November 2004
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Nicaragua: Fifth and Sixth Reviews Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Request for Waiver and Modification of Performance Criteria, and Financing Assurances Review—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Nicaragua

In the context of the fifth and sixth reviews under the three-year arrangement under the Poverty Reduction and Growth Facility, request for waiver and modification of performance criteria, and financing assurances review with Nicaragua, the following documents have been released and are included in this package:

- the staff report for the fifth and sixth reviews under the three-year arrangement under the Poverty Reduction and Growth Facility, request for waiver and modification of performance criteria, and financing assurances review, prepared by a staff team of the IMF, following discussions that ended on **July 17, 2004,** 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 August 24, 2004**. 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 Press Release summarizing the **views of the Executive Board as expressed during its September 8, 2004 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 *
Memorandum of Economic and Financial Policies by the authorities of Nicaragua*
Technical Memorandum of Understanding*
*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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INTERNATIONAL MONETARY FUND

NICARAGUA

Fifth and Sixth Reviews Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Request for Waiver and Modification of Performance Criteria, and Financing Assurances Review

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

Approved by Markus Rodlauer and G. Russell Kincaid

August 24, 2004

PRGF arrangement. A three-year PRGF arrangement for SDR 97.5 million (75 percent of quota) was approved on December 13, 2002. The first and second reviews were completed on June 18, 2003, the third review on October 20, 2003, and the fourth review and completion point under the enhanced HIPC Initiative on January 23, 2004.

Economic developments. The macroeconomic framework is broadly on track. Growth is recovering; inflation is somewhat higher mainly because of higher oil prices; and the external position has strengthened further since the last review. The fiscal deficit was slightly higher in 2003 than programmed (because of a revenue shortfall and expenditure overruns), but measures have been taken to keep the fiscal program on track.

Main review issues. The policy discussions focused on the macroeconomic framework for 2004, including the fiscal measures needed to keep the fiscal program on track; fiscal reforms to ensure medium-term debt sustainability; other structural reforms, with emphasis on the banking sector; and financing assurances.

Mission. The mission visited Managua during March 9–17, and follow-up discussions were held at headquarters during March 29–April 2 and in Managua during July 12–17. The mission met with President Bolaños, Secretary General of the Presidency Montealegre, Finance Minister Montiel, Planning Minister De Franco, Central Bank President Alonso, other senior government officials and representatives of the assembly, civil society, and the private sector. The team comprised Philip Young (head), Sergio Martín, Monica Perez dos Santos, Jordi Prat, Mayra Zermeño (all WHD), Antonio Spilimbergo (FAD), James P. Walsh (PDR), Armando Morales (MFD), Gabriela Rosenberg (LEG), Luis Breuer (resident representative; head of July mission), and Humberto Arbulú-Neira (incoming resident representative). Mr. Rodlauer (WHD) joined the mission for a growth seminar on March 9. World Bank and IDB staff participated in some of the meetings.

Contents Page

Boxes

Appendices

Attachments

Abbreviations and Acronyms

BCN	Central Bank of Nicaragua
BCP	Basel Core Principles
BPI	Indemnity Bonds
CDs	Certificates of Deposit
CPS	Combined Public Sector
DGA	General Directorate of Customs
DGI	General Directorate of Internal Revenue
DRF	Debt Reduction Facility
DSA	Debt Sustainability Analysis
ENACAL	Nicaraguan Water and Sewerage Company
ENITEL	National Company for Telecommunications
ENTRESA	National Company for Electricity Transmission
FAD	Fiscal Affairs Department
FISE	Emergency Social Investment Fund
FSAP	Financial Sector Assessment Program
GCO	Comptroller General's Office
GDDS	General Data Dissemination System
HIPC	Heavily Indebted Poor Countries
IDA	International Development Association
IDB	Inter-American Development Bank
IDR	*Instituto de Desarrollo Rural*
INIFOM	Nicaraguan Institute of Municipal Development
LEG	Legal Department
LOI	Letter of Intent
MFD	Monetary and Financial Department
NDP	National Development Plan
NIR	Net International Reserves
NPL	Nonperforming Loans
NPV	Net Present Value
ODA	Overseas Development Assistance
PAYG	Pay-as-you-go
PC	Performance Criterion
PIP	Public Investment Plan
PLC	*Partido Liberal Constitucionalista*
PRGF	Poverty Reduction and Growth Facility
PRSC	Poverty Reduction Support Credit
PRSP	Poverty Reduction Strategy Paper
SECEP	Secretariat of Coordination and Strategy of the Presidency
SMEFP	Supplementary Memorandum of Economic and Financial Policies
SBOIF	Superintendency of Banks and Other Financial Institutions
STA	Statistics Department
TA	Technical Assistance
TMU	Technical Memorandum of Understanding
VAT	Value-added Tax
WB	World Bank

EXECUTIVE SUMMARY

Background

- **Maintaining the domestic consensus on prudent policies and reforms is a major challenge in the current difficult political environment.** In 2003, consensus was facilitated by the common goal of reaching HIPC completion (accomplished in January 2004). Municipal elections scheduled for November 2004 have increasingly overshadowed the political landscape this year.

- **Macroeconomic performance has been broadly satisfactory.** Economic growth is accelerating; inflation, albeit somewhat higher due to increased oil prices, remains under control; and official reserves are above program targets. The performance criterion on public savings and all indicative fiscal targets were missed in late 2003, but the March 2004 targets were met and measures have been taken to keep the program on track. However, a mid-May structural PC on approving a law granting legal protection to supervisors was not observed.

- **Despite the favorable performance, the economy remains vulnerable because of high public debt, extensive dollarization, and weakness in the financial system.** To address these vulnerabilities, the government's reform agenda (as outlined in the National Development Plan) includes continued fiscal consolidation, financial sector reforms, other structural reforms to strengthen competition and growth, and improved governance and transparency.

Policy discussions

- **The macroeconomic framework for 2004 has been broadly maintained.** Growth is projected to accelerate to 3.7 percent in 2004, inflation to increase to 7 percent, and the external position to strengthen further as exports are boosted by the recovery in partner countries.

- **The authorities have adopted measures to keep the fiscal program on track, but important challenges remain.** The program contains important fiscal reforms, including steps to improve tax administration, tighten expenditure control, and raise the quality of government spending.

- **Monetary policy is on track.** The external position has continued to improve, with international reserves exceeding the program targets by a wide margin. The authorities are finalizing a comprehensive study that will suggest options for future exchange rate policy.

- **The structural reform agenda is moving forward, although somewhat slower than originally envisaged.** A timetable has been adopted to ensure that decentralization is fiscally neutral by 2007. The authorities are reassessing their pension reform strategy, in collaboration with the World Bank, to ensure that the reform is consistent with macroeconomic sustainability.

- **Program risks remain high.** Spending pressures from vested interests will likely intensify as the November municipal elections approach. The program addresses these risks through further fiscal consolidation and structural reforms to address the vulnerabilities described above.

I. Background and Recent Developments

1. **Consolidating the domestic consensus on prudent policies and structural reforms remains a challenge**. During 2003, the authorities were able to keep the program broadly on track, despite a difficult political environment (Box 1), supported by a broad national consensus on achieving HIPC completion (accomplished in January 2004). With municipal elections scheduled for November 2004, pressures are again building to relax fiscal discipline and reaching consensus on the structural agenda has become more difficult. Nonetheless, a widespread recognition in Nicaragua that the PRGF-supported program has contributed to an economic recovery, and that sustained program implementation is necessary for continued growth and donor support, should help mitigate these pressures.

Box 1. The Political Environment

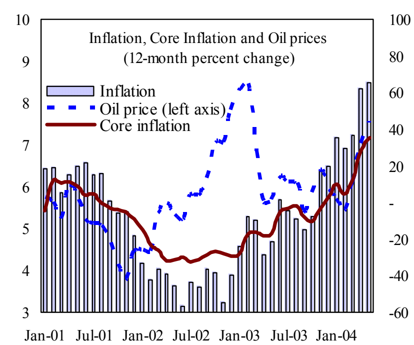
The political environment in Nicaragua remains highly fractured, complicating steady implementation of the government's economic program. Nicaragua has long been divided into two political camps: the *Sandinistas* (FSLN) and the anti-*Sandinistas* (led by the Constitutionalist Liberal Party, PLC). In 2002, President Bolaños, who was elected with the support of the PLC, clashed with a majority of the party over his anti-corruption actions, which included the prosecution and subsequent conviction of former president Alemán. As a result, the government has had to seek new political alliances for every key policy initiative.

The political arena in 2004 remains dominated by the conflict over the future of former president Alemán, the government's initiative to reform the judiciary, and municipal elections. A majority of PLC deputies remain loyal to Mr. Alemán, and his recent transfer from house arrest to prison has further raised tensions. The judicial reform proposed by the government aims at granting independence to the administration of justice, including from interference by political parties. The elections of 152 mayors could contribute to deepening the country's polarization around the two main political camps.

President Bolaños recently called for a national dialogue to garner the needed domestic consensus to advance the reform agenda. He proposed that the dialogue center on core governance and growth issues, including depoliticizing the judiciary, presidential term limits, strengthening property rights and institutions, prudent macroeconomic policies, a multiannual budget and public wage policy, and strengthening the electoral system.

2. **Macroeconomic results have been largely favorable:**

- ***A moderate recovery is underway.*** Real GDP is estimated to have grown by 2.3 percent in 2003, in line with the program. A recovery of credit to the private sector is continuing, and formal sector employment is growing at an annual rate of about 5 percent. Inflation has edged up since early 2003, mainly due to the rise in world oil prices; estimated core inflation[1] is running at about 7 percent—about ¾ percentage point less than the headline rate.



Source: Central Bank of Nicaragua.

[1] Excludes food and energy prices.

- ***The external position is stronger than programmed.*** Private capital flows and buoyant foreign remittances, though volatile, boosted NIR to over US$30 million (0.8 percent of GDP) above the end-2003 program floor. Exports rose by almost 8 percent in 2003, led by a recovery in coffee prices and an expansion of nontradi-ional manufactures. Imports grew by 6 percent, reflecting higher oil prices and strong growth of consumer goods imports.

3. **Despite the favorable macroeconomic outturn in 2003, the performance criterion on public savings and all indicative fiscal targets were missed at end-2003; nonetheless, data for the first quarter of 2004 indicate that the program is on track.**

- ***Tax revenues in 2003 fell short of program projections by 0.4 percent of GDP.*** Income tax collections were affected by legal challenges, taxpayer resistance to the new minimum income tax, and greater use of the accelerated depreciation scheme;[2] VAT receipts suffered from larger rebates associated with former zero-rated products,[3] and some accumulated arrears on VAT, which are to be cleared in 2004.

- ***Capital spending accelerated in the fourth quarter of 2003.*** The additional spending (0.9 percent of GDP above the program) was fully financed by concessional external resources (grants or loans from multilateral organizations) and was largely directed to poverty-reducing programs.

- ***As a result, the overall deficit of the combined public sector (CPS) before grants (indicative target) was missed by 0.8 percent of GDP, while the end-2003 performance criterion (PC) on savings of the CPS was missed by 0.2 percent of GDP.*** The authorities are requesting a waiver for the savings PC on the basis of the minor deviation and the measures taken to keep the fiscal program on track this year (¶2 of the attached Letter of Intent).

- Data through May 2004 indicate that economic activity continues to grow, fiscal revenues have been performing well, and government expenditures are broadly as programmed. All quantitative PCs and indicative targets for the sixth review have been met, except for the indicative target on primary spending of the central government, which was exceeded slightly (by less than 0.1 percent of annual GDP). However, a structural PC on approving a law to grant legal protection to supervisors was not observed, due to continued debate in the assembly on some elements of the draft law submitted in December 2003.

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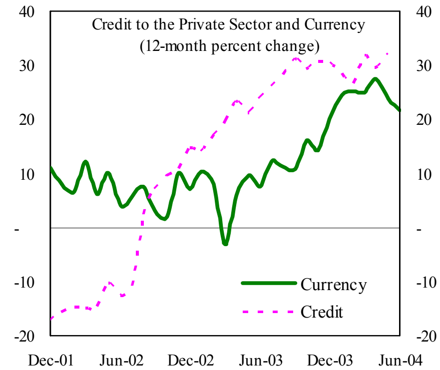
[2] The accelerated scheme allows firms to decide themselves on the depreciation rate for their investments. The use of this scheme rose sharply in 2003 as firms took advantage of it in anticipation of the restrictions imposed by the May 2003 tax reform (limiting it to export firms and ongoing investments as of June 2003).

[3] The zero-VAT rate was in effect for 53 products until May 2003, with firms producing these goods entitled to reimbursement for the VAT they paid on inputs. The May 2003 tax reform eliminated the zero VAT rate.

4. **The monetary program is on track**. Currency grew rapidly in 2003 and early 2004 (from a low base following the banking crisis of 2000–01), reflecting increased economic activity, renewed confidence in economic management, and falling interest rates. Private sector credit has continued to rebound since the fourth quarter of 2002, reflecting the improving business outlook and the "crowding-in" effect of fiscal consolidation and the reduction of domestic public debt.



Source: Central Bank of Nicaragua.

5. **The authorities are reinforcing their growth strategy through the national development plan (NDP).** The NDP is part of the authorities' effort to reinvigorate policy reform momentum following HIPC completion, developing in particular, the first pillar of their strategy on poverty reduction, economic growth, structural reform, and institutional strengthening.[4] Staff has strongly encouraged these efforts, including through participation in a high-level growth workshop in March 2004.[5]

II. Policy Discussions[6]

6. **The macroeconomic framework for 2004 is being maintained.** The key economic objectives are:

	2002	Prog. 1/ 2003	Prel. 2003	Prog. 1/ 2/ 2004	Rev. Prog. 3/ 2004	Rev. Prog. (Adjusted) 2/ 2004
Real GDP growth (in percent)	1.0	2.3	2.3	3.7	3.7	3.7
Consumer prices (end period)	4.0	6.0	6.6	5.0	7.0	7.0
Gross international reserves (in millions of US$)	453.7	446.6	504.1	524.3	553.2	550.2
Change in augmented reserve position 4/ (in millions of US$)	81.9	55.1	89.0	66.2	134.1	134.1
Central government overall balance after grants (in percent of GDP)	-4.1	-2.3	-3.3	-1.2	0.5	-0.7
Combined public sector balance after grants (in percent of GDP)	-5.5	-3.8	-4.4	-3.1	-1.7	-2.9
Savings of the combined public sector (in percent of GDP)	-2.5	0.2	0.0	3.5	2.4	3.3

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

1/ As stated in IMF Country Report No. 04/71. For 2004, CPS deficit has been adjusted to account for delay in pension reform (lower by 0.6 percent of GDP).
2/ Using previous HIPC accounting methodology—external debt service in fiscal accounts recorded net of relief.
3/ HIPC relief from multilaterals creditors shown as grants, with total interest payments recorded as current expenditure and total amortization shown below the line.
4/ Change in official NIR plus net repayment of public sector domestic debt (central bank and central government).

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[4] A more detailed description of the NDP is presented in Box 5 of IMF Country Report No. 04/71.

[5] The seminar was organized jointly by the government, the IMF, and the World Bank.

[6] Paragraph references (¶) in this section refer to the SMEFP, unless otherwise indicated.

A. Fiscal Policy

7. **The authorities concurred with the staff that achieving long-term debt sustainability will require continued fiscal consolidation.** As shown in the completion point debt sustainability analysis (DSA),[7] the public debt burden remains high, requiring further efforts at fiscal consolidation over many years to put the debt dynamics on a sustainable path. In addition, decentralization, pension reform, and civil service reform will carry additional near- and medium-term fiscal costs that will need to be absorbed within the overall budget constraint. To address these challenges, the authorities' medium-term fiscal program includes further efforts to strengthen tax administration, streamline and raise the quality of public expenditures, and improve public enterprise management. They remain fully committed to the fiscal adjustment path in the program, which is embodied in the policies outlined in the National Development Plan.

Central government budget

8. **The authorities are taking measures to ensure that the budget for 2004 remains on track.** Measures equivalent to about ½ percent of GDP (see table below) have been adopted to ensure that the central government balance and the combined public sector balance for the entire year remain in line with the program. On the revenue side (¶8), the VAT base is being expanded, a new tax on gambling will be introduced by September 2004, and water and sewerage billing is being strengthened. In addition, the tax office (DGI) has intensified its efforts to collect 2003 tax arrears. The government also remains firmly committed to oppose any additional tax benefits to the private or public sectors, and to maintain a database on forgone revenues arising from tax exemptions.

Summary of Fiscal Measures 1/	Expected yield in 2004 (In percent of GDP)
Total	0.55
Central government	0.44
Tax policy measures	0.15
Expenditure cuts	0.29
Public enterprises	0.10
ENACAL (water and sewerage company)	0.06
ENTRESA (electricity transmission)	0.04
Municipalities debt payments to INSS	0.01

Source: Data provided by the Ministry of Finance.

1/ Measures are defined as the difference in yield between the active and passive scenarios, where the latter is based on no policy change. Excludes revenue overperformance in early 2004.

[7] Nicaragua—Enhanced Initiative for Heavily Indebted Poor Countries—Completion Point Document (IMF Country Report No. 04/72).

9. **The authorities have strengthened controls over public spending to prevent renewed expenditure overruns (¶11).** They have created a monthly reporting and monitoring system for current and capital expenditures. To strengthen accounting discipline and monitoring capacity, responsibility for the payment to suppliers and contractors is being transferred from the numerous executing agencies to the ministry of finance, and accounting procedures are being strengthened. The authorities also remain committed to postponing capital spending by the equivalent amount of any shortfall in tied foreign financing, while making every effort to protect poverty-reducing spending.

10. **The composition of the budget for 2004 has been modified, while the overall fiscal deficit targets are unchanged (¶9).**

- ***On June 17, the assembly approved higher spending than envisioned under the program.*** The additional spending amounted to about 0.4 percent of GDP, mainly for higher teachers' salaries, transfers to universities,[8] and subsidies to public transportation cooperatives.[9]

- ***The additional spending will be offset by a projected overperformance in revenues (0.3 percent of GDP) based on a better-than-programmed outturn in the first part of the year,[10] and by cuts in nonpoverty-related expenditures***[11] (0.1 percent of GDP). Staff cautioned that if demands from other groups for similar salary increases were met, this would jeopardize attainment of the program's fiscal targets.

- ***The budget also faces additional costs of about 0.2 percent of GDP because of higher oil prices.*** These include higher costs in oil consumption (0.1 percent of GDP) and investment projects (0.1 percent of GDP). The authorities are compensating the additional current costs by reducing fuel and electricity consumption (by executive order). Although the authorities expect that higher capital costs will be compensated by under execution of projects, they have requested a slight increase in the adjustor for higher project financing from the World Bank and IDB, by 0.1 percent of GDP, to accommodate the higher costs if necessary.

11. **The authorities agreed with the staff that further improving the growth and anti-poverty orientation of public spending is critical to their long-term development**

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[8] In response to a ruling by the supreme court calling for a transfer to universities equivalent to 6 percent of budget expenditures.

[9] This measure was taken to cushion the impact of higher oil prices on the poor.

[10] The mission agreed with the authorities that the overperformance should be sustainable, as it largely reflected the growing impact of the 2003 tax reform and stronger economic activity.

[11] These expenditures measures include slowing down nonpriority investments and strict enforcement of the requirements on municipal transfers.

goals. To this end, they have extended the mandate of the Public Expenditure Commission to include the following tasks (¶10 and ¶11):

- Assess the public investment plan (PIP) to determine projects' social rates of return, and facilitate project prioritization.
- Improve the classification of current and capital spending in the PIP.
- Carry out an annual public expenditure review, with World Bank (WB) support.
- Refine the definition of poverty-reducing spending, in consultation with the WB.

Public enterprises

12. **The authorities are working to improve the efficiency of public enterprises (¶14)**. The water and sewerage company (ENACAL) is strengthening collections of overdue accounts, including through outsourcing of billing and collection, and a revised legal framework was approved in December 2003, giving the company additional powers for the collection of arrears. Regarding the power sector, the authorities are implementing the roadmap agreed in 2003 with IDA and the IDB, including steps to improve financial and operational efficiency, make government subsidies more transparent, and improve the sector's policy, regulatory, and legal frameworks. Nonetheless, important challenges remain, including to improve the regulatory and tariff framework.

Fiscal reforms

13. **Several key reforms are underway to support medium-term fiscal consolidation (¶13, Box 2):**

- **Tax administration.** As part of a comprehensive effort to improve tax administration, the DGI has reorganized the large taxpayers unit, updated the database on large taxpayers, and started a pilot program to reduce the number of non-filers, stop-filers, and inaccurate returns.[12] [13] The customs office (DGA) has started to implement an action plan to improve customs administration with technical assistance from the IDB.[14] A new Tax Code, incorporating comments from FAD, is now under consideration by the national assembly (Box 3), with approval expected by October 2004.

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[12] FAD appointed a resident tax advisor in April 2004, to help implement the DGI's action plan.

[13] Staff is proposing to replace an earlier benchmark on presenting a three-year strategic IT plan with a new benchmark on implementing effective procedures to monitor stop filers and delinquent taxpayers, in line with FAD recommendations.

[14] FAD will review the work plan and coordinate closely with the IDB.

Box 2. Medium-Term Fiscal Program

Fiscal consolidation is a key plank of the government's medium-term economic strategy. The strategy comprises actions on a number of fronts, including tax reform, spending reform, and structural reform.

Tax reform

- **Tax administration.** The objective of reforming the domestic tax (DGI) and customs administration (DGA) is to increase revenue collections by transforming the tax administration into a modern and efficient institution and strengthening the legal framework.

- **Tax code.** The draft Tax Code sets out the rights and obligations of tax administration and taxpayers and establishes sanctions for tax violations (Box 3).

Spending reform

- **Public expenditure commission.** The commission, established in 2003 to enhance the growth and anti-poverty orientation of the budget, will review the spending of key ministries (education, health, and those carrying out investment projects). A key task of the commission is to conduct a thorough review of the public investment program and establish a priority list for project implementation. The recommendations are to be incorporated into next year's budget.

Structural reforms

- **Pension reform**. Following the findings of an inter-institutional pension reform committee, which identified the transition cost of pension reform, the authorities in close consultation with the World Bank are reassessing their reform strategy. A revised strategy is to be adopted by the time of the next review.

- **Decentralization.** The municipal transfers law (July 2003) calls for increasing revenue transfers to municipalities starting in 2004, but does not simultaneously devolve commensurate spending responsibilities. The authorities are committed to gradually shifting spending responsibilities with a view to full fiscal neutrality by 2007.

- **Civil service reform.** A new civil service law was approved last December, which aims at making the civil service more professional. Implementation started in July 2004, and will be completed in 2007. The fiscal cost is being estimated and will be included in the annual budget, starting in 2005.

- **Fiscal responsibility law.** The draft law (submission is proposed as a structural PC for mid-October 2004; was a structural benchmark for June 2004) should include, *inter alia*, fiscal rules for all levels of government; explicit transparency requirements to underpin the credibility of such rules; a comprehensive coverage of debt (domestic and external); and provide for an independent agency to monitor and enforce the new framework. FAD and LEG have provided comments on a preliminary draft of the law, and the authorities are preparing a revised draft.

- **Transparency.** The authorities have made progress improving the tracking of poverty-reducing spending and putting budget execution reports on the finance ministry's web page. They also intend to prepare a comprehensive list of tax exemptions by major type of tax category by end-October 2004.

Administrative career law for customs and tax offices. This draft law, submitted to the assembly in late 2003 and still under discussion, is intended to strengthen human resource management in the tax collection agencies by establishing criteria for hiring, promotion, and retirement.

Box 3. The Tax Code

Nicaragua needs a modern tax code that promotes taxpayer compliance, strengthens the tax administration's capacity to determine and collect tax liabilities, and establishes effective sanctions for those who fail to comply with their obligations. A new draft tax code was submitted to the assembly in November 2003. Its approval was a benchmark for March 2004; it is now expected for end-October 2004.

The tax code should focus on: (1) describing the elements giving rise to a tax liability; (2) establishing administrative nonjudicial procedures for tax collection and for contesting a tax liability; and (3) outlining an effective regime for penalties and sanctions.

In particular, the tax code should specify that:

- The elements giving rise to a tax liability (i.e., the tax base, tax rate, and taxpayer) can only be established by law;
- The procedures for collecting taxes and for solving disputes shall be administrative, to avoid the problems associated with current judicial procedures (i.e., high costs, overloaded judges and courts, and the possibility of corruption);
- In case of a dispute, the tax administration's silence should be interpreted as denying a taxpayer's petition, once the time for a ruling has lapsed; and
- The tax administration shall not be allowed to forgive the payment of interest and penalties.

The tax code should also clearly identify (1) when a tax liability arises and what the components of that tax liability are (i.e., tax, fees, penalties, and interest); and (2) an effective regime of sanctions, including what constitutes a tax crime.

The tax code should enter into force six months after its approval. This would allow time for the approval of implementing regulations and for the necessary training of staff.

- **Decentralization.** The municipal transfers law (July 2003) mandates increased revenue transfers to municipalities starting in 2004,[15] but does not simultaneously devolve commensurate spending responsibilities (Appendix IV). The mission, supported by the WB and IDB staff, urged the authorities to match revenue transfers with spending devolution, to ensure fiscal neutrality of the process. The mission emphasized that there were important risks involved in the decentralization process stemming from, *inter alia*, weak control and monitoring of municipal spending, poorly specified municipal mandates, and weak governance structures in the municipalities. The authorities agreed that fiscal neutrality is an important medium-term goal, but explained that because of the lack of implementation capacity in municipalities, and the need to reach a domestic consensus on the devolution of spending responsibilities, this could only be achieved gradually: in 2004, about

[15] In 2004, transfers to municipalities will amount to 4 percent of tax revenue, rising gradually to 10 percent by 2010.

10 percent of revenue transfers will be matched by spending transfers,[16] rising gradually to 100 percent by 2007.[17] To this end:

- A special advisor has been appointed (prior action) to make specific recommendations on reorganizing intergovernmental relationships and to devise a clear timetable and management process for devolving expenditures and responsibilities.

- A presidential decree will be issued modifying the regulations of the Law of Municipalities in a fiscally sustainable manner, consistent with the conditionality under the World Bank's Poverty Reduction Support Credit (PRSC).

- A unit will be created in the ministry of finance to report on decentralization (September 2004 benchmark).[18] The unit will collect data on municipal operations.[19] Under the current law, municipalities must submit their annual budget before February 15 in order to be eligible to receive central government transfers.

- **Pension reform.** Pension reform is moving more slowly than originally envisaged.[20] Although the authorities committed to a roadmap for pension reform prior to HIPC completion,[21] at the recommendation of IMF-WB staff, the authorities have postponed implementing a new system until the fiscal implications are well defined and compensating reforms are adopted for the public pension system. The authorities agreed that proceeding hastily could result in a poorly designed and costly system. They have agreed to complete a review of the pension reform strategy, in close consultation with the World Bank, by end-October 2004. The postponement should result in only marginal fiscal costs over the long term. The program targets have been adjusted to reflect the delay in introducing the new system.[22]

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[16] Mainly, capital projects that were to be implemented by central government agencies.

[17] The gradual schedule (see ¶13), while not optimal, still fits into the PRGF's macroeconomic framework.

[18] This benchmark, and one on shifting expenditure responsibilities to municipalities (equivalent to one-third of revenues transfers in the 2005 budget), replace two previous benchmarks in the decentralization area (IMF Country Report No. 04/71, Attachment II, Table 2).

[19] With technical assistance from the international financial institutions, the authorities intend to expand the definition of the nonfinancial public sector to include municipalities. A specific action plan will be devised at the next review.

[20] Originally, the new pension system was to start in July 2004.

[21] This was a trigger condition.

[22] As indicated in IMF Country Report No. 04/71, the combined public sector deficit was expected to widen by 1.2 percent of GDP a year as a result of the start of private pension funds (because of lower contributions). The delay should therefore reduce the fiscal deficit commensurately.

- **Debt management.** A new public debt law, approved in December 2003, established the procedures for public sector borrowing and created a technical committee to formulate an annual public debt strategy. The committee's first report was presented to the assembly in July 2004.

B. Monetary and Exchange Rate Policies

14. **The stance of monetary policy remains broadly appropriate, as evidenced by the achievement of the program targets for international reserves and inflation remaining under control (in the context of the crawling peg regime).** The monetary program for 2004 targets a further NIR buildup of US$20 million (¶16), with currency growth slowing to about 9 percent (broadly in line with nominal GDP growth). Notwithstanding the recent accumulation of international reserves, they cover only about half the annual gross financing requirement and the financial system remains highly dollarized. Consistent with the program, net public domestic debt is projected to decline by US$114 million (3 percent of GDP). Although headline inflation has crept up, this reflects mainly the impact of high world oil prices, and the authorities are confident that inflation will come down as oil prices stabilize (as projected by WEO). Staff recommended keeping the inflation outlook under close review in the coming months.

15. **The crawling peg has been useful as a nominal anchor, but it is also an important source of vulnerability.** For 2004, the authorities have announced a rate of crawl of 5 percent (down from 6 percent last year). They have been working on a study of Nicaragua's exchange rate regime. The study, in line with FSAP findings, is to be completed by the next review.

16. **Bank lending has continued to grow rapidly, but the authorities expect it to slow in the course of the year.** They noted that interest rates, after falling sharply over the past few months, had leveled off recently, and they expected new prudential regulations on maturity mismatches and currency risk to play a moderating effect on credit growth. Although credit card lending has grown particularly fast in recent months, the authorities noted that this was still only a relatively small proportion of total lending, and interest rates adequately reflected risk. The staff recommended close prudential oversight, with focus on areas of particularly rapid credit growth.

C. Financial Sector

17. **The economic recovery and lower domestic interest rates are boosting bank profitability.**[23] Financial sector indicators are stable or improving (nonperforming loan ratios are declining, returns are increasing, and provisions are little changed relative to

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[23] Deposit rates have fallen faster than lending rates.

nonperforming loans in the first quarter). However, these data need to be interpreted cautiously in light of concerns about data reliability.

Nicaragua: Selected Financial Soundness Indicators for the Financial System

(In percent)

	2001	2002	Prel. 2003
Capital adequacy ratio	16.4	18.0	14.2
NPLs to gross loans	9.3	12.3	12.7
Return on equity	28.7	23.9	29.2
Ratio of liquid assets to total short-term liabilities	157.6	155.8	159.1
Foreign currency liabilities to total liabilities 1/	70.8	73.2	71.0
Foreign currency loans to total loans	81.9	82.3	83.3

Source: Superintendency of banks and other financial institutions.
1/ Excludes liabilities in córdobas indexed to the exchange rate.

18. **The FSAP missions commended the authorities on their effort to strengthen the financial sector.**[24] The mission noted the progress made with banking reforms in recent years, in parallel with the consolidation process experienced by the banking system following the severe banking crisis in 2000–01. Areas of progress include the initial implementation of a risk-analysis approach, new capital requirements for open foreign currency positions, liquidity requirements based on maturity mismatches (in line with MFD recommendations), payments system reform, and a new public debt law.

19. **At the same time, the FSAP missions also identified several areas for improvement (Box 4).**[25] In particular, bank supervisors need better legal protection (several judiciary rulings on supervisory decisions have made it difficult for bank supervisors to effectively fulfill their mandate) and the supervision of the operations of "foreign" parallel banks[26] needs to improve—because of lack of consolidated supervision, the true condition of financial groups is uncertain.

20. **The authorities agreed with the FSAP's key recommendations and intend to use them in formulating a roadmap for additional reforms.**

- ***In particular, they agreed with staff that better legal protection for bank supervisors is needed.*** In December 2003, the authorities submitted to the assembly a draft law to this effect (PC), which was not approved by the assembly in mid-May 2004 (PC) due to continued debate on key elements of the draft law. With Fund technical assistance, the authorities prepared in July 2004 a revised draft legislation on legal protection;[27]

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[24] FSAP missions visited Managua in November/December 2003 and February 2004.

[25] FSAP recommendations are described in detail in the accompanying FSSA report.

[26] Regional banks that share the same majority shareholders as domestic banks.

[27] The revised draft law incorporated most, but not all of the recommendations provided by LEG and MFD.

Box 4. Key Recommendations of the FSAP Missions

Short-term priority actions

Legal framework

- Approve adequate legal protection for supervisors.
- Amend the banking law and issue regulations to enable consolidated supervision.
- Improve banking resolution procedures, including enactment of new legislation.
- Review composition and tenure of the boards of the BCN and the SBOIF.
- Eliminate excessive scope for banking secrecy in banking law.
- Amend provisions in the SBOIF law that compromise the independence and discretion of the superintendent.

Monetary operations and systemic liquidity

- Increase credibility of the safety net by improving design of facilities.
- Revise the reserve requirement regime in the BCN law.
- Settle large-value payments exclusively through a designated gross settlement system to reduce credit risk and settle low-value payments through a system focused more on cost efficiency than on safety (e.g., reducing the use of the check).

Banking regulation and supervision

- Strengthen "ring-fencing" of operations of the local banks involved in cross-border activities.
- Incorporate predetermined triggers for the application of corrective measures when a bank's capital ratio falls below a certain level.
- Adopt and enforce IFRS or U.S. GAAP as the accounting framework for financial institutions.
- Approve regulations on fit and proper attributes to be furnished by all persons interested in purchasing shares of a financial institution, and extend it to directors and officers of all financial institutions.
- Increase role of the SBOIF on the surveillance of major acquisitions of financial institutions.

Short- and medium-term actions

- Recapitalize the BCN and improve fiscal-monetary coordination.
- Make consistent deposit insurance coverage and premium, in line with comparable countries.
- Increase payment instruments and services offered by the automated clearinghouse.
- Make collections and disbursements for the public sector through electronic means.
- Link the Central Securities Depository System (CENIVAL) with an electronic payments system, like the one envisaged by the BCN.
- Reforms to the parameters of the pension regime, including minimum pension, to the minimum pension guaranteed, social security contributions, and age of retirement, to ensure fiscal sustainability.
- Eliminate lending interest rate ceiling on micro-lending operations (as soon as feasible).

Structural measures

- Implement the reform of the judiciary.
- Introduce legislation on administrative processes.
- Clarify jurisdiction of the General Comptroller's Office.
- To favor a reduction in currency mismatches over the long run, ensure adequate international liquidity, provide instruments denominated in córdobas, undertake prudential measures to induce monitoring of exchange rate risk.
- Promote the introduction of new means of payments such as electronic transfers and direct debits.
- Request that banks include an analysis of repayment capabilities of unhedged borrowers when preparing and classifying loans.
- Set exposure thresholds for government security holdings.
- Implement a proactive and prudent national public debt strategy.
- Prepare an action plan to facilitate land titling, property registries, and out-of-court reorganization plans.

however, key elements of the revised draft law were found unconstitutional[28] by the state attorney general (*Procurador General de la República*).[29] In view of this finding, a two-stage strategy is being pursued. First, a prior action is proposed whereby the superintendency of banks (SB) would issue a resolution aimed at strengthening the existing framework for coverage by the SB of the legal expenses incurred for suits initiated against SB's staff, for actions taken in the course of their official duties. It would explicitly provide for such coverage through the establishment of a new budgetary item in the SB budget starting in 2005.[30] Second, the authorities will request a follow-up technical assistance mission (MFD/LEG) to explore means of strengthening legal protection to SB staff against criminal suits. Based on the outcome of the TA mission, a PC on further strengthening the legal protection framework may be established at the time of the next (seventh) review.

- ***The authorities plan to overhaul the legal framework for the financial sector, in line with international best practices.*** Revisions to the financial sector laws, incorporating recommendations from the Fund[31] and the WB, will be submitted to the assembly by September 2004 (structural benchmark). A new central bank law is to streamline the reserve requirement regime, the management of central bank securities, and the design of liquidity arrangements.

- **The authorities agreed that the risks associated with dollarization need to be reduced, but stressed that this would be a long-term process.** They noted the important reforms already undertaken to improve supervision and risk management in the financial sector. In addition, they agreed with the staff that restoring the córdoba's ability to compete with the U.S. dollar will require sustained implementation of prudent macroeconomic policies, institutional reforms, and steps to deepen domestic capital markets.

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[28] The Nicaraguan constitution (Article 131) states that "[t]he State, in accordance with the law, shall be economically liable for damages on the people's assets, rights and interests, caused by the public officers' actions or omissions in the performance of their duties, with the exception of force majeure. The state may seek reimbursement against the public officer or employee that caused the damage. Public officers and employees are personally liable for violations to the constitution, for lack of administrative ethics, and for any other crime or misdemeanor incurred in the performance of their duties. They are also liable to the state for damages caused by their abuse, negligence, and omission in the performance of their duties."

[29] The attorney general's opinion stated that under Nicaragua's constitution the state is liable for damages resulting from public officers' actions in the performance of their duties, and that it may seek reimbursement from these officers irrespective of the good or bad faith of their conduct. With respect to criminal liabilities, the attorney general's opinion stated that so long as the criminal code defines a conduct as "criminal," public officers are required under the constitution to appear before the courts upon the initiation of an action by the Public Ministry (headed by the prosecutor general), irrespective of whether evidence of malice has been argued.

[30] Several other Latin American countries (e.g., Guatemala, Brazil, Panama, Ecuador) pay for litigation costs of supervisors when they are sued for official actions taken in good faith, or have some form of insurance to cover these costs.

[31] Recommendations on legal reform were made by an MFD technical assistance mission that visited Managua in September 2003, the FSAP missions of November/December 2003 and February 2004, and a LEG technical assistance mission in July 2004 (to advise on the banking resolution framework).

D. Program Financing

Private debts

21. **Overdue payments on domestic "indemnity bonds" have been cleared.** A September 2003 decision by a Belgian court, which would have attached payments made on these bonds by Nicaragua through Euroclear (IMF Country Report No. 04/71), has been overturned on appeal, allowing these payments to be made from a special account in Nicaragua, in which the authorities had set aside the necessary funds.

22. **Nicaragua expects to settle the remaining claims of external commercial creditors through an IDA-sponsored Debt Reduction Facility (DRF).** The Executive Board of IDA approved a grant under the facility in March 2004. The authorities intend to use the facility and IDA-financed advisors' services to resolve the remaining commercial debts (approximately US$200 million face value, excluding overdue interest and penalties).[32] IDA staff has been in contact with the authorities regarding the procedures to be followed in order to make use of the grant. Under the terms of the DRF, outstanding commercial debt would be bought back at a negotiated price by the facility, and no debt service would be due on extinguished claims.

23. **A transparent and good-faith mechanism is thus in place to clear all remaining arrears, in line with the assumption for program financing.** Given recent developments with the indemnity bonds (BPIs) and the DRF, the staff considers the requirements met for the Fund's policy on lending into arrears.

Official creditors

24. **Progress has also been made in completing agreements with official creditors.** After Nicaragua reached the completion point, Paris Club members met in early March and agreed to provide US$142 million of additional relief (NPV terms), beyond that required under the enhanced HIPC Initiative (Box 5). The authorities have continued their efforts to sign restructuring agreements with their non-Paris Club official creditors. Although negotiations with Taiwan Province of China and Venezuela remain difficult, the authorities hope to sign agreements in 2004 with all remaining non-Paris Club creditors, including Hungary, India, and Poland.

Disbursements and privatization receipts in 2004

- **Disbursements.** The WB and IDB continue to provide substantial BOP support in 2004. The WB disbursed its first tranche (US$35 million) of the PRSC in March (see below). The IDB has several ongoing program credits and expects to disburse US$30 million this year. A number of bilateral donors are providing direct budgetary support, projected at about US$45 million in 2004 (US$30 million in grants).

[32] Including overdue interest and penalties, outstanding debt to commercial creditors at end-2002 stood at US$954 million (IMF Country Report No. 04/72).

Box 5. Paris Club Debt Relief

Following Nicaragua's completion point under the enhanced HIPC Initiative in January 2004, the Paris Club met on March 3–4 to discuss implementation of its share of HIPC relief. The meeting was attended by all members with outstanding claims on Nicaragua.

Paris Club calculations resulted in a somewhat higher stock of debt than calculated at completion point, and thus a larger effort by Paris Club members than laid out in the completion point document. While the decision point DSA was recalculated at completion point, using end-1999 parameters, the Paris Club recalculated expected HIPC assistance to Nicaragua using end-2003 exchange and discount rates. Members thus elected to cancel US$902 million in NPV terms of HIPC-eligible debt, while the completion point document laid out US$869 million as the Club's share. To reach this amount, the Club cancelled all remaining pre-cutoff-date claims, all post-cutoff-date Overseas Development Assistance (non-ODA) claims, and 31 percent of post-cutoff-date ODA claims.

During the preparation for the completion point DSA, Bank and Fund staffs, at the request of the authorities, included various certificates of deposit (CDs) owed by the Central Bank of Nicaragua to other central banks in stock estimates. While such CDs constitute a large share of Nicaragua's debt to creditors such as Libya, only one (for US$10 million) is owed to a Paris Club central bank (Bank of Spain). While the Paris Club does not generally treat CDs as debt eligible for rescheduling, the Spanish authorities agreed on a bilateral basis to settle this CD.

Members of the Club also elected to provide additional relief (US$142 million in NPV terms) beyond that required under the enhanced HIPC Initiative. This leaves Nicaragua with an outstanding stock of debt with the Paris Club of only US$62 million in nominal terms.

Nicaragua: Program Financing

(In millions of U.S. dollars)

	2003		2004 Projections				
	Prog.	Prel.	QI	QII	QIII	QIV	Total
Total	**403.7**	**427.1**	**163.6**	**133.1**	**79.4**	**81.0**	**457.1**
Loans	**232.3**	**273.3**	**90.1**	**87.0**	**43.0**	**35.1**	**255.2**
Untied	59.0	50.1	36.0	15.0	15.0	14.1	80.0
IDB	34.8	24.8	0.0	15.0	15.0	0.0	30.0
World Bank	16.2	16.2	36.0	0.0	0.0	0.0	36.0
Others	8.0	9.1	0.0	0.0	0.0	14.1	14.1
Tied	173.3	223.5	54.1	72.1	28.0	21.0	175.2
Grants	**130.3**	**139.7**	**23.9**	**46.1**	**35.3**	**35.9**	**141.2**
Untied	30.4	27.5	7.6	10.5	6.4	5.5	30.0
Tied	99.9	112.2	16.3	35.6	28.9	30.4	111.2
Privatization	**41.1**	**13.8**	**49.6**	**0.0**	**1.1**	**10.0**	**60.7**

Source: Central Bank of Nicaragua.

- **Privatization receipts.** In January 2004, the government sold its remaining shares in the telephone company (ENITEL), and the proceeds (US$49.6 million) have been received. Other privatization receipts during 2004 are projected at US$11 million, including US$10 million from the foreign company managing ENITEL.[33]

Medium-term debt outlook

25. **The outlook for external and total public debt remains in line with completion-point forecasts.** Projections for disbursements are similar to those presented in the completion point document (IMF Country Report No. 04/72), and remain on highly concessional terms. While debt service in 2003 and 2004 is slightly higher than estimated at completion point,[34] debt-service indicators in the medium term are largely unchanged. Assuming disbursements are in line with completion point projections and prudent fiscal policies are maintained, Nicaragua's debt position can be expected to improve gradually.

E. Other Issues

26. **Governance and institutions.** The authorities are pushing ahead forcefully with their efforts to improve governance, strengthen institutions, and fight corruption. Implementation of civil service reform started in mid-2004, with support from the WB, and its costs will be included explicitly in the 2005 budget. In addition, steps are being taken to strengthen public procurement practices and the comptroller's office, with assistance from the IDB. As part of the Poverty Reduction Strategy Paper (PRSP) and the NDP, the authorities have made public their strategy for judicial reform, and the program incorporates a benchmark on presenting an action plan for judicial reform by end-June 2004 that is currently in progress.

27. **Poverty alleviation.** The WB's PRSC emphasizes poverty reduction. The reforms supported under the PRSC aim to (i) maintain macroeconomic stability and protect poverty spending; (ii) increase the efficiency of the public sector while improving its transparency and accountability; (iii) improve the effectiveness of public expenditure through better targeting and coordination of sector programs; and (iv) strengthen prospects for investment and broad-based growth. The IDB assigns the highest priority to social and productive investments that benefit the poorest, including programs that provide incentives for human capital formation and programs that generate employment for the poorest groups.

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[33] In August 2001, the government sold 40 percent of its shares in ENITEL to a foreign company. That foreign company was then awarded a management contract for the entire firm.

[34] This is largely due to continued discussions with the Central American Bank for Economic Integration on modalities for delivery of HIPC relief, and increased debt service to Taiwan Province of China, which has not agreed to provide relief so far. Debt service projections assume a stock operation with Taiwan Province of China on Paris Club-comparable terms at end-2004. Terms of the March 2004 Paris Club Agreed Minute had little impact on debt service, reflecting generous bilateral agreements signed with almost all creditors during the interim period that were already taken into account at completion point.

28. **Safeguards assessment.** The authorities have implemented all of the recommendations of the initial safeguards assessment, and adopted an action plan for implementation of the second assessment, including the adoption of international accounting practices by end-2004 (Attachment III, Technical Memorandum of Understanding, ¶29).

29. **Outreach efforts.** The mission met with members of the assembly and representatives of civil society, the private sector, and donors. In these meetings, the mission emphasized the importance of maintaining the consensus on the core elements of Nicaragua's growth and poverty reduction strategy, as embodied in the government's NDP, including continued fiscal prudence and key structural reforms.

30. **Statistical issues.** Following Nicaragua's decision to participate in the General Data Dissemination System (GDDS), substantial technical assistance is being provided by STA to help the authorities prepare required metadata and plans for improvement.[35] Preparations for GDDS participation are well advanced and the authorities expect to complete all the necessary steps in the coming months. They intend to start publishing quarterly debt reports by September 2004.

III. Program Risks and Monitoring

31. **The difficult political environment continues to pose major challenges to economic management and achievement of program objectives.** There is a clear risk that domestic consensus for reforms and prudent policies could weaken in the run-up to the November 2004 municipal elections. The economy also continues to face important economic vulnerabilities stemming from high debt, a weak banking sector, and widespread dollarization. On the upside, demand for Nicaragua's exports is recovering well and substantial external financing, conditioned on successful program implementation, should also help mitigate the risks.

32. **Program monitoring.** Prior actions for the fifth and sixth reviews are summarized in Attachment II, Table 2. Following HIPC completion and the associated accounting methodology changes,[36] revised quantitative targets are being proposed as PCs for September and December 2004.[37] Reflecting the continued concern over the high public debt burden, and the priority given to returning Nicaragua's debt dynamics to a sustainable path, it is proposed to replace the PC on CPS savings with two new PCs (starting in September 2004)—one on the overall balance of the CPS (after grants), and one on the overall balance

[35] Following missions to develop metadata in the key sectors, the authorities will request further special missions, if needed, and subsequently approve the posting of metadata on the IMF's Dissemination Standards Bulletin Board.
[36] Following HIPC completion, only debt service to multilaterals is recorded in the fiscal accounts at full value, with relief shown as exceptional financing. Debt service to other creditors, following recent stock operations, is shown after all relief.
[37] The September and December 2004 targets were indicative at the time of the last review.

of the central government (after grants). New benchmarks are being proposed on the work of the public expenditure commission (September 2004), progress toward a fiscally neutral decentralization process (September 2004), and reform of the judicial sector (September 2004). Following nonobservance of the May 2004 PC on granting legal protection to banking supervisors, the authorities have approved a new resolution of the superintendency of banks which provides an explicit coverage of legal expenses for staff sued for actions taken in the course of their official duties (see paragraph 20). Modifications to benchmarks on decentralization and the fiscal responsibility law are being proposed to give the authorities more time to do the necessary analysis and build domestic consensus. In addition, the authorities are committed to moving to full accrual recording of central government budgetary transactions, including interest and amortization, starting with the 2005 budget execution (Attachment III, Technical Memorandum of Understanding, ¶15). The program definition of the CPS overall balance is being expanded to include some state-owned enterprises, for which data are now available (see TMU, ¶2).[38] It will eventually be expanded to include municipalities, as data become available (see TMU, ¶2). It is proposed to use the expanded CPS balance as an indicative target in 2004 (beginning with the seventh review) and as a PC, starting in 2005.

IV. STAFF APPRAISAL

33. **Performance under the PRGF has been broadly satisfactory, but keeping the program on track remains a challenge.** The staff commends the authorities for their strong ownership of the program, which has contributed to a broader understanding in Nicaragua that a stable macroeconomic framework, structural reforms, and better governance are essential to achieving strong and lasting economic growth and poverty alleviation. Although renewed pressures for higher budget spending have been addressed within the overall macroeconomic framework of the program, they are indicative of the still very fragile domestic consensus on the program, the continuing challenge posed by the difficult political environment, and the ongoing risk to the government's ability to maintain fiscal discipline.

34. **Notwithstanding the recovery, the economy remains vulnerable and maintenance of a prudent policy stance is essential to protect the hard-won achievements.** Real GDP growth is rising, inflation remains under control, international reserves have strengthened, and economic prospects have improved. However, significant vulnerabilities remain, including from the large public debt, the weak financial sector, and widespread dollarization. In view of the above, it will be essential to maintain a prudent borrowing policy, one which raises the debt stock only to finance public capital projects with adequate returns.

35. **Strengthening the domestic consensus on prudent policies and reforms is critical.** The broad national consensus on achieving HIPC completion was critical in generating

[38] The new public enterprises are being included based on the preliminary criteria laid out in *Public Investment and Fiscal Policy (*available via internet: http://www.imf.org).

support for good policies and structural reforms. In the post-HIPC phase, maintaining and further strengthening this consensus is a major challenge, especially in the run up to municipal elections in November 2004. The authorities' effort to consolidate public support around their NDP is commendable, focused on achieving sustained rapid growth and macroeconomic stability. The staff also supports the authorities' call for a national dialogue around key governance and growth issues.

36. **Continued strengthening of the public finances is key to macroeconomic stability.** In particular, on-going efforts to improve tax administration and the quality of public spending need to be sustained. Tax benefits should not be widened and pressures to increase spending beyond the program levels should be firmly resisted. Earmarking of budgetary resources, such as mandatory transfers to universities and other recipients, increases budget rigidities, and the authorities should reduce such practices over time.

37. **The staff welcomes the authorities' intention to further strengthen the quality of public spending.** In particular, the plan to conduct a more thorough analysis of the public investment program, in consultation with the World Bank and IDB, is appropriate, as it is essential to ensure that such spending is directed to the most productive projects and priority social needs.

38. **Decentralization should bring significant benefits, but important challenges remain to be addressed.** The staff urges the authorities to push forward more quickly with their plans to devolve spending responsibilities commensurate with the revenue transfers. In addition, they should implement appropriate mechanisms to audit local expenditures, and ensure that local investment projects are consistent with the national investment plan. The authorities' plan envisages moving gradually toward fiscal neutrality by 2007. While the staff recommended fiscal neutrality from the start, the authorities' plan still fits within the PRGF macroeconomic framework. However, the lengthier transition period carries the risk that the municipalities become accustomed to the revenue transfers and initiate new spending that would be hard to cut back when the central government eventually transfers expenditure responsibilities.

39. **Pension reform needs to move forward in a way that safeguards macroeconomic stability**. In close collaboration with the World Bank, the authorities are reassessing their strategy in this area, to ensure that the fiscal costs of the reform are consistent with their medium-term macroeconomic objectives. The staff urges the authorities to garner the necessary domestic consensus to move ahead in this area, with appropriate speed and deliberation to ensure a successful reform.

40. **Despite the progress already achieved, the prudential and supervisory framework of the financial sector needs further strengthening.** The staff welcomes the recent approval of prudential norms on maturity and currency risks. It also welcomes the authorities' approval (as a prior action for these reviews) of a new resolution of the superintendency of banks, which explicitly provides for covering the legal expenses of staff sued for actions taken in the course of their official duties. It is crucial to take further

measures to allow supervisors to carry out effectively their work. The recent FSAP missions identified key remaining financial sector reforms. The authorities are in broad agreement with those recommendations, and intend to use them to strengthen their reform agenda.

41. **The pace and quality of credit growth should be monitored carefully.** The authorities see the recent acceleration as a normal recovery from very low levels following the 2000–01 banking crisis and as supporting the economic recovery. The staff broadly agrees with this assessment, but recommends vigilance in monitoring the quality of loans. In particular, borrowing by municipalities should be monitored closely and given an adequate risk classification by banks. Though still a relatively small proportion of total credit, credit card debt is rising rapidly and also needs to be watched with particular care.

42. **In light of the satisfactory performance under the program, the staff recommends completion of the fifth and sixth reviews under the PRGF.** Satisfactory assurances of external financing are evidenced by the recent successful Paris Club negotiation, the clearance of arrears on indemnity bonds, and the authorities' intent to use the IDA Debt Reduction Facility to resolve the commercial debt problem. Thus, the staff recommends completion of the financing assurances review. The staff supports the authorities' request for a waiver of the performance criterion on public savings since the deviation was minor and the authorities are taking the necessary measures to keep the fiscal program on track. Staff also supports the authorities' request for a waiver of the structural PC on granting effective legal protection for bank supervisors in light of the authorities' corrective actions, evidenced by the framework designed for allocating resources to cover bank supervisors' legal expenses arising from lawsuits initiated in connection with the performance of their official duties, as well as by their efforts to put in place alternative measures that will strengthen further the existing framework for legal protection, including a study on relevant criminal law provisions to identify areas where the law could be improved.

Box 6. Structural Conditionality

Structural conditionality under the current PRGF arrangement (2002–05) encompasses the following areas:

- ***Fiscal consolidation:*** The public expenditure commission will make specific recommendations for improving the classification of current and capital spending and propose a new definition for poverty reducing spending. Action plans to strengthen the DGI and DGA are expected to reinforce tax administration and the legal framework. A special advisor has been appointed, to be supported by a new unit at the ministry of finance, to oversee the decentralization process. The tax code will define the obligations of taxpayers and tax officials and provide the legal framework to enforce collection and penalize evasion. The fiscal responsibility law should establish a multi-year expenditure framework, including medium-term fiscal targets. The financial administration law should strengthen budgetary and accounting procedures. The authorities are working closely with the World Bank to design a pension reform that is fiscally sustainable.

- ***Financial system*:** Strengthening the prudential framework and enforcement of existing provisioning and capital requirements are key program elements. Implementation of new on-site technical and administrative procedures, improving the current deposit insurance legal framework, as well as implementing the necessary legal amendments for effective bank supervision (in line with Basel Core Principles) are also envisaged in the program. Changes to the legal framework of the banking system would include better protection and safeguards for staff of the superintendency of banks and the BCN.

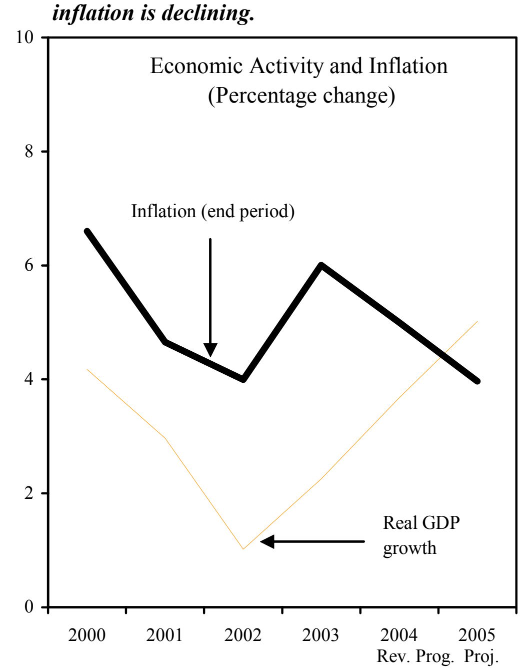
- ***Governance and transparency*:** Judicial reform will support the government's efforts in fighting corruption, upgrading education at the judicial school, strengthening creditor protection, and paving the way for foreign investment. The approval of a law on domestic and external indebtedness signals a commitment to a sustainable debt position. The administrative career law for the customs and tax offices will strengthen human resource management.

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. The reviews included 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 telecommunications 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.

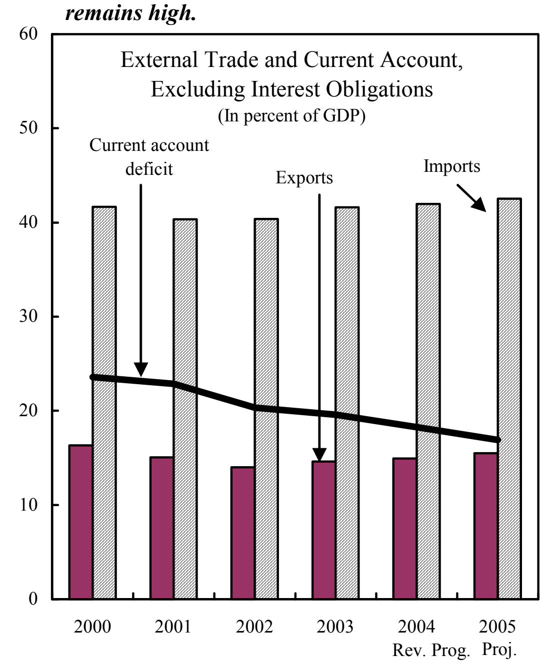
Structural areas covered by World Bank and IDB. Disbursements of WB program loans are conditioned on strengthening the policy and regulatory environment in the telecommunications sector and the rural electricity sector, creating a more equitable and sustainable pension system, working toward improving the quality of public spending, reforming the public sector management system and civil service, improving the soundness of financial intermediaries that serve small productive units in rural and peri-urban areas, strengthening the superintendency of banks, modernizing rural municipalities, developing human capital, reviving agriculture and strengthening natural resource management, rehabilitating the road network, strengthening land rights, supporting the social safety net and combating rural poverty, and improving protection from natural disasters. The IDB lending program is focused on three areas: economic development (strengthening the financial system, reforming the pension system, improving credit to small enterprises and rural cooperatives, reforming the electricity sector, reactivating rural production, reinforcing transportation infrastructure), governance (modernizing the comptroller's office and the judicial system, supporting decentralization, improving transparency, and control of public procurement) and social programs for the most vulnerable groups (strengthening social protection—with emphasis on child care, modernizing the water sector, reforming the health and education sectors).

Figure 1. Nicaragua: Main Economic Indicators

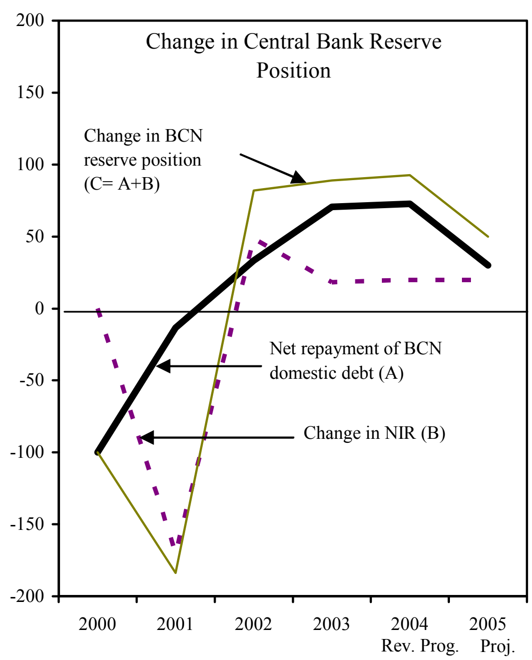
The economic recovery is strengthening, and inflation is declining.



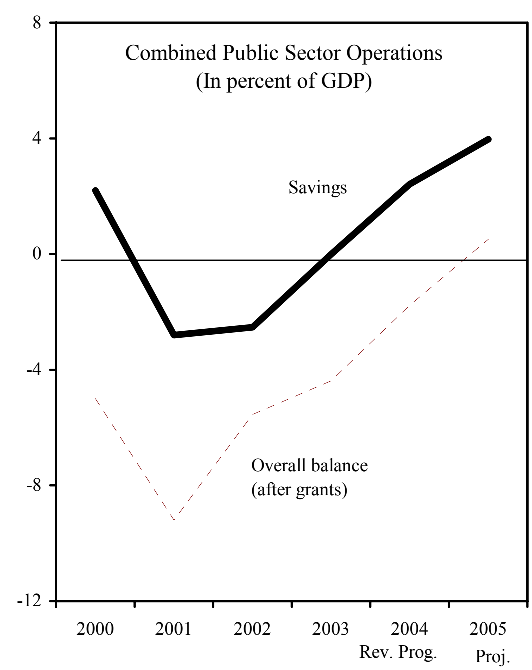
The current account deficit has narrowed, but remains high.



The central bank's international reserves are rising...

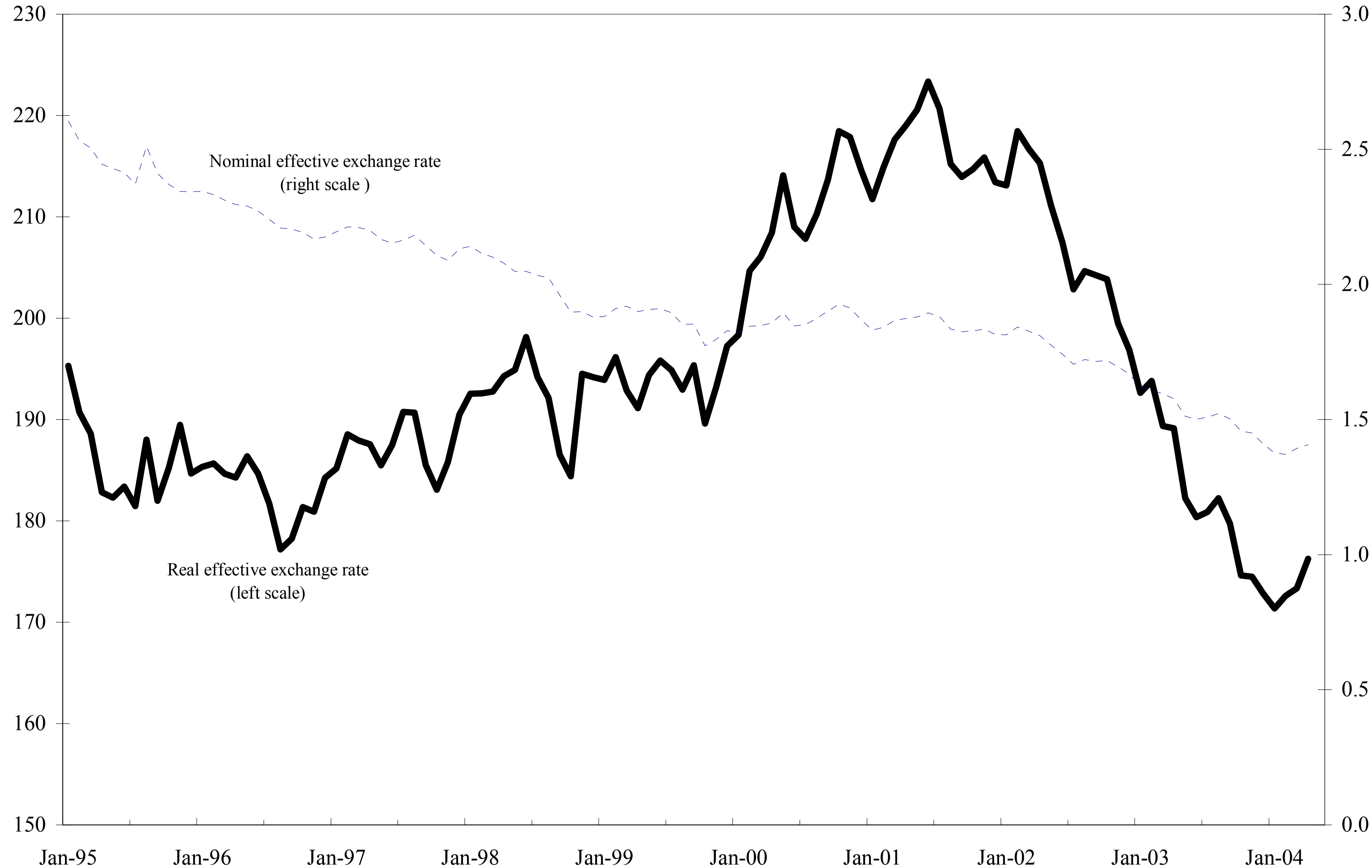


...and the public finances continue improving.



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

Figure 2. Nicaragua: Exchange Rate Developments, 1995-2003
(1990=100)



Source: IMF, Information Notice System.

Table 1. Nicaragua: Selected Economic and Financial Indicators

	2001	2002	2003 Prog. 1/	2003 Prel.	Prog. 2004	Proj. 2005
	(Annual percentage change; unless otherwise indicated)					
National income, prices, and unemployment						
Real GDP	3.0	1.0	2.3	2.3	3.7	3.8
Consumer prices (end of period)	4.7	4.0	6.0	6.6	7.0	4.5
Consumer prices (period average)	7.4	4.0	5.2	5.2	7.6	4.9
Unemployment rate (percent)	11.3	11.6	...	...	...	...
External sector						
Exports, f.o.b.	-6.2	-7.3	-0.9	7.7	10.7	7.6
Export volume	11.8	-7.8	-2.2	5.9	8.3	4.8
Imports, f.o.b.	-1.7	-0.2	-0.8	6.3	11.9	5.9
Import volume	2.5	-2.3	-4.3	2.1	9.4	3.2
Terms of trade (deterioration -)	-13.0	-1.4	-2.5	-2.3	-1.3	-1.9
Real effective exchange rate end of period (depreciation -)	-0.5	-7.8	...	-12.8	...	...
Money and credit						
Net domestic assets of the central bank 2/	141.7	-28.5	5.0	6.9	-3.6	-3.6
Net credit to nonfinancial public sector 2/	343.2	-68.2	-103.6	-80.6	-136.9	-137.9
Net credit to financial institutions 2/	-54.0	-35.8	-3.1	-28.8	1.6	0.9
Currency in circulation	11.1	7.0	8.9	20.2	9.1	9.1
Financial system liabilities to the private sector	7.2	13.6	8.4	14.8	9.9	9.3
Financial system credit to the private sector	-43.5	14.3	13.8	26.6	28.1	16.3
Money income velocity (GDP/M3)	2.7	2.5	2.5	2.4	2.4	2.4
Interest rate on deposits (percent per annum) 3/	9.2	6.9	...	5.3	...	...
	(In percent of GDP)					
Public sector						
Tax revenues of the central government	13.6	14.3	16.3	15.8	16.5	17.1
Central government overall balance, after grants	-8.9	-4.1	-2.3	-3.3	0.5	2.2
Combined public sector savings 4/	-2.8	-2.5	0.2	0.0	2.4	4.0
Combined public sector primary expenditure 4/	16.7	15.6	15.4	15.4	15.3	14.9
Combined public sector overall balance, after grants 4/	-9.2	-5.5	-3.8	-4.4	-1.7	0.7
Central bank operational results (losses -)	-1.3	-2.0	-1.8	-1.6	-2.1	-1.7
Combined public sector debt 5/	213.7	212.3	200.3	208.4	117.9	112.7
Domestic debt	38.0	50.1	36.2	45.7	41.3	38.7
External debt	175.7	162.2	164.1	162.7	76.6	74.0
Savings and investment						
Gross domestic investment	31.0	32.1	31.9	31.5	32.4	31.3
Public	8.5	6.7	7.7	7.0	6.9	6.8
Private	22.5	25.5	24.2	24.4	25.5	24.5
National savings	9.3	10.4	12.6	12.0	11.8	11.9
Public	-2.8	-2.5	0.2	0.0	2.4	4.2
Private	12.1	12.9	12.4	12.0	9.4	7.8
External savings 6/	21.7	21.7	19.3	19.4	20.6	19.4
External sector						
External current account balance 7/	-22.9	-20.3	-17.9	-19.6	-20.5	-19.4
(Excluding interest obligations)	-16.7	-17.1	-14.6	-16.4	-17.7	-16.7
Trade balance (deficit -)	-25.3	-26.4	-25.2	-27.0	-28.8	-29.1
	(In percent of exports of goods and nonfactor services)					
Contractual debt service, before debt relief	38.5	45.8	38.1	35.8	28.0	26.6
Gross international reserves (in months of imports)	2.4	2.6	2.8	2.8	2.8	3.0

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

1/ As stated in IMF Country Report No. 04/71, adjusted for delay in pension reform.
2/ In relation to currency in circulation at the beginning of the year.
3/ Six-month deposit rate, U.S. dollar-linked instruments, end of period.
4/ Includes central bank operational balance.
5/ Nominal stock of debt relative to GDP.
6/ Includes capital transfers.
7/ 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.

Table 2. Nicaragua: Real Gross Domestic Product by Expenditure Category

	2001	2002	Prel. 2003	Prog. 2004	Proj. 2005
			(In millions of 1994 cordobas)		
Consumption	25,021	25,360	26,312	27,718	29,065
Private sector	21,496	22,257	23,122	24,608	25,975
Public sector	3,525	3,103	3,190	3,109	3,090
Gross domestic investment	7,794	8,167	7,697	8,457	8,365
Fixed capital formation	6,992	7,008	6,955	7,215	7,894
Private sector	5,197	5,563	5,361	5,561	6,195
Public sector	1,795	1,445	1,594	1,654	1,698
Inventory change	803	1,159	742	1,242	471
Gross domestic expenditure	32,815	33,527	34,009	36,175	37,430
Exports of goods and nonfactor services	7,508	7,047	7,616	8,125	8,483
Imports of goods and nonfactor services	12,414	12,377	12,775	14,392	14,878
GDP at market prices	**27,909**	**28,197**	**28,850**	**29,908**	**31,035**
			(Annual percentage change at constant prices)		
Consumption	1.5	1.4	3.8	5.3	4.9
Private sector	2.3	3.5	3.9	6.4	5.6
Public sector	-3.3	-12.0	2.8	-2.5	-0.6
Gross domestic investment	-4.3	4.8	-5.8	9.9	-1.1
Fixed capital formation	-2.8	0.2	-0.8	3.7	9.4
Private sector	-4.8	7.1	-3.6	3.7	11.4
Public sector	3.4	-19.5	10.3	3.8	2.7
Gross domestic expenditure	0.0	2.2	1.4	6.4	3.5
Exports of goods and nonfactor services	10.8	-6.1	8.1	6.7	4.4
Imports of goods and nonfactor services	-0.4	-0.3	3.2	12.7	3.4
GDP at market prices	**3.0**	**1.0**	**2.3**	**3.7**	**3.8**
			(In percent of GDP at current prices)		
Gross domestic investment	31.0	32.1	31.5	32.4	31.3
Fixed capital formation	29.5	28.7	27.7	27.9	29.3
Private sector	21.0	22.0	20.7	21.0	22.5
Public sector	8.5	6.7	7.0	6.9	6.8
Inventory change	1.4	3.5	3.7	4.5	2.0
National savings	9.3	10.4	12.0	11.8	11.9
Private savings	12.1	12.9	11.8	9.4	7.8
Public savings	-2.8	-2.5	0.2	2.4	4.2
			(Percent change, unless otherwise indicated)		
Memorandum items:					
Nominal GDP (in millions of cordobas)	54,000	57,099	62,458	69,385	75,250
Annual rate of growth	7.7	5.7	9.4	11.1	8.5
GDP deflator	4.7	4.7	6.9	7.2	4.5
CPI (avg)	7.4	4.0	5.2	7.8	4.7
CPI (eop)	4.7	4.0	6.6	7.0	4.5
ICOR	6.5	10.7	13.6	12.0	8.7

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

Table 3. Nicaragua: Gross Domestic Product by Sector

	2001	2002	Prel. 2003	Rev. Prog. 2004	Proj. 2005
	(Annual percentage change at 1994 prices)				
Real gross domestic product	**3.0**	**1.0**	**2.3**	**3.7**	**3.8**
Taxes less subsidies on production and imports	5.3	-1.6	-0.4	4.0	3.8
Financial intermediation services	2.4	10.1	10.0	10.0	10.0
Primary sector	**2.0**	**-0.2**	**1.9**	**2.8**	**3.9**
Agriculture	0.8	-5.1	-0.7	2.0	4.5
Livestock	5.1	4.4	4.2	3.5	4.0
Fishing	-4.9	7.0	5.7	2.6	2.7
Forestry	3.0	2.9	2.4	3.5	2.2
Mining	5.5	5.1	4.6	5.2	3.0
Secondary sector	**3.9**	**-0.6**	**2.9**	**5.6**	**4.5**
Manufacturing	4.0	2.1	3.2	4.7	4.6
Construction	4.0	-11.8	3.5	10.8	4.7
Utilities (energy and water)	3.0	2.5	-1.2	1.7	2.6
Services	**2.4**	**3.4**	**3.0**	**3.3**	**3.6**
Commerce	3.8	3.1	2.3	3.3	4.7
General government	-0.1	-0.6	0.9	0.7	0.8
Transport and communications	2.2	6.2	5.5	5.5	5.2
Finance	-7.2	7.9	5.0	5.0	4.0
Real estate and housing	5.1	3.7	3.5	3.7	2.6
Other services	2.1	3.0	2.8	2.6	2.6
	(Contribution to real GDP growth)				
Real gross domestic product	**3.0**	**1.0**	**2.3**	**3.7**	**3.8**
Taxes less subsidies on production and imports	0.5	-0.2	0.0	0.4	0.4
Financial intermediation services	0.0	-0.2	-0.2	-0.2	-0.2
Primary sector	**0.4**	**0.0**	**0.4**	**0.6**	**0.8**
Agriculture	0.1	-0.5	-0.1	0.2	0.4
Livestock	0.3	0.3	0.3	0.3	0.3
Fishing	-0.1	0.1	0.1	0.0	0.0
Forestry	0.0	0.0	0.0	0.0	0.0
Mining	0.1	0.1	0.1	0.1	0.0
Secondary sector	**0.9**	**-0.1**	**0.7**	**1.3**	**1.1**
Manufacturing	0.7	0.4	0.6	0.8	0.8
Construction	0.2	-0.6	0.1	0.5	0.2
Utilities (energy and water)	0.1	0.0	0.0	0.0	0.0
Services	**1.1**	**1.5**	**1.4**	**1.6**	**1.7**
Commerce	0.7	0.6	0.4	0.6	0.8
General government	0.0	0.0	0.1	0.0	0.0
Transport and communications	0.1	0.4	0.4	0.4	0.4
Finance	-0.2	0.2	0.1	0.1	0.1
Real estate and housing	0.3	0.2	0.2	0.3	0.2
Other services	0.1	0.2	0.2	0.2	0.2

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

Table 4. Nicaragua: Consolidated Operations of the Combined Public Sector

(In percent of GDP; unless otherwise indicated)

			2003		2004		Proj.
	2001	2002	Prog. 1/	Prel.	Prog. 1/	Rev. Prog. 2/	2005 2/
Total current revenue	**19.7**	**20.3**	**22.1**	**21.8**	**22.5**	**22.3**	**22.9**
Current revenue of the general government	19.4	20.1	22.0	21.7	22.3	22.1	22.8
Operational surplus of public utilities	0.3	0.2	0.1	0.0	0.3	0.2	0.2
Total current expenditure	**22.5**	**22.8**	**21.9**	**21.8**	**19.0**	**19.9**	**18.9**
Consumption and transfers	16.3	15.2	15.0	15.1	14.8	14.9	14.5
Nonfinancial public sector interest payments 3/	4.9	5.7	5.1	5.1	2.1	2.9	2.8
Central bank operational results (losses +)	1.3	2.0	1.8	1.6	2.1	2.1	1.7
Combined public sector savings	**-2.8**	**-2.5**	**0.2**	**0.0**	**3.5**	**2.4**	**4.0**
Excluding interest payments	3.0	4.7	6.7	6.3	7.3	7.0	8.1
Capital expenditure and net lending							
(net of capital revenue)	**10.6**	**8.0**	**9.1**	**9.7**	**9.7**	**9.4**	**9.3**
Combined public sector primary balance (before grants)	**-7.6**	**-3.3**	**-2.4**	**-3.3**	**-2.4**	**-2.4**	**-1.2**
Combined public sector balance (before grants)	**-13.4**	**-10.5**	**-8.9**	**-9.7**	**-6.2**	**-7.0**	**-5.3**
Grants	**4.2**	**5.0**	**5.0**	**5.3**	**3.1**	**5.3**	**5.9**
Interim debt relief: HIPC 4/	1.1	2.0	1.9	1.9	0.0	2.1	2.3
Other 5/	3.0	3.0	3.1	3.4	3.1	3.2	3.6
Combined public sector balance (after grants)	**-9.2**	**-5.5**	**-3.8**	**-4.4**	**-3.1**	**-1.7**	**0.7**
Financing	**9.2**	**5.5**	**3.8**	**4.4**	**3.1**	**1.7**	**-0.7**
Net external financing 4/	3.8	4.2	5.2	5.7	5.6	4.5	3.5
Domestic financing, net	4.5	0.9	-2.3	-1.6	-2.9	-4.2	-4.4
Privatization	0.9	0.4	1.0	0.3	0.4	1.4	0.2
Memorandum items:							
Total expenditure of the combined public sector	33.0	30.8	31.0	31.4	28.7	29.3	28.2
Total interest of the combined public sector	5.8	7.2	6.5	6.4	3.8	4.6	4.1
Total primary expenditure	27.2	23.6	24.5	25.1	24.9	24.7	24.1
Total primary current expenditure	16.7	15.6	15.4	15.4	15.2	15.3	14.9
Overall balance of the general government (after grants)	-7.7	-3.2	-1.7	-2.5	-0.5	1.2	3.0
Primary balance of the general government	-2.8	2.5	3.4	2.6	1.7	4.0	5.8
Overall balance of the public enterprises (after grants)	-0.2	-0.4	-0.3	-0.3	-0.6	-0.7	-0.6
Total poverty-reducing expenditure	9.0	10.2	11.0	11.4	11.4	11.4	11.6
Total HIPC debt relief 6/	2.0	6.0	5.8	6.0	5.5	4.2	4.7
From multilaterals	1.1	2.0	1.9	1.8	1.9	1.4	1.8
Interest	0.5	1.0	0.8	0.8	0.8	0.9	0.7
Principal	0.6	1.0	1.1	1.0	1.1	0.6	1.1
From bilaterals	0.9	4.0	4.0	4.1	3.6	2.8	2.9
Interest	0.4	1.6	1.5	1.6	1.7	1.2	1.2
Principal	0.5	2.4	2.5	2.5	1.9	1.6	1.7
GDP (in millions of cordobas)	54,000	57,099	61,927	62,458	68,077	69,385	75,250

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

1/ As stated in IMF Country Report No. 04/71. In 2004, CPS deficit has been adjusted to account for delay in pension reform (lower by 0.6 percent of GDP).
2/ HIPC relief from multilateral creditors shown as grants, with total interest payments recorded as current expenditure and total amortization shown below the
Prior to the current review debt service was shown on a net basis, i.e., interest and amortization were shown net of HIPC debt relief from multilaterals.
3/ Includes the interest cost of bank resolution.
4/ Relief from official creditors is shown as exceptional financing.
5/ Mainly project-related grants from bilateral donors.
6/ HIPC relief from bilaterals following completion point is shown only for illustrative purposes; only multilateral relief appears in fiscal accounts.

Table 5. Nicaragua: Summary Operations of the Central Government

(In percent of GDP)

	2002	2003 Prog. 1/	2003 Prel.	Prog. 2/ 2004	Proj. 2/ 2005
Total current revenue	**15.0**	**16.7**	**16.3**	**17.0**	**17.6**
Tax revenue	14.3	16.3	15.8	16.5	17.1
Nontax revenue and current transfers	0.7	0.4	0.5	0.5	0.5
Total current expenditures	**16.8**	**15.9**	**15.9**	**13.5**	**13.1**
Consumption and transfers	11.1	10.8	10.8	10.7	10.3
Of which : wages and salaries	4.4	4.5	4.5	4.2	4.2
Interest payments 3/	5.7	5.1	5.0	2.9	2.8
Savings	**-1.8**	**0.8**	**0.4**	**3.4**	**4.6**
Capital expenditure and net lending (net of capital revenue)	**6.8**	**7.6**	**8.5**	**7.8**	**7.8**
Primary balance before grants	**-2.9**	**-1.8**	**-3.0**	**-1.5**	**-0.4**
Overall balance before grants	**-8.6**	**-6.9**	**-8.1**	**-4.3**	**-3.2**
Grants	4.5	4.5	4.8	4.8	5.4
Of which: HIPC interim debt relief 4/	2.0	1.9	1.9	2.1	2.3
Overall balance after grants	**-4.1**	**-2.3**	**-3.3**	**0.5**	**2.2**
Financing	**4.1**	**2.3**	**3.3**	**-0.5**	**-2.2**
Net external financing 4/	3.7	4.8	5.4	3.9	2.9
Domestic financing, net	0.0	-3.5	-2.4	-5.8	-5.4
Privatization	0.4	1.0	0.3	1.4	0.2
Memorandum items:					
Total expenditure	23.7	23.6	24.4	21.3	20.9
Total primary expenditure	17.9	18.5	19.3	18.4	18.1
Total primary current expenditure	11.1	10.8	10.8	10.7	10.3
GDP (in millions of cordobas)	57,099	61,927	62,458	69,385	75,250

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

1/ As stated in IMF Country Report No. 04/71.

2/ HIPC relief from multilateral creditors shown as grants, with total interest payments recorded as current expenditure and total amortization shown below the line. Prior to the current review debt service was shown on a net basis, i.e., interest and amortization were shown net of HIPC debt relief from multilaterals.

3/ Includes the interest cost of bank resolution.

4/ Relief from official creditors is shown as exceptional financing.

Table 6. Nicaragua: Consolidated Operations of the Combined Public Sector - Quarterly

(In millions of cordobas)

	2003					2004				
	Prel.			QIV		QI		QII	Revised Program 2/	
	QI	QII	QIII	Prog. 1/	Prel.	Prog. 1/	Prel.	Prog. 1/	QIII	QIV
Total current revenue	3,280	3,126	3,576	3,586	3,499	3,727	3,952	3,715	3,835	3,883
Current revenue of the general government	3,263	3,122	3,562	3,569	3,509	3,674	3,917	3,671	3,817	3,861
Operational surplus of public utilities	17	4	14	16	-10	53	35	44	18	22
Total current expenditure	3,351	3,068	3,523	3,613	3,545	3,004	3,075	3,239	3,747	3,653
Consumption and transfers	2,088	2,248	2,309	2,613	2,683	2,355	2,256	2,452	2,703	2,793
Nonfinancial public sector interest payments 3/	967	619	1,015	564	554	326	537	373	599	447
Central bank operational results (losses +)	297	201	199	437	308	323	282	415	445	414
Combined public sector savings	-71	58	53	-27	-46	723	877	476	88	230
Excluding interest payments	1,135	822	1,231	891	740	1,309	1,645	1,200	1,071	1,007
Capital expenditure and net lending (net of capital revenue)	894	1,389	1,374	1,519	2,325	1,337	1,371	1,880	1,657	1,526
Combined public sector primary balance (before grants)	241	-567	-143	-628	-1,585	-28	274	-679	-586	-519
Combined public sector balance (before grants)	-965	-1,332	-1,321	-1,547	-2,371	-614	-494	-1,404	-1,570	-1,297
Grants	345	995	1,055	728	878	330	673	607	1,020	1,002
HIPC Interim debt relief 4/	102	388	483	192	191	0	294	0	459	429
Other	243	607	572	536	687	330	379	607	561	573
Combined public sector balance (after grants)	-620	-337	-265	-818	-1,493	-284	179	-797	-550	-295
Financing	620	337	265	818	1,493	284	-179	797	550	295
Net external financing 4/	672	1,055	815	789	978	1,165	1,223	1,045	360	384
Domestic financing, net	-52	-718	-567	-575	325	-881	-2,191	-265	172	-248
Of which: Central Bank of Nicaragua	-397	-719	-476	-432	219	-629	-2,011	-434	180	-295
Privatization	0	0	18	604	190	0	789	17	17	159

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

1/ As stated in IMF Country Report No. 04/71. In 2004, CPS deficit has been adjusted to account for delay in pension reform (lower by 0.6 percent of GDP).
2/ HIPC relief from multilateral creditors shown as grants, with total interest payments recorded as current expenditure and total amortization shown below the line.
3/ Includes the interest cost of bank resolution.
4/ Relief from official creditors is shown as exceptional financing.

Table 7. Nicaragua: Summary Operations of the Central Government - Quarterly

(In millions of cordobas)

	2003					2004				
	Prel.			QIV		QI		QII	Revised Program 2/	
	QI	QII	QIII	Prog. 1/	Prel.	Prog. 1/	Prel.	Prog. 1/	QIII	QIV
Total current revenue	2,453	2,279	2,761	2,742	2,659	2,752	2,900	2,800	2,979	3,005
Tax revenue	2,383	2,234	2,656	2,627	2,579	2,683	2,822	2,730	2,882	2,905
Nontax revenue and current transfers	70	45	105	115	80	69	78	70	96	100
Total current expenditures	2,483	2,259	2,710	2,411	2,459	1,999	2,149	2,133	2,597	2,387
Consumption and transfers	1,517	1,640	1,696	1,850	1,906	1,676	1,614	1,763	2,000	1,943
Of which: wages and salaries	601	659	697	849	855	650	645	660	686	899
Interest payments 3/	966	619	1,014	562	553	323	535	370	596	444
Savings	-30	20	51	331	200	753	751	667	382	618
Capital expenditure and net lending (net of capital revenue)	794	1,210	1,166	1,264	2,124	1,084	1,180	1,573	1,337	1,251
Primary balance before grants	142	-571	-101	-371	-1,371	-8	106	-536	-358	-189
Overall balance before grants	-824	-1,190	-1,115	-933	-1,924	-331	-429	-906	-954	-633
Grants	301	860	1,009	697	831	241	628	507	910	917
Of which: HIPC interim relief 4/	102	388	483	192	191	0	294	0	459	429
Overall balance after grants	-522	-330	-106	-236	-1,092	-90	199	-400	-44	283
Financing	522	330	106	236	1,092	90	-199	400	44	-283
Net external financing 4/	640	1,016	756	718	952	1,058	1,171	944	253	263
Domestic financing, net	-118	-686	-668	-1,086	-49	-968	-2,158	-561	-226	-706
Privatization	0	0	18	604	190	0	789	17	17	159

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

1/ As stated in IMF Country Report No. 04/71.
2/ HIPC relief from multilateral creditors shown as grants, with total interest payments recorded as current expenditure and total amortization shown below the line.
3/ Includes the interest cost of bank resolution.
4/ Relief from official creditors is shown as exceptional financing.

Table 8. Nicaragua: Summary Accounts of the Central Bank

(Flows in millions of cordobas; unless otherwise stated)

	2001	2002	2003 Prog. 1/	2003 Prel.	2004 Prog.1/	2004 Rev. Prog.	Proj. 2005
Exchange rate (cordobas/US$)	13.4	14.3	...	15.1	...	...	...
Net international reserves	**-2,289**	**692**	**-227**	**277**	**317**	**318**	**333**
(In millions of US$)	-170	49	-15	18	20	20	20
Net domestic assets	**2,484**	**-555**	**429**	**144**	**-90**	**-91**	**-86**
Net credit to nonfinancial public sector (NFPS) 2/	2,837	-1,329	-1,974	-1,681	-2,189	-3,455	-2,041
Operational losses	680	1,115	1,123	1,006	1,418	1,490	1,255
Net credit to the financial system	-947	-698	-71	-600	-296	22	-497
CENIS, BOMEX, and TELs 3/	-276	407	1,524	1,719	657	1,358	1,082
Foreign liabilities (medium- and long-term)	174	143	262	237	247	427	31
Other	16	-193	-434	-536	72	68	84
Currency	**195**	**136**	**202**	**421**	**227**	**227**	**247**
Memorandum items:							
Currency (stock)	1,949	2,086	2,288	2,506	2,515	2,734	2,981
Currency (annual change; in percent)	11.1	7.0	9.7	20.2	9.9	9.1	9.0
Strengthening of BCN reserve position (in millions of US$) 4/	-184	82	55	89	61	97	92
Net repayment of BCN domestic debt (+)	-13	33	70	71	41	77	72
Increase in NIR (+)	-170	49	-15	18	20	20	20
Foreign currency deposits (in percent of banking system deposits) 5/	70.6	72.1	...	69.6	...	70.3	71.1
Foreign currency loans (in percent of total loans) 5/	83.6	83.1	...	84.3	...	84.3	84.7

Sources: Central Bank of Nicaragua; Superintendency of Banks; and Fund staff estimates/projections.

1/ As stated in IMF Country Report No. 04/71.
2/ Includes bonds of C$3,853 million issued to recapitalize weak banks in 2001.
3/ *Certificados Negociables de Inversión (CENIS), Bonos en Moneda Extranjera (BOMEX), and Títulos Especiales de Liquidez (TELs).*
4/ Defined as the sum of the net repayment of BCN domestic debt and the change in NIR.
5/ Official data. Excludes other deposits/loans with implicit dollar indexation.

Table 9. Nicaragua: Summary Accounts of the Central Bank - Quarterly

(Flows in millions of cordobas; unless otherwise stated)

	2003		2004						
	QIV		QI		QII	QIII		QIV	
	Prog. 1/	Prel.	Prog. 1/	Rev. Prog.	Prog. 1/	Prog. 1/	Rev. Prog.	Prog. 1/	Rev. Prog.
Net international reserves	**-440**	**-269**	**0**	**1,084**	**78**	**-62**	**-1,024**	**305**	**-266**
(In millions of US$)	-29	-18	0	68	5	-4	-64	19	-17
Net domestic assets	**822**	**868**	**-202**	**-1,211**	**-106**	**35**	**958**	**179**	**776**
Net credit to nonfinancial public sector 2/	-490	217	-345	-2,046	-434	-615	49	-580	-447
Net credit to the financial system 3/	210	-322	-221	73	-126	3	63	49	34
CENIS, BOMEX, and TELs 4/	669	683	0	371	1	99	161	348	586
Foreign liabilities (medium- and long-term)	23	8	14	76	18	215	198	0	142
Other 3/	411	281	349	315	435	333	487	362	461
Currency	**383**	**599**	**-202**	**-126**	**-28**	**-27**	**-65**	**485**	**510**
Memorandum items:									
Currency (stock)	2,288	2,507	2,086	2,380	2,058	2,031	2,223	2,516	2,734
Currency (annual change; in percent)	10	20	10	25	9	7	17	10	9
Strengthening of BCN reserve position									
(in millions of US$) 5/	6	18	0	83	5	2	-54	41	20
Net repayment of BCN domestic debt (+)	35	36	0	15	0	6	10	22	37
Increase in NIR (+)	-29	-18	0	68	5	-4	-64	19	-17

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

1/ As stated in IMF Country Report No. 04/71.
2/ Includes bonds issued to recapitalize weak banks.
3/ From 2002 onward, asset recovery of closed banks is included in "other."
4/ *Certificados Negociables de Inversión (CENIS), Bonos en Moneda Extranjera (BOMEX), and Títulos Especiales de Liquidez (TELs).*
5/ Defined as the sum of the net repayment of BCN domestic debt and the change in NIR.

Table 10. Nicaragua: Operations of the Central Bank and the Financial System

(Stocks in millions of cordobas; unless otherwise indicated)

	2001	2002	2003 Prog. 1/	2003 Prel.	2004 Prog. 1/	2004 Rev. Prog.	Proj. 2005
			I. Central Bank				
Net international reserves	**210**	**913.8**	**745**	**1,245**	**1,104**	**1,632**	**2,038**
(In millions of U.S. dollars)	16	64	49	82	69	102	122
Net domestic assets	**1,740**	**1,172**	**1,543**	**1,261**	**1,412**	**1,102**	**943**
Net credit to NFPS	34,467	33,725	31,663	32,353	29,578	29,108	27,093
Net credit to the financial system	207	-675	-695	-1,224	-951	-1,162	-1,634
CENIs, BOMEX and TELs	-7,456	-8,654	-7,466	-7,451	-7,142	-6,505	-5,714
Medium- and long-term foreign liabilities	-23,806	-25,477	-26,744	-26,760	-27,970	-27,810	-29,022
Other	-1,673	2,252	4,785	4,343	7,897	7,470	10,220
Currency	**1,949**	**2,086**	**2,288**	**2,507**	**2,516**	**2,734**	**2,981**
			II. Consolidated Financial System				
Net international reserves	**3,011**	**4,376**	**5,542**	**5,256**	**7,745**	**6,634**	**8,135**
(In millions of U.S. dollars)	224	307	367	348	486	416	488
Net domestic assets	**16,370**	**17,450**	**18,043**	**19,662**	**17,788**	**19,159**	**21,367**
Net credit to nonfinancial public sector	30,445	33,072	31,984	33,615	29,418	29,718	27,541
Credit to the private sector	9,747	11,145	12,986	14,110	15,140	18,075	21,020
Medium- and long-term foreign liabilities	-24,475	-26,624	-27,907	-27,861	-29,161	-29,481	-30,490
Other net assets	653	-143	980	-202	2,391	847	3,296
Liabilities to the private sector	**19,380**	**21,826**	**23,585**	**24,918**	**25,533**	**25,793**	**29,502**

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

1/ As stated in IMF Country Report No. 04/71.

Table 11. Nicaragua: Balance of Payments

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

	2001	2002	2003 Prog. 1/	2003 Prel.	Prog. 2/ 2004	Proj. 2005
Current account	**-919**	**-815**	**-732**	**-810**	**-895**	**-876**
Excluding interest obligations	-672	-685	-600	-679	-773	-754
Trade balance	-1015	-1057	-1033	-1116	-1255	-1318
Exports, f.o.b.	605	561	591	604	669	720
Imports, f.o.b.	-1,620	-1,618	-1,624	-1,720	-1924	-2,037
Nonfactor services (net)	-12	4	-6	21	21	28
Receipts	342	340	345	393	427	462
Payments	-354	-336	-351	-372	-406	-434
Official interest obligations 3/	-247	-130	-132	-132	-122	-122
Other current transactions (net)	356	367	438	417	463	464
Factor services receipts	15	11	8	7	8	13
Noninterest factor services payments	-84	-71	-77	-77	-80	-80
Private transfers 4/	425	428	507	487	533	603
Capital account	**508**	**653**	**562**	**651**	**704**	**655**
Official (net)	359	244	356	394	331	272
Official transfers	344	319	330	338	261	225
Public sector consolidated	122	118	134	140	141	145
Other	174	130	120	122	120	80
HIPC interim relief from multilaterals 5/	49	71	76	76	0	0
Disbursements	211	204	243	274	255	240
Amortization	-177	-278	-217	-217	-186	-193
Other (net)	-20	0	0	0	0	
Other capital (private)	149	408	206	257	373	383
Foreign direct investment	132	188	200	202	261	250
Commercial banks	-85	-25	-47	-30	-44	-49
Commercial credits	70	34	0	0	77	0
CENIs	52	17	-2	8	24	5
Private capital transfers	60	34	48	32	32	32
Net other private capital flows	-50	125	7	-20	23	145
Errors and omissions	-30	35	0	65	0	0
Overall balance	**-411**	**-162**	**-170**	**-159**	**-191**	**-221**
Change in net international reserves (- increase)	170	-49	-7	-18	-20	-20
Of which: IMF (net)	-5	7	21	24	53	30
Net change in arrears (decrease -)	-285	-574	-1794	5	-1442	0
Of which: overdue payments 6/	0	0	5	5	0	0
Exceptional financing	526	785	1967	172	1653	241
Paris Club rescheduling	31	228	20	20	32	33
Non-Paris Club rescheduling 7/	495	557	1943	145	1609	196
Additional relief from Paris Club creditors	0	0	3	7	11	12
Memorandum items:						
Current account (in percent of GDP)	-22.9	-20.3	-17.9	-19.6	-20.5	-19.4
Excluding interest obligations (in percent of GDP)	-16.7	-17.1	-14.6	-16.4	-17.7	-16.7
Gross reserves 8/	382.8	454.2	446.6	504.1	553.2	608.0
Gross reserves (in months of imports)	2.4	2.6	2.8	2.8	2.8	3.0
Net international reserves (adjusted)	15.6	64.1	49.3	82.4	102.4	122.4
Debt service ratio 8/	38.5	45.8	38.1	35.8	28.0	26.6
Debt service ratio, actual payments 8/	22.4	16.4	12.4	10.9	7.5	3.6
Gross official grants and loans (in percent of GDP)	12.5	13.3	14.7	15.5	11.9	10.1
Net official grants and loans (in percent of GDP)	10.5	10.0	12.2	13.0	10.5	10.0
Oil price	24.3	25.0	28.9	28.9	34.5	32.8
GDP	4,016	4,007	4,099	4,135	4,354	4,519

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

1/ As stated in IMF Country Report No. 04/71.
2/ Figures for 2004 and beyond reflect completion point reached in January 2004.
3/ Includes remittances from abroad and component of transfers from NGOs.
4/ HIPC assistance from multilaterals classified as exceptional financing following completion point.
5/ Not considered arrears for program purposes.
6/ Including HIPC assistance.
7/ NIR plus net IMF flows and transfers to the government.
8/ In percent of exports of goods and nonfactor services.

Table 12. Nicaragua: Public Sector Domestic Debt 1/

(Stocks in net present value)

	2001	2002	Prel. 2003	Rev. Prog. 2004	Proj. 2005
	(In millions of U.S. dollars)				
BCN liabilities	**670**	**646**	**516**	**404**	**375**
Certificados Negociables de Inversión (CENIs)	610	586	516	404	375
Auctioned	187	184	182	128	135
Coffee-related	10	9	0	0	0
Bank resolution (from Interbank onward)	413	393	335	276	240
Bonos en Moneda Extranjera (BOMEX)	21	10	0	0	0
Títulos Especiales de Liquidez (TELs)	39	49	0	0	0
MHCP liabilities	**809**	**699**	**721**	**794**	**845**
Indemnization bonds (BPIs) 2/	763	538	547	607	657
Recognition of debt incurred in 2002 (BPIs)	0	125	141	158	177
New issues	0	0	0	0	0
Other paper	46	36	33	29	11
	(In percent of GDP)				
Combined public sector domestic debt	**36.8**	**33.6**	**30.2**	**29.0**	**28.6**
Central bank	16.7	16.1	12.6	9.8	8.8
Government	20.1	17.5	17.6	19.2	19.8

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

1/ Revised information by the sources.
2/ Increase in 2002 reflects previously awarded court claims on properties confiscated during the Sandinista government.

Table 13. Nicaragua: Public Sector External Debt and Debt Service

			2003		2004	
	2001	2002	Prog. 1/	Prel.	Prog.1/	Rev. Prog. 2/
			(In millions of U.S. dollars; end of period)			
Total debt	7,040	6,705	7,009	7,009	3,627	3,300
Bilaterals	3,740	3,177	3,216	3,216	826	826
Multilaterals	2,343	2,574	2,731	2,731	2,519	2,474
Commercial banks 3/	909	954	1,056	1,056	282	0
Other	48	0	5	5	0	0
			(In percent of GDP)			
Total debt	176	162	164	163	85	77
Bilaterals	93	77	75	75	19	19
Multilaterals	58	62	64	63	60	57
Commercial banks	23	23	25	25	6	0
Other	1	0	0	0	0	0
			(In millions of U.S. dollars)			
Total debt service obligations	429	413	357	357	316	327
Principal	182	284	225	225	188	205
Interest	248	130	132	132	127	122
Debt service paid	257	158	116	116	93	107
Principal	127	120	72	72	39	65
Interest	130	37	44	44	54	42
Debt service not paid	173	255	241	241	222	220
Principal	55	163	153	153	149	140
Interest	118	92	88	88	73	80
			(In percent of GDP)			
Total debt service obligations	11	10	8	8	7	7
Principal	5	7	5	5	4	5
Interest	6	3	3	3	3	3
Debt service paid	6	4	3	3	2	2
Principal	3	3	2	2	1	1
Interest	3	1	1	1	1	1
Debt service not paid	4	6	6	6	5	5
Principal	1	4	4	4	3	3
Interest	3	2	2	2	2	2
			(In percent of exports of goods and nonfactor services)			
Total debt service obligations	47	41	32	32	26	27
Principal	20	28	20	20	15	17
Interest	27	13	12	12	10	10
Debt service paid	28	16	10	10	8	9
Principal	14	12	6	6	3	5
Interest	14	4	4	4	4	3
Debt service not paid	19	25	22	22	18	18
Principal	6	16	14	14	12	11
Interest	13	9	8	8	6	7

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

1/ As stated in IMF Country Report No. 04/71.
2/ 2004 data show post-completion point flow relief from multilaterals as well as members of the Paris Club.
3/ Stocks include debts owed to creditors not participating in 1995 buyback operation.

Table 14. Nicaragua: Revised Phasing of IMF Disbursements and Reviews

Date of Disbursement	Amount (In millions of SDRS)	
First-year program		
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.
October 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.
Second-year program		
August 2004	13.930	Completion of fifth and sixth reviews and observance of end-December 2003 and end-March 2004 performance criteria
November 2004	6.965	Completion of seventh review and observance of end-June performance criteria.
January 2005	6.965	Completion of eighth review and observance of end-September performance criteria.
Third-year program		
April 2005	13.930	Completion of ninth review and observance of end-December 2004 performance criteria.
October 2005	13.920	Completion of tenth review and observance of end-June 2005 performance criteria.
Total	**97.500**	

Sources: FIN and WHD.

Table 15. Nicaragua: External Financing

(In millions of U.S. dollars)

	2001	2002	2003 Prog. 1/	2003 Prel.	2004 Prog. 1/	2004 Rev. Prog.	Proj. 2005
Gross financing requirements	**-924**	**-1,151**	**-984**	**-1,075**	**-926**	**-1,162**	**-1,128**
External current account deficit (excluding official transfers)	-919	-815	-732	-810	-676	-895	-876
Debt amortization	-177	-278	-217	-217	-172	-186	-193
Gross reserves accumulation 2/	177	-55	-27	-43	-64	-73	-50
IMF repurchases and repayments	-5	-3	-8	-5	-14	-8	-9
Gross financing sources	**924**	**1,151**	**984**	**1,075**	**926**	**1,162**	**1,128**
Foreign direct investment (net)	132	188	200	202	200	261	250
Debt financing from private creditors	47	194	11	-11	-52	89	-12
Trade pre-financing	70	34	0	0	0	77	0
Commercial banks' reserves	-85	-25	-47	-30	-101	-44	-49
Other private capital (including CENIS)	62	185	58	20	49	56	37
Official transfers	344	319	330	338	230	261	225
Disbursements (medium- and long-term loans)	211	204	243	274	258	255	240
Of which : balance of payments financing	35	35	60	50	75	80	0
Of which : expected new commitments	...	15	30	30	50	175	0
IMF disbursements	0	9	28	30	59	61	39
Net change in arrears	-285	-574	-1,794	5	0	-1,442	0
Other flows 3/	-50	26	0	65	0	23	145
Exceptional financing	524	785	1,966	173	231	1,653	241

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

1/ As stated in IMF Country Report No. 04/71.
2/ Calculated with NIR excluding foreign currency reserve requirement deposits of commercial banks at the BCN and transfers to the government.
3/ Includes all other net financial flows, and errors and omissions.

Table 16. Nicaragua: Medium-Term Macroeconomic Framework

	Prog.	Staff Projections				
	2004	2005 1/	2006	2007	2008	2009
	(Annual percentage change)					
GDP at constant prices	3.7	3.8	4.2	4.6	4.8	5.0
Consumer prices (end of period)	7.0	4.5	4.0	3.0	2.0	2.0
Consumer prices (period average)	7.6	4.9	4.2	3.5	2.5	2.0
GDP deflator	7.2	4.5	3.9	3.1	2.8	2.3
Exports, f.o.b.	10.7	7.6	6.6	6.2	5.9	6.0
Export volume	8.3	4.8	4.4	4.1	3.9	3.9
Imports, f.o.b.	11.9	5.9	5.7	5.3	5.2	5.0
Import volume	9.4	3.2	3.6	3.3	3.1	2.9
Terms of trade (deterioration -)	-1.3	-1.9	-0.6	-0.7	-0.6	0.2
	(In percent of three-year average of exports of goods and services)					
Debt service ratio, actual payments	6.6	6.9	8.9	9.9	9.9	8.6
	(In percent of GDP)					
External current account balance	-20.5	-19.4	-19.1	-18.7	-17.9	-16.7
External current account, excluding interest obligations	-17.7	-16.7	-16.5	-16.3	-15.5	-14.5
Tax revenues of the central government	16.5	17.1	17.2	17.2	17.2	17.2
Central government overall balance, after grants	0.5	2.2	1.8	2.7	2.6	2.9
Combined public sector savings	2.4	4.0	4.0	4.9	5.4	5.5
Combined public sector primary current expenditure	15.3	14.9	15.3	14.5	14.1	14.1
Combined public sector overall balance, after grants	-1.7	0.7	0.6	1.6	1.8	2.1
Central bank operational results (losses -)	-2.1	-1.7	-1.4	-1.2	-1.0	-0.9
Combined public sector debt 2/	117.9	112.7	109.5	104.1	97.5	94.9
Domestic debt	41.3	38.7	35.9	32.4	28.3	26.3
External debt	76.6	74.0	73.6	71.7	69.2	68.6
Private sector S-I gap	-16.0	-16.7	-16.6	-17.2	-16.9	-15.8
Investment	32.4	31.3	31.1	31.1	31.4	31.4
Public sector	6.9	6.8	6.7	6.5	6.5	6.5
Private sector	25.5	24.5	24.3	24.6	24.9	24.9
National savings	11.8	11.9	11.9	12.4	13.6	14.7
Public sector	2.4	4.2	4.1	5.0	5.5	5.7
Private sector	9.4	7.8	7.8	7.4	8.0	9.1
External savings 3/	20.6	19.4	19.1	18.7	17.9	16.7
Memorandum items:						
Nominal GDP (in millions of cordobas)	69,385	75,250	81,464	87,803	94,510	101,468
GDP (in millions of US$)	4,354	4,519	4,727	4,970	5,271	5,631
Gross international reserves to M3	26.6	27.8	28.3	28.5	28.6	28.7
Gross international reserves (in millions of U.S. dollars)	553.2	608.0	637.9	677.0	717.5	771.0
Gross reserves (in months of imports)	2.8	3.0	2.9	2.9	3.0	3.0
Debt service ratio 4/	28.0	26.6	25.0	23.5	22.1	20.8
Debt service ratio, actual payments 4/	7.5	7.6	8.4	8.2	8	7.8
Gross official grants and loans (in percent of GDP)	11.9	10.3	9.6	9.5	9.9	10.1
Net official grants and loans (in percent of GDP)	10.5	10.0	10.5	10.5	10.5	10.5

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

1/ Assumes that private pension funds initiate operations in October 2005.

2/ Nominal stock of debt relative to GDP. Data for 2002 have been revised upward, mainly reflecting inclusion of indemnity bond debt in 2002, to be issued in 2003 (subject to assembly approval), but for obligations incurred in 2002.

3/ Includes capital transfers.

4/ In percent of exports of goods and services.

Table 17. Nicaragua: Millennium Development Goals 1/

	1990	1995	2001	2002	Target 2/ 2015
General Social Indicators					
Population (millions)	3.8	4.4	5.2	5.3	...
Adult literacy rate (percent of people of ages 15 and over)	62.7	64.6	66.8	67.1	...
Total fertility rate (births for women)	4.8	3.9	3.5	3.4	...
Life expectancy at birth	64.5	67.3	68.6	68.7	...
Goal 1. Eradicate extreme poverty and hunger					
Target: Halve between 1990 and 2015, the proportion of people who suffer from hunger.					
1. Prevalence of child malnutrition (percent of children under 5)	...	11.0	...	...	...
2. Population below minimum level of dietary energy consumption (in percent)	30.0	...	29.0	...	15.0
Goal 2. Achieve universal primary education					
Target: Ensure that, by 2015, children everywhere will be able to complete a full curse of primary schooling.					
3. Net primary enrollment ratio (percent of relevant age group)	72.2	77.6	80.7	...	100.0
4. Percentage of cohort reaching grade 5 (in percent)	45.6	47.0	48.4	...	100.0
5. Youth literacy rate ((in percent of ages 15-24)	68.2	69.9	72.0	72.3	100.0
Goal 3. Promote gender equality					
Targets: Eliminate gender disparity, in primary and secondary education preferably by 2005, and to all levels of education no later than 2015.					
6. Ratio of young literate females to males (percent of ages 15-24)	101.4	101.6	101.9	101.9	100.0
7. Proportion of seats held by women in national parliament (in percent)	15.0	11.0	10.0	21.0	...
Goal 4. Reduce child mortality					
Target: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.					
8. Under five mortality rate (per 1000)	66.0	54.0	43.0	44.4	21.8
9. Infant mortality rate (per 1000 live births)	52.0	43.0	36.0	36.0	...
10. Immunization, measles (percent of children under 12 months)	82.0	81.0	99.0	...	...
Goal 5. Improve maternal health					
Target: Reduce by three quarters, between 1990 and 2015, the maternal mortality ratio.					
11. Maternal mortality ratio (modeled estimate per 100,000 live births)	...	250.0	...	...	...
12. Births attended by skilled health staff (percent of total)	...	59.2	...	...	...

Table 17. Nicaragua: Millennium Development Goals 1/

	1990	1995	2001	2002	Target 2/ 2015
Goal 6. Combat HIV/AIDS, malaria and other diseases					
Target: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.					
13. Prevalence of HIV, female (percent of ages 15-24)	...	...	...	0.1	...
14. Contraceptive prevalence rate (percent of women of ages 15-49)	44.0	...	...	...	...
15. Number of children orphaned by HIV/AIDS	...	...	...	2,000.0	...
16. Incidence of tuberculosis (per 1,000 people)	...	...	...	84.6	...
17. Tuberculosis cases detected under DOTS (in percent)	...	...	77.0	76.0	...
Goal 7. Ensure environmental sustainability					
Targets: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million dwellers.					
18. Forest area (percent of total land area)	36.7	...	27.0	...	...
19. Nationally protected areas (percent of total land area)	...	7.4	7.5	17.8	
20. GDP per unit of energy use (PPP in US$ per Kg. oil equivalent)	3.1	4.2	...	...	...
21. CO2 emissions (metric tons per capita)	0.7	0.6	0.8	...	...
22. Access to an improved water source (percent of population)	70.0	...	77.0	...	...
23. Access to improved sanitation (percent of population)	76.0	...	85.0	...	...
Goal 8. Develop a Global Partnership for Development					
Targets: Develop further an open rule-based, predictable, non-discriminatory trading and financial system. Address the special needs of the least developed countries and landlocked countries and small islands developing states. Deal comprehensively with the debt problems of developing countries trough national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with the private sector, make available the benefits of new technologies, specially information and communications.					
24. Youth unemployment rate (percent of total labor force of ages 15-24)	11.1	...	...	...	...
25. Fixed line and mobile telephones (per 1,000 people)	...	23.1	49.0	...	...
26. Personal computers (per 1,000 people)	...	...	9.6	...	...

Source: World Development Indicators database, April 2002.

1/ Includes only indicators for which data is available for any given year.

2/ Targets are indicated quantitatively, wherever possible, but specifics are described in the goals sections.

NICARAGUA—FUND RELATIONS
(As of June 30, 2004)

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	0.21	1.10

IV. Outstanding Purchases and Loans:

	SDR Million	Percent of Quota
ESAF/PRGF arrangements	153.75	118.27

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	41.79
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)

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	5.76	3.45	7.49	10.03	11.78
Charges/Interest	0.54	1.03	0.93	0.81	0.70
Total	6.30	4.48	8.42	10.84	12.48

VII. Implementation of HIPC Initiative:

	Enhanced Framework
Commitment of HIPC assistance	
Decision point date	December 2000
Assistance committed by all creditors (US$ million)[1]	3,308.00
Of which: IMF assistance (US$ million)	82.20
(SDR equivalent in millions)	63.54
Completion point date	January 2004
Disbursement of IMF assistance (SDR million)	
Assistance disbursed to the member	63.54
Interim assistance	2.55
Completion point balance	60.99
Additional disbursement of interest income[2]	7.62
Total disbursements	**71.16**

VIII. Safeguards Assessments:

The updated assessment of the BCN, which was completed on August 29, 2003, found that it continues to maintain strong safeguards and has taken steps to implement the recommendations made in the 2001 safeguards assessment. The main recommendations of the 2003 safeguards assessment were reported in last year's staff report (Third Review Under the Three-Year Arrangement Under the PRGF), and included the adoption of International Accounting Standards (IAS). A task force has been established by the BCN to ensure adequate training for the transition to full IAS. The updated assessment's recommendations have been implemented, with the exception of the adoption of full IAS, which is planned for the 2004 financial statements.

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. For 2004, the monthly crawl has been reduced from an annual rate of 6 percent in 2003 to 5 percent.

As of June 30, 2004, the exchange rate in the official market was C$15.93 per U.S. dollar.

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[1] Assistance committed under the original framework is expressed in 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.

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 administration	October 2003
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
LEG	Banking resolution	July 2004
MFD	Banking legislation and banking supervision	September 2003
MFD	Banking supervision	October 2002
MFD	Banking 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
STA	Monetary and finance statistics	November 2003
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. Humberto Arbulú-Neira assumed the position of resident representative in Nicaragua in August 2004.

NICARAGUA—RELATIONS WITH THE WORLD BANK GROUP
(As of June 30, 2004)

I. FINANCIAL RELATIONS

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

	Bank	IDA	Total
Fully disbursed loans (31) and credits (26)	229.6	1,038.4	1,268.0
Credits/loans currently undisbursed	0.0	220.3	220.3
Total (net of cancellations)	**229.6**	**1,238.7**	**1,468.3**
Of which:			
Repaid	224.1	28.3	252.4
Borrower obligations	0.0	1,074.4	1,074.4
Amount sold and repaid	5.6	0.0	5.6

B. World Bank/IDA Loan Commitments and Disbursements

1. As of June 30, 2004, total loans/credits disbursed and undisbursed from the Bank/IDA amounted to US$1,468 million. The currently active portfolio consists of 16 projects for a total commitment of US$508 million, of which US$200 million remains to be disbursed. The last credit approved by the World Bank Board of Directors was the Broad-Based Access to Financial Services project on May 18, 2004, for US$7 million. The project's principal objective is to improve access to financial services provided by sound, profitable financial institutions for low-income households and micro and small businesses. Nicaragua has been an IDA-only country since lending resumed in the early 1990s.

2. Nicaragua reached the HIPC Decision Point on December 21, 2000, qualifying for debt relief assistance equal to US$383 million. This assistance is being delivered through 90 percent reduction in debt service to IDA over the period 2001–23, of which US$23 million was delivered as interim relief. On January 23, 2004, Nicaragua reached the Completion Point under the enhanced HIPC Initiative making the IDA debt service reduction for the remaining period up to 2023 irrevocable.

II. PLANS FOR THE NEXT 12 MONTHS

3. IDA completed a new Country Assistance Strategy (CAS) in December 2002, which is fully aligned with the four pillars of the Nicaragua Poverty Reduction Strategy. In January 2004, IDA approved a Poverty Reduction Support Credit for US$70 million, which represents the first of a planned series of fast disbursing programmatic credits to support the implementation of the PRSP. Other projects for which future IDA support is being considered include an Agro-Forestry sector project, Education and Health projects, and a Rural Telecommunications project.

NICARAGUA—RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK
(As of July 19, 2004)

I. FINANCIAL RELATIONS

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

Year	Purpose	Amount
2004	Roads Program for Competitiveness—Zone III	40.0
	Citizen's Security	7.0
	Social Policy Reform Program II	25.0
	Health Services	30.0
	National Development Plan Implementation	70.0
	Family Ministry Strengthening	3.0

B. IDB Loan Commitments and Disbursements

As of July 19, 2004, there are 38 projects in the Bank's portfolio for US$754.7 million, with an undisbursed balance of US$449.0 million. For the next six months, tentatively, six projects for US$175.0 million are programmed for approval. In addition, this program is complemented by two projects from the private sector group of the Bank for a total of US$40 million.

During 2003, the Bank disbursed to Nicaragua US$98.4 million from project execution, and granted US$39.2 million (nominal) of HIPC interim debt relief. For 2004, project disbursements for US$170.0 and HIPC relief for US$38.2 million are projected.

II. RECENT TECHNICAL ASSISTANCE

The Bank's program for 2004 also includes three nonreimbursable technical cooperation projects for US$1.4 million.

III. RECENT AGREEMENTS

Contracts for two projects—for a total of US$47 million—were signed during the second quarter of 2004.

IV. RECENT EVENTS

The Board of the Bank, on May 5, 2004, granted full debt relief to Nicaragua after reaching the HIPC Completion Point. The relief amounts to US$727 million in nominal terms.

DECENTRALIZATION[1]

This appendix examines how Nicaragua is pursuing decentralization. It describes the Municipal Transfers Law (MTL) and current municipal responsibilities. In addition, it draws on international experience with decentralization to arrive at some policy recommendations.

1. **Nicaragua has embarked on an ambitious decentralization process**. The constitution states that the central government should transfer sufficient funds to municipalities to carry out their responsibilities. However, ambiguities in the institutional framework—the municipal mandates are poorly specified—and a lack of resources have delayed decentralization. However, with the recent approval of the MTL in July 2003, the process has gained momentum.

Pre-2004 municipal financing

2. **Local revenues, which come mostly from a poorly-enforced property tax, are limited**. Prior to 2004, the central government used to transfer to municipalities about 0.2 percent of GDP per year to finance mostly current expenditure. In addition, international donors have provided financing to municipalities for specific capital projects. Municipal capital expenditure is largely financed and executed by central government agencies in charge of local development (Table 1).[2]

Municipal Transfers Law

3. **The MTL (approved in July 2003) increases substantially the funds available to municipalities.** It mandates that the central government transfer 4 percent of central government tax revenues (approximately 0.8 percent of GDP) to municipalities in 2004. The transfer will progressively increase until it reaches at least 10 percent of tax revenues (a projected 2.1 percent of GDP) in 2010. The transfers are allocated to different municipalities according to a formula that aims to give incentives for raising local revenues as well as to compensate poor municipalities. There are few constraints on the use of these transfers, with the exception that about 70 percent should be spent on (loosely defined) capital investment.

4. **As a result of the new law, transfers to municipalities will jump sharply.** Out of 152 municipalities, more than 120 will more than double their budget in 2004. Transfers will become the largest source of financing for all municipalities, with the exception of Managua.

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[1] Prepared by Antonio Spilimbergo (FAD).

[2] The key central government agencies in charge of municipal development include INIFOM (*Instituto Nicaraguense de Fomento Municipal*), FISE (*Fondo Inversion Social de Emergencia*), and IDR (*Instituto de Desarrollo Rural*). All these agencies are, to varying degrees, cofinanced by the central government and international donors.

5. **The 2003 Municipal Transfer Law has several positive aspects**:

- It reduces the volatility of revenues to municipalities, permitting more effective planning at the local government level.
- It introduces incentives to increase local revenues given that efficiency in collecting local taxes is a criterion to divide total transfers across municipalities.
- It gives relatively more resources to poor municipalities.
- By empowering municipalities and fostering local participation, it strengthens the basis for democracy in the long run.

6. **However, the 2003 Municipal Transfer Law also has some drawbacks:**

- By not transferring equivalent expenditure responsibilities, it is not fiscally neutral. The central government will continue paying for many local services, while municipalities will use the transfers for new projects.
- Many municipalities have serious governance problems, and the law does not contain appropriate mechanisms to ensure proper auditing of local expenditure.
- The law has no provision to ensure that local investment projects are consistent with the national public investment plan and with the government's commitment to increase pro-poor public expenditure.
- By earmarking an increasing share of fiscal revenues for municipalities, the law makes the national budget less flexible.
- The transfer law could have an adverse effect on inflows of foreign assistance if donors, who typically cofinance a large part of public investment, are reluctant to transfer funds directly to municipalities.

Municipal responsibilities

7. **The legal devolution of expenditure responsibilities from the central government to municipalities is difficult because expenditure responsibilities are ill-defined.** The 1988 Municipal Law and the 1998 Reformed Municipal Law lay out the general responsibilities of municipalities and central government. Formally, the law embraces the principle of subsidiarity, according to which expenditure responsibilities should be assigned to the lowest government level that is able to perform the task efficiently.[3] The law

[3] Article 2, item 3, of the Municipal Law states that "any matter that has implication for the municipal socioeconomic development and any function that may be performed efficiently within its jurisdiction or require a relationship with the local community must be of municipal competence. Municipalities must develop

(continued)

distinguishes between exclusive, concurrent, and delegated functions. The exclusive functions are limited to basic services to local population, such as garbage collection and civil registry. The concurrent functions are those for which municipalities and the central government are jointly responsible, such as education, culture, and the environment. The delegated functions are those that the central government can delegate to municipalities, such as local aqueducts and roads. An overview of the responsibilities is given in the table on intergovernmental relationships below.

8. **From an economic point of view, the MTL, which should define the municipal responsibilities, has three main shortcomings:**

- **It does not specify which level of government should pay for common responsibilities;** in the absence of clear legal guidelines, the use and availability of financing have determined the relative responsibilities. In practice, the central government, or its agencies, has assumed full responsibility especially in poor municipalities.

- **It has a large number of conflicts with other laws and regulations.** This is particularly true in the fields of health, education, sanitation, and environment.

- **It fails to recognize the limited resources available at the municipal level.** The law offers more a wish list of activities that municipalities should ideally perform than an indication of priorities. Therefore, it raises an unrealistic local expectation of higher transfers to finance these mandates. At the same time, the list of mandates is too extensive and impractical to serve as a useful benchmark against which to evaluate the efficiency of municipalities.

9. **In the absence of a clear definition of responsibilities, and because of the lack of funding, a substantial part of municipal funds is devoted to current spending—mostly salaries and goods and services—leaving little room for investment.** In particular, Managua, which accounts for about one-fifth of the total population, spent 63 percent of its budget on salaries and goods and services in 2000 (Table 1), compared with 51 percent in the rest of the municipalities. However, since then the ratio in Managua has declined to about half (more recent data for the rest of the municipalities are not available).

10. **The institutional framework that regulates local borrowing capacity is weak.** Even though the municipal budget law and the public debt law determine the borrowing capacity of municipalities, there are no effective controls. This was not a problem before 2004 when local authorities had limited capacity to borrow given the limited amount of resources. The most common form of financing was by accumulating large arrears with providers of goods and services. In addition, municipalities have accumulated large debts with the social security institute by not paying employers' contributions.

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the necessary technical, administrative, and financial capability to carry out the responsibilities assigned to them."

11. **Auditing of local authorities is basically nonexistent**. The Comptroller General's Office (CGO) has a broad mandate of overseeing the general government, including municipalities. In practice, because of limited resources, the CGO cannot perform consistent auditing of municipalities. Less than 10 out of 152 municipalities have their activities audited externally. Foreign donors generally audit the projects that they finance, but this represents only a fraction of the budget.

International comparison

12. **Nicaragua is already fairly decentralized by international standards.** Municipal government spending is equivalent to 1.7 percent of GDP, compared with an average of less than 1 percent of GDP in countries of a similar size. Only larger countries, such as Bolivia, have a higher share of local spending.

13. **In pursuing decentralization, Nicaragua is following the example of several other Latin American countries.** Unfortunately, Nicaragua is bound to encounter the same fiscal, financial, and efficiency problems that other countries have also faced:

- **Lack of fiscal neutrality.** Revenue sharing that is not accompanied by commensurate expenditure devolution has resulted in an increase in overall fiscal expenditure. Colombia and Ecuador are good examples of revenue-sharing agreements that were not accompanied by commensurate devolutions of expenditures.

- **Lack of control over local borrowing.** Often, local authorities were given borrowing capabilities with explicit and implicit central government guarantees and the resulting local borrowing spree created instability in the national financial market. Argentina, Brazil, and Colombia are examples of the problems that can arise when fiscal decentralization and implicit central government guarantees increase the possibility of local borrowing. Without adequate supervision and controls, the same problems could occur in Nicaragua.

- **Inefficient use of local resources.** Local governments are not ready to deal with administrative issues and tend to waste resources if not properly monitored. Brazil and Argentina illustrate the efficiency problems stemming from poor coordination between central government and local spending. The efficiency of many municipalities in Nicaragua is still quite low.

These problems have led countries that pursued aggressive decentralization at the beginning of the 1990s to reconsider their approach.

Policy recommendations

14. **To avoid similar problems, Nicaragua should reorganize its intergovernmental relationships**. The decentralization strategy should be designed with a view to clarifying the respective goals of each level of government. Five guiding criteria should be followed:

- **Fiscal neutrality.** Revenues transferred to municipalities should be matched by transfers of expenditure responsibilities.
- **Efficiency.** The quality of the municipal services should improve as control is shifted to local governments.
- **Equality.** Municipalities with less means to fulfill their mandates should be given relatively more resources.
- **Clarity.** The assignment of expenditure responsibilities between municipalities and central government should be clear.
- **Transparency.** Proper monitoring should ensure the transparency of resource allocation at all levels of government.

15. **The government should ensure that transfers are fiscally neutral as soon as possible.** It is economically and politically inefficient to give resources to municipalities while postponing the devolution of expenditure responsibilities to a later stage. The availability of funding without a clear mandate will worsen governance problems in municipalities. A slower process of revenue transfers should be considered if municipalities do not have the implementation capacity for new responsibilities.

16. **The efficiency of local spending needs to improve.** This will require strengthening the central agencies in charge of monitoring municipalities. The agencies currently carrying out this responsibility were designed for other purposes, mainly to channel international aid to local governments, and are not equipped to address the new challenges stemming from decentralization. The authorities should also reconsider intergovernmental relationships to improve efficiency (i.e., reallocating specific expenditure responsibilities between the different levels of government).

17. **Equality of transfers is necessary to ensure that rural municipalities, in which a large share of the population is concentrated, have the means to satisfy the basic needs of the rural population.** This goal is also complementary to the efforts by the central government and international community to eradicate rural poverty.

18. **Clarity in defining the ultimate objective of decentralization is necessary so that the process remains efficient and well targeted.** Clear goals will also help provide effective benchmarks, against which the process can be evaluated in the future. Moreover, clarity of goals is a precondition for effective monitoring.

19. **Transparency is necessary to assure that the public shares ownership of decentralization and there is no conflict between central government and municipalities.** Presently, the central government and municipalities do not collaborate effectively, partly reflecting distrust on the end-use of the transfers. The government should strengthen auditing and monitoring as well as have strong rules overseeing local borrowing. *De jure*, the government can intervene in these areas; *de facto,* limited resources are a constraint. The government should consider increasing the resources for the agencies overseeing municipalities.

20. The central government should have appropriate legal instruments to intervene whenever the level of local services falls below an acceptable level. The constitution states that the central government is ultimately responsible for the welfare of its citizens. However, the law does not specify the form this responsibility should take. Given the new resources and responsibilities being shifted to municipalities, new legislation to address this issue is needed.

Summary Table on Intergovernmental Relationships

	Central Government	Municipal Governments
Expenditure Responsibilities	**Exclusive:** Defense, national security, foreign relations, justice, money and banking, taxation and public borrowing, regulation of public services and public infrastructure, civil security, and social security.	**Exclusive:** Urban and rural municipal development and maintenance; management of local public services, promotion of agriculture, handicrafts, and forests; construction and management of public cemeteries; local planning, regulation and control of land use; and construction and maintenance of recreational facilities.
	Shared: Local infrastructure, roads, education, public health, environment and natural resources conservation, culture, tourism promotion and development, public transportation development and regulation, solid waste disposal, execution and monitoring of local public infrastructure, water and sewerage management.	
Resources	**Exclusive:** Income and profits tax, value added tax, excises, custom duties, other small taxes, and fees.	**Exclusive:** Local sales tax, property tax, and municipal fees.
	Shared: Minor taxes. Taxes on sugar.	
Transfers	**Before 2004:** Discretionary transfers from central government to municipalities. The amount was discussed every year, in the context of the annual budget, and usually amounted to 1 percent of fiscal revenues.	
	Starting in 2004: By law, the central government must transfer at least 4 percent of fiscal revenues. This amount is to be progressively increased by at least a half percentage point each year (as long as real GDP growth in the previous year was greater than or equal to 1 percent) until it reaches 10 percent of central government tax revenues in 2010.	
Auditing	**Common:** *De jure,* the General Controller Office (GCO) has the general mandate to oversee all public expenditure. *De facto,* the GCO does not have the means to audit municipalities.	
		Very few municipalities are audited.
Legal Limits to Borrowing Capacity	**Common:** The law on public debt regulates all public borrowing. The minister of finance is responsible for ensuring the fiscal sustainability of aggregate public borrowing	
		The municipal budgetary law states that municipal public debt service should not exceed 20 percent of the annual municipal budget. Moreover, a municipal administration cannot leave debt for future administrations, unless specifically authorized to do so by a citizens' council.

Source: Authors' elaborations based on Municipal Law, Municipal Transfer Law, and Law on Public Borrowing.

Table 1. Nicaragua: Expenditure Composition

Table 1a. Expenditure: Managua (In percent of total expenditure; unless otherwise indicated)

	Wages	Goods and Services	Social Security Contributions	Capital Investment	Others	Total Expenditure (In percent of GDP)
1990	20	64	2	13	1	0.60
1991	29	40	2	26	3	1.01
1992	34	39	1	20	6	1.20
1993	36	30	0	27	6	1.09
1994	36	26	...	32	7	1.03
1995	38	30	0	23	9	0.87
1996	46	31	2	11	10	0.77
1997	37	20	5	27	12	0.85
1998	36	26	4	23	11	0.78
1999	37	25	3	27	7	0.85
2000	38	25	4	22	11	0.75
2001	44	27	6	15	8	0.72
2002	40	25	5	23	8	0.70
2003	27	25	4	38	6	0.98

Table 1b. Expenditure: Rest of Municipalities (In percent of total expenditure; unless otherwise indicated)

	Wages	Goods and Services	Social Security Contributions	Capital Investment	Others	Total Expenditure (In percent of GDP)
1990	23	60	...	15	3	0.16
1991	32	41	...	20	7	0.74
1992	35	37	...	21	6	0.79
1993	37	39	...	18	6	0.83
1994	31	36	...	29	4	0.98
1995	30	36	...	30	5	0.98
1996	28	32	...	36	4	0.75
1997	31	38	...	28	2	0.88
1998	26	36	...	32	6	0.85
1999	29	31	...	35	4	0.75
2000	25	26	...	46	3	0.90

Table 1c. Expenditure: Central Government (In percent of total expenditure; unless otherwise indicated)

	Wages	Goods and Services	Debt Interest	Current Transfers	Capital Transfers	Capital Investment	Others	Total Expenditure (Percent of GDP)
1990	21	61	0	14	2	3	...	21.51
1991	30	28	4	24	2	8	3	16.60
1992	30	20	10	18	9	12	1	17.33
1993	27	20	14	14	15	9	1	16.89
1994	22	16	17	16	12	15	2	18.83
1995	20	11	13	19	17	17	3	18.29
1996	17	19	10	19	14	21	0	18.06
1997	17	13	16	20	17	17	0	17.91
1998	19	15	15	19	14	18	...	18.50
1999	17	13	7	16	21	24	2	22.52
2000	16	12	9	20	18	26	0	23.49
2001	17	15	10	21	18	19	1	24.57
2002	21	11	14	21	12	20	...	20.90
2003 1/	20	10	18	19	13	21	0	20.05

Source: Authors' estimates based on data provided by the Central Bank of Nicaragua.

1/ Updated to November 2003.

Table 2: Nicaragua: Revenue Composition

Table 2a. Revenue: Managua (In percent of revenues; unless otherwise indicated)

	Current Revenues	Current Transfers	Capital Transfer	Others	Grants	Total Revenue (In percent of GDP)
1990	32	53	15	...	...	0.57
1991	85	6	...	...	9	0.99
1992	91	7	1	...	1	1.14
1993	86	2	1	...	11	1.03
1994	87	...	1	...	12	1.01
1995	98	...	2	...	...	0.83
1996	100	...	...	...	...	0.76
1997	93	...	6	...	0	0.85
1998	100	...	...	...	0	0.86
1999	100	...	...	...	...	0.92
2000	96	...	0	3	...	0.82
2001	94	...	...	3	4	0.79
2002	97	...	...	3	...	0.76
2003	96	...	...	4	...	0.84

Table 2b. Revenue: Rest of Municipalities (In percent of revenues; unless otherwise indicated)

	Current Revenues	Current Transfers	Capital Transfers	Others	Grants	Total Revenue (In percent of GDP)
1990	73	15	10	...	2	0.16
1991	89	2	5	...	4	0.70
1992	87	2	7	...	4	1.06
1993	84	2	10	...	5	0.86
1994	64	1	24	...	11	1.15
1995	64	1	25	...	10	1.16
1996	55	1	35	...	9	0.84
1997	78	1	14	...	7	1.01
1998	69	3	18	...	10	0.98
1999	66	8	14	...	12	0.81
2000	51	9	33	...	8	1.01

Table 2c. Revenue: Central Government (In percent of GDP; unless otherwise indicated)

	Current Revenues	Current Transfers	Capital Revenues	Others	Grants	Total Revenues (In percent of GDP)
1990	91	...	0	...	9	9.97
1991	62	...	1	...	37	19.12
1992	82	...	1	...	17	15.30
1993	71	...	2	...	27	16.86
1994	80	...	1	...	19	15.65
1995	71	...	2	...	28	18.01
1996	75	...	1	...	24	17.15
1997	85	...	0	...	15	17.15
1998	89	...	0	...	10	17.41
1999	78	...	0	...	22	19.62
2000	69	...	0	13	17	21.70
2001	77	...	0	5	17	18.27
2002	75	...	0	2	23	19.96
2003 1/	77	...	0	0	23	19.11

Source: Authors' elaboration based on data from Central Bank of Nicaragua.
1/ Updated to November 2003.

Table 3. Nicaragua: International Comparison

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Nicaragua											
Subnational expenditures (percent of GDP)	0.8	1.7	2.0	1.9	2.0	1.8	1.5	1.7	1.6	1.6	1.7
Subnational revenues (percent of GDP)	0.7	1.6	2.2	1.7	1.9	1.9	1.5	1.8	1.7	1.6	1.7
Vertical imbalance	55.0	4.0	8.4	5.6	13.3	16.2	18.8	8.0	11.7	10.5	16.3
Subnational expenditures (percent of total expenditure)	5.0	10.5	11.5	11.4	10.6	10.1	8.5	9.7	8.8	7.1	7.0
Subnational revenues (percent of total revenues)	11.5	14.3	18.1	15.1	16.1	15.3	12.4	13.0	11.7	11.2	12.1
Composition of subnational revenues and grants											
Of which: Taxes	34.6	85.4	79.1	76.5	68.9	68.2	68.9	74.5	73.3	75.3	58.3
Transfers from the central government	56.8	4.5	7.8	6.2	14.0	16.1	18.8	7.8	11.0	10.2	15.4
Composition of subnational spending											
Of which: Capital Spending	13.6	23.3	20.7	23.1	30.1	26.6	23.2	27.2	27.4	30.8	35.1
Memorandum item:											
Share of capital spending for CG	4.2	13.0	21.3	24.8	29.7	37.6	35.1	33.6	31.8	46.9	43.4
Bolivia											
Subnational expenditures (percent of GDP)	3.6	3.8	4.0	5.6	5.5	5.7	9.6	10.3	10.0	9.5	...
Subnational revenues (percent of GDP)	2.8	3.0	3.0	4.8	4.9	4.9	4.5	5.3	5.3	4.9	...
Vertical imbalance	6.5	7.0	5.1	5.4	7.2	6.7	24.3	23.2	24.0	24.4	...
Subnational expenditures (percent of total expenditure)	18.2	18.3	16.4	18.8	19.1	21.4	29.4	31.9	31.2	29.3	...
Subnational revenues (percent of total revenues)	17.0	16.7	16.5	22.8	22.5	23.0	20.6	23.7	23.0	21.6	...
Composition of subnational revenues and grants											
Of which: Taxes	43.7	50.5	54.4	40.8	36.9	46.2	35.0	35.4	36.4	38.9	...
Transfers from the central government	8.4	8.9	6.7	6.3	8.1	7.8	50.9	45.2	45.4	47.4	...
Costa Rica											
Subnational expenditures (percent of GDP)	0.8	0.6	0.6	0.7	0.6	0.6	0.7	0.8	0.7	0.8	...
Subnational revenues (percent of GDP)	0.7	0.5	0.6	0.6	0.5	0.6	0.8	0.7	0.6	0.6	...
Vertical imbalance	12.7	12.4	6.5	13.6	11.1	5.7	....	4.1	...	...	...
Subnational expenditures (percent of total expenditure)	3.0	2.8	3.1	3.1	2.5	2.4	2.8	3.5	3.2	3.4	...
Subnational revenues (percent of total revenues)	3.0	2.6	2.9	2.7	2.7	2.6	3.6	3.1	2.9	2.9	...
Composition of subnational revenues and grants											
Of which: Taxes	56.2	51.8	57.1	58.5	51.2	52.2	63.8	50.0	52.0	43.0	...
Transfers from the central government	14.2	13.9	6.7	15.3	12.7	5.8	...	5.0	...	...	...
Panama											
Subnational expenditures (percent of GDP)	0.6	0.7	0.7	0.6	0.6	...	...	...	...	...	...
Subnational revenues (percent of GDP)	0.7	0.8	0.7	0.7	0.7	...	...	...	...	...	...
Vertical imbalance	1.5	1.3	...	...	...	...	...	...	...	...	...
Subnational expenditures (percent of total expenditure)	2.5	2.8	2.6	2.4	2.4	...	...	...	...	...	...
Subnational revenues (percent of total revenues)	2.8	2.6	2.6	2.4	2.5	...	...	...	...	...	...
Composition of subnational revenues and grants											
Of which: Taxes	73.6	70.2	71.3	74.7	74.9	...	...	...	...	...	...
Transfers from the central government	1.3	1.1	...	...	...	...	...	...	...	...	...
Dominican Republic											
Subnational expenditures (percent of GDP)	0.2	0.3	0.3	0.4	0.3	0.3	0.4	...	...	...	...
Subnational revenues (percent of GDP)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	...	...	...	...
Vertical imbalance	24.5	0.4	2.5	1.6	2.7	2.3	2.4	...	...	...	...
Subnational expenditures (percent of total expenditure)	1.6	2.8	2.5	2.1	2.0	2.1	2.6	...	...	...	...
Subnational revenues (percent of total revenues)	0.5	1.0	0.8	0.8	0.8	0.9	0.8	...	...	...	...
Composition of subnational revenues and grants											
Of which: Taxes	22.3	18.8	17.7	19.4	19.4	20.8	22.5	...	...	...	...
Transfers from the central government	70.4	1.0	6.5	4.1	7.0	5.2	8.2	...	...	...	...
Guatemala											
Subnational expenditures (percent of GDP)	1.1	0.8	1.0	1.0	...	...	...	...	...	...	...
Subnational revenues (percent of GDP)	0.3	0.4	0.3	0.3	...	...	...	...	...	...	...
Vertical imbalance	21.5	26.8	20.9	22.5	...	...	...	...	...	...	...
Subnational expenditures (percent of total expenditure)	...	...	...	...	...	...	...	...	...	...	...
Subnational revenues (percent of total revenues)	3.9	3.8	3.2	3.7	...	...	...	...	...	...	...
Composition of subnational revenues and grants											
Of which: Taxes	7.8	16.9	14.2	13.2	...	...	...	...	...	...	...
Transfers from the central government	71.1	59.2	64.0	66.9	...	...	...	...	...	...	...

Source: GFS and data provided by the Central Bank of Nicaragua.

REPUBLICA DE NICARAGUA

Managua, August 12, 2004

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. de Rato:

1. We are attaching the Supplementary Memorandum of Economic and Financial Policies (SMEFP) and a revised Technical Memorandum of Understanding that reviews economic developments and policy implementation through end-May 2004 under the PRGF arrangement approved in December 2002, and sets out specific objectives and targets for the period June–December 2004. Based on the good track record and policies adopted, we request completion of the fifth and sixth reviews under the PRGF arrangement and the establishment of corresponding performance criteria (PCs) for end-September and end-December 2004 and a structural PC for October 15, 2004 (paragraph 4 below). We also present the following requests for: (i) a waiver for the nonobservance of the December 2003 quantitative PC on CPS savings (paragraph 2 below); (ii) a waiver for the nonobservance of the mid-May 2004 structural PC on granting legal protection to staff of the superintendency of banks; (iii) a replacement of the performance criterion on CPS savings, starting in September 2004 (paragraph 3 below); (iv) the completion of the financing assurance review (paragraph 5 below); and (v) a set of prior actions for the completion of the fifth and sixth reviews (paragraph 6 below).

2. Nicaragua's economic performance through May 2004 continues to be consistent with the program. Macroeconomic policies have been in line with the PRGF arrangement, and progress has been made on the structural agenda. Consequently, all quantitative and structural PCs for end-December 2003 were met, with one exception, and all end-March 2004 quantitative PCs were also met. However, a mid-May structural PC was not observed. The end-December 2003 target for combined public sector (CPS) savings was missed by a minor amount (0.2 percent of GDP), reflecting a tax shortfall, which was only partially offset by a lower quasi-fiscal deficit. The government has taken corrective measures to address the revenue shortfall and, thus, fiscal targets for the balance of 2004 remain unchanged. We have strengthened resolutions of the superintendency of banks and central bank to cover explicitly the legal expenses of staff sued in the course of their official duties. We have also requested technical assistance from the Fund to help draft legislation to strengthen legal protection for bank supervisors.

3. Reflecting the continued concern over the high public debt burden, and the priority given to returning Nicaragua's debt dynamics to a sustainable path, we request the replacement of the PC on CPS savings with two new PCs—one on the overall balance of the CPS (after grants), and one on the overall balance of the central government (after grants).

4. New PCs for end-September and end-December 2004, which were indicative in the past review, are being requested. We are also requesting establishment of a new structural PC for October 15, 2004 on submission to the assembly of a draft Fiscal Responsibility Law. Following HIPC completion, and the associated accounting methodology changes, only debt service to multilaterals is recorded in the fiscal accounts at full value, with relief shown as exceptional financing. Debt service to other creditors, following recent stock operations, is shown after all relief.

5. The request for completion of the financing assurances review is based on satisfactory assurances of external financing evidenced by the recent successful Paris Club negotiation, the clearance of arrears on indemnity bonds, and our intent to use the IDA Debt Reduction Facility to resolve the commercial debt problem.

6. A set of prior actions is proposed for completion of the fifth and sixth reviews that includes *inter alia* implementation of a budget modification in line with the fiscal program, as well as fiscal measures to achieve the targeted revenue gains and expenditure savings (specifics are provided in Table 2 of the SMEFP).

7. Based on two years of experience with implementation of the PRSP, as well as the results of a growth seminar held in Nicaragua earlier this year, we have strengthened the PRSP. We have completed a first draft of an enhanced PRSP which is now being discussed within the government and the civil society before its final adoption.

8. We are committed to continue good faith negotiations with all non–Paris Club official and private creditors to seek debt relief at least comparable to that granted by Paris Club creditors under the enhanced HIPC Initiative.

9. We are confident that the policies and measures set forth in the SMEFP are adequate to achieve the program's objectives under the PRGF arrangement. Nonetheless, we stand ready to take, in consultation with the Fund, further measures that may be needed for the successful implementation of the program. To this end, we will continue consulting with the Fund on relevant economic and financial policies, and provide the Fund with the 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 SMEFP and will report on the progress of the program periodically.

10. We propose that for the remainder of the second year of the arrangement, the Fund carry out program reviews by November 2004 and January 2005, based on the observance, respectively, of end-June 2004, and end-September 2004 quantitative and structural performance criteria established in Tables 1 and 2 of the attached memorandum.

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

Sincerely yours,

/s/
Mario B. Alonso I.
President
Central Bank of Nicaragua

/s/
Eduardo Luis Montiel
Minister of Finance

SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. The government of Nicaragua reaffirms its commitment to the strategy embodied in the Poverty Reduction Strategy Paper (PRSP), as updated in the 2003 PRSP progress report, and the program supported by the Poverty Reduction and Growth Facility (PRGF). This memorandum supplements the Memorandum of Economic and Financial Policies of November 19, 2002, and the associated supplements,[1] and outlines the key next steps envisaged in implementing our program.

2. Economic growth and inflation in 2003 were broadly in line with the program targets. Real GDP grew by 2.3 percent, and it is projected to expand by 3.7 percent in 2004. Inflation was 6½ percent, slightly above the program target of 6 percent, due to a jump in prices for perishable goods and petroleum products in November–December. NIR accumulation surpassed the end-December performance criterion (PC) by US$33 million (0.8 percent of GDP), despite a delay in the sale of the government's shares in ENITEL (telecommunications company). As a result of the sustained implementation of prudent economic policies, interest rates (and the spread between domestic and foreign rates, in dollar terms) have been trending downward, declining by about 200 basis points since January 2002.

3. Policy implementation has been broadly consistent with the program and all structural and quantitative performance criteria (PCs) for end-December 2003 were observed, with one exception, and all end-March 2004 PCs were observed. In December, the floor on combined public sector (CPS) savings was missed by 0.2 percent of GDP, reflecting a tax revenue shortfall (described below), which was only partially offset by a lower quasi-fiscal deficit. This shortfall has now been corrected, and the end-March CPS savings target was met. In line with the financial sector reform agenda, in December 2003 we submitted to the assembly a draft law to grant legal protection to bank supervisors.

4. The 2003 fiscal program did not perform as envisaged in December due to tax revenue shortfalls and higher-than-programmed capital spending. Tax revenues fell short of the program projections by 0.4 percent of GDP, mainly on account of lower receipts for income taxes and the value added tax (VAT). Proceeds from the income tax were affected by legal challenges and taxpayer resistance to the minimum income tax (1 percent of gross assets), while net VAT receipts fell short of projections, largely due to tax rebates arising from former zero-rated products.[2]

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[1] Dated June 3, 2003, October 2, 2003, and December 22, 2003

[2] The zero-VAT rate was in effect for 53 products between September 2002 and May 2003.

5. Higher capital spending in the CPS (0.6 percent of GDP), fully financed by concessional external resources (grants or loans from multilateral organizations), resulted in most indicative fiscal targets for end-December being missed. The majority of the increased spending was directed to anti-poverty programs, which increased to 11.4 percent of GDP and exceeded the program target by 0.4 percent of GDP.

Macroeconomic framework for 2004

6. Our key economic objectives in the macroeconomic framework for 2004 are as follows:

Key Macroeconomic Objectives
(In percent of GDP, unless otherwise indicated)

	Prel. 2003	Rev. Prog. 2004
Real GDP growth (in percent)	2.3	3.7
Consumer prices (end period)	6.6	7.0
Gross international reserves (in millions of US$)	504.2	553.2
Change in augmented BCN reserve position (in millions of US$)	89.0	97.3
Combined public sector deficit, after grants	-4.4	-1.7

Sources: Central Bank of Nicaragua (BCN) and Ministry of Finance.

Fiscal policy

7. We remain fully committed to the medium-term fiscal strategy outlined in the PRGF-supported program. For 2004, our fiscal program targets a CPS deficit (after grants) of 1.7 percent of GDP. After adjusting for HIPC debt relief, CPS savings for 2004 is projected at 2.4 percent of GDP. To meet these targets, we are taking both revenue and expenditure measures.

Fiscal Indicators
(In percent of GDP)

	2003		2004
	Prog.	Prel.	Rev. Prog.
Combined public sector deficit, after grants	-3.8	-4.4	-1.7
Combined public sector deficit, before grants	-8.9	-9.7	-7.0
Combined public sector savings	0.2	0.0	2.4
Combined public sector primary savings	6.7	6.3	7.0
Combined public sector primary expenditure	24.5	25.1	24.7
Tax revenues of the central government	16.3	15.8	16.5
Total poverty-reducing spending	11.0	11.4	11.4

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

8. On the revenue side, the tax base for the application of the VAT to soft drinks was raised and we expect the assembly to approve a new tax on gambling activities by September 2004. Tariffs on water services will be adjusted by 10 percent effective in December 2004, in line with the current rules on tariff indexation. The tax office agreed with the main public enterprises the elimination before end-2004 of their 2003 tax arrears (C$14 million), of which about half has already been collected. In addition, the revenue overperformance of the first-half of 2004, is largely financing the increase in expenditures approved by the assembly (see below). The government is firmly committed to oppose any extension of tax benefits or granting any form of tax relief to the private or public sectors without compensatory measures that protect tax revenues, to limit the use of the accelerated depreciation scheme solely to exporters, and to maintain a database on forgone revenues arising from existing tax exemptions and exonerations.

9. On the expenditure side, we have made some fiscally-neutral changes to the 2004 budget. We will require municipalities to use a portion of their 2004 transfers from the central administration to partially reduce their payment arrears to the social security institute (INSS). Expenditures of INIFOM, IDR, FISE and INVUR will be reduced by C$37 million during 2004. In addition, the budget reform eliminated most vacancies in the central administration (except for education, health and police), and included minor budget reductions in other areas. At the same time, to maintain social peace and support for the program, we have modified the 2004 budget to allow for higher salaries for teachers (C$122 million, equivalent to 0.2 percent of GDP),[1] for transfers to universities (C$140 million, equivalent to 0.2 percent of GDP),[2] subsidies to public transportation (C$40 million, equivalent to 0.06 percent of GDP),[3] and other small projects (C$69 million, equivalent to 0.1 percent of GDP).

10. We are facing additional expenditures of about 0.2 percent of GDP due to higher oil prices than originally envisaged in the program, reflecting higher costs in oil consumption (0.1 percent of GDP) and public investment projects (0.1 percent of GDP). We are compensating the higher current oil-related expenditures by reducing public fuel and electricity consumption (a recent presidential directive was issued to this effect). However, to protect priority projects, we will finance the additional investment costs with highly concessional financing from the World Bank and IDB.

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[1] It was necessary to address pressing needs in the education sector.

[2] In response to a ruling by the supreme court calling for a transfer to universities equivalent to 6 percent of budget expenditures.

[3] Targeted to cushion the impact of higher oil prices on the poor.

Corrective Actions in 2004

Revenue measures

- Collect overdue VAT from MTI.
- Change VAT tax base from wholesale to retail value for soft drinks.
- Collect net income tax arrears from nonconsolidated state enterprises.
- New tax on gambling operations.

Expenditure measures

- Slow the pace of capital spending, with emphasis on nonpoverty spending.
- Implement capital spending cuts in the central government to compensate partially for higher transfers to municipalities.
- Require municipalities to use transferred revenues to partially reduce arrears to INSS.
- Selected cuts in the ministry of education's general budget partially offsetting the increase in teachers' salaries.
- Eliminate most vacancies in central administration.

Other measures

- Strengthen arrears collections in ENACAL and ENTRESA.

11. We are also strengthening the quality of public expenditures, including through the work of the Public Expenditure Commission (PEC). By end-September, we will initiate a thorough assessment of the main investment projects to determine their social rate of return, and prioritize the use of scarce resources. The PEC will also make specific recommendations for improving the classification of current and capital spending and propose a new definition for poverty reducing spending. For the next review, we will prepare revised series of current and capital expenditures back to 2003. Following the agreement with the World Bank under the PRSC, the PEC will analyze public expenditures and make recommendations to improve their effectiveness in an annual public expenditure review. The PRSP progress report will include a forward-looking discussion of the annual public investment program (PIP) and the government's priorities in capital spending. If necessary, we will adjust public expenditures in order to preserve macroeconomic stability, in line with the priorities established above.

12. We have expanded the mandate of the PEC to include monthly reporting and monitoring of current and capital expenditures, by institution, in order to provide an early warning system for any expenditure deviation in the future. We will improve the control and tracking system of public spending, including by transferring responsibility for the payment to suppliers and contractors from the numerous executing agencies to the ministry of finance. If tied foreign financing of capital spending is lower than the amounts in the table below, we will postpone capital spending by an equivalent amount, while making every effort to protect poverty-reducing spending.

External Financing of the Nonfinancial Public Sector
(In millions of U.S. dollars, cumulative)

	2003	2004				
	Prel.	QI	QII	QIII	QIV	Total
Tied resources	**335.6**	**70.4**	**178.1**	**235.0**	**286.4**	**286.4**
Loans	223.5	54.1	126.2	154.2	175.2	175.2
IDB/World Bank	169.7	46.4	109.5	127.5	141.0	141.0
Others	53.8	7.7	16.7	26.7	34.2	34.2
Grants 1/	112.1	16.3	51.9	80.8	111.2	111.2

Source: Central Bank of Nicaragua.

1/ No tied grants were received from the IDB or World Bank in 2003, and none are expected in 2004.

Main Responsibilities of the PEC

The main responsibilities of the PEC for 2004 are:

- Make recommendations for prioritizing capital spending, based on the expected impact on growth and poverty reduction.
- Analyze the classification of capital and current spending at the project level and make recommendations to improve it.
- Analyze public expenditure allocations and make recommendations to improve effectiveness of public expenditure in an annual Public Expenditure Review.
- Define efficiency indicators for education and health expenditures, along with the *Ministerio de Educación* (MECD) and *Ministerio de Salud* (MINSA). Report these indicators in the quarterly *Informe de Ejecución del Presupuesto.*
- Propose a new definition for poverty expenditures to be used in the second generation PRSP.

PEC recommendations will be published by September 2004, with a view to incorporating them in the 2005 budget.

13. We are preparing a Poverty and Social Impact Analysis (PSIA) of the PIP with assistance from the World Bank. The PSIA seeks to (i) assess the procedures for selecting the activities included in the PIP to accelerate growth and reduce poverty; (ii) evaluate the regional distribution of investment spending; and (iii) improve the efficiency and targeting of public investment. The PSIA was completed in April 2004 and will be reviewed shortly with the World Bank.

14. We continue to move forward with several other reforms that are underway to support medium-term fiscal sustainability. These include:

- **Tax administration.** The internal tax office (DGI) is implementing an action plan, which is summarized in the table below. Specifically, the DGI has updated the large taxpayer database, centralized large taxpayer operations into one unit, and assigned the most experienced auditors to this unit. In addition, the DGI is preparing a strategic plan to improve its information technology systems, which should help in cross-checking data and hence in improving collections. We welcome the appointment of a Fund resident tax advisor who is assisting in the implementation of the tax office's action plan.
- **Tax code.** We revised the draft tax code, which sets out the rights and obligations of tax officials and taxpayers and establishes sanctions for tax violations. The recommendations of Fund staff have been incorporated and the draft tax code is now being discussed by the national assembly.
- **Law on administrative career for customs and tax offices.** This draft, submitted to the assembly in November 2003, is intended to strengthen human resource management in the tax collection agencies by establishing hiring, promotion, and retirement criteria.
- **Decentralization.** The July 2003 transfers law calls for increasing revenue transfers to municipalities starting in 2004, but does not simultaneously devolve commensurate spending responsibilities. In consultation with World Bank and Fund staff, we have established an action plan, described in the box below, which would improve the definition of municipal responsibilities, redefine the role of selected central administration agencies that carry out spending in municipalities, and strengthen the legal framework for decentralization. Our broad objective is to ensure a prudent and fiscally-neutral decentralization process in order to protect macroeconomic stability and improve the effectiveness of public spending. Thus, beginning in 2004 municipalities will be required to use a portion of their transfers, which amount to C$407 million, to fulfill their obligations with INSS. By end-August, in consultation with the World Bank, we will complete a study with the objective of identifying which expenditures can be transferred to municipalities from the central government in order to achieve full fiscal neutrality, as well as improved expenditure efficiency. Each year, beginning in 2005, expenditures equivalent to one-third of the revenue transfers will be shifted to municipalities, such that by 2007, full fiscal neutrality will be achieved.
- **Law on fiscal responsibility and law on financial administration (LFA).** We will submit to the assembly, by October 15, 2004, proposals for a fiscal responsibility law (FRL) and a law on financial administration (LFA). The FRL which will include fiscal rules for the central government and municipalities, and explicit transparency requirements to underpin the credibility of such rules. The LFA will strengthen budgetary and accounting procedures. Assembly approval of both laws is expected by December 2004.

Internal Tax Administration's Action Plan for 2004	
Key Actions	**Expected Date of Implementation**
1. Strengthen the tax office's large taxpayers unit by updating its database, establishing new procedures to monitor nonfilers and delinquent taxpayers, and improving the effectiveness of audits.	Done
2. Approve the law of casinos.	End-September
3. Reorganize the DGI and redefine assignments to each core functional department (tax collection, audit, and tax enforcement).	End-August
4. Present a three-year strategic IT plan.	End-September
5. Establish procedures to systematically exchange taxpayer-related information among the DGI, DGA, INSS, and other public institutions.	End-September
6. Reduce stop filing rates in all local offices to less than 20 percent (from 60 percent at end-March 2004).	End-December
7. Reduce stock of tax arrears from 3.5 percent of total DGI revenue collection (at end-2003) to less than 2 percent of total DGI revenue collection.	End-December
8. Make substantial progress in developing a data warehouse to support tax audit and tax enforcement work.	End-December
9. Assess the feasibility of setting up a tax collection system via financial institutions.	End-December

Action Plan to Strengthen Decentralization

Definition of municipal responsibilities. We have appointed a special advisor, who will recommend alternatives to reorganize intergovernmental relationships with the goals of fiscal neutrality, efficiency, transparency, clarity, and equity. The special advisor will also devise a timetable and management process for devolving expenditures and responsibilities to municipalities. A presidential decree will be issued modifying the regulations of the Law of Municipalities in a fiscally sustainable manner, consistent with the conditionality under the World Bank's PRSC. By September 2004, we will create and staff a unit at the ministry of finance to monitor the decentralization process. This unit will be responsible for collecting data on municipal operations.

Roles of central government agencies. The roles and the financing of IDR, INIFOM, FISE, INVUR and other institutions involved in municipal issues, will also be redefined following the recommendations of the special advisor with the goal of ensuring efficiency and fiscal neutrality.

Transfer of responsibilities to municipalities. By January 2007, all transfers to municipalities will be fully matched by corresponding spending responsibilities.

- **Pension reform.** Following the findings of the inter-institutional pension reform committee, which identified the transition cost of moving from a pay-as-you-go to a capitalization system, and to ensure macroeconomic stability, we are reassessing, in close consultation with the WB, our overall reform strategy for the system.

- **Debt management.** In December 2003, the assembly approved the public debt law that establishes the procedures for public sector borrowing and created a technical debt committee, which is entrusted with the formulation of an annual public debt strategy. We have issued the implementing regulations, which include clear limits on public guarantees and subnational borrowing. The ministry of finance, in coordination with the central bank, has begun issuing short-term treasury bills with the purpose of establishing a domestic market for such bills. The U.S. Treasury and the WB are providing technical assistance to the ministry of finance to strengthen its debt management capabilities. We are working with the World Bank's recently-approved DRF to settle outstanding claims by private creditors. We have cleared arrears on BPIs accrued since last year. We remain committed to maintain a prudent external borrowing policy, in line with the assumptions made at the time of HIPC completion.

- **Civil service reform.** A new civil service law was approved by the assembly in November 2003 and published in December 2003. Implementation of the civil service reform will be gradual, starting in July 2004 and will be completed by June 2007. Together with the WB, we are estimating the cost of civil service reform, which will be included in the annual budget, starting in 2005. In consultation with Fund staff, we will ensure that the cost of civil service reform is consistent with the agreed macroeconomic framework.

15. We will continue improving the efficiency of public enterprises. We are targeting an operational surplus of 0.2 percent of GDP for 2004. The water and sewerage company (ENACAL) is strengthening its collections of overdue accounts, including through the planned outsourcing of billing and collection. In December 2003, the assembly approved changes to the legal framework of ENACAL, including granting additional legal powers for the collection of arrears (such as cutting off water services to delinquent customers). In addition, tariffs will be revised, as noted above. With respect to the power sector, we are implementing the roadmap agreed in 2003 with WB and the IDB, including steps to improve financial and operational efficiency, making government subsidies more transparent, and improving the sector's policy, regulatory, and legal frameworks.

16. In view of the weak financial situation of some public enterprises, as evidenced by their inability to fulfill their tax obligations, we are analyzing various options to address this problem, including, *inter alia*, privatization, leasing, and concessions of selected enterprises.

Monetary and exchange rate policy

17. Monetary policy in 2004 will remain guided by the objectives of maintaining low inflation, reducing domestic debt, and strengthening the external position of the central bank.

Specifically, the program targets a further buildup of US$20 million of NIR and a net repayment of central bank domestic debt of US$77 million (in addition to a reduction of central government domestic debt of US$36.7 million).

18. Exchange rate policy during 2004 will continue to be guided by the crawling peg arrangement. The annual rate of crawl vis-à-vis the U.S. dollar has been lowered to 5 percent (from 6 percent in 2003).

Financial sector policies

19. Further strengthening of the financial sector remains high on our agenda. In this context:

- We recognize that for the purpose of providing a sound legal framework for banking supervision in Nicaragua, strengthening legal protection for staff of the superintendency of banks (SB) and the central bank (BCN) is an urgent priority. Therefore, new resolutions of the SB and BCN have been approved that covers explicitly legal expenses of staff sued for actions taken in the course of their official duties, through the establishment of a new budgetary item in the SB budget starting in 2005 for the sole purposes of covering these legal expenses.

- We are enhancing prudential norms and supervision in line with Basel Core Principles. The SB has approved norms to limit risk derived from maturity mismatches (November 2003) and currency mismatches (December 2003).

- We are working to overhaul the legal framework for the financial sector in line with international best practices. MFD technical assistance missions made specific recommendations to upgrade the legal framework, with particular emphasis on the bank resolution strategy. We intend to submit to the assembly the draft laws by end-September 2004. In addition, we have reviewed the recommendations of the FSAP in consultation with the PRGF review missions, which will serve as the basis to strengthen our financial sector reform agenda.

- New on-site technical and administrative procedures for banking supervision were approved in January 2004, in line with MFD recommendations.

National Development Plan

20. We have started to implement our National Development Plan (NDP), which already incorporates comments of civil society groups, business organizations, local governments, and the international community. We give high priority to maintaining macroeconomic stability, prioritizing public investment projects and efficiently executing them, and accelerating key institutional reforms, including judicial reform and decentralization. In this

regard, we are strengthening our poverty-reduction strategy and will include key elements of our NDP in an enhanced PRSP (to be published in September 2004).

21. As part of this process, we carried out a growth workshop that was attended by leaders of the business, political, civil, and international communities. The importance that the government attaches to economic growth and poverty reduction was evidenced by the high-level participation in the workshop, including President Bolaños, members of his economic cabinet, and other assembly members. Participants contributed useful insights on ways to accelerate broad-based economic growth, including by addressing the obstacles to growth, and building a national consensus around prudent policies and structural reforms.

22. We continue to pursue key structural reforms envisaged in the program. The remaining government shares in the telecommunications company (ENITEL) were sold in January 2004, and the proceeds (US$49.6 million) have been received. We are pushing ahead with our efforts to improve governance and fight corruption. We are working on a law that should make the electoral process less prone to political influence, by making it more technical and professional. Also, as part of our judicial reform agenda, we are working on a draft *Real Estate Registry Law and a new Public Property Registry* that would guarantee property rights of landowners. We are also taking the required steps for the implementation of the new civil service law. In addition, with the support of the World Bank and the IDB, we are further strengthening public procurement practices and the comptroller's office.

23. Last year, the government presented its general proposal for judicial reform and launched a national consultation process. In February 2004, after finishing this consultation process, the executive branch sent to the national assembly a new judicial career law, which aims to depoliticize the judiciary. The draft law proposes separating jurisdictional functions from administrative and financial functions, as well as modernizing personnel evaluation procedures. The whole process intends to delimit and separate the functions of the administration of justice with those of selecting judges, thereby contributing to the independence of judges and strengthening governance.

Safeguards assessment and program implementation

24. We have implemented all of the recommendations of the initial safeguards assessment, and agreed to an action plan for implementation of the second assessment, including the adoption of international accounting practices by end-2004.

25. Implementation of the second annual program supported by the PRGF arrangement will continue to be monitored through quarterly reviews, performance criteria, and benchmarks. Tables 1 and 2 present the quantitative and structural PCs for March, June, September, and December 2004, as well as the proposed prior actions and structural benchmarks. We continue to be firmly committed to the success of the program and stand ready to implement additional measures, as needed, to achieve its objectives.

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

	Cumulative Flows from January 1, 2002			Cumulative Flows from January 1, 2004							
	December 31, 2003			March 31, 2004			June 30, 2004	September 30, 2004		December 31, 2004	
	Prog. 1/ 2/	Actual	Deviation (-)	Prog. 1/ 3/ 4/	Actual	Deviation (-)	Prog.	Prog. 4/	Rev. Prog. 5/	Prog. 4/	Rev. Prog. 5/
	(In millions of cordobas)										
Net domestic financing of the combined public sector (ceilings)	-474	-491	17	-1,646	-2,191	546	-1,146	-1,624	-2,636	-1,996	-2,884
Savings of the combined public sector (floors)	-1,332	-1,455	-124	723	1,042	319	1,199	...	...	...	...
Net domestic assets of the central bank (ceilings)	-126	-413	288	-201	-1,211	1,009	-308	-273	-867	-94	-91
Central government overall balance, after grants (ceilings)	...	...	...	...	...	...	...	-763	30	-807	314
Combined public sector overall balance, after grants (ceilings)	...	...	...	...	...	...	...	-1,648	-906	-2,113	-1,201
	(In millions of U.S. dollars)										
Net international reserves of the central bank (floors)	34	67	33	0	68	68	5	1	37	20	20
Net repayment of public domestic debt (+) (floors) 6/	50	104	53	19	29	10	47	58	63	86	114
Disbursements of nonconcessional external debt contracted 7/ or guaranteed by the public sector (ceilings)	0	0	0	0	0	0	0	0	0	0	0
Stock of external payments arrears (ceilings) 7/	0	0	0	0	0	0	0	0	0	0	0
	(In millions of cordobas)										
Indicative targets											
Savings of the combined public sector (floors)	...	...	...	...	...	...	...	1,958	1,415	2,396	1,645
Tax revenue of the central government (floors)	18,217	17,989	-228	2,683	2,822	139	5,412	8,382	8,511	11,350	11,416
Total primary expenditure of the central government (ceilings)	21,700	22,298	-598	2,766	2,805	-39	6,109	9,379	9,596	12,729	12,790
Deficit of the combined public sector, before grants (ceilings)	-11,501	-11,992	-491	-614	-329	285	-2,018	-3,035	-3,575	-4,197	-4,872
Net domestic financing of the nonfinancial public sector (ceilings) 8/	-3,457	-3,357	-101	-1,969	-2,474	505	-1,884	-2,681	-3,712	-3,403	-4,374
Memorandum items											
Privatization (In millions of US$)	57	30	-27	0	50	50	1	1	51	17	61

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

1/ As stated in IMF CR No. 04/71.

2/ Net domestic financing of the CPS and NFPS was adjusted upward by US$30 million due to lower privatization receipts. Net repayment of public domestic debt was adjusted downward by US$63 million due to lower privatization receipts (US$30 million) and higher NIR accumulation (US$33 million); it was adjusted downward by US$10 million due to the placement of government bonds. Net downward adjustment of US$53 million.

3/ Net domestic financing of the CPS and NFPS was adjusted downward by US$48.1 million due to higher privatization receipts (US$49.6) and lower BOP support (US$1.5 million). Net repayment of public domestic debt was adjusted upward by US$48.1 million due to higher privatization receipts (US$49.6 million) and lower BOP support (US$1.5 million); and downward by US$68 million due to higher NIR accumulat on.

4/ Program numbers adjusted for the delay in pension reform. September/December 2004 targets were indicative.

5/ Revised program as stated in IMF CR No. 04/71 adjusted by HIPC assistance from multilaterals, higher-than-programmed external debt service (mainly reflecting higher interest rates), and modifications to the budget.

6/ Includes dollar-denominated and dollar-indexed debt. Beginning in 2004, includes debt of the central bank and central government. For previous years, the PC refers only to central bank debt.

7/ Measured on a continuous basis.

8/ On a cash basis.

Table 2. Nicaragua: Fifth and Sixth Program Reviews—Prior Actions, Structural Performance Criteria, and Benchmarks

Measures	Original Program 1/	Revised Program 2/	
	Expected Date of Implementation	Date of Implementation	Status of Implementation
I. Prior Actions			
• **Fiscal measures** ♦ Collect at least C$40 million from the revenue measures described in ¶8. ♦ Implement expenditure savings measures of at least C$20 million as described in ¶9. ♦ Establish a timetable to reduce transfers by C$37 million to INIFOM, IDR, FISE, and INVUR during 2004.		May 25, 2004	Done. Done.
• **Implement a budget reform consistent with the 2004 fiscal program discussed with Fund staff.** The budget reform should not increase the 2004 budget deficit.		August 2004	Done.
• **Establish a monthly monitoring system for current and capital expenditures, by institution.**		End-April 2004	Done.
• **Appoint a special advisor to make specific recommendations on reorganizing intergovernmental relationships and to devise a clear calendar and management process for devolving expenditures and responsibilities.**		August 2004	Done.
• **Approve a new superintendency of banks resolution to cover explicitly legal expenses for staff sued for actions taken in the course of their official duties (TMU ¶27).**		August 2004	Done.
II. Performance Criteria			
1. Grant legal protection to staff of the superintendency of banks			
(i) Submission of a draft law to the assembly.		End-December 2003	Done.
(ii) Approval of a law by the assembly.		Mid-May 2004	Not observed. Waiver requested.
2. Fiscal responsibility law			
Submission to the assembly (TMU ¶24).		October 15, 2004	

Table 2. Nicaragua: Fifth and Sixth Program Reviews—Prior Actions, Structural Performance Criteria, and Benchmarks

Measures	Original Program 1/	Revised Program 2/	
	Expected Date of Implementation	Date of Implementation	Status of Implementation
III. Benchmarks			
Fiscal			
1. Fiscal responsibility law			
(i) Submission to the assembly.		End-June 2004	Delayed.
(ii) Approval by the assembly (TMU ¶24).		End-December 2004	
2. Revised Tax Code			
(i) Submission to the assembly.		End-2003	Submitted in Nov. 2003.
(ii) Approval by the assembly.		End-March 2004	Delayed.
(iii) Approval by the assembly (TMU ¶25).		End-October 2004	
3. Approval by the assembly of the law on domestic and external public indebtedness		End-2003	Done.
4. Strengthen tax administration through:			
(i) DGI (domestic tax administration) to adopt an action plan for 2004–06, including:	End-March 2004	End-December 2003	Done.
(a) Strengthen the tax office's large taxpayers' unit (LTU) (TMU ¶28).		End-March 2004	Substantial progress made by end-June 2004.
(b) Implement effective procedures to monitor stop filers and delinquent taxpayers in all local offices (TMU ¶29).		End-December 2004	
(c) Present a three-year strategic IT plan.		End-September 2004	Eliminated, not considered macro-critical.
(ii) Adoption of an action plan for DGA (customs) for 2004–06.	End-June 2003	End-March 2004	Delayed.
(iii) Adoption of an action plan for DGA (customs) for 2004–06.		End-September 2004	Authorities are in the process of designing the action plan.

Table 2. Nicaragua: Fifth and Sixth Program Reviews—Prior Actions, Structural Performance Criteria, and Benchmarks

Measures	Original Program 1/	Revised Program 2/	
	Expected Date of Implementation	Date of Implementation	Status of Implementation
5. Public expenditure commission to advice government on how to improve the effectiveness of public spending to generate growth and reduce poverty.			
(i) Review public spending with the aim of improving efficiency of MINSA, MECD, MTI, INIFOM, IDR, and FISE. 3/		End-March 2004	Done.
(ii) Define efficiency indicators for MECD and MINSA, and report them, quarterly, in the *"Informe Ejecutivo del Presupuesto de 2005."*		End-September 2004	
(iii) Improve classification of capital and current expenditures, starting with the 2005 budget (TMU ¶30).		End-September 2004	
6. Law on financial administration			
(i) Submission to the assembly.		October 15, 2004	
(ii) Approval by the assembly.		End-December 2004	
7. Decentralization 4/			
(i) Issue a presidential decree to modify the municipality law's regulations		End-September 2004	Replaced with (iii) and (iv) below.
(ii) Establish a legal framework that redefines the responsibilities of the FISE and INIFOM.		End-September 2004	Replaced with (iii) and (iv) below.
(iii) Expenditures equivalent to one-third (1/3) of revenue transfers shifted to municipalities as part of the 2005 budget.		End-September 2004	
(iv) Creation and staffing of unit in ministry of finance to report on decentralization (TMU ¶31).		End-September 2004	
8. Pension reform. Complete a review of the pension reform strategy, with technical assistance from the World Bank (TMU ¶32).		End-October 2004	
Financial Sector			
9. Approval of new on-site technical and administrative procedures for banking supervision, including the inspection manual and regulatory actions for noncompliance with norms in effect, in line with Basel Core Principles.		End-December 2003	Approved on January 16, 2004. Will be modified to incorporate FSAP recommendations.

Table 2. Nicaragua: Fifth and Sixth Program Reviews—Prior Actions, Structural Performance Criteria, and Benchmarks

Measures	Original Program 1/	Revised Program 2/	
	Expected Date of Implementation	Date of Implementation	Status of Implementation
10. Approval of prudential norms to limit risks derived from maturity mismatches between assets and liabilities.	End-March 2003	End-November 2003	Approved in October 2003.
11. Submission to the assembly of amendments to financial sector laws in line with Basel Core Principles for effective bank supervision and for changes in FOGADE.	End-September 2003	End-September 2004	
12. Strengthen legal protection for staff of the Central Bank of Nicaragua.			
(i) Submission to the assembly.		End-December 2003	Done.
(ii) Approval by the assembly.		May 15, 2004	Delayed.
Privatization			
13. Divest the remaining government stake in ENITEL.	End-September 2003	End-December 2003	Completed in January 2004.
Governance			
14. Judicial reform			
(i) Launch national consultation process of authorities' proposal.		End-December 2003	Done.
(ii) Present a detailed action plan.		End-June 2004	Delayed.
(iii) Present a detailed action plan.		End-September 2004	
(iv) Establish academic degrees for graduating judicial students.		End-September 2004	

1/ As indicated in IMF Country Report No. 03/24. The specific requirements for the implementation of these measures are specified in the Technical Memorandum of Understanding (TMU).
2/ The specific requirements for the implementation of these measures are specified in the TMU.
3/ Health Ministry (MINSA), Education Ministry (MECD), Ministry of Transportation and Infrastructure (MTI), Nicaraguan Institute of Municipal Development (INIFOM), Rural Development Institute (IDR), and Emergency Social Investment Fund (FISE).
4/ These measures aim at balancing, in the medium term, the resource transfers with the corresponding transfers of expenditure responsibilities to municipalities. The broad objective is to improve the efficiency of public spending by ensuring greater participation and accountability at the local level for spending decisions.

NICARAGUA—TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This technical memorandum incorporates all previous understandings between the Nicaraguan authorities and the Fund relating to the monitoring of the Poverty Reduction and Growth Facility (PRGF) arrangement into one document. For 2004, the quantitative performance criteria and indicative targets will be defined as cumulative flows from January 1, 2004.

Fiscal Targets

2. **Coverage of fiscal accounts**

(a) Nonfinancial public sector (NFPS) includes the central government (CG), the Nicaraguan social security institute (INSS), the municipality of Managua (ALMA), and two public sector enterprises: ENTRESA (electricity transmission) and ENACAL (water and sewerage company).[1,2]

(b) Combined public sector (CPS) includes the nonfinancial public sector (NFPS) and the operating result (quasi-fiscal balance) of the Central Bank of Nicaragua (BCN).

3. **Interest on the domestic debt** is registered on a cash basis.[3] For 2004 and beyond, the targets for public savings, the overall balance, and net domestic financing (NDF) of the CPS are based entirely on cash interest payments.

4. **Interest on the external debt** presents cash payments for all creditors and HIPC flow assistance for multilateral creditors.

5. **Total primary expenditure of the CG** is defined as the sum of wages and salaries, other goods and services, current and capital transfers, capital expenditure, and net lending.

6. **The CG overall balance after grants** is defined as total revenues of the CG minus total expenditures of the CG plus total foreign grants to the CG.

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[1] Starting in 2005, all operations of the electricity holding company (ENEL), the telecommunications regulatory agency (TELCOR), and the port company (ENAP) will be included in the program. The definition of the CPS overall balance is being expanded to include these enterprises. By September 2004, the expanded CPS overall balance will be included as an indicative target. Starting in 2005, the expanded CPS overall balance will be included as a PC. As complete and timely information becomes available for other public sector entities, the government intends to expand the definition of the public sector.

[2] With technical assistance from the international financial institutions, we intend to expand the definition of the nonfinancial public sector to include municipalities. A specific action plan will be devised at the next review.

[3] The BCN and the CG are taking steps to improve their debt statistics in order to be able to calculate all interest on an accrual basis, as recommended GFS manual.

7. **Adjusters.** The target for the overall balance (after grants) of the CG will be adjusted upwards (up to US$ 56.5 million for the whole year) in the event of additional project disbursements from the World Bank and/or IDB in excess of those presented in Table 1.

Table 1. Cumulative Project Disbursements by IDB and IDA for Nicaragua

(In millions of U.S. dollars)

Quarter	Expected Disbursements
2004	
QI	44.5
QII	102.4
QIII	116.2
QIV	125.4

8. **Savings of the CPS** is defined as the difference between current revenue and current expenditure of the nonfinancial public sector, plus the operating result of the BCN.

9. **Adjusters:** The floor of the CPS savings will be adjusted: (a) upward (unlimited) in the event of additional revenues associated with delays in the implementation of the privately managed pension funds, assumed to take place on August 1, 2005; and (b) downward in the event of lower revenues because implementation of the privately managed pension funds occurs before August 1, 2005.

10. **Overall balance (after grants) of the CPS** is defined as total revenues minus total expenditures of the nonfinancial public sector, plus the operating result (quasi-fiscal balance) of the Central Bank of Nicaragua (BCN), plus total foreign grants to the nonfinancial public sector.

11. **Adjusters:** The target for the overall balance of the CPS (after grants) will be adjusted: (a) downward (unlimited) in the event of additional revenues associated with delays in the implementation of the privately managed pension funds, assumed to take place on August 1, 2005; (b) upward in the event of lower revenues because implementation of the privately managed pension funds occurs before August 1, 2005; (c) upward (up to US$56.5 million for the whole year) in the event of additional project disbursements from the World Bank and/or IDB in excess of those presented in Table 1.

12. **Net domestic financing (NDF) of the CPS.** For 2004, NDF of the CPS comprises the operating result of the BCN and the change from their respective stocks at the end of the previous year of the sum of (a) the outstanding stock of debt of the NFPS to the domestic financial system (BCN, commercial banks, and the *Fondo Nicaragüense de Inversiones* (FNI)) net of deposits (including arrears that correspond to obligations considered eligible for

refinancing or rescheduling, or other debt reduction mechanisms) with the foreign currency part of the net debt to the banking system converted into córdobas at the program exchange rate (C$15.9 per U.S. dollar for 2004); (b) the outstanding stock of domestically-issued public sector debt held by private residents and nonresidents with the foreign currency part converted into córdobas at the program exchange rate (C$15.9 per U.S. dollar for 2004); (c) the outstanding stock of suppliers' credits; and (d) the outstanding stock of floating debt.

13. **Adjusters**: The ceiling on the cumulative NDF of the CPS will be adjusted: (a) upward by up to US$35 million, US$15 million, US$15 million, and US$15 million, in the first quarter of 2004, the second quarter of 2004, the third quarter of 2004, and the fourth quarter of 2004, respectively, in the event of lower disbursements of balance of payments support and/or privatization receipts than the amounts shown in Table 4; (b) downward (unlimited) in the event of higher disbursements of balance of payments support and/or privatization receipts than the amounts shown in Table 4; (c) downward (unlimited) in the event of additional revenues associated with delays in the implementation of the privately managed pension funds; and (d) upward in the event of lower revenues because implementation of the privately managed pension funds occurs before August 2005. This assumes a two-month lag between collection of contributions by privately managed pension funds and their transfer to the government.

14. **Reporting:** The BCN will send to the IMF monthly electronic information on the detailed operations of the CPS. The monthly information will be provided no later than five weeks after the end of each month.

15. **Reporting by Ministry of Finance:** The Ministry of Finance will transmit to the IMF monthly information on exonerations and exemptions by type of tax. The monthly information will be sent no later than five weeks after the end of each month.

16. **Transition of the fiscal accounts from cash to accrual accounting.** We are committed to the following timetable for the transition of the CG accounts from cash to accrual accounting.

Table 2. Timetable for the Transition of CG Accounts from Cash to Accrual Accounting

Measures	Date of Implementation
1. Undertake a study to determine how to apply accrual accounting principles to the budget.[4]	June 2004
2. Formalize the accrual accounting criteria to be utilized in the 2005 budget.	August 2004
3. Train staff in budget office on the new accrual accounting guidelines.	August 2004
4. Implement accrual accounting criteria starting with the 2005 budget.	January 2005

[4] Study is ongoing and is expected to be concluded by end-August.

Monetary Targets

17. **Net international reserves (NIR) of the BCN**. For program purposes, NIR is defined as the difference between the (a) gross foreign assets of the BCN that are readily available; and (b) short-term reserve liabilities of the BCN (including purchases and credits from the IMF), plus arrears on foreign debt service, plus foreign currency reserve requirement deposits of commercial banks at the BCN.

18. **Readily available foreign assets of the BCN** exclude those that are pledged or otherwise encumbered, including, but not limited to, reserve assets used as collateral or guarantee for a third-party external liability.

19. **Net domestic assets (NDA) of the BCN** are defined as the difference between the change in the stock of currency issued and net international reserves, valued at the program exchange rate.

20. **Net repayment of the domestic debt of the BCN and the CG.** For program purposes, it is defined as the difference between new placements and redemptions of: (i) the BCN CENIs, TEIs, standardized *letras* and any other BCN paper held by institutions outside the CG; and (ii) the CG's treasury bonds, BPIs, and any other obligations owed to institutions or individuals outside the CG, except the BCN. It also includes all domestically placed paper held by residents and nonresidents. This amount will be converted into U.S. dollars at the program exchange rates (of C$15.9 per U.S. dollar for 2004).

21. **Adjusters.** The net repayment of the domestic debt of the BCN and the CG will be adjusted: (a) downward by up US$35 million, US$15 million, US$15 million, and US$15 million in the first quarter of 2004, the second quarter of 2004, the third quarter of 2004, and the fourth quarter of 2004, respectively, in the event of lower disbursements of balance of payments support and/or privatization receipts than the amounts shown in Table 4; (b) upward (unlimited) in the event of higher disbursements of balance of payments support and/or privatization receipts than the amounts shown in Table 4; and (c) downward to the extent that the NIR target is exceeded.

22. **Reporting.** The BCN will send to the IMF (a) daily electronic mail containing information of daily accounts of the BCN (stocks and flows) within two days of the end of the last working day; (b) monthly electronic mail with information of monthly accounts of the BCN, commercial banks and FNI (stocks and flows), within four weeks of the end of the month; and (c) quarterly accounts of the BCN, commercial banks, and FNI (stocks and flows) within five weeks of the end of the quarter.

Structural Measures

23. **The procedures established in the new banking supervision inspection manual** will be complemented by inspection guidelines for specific areas of banking supervision in

line with MFD recommendations. In order to enforce supervisory action, penalties, and regulatory actions for noncompliance with regulatory norms, regulations will be made consistent with the updated legal framework, especially concerning consolidated supervision and remedial measures in the context of new banking resolution framework. In addition, other complementary regulations should be approved, including on fines (as anticipated in Article 150 of the Banking Law); on guidelines for corrective measures (including civil penalties); on fit and proper criteria; and on major acquisitions. Finally, to improve the quality of reporting, accounting rules should be updated and "balance sheet evergreening" (for example arising from the treatment of restructured coffee loans) should be phased out within a reasonable period.

24. **The fiscal responsibility law (FRL)** should include, but is not limited to, the following key elements: (1) to set forth a regime aimed at achieving long-term fiscal sustainability by (i) limiting growth of real current primary expenditure, and (ii) decreasing total public debt (domestic and external), and (2) to establish an independent body or agency, which does not have direct responsibility in implementing the FRL, charged with the authority of monitoring implementation, and imposing sanctions in case of nonobservance, of the FRL.

25. **The tax code** should include, but not be limited to, the following key elements: (i) the procedure for the enforced collection of tax liabilities should be amended in the draft tax code so that this is possible through administrative procedures (i.e., handled through the tax administration) instead of only through judicial procedures (which requires prior court approval), as is currently the case; (ii) the tax administration should not be authorized to forgive the payment of interest and penalties (i.e., no tax amnesties based on administrative actions); (iii) if the tax administration does not issue a ruling on a case initiated by the taxpayer within the statutory time frame, the tax administration's "silence" should be interpreted as a negative answer to the inquiry. The taxpayer would then have the option of either appealing that tacit ruling, or waiting until the ruling is actually issued; (iv) under the principle of "legality," the code should specify that only by "law" (not by decree) can the basis be established for: (a) the "taxable acts," (b) the calculation of the tax liability, (c) the tax rate, and (d) the taxpayer.

26. **The changes to the legal framework, which are in line with Basle Core Principles for effective banking supervision,** will (a) introduce legal protection for supervisors (Principle 1); (b) establish a mechanism to review and reject any proposals to transfer significant ownership in existing banks to other parties (Principle 4); (c) grant supervisors the ability to do supervision on a consolidated basis (Principle 20); and (d) grant supervisors adequate supervisory measures to bring about timely corrective action when, among other reasons, banks fail to meet prudential requirements (Principle 22). In addition, the revised legal framework will eliminate the superintendency's restrictions on sharing information with similar institutions in other countries; and remove secrecy on bank assets.

27. **Issuance of a resolution by the board of directors of the superintendency of banks (SB) should include**, but not be limited to, the following main elements: (i) the establishment of a specific budgetary item in the SB's budget starting in the 2005 for the coverage of legal expenses (attorney fees and other costs (*costas*)) arising from lawsuits for actions taken in the course of performing their official duties; (ii) the provision of a mechanism under which in the event of insufficiency of resources in the original budgetary allocation, the SB is authorized to request and the Board to approve the allocation of the necessary additional funds under a supplement item of the BS's budget for the coverage of the above-mentioned excess of expenses, and (iii) the granting to the Superintendent of authority to issue implementing regulations to ensure that the process of hiring attorneys that will provide legal defense shall be made under market conditions. Finally, new legislation will be prepared to set up a banking resolution framework that would provide adequate incentives and safeguards for an effective and transparent resolution mechanism.

28. **To strengthen the large taxpayers' unit (LTU)** will be understood to mean consolidate the administration of all large taxpayers into one office, apply clear selection criteria to ensure only the large taxpayers are administered by the LTU, and significantly strengthen LTU audit, starting by assigning the most experienced auditors to the unit. In addition, it will be understood to mean that the percentage of stop filers cannot exceed 2 percent of all registered large taxpayers, and that tax arrears will not exceed 2 percent of total revenues collected by the DGI.

29. **To implement effective procedures to monitor stop filers and delinquent taxpayers in all local offices** will be understood to mean reduce the average number of stop filers in all local tax offices to below 20 percent at the end of December 2004. In addition, the control of delinquent taxpayers will be understood to mean a reduction in the stock of tax arrears to less than 2 percent of total DGI revenue collection at the end of December 2004.

30. **Improvement of the classification of capital and current expenditures** will be understood to mean to examine the classification of investment between current and capital of at least 50 percent of the externally financed projects included in the 2005 budget.

31. **The unit that will be created in the ministry of finance to report on decentralization** will collect quarterly data on municipal operations.

32. **Pension reform study** should estimate the alternative fiscal costs of various sensitivity analyses that include parametric reforms (increase of retirement age, minimum number of contributions, minimum pension, replacement rate, etc.), the estimation of the compensation bond, and the different parameters used in the estimation of the transition costs.

Safeguards Assessment

33. **To address the vulnerabilities identified during the safeguards assessment of the BCN completed in August 2003,** we propose the following timetable:

Table 3. Timetable for the Implementation of Safeguards Assessment Recommendations

Measures	Expected Date of Implementation	Status
1. International Accounting Standards (IAS)		
a. Disclose the differences between IAS and the BCN accounting practices:		
(i) in the 2002 financial statements.	October 2003	Done
(ii) in the 2003 financial statements.	End-June 2004	In progress
b. Full adoption of IAS (beginning with the 2004 financial statements).		
– Initiate migration to IAS.	July 2004	Awaiting recommendations from external auditors
– Complete migration of IAS.	End-December 2004	
2. Adopt a Board resolution to appoint external auditors for three-year terms. The appointments should continue to be on an open competitive bidding basis by international auditing firms with expertise in International Standards on Auditing and IAS, in accordance with national legislation.	End-October 2003	Done
3. Submit amendment of the BCN Law to the assembly to enhance the specificity of existing provisions for the removal of BCN Board members from office.	Mid-May 2004	Done

To adopt IAS, the BCN hired a new external auditor in April 2004 for a three-year period and established a program to ensure adequate training for the staff of the accounting department and identify the necessary changes to the central bank law. The auditor will perform the reconciliation of the 2003 financial statements and will start the transition in June from Nicaraguan accounting standards to IAS by the end of the year.

External Sector Targets

34. **Borrowing on nonconcessional terms.** For the purpose of the ceiling on the contracting of nonconcessional external debt of the NFPS and the BCN, external debt limits apply to the contracting or guaranteeing of nonconcessional external debt by the public

sector[53] and the BCN or any other agencies on their behalf. This limit applies not only to debt as defined in Point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted by the IMF on August 24, 2000, but also to commitments contracted or guaranteed for which value has not been received. External debt includes all current liabilities with a nonresident party, which are created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, at some future point(s) in time to discharge the principal and/or interest liabilities under the contract. This definition includes loans, suppliers' credits, and leases (operational and financial leases). The ceiling on contracting of nonconcessional external debt applies both to medium- and long-term debt defined as debt with maturity of one year or longer, as well as to short-term debt, defined as debt with maturity of less than one year. For program purposes, BCN instruments placed in the domestic market held by nonresidents, will be excluded from the ceiling on the contracting of nonconcessional external debt and included in the net repayment of the domestic debt of the BCN target.

35. **Excluded** from the ceiling on debt with a maturity of less than one year are import-related credits and BCN reserve liabilities. Borrowing from the Fund is excluded from the ceiling (maturities up to one year).

36. **Concessionality** will be based on a currency-specific discount rate based on the 10-year average of the OECD's commercial interest reference rates (CIRR) for loans or leases with maturities greater than 15 years and on the six-month average CIRR for loans or leases maturing in less than 15 years. Maturity will be determined on the basis of the original loan contract. Under this definition of concessionality, only debt with a grant element equivalent to 35 percent or more will be excluded from the debt limits.

37. **New loan reporting:** A loan-by-loan accounting of all new loans contracted or guaranteed by the public sector, including detailed information on the amounts, currencies, and terms and conditions, as well as relevant supporting materials, will be transmitted on a quarterly basis within four weeks of the end of each quarter by the BCN.

38. **External payments arrears.** External payments arrears are defined as overdue debt service obligations arising from external debt contracted or guaranteed by the public sector, except on external debt subject to rescheduling or restructuring. For purposes of this performance criterion, liabilities arising from the Bonds for the Payment of Indemnification ("Indemnity Bonds") are excluded.

39. **External arrears reporting:** The accounting of nonreschedulable external arrears by creditor (if any), with detailed explanations, will be transmitted by the BCN on a monthly basis within four weeks of the end of each month.

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[53] As regards external sector targets, the public sector comprises the nonfinancial public sector as defined under fiscal targets, as well as all other public sector entities and enterprises including, the airport, the lottery, CORNAP, and ENAP.

40. **Domestic arrears reporting:** The accounting of domestic arrears by creditor (if any), with detailed explanations, will be transmitted by the BCN on a monthly basis within four weeks of the end of each month.

Other Definitions

41. **Privatization receipts** are defined as payments received by the government in connection with the sale of state assets net of any fee. The programmed amounts consistent with this definition are shown in Table 4. Privatization revenues in foreign exchange are those recorded as such in the balance of payments.

42. **Balance of payments support.** Official external untied financial assistance is defined as loans and grants provided by foreign official entities that are received by the government for unrestricted budgetary use. The amounts assumed in the program consistent with this definition are shown in Table 4.

43. **Accounting of HIPC assistance**. For the purposes of fiscal targets, HIPC assistance from multilateral creditors is categorized as grants. Only cash payments to other creditors are shown.

Table 4. Cumulative Program Financing

(In millions of U.S. dollars)

	Privatization	BOP Support	Asset Recovery 1/
Cumulative from October 2002			
2002			
QIV	11	35	4
2003			
QI	11	35	6
QII	11	76	5
QIII	12	76	29
QIV 2/	3	95	29
Cumulative from January 2004			
2004			
Q I 2/	50	35	0
Q II	51	50	0
Q III	51	65	0
Q IV	61	80	0

1/ Corresponds to the receipts of asset recovery net of the administration cost. This cost should not exceed US$5.6 million. Includes US$11 million received in BPI (face value), which for program purposes are recorded at market value (36 percent of the face value).

2/ From December 2003 through June 2004, adjusters will be calculated using the information shown in Table 4 of the TMU contained in IMF Country Report No. 03/71.

Press Release No. 04/189
FOR IMMEDIATE RELEASE
September 8, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fifth and Sixth Reviews Under Nicaragua's PRGF Arrangement, Approves Disbursement Amounting to US$20 Million

The Executive Board of the International Monetary Fund (IMF) completed today the fifth and sixth reviews of Nicaragua's performance under its Poverty Reduction and Growth (PRGF) arrangement. In completing the reviews, the Executive Board approved Nicaragua's request for waivers of the nonobservance of performance criteria. In addition, the Executive Board completed the financing assurances review under Nicaragua's PRGF arrangement. These decisions enable the release of a further SDR 13.93 million (about US$20 million).

Nicaragua's three-year, SDR 97.5 million (about US$142 million) PRGF arrangement was approved in principle on December 4, 2002 (see Press Release No. 02/53). Completion of the latest reviews will bring total disbursements under the arrangement to SDR 55.72 million (about US$81million).

After the Executive Board's discussion of Nicaragua, Mr. Agustín Carstens, Deputy Managing Director and Acting Chair, issued the following statement:

"Nicaragua's performance under the PRGF arrangement continues to be favorable. Implementation of prudent macroeconomic policies and structural reforms has contributed to a strengthening economic recovery, financial stability, and a much improved external position. Based on this solid track record, Nicaragua's creditors have provided debt relief in the context of the enhanced HIPC Initiative. Notwithstanding these achievements, Nicaragua continues to face important economic vulnerabilities, in particular from high public debt and widespread financial dollarization. The favorable economic environment provides an excellent opportunity to move ahead forcefully with the reform agenda and further solidify the important gains achieved under the program.

"The authorities have continued to strengthen their poverty-reducing and growth-enhancing policy strategies, consistent with their PRSP and the PRGF-supported program. The National Development Plan, which sets forth the authorities' economic strategy, emphasizes the private sector as the main engine of growth, supported by targeted public investment, a strengthened institutional framework, and improved governance.

"Despite a difficult political environment, the authorities have kept the fiscal program broadly on track. Tax reform, strengthened tax administration, spending restraint, and a more focused public investment program have substantially improved the public finances. Nonetheless, important challenges remain: the public debt is high, and important fiscal reforms are still to be implemented. In particular, the ongoing decentralization process must ensure that revenue transfers to municipalities are matched with the devolution of spending responsibilities. The authorities are reassessing their pension reform strategy, in close consultation with the World Bank, to ensure its consistency with the medium-term fiscal program. The recently approved civil service reform is being implemented carefully to ensure sustained fiscal consolidation.

"The authorities are moving forward with reforms to strengthen the financial sector. They participated in the IMF-World Bank Financial Sector Assessment Program (FSAP), and are already incorporating many of the FSAP recommendations into their program. Important priorities in this regard are the ongoing efforts to strengthen the legal protection of bank supervisors for good faith actions taken in the course of their official duties and to amend financial sector laws to bring them in line with international best practices.

"Overall, performance under the PRGF-supported program has been favorable. The authorities are to be commended for their strong ownership of the program, which has contributed to a broader understanding in Nicaragua that a stable macroeconomic framework, structural reforms, and better governance are essential to achieving strong and lasting growth and poverty alleviation. Their efforts to fight corruption and strengthen public sector institutions deserve the strong support of the international community. In order to maintain this favorable forward momentum, the authorities need to make every effort to further strengthen the domestic consensus on the prudent policies and structural reforms needed to sustain growth and reduce poverty," Mr. Castens said.

The PRGF is the IMF's concessional facility for low-income countries. It is intended that PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent, and are repayable over 10 years with a 5½-year grace period on principal payments.

**Statement by Luís Martí, Executive Director for Nicaragua
and Gerardo Peraza, Senior Advisor to Executive Director
September 8, 2004**

On behalf of our Nicaraguan authorities, we would like to convey our appreciation to the staff for the valuable policy advice and continued support for the implementation of the program. As indicated in the attached Supplementary Memorandum of Economic and Financial Policies (SMEP), the authorities remain committed to the strategy embodied in the Poverty Reduction Strategy Paper (PRSP).

Despite daunting political challenges, the authorities continue to demonstrate strong ownership and political will to keep the Poverty Reduction Growth Facility (PRGF) arrangement on track. They are committed to preserving macroeconomic stability, prioritizing public investment projects, accelerating key institutional reforms, while maintaining the public debt on a sustainable path.

The authorities have continued building domestic support for the reform program and the adjustment effort. They are about to publish an enhanced PRSP that draws on the National Development Plan. This enhanced strategy benefited from the views of the civil society, business organizations, local governments, and the international community.

Broad-based recovery

Strong program implementation is leading to restored confidence and higher growth. Short-term economic indicators point to a rapid and broad-based recovery in the first five months of 2004. Exports are also showing a robust increase, growing 25 percent in dollar terms in January-June of this year, compared to the same period in 2003. The recovery has led to an increase in formal employment with more than 21,000 new jobs so far this year. The authorities are maintaining the 2004 GDP growth projection at around 4 percent, compared to 2.3 percent growth last year. Inflation rose to 8.5 percent in August, reflecting mostly higher oil prices.

Adjusting the 2004 fiscal budget

The authorities remain committed to the medium-term fiscal strategy outlined in the PRGF-supported program. They are taking measures to compensate social pressures and costs overruns associated to raising oil prices to keep the 2004 budget on track. Revenue overperformance in the first half of 2004 will compensate in part higher salaries for teachers and transfers for universities. The authorities will introduce additional revenue measures and strengthen tax administration in the second half of 2004. The authorities oppose any extension of tax benefits or granting any form of tax relief to the private or public sectors, and the Ministry of Finance is enforcing greater accounting discipline and monitoring of project execution.

Targeting the poor

Since the arrival of the new administration in January 2002, public investment has become the main instrument in the fight against poverty. The Public Expenditure Commission (PEC) is the government agency responsible for strengthening the quality of public expenditures and prioritizing capital spending. The agency has already embarked in an assessment of the main investment projects and rationalization of scarce resources. The enhanced PRSP will contain a forward-looking discussion of the annual public investment program and the government's priorities in capital spending. The World Bank, through the PRSC, is supporting this effort.

Monetary and exchange rate policy

The Central Bank of Nicaragua (CBN) will continue with its objectives of maintaining low inflation, reducing domestic debt, and strengthening the external position of the central bank. The CBN is aiming at a further buildup of US$20 million on net international reserves and a net repayment of domestic debt. So far, the CBN has accommodated a slightly higher inflation resulting from the spike in oil prices. Because of persistent volatility in world oil markets, the CBN and Fund staff need to revisit the inflation path for the rest of the year. However, the CBN is ready to tighten up monetary conditions if inflation increases above current levels.

Structural reform agenda

Nicaraguan authorities continue to carry out the reform program despite tough political resistance. Box 6 of the staff report summarizes the three major areas of reform—fiscal consolidation, financial system, and governance and transparency. In light of political realities and strong ownership, the authorities are re-assessing the content and timing of some of the reforms:

- ***Financial system***

The authorities are committed to further strengthening of the financial sector. They broadly agree with the FSAP's recommendations and plan to consider them for program design. In particular, as reported in the accompanying Financial Sector Stability Assessment, the authorities agree on the need to improve legislation and regulations on consolidated supervision, remedial actions, and the prudential rules to address sovereign and credit risk. In addition, the authorities have already indicated their interest in a regional study that may cover consolidated supervision of regional financial conglomerates and offshore banks; payment and securities settlement systems; and insurance and re-insurance.

The Superintendency of Banks (SB) moved quickly to issue a resolution to cover explicitly legal expenses for staff sued for actions taken in the course of their official duties in light of the attorney general's findings that key elements of draft law submitted to national assembly were unconstitutional. The authorities are working closely with MFD and LEG to identify alternatives to strengthen the legal protection to SB staff against criminal suits.

▪ ***Decentralization and fiscal responsibility***

The Nicaraguan government is convinced about the benefits of administrative decentralization, with municipalities having a greater role in the decision-making and implementation of projects to reduce poverty. However, due to the shortcomings of the July 2003 transfers law, which calls for increasing revenue transfers but without commensurate spending responsibilities, the authorities are adopting a two-stage approach to ensure a prudent decentralization process. In the short-term, municipalities will use some of their additional transfers to fulfill their social security obligations. In the medium-term, the authorities plan to transfer responsibilities to local governments in order to achieve full fiscal neutrality by 2007.

To enforce fiscal discipline and transparency, the authorities will introduce explicit fiscal rules for the central government and municipalities by the end-2004. An FAD mission is currently in Managua assisting the authorities to review the financial administration and fiscal responsibility draft laws.

▪ ***Pension reform***

The authorities, at the recommendation of the IMF/WB staff, have postponed implementation of a new pension system until the fiscal cost is better defined. They strongly believe that a hastily implementation could result in a poorly designed and costly system that could turn out unsustainable in the medium-term. The Minister of Finance has already requested technical assistance from the FAD to review the current transition cost estimates to the new capitalization system, as well as the viability of other alternatives, such as a parametric change to the current PAYG system.

▪ ***Governance and transparency***

The Nicaraguan authorities, as acknowledged by the staff, are "pushing ahead forcefully" in their effort to improve governance, strengthen institutions, and fight corruption. So far they have succeeded in forming alliances with the opposition to pass key initiatives. The authorities will continue relying on consultation with different sectors to build domestic consensus for reform. Finally, the authorities are broadening the coverage of the public sector finances to include three major public enterprises (power generation, telecommunications, and the port authority) into the program monitoring. This will permit a more comprehensive reporting of the consolidated public sector.