent of GDP higher spending than originally envisaged (mainly on salaries for health and education), but the deficit and savings targets of the program were preserved through additional taxes on automobiles, cigarettes, and commercial banks. During the first quarter of 2003 fiscal performance was better than envisaged under the program, and only the PC on domestic financing of the combined public sector for March 2003 was not met by a small amount (about US$2 million). This is fully explained by shortfalls in balance of payments support (beyond the adjustments allowed under the program) that had been programed for March and was received in the second quarter of 2003.

4. We have intensified our efforts to broaden domestic support for our economic program. Of particular importance was the agreement reached in March 2003 with a qualified majority of the NA, which was instrumental to reduce social tensions and obtain support for the tax reform. As part of the agreement, public spending is to increase by 0.7 percent of GDP in 2003, of which 0.4 percent of GDP is current spending and 0.3 percent of GDP capital outlays (about 0.2 percent of GDP in poverty reducing programs). To preserve the fiscal deficit target (6.3 percent of GDP in 2003) it was also agreed to approve a larger-than-initially envisaged tax reform.

5. The tax reform package submitted by the executive and approved by the assembly in April (prior action) aims to improve substantially the efficiency and equity of the system,

while raising revenues of 1.2 percent of GDP in 2003 (C$500 million) and 1.7 percent of GDP on an annual basis (C$700 million). This compares with an expected yield of 0.5 percent of GDP in 2003 (1 percent of GDP on an annual basis) initially envisaged under the program. The implementing regulations (prior action) were recently approved, with the reform coming into effect on June 3, 2003. Its main components include the elimination of the zero VAT rate (except for exports), while allowing VAT exemptions for the basic-goods basket of 53 items and on raw, intermediate, and other materials physically incorporated into eight basic products; the net reduction of other exemptions on domestic and imported goods; the implementation of a minimum income tax for corporations and sole proprietors via withholding of 1 percent of asset value (0.6 percent of deposits for banks); and a substantial simplification in the excise tax rate structure.

6. Strengthening tax administration is a key priority for 2003 and will be an important focus of discussions with the staff to complete the third review. In this connection, we will adopt and begin implementation of action plans to strengthen the customs and internal tax agencies by end-September 2003. To support these efforts, which will aim at increasing tax revenues by a cumulative 0.6 percent of GDP by 2005, we are requesting additional TA from the Fund.

7. Primary spending of the consolidated public sector is expected to reach a level of 36.3 percent of GDP in 2003 (about 1 percent higher than in the original program), while poverty reducing spending would increase to 16.1 percent of GDP (0.3 percent of GDP higher than programmed). Current and capital spending would increase by 0.7 percent of GDP and 0.4 percent of GDP in relation to the program, respectively (largely reflecting the expenditure revisions of February and April outlined above), but still remain below the 2002 levels.

8. In the long run, increases in spending not directed at poverty reduction or enhanced growth opportunities, even when fully financed by tax revenue, cannot be viewed as a sustainable strategy to address social pressures. For this reason, we view the improvement in the effectiveness of public spending for poverty reduction as critical to our long-run development goals. To this end a high-level commission will be created in consultation with the World Bank to assess fiscal spending and make recommendations to enhance its effectiveness in generating economic growth and reducing poverty in line with the PRSP. The commission is to be established and its terms of reference prepared by mid-June 2003 (structural benchmark), and will make concrete recommendations by mid-September 2003 (structural benchmark) in time for the preparation of the 2004 budget.

9. The asset recovery plan is being implemented on schedule through a firm hired in December 2002 with international experience in asset management. The bidding process was launched in April 2003, and the auctions are expected to take place before end-June 2003. The authorities will not withdraw any of the assets from the auctions. A special scheme that allows coffee-related debt to be repaid using government bonds at face value ended in May 2003; the total amount of debts eligible for this scheme was less than US$31 million (about 7 percent of assets to be sold); and there will be no such similar schemes for other sectors.

10. Monetary policy in 2003 will remain guided by the objective of strengthening the position of the central bank in the context of low-inflation and the crawling peg exchange rate system (with an annual rate of crawl vis-à-vis the U.S. dollar of 6 percent). As part of the strategy to reduce economic vulnerabilities and achieve interest savings, the government plans to further reduce the central bank's domestic debt by US$15 million in 2003, including through buybacks of central bank securities.

11. Strengthening the banking system remains high on the government's agenda. The government will continue to strictly enforce compliance with the regulatory framework, including the capital adequacy requirement. By end-September 2003, new prudential norms limiting liquidity risks will be approved; and the superintendency of banks will start implementing comprehensive regular on-site inspections for all banks (as allowed by the current legislation). By September 2003, a new unit will be set up at FOGADE, the public deposit insurance agency, to manage and liquidate assets in the event of bank failures and legislation will be submitted to the assembly to bring the regulatory framework of the banking system in line with Basel Core Principles. We have requested participation in the IMF's Financial Sector Assessment Program (FSAP) as soon as possible, which will contribute to our policy dialogue on these issues.

12. We continue to pursue the important other structural reforms envisaged in the program. In particular, we remain committed to judicial reform and to seeking the approval of the Law on Public Indebtedness. Regarding the former, we are working on a proposal, which will be completed and made public by September 2003. This proposal will take into account the work done by last year's Presidential commission on this subject and by the Supreme Court with bilateral assistance. Subsequently, a national consultation process will be launched with the end-product being draft legislation to be submitted to the NA.

13. Following the recommendations of the Fund's Stage One Safeguards Assessment of the BCN, the central bank recently sent to the Fund the internal audit report on the reconciliation of international reserves and wrote-off long-overdue outstanding loans to central government/agencies.

14. Efforts are continuing to improve our statistical database. A new GDP series for the period 1994–2000 was officially adopted in late March 2003 and published in mid-May 2003, entailing a 70-percent upward revision based on more accurate survey-based data sources; preliminary GDP estimates for 2001–02 under the new methodology will be ready by June 2003. The revised national accounts will be incorporated into the macroeconomic framework of our PRGF-supported program in the context of the third review. Work is ongoing (with technical assistance from the IMF) to improve the database and sectorization of banking sector accounts, which by end-June 2003 will result in a major improvement in the consistency between the monetary and fiscal sector statistics, and in the quality of data on credit for the private sector. Work to improve balance of payments statistics is also ongoing, but we would like to receive further technical assistance to strengthen these efforts.

15. Implementation of the first annual program supported by the PRGF arrangement will continue to be monitored through quarterly reviews, performance criteria and benchmarks (Tables 1 and 2). The government continues to be firmly committed to the success of the program and stands ready to implement additional measures, as needed, to achieve its objectives.

Table 1. Nicaragua: Quantitative Performance Criteria for 2002–03 PRGF-Supported Program (Performed)

	Cumulative Flows from January 1, 2002										
	Sep. 30, 2002			Dec. 31, 2002				Mar. 31, 2003			
	Prog. 1/	Actual	Base Adjustment	Prog. 1/	Adj. Prog. 2/	Actual	Margin (+), Deviation (-)	Prog. 1/	Adj. Prog. 2/	Actual	Margin (+), Deviation (-)
(In millions of cordobas)											
Net domestic financing of the combined public sector (ceilings) 3/	1,005	881	-124	704	739	520	219	188	441	467	-26
Savings of the combined public sector (floors)	-1,246	-1,224	22	-1,533	-1,511	-1,449	62	-1,641	-1,619	-1,526	94
Net domestic assets of the central bank (ceilings) 3/	-43	-41	2	325	327	-555	882	92	95	-623	718
(In millions of U.S. dollars)											
Net international reserves of the central bank (floors)	-13	-13	0	-13	-13	49	62	-3	-3	41	44
Net repayment of the domestic debt of the central bank (+) (floors) 3/ 4/ 5/	23	23	0	33	-31	33	64	39	-11	18	29
Disbursements of nonconcessional external debt contracted or guaranteed by the public sector (ceilings) 6/	0	0	0	0	0	0	0	0	0	0	0
Stock of external payments arrears (ceilings) 6/	0	0	0	0	0	0	0	0	0	0	0
(In millions of cordobas)											
Memorandum items:											
Indicative targets											
Tax revenue of the central government (floors)	6,007	6,001	-6	8,063	8,057	8,138	81	10,377	10,371	10,520	149
Total primary expenditure of the central government (ceilings)	7,105	7,231	126	10,098	10,224	10,240	-16	12,420	12,546	12,553	-7
Deficit of the combined public sector, before grants (ceilings)	-4,403	-4,406	-3	-6,052	-6,055	-6,004	52	-7,120	-7,123	-6,974	149
Net domestic financing of the non-financial public sector (ceilings) 7/	-869	-1,005	-136	-1,144	-1,121	-1,338	217	-2,208	-1,966	-1,929	-38

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

1/ As stated in EBS/02/94 (11/20/2002).

2/ Adjusted to incorporate actual data for January–September 2002.

3/ Performance criteria for end-December 2002 and end-March 2003 were adjusted for lower disbursements of balance of payments support than programmed and for lower privatization receipts.

4/ Performance criteria for end-December 2002 and end-March 2003 were adjusted downwards by the excess of NIR accumulation compared with the target and upward by lower repayment of central government domestic debt.

5/ Includes dollar-denominated and dollar-indexed debt.

6/ Measured on a continuous basis.

7/ On a cash basis.

Table 1a. Nicaragua: Quantitative Performance Criteria for 2003 PRGF-Supported Program

	September 30, 2002	Cumulative Flows from January 1, 2002 June 30, 2003		September 30, 2003		December 31, 2003
	Program 1/	Prog. 1/	Rev. Prog.	Prog. 1/	Rev. Prog.	Indicative
	(In millions of cordobas)					
Net domestic financing of the combined public sector (ceilings)	1,005	435	17	-206	-227	-535
Savings of the combined public sector (floors)	-1,246	-1,664	-1,433	-1,787	-1,651	-1,760
Net domestic assets of the central bank (ceilings)	-43	-176	-762	-395	-806	-126
	(In millions of U.S. dollars)					
Net international reserves of the central bank (floors)	-13	6	44	17	46	34
Net repayment of the domestic debt of the central bank (+) (floors) 2/	23	56	38	74	84	118
Disbursements of nonconcessional external debt contracted 3/ or guaranteed by the public sector (ceilings)	0	0	0	0	0	0
Stock of external payments arrears (ceilings) 3/	0	0	0	0	0	0
	(In millions of cordobas)					
Memorandum items:						
Indicative targets						
Tax revenue of the central government (floors)	6,007	12,674	12,950	15,198	15,724	18,339
Total primary expenditure of the central government (ceilings)	7,105	14,986	15,209	17,648	18,105	21,195
Deficit of the combined public sector, before grants (ceilings)	-4,403	-8,413	-8,160	-9,859	-9,856	-11,389
Net domestic financing of the nonfinancial public sector (ceilings) 4/	-869	-2,624	-2,941	-3,356	-3,478	-3,703

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

1/ As stated in EBS/02/94 (11/20/2002).
2/ Includes dollar-denominated and dollar-indexed debt.
3/ Measured on a continuous basis.
4/ On a cash basis.

Table 2. Nicaragua: Prior Actions, Structural Performance Criteria, and Benchmarks 1/

Measures	Program: Expected Date of Implementation Through 2nd Review	Program: Status of Implementation	Revised Program: Expected Date of Implementation
I. Prior Actions for Completion of First and Second Reviews			
1. Approval by the national assembly of a tax reform with an estimated net yield of at least C$700 million (1.7 percent of GDP) on an annual basis and C$500 million in 2003 (1.2 percent of annual GDP), and consistent with a combined public sector deficit no higher than 6.3 percent of GDP. The reform should include the elimination of the list of zero-rated VAT products, except for exports, a minimum corporate income tax of 1 percent of assets value, and the taxation of interest income, as described in Paragraph 5 of the Supplementary Memorandum of Economic and Financial Policies (SMEFP).		Done	End-April 2003
2. Approval of the implementing tax reform regulations, limiting to eight the number of VAT exempted basic goods (rice, chicken, sugar, eggs, milk, cooking oil, coffee, and soap) for which raw, intermediate, and other materials physically incorporated into the products are also VAT-exempt; and enabling the collection of a minimum income tax for corporations and sole proprietors via withholding of 1 percent of asset value (0.6 percent of deposits for banks) to begin in July 2003 (see Paragraph 5 of the SMEFP).		Done	Mid-May 2003
II. Performance Criteria			
1. Confirmation by the authorities of compliance by all banks with existing capital adequacy requirements.	End-December 2002	Observed	
2. Asset Recovery Plan (see Paragraph 9 of the SMEFP)			
(i) **Signature of a contract with an international firm to implement asset recoveries.**	End-December 2002	Observed	
(ii) **End of the asset recovery process.**	End-June 2003		End-June 2003
(iii) **Conclude implementation of asset recovery plan for assets received from intervened banks.**	End-September 2003		End-September 2003
3. Approval by the national assembly of a 2003 budget for the central government which, with the projected yield of the 2003 tax package, is consistent with a combined public sector deficit (after grants) target equal or less than 6.3 of GDP.	End-December 2002	Not observed, but in February 2003 an amended budget in line with the program was approved (see Paragraph 3 of the SMEFP).	

Table 2. Nicaragua: Prior Actions, Structural Performance Criteria, and Benchmarks 1/ (Continued)

Measures	Program		Revised Program
	Expected Date of Implementation Through 2nd Review	Status of Implementation	Expected Date of Implementation
III. Benchmarks			
1. Submission to the national assembly of the law on domestic and external indebtedness of the public sector.	End-December 2002	Observed	
2. Submission to the national assembly of an appropriate 2003 tax reform package, in line with Paragraph 17 of the MEFP, yielding 1.0 percent of GDP on an annual basis.	End-March 2003	Modified and converted to a prior action for completion of the 1st and 2nd reviews. See I.1 above.	
3. Approval of prudential norms to limit risks derived from maturity mismatches between assets and liabilities.	End-March 2003	Postponed to receive TA.	End-September 2003
4. Publication and official adoption by the central bank of revised national accounts of (see Paragraph 14 of the SMEFP)			
(i) actual figures for 1994–2000; and	End-March 2003	Adopted in March and published in mid-May.	
(ii) preliminary estimates for 2001 and 2002.			End-June 2003
5. Approval by the national assembly of an appropriate 2003 tax reform package, in line with Paragraph 17 of the MEFP, yielding 1.0 percent of GDP on an annual basis.	End-June 2003	Modified and converted to a prior action for completion of the 1st and 2nd reviews. See I.1 above.	
6. Strengthen tax administration through (see Paragraph 6 of the SMEFP):			
(i) the adoption by the DGA (customs) and DGI (internal tax administration) of action plans for the period 2003–05; and	End-June 2003		End-September 2003
(ii) progress in the implementation of the action plans. 2/	End-December 2003		End-December 2003
7. Start implementing a plan for regular on-site bank inspections, in line with recommendations of MAE 2001 mission.	End-June 2003		End-June 2003

Table 2. Nicaragua: Prior Actions, Structural Performance Criteria, and Benchmarks 1/ (Concluded)

	Program		Revised Program
Measures	**Expected Date of Implementation Through 2nd Review**	**Status of Implementation**	**Expected Date of Implementation**
8. Commission on the quality of public spending to advise the government on how to improve the effectiveness of public spending to generate growth and reduce poverty (see Paragraph 8 of the SMEFP).			
(i) Agree on terms of reference and establish the Commission.			Mid-June 2003
(ii) Present the findings and recommendations for 2004 budget and beyond.			Mid-September 2003
9. Submission to the national assembly of legal amendments in line with Basel Core Principles for effective bank supervision and for changes in FOGADE.	End-September 2003	Changes in enabling legislation for FOGADE was added.	End-September 2003
10. Divest the remaining government stake in ENITEL.	End-September 2003		End-September 2003
11. Judicial reform (see Paragraph 12 of the SMEFP)			
(i) Complete and make public authorities' proposal.			End-September 2003
(ii) Launch national consultation process.			End-December 2003

1/ The specific requirements for the implementation of these measures are specified in the TMU attached to the LOI from the authorities dated November 19, 2002, and in the Supplementary TMU attached to this LOI.

2/ Specific measures will be determined at the time of the adoption of the plans.

Nicaragua—Supplementary Technical Memorandum of Understanding

The Technical Memorandum of Understanding (TMU) attached to the Memorandum of Economic and Financial Policies of November 19, 2002 remains in effect, except as modified by this Supplementary TMU. Tables 1 and 2 below replace the previous tables 1 and 3 of the TMU attached to the Memorandum of Economic and Financial Policies of November 19, 2002.

A. Fiscal Targets

Interest on the domestic debt, includes interest on a due basis, except for the cost of CENIS issued for bank resolution, which are shown on accrual basis. The following table presents the projected interest cost of bank resolutions based on program assumptions, which include a debt buyback of US$20 million during the third quarter of 2003. The interest table is for illustrative purposes only; program performance will be evaluated using actual data.

Table 1. Financial Cost of Bank Resolution 1/
(In millions of cordobas)

	Accrual	Due	Adjustment
2002	1,042	299	743
2003	905	938	-33
2004	343	2,224	-1,881

1/ Corresponds to the interest and dollar-indexation cost associated with the issuance of CENIS due to the bank resolution implemented in 2000–01.

B. Monetary Targets

Net Repayment of the Domestic Debt of the Central Bank

Adjusters: The net repayment of the domestic debt of the central bank will be adjusted: (i) upward (unlimited) in the second quarter in the event of higher asset recovery proceeds than the amounts shown in Table 2; and (ii) upward/downward by up to US$15 million in the third quarter in the event of higher/lower asset recovery proceeds than the amounts shown in Table 2.

Table 2. Nicaragua: Cumulative Program Financing
(In millions of U.S. dollars)

	Privatization	BOP Support	Asset Recovery
	2002		
Q4	11	35	4
	2003		
Q1	11	35	5
Q2	13	75	19
Q3	43	83	49
Q4	53	103	49

Source: Fund staff estimates and projections.

Statement by the IMF Staff Representative
June 18, 2003

1. This statement provides additional information that has become available since the issuance of the staff report on June 4, 2003. This information does not alter the thrust of the staff appraisal.

2. **Implementation of the central bank's asset recovery program continues to be broadly on track, although with a slight modification in the schedule for the next and final auction.** Despite strong opposition from several groups, the first and main auction of assets was successfully held on May 21, involving most real estate and loans acquired by the central bank during the 2001–02 banking crisis. Other smaller auctions involving the sale of artworks, furniture and other items, were held subsequently. Total proceeds from the auctions to date, as well as from recoveries of loans through the special scheme granted to the coffee sector (Paragraph 13 of the Staff Report) are estimated at about US$27 million. Remaining assets were scheduled to be disposed at a final auction on June 26, including assets unsold during previous auctions as well as the coffee-related and small debtor loans that had been excluded from the first auctions (completion of asset sales by end-June constitutes a performance criterion for the next review). However, at the request of the international firm selected to carry out the recoveries, the last auction has been postponed to mid-July in order to appropriately incorporate the experience gained during the first auction (in particular, to ensure smooth functioning of technical support which had experienced some glitches during the first auction).

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

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IMF Completes First and Second Reviews of Nicaragua's PRGF-Supported Program, Approves US$19.8 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the first and second reviews of Nicaragua's performance under a three-year, SDR 97.50 million (about US$138.8 million) Poverty Reduction and Growth Facility (PRGF) arrangement, which was approved on December 4, 2002 (see Press Release No. 02/53). The completion of these reviews enable the release of SDR 13.93 million (about US$19.8 million) to Nicaragua.

The Executive Board also approved Nicaragua's request for waivers on the non-observance of the end-December 2002 structural performance criterion on approval by the national assembly of a 2003 budget for the central government in line with the program, and the end-March 2003 quantitative performance criterion on the net domestic financing of the combined public sector.

Following the Executive Board's discussion of Nicaragua on June 18, 2003, Eduardo Aninat, Deputy Managing Director and acting Chair, made the following statement:

"Nicaragua's performance under its PRGF-supported program has been broadly satisfactory. A moderate recovery of the economy is underway, inflation remains low, the external position has strengthened, and the fiscal program has been kept on track, notwithstanding a difficult economic, social, and political situation and strong pressures for additional spending.
In completing the first and second reviews under the arrangement, the Executive Board noted, in particular, the approval of an appropriate budget for 2003 and of the second stage of the comprehensive tax reform, the implementation of the central banks' asset recovery plan broadly on schedule, and the strengthened enforcement of financial prudential regulations.

"The Nicaraguan authorities have reaffirmed their commitment to the growth and poverty reduction strategy embodied in the program, and the Fund looks forward to its continued forceful implementation supported by strong efforts to secure greater domestic ownership of the reform agenda. Priority objectives for the remainder of 2003 are to further reduce the fiscal deficit while increasing poverty-reducing spending; strengthen the financial sector; and carry to completion the asset recovery plan.

"Sustained structural reforms will remain key to achieving the objectives of Nicaragua's growth and poverty reduction strategy. This will include measures to strengthen tax and customs administration and improve the implementation and monitoring of poverty-reducing programs, as well as continued strong efforts to improve governance, which will strengthen investor confidence and help raise the country's growth potential.

"A continued strong policy performance will enable Nicaragua to reach its completion point under the HIPC Initiative and have access to a substantial relief of its debt burden," Mr. Aninat stated.

Statement by Luis Martí, Executive Director for Nicaragua and Orlando Garner, Advisor to the Executive Director June 18, 2003

On behalf of our Nicaraguan authorities, we would like to thank the Staff and the Management of the International Monetary Fund (IMF) for all the advice and work done toward the making of the report on the country's economic situation and for their broad set of recommendations. Also, they want to recognize the technical assistance received from the Fund and look forward to continue with this helpful relationship.

At this time our authorities request the Fund's support for the completion of the first and second review under the PRGF arrangement, the review of the performance criteria for June 2003 and September 2003, and for a grant waiver for the nonobservance in due time of two performance criteria: the structural performance criteria related to the approval of the 2003 budget and the quantitative performance criteria for net domestic financing of the consolidated public sector. Both conditions have already been fulfilled, in addition to the prior conditions for this review that are fully described in Table II, Attachment II of the staff paper.

Background

Early this year during the Board visit to Central America, the visiting directors had a close view of the Nicaraguan political environment, and the difficulties that this government is facing in promoting a broad economic and structural reform agenda (See Box 1 of the staff paper). The still young Nicaraguan democracy requires a lot of lobbying and dialog among the different actors in order to execute the planned reform agenda and the government has relied heavily upon the discussions promoted in the CONPES (Commission for Economic and Social Planning) where there is representation of almost all the member of the civil society. Our authorities remain grateful for the role that the Directors played during this visit, contributing a great deal to open new channels of dialogue and communication among the government, the different political parties and rest of the groups of the civil society toward attaining the necessary consensus for the approval of envisaged program reforms. Once again, the Nicaraguan Government would like to thank Directors, not only for their interest in enhancing their knowledge of the country, but also for their support to the program showed during their visit.

Amid this complex political environment, the strong commitment of our authorities has persevered, resulting in macroeconomic performance for 2002 well in line with the program, real GDP growth as envisaged at 1 percent, inflation drop to 4 percent below the targeted 6 percent and the external sector strengthened.

Fiscal Policy

Fiscal policy is one of the basic pillars of the program. For this reason our authorities have taken bold measures to protect its foundations, such as the Presidential partial veto to the

2003 budget that was modified unilaterally by Congress, incorporating additional expenditures that were above the program target. Before taking this decision, the President of Nicaragua addressed the nation explaining that even as this addition to the budget would sound right on the surface (municipality transfers and salary rises to policemen, health workers and teachers), it was a serious threat to the country since the completion point and donors' assistance were at risk of being lost if the program went out of track, and for the good of each and every one of the Nicaraguan people he was vetoing the budget. Following the veto and in search of the necessary consensus for the approval of a sustainable budget, a higher spending equivalent to 0.3 percent of GDP[1] was allowed, yet at this time the compensatory revenue measures were incorporated in the form of taxes on luxury cars, cigarettes and commercial banks[2], in addition to some spending cuts, among them a 20 percent reduction in the salaries of the President and all his cabinet ministers, deputy ministers and secretary generals.

It is important to emphasize that at no time has the poverty reduction spending been compromised—as a matter of fact part of the above additional spending (0.2 percent) has been devoted to this purpose. Moreover, for this year the authorities have budgeted funds in a higher amount than originally planned. To have more transparency and better management of the public spending—especially those oriented toward poverty reduction and growth—the Government is establishing a high-level commission that will lend advice to the authorities in this matter. This is one of the agreed benchmarks.

Other bold measure taken prior to this review was the second stage of the tax reform initiated in 2002. This reform that aims to increase efficiency, equity and fairness in the tax system will generate additional revenues on an annual basis of about 1.7 percent of GDP—this surpasses the 1 percent that originally was envisaged under the program. The additional revenues will be used to attend extra expenditures that were agreed on with the legislative power.

Now that a reasonable tax burden has been reached, our authorities will focus their attention on improving customs and tax administration—they expect that once these measures are in place they will improve tax collection by about 0.6 percent of GDP at the end of the program. The government is requiring the Fund's technical assistance for the inception of these measures. Our authorities are fully committed to achieve this benchmark that is scheduled for the third review of the program. '

Monetary and Exchange Rate Policies

[1] The supplementary spending was called for to incorporate increases in the salaries of policemen, health workers and teachers, as well as additional resources to enhance the activities of the Electoral Council, the Judicial System and the Nicaraguan Fire Department. Funds were also allocated for the protection of national landmarks that were close to collapse and required immediate intervention.

[2] These three measures yield a total revenue of 0.3 percent of GDP.

The Central Bank's law mandates price and exchange rate stability as well as the protection of the economy's payment system as the main objectives of the institution. With these in mind, our authorities are conducting a monetary policy that aims at strengthening the financial position of the central bank, in the context of low-inflation and a crawling peg exchange rate system.

With the purpose of improving the financial position of the Central Bank, our authorities are taking the following measures:

- Early buybacks of the bank's domestic debt to help dilute the high concentration debt service that falls due in 2004.

- A proposal to commercial banks to exchange on a voluntary basis their bond holdings for new instruments bearing a lower interest rate and longer maturity, but as indicated in the staff paper, with better financial characteristics that will make these instruments more negotiable. It is important to mention that the commercial banks understand the significance of this measure and have indicated their willingness to cooperate with the Central Bank to make this swap possible.

- They concluded an auction of the assets that the Central Bank had received from intervened banks. To guarantee the transparency of the process, it was conducted by a well known international firm.

Regarding exchange rate policy, our authorities consider that the crawling peg exchange rate regime has served Nicaragua well and will continue using it as an anchor to control inflation. Nonetheless, they have taken notice of the staff's concern about the risk and vulnerabilities associated with a peg, and as indicated in the staff paper, they will conduct a study of their actual exchange rate system to be discussed with the Fund staff.

Financial Sector

As indicated in paragraph 11 of the Supplementary Memorandum of the Economic and Financial Policies, the strengthening of the financial sector is a high priority in the government's agenda. To this end, they have tightened banking supervision and are strictly enforcing the existing regulatory and prudential framework. As the staff point out, the supervisory authority will conduct on-site inspections of all banks and will take the necessary actions to correct any anomaly discovered during these visits.

Once again, our authorities would like to confirm their resolution to obtain the approval of the National Assembly (Not latter than September 2003) of the required reforms of the financial laws that will allow to establish a new set of prudential norms limiting liquidity risk and a regulatory framework in line with Basel Core Principles. Additionally, and with the assistance of the World Bank, they are working in establishing a unit responsible for the management and liquidation of assets resulting from possible bank failures. This unit will be a component of the recently created deposit insurance system (FOGADE).

To identify the strengths and vulnerabilities of the Nicaraguan financial system, and to determine the system's developmental and technical assistance needs, as well as to help prioritize policy responses, the government is requesting the inclusion of the country in the Financial Assessment Program (FSAP).

External Debt

At the outset, our authorities would like to recognize the assistance given to Nicaragua by the International community during the 2002 Paris Club meeting, where most of the donors offered full debt forgiveness. The government would also like to reaffirm their commitment to only obtain concessional loans and carry no arrears, and they are doing their best efforts to obtain comparable HIPC debt relief from all non-Paris Club creditors.

The Nicaraguan Government has indicated their determination to comply with all the necessary conditions to reach the HIPC completion point by the end of 2003. In search of this objective, substantial progress has been made not only in macroeconomic aspects but in the areas of structural reforms and governance as well. On top of this, there is a well designed PRSP that is in its second year of implementation.

External Sector

Nicaragua is a relatively open economy that will be strengthened by a free trade agreement between the Central American countries and the USA. As indicated in the staff report, this agreement will be an essential source of medium-term growth, that will add to the benefits of the free-trade agreements with Mexico, Chile, Panama, Dominican Republic (these last three agreements are in the process of ratification by the National Assembly), and to those of the agreement with Canada that is being negotiated at this present.

Another important action toward trade liberalization was the recent elimination of a tax surcharge imposed on the imports coming from Honduras. This action makes trade within the Central American countries almost free.

To further facilitate trade, our authorities are in the process of revising their custom methodology and database. As indicated in the staff paper, they will seek the Fund's technical assistance for this important task.

To conclude, our authorities remain confident that they will be able to gather the necessary political support to continue with the pace of reform, especially now that the main challenges (the budget and the tax reforms) of the program have been accomplished. We sincerely believe that underneath the political disputes there is clear understanding among the different political parties of the serious implications if the program goes out of track, and it can be expected that none of them will risk their political capital by going against the program.

Our authorities would like to reiterate their commitment with regard to the fight against corruption and to the improvement of governance and transparency in all governmental activities.