

Nicaragua: Poverty Reduction Strategy Paper—Joint Staff Advisory Note

The attached Joint Staff Advisory Note (JSAN) of the Poverty Reduction Strategy Paper for Nicaragua, prepared jointly by the staffs of the World Bank and the IMF, was distributed with the member country's Poverty Reduction Strategy Paper to the Executive Boards of the two institutions. The objective of the JSAN is to provide focused, frank, and constructive feedback to the country on progress in implementing its Poverty Reduction Strategy.

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**International Monetary Fund
Washington, D.C.**

**INTERNATIONAL MONETARY FUND AND
INTERNATIONAL DEVELOPMENT ASSOCIATION**

NICARAGUA

Joint Staff Advisory Note on the Poverty Reduction Strategy Paper

Prepared by the staffs of the International Monetary Fund
and the International Development Association

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December 29, 2005

I. OVERVIEW

1. **The Government of Nicaragua has completed its National Development Plan 2005–2009 (Plan Nacional de Desarrollo 2005–2009),¹ to be presented to the Boards of the IMF and IDA as the country’s second generation Poverty Reduction Strategy Paper (henceforth PRSP-II).** The PRSP-II reflects a rethinking of the country’s development strategy that started with the Proposal for a National Development Plan (PPND) in 2003, and which was further elaborated in the Operational National Development Plan (PNDO) in 2004. The PRSP-II builds on the PRSP-I presented to the Boards of the IMF and IDA in September 2001, but places more emphasis on economic activity and employment growth for poverty reduction as opposed to the early PRSP-I which focused more on measures to improve social indicators. It includes better-articulated policy actions and reforms to support the private sector and increased spending on economic infrastructure. For human capital development, it aims to improve the balance between central government interventions and local responsibilities to accelerate progress in social indicators while maintaining fiscal discipline. The four strategic areas of the PRSP-II are: (i) economic growth for poverty reduction; (ii) human capital development and social protection; (iii) productive and social public infrastructure; and, (iv) governance and state reforms. The PRSP-II is framed in a medium term macro-framework in which prudent economic policies, including fiscal discipline, help sustain an improvement in key indicators: growth reaches 4.3 percent on annual average over 2005–09, while inflation gradually falls to around 3 percent per year. This facilitates for the attainment of the 2009 milestones for reaching the MDGs. The PRSP-II also presents the results of the implementation of the PRSP-I between 2003 and 2005. It is the product of broad consultation at the local and sectoral levels, characterized by the

¹ *Plan Nacional de Desarrollo 2005–2009*, Government of Nicaragua, November 2005.

government as a process of participation for the construction of the PRSP-II. Donors² expressed their support for the PRSP-II, and made significant progress in harmonizing cooperation by co-signing with the GON on May 18, 2005 a Joint Financing Agreement (JFA) for General Budget Support, integrating a Performance Assessment Matrix (PAM) with detailed commitments made by GON to policy actions and indicators consistent with the PRSP-II.

II. THE POVERTY REDUCTION STRATEGY

A. Country Ownership and Participation

2. The PRSP-II emerged from a broad participatory process at the local level with departmental development councils, and consultations at the sectoral level.

Consultations for the PRSP-II took place in four stages through a series of seventeen workshops at the departmental level to ensure civil society participation including the private sector and donors. This process incorporated the dissemination in 2003 of the Vision of Nation and the PPND, and in 2004 of the PNDO. The consultation of the PRSP-II culminated at the national level with the discussion of the National Development Plan 2005–2009 in August of 2005 at the National Commission for Economic and Social Planning (CONPES). The authorities have also held bilateral meetings on the strategy laid out in the PRSP-II with the National Assembly's PRSP Commission. The PRSP-II and other relevant material to the PRSP under the revised strategy are posted on the National Development Plan website www.pnd.gob.ni and at the Office of the President's website www.presidencia.gob.ni.

3. The participatory process of elaborating the PRSP-II comprised the production of territorial plans, and the discussion of sectoral priorities and policy matrices.

Territorial plans were produced for all 15 departments and two autonomous regions, including actions, goals, targets and budgets, incorporating funding sources whenever possible. At the sectoral level, the government established six fora with donor participation to discuss sectoral priorities and elaborate policy matrices in education, health, social protection, governance, production and competitiveness, and infrastructure.

4. The PRSP-II incorporates demands voiced at the consultation sessions, such as increasing infrastructure investment, emphasizing participation and decentralization in PRSP-II implementation, increasing transparency in monitoring and evaluation, and improving alignment of donor contributions to PRSP-II goals. Discussions covered the four PRSP-II strategic areas and helped establishing the five overarching PRSP-II results for the period 2005–2009 (¶1).

² Germany, Finland, Norway, Netherlands, DFID, Sweden, Switzerland, European Commission, and the World Bank.

B. Medium-Term Macroeconomic Framework

5. **In the face of difficult economic circumstances, a new government in 2002 embarked on an economic reform program, which succeeded in steering the Nicaraguan economy back on course.** In 2000–01, Nicaragua experienced a banking crisis, a weakening of fiscal and monetary policy and deterioration in the external environment (from 1999–02). The government that took office in 2002 moved quickly to address the large imbalances, tightening the fiscal and monetary policy stance. Following these policy steps, the economy recovered strongly. Real GDP growth accelerated from 0.8 percent y/y in 2002, reaching 5.1 percent in 2004 y/y. The external position strengthened and inflation remained stable. However, since 2004 the economy has been adversely affected by the sharp increases in global oil prices, which have slowed growth, contributed to rising inflation and led to a widening of the external current account deficit.

Table 1. Nicaragua: Medium-term Macroeconomic Framework

	2004	2005	Projected				
			2006	2007	2008	2009	2010
GDP growth (percent)	5.1	4.0	3.7	4.3	4.6	4.8	5.0
CPI (avg, in percent)	8.5	9.7	8.8	6.2	4.0	3.0	3.0
GDP deflator (percent)	10.2	10.9	8.3	5.0	3.0	2.5	2.5
Current account (in percent of GDP)	-16.1	-16.9	-16.7	-16.0	-15.2	-14.5	-13.7
Gross international reserves (in months of imports of G&NFS)	2.8	2.3	2.5	2.7	2.8	3.1	3.3
Combined public sector balance before grants	-6.3	-6.0	-6.0	-5.2	-4.9	-4.5	-4.1
Combined public sector balance after grants	-2.8	-2.2	-2.2	-1.3	-1.2	-0.9	-0.6
Combined public sector debt 1/	92.7	86.5	83.4	81.1	80.1	78.5	76.9
Domestic debt	29.4	25.2	20.0	15.2	11.7	8.3	5.6
External debt	63.3	61.3	63.4	65.9	68.3	70.2	71.3
Memorandum items:							
Nominal GDP (C\$ mn)	72,603	83,793	94,120	103,075	111,051	119,291	128,387
GDP (US\$ mn)	4,556	5,008	5,358	5,587	5,789	6,037	6,308

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

1/ Assuming full delivery of full HIPC relief for 2004. Measured at face value.

6. **The macroeconomic framework underpinning the PRSP-II is consistent with maintaining stability and supporting the authorities' poverty reduction goals.** The PRSP-II underscores the importance of macroeconomic stability and medium- and long-term sustainability. With steadfast policy implementation, the objectives of the PRSP-II's macroeconomic framework should be attainable, yet are subject to a number of risks, some of which are acknowledged by the report. In the near term, as the effects of the oil shock wane, economic activity is expected to pick up again reaching an average of 4.3 percent over 2005–09, while inflation is expected to gradually decrease to about 3 percent annually. Over

the medium term, growth is expected to converge toward potential output growth, estimated at about 5 percent (Table 1).

7. **The PRSP-II discusses several strategic policies for boosting medium term economic growth.** The role of the private sector as the main engine of growth through the stimulation of investment and exports is underscored. It also emphasizes the objective of broad-based economic growth that promotes employment and rural development. To this end, the authorities intend to improve the investment climate, increase public infrastructure spending, enhance investment in human capital, and strengthen protection of vulnerable groups. The PRSP-II presents a detailed analysis and costing of several strategic supply side sources of growth, including financial services, agriculture, and rural development. It also identifies a set of policy measures for promoting exports, including: (i) developing research capacities and market intelligence; (ii) simplifying administrative procedures for exports with the development of an “Export Gateway”; and (iii) facilitating meeting quality and certification standards in trading partners. However, it will be important to further assess how such measures can in practice be implemented.

8. **The medium-term framework hinges on sustained fiscal consolidation and maintaining stable monetary policies.** The fiscal strategy aims to reduce the overall fiscal deficit through continued efforts to improve revenue administration and rationalize expenditures, while increasingly aligning expenditures with the priorities of the PRSP-II. To this end, it will be imperative to continue efforts to strengthen the tax administration. A crucial element of this will be early action to amend the tax code approved in October 2005, which undermines the authority of the tax administration and risks having an adverse impact on revenue collections. Looking forward, the combined public sector (CPS) deficit after grants is projected to fall to 0.6 percent of GDP by 2010 with gradually paced adjustment made possible by the continued availability of a high level of grants and other concessional finance. Monetary policy will remain guided by the objectives of low inflation, while strengthening the central bank reserve position. Lowering the stock of external as well as domestic debt is also critical to reducing vulnerabilities and to supporting commercial bank lending to the private sector.

9. **It would be important to strengthen the analysis of how best to reduce domestic vulnerabilities and buffer the economy from external shocks.** The authorities recognize in the PRSP-II that the PRSP-I did not adequately prepare for scenarios of possible negative shocks to the economy (external or domestic). During the period between 2001–04, the Nicaraguan economy suffered commodity price shocks (including a rise in oil and a sharp decline in the prices of coffee and other agro-export products), hurricanes and a banking crisis, which together muted the gains foreseen by the PRSP-I. The PRSP-II stresses a number of risks that may affect the path toward growth and poverty reduction. For example, the document explores the risks arising from a protracted period without an active Fund-supported program and its implications for the macroeconomic framework program financing. It will also be important to evaluate ways to increase the economy’s resilience to external shocks in view of the existing vulnerabilities within the economy. These include measures to reduce the high level of dollarization and address risks in the financial sector (for example of currency mismatches). Moreover, debt levels remain high, despite significant

progress in the context of the HIPC Initiative, and the debt dynamics are sensitive to an array of downside risks, which could be further explored. In the same context, it will be useful to evaluate the suitability of the current exchange rate regime over the medium term.

C. Poverty Diagnostics

10. **Nicaragua has made progress in implementing the PRSP-I.** Since adopting the PRSP-I, poverty reducing spending has increased, from 10.4 percent of GDP in 2002 to 12.3 percent of GDP in 2004 as well as in 2005. The positive effects of these increases are reflected in improved indicators in the education and water sectors, where PRSP-I targets were overachieved in 2003 and 2004. However, implementation of the PRSP-I in the health sector has stalled and targets have not been achieved while the coverage of vaccination programs has been weak. Although assessing progress in implementation of the PRSP-I is hampered by the absence of recent data on poverty trends, existing information indicates a consistent trend in reducing poverty. The share of the total population living in poverty fell from 50 percent to 46 percent between 1993–01, while that in extreme poverty declined from 19 percent to 15 percent over the same period

11. **The PRSP-II is anchored in a detailed analysis of the evolution of poverty, the territorial distribution of economic activities and the determinants of growth.** Poverty diagnostics is survey-based using a comprehensive database comprising a series of Living Standards Measurement Survey (LSMS) surveys carried out in 1993, 1998, 1999, and 2001 (panel surveys are the 1998 and the 2001), and the Demographic and Health Surveys (DHS) in 1998 and 2001. The poverty analysis establishes a trend in reducing poverty and a considerable responsiveness of poverty reduction to economic growth.³ The PRSP-II makes use of a poverty map jointly with information on migration and the spatial distribution of economic activities, and the analysis of the key determinants of growth in Nicaragua to formulate policies to support economic growth for poverty reduction.^{4,5} The prospective composition of priority spending consistent with progress in social indicators has been expressed for the first time in the 2006 Budget Proposal in a three-year medium-term expenditure framework (MTEF) for three key sectors: education, health and infrastructure.⁶

12. **The Fund and Bank Staffs attach particular importance to ongoing efforts to update welfare analyses in Nicaragua.** Although new data are not yet available to assess the impact of more recent policies stemming from the PRSP-I, new information is being

³ World Bank (2003) Nicaragua Poverty Assessment Report No. 26128-NI.

⁴ *Plan Nacional de Desarrollo 2005-2009*, Government of Nicaragua, November 2005. Chapters 2 and 3, and Annex 3.

⁵ Nicaragua Development Policy Review on Sustaining Broad-based Growth, World Bank Report no. 29115-NI, December 2004.

⁶ The MTEF, incorporated as an Annex into the 2006 Budget Proposal, is on the website www.hacienda.gob.ni/hacienda/ppresupuesto2006/mpmp1.jsp

collected this year; a new Population Census was fielded in May–June 2005 and a new Living Standards Measurement Survey (LSMS) was fielded from July to October 2005. Staffs suggest incorporating new welfare analyses findings arising from this information in the next PRSP-II progress report. With regard to statistical capacity, the National Institute of Statistics (Instituto Nacional de Estadísticas y Censos, INEC) will deepen the systematic analysis of poverty from seven regions in Nicaragua to departmental level (15 departments and two autonomous regions) with the 2005 LSMS. This survey will extend the already comprehensive database derived from the series of LSMS and DHS surveys, and will allow for assessing progress in poverty reduction from 2001 to 2005.

D. Targets and Intermediate Indicators

13. Targets and intermediate indicators for the PRSP-II build on those established in the PRSP-I, incorporating new ones that emphasize boosting economic growth.

PRSP-I targets and intermediate indicators focused mostly on the social sectors and MDGs. New targets and indicators have been added to the PRSP-II in the following areas:

(i) macroeconomic performance, (ii) economic infrastructure, (iii) regulatory framework and bureaucratic procedures, (iv) property rights, (v) access to financial services, (vi) investment attraction, (vii) food security, and (viii) sustainable environmental development. Staffs commend the concerted efforts made by the authorities at the sectoral levels to broadly discuss policy actions related to achieving these targets and indicators. The results are detailed in the matrix of goals and actions 2005–09, which was elaborated simultaneously and is consistent with the PAM annexed to the signed JFA.

14. Education and water goals have been overachieved in both 2003 and 2004, while those for health have lagged.

The positive education outcomes have been influenced by complementary sector specific support such as the Education-for-All Fast Track Initiative (EFA-FTI) and significant efforts in sectoral coordination and donor alignment reflected in a good implementation of the education sector's Common Work Program (*Plan Comun de Trabajo*, PCT). The PCT is supported by bilateral and multilateral donors; including the European Union, Canada, Denmark and IDA. Goals for water coverage at the national level were also overachieved, in particular, urban areas such as the cities of Matagalpa and Jinotega had significant investments translating in increased water quality, service and coverage. However, the achievement of health goals is lagging behind and coverage of vaccination programs in 2004 has been insufficient, raising concerns about effectiveness of the health system in implementing actions prioritized by the PRSP-II. Lack of progress in health indicators can be partly attributed to a significant share of recurrent spending dedicated to salaries and to historical spending allocations as opposed to priority spending. To address these concerns, the health sector has formulated a new Health Plan for 2005–09 incorporating the definition of five strategic priorities aiming at attaining the MDGs: (i) increasing survival rates and quality of life of women in reproductive years, (ii) increasing survival rates and quality of life of children under five years old, (iii) improving nutritional levels of children under five years old, (iv) promotion of healthy habits and attitudes, and (v) implementing policy actions aiming at attaining the MDGs and PRSP-II goals, including

those related to HIV/AIDs. These priorities have been expressed for the first time in the 2006 Budget Proposal in a sectoral three-year MTEF.⁷

E. Policies and Programs

15. **The PRSP-II adequately stresses the crucial importance of growth for poverty reduction. Staffs suggest further efforts would be needed to attain the MDGs.** While staffs concur that stepping up policies to generate greater wealth and productive development are key for Nicaragua's economic development in the coming years, significant efforts are also needed to enhance the impact of growth on poverty reduction. Achieving the MDGs in Nicaragua appears feasible as long as sustained and concerted efforts are made to prioritize PRSP-II spending. In particular, sustaining poverty reduction is vital to attain these MDGs whereas lack of progress in the PRSP targets in health requires sectoral budget allocations that support implementation of the strategic priorities identified in the Health Plan.

16. **Budgetary programming needs to be better aligned to PRSP-II goals. Staffs encourage the authorities to improve the efficiency of budget allocations and prioritize poverty spending in budget formulation and execution.** Ongoing efforts for establishing an MTEF and improving donor harmonization adequately aim towards improving progress in PRSP-II goals. The recently approved Financial Administration Law is a first step towards developing a Medium-term Expenditure Framework (MTEF). Further elaboration of the medium term fiscal policy formulation framework in the context of a road map for moving towards implementation of a Fiscal Responsibility Law should help to improve the linkages between budgetary programming and PRSP-II goals. However, Nicaragua's budgetary allocations are constrained by significant earmarking, which if not significantly reduced could limit the scope for improvements in the targeting of poverty alleviation programs. As a share of total spending, six percent is assigned to universities and four percent to the Supreme Court, and as a share of revenues, six percent is assigned to municipalities. Earmarked funds to universities have been shown to favor the non-poor for the most part. A recent Poverty and Social Impact Analysis (PSIA)⁸ showed that over 90 percent of university spending favors the non-poor while the extreme poor received zero from this allocation as they are not represented among students enrolled at this level. Thus, ensuring that public spending is mostly pro-poor requires better targeting of spending while ensuring sufficient budgetary allocations to attain PRSP-II goals. Programmatic decision-making can increase impact by selecting the most cost-effective anti-poverty programs and by improving the targeting of spending out of earmarked funds, including those transferred to universities, the Supreme Court, as well as municipalities.

⁷ The Health Sector MTEF incorporated as an Annex into the 2006 Budget Proposal is in the website www.hacienda.gob.ni/hacienda/ppresupuesto2006/F_5_1_MGSMP_MINSA.pdf

⁸ Nicaragua PSIA (2003) The Incidence Of Public Education Spending In Nicaragua: The Impact of the Education for All—Fast Track Initiative.

17. **Staffs suggest that the next PRSP-II progress report undertake a further analysis of how participation in CAFTA-DR can be incorporated into the strategy to promote trade and investment.** The authorities should also ensure that the economic gains from the CAFTA-DR trade agreement and deeper regional integration efforts are maximized and shared across the population. These gains, which are expected to stem from expanded and more permanent market access to the United States (Nicaragua's main trading partner) and from associated structural reforms, are expected to lead to higher investment, exports, and growth. Long tariff phase-out periods of 10, 15, and 20 years were negotiated for commodities affecting incomes. The authorities already have commissioned and disseminated in a CAFTA-DR Forum a study on the possible impact of this trade agreement on agriculture. Staffs suggest incorporating these results into the next PRSP-II progress report, including possible compensatory measures to mitigate potential social impacts on specific sectors (e.g. traditional agriculture). In addition, the authorities should continue to strengthen domestic revenue to offset the expected reduction of collection of international trade taxes on account of CAFTA-DR that is expected over the medium term.⁹

F. Public Expenditure Management

18. **The PRSP-II stresses improvements in public financial management, including mechanisms for implementing and tracking poverty spending.** Nicaragua's public expenditure management (PEM) system has improved since the January 2004 completion point.¹⁰ The PRSP-II stresses enhancements to PEM major systems; the Integrated Financial and Administrative Management System (SIGFA) and the National System for Public Investments (SNIP). SIGFA's recent upgrades include integrating the subsystems for budget, accounting and treasury for monthly closing of national accounting and conciliation of accounts statements with the budget. SNIP, in accordance to progress in participatory budgeting under the PRSP-II, has established Territorial Units for Public Investment (UTIPs) in all departments. The Ministry of Finance (MHCP) manages both planning and execution of the budget, including poverty spending, through SIGFA. The national budget identifies all public spending and transfers associated with poverty-reducing activities, including HIPC debt relief, as well as all other external and internal sources of financing for those programs. With this information, which is publicly available, it has been possible to verify that the increase in external resources inflows, including from HIPC debt relief, have been dedicated

⁹ The magnitude of the fiscal impact will depend on various factors, including trade diversion, import price elasticities, and the overall response of economic activity. Of all the signatory countries, Nicaragua is expected to face the smallest fiscal impact, because of its lower share of imports whose tariffs will be reduced immediately in addition to a relatively lower share of U.S. imports.

¹⁰ PEM Performance Post HIPC Completion Point Paper.

to poverty-reducing activities, with no significant decline in domestic resources previously allocated to these activities.¹¹

19. **The PRSP-II affirms the Supplementary Social Fund (FSS) will continue to be the entity responsible for monitoring the allocation and use of PRSP-II poverty spending and HIPC debt relief.** This mechanism was already assessed by staffs as adequate at HIPC completion point¹² and was used throughout PRSP-I implementation. The FSS is a *virtual* fund, similar to those used in other HIPC countries;¹³ virtual funds track poverty spending through the ‘tagging’ of specific expenditures on the budget. SIGFA is in the process of tagging the new spending items consistent with the new poverty spending definition to be used for 2007 budget preparation. Staffs underscores the importance of the authorities’ already completed conversion of poverty spending data for the past few years of 2004 and 2005, in line with the new definition, in order to preserve consistency with the historical series and allow for correct spending comparisons. The authorities have met satisfactorily the targets for PRSP-I poverty spending as a share of GDP in the past, and have set subsequent targets with a positive trend under the PRSP-II.¹⁴

20. **While improvements have taken place in public sector expenditure management, further efforts are needed.** Areas needing continued efforts are: (i) further reforms of the decentralization framework (through amending the Municipal Transfers Law and the Municipality Law) to ensure fiscal neutrality and preserve poverty reducing spending, as well as increase accountability and the efficiency of spending at the municipal level; (ii) supporting the implementation of the Civil Service Reform thereby ensuring a more equitable working environment with better performance incentives and improved civil service quality, and enhancing public service management and delivery in key economic and social sectors; (iii) strengthening the government’s fiscal, financial and fiduciary management, specially in auditing, resulting in a more accurate, timely, relevant and transparent public sector; (iv) incorporating into the budget the operations of autonomous entities; and (v) supporting the activities of the new consensus-building body established under the Financial Administration Law to assess the realism of the financing sources proposed by the national assembly. These areas are adequately supported with technical assistance and donor funding by means of budget support as well as project lending.

¹¹ World Bank (2004) HIPC Completion Point Document Report No. P7614, Box 3.

¹² *Ibidem*, pp. 9–10.

¹³ Virtual and poverty funds are contrasted in the Joint World Bank-IMF paper on “Tracking of Poverty-Reducing Spending in Heavily Indebted Poor Countries (HIPC),” March 27, 2001.

¹⁴ According to the PRSP-II document, poverty reduction spending (under the PRSP-I classification) reached 12.3 percent of GDP in 2004 in contrast to the 11.6 percent target, and it is expected to reach (under the new PRSP-II classification) 12.4 percent in 2006, an increase of about 0.2 percentage points of GDP annually.

G. Monitoring and Evaluation

21. **The National System of Development Indicators (SINASID) has been successfully launched.** SINASID provides broad access to indicators and systematizes progress made to date in the implementation of the strategy (website www.sinasid.gob.ni). SINASID could be further enhanced in the formulation and monitoring of PRSP-II programs, projects and indicators at the national, departmental and municipal levels. The system could be improved in two ways, by supporting better quality of administrative data at the sectoral and municipal levels, and by establishing an interface with SIGFA to provide information on execution of disaggregated anti-poverty spending by programmatic area on-line. This would also contribute to fiscal transparency.
22. **A PSIA was carried out to assess the impact of public investment on growth and poverty reduction.** The PRSP-II incorporates the results. The National System for Public Investment (SNIP) has incorporated these PSIA findings into program selection criteria, by strengthening the estimation of cost-effectiveness indicators in project preparation. The work was coordinated by SNIP, under close collaboration with other department's of the Presidency's Technical Secretariat (SETEC), and with Bank technical and financial support.
23. **Another PSIA has been initiated** on the distributional impact of the decentralization of water services to be financed by the Bank and KfW. Staffs attach particular importance to the redistributive impact and potential coverage gains from water services. Staffs encourage the authorities to translate the poverty and social impact analysis findings into specific anti-poverty policy actions and report on the progress made in the next PRSP-II progress report.

III. CONCLUSIONS AND ISSUES FOR DISCUSSION

A. Risks to the Strategy

24. **Despite the progress made in completing the PRSP-II, including some challenges identified in previous joint staff assessments, the implementation of the strategy continues to face significant risks:**
- *Politicized decision-making.* As with the PRSP-I, the implementation of the PRSP-II, faces significant political risks due to the wide rift between the Executive and the National Assembly, which continues to delay decision-making and policy implementation. While the political situation has improved recently, the risk remains that tensions could resurface and the situation deteriorate even further in the run-up to the Presidential and legislative elections in November 2006.
 - *Sustaining fiscal adjustment and ensuring long-term sustainability.* Despite recent progress, Nicaragua's debt—both external and public—is still high and subject to significant risks of distress. Sustained fiscal consolidation will be key to address this major source of vulnerability. In addition, there are risks associated with the potential fiscal burden of the revenue transfers to municipalities without commensurate devolution of expenditure responsibilities, fiscal rigidities associated with

constitutionally mandated earmarking and an increasing public wage bill, civil service reform, as well as quasi-fiscal pressures arising from the recent problems in the power sector. The authorities would also need to address the actuarial insolvency of the public pension system.

- *Financial sector.* Financial sector vulnerability arises mainly from the exposure of large banks to government bonds, the high level of dollarization and a widespread indexation to the exchange rate in financial contracts. Together, these factors make financial stability highly vulnerable to the sustainability of government debt and to the crawling peg regime.
- *Institutional weaknesses.* While there have been significant advances in strengthening public financial management, risks to program implementation continue to be posed by weaknesses in the courts and the comptroller's office. The absence of a well-functioning judicial system undermines private sector confidence and limits the impact of efforts to reduce poverty through faster growth.
- *Enhancing the economy's resilience to shocks.* Nicaragua remains vulnerable to natural disasters and conditions (*El Niño, hurricanes, earthquakes*) and to terms of trade shocks (*commodity price declines, oil price increases*). Natural disasters and external shocks could have a major negative impact on growth and consequently hamper poverty reduction. The authorities should ensure the economy's ability to absorb shocks through structural changes, such as the diversification of the export base, accompanied by enhanced natural disaster management, areas that are at present supported adequately with technical assistance and donor funding.

25. **The PRSP-II would benefit from a more in-depth analysis of the risks to the strategy.** The IDA and Fund staffs recommend that the authorities incorporate the analysis of these risks, including outlining contingency measures, into the next PRSP-II progress report.

B. Priority Areas for Strengthening the PRS and its Implementation

26. **The PRSP-II presents a coherent medium-term macroeconomic framework and credible efforts toward implementing the poverty reduction strategy.** The staffs caution that the economic outlook is confronted with important risks and vulnerabilities underscoring the need for continued prudent macroeconomic policies, complemented by structural reforms to raise the economy's growth prospects, improve the investment climate, and absorb potential shocks. Sustained macroeconomic stability and broad-based economic growth continue to be key elements for achieving policy objectives and strategy targets.

27. **Although the authorities have made significant progress in moving towards implementation of the PRSP-II, further efforts are needed.** Progress has been achieved in several areas cited in previous joint staff assessments, namely in:

- maintaining macroeconomic stability, *while achieving poverty-reducing spending targets;*

- strengthening transparency in fiscal and public financial management systems (including SIGFA and continued improvements in the government's fiscal, financial and fiduciary management);
- consolidating the system of monitoring indicators (by developing SINASID);
- pursuing government-led efforts to align donor assistance to the PRSP-II and significant progress in harmonization culminating in the JFA and PAM; and,
- understanding better the distributional impacts of public investment and of sectoral reforms, in particular by completing a PSIA on the contribution of public investment to growth and poverty reduction and initiating another on the decentralization of water services.

Areas where further work is needed include:

- prioritizing the immediate implementation of measures aimed at raising the likelihood of attaining PRSP-II/MDG goals, such as ensuring PRSP-II spending allocations in budget formulation and execution, and improved targeting of key interventions;
- sustaining fiscal consolidation by making further progress on neutralizing the fiscal impact of transfers under the Municipal Transfers Law, containing the fiscal impact of the pension system, and ensuring sustainable implementation of the civil service reform;
- maintaining financial stability by ensuring the implementation of the authorities' financial sector reform laws, and strengthening the integrity of the financial sector by enacting an anti-money laundering framework;
- tackling urgently the growing losses of the electricity sector due to the rise in oil prices by increases to electricity tariffs required to stem losses in the power sector avoiding the introduction of distortionary interventions;
- identifying fiscal contingency measures to address the risks to the strategy to ensure satisfactory implementation of the PRSP-II; and
- implementing social auditing mechanisms such as citizen report cards, to ensure that programs and projects translate into tangible and sustainable benefits to the population, and enhancing SINASID to support PRSP-II implementation, monitoring and evaluation, and the strategy's budgetary decision making process.

28. **Executive Directors may wish to focus on the following issues and questions:**

- Do the Executive Directors concur with the areas identified by staffs as key implementation risks?

- Do the Executive Directors concur with the areas identified by staffs as priorities for strengthening the PRS and its implementation?