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Evaluation of USAID/Nicaragua Economic Support and Recovery Programs I, II, and III

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GLOSSARY

A.I.D.	U.S. Agency for International Development
APP	Area del Propiedad del Pueblo; publicly owned, nonfinancial, nontrading, nonutility enterprises
BANIC	Banco Nacional de Industria y Comercio; National Bank of Commerce and Industry
BCN	Banco Central de Nicaragua; Central Bank
BIN	Banco Inmobiliario; government mortgage bank
BND	Banco Nacional de Desarrollo; National Development Bank
BOP	balance of payments
CACM	Central American Common Market
c.i.f.	cost, insurance, and freight
CO	córdoba oro; new Nicaraguan currency
CORFIN	Corporación Nacional Financiera; Nicaraguan national bank holding company
CORNAP	Corporaciones Nacionales del Area Pública; national holding company for state-owned, nonfinancial, nontrading, nonutility corporations
COSEP	Consejo del Sector Privado; Private Sector Council
DAEC	Development Assistance Executive Committee
ENABAS	Empresa Nacional de Abastecimiento; National Consumer Goods Corporation
ERC	Economic Recovery Credit
ESF	Economic Support Funds
ESR	Economic Stabilization and Recovery
FED	U.S. Federal Reserve Bank
FY	fiscal year
GDP	gross domestic product
GON	Government of Nicaragua
IDB	Inter-American Development Bank
IMF	International Monetary Fund
INSSBI	Social Security Institute
LAC	Latin America and the Caribbean
MIFIN	Ministry of Finance
NFPS	nonfinancial public sector
PAAD	Program Assistance Approval Document
PCO	Occupational Conversion Program
PEPS	Program, Economics, and Private Sector Office
QR	Quantitative Restriction
SAL	Structural Adjustment Loan
TCIP	Trade Credit Insurance Program
UNDP	United Nations Development Programme
USAID	A.I.D. Mission
VPOIC	Vice Presidency of International Commercial Operations
VPOBI	Vice Presidency of International Banking Operations
VPTI	Vice Presidency of International Treasury
VPCE	Vice Presidency of Foreign Trade
VPIC	Vice Presidency of Internal Control

PREFACE

This evaluation report was prepared for USAID/Nicaragua under Contract No. 524-0301-C-00-1367-00 during November 1991. The project research team, consisting of Dr. John Newton as team leader, Mr. Haris Jafri as macroeconomist, Mr. Edgar Gordon as trade economist, and Dr. Edgar Pereira as financial management specialist, carried out the basic research for the evaluation during September and October, returning to Washington to prepare the final report. This version of the report responds to all comments and observations received at the date of its submission.

The project team would like to thank Dr. Janet Ballantyne, Nicaragua Mission Director, and her staff for their support during the course of this project. Dr. Robert Burke, Dr. Elaine Grigsby, and Mr. Richard Layton were particularly helpful. Special thanks are due the many officials of the Government of Nicaragua, listed in Appendix C, who took the time to express their views and provide information to the team.

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Chapter 1

INTRODUCTION AND EXECUTIVE SUMMARY

This report presents results of the first evaluation of the Nicaragua Economic Support and Recovery (ESR) Program, covering stages I, II, and III of the program during the period June 1990 through September 1991. The evaluation addresses both direct funding impacts and the conditionality associated with this balance-of-payments support program, and is intended to determine whether the program has had the desired positive effects on the economy of Nicaragua. Chapter 2 of the report discusses the macroeconomic effects of the ESR Program in the context of the overall Government of Nicaragua economic stabilization and recovery program, while Chapter 3 addresses the effects of the specific items of conditionality included in the ESR Program. In Chapter 4 the analysis focuses on the fiscal sector, specifically the impacts of the Nicaraguan occupational conversion program on fiscal accounts. The external sector is the subject of Chapter 5, with emphasis on the import distribution effects of ESR-provided foreign exchange. Finally, Chapter 6 presents the evaluation team's analysis of the administration of dollar funding under the ESR program. Several appendixes present supporting details on issues not required for the main narrative, including sources of information and background analysis. The remainder of this introductory chapter consists of a more detailed exposition of the objectives of the evaluation and an executive summary of the results and recommendations of the report.

Project Objectives

This evaluation is intended to analyze the impact of the U.S. policy-based balance-of-payment (BOP) funding provided to the Government of Nicaragua under the first three USAID/Nicaragua ESR programs. Four specific objectives may be identified:

- Assessment of the direct effects of dollar funding in such areas as import financing, support of U.S.-Nicaragua trade, and domestic budgetary support.

- Evaluation of the impact of the programs' conditionality and funding on economic stabilization and recovery, in the context of the overall Government of Nicaragua stabilization program.
- Analysis of the administrative procedures associated with both dollar and local currency funding, determining the extent to which these procedures have either supported or undermined the policy reforms that are the goals of the ESR program.
- Development of recommendations for improving and/or continuing the impact of the programs in the future.

These objectives are to be addressed in terms of both policy reform and real economic impact, although it is recognized that the economic impacts of a stabilization program in an economy as damaged as that of Nicaragua may not be evident, either statistically or factually, at such an early stage.

Summary of Results

Although the ESR programs have been in effect less than 18 months, their impacts to date have been quite positive. The dollar-denominated BOP support inherent in the programs has had the desired effect of supporting necessary imports and basic public expenditure, allowing the country to survive the initial stages of the stabilization program; the conditionality for succeeding tranches has been met by the Government of Nicaragua in a timely manner and with positive initial results; and the administration of the program has proceeded fairly smoothly, with successive problems being dealt with by progressive administrative development on the part of the Central Bank of Nicaragua (BCN). Nevertheless, the true test of the effectiveness of these programs will lie in the successful medium-term recovery of the Nicaraguan economy, an event that cannot be expected for several months and that will require continuing support and policy dialogue on the part of USAID/Nicaragua. This executive summary presents the basic conclusions of the evaluation of these issues, following the order of the chapters of the full report.

Effects of ESR Support on Economic Stabilization and Recovery

When the Chamorro administration took office in April 1990, its initial attempts at stabilizing and reviving a badly damaged economy did not prove adequate to deal with the major outstanding policy problems–namely, hyperinflation, fiscal imbalance, and exchange rate instability. The Government of Nicaragua made changes in tax administration during 1990 and initiated other reforms concerning expenditure control, use of monetary instruments, and labor policy, which laid the foundation for a strengthened stabilization effort in March 1991. Nonetheless, the economic situation in early 1991 can be described as major macroeconomic disequilibrium, with hyperinflation at the rate of 13,500 percent. The first objective of a new stabilization program was ending hyperinflation.

With this primary goal, the Government of Nicaragua, with the close collaboration and support of A.I.D. and the IMF, began developing a program late in 1990 that took effect in March 1991. Its principal elements are as follows:

1. Devaluing the córdoba oro to a sustainable level and substituting it for the paper córdoba;

2. Balancing public spending so that the remaining fiscal deficit could be funded by foreign grants without net domestic financing;

3. Reaching agreement with public sector unions on a viable wage increase;

4. Controlling monetary aggregates by limiting uses of liquidity; and

5. Maintaining positive real interest rates.

The first policy was the "anchor" of the program; the second policy was crucial to the success of the first.

Through the ESR programs, A.I.D. played a pivotal role in the development and maintenance of the Government of Nicaragua's stabilization and policy reform program. The initial import financing and later budgetary support allowed the economy to survive the initial trauma of adjustment without major recession, while the clearance of multilateral arrears under ESR II and ESR III allowed for the resumption of other programs of international financial institutions (IFIs) and donors. A.I.D. also played a major role in the initial policy dialogue prior to ESR I and has continued that role with policy conditionality under ESR II and ESR III.

Given the condition of the Nicaraguan economy in 1990, the stabilization program has been an undeniable success: prices and exchange rates have stabilized, real interest rates are positive, and real wages have adjusted to some extent. In addition, although the separate effects of individual donor activities are difficult to measure, the ESR program has had obvious positive impacts in terms of fiscal support and policy conditionality. The ESR macroeconomic policy conditions have been well coordinated with the IMF as key aspects of the stabilization program. While ESR I contained no explicit policy conditionality, ESR II and III specified monthly targets for fiscal, monetary, and balance-of-payments performance, all of which have been fulfilled.

In sum, the major program objectives of price and exchange rate stability have largely been attained for the present. Future developments, however, such as excessive wage demands, could represent a potential danger to such stability. The exchange rate could also be affected by rising demand for foreign exchange arising from the resumption of growth. The program's successes at the macroeconomic level have been paralleled by encouraging initial signs at the sectoral level, although it is still too early to expect significant real growth. The commercial sector is growing, as are certain agricultural subsectors. Industrial growth will require a return of investor confidence and the availability of medium-term credit. Most important, the stage has been set for the resumption of private sector-led growth by privatization, liberalization, and demonopolization efforts supported by ESR conditionality and funding.

Concerning the importance of separate elements of the ESR programs, direct dollar transfers have had the most immediate and significant effect, followed closely by policy conditionality; the local currency program has played a smaller role. Dollar transfers lessened the pain of cutting spending and raising taxes to reach the objective of eliminating the central government deficit: the prospect of a fairly rapid resumption of activity was enhanced, and a major budgetary deficit in 1990 was transformed into a surplus in 1991. In terms of policy dialogue, A.I.D. has had an influence on Nicaraguan stabilization policy since late 1989 through regular contacts with policymakers, visits by noted economists and other specialists, and indirect influence through the IMF. In fact, A.I.D. initiated intensive policy dialogue with the new government's transition team even before assumption of office by President Chamorro, greatly influencing the direction and substance of the new government's economic policy. USAID/Nicaragua has continued to have specific influence on the content of the stabilization program and on policy reform by making certain targets conditions to the release of tranches of ESR II and III.

Local currency programming has been a less important element of ESR activity; under ESR I and II there was no effective local currency programming. Although the Government of Nicaragua was required to deposit the proceeds of U.S. dollar sales in an earmarked account, USAID/Nicaragua did not formally require and monitor specific uses of these funds.

The ESR III agreement on local currency continues prior practice in a more explicit way. Counterpart deposits can be used for budget support, for offsetting exchange losses of the BCN, or for repaying Government of Nicaragua debt to the BCN. As with ESR I and II, as long as such uses do not violate credit management guidelines and fiscal programming, there is no harm in local currency generation.

Effectiveness of ESR Policy Conditionality

Beginning with ESR II, USAID/Nicaragua conditioned the release of successive tranches of dollar funding on Government of Nicaragua completion of policy-related goals in certain fields. The initial conditions included fiscal and monetary targets, or demand management, followed by several private sector-oriented reforms, including demonopolizing foreign trade, opening the financial sector to private enterprise, and privatizing state-owned enterprises. A.I.D. also supported the occupational conversion program and conditioned release of funding on certain public employment reduction targets.

With respect to macroeconomic management, the effects of ESR conditionality are best understood in the context of the overall stabilization program for Nicaragua, which was in large part a product of earlier policy dialogue between A.I.D. and the Government of Nicaragua. ESR II conditionality with respect to demand management was specific and covered a wide range of policy reforms, including (1) preparation of an economic program that would include a fiscal program with limitations on deficit financing in addition to a corresponding monetary program containing a target for the reduction in the growth rate of liquidity to a level consistent with price stability, and (2) compliance with the fiscal and monetary targets included in the economic program submitted to the Paris Consultative Group meeting in December 1990. These conditions have been met in full, as have related conditions with respect to public employment reduction. The tranche release conditions of ESR III with respect to demand management required compliance with the monthly targets in the government's March economic program. The government has complied with ESR III conditionality regarding demand management, including that for the fourth tranche release.

In terms of trade liberalization, the condition for the release of the second tranche of ESR II requires the licensing of private operators in foreign trade activities that are currently operated exclusively by state-owned enterprises. This condition has been substantively met. The initial impacts of this conditionality compliance are evident, although significant concrete benefits can hardly be expected in the context of Nicaragua's damaged economy. Tariff and tax rates were cut, state trading monopolies were eliminated in principle, quantitative restrictions were eliminated except on grains and certain other foods, access to foreign exchange was made much easier, and a unitary exchange rate was established. Nicaragua remains, however, a highly protected economy. Responsible export-led growth will require further reforms.

Concerning financial sector reform, the basic approach of ESR conditionality has been to open the sector to private banking. ESR II conditionality required the licensing of privately owned financial intermediaries, and the conditions of ESR III are to permit the establishment (without discrimination) of private banks empowered to offer a full range of commercial banking services—that is, buying and selling foreign exchange, opening letters of credit, and accepting deposits. All the ESR II and III conditions on financial market reform have been fulfilled.

The USAID/Nicaragua approach to encouraging privatization of state-owned enterprises has been to support planning and valuation and to arrive at reasonable divestment procedures, while staying clear of the constitutional and administrative details of the process. Under ESR II, the condition for the release of the third tranche required the establishment of a regulatory framework for the privatization of state-owned enterprises. ESR III includes a covenant that the Government of Nicaragua will continue to implement its privatization program. Such implementation is proceeding. Hence, ESR II and III conditionality on privatization has been fulfilled.

Performance-Based Disbursement and Occupational Conversion

In March 1991, as part of a comprehensive public sector restructuring effort, the Government of Nicaragua initiated the implementation of an occupational conversion program (PCO), a euphemism for employment reduction. The budgetary costs of this program through September 1991 have largely been financed by ESR III releases, and corresponding conditionality has been established. This conditionality has been fulfilled and significant budgetary savings should be realized from 1992 onward.

The impact of the PCO on public sector finances can be measured by net savings. For central government, there would be negative net savings (i.e., increased expenditures) of 0.4 percent of estimated 1991 GDP in 1991 and net savings of 0.4 percent of projected 1992 GDP in 1992—or an improvement of 0.8 percent of GDP in 1992. In 1993 and in subsequent years, the Government of Nicaragua would reap net savings of 0.6 percent of projected 1992 GDP. For the nonfinancial public sector, there would be negative net savings (increased expenditures) of 0.7 percent of estimated 1991 GDP in 1991, net savings of 0.7 percent of projected 1992 GDP in 1992, and net savings of 1.1 percent of projected 1992 GDP in 1993 and beyond. The negative net savings (increased expenditures) are notional to the extent that they are financed by ESR releases. For the public sector as a whole, there would be negative net savings (increased expenditures) of 0.9 percent of estimated 1991 GDP in 1991 and net savings of 0.8 percent of projected 1992 GDP in 1992 and 2.1 percent of projected 1992 GDP in 1993 and in subsequent years.

The evaluation of the budgetary impact of PCO implementation is not affected by the general salary adjustments granted in March and June 1991, since these adjustments have already been taken into account in the monthly budgetary planning for 1991. The sectoral wage increases granted in recent weeks have not so far been large enough to warrant re-examination. However, given the recent accentuation of pressures for wage increases, the public sector wage bill must be kept under continuing review. In addition, since the cost of PCO is being financed through ESR releases, it may be argued that the gross savings figures in the text of the report are really equivalent to net savings from the Government of Nicaragua's budgetary point of view.

Effects of ESR-Provided Foreign Exchange on Import Activity

Comparing ESR-supported imports with total Nicaraguan imports in terms of their economic use, their geographical origin, and the sector to which they are destined, leads to the general conclusion that the trade-related objectives of the ESR programs—promoting private sector imports, promoting U.S. imports, and delivering fast-disbursing aid in support of Nicaraguan stabilization goals—are largely being met.

The A.I.D. program funds 21 percent of all Nicaraguan imports, but because of its concentration in petroleum products, it pays for the equivalent of 93 percent of all imports of that type. In the intermediate products category, ESR funding supports 12 percent of imports and 6 percent of the investment good imports. Private sector imports have predominated in the nonpetroleum ESR-supported category, accounting for 55 percent of the total. Because petroleum imports are so extensive, however, and because they are an almost complete monopoly of a state enterprise, 90 percent of total ESR imports have gone to the public sector. The evaluation team does not consider this proportion to be out of keeping with ESR goals and objectives, however, because petroleum imports are indispensable for the economic recovery of the country and because petroleum imports by the public sector are in fact used by the private sector.

A.I.D. ESF programs are generally intended to promote U.S. imports to the host country, in addition to fulfilling the country-specific objectives of the separate programs. Initially, and in the short run, a potential conflict existed between moving imports quickly and limiting them to the private sector and products from the United States. This occurred in a country that had not traded with the United States for nearly 10 years and where the public sector monopolized international trading. This potential conflict has turned out to be not very prominent in the longer term and was resolved in the short term by giving priority to the goal of stabilization.

Through August 1991, ESR program funds had been used to finance imports from the United States (15 percent), Central America (2 percent), and Caribbean petroleum- producing countries (83 percent). During the first half of 1991, about 17 percent of U.S. imports and 3 percent of Central American imports were being financed by the program. Total imports from the United States are now growing more quickly than those from other areas and are now much larger than the ESR-funded component—perhaps a sign of a multiplier effect of ESR BOP support. The United States has again become a major trading partner of Nicaragua, with a 19 percent share of its imports in the first half of 1991.

ESR funds, like A.I.D. funds in other country programs, cannot be used in the same manner as foreign exchange derived from a country's own earnings because of the geographic and product limitations imposed by U.S. law and regulations. The BCN had minor problems with documenting such ascription during the early months of the ESR program. Also, because of the geographic and product restrictions on ESR funds, the Central Bank occasionally resorts to other sources of foreign exchange before using ESR funding, resulting in uneven use of ESR funds over the year. As the BCN develops its administrative apparatus and trains its staff in the optimal management of reserves, the documentation and reserve flow issues should resolve themselves. Moreover, the general pattern of use of ESR funding to date has followed the normal annual product cycle in Nicaragua, and the USAID disbursement schedule has been designed to account for that cycle. Since traditional exports are concentrated in the first half of the year and imports in the second half, the need for BOP support is concentrated in the second half of the year.

Management of U.S. Dollar Funding Under the ESR Programs

The joint USAID and Government of Nicaragua administrative objective in terms of the ESR program is to move the funds as quickly and efficiently as possible within the framework of USAID regulations, consistently with the objectives of the Economic Stabilization and Reform Program. Since the BCN reforms of September 2, 1991, administrative procedures on the part of USAID/Nicaragua and the Central Bank of Nicaragua have performed in a manner consistent with this objective, although improvements are still possible. Before the BCN reform, the centralization of activities in the Vice Presidency for International Commerce created inefficiencies. The number of ineligible transactions increased, and the control of importer local currency payments was inadequate. The evaluation team found no corresponding problems with USAID's administrative procedures during this period.

The September reforms included a decision to turn over the management of foreign exchange transactions to the commercial banks and to authorize the establishment of foreign exchange houses. It also included the goal of achieving a totally liberalized foreign exchange system by eliminating all qualitative and quantitative import restrictions; the bank decentralized procedures for authorizing foreign exchange for imports by naming delegates to the commercial banks and authorizing them to review and approve the import requests under the ESR program. Aspects of this decentralization—the delegation of authority to determine the eligibility of and authorize the transaction and to assign the transaction to a project and to a separate account—are consistent with the objective of moving the ESR funds as efficiently as possible. Its shortcomings, however, are as follows: (1) BCN would lose control of the eligibility decision; (2) the final responsibility for the program within BCN is still not defined; and (3) delegation of authority by BCN to commercial banks appears to be carried out without USAID acquiescence, even though the grant agreement itself is between BCN and A.I.D.

The import of nonpetroleum tradeable goods under the ESR program is subject to five basic requirements:

1. The amount of the transaction must be at least $10,000.

2. Goods must be included on the eligibility list contained in A.I.D. Handbook 1, Supplement B, Chapter 4D.

3. Importers must present three pro forma invoices from reliable exporters or present a justification for not doing so.

4. Importers must present a certificate stating the eligibility of the source and origin of the goods (United States or Central America).

5. Importers must comply with all procedures and regulations established by BCN and other Government of Nicaragua authorities for the acquisition of foreign exchange and importation of goods into the country. According to importers interviewed by the evaluation team, these requirements have not impeded transactions since September 2, 1991.

Beginning with the September 2, 1991, administrative reforms, the BCN announced a largely free foreign exchange market for imports–free, that is, in the sense that there are no overt restrictions regarding the users and end uses of foreign exchange for imports. Nevertheless, the system is still characterized by central bank intervention in the exchange market, and there are some restrictions on the use of foreign exchange from certain sources, including A.I.D.'s requirements of pro forma quotes, eligibility of goods, and source and origin certificates. The question of importance for this evaluation, however, is whether the foreign exchange system is functionally free—or freely available at rates approximating market rates. The conclusion of the evaluation team is that current restrictions and controls do not unduly impede the free flow of exchange. In particular, restrictions such as those on A.I.D.'s ESR funds are no great impediment.

Because the new system of trade finance in Nicaragua has been operating for only slightly over 1 month, it is difficult to evaluate its operational capacity. Interviews with officials at the private banks and at one state bank gave the impression that they are preparing for extensive competition based on service provision, and the one operating private bank reports significant volume in letters of credit. Nevertheless, in present-day Nicaraguan banking practice, payment instruments for foreign trade are severely limited. The irrevocable letter of credit is the most widely used instrument of payment for imports to Nicaragua. U.S. banks do not confirm letters of credit from Nicaraguan banks unless they have in deposit in blocked accounts the collateral amounts. Similarly, exporters do not ship until the irrevocability of the letter of credit has been confirmed and payment has been authorized upon presentation of embarkation documents. Some large importers have re-established supplier's credit, however, and some are actively using it.

Interviews with representatives of the chambers of Industry and Commerce, private importers, and commercial bank officials revealed problems, especially lack of information and the initially complicated procedures set up by BCN, which impeded the use of ESR funds by private sector importers before the September 1991 reforms. The evaluation team concurs in part with the complaints concerning prior procedures, but the fact that substantial ESR imports had been funded reveals that even without formal advertising, the commercial sector knew about its existence. At present, with information available and the procedures simplified and decentralized, the complaint most widely voiced by importers is the cash basis feature of the A.I.D. program. They cite the Trade Credit Insurance Program (TCIP), concurrently offered by the private banks, as more attractive because of the 180- to 365-day credit available through it. The evaluation team noted the scarcity of short- and medium-term credit to the commercial and industrial sectors, but believes that the condition is in part a micro-level response to "suddenly responsible" banking practices resulting from financial reform. Several interviewees believed that trade channels with the United States had atrophied because of the trade embargo and that only recently have importers begun re-establishing their supplier network. This situation may have been the case initially but appears to be transitory. The evaluation team did confirm, however, that many importers have trouble accessing information on U.S. product availability: access to the U.S. Embassy and its commercial information is difficult under the best of circumstances, and the U.S. Chamber of Commerce in Nicaragua is not yet active. Few interviewees mentioned the three pro-forma price quotation requirement or the certificate of origin or any other ESR requirement as real obstacles to the use of ESR funds. Nevertheless, the three-quote requirement could be an imposition once trade accelerates. In addition, traders customarily request quotes only to the extent that their own economic interest requires that they do so. There is no current problem in Nicaragua with capital flight (and with overstating prices), and thus there is no reason for public sector interference in a private sector pricing decision. Requiring three price quotes unnecessarily encumbers the ESR system.

Recommendations

The evaluation team developed recommendations on both future ESR conditionality and support and the administration of the ESR programs. The following summary should be considered a representative listing of those recommendations, which are detailed in the text.

Recommendations on ESR Conditionality and Support

The major policy reforms constituting initial USAID/Nicaragua ESR conditionality—stabilization measures, elimination of state trading, private banking, privatization, and trade liberalization—although fulfilled, are still at early stages and will require careful monitoring for the next few years, which in itself could occupy a significant portion of any future ESR conditionality. In terms of reinforcing current conditionality policy, four areas will require special attention: (1) public sector employment reduction, (2) privatization, (3) financial sector reform, and (4) improving tax and custom revenues.

In addition, USAID/Nicaragua could maintain the lead in policy reform by developing new policies appropriate to the next stage of the stabilization process, facilitating the resumption of growth. Areas in which new policy reform and related support will be necessary include (1) small business development, (2) export promotion, and (3) provision of medium-term credit. All three areas are crucial to the intermediate-term development of the Nicaraguan economy and would serve to improve the balance of payments situation in the medium term.

Although not necessarily associated with formal conditionality, local currency management has often been used in ESF programs as a means of influencing host government behavior. Basing its judgment on familiarity with the experience of other Central American ESF programs, the evaluation team recommends that USAID/Nicaragua avoid the temptation of micromanaging ESR-generated local currency. A programming exercise attempting to match specific funds and specific spending projects would be a time consuming and inefficient use of USAID and Government of Nicaragua staff resources.

As a final comment on ESR conditionality and policy dialogue, the evaluation team recommends that USAID/Nicaragua continue the "positive and collegial" approach to policy design mentioned in Chapter 2. At this point, USAID and Government of Nicaragua officials are participants in the policy formulation process, and conditionality is not viewed as an imposition of an external viewpoint so much as support of Government of Nicaragua policy reform; that attitude should continue.

Recommendations on Program Administration

In order to streamline the ESR funding authorization process and to minimize the number of ineligible transactions, the team recommends the following actions.

- BCN should allocate ESR funds to the commercial banks on a first-come, first-served basis but continue to be involved in the prescreening of import eligibility as outlined above.

- BCN should encourage the use of ESR funds to pay supplier's credit for eligible import transactions completed after the effective date of the covenants.

- BCN should establish a centralized unit for monitoring the foreign exchange authorization procedure under the A.I.D. program.

- USAID should approve the procedures proposed by BCN for foreign exchange authorization for ESR imports with the following exceptions:

  - BCN should withdraw the authorization given to the U.S. correspondent banks to accept debit instructions directly from the local commercial banks;

  - BCN should continue to review the eligibility of the transaction before authorizing the debiting of the separate accounts for the purpose of providing collateral for the letter of credit; and

  - BCN should assign responsibility for the eligibility review to the Vice Presidency of Foreign Trade and make it nondelegable.

The evaluation team recommends the following steps in order to further expedite specific transactions.

- Although most importers are able to obtain three pro forma invoices or a justification for not presenting them, in order to decrease the bureaucratic procedures associated with ESR requirements and to make them consistent with BCN requirements for other imports, decrease the number of required invoices to one.

- Make the presentation of the certificate of source and origin by the exporter to the U.S. correspondent bank a requirement for the negotiation of the letter of credit. The team understands that

BCN used this procedure in some of its letters of credit and, as a result of progress reports submitted during this evaluation, USAID reminded BCN of this fact in a memorandum of October 22, 1991.

- Supply to BCN and the commercial banks a Spanish translation of the eligibility list in A.I.D. Handbook 1, Supplement B, Chapter 4D.

- Improve access to information on U.S. products. USAID donations of Thomas Registries to institutions such as the Nicaraguan Chamber of Commerce or the Central Bank Library will be very effective.

The following recommendations would lead to an expansion of the base of program users.

- USAID and BCN should sponsor the training of small importers in management and accounting, perhaps as part of a small business development project.

- USAID should make used and reconditioned U.S. and Central American products eligible for importation using ESR funds.

Chapter 2

EFFECTS OF ESR BALANCE-OF-PAYMENTS SUPPORT ON ECONOMIC STABILIZATION AND RECOVERY IN NICARAGUA

This chapter outlines the major macroeconomic elements of the Government of Nicaragua stabilization program put into effect in March 1991 and the role played by USAID ESR programs in overall stabilization and reform. Supporting details are presented in Appendixes D through G. The conclusion resulting from the analysis of this chapter and supporting appendixes is that ESR programs have been an indispensable component of the overall Government of Nicaragua stabilization program, providing the budgetary and balance of payments support necessary to avoid a serious recession during the reform process and setting the framework of policy reform itself.

Assessment of the Government of Nicaragua Stabilization Program

The Chamorro administration, which took office in April 1990, inherited a damaged and declining economy, dominated by the state and suffering from serious inflation and social unrest. Its initial attempts at stabilization through piecemeal efforts in 1990 failed to have lasting effects, because the major elements of real exchange rate overvaluation, excessive budgetary spending, and massive wage increases could not be controlled. By the end of the year, the circulating currency, the "paper" córdoba, was nearly worthless, and the one-to-one parity to the dollar of the new currency, the córdoba oro, was unrealistic. The Government of Nicaragua did make some changes in taxation and tax administration late in 1990, which had the effect of increasing revenue in 1991 and laying the foundation for a strengthened stabilization effort in that year. The policies attempted during 1990 and their impact are described in some detail in Appendix D. The emphasis here is on the program put into effect in 1991.

Initial Objectives and Methods

The economic situation in early 1991 can be described as a major macroeconomic disequilibrium: hyperinflation at the rate of 13,500 percent in 1990 meant that in practice Nicaragua was on a dollar standard. The first objective of a new stabilization program had to be ending hyperinflation by taking measures to control the economy's liquidity and influence price expectations. With this primary goal in mind, the Government of Nicaragua, with the close collaboration and support of A.I.D. and the IMF, began developing a program late in 1990 that was put into effect in March 1991. Its principal elements are

- Devaluing the córdoba oro to a level the government hoped could be sustained indefinitely and substituting it for the paper córdoba.

- Restraining public spending and increasing public revenue so that the remaining fiscal deficit could be funded by foreign grants without recourse to domestic net bank financing.

- Reaching agreement with public sector unions on a wage increase that would not invalidate the devaluation or the fiscal targets.

- Controlling monetary aggregates by limiting uses of liquidity (mainly credit expansion) to the public's willingness to hold domestic liquid financial assets,[1] consistent with an acceptable balance of payments and price performance.

- Maintaining positive real interest rates.

The first policy mentioned above was the primary "anchor" of the program, while the second policy was crucial to the success of the first. A stable exchange rate is an important signal for dampening inflationary expectations, while avoidance of net domestic bank financing of the nonfinancial public sector deficit is necessary for fulfillment of the exchange reserve target, which in turn makes it possible to maintain a stable exchange rate. Such fiscal restraint is also a signal to the private sector that the government is serious enough about stabilization to cut back its own spending. These were conceived as essential first steps in convincing the populace, after the hyperinflation Nicaragua suffered during 1990, that price and exchange rate stability was attainable.

[1]The main sources of liquidity are currency issue plus deposits of banks in the BCN (the so-called monetary base, a proxy for willingness to hold), foreign grant counterpart, and medium- and long-term liabilities of the BCN.

In an open economy as small as that of Nicaragua, with imports equal to 50 percent of GDP and exports equal to 25 percent, the exchange rate has a powerful effect on price expectations. In this context, a major objective of any stabilization program must be to keep the exchange rate stable as long as possible, engendering the attitude that future inflation will be moderate. Such a policy requires that foreign exchange for imports and related services (freight insurance, travel, etc.) can be obtained without attempts to ration by delay. In effect there is a stable elastic supply of goods that can be fed into the economy to support production and supplement consumption.

Excessive wage increases were and continue to be a major impediment to the Government of Nicaragua program of recovery and policy reform. Since the public sector unions are large, pervasive, and belong to the political opposition, obtaining their assent to a wage settlement that did not destroy the rest of the stabilization program was vital to the success of overall reform and recovery. An accord was reached, and available current evidence points to a significant decline in real wages since March—a painful but necessary adjustment to break the hyperinflationary spiral.

Finally, bank credit had to be controlled in order to (1) keep economic activity within the bounds of available foreign exchange, and (2) ensure that credit did not subsidize unproductive activities, especially through unrealistically low interest rates. By restricting state commercial bank rediscounts at the Central Bank to those based on the on-lending of foreign assistance, the state enterprises would be forced to operate as commercial entities and make the adjustments the stabilization program required.

Role of USAID/Nicaragua and the ESR Program

Through the ESR programs, A.I.D. has played a pivotal role in the development and maintenance of the Government of Nicaragua stabilization and policy reform program. The initial import financing and later budgetary support allowed the economy to survive the initial trauma of adjustment without major recession, while the clearance of arrears to multilateral institutions under ESR II and ESR III allowed for the resumption of other programs of international financial institutions (IFIs) and donors. A.I.D. also played a major role in the initial policy dialogue prior to ESR I and has continued that role with policy conditionality under ESR II and ESR III.

The three ESR programs were timed to support initial stabilization efforts, to allow clearing of international arrears, and to support specific strategic elements of policy reform. The first, in the spring of 1990, was a $60 million emergency foreign exchange grant with no conditions, intended to alleviate shortages of essential imports. The second, for $118 million, was signed in December 1990; it was a combination grant, with $50 million earmarked for paying arrears and the remainder meant for standard balance-of-payments assistance. The BOP component consisted of general support and of resources tied to reduction of public sector employment ("occupational conversion," discussed in Chapter 4). The third ESR program was signed in May 1991 and provided $135 million in addition to $25 million for payment of multilateral arrears and $2.5 million in support of the occupational conversion program. In addition, the transfers to the Central Bank earned interest until they were expended, and the resulting income was also available to pay for imports.

Specific ways in which ESR programs have provided crucial assistance to the Government of Nicaragua in charting its economic policies and in reaching agreements with the IFIs are as follows:

- After the Chamorro electoral victory, A.I.D. was the first international donor to lend support, with both technical and financial assistance.

- A.I.D. actively participated with the Government of Nicaragua, the IMF, the World Bank, and the IDB in the formulation of a stabilization program.

- The monthly targets and other conditions of the ESR program helped keep the Government of Nicaragua program on schedule during the period before agreements were finalized with the IFIs.

- As the largest donor, with 40 percent of total aid in 1991 and practically all of the grant balance-of-payments assistance, USAID provided support substituting for domestic public revenue during the initial stages of stabilization and supplied enough foreign exchange for imports to be liberalized.

- A.I.D. provided the largest component of resources to clearing up the arrears of the IFIs, enabling them to resume aid. Although there were no arrears to the IMF, the standby arrangement could be finalized only after arrears to the World Bank and the IDB had been cleared.

Initial Results of the Program

Given the condition of the Nicaraguan economy in 1990, the stabilization program has been an undeniable success: prices and exchange rates have stabilized, real interest rates are positive, and real wages have adjusted to some extent. In addition, although the separate effects of individual donor activities are difficult to measure, the ESR program has had obvious positive impacts in terms of fiscal support and policy conditionality. This section summarizes the initial impact on the economy of the stabilization program in general and of certain sectoral programs in the areas of finance, trade, and privatization.

The ESR macroeconomic policy conditions have been well coordinated with the IMF as key aspects of the stabilization program. While ESR I contained no explicit policy conditionality, ESR II and III specified monthly targets for fiscal, monetary and balance of payments performance, all of which have been fulfilled. The last of these conditions was required by the end of September 1991. In addition, the performance criteria of the IMF standby arrangements in the above policy areas for the end of September 1991 have also been met. Consequently, the nonfinancial public sector (which excludes CORNAP enterprises and public financial institutions) is no longer the promoter of inflation but a force for stability. That change, plus the policy of limiting rediscounts to the commercial banking system, has enabled the Central Bank to control its total domestic credit, reflected in the net domestic assets target. The occupational conversion program, another element of ESR conditionality, actually increases public expenditures in 1991 by 0.7 percent of GDP, due to severance payments, but leads to significant net savings from 1992 onward. The potential inflationary impact this year was offset by a special ESR allocation. (This program is analyzed in more detail in Chapter 5.)

Following are the major areas of impact of the stabilization program on the Nicaraguan economy:

- **Prices:** After rising 300 percent in March and April, the CPI fell 10 percent through the end of September, showing dramatic and rapid control of hyperinflation.

- **Liquidity:** Money supply (M_1) rose 15 percent during June-September 1991, at a rate significantly higher than the rate of inflation, reflecting restoration of confidence in the currency and buildup of external reserves.

- **Exchange Rate:** As measured by the IMF's real effective index (which takes into account inflation and the còrdoba's relationship to nondollar currencies) the còrdoba oro had depreciated by 17 percent by the end of June; the discount in the street market is curently about 4 to 5 percent. Because of changes in underlying relationships, the existing real effective index is no longer considered reliable and a new one is being prepared.

- **Interest Rates:** Positive real interest rates are being maintained and control of interest rates has been liberalized and made more flexible. Currently, *minimum* deposit and lending rates of 12 percent and 18 percent are prescribed, with freedom for banks to set higher rates in response to market factors. Also, variable rates have been introduced (see Chapter 3).

- Wages: With the introduction of the March program and the massive devaluation, the Government awarded a general wage increase of 160 percent in March and another general increase of 20 percent in June, with some exceptions and additions for specific sectors (see Appendix D on recent wage developments). Given the higher rate of inflation during January-April, evidence points to a significant reduction in real wages, which has been crucial to the success of the stabilization effort. However, pressure for wage increases has recently gathered momentum.

In sum, the major program objectives of price and exchange rate stability have largely been attained. Future developments, however, such as excessive wage demands, could represent a potential danger to such stability. The exchange rate could also be affected by rising demand for foreign exchange arising from the resumption of growth.

The success of the stabilization program in macroeconomic terms is reflected at the sectoral level. The ultimate goal of the program is to give private investors the incentive, the stability and the freedom to make investments. Furthering that goal, the first stage of the stabilization program has provided price and exchange rate stability to facilitate private decision making. It has also liberalized areas of the economy formerly in the hands of the state, including banking and international trade, and has placed some state enterprises on the market or returned them to their owners. (The privatization process is described more fully in Chapter 3.) Conditionality under ESR II and III was thus effective in reviving markets as allocators of resources and stimulating competition. Perhaps most important, however, the ESR-supported reform program has given businessmen the flexibility to pay in dollars for any foreign product they can afford in local currency by freeing the foreign exchange approval process.[2]

Currently, demand for credit is not strong in Nicaragua, due to generally depressed economic conditions and investor uncertainty, as well as to high interest rates and credit discipline induced by financial reform. As the economy revives, however, the tight domestic credit required to protect Nicaragua's still fairly meager supply of foreign exchange will be an increasing impediment to investment. Externally, the country has no commercial credit rating: there are no medium-term supplier loans from either commercial banks or export credit agencies, unless backed by special guarantee. Thus, foreign assistance, preferably on grant terms, is essential to

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[2]The success of the program in this respect is widely acknowledged at all levels by the public and private sector representatives interviewed by the evaluation team. Confirmation at the microeconomic level, however, is beyond the scope and resources of this project.

support renewed growth. This conclusion is supported by the balance of payments analysis in Appendix G.

Resumption of economic growth will almost certainly require some loosening of credit to finance general imports. With both reserves and balance-of-payments assistance at levels that can meet only a moderate upswing, such a movement will put pressure on both prices and the exchange rate, if not carefully coordinated with a stable credit policy. For the near term, in fact, the exchange rate may be the most vulnerable aspect of current policy reform. If the real exchange rate becomes overvalued, it will raise the demand for imports and hold back the growth of exports, particularly of nontraditional products, which usually have the weakest comparative advantage. The choices will then be devaluation or rationing foreign exchange by one device or another, and neither choice is an appealing one. For this reason, continued ESR funding will be necessary for the success of the Government of Nicaragua program, as it has been in the past.

For supporting imports as well, ESR assistance is indispensable. Additions of $80 million to reserves in 1990 helped to increase the import level slightly. Without such additions, imports would certainly have declined, given the otherwise low level of reserves. Although the Central Bank hardly utilized ESR funds at all during the first half of 1991, the transfer of $60 million in June swelled reserves. Increased use of ESR funds in the second half of the year will sustain and increase imports slightly and may lead to a small increase in reserves for the year.

Turning to real domestic production, the adjustments imposed by the stabilization program are likely to lead to a short-term decline of production as a whole, even though a few sectors are growing. The IMF standby program assumes a small decline of GDP this year and a 4 percent increase in 1992. Last year's poor harvest adversely affected production and is expected to have a strong unfavorable impact on exports in 1991. A continued decrease in fixed investments is likely as old projects are completed and few new ones are started. Commercial distribution, including importation, is one sector that is flourishing because of the new access to foreign exchange and expectations of large and quick returns.

Uncertainty over permanency of the new economic situation is preventing private sector investment in long-term projects. The shifting relationship between the government and the political opposition, as exemplified by both Congressional and union activities, adds to the tension. The Government of Nicaragua approach to this problem, as included in the current standby program, is an increase in public investment. For the consolidated public sector the projected rise is from 5.8 percent of GDP in 1991 to 10 percent in 1992. The shift from surplus to deficit in the projections for the overall fiscal deficit is programmed to be balanced by external financing, while Central Bank credit to the public sector is to continue its decline. This evolution, according to government economists, will encourage private investors to return to the market.

Another potential risk to the present stability is that a succession of wage concessions could increase the public sector wage bill to the point that a deficit emerges and recourse either to Central Bank credit or to a cutback of planned public investment becomes necessary.

In conclusion, the macroeconomic successes of the Nicaraguan stabilization program have been accompanied by some improvement at the sectoral level, although it is still too early to expect significant real growth. It is probable that there will be a moderate revival of economic growth in 1992, led by commerce and public investment and supported by projects in services and possibly housing. This revival involves risks, however, as there may be an increase in inflationary pressure and a shortage of dollars. Prices may rise, with the extent of the increase depending on wage settlements and the availability of foreign exchange.

Relative Importance of Separate Elements of the ESR Program

ESR programs to date have had an effect on the Nicaraguan stabilization program and thus the economy through three major mechanisms: direct dollar transfers, policy conditionality, and local currency generation and programming. Direct transfers have had the most immediate and arguably the most significant effect, followed closely by policy conditionality. The local currency program has played a smaller role.[3]

Transfer of Resources

ESR-provided funding has two aspects: the supply of dollars to increase the foreign exchange available to buy imports and to pay certain arrears and the use of those proceeds as transfers to the public budget to supplement tax revenue. With respect to dollar transfers, as of the end of September 1991, approximately $224 million had been disbursed for imports, and $75 million had been transferred to a special escrow account for the payment of arrears. This operation was successfully carried out so that Nicaragua was able to conclude important agreements to receive financial assistance from the IMF, the World Bank, and the IDB. The role of ESR dollar aid in the context of other donor assistance and its balance-of-payments implications is addressed in Appendix G.

[3]Local currency programming in the strict sense was not an element of ESR I and II, although ESR II did allocate funds for Government of Nicaragua budgetary purposes.

Budgetary Effects of ESR Dollar Transfers

In the absence of external grants and in view of current Government of Nicaragua revenue performance, the expenditure cuts and tax increases required to balance the Nicaraguan national budget would have had to be so severe that either (1) there would have been no agreement on an acceptable stabilization plan, or (2) the resulting program would have created a deep recession. The following table shows how external grants lessened the pain of cutting spending and raising taxes to reach the objective of eliminating the central government deficit.

Table 2-1. Central Government Budget (as percentage of GDP)

	1990	1991	1992
1. Total domestic revenue of which:	15.7	20.3	20.3
a. taxes	14.3	18.9	19.5
b. other	1.4	2.0	0.8
2. Expenditures	31.9[a]	27.3	26.3
3. Balance (1-2)	-16.2	-6.4	-6.0
4. Grants	1.4[a]	8.5	4.9
5. Balance (3-4)	-14.8	2.1	-1.1

[a]Excludes 13.4 percent of defense expenditure and corresponding military grants received from Eastern European countries.
Source: IMF.

The program called for a cut in expenditures of 4.6 percent of GDP and an increase in tax revenue of 5.6 percent of GDP. External grants contributed 8.5 percent of GDP toward bridging the gap, helping avoid a significant additional burden on the private sector and preventing more drastic and mandatory cuts in public sector employment. As a result of the grants, the burdens of taxation were more tolerable, the prospect of a fairly rapid resumption of activity was enhanced, and a major budgetary deficit in 1990 was transformed into a surplus in 1991.

Policy Dialogue

As discussed in more detail in Chapter 3, A.I.D. has had an influence on Nicaraguan stabilization policy since late 1989 through regular contacts with policymakers, visits by noted economists and other specialists, and indirect influence through the IMF. In fact, A.I.D. initiated intensive policy dialogue with the new government's transition team even before assumption of office by President Chamorro, greatly influencing the direction and substance of the new government's economic policy. USAID/Nicaragua has continued to have specific influence on the content of the stabilization program and on policy reform by making certain targets conditional to the release of tranches of ESR II and ESR III. Officials of the Government of Nicaragua reported that the policy dialogue with USAID/Nicaragua has not only been helpful in terms of setting and maintaining policy reform schedules, but that the policy formulation process has been notably positive and collegial in comparison with such processes under other country programs.

By attaching conditions to disbursements, A.I.D. played significant roles in two crucial areas: stabilization and competition. In the former, since the IMF was unwilling to conclude a standby arrangement, owing to the existence of arrears to the World Bank and the IDB, the ESR III monthly targets provided a good substitute to keep the program on course by tying tranche releases to successful performance. The second focus, and the one where USAID's contribution is the most original in comparison with the international agencies, is the emphasis on breaking up state monopolies in key areas of the economy. The first area is government control of most exports and a substantial portion of imports. Conditionality provided the impetus for the Government of Nicaragua to avoid legal obstacles to privatization via creative legal interpretation, in order to end the state monopoly of traditional exports. In a like manner, legislative changes were promulgated to permit private banking and promote privatization. Both reforms are essential to a functioning market system, even in the presence of favorable macroeconomic conditions.

Local Currency Generation

Under ESR I and ESR II there was no effective local currency programming. Although the Government of Nicaragua was required to deposit the proceeds of U.S. dollar sales in an earmarked account, USAID/Nicaragua did not formally require and monitor specific uses of these funds. Even though no formal local currency management procedure was established, however, a local currency counterpart did exist for ESR I and II. The Central Bank, as the government's representative in managing the funds, received the proceeds of dollar sales, which it then gradually transferred to the Treasury as budget support. Since one purpose of balance-of-payments support is to supplement tax revenues (as shown in the preceding section), this procedure is effective and should continue as long as the currency created falls within credit management guidelines.

The ESR III agreement on local currency continues prior practice in a more explicit way. Counterpart deposits can be used for budget support, offsetting exchange losses of the BCN, or repaying Government of Nicaragua debt to the BCN. As with ESR I and II, as long as such uses do not violate credit management guidelines and fiscal programming, there is no harm in local currency generation. Only in relatively unlikely scenarios could the timing of córdoba creation lead to inflationary pressures. On the basis of experience of other Central American ESF programs, however, the evaluation team recommends that USAID/Nicaragua avoid the temptation of micromanaging ESR-generated local currency. A programming exercise attempting to match specific funds and specific spending projects would be a time-consuming and inefficient use of A.I.D. and Government of Nicaragua staff resources.

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Chapter 3

EFFECTIVENESS OF ESR POLICY CONDITIONALITY

In terms of compliance with conditionality and the immediate effects of that compliance, the Nicaragua ESR programs have been among the most successful policy-based ESF efforts to date in Central America. Requirements set by USAID/Nicaragua have concentrated on private sector development and deconcentration of public sector influence, but have also included macroeconomic stabilization targets and clearing of arrears. The Government of Nicaragua has met each of the items of conditionality in a timely manner, and the short-term effects give cause for optimism. Of course the intermediate- and long-term impacts of conditionality are of paramount importance, but those impacts can be addressed only superficially at this early date in the stabilization and reform program. This chapter presents an analysis of the effectiveness of ESR policy conditionality, including its economic impact to the extent possible.[4] The first section assesses the conditionality of the ESR programs in terms of demand management, trade policy, financial sector reform, and privatization, and the final section addresses the prospective form of future programs.

Policy Reforms Resulting From ESR I, II and III

Beginning with ESR II, USAID/Nicaragua conditioned the release of successive tranches of dollar funding on Government of Nicaragua completion of policy-related goals in certain fields. The initial conditions were related to the stabilization program itself and included fiscal and monetary targets or demand management. Perhaps more important, and certainly more unique to A.I.D. within the overall reform program, were the structural changes implied by several private sector-oriented reforms, including demonopolizing foreign trade, opening the financial sector to private enterprise, and privatizing state-

[4]An analysis of the economic impacts of the ESR program at the firm or industry level, however, is beyond the scope and resources of this evaluation and, in addition, would be premature at this stage of the reform program.

owned enterprises. A.I.D. also supported the occupational conversion program and conditioned release of funding on certain public employment reduction targets (see Chapter 4).

Demand Management

With respect to macroeconomic management, the effects of ESR conditionality are best understood in the context of the overall stabilization program for Nicaragua, which was in large part a product of earlier A.I.D.-Government of Nicaragua policy dialogue. The policy reforms undertaken by the new government in the second half of 1990, many of which began to yield results in 1991, established a credible policy track record. On that basis the IMF initiated an informal monitoring program with the Government of Nicaragua in January 1991, as a prelude to a standby arrangement. The next major step was formulation of the Government of Nicaragua's 3-year Program for Economic Recovery and Growth, which was presented on March 25, 1991, to the Consultative Group meeting in Washington. The implementation of the program, prepared with the assistance of USAID and the IFIs, began on March 3, 1991. The program is comprehensive, consistent, and sequenced reform in the areas of stabilization, structural adjustment, and poverty alleviation. Elements of this program have been incorporated in the policy commitments underlying USAID/Nicaragua's ESR III, the IMF standby arrangement, the World Bank's economic recovery credit, and the IDB's trade and finance adjustment loan. ESR II is also relevant because it helped pave the way for the March program.

ESR II conditionality with respect to demand management was specific and covered a wide range of policy reforms, including (1) preparation of an economic program consisting of a fiscal program with specific targets for expenditure reduction and deficit reduction, and a corresponding monetary program containing a target for the reduction of the growth rate of liquidity to a level consistent with price stability; and (2) compliance with the fiscal and monetary targets included in the economic program submitted to the Paris Consultative Group meeting in December 1990. These conditions have been met in full, as have related conditions for public employment reduction, which are dealt with in detail in Chapter 4.

The tranche release conditions of ESR III with respect to demand management required compliance with the monthly targets in the Government's March economic program for net domestic assets of the Central Bank of Nicaragua (BCN), net foreign assets of the Central Bank, and net credit of the Central Government for March 1991 (required for first tranche release mid-April), April 1991 (required for second tranche release mid-May), May and June 1991 (required for third tranche release mid-July), and July, August, and September 1991 (required for fourth tranche release mid-October). The Government has complied with ESR III conditionality regarding demand management, including that for the 4th tranche release.

Not only has the Government of Nicaragua been able to comply with all the conditions of ESR II and ESR III, but it has also been able, according to preliminary figures, to comply with the quantitative performance criteria of the IMF standby arrangement for September 30, 1991, including those with respect to demand management—namely, targets for current expenditures of the Central Government, net domestic bank credit to the nonfinancial public sector (NFPS), net domestic assets of the Central Bank, and net international reserves of the Central Bank. Since the IMF has quarterly targets, this is the first set of performance criteria monitored under the standby arrangement.

The demand management policies and measures that have enabled the Government of Nicaragua to establish such a good track record are discussed at length in Appendix D. In the case of fiscal policy, these policies have consisted of (1) tax reform and tariff reform, implemented in late 1990; (2) measures to reform tax administration, initiated in late 1990 and continuing; (3) rigorous expenditure restraint in general, including, in particular, the Occupational Conversion Program (PCO); and, above all, (4) firm government commitment since January 1991 to limit expenditures to available revenues and foreign grants and not permit the nonfinancial public sector to have recourse to net domestic bank credit.

In the field of monetary policy, the basic approach has been to limit the use of liquid resources provided to BCN (by the public's willingness to hold domestic liquid financial assets, and through counterpart of foreign grants to the Government of Nicaragua and medium- and long-term foreign loans to BCN), in order to permit overall balance-of-payments equilibrium (i.e., no change in net international revenues of BCN) in 1991. Since the nonfinancial public sector has been denied access to net domestic bank credit, more of BCN liquid resources have been made available to the private sector. This policy has involved severe limiting of rediscounts to state-owned banks, forcing them to begin improving their operational and institutional capabilities. Returning confidence (with the end of hyperinflation) has led to an increase in the public's willingness to hold domestic liquid financial assets. This, in turn, has been translated into an increase in BCN's net international reserves, given the rather weak private sector demand for credit owing to depressed economic conditions. Monetary management in 1991 was simplified because of the replacement of the paper córdoba with the córdoba oro in March. These monetary measures, supplemented by a significant liberalization of interest rate policy, have laid the groundwork for a major reform of the financial system (Appendix E). Another key factor is that credit discipline is being introduced with emphasis on loan recovery (with an 80 percent recovery rate so far this year) and sound lending criteria.

Crucial to the successful implementation of fiscal as well as monetary policy has been the establishment of a monthly programming and monitoring process—a process encouraged by the monthly ESR targets.

Trade and Foreign Exchange Liberalization

With respect to trade liberalization, release of the second tranche of ESR II requires the licensing of private operators in foreign trade activities, currently is the exclusive province of state-owned enterprises. This condition has been substantially met. Even though state trading cannot be formally abolished—since the constitution inherited from the previous regime establishes a state monopoly of foreign trade for the traditional export commodities—the Government of Nicaragua has acted to open up export and import business (except petroleum imports) to private traders. ESR III also includes the covenants (not tranche release conditions) that the Government of Nicaragua will carry out a study of nontariff barriers and will continue to license all eligible firms without discrimination. Available evidence indicates that these covenants are being met, although the evaluation team has not seen the study of nontariff barriers or interviewed potential licensees. Hence, ESR II and ESR III conditionality with respect to trade liberalization has been fulfilled.

The initial impacts of this conditionality compliance are evident, although significant concrete benefits can hardly be expected in the context of Nicaragua's damaged economy. For a full decade, Sandinista economic policy insulated the domestic economy from international prices by a highly protective system consisting of tariffs, taxes, state trading, quantitative restrictions, foreign exchange rationing, and multiple exchange rates. In the period of little less than a year between President Chamorro's assumption of power and the inauguration of the new stabilization program in March 1991, tariff and tax rates were cut, state trading monopolies were eliminated in principle, quantitative restrictions were eliminated except on grains and certain other foods, access to foreign exchange was made much easier, and a unitary exchange rate was established. The remainder of this section will concentrate on what are now the most important trade-related issues: (1) the current role of state trading companies in exporting and importing; (2) the high levels of protection inherent in the tariff and tax system and the plans to reduce them; and (3) some remaining quantitative restrictions. Notwithstanding the early policy gains, the continuing general objective of the reform program is to open up the economy to international competition as widely and as rapidly as possible. The tariff reduction schedule has become a condition for release of part of the new IDA Economic Recovery Credit (ERC) loan.

Efficient administration of Nicaraguan foreign trade requires that state trading either eventually be eliminated through competition with the private sector or survive only by adopting private sector methods. The basic goals of trade liberalization should be to reduce protection sufficiently that domestic producers compete with imports in their respective sectors, while exporters are able to compete abroad without disadvantage from the high cost of protected domestic inputs. Finally, to the extent that some import limits are required, quantitative controls should be replaced by tariffs, since pricing is a more effective rationing device.

Details of past and current state trading, tariffs/taxes, and quantitative restrictions are analyzed in Appendix G. In the case of state trading, the conclusion of the evaluation team is that public enterprises do not hinder imports in any obvious way, now that foreign exchange is freely available to both private and public sector importers. Private import-based commerce, in fact, is the most rapidly growing sector of the economy. With regard to exports, the more important problem is that the *producers* of certain major products are still in the public sector: trading companies per se are not the major impediment to growth, and their influence can be eliminated in the same manner as that of import trading companies, once production is in private hands.

Liberalizing the foreign exchange system has eliminated the first barrier to competition with imports, but Nicaragua remains a highly protected economy behind its tariffs and taxes on imports. In the intermediate term, this protection may be more important than state trading as a deterrent to competition, and the Government of Nicaragua should proceed as quickly as possible with tariff reform, before a counter-reform interest group coalesces. Resistance in business circles to the rather drastic tariff reduction has apparently been slight so far. Such reductions will begin to be felt more sharply in the spring of 1992, when the ceiling falls to 40 percent, which would still produce an *effective* rate of 70 percent (as explained in Appendix G). Only at the end of the process, when the ceiling falls to 20 percent, will real payoffs in increased efficiency begin to be evident.

Financial Market Reform

The basic approach of ESR conditionality in the financial arena has been to open the sector to private banking. ESR II conditionality required the licensing of privately owned financial intermediaries, and the conditions of ESR III are to permit the establishment (on a nondiscriminatory basis) of private banks empowered to offer a full range of commercial banking services—that is, to buy and sell foreign exchange, open letters of credit, and accept deposits. In terms of compliance, one private bank started operations in August 1991, and four others have been licensed; the BCN has allocated them all equal initial shares of ESR funding. These banks are authorized to perform all the functions specified above. In addition, four private exchange houses have been authorized and are functioning. Thus, all the ESR II and ESR III conditions with respect to financial market reform have been fulfilled. The implementation of financial sector reform so far (as detailed in Appendix E) represents an excellent beginning for the short period of time the reform has been under way. This progress is an indication that not only are Government of Nicaragua officials complying with conditionality but that they support the policies involved, so that most implementation problems are of a technical nature (where foreign aid can be most helpful) rather than of an internally political nature.

As in the case of trade reform, financial sector policy reform and its immediate impacts are positive, in the context of a badly damaged and distorted Nicaraguan economy. Various studies of the Nicaraguan economy conducted by external donors in the past year have commented that, in 1979, Nicaragua had one of the most advanced financial systems in Central America. The financial system deteriorated greatly over the next decade as a result of policies similar to those followed in centrally planned economics in Eastern Europe and elsewhere, and with similar results. Examples of policies implemented include exchange controls, import controls, and, in general, a high degree of state intervention in and control over policies and operations of financial institutions, including nationalization of banks and elimination of competition from private banks. The Central Bank of Nicaragua became involved in commercial activities, leading to control of interest rates and imposition of low ceilings that resulted in highly negative real interest rates. Subsidized credit and preferential interest rates were offered for favored activities and to favored sectors and borrowers, culminating in periodic forgiveness or rescheduling of overdue loans and the erosion of accounting standards and virtual absence of meaningful, prudent bank supervision.

As a result of the pursuit of such policies for more than a decade and hyperinflation, professional competence suffered and overstaffing of financial institutions became the rule. At the beginning of 1991, the four nationalized banks had a staff of nearly 8,000, and the ratio of administrative expenses to total assets was 8 percent on the average, compared with a maximum of 3.4 percent recommended for bank soundness. Nonperforming loans amount, on the average, to almost 50 percent of the loan portfolio, or three times the capital and reserves, of the nationalized banks.

It is important to note the significant progress made this year. By October 1991, the four nationalized banks had reduced staff by 38 percent, to approximately 5,000. Private banks now at least do exist and can perform most normal commercial banking functions, and they are now given precedence for Central Bank credit. The first functioning bank is currently issuing a significant volume of letters of credit and has an extensive list of initial loan requests, although deposit taking has yet to reach a significant level.

From the very beginning, financial sector reform has been high on the agenda of the new government and external donors, but higher priority had to be accorded to the control of hyperinflation. During the formulation of ESR I and II, financial sector reform issues were discussed, but only in ESR III was conditionality with respect to financial sector reform formally included. The current IMF standby and the World Bank's ERC include binding performance criteria with respect to financial sector reform.

Privatization

The USAID/Nicaragua approach to encouraging privatization of state-owned enterprises has been to support planning and valuation and to arrive at reasonable divestment procedures, while staying clear of the constitutional and administrative details of the process. Under ESR II, the condition for release of the third tranche required the establishment of a regulatory framework for the privatization of state-owned enterprises. In response to this condition, CORNAP produced a strategy for privatization in June 1991. ESR III includes a covenant that the Government of Nicaragua will continue to implement its privatization program. Such implementation is proceeding, as shown below. Hence, ESR II and III conditionality with respect to privatization has been fulfilled.

From 1980 onward, beginning with the confiscation of the property of Anastasio Somoza and his family, the Sandinista state attempted to nationalize the economy of Nicaragua. As a result of various prior stages of nationalization, legal or semilegal purchase, and outright confiscation, the Chamorro administration in 1990 inherited about 350 enterprises distributed over the agricultural, industrial, and service sectors. These include farms, stores, factories, hotels, fisheries, and other properties, all currently managed by CORNAP. The holdings of this agency do not include the traditional public sector of public utilities and transport, nor do they include the banking system. There are no current plans to sell utilities, but the financial sector is being opened to private investment. CORNAP estimates that, as of 1990, its holdings were producing 31 percent of GDP, including 40 percent of industrial production, 50 percent of fisheries, and major parts of the traditional agricultural exports such as coffee and sugar. CORNAP's task is to manage these enterprises temporarily while developing a strategy to return them to the private sector, liquidate them, or otherwise regularize their position so that CORNAP itself can eventually be phased out. It has a small staff, must rely for most of its substantive work on consultants, and is under contradictory pressure from many directions—former owners, workers, peasants, fishermen, and parts of the government.

Two sets of procedures for privatization are currently in use in Nicaragua. Under the first, once a company is determined to be claim free, has a labor force prepared to accept privatization, and is potentially attractive to local or foreign investors, it will be valued and probably sold by bid. If it has problems but is still economically attractive, it may be leased or in some cases operated for CORNAP by management contract. Workers can claim up to 25 percent of the state-owned shares. This procedure applies to industrial and service enterprises, including agroindustry, but not to operating farms. Because of conflicting political forces, the need to settle former soldiers of both sides, and the need to find land for local residents, state-owned farms will have ownership transferred by political negotiations, managed by the Office of the President, rather than by bid.

To the extent that CORNAP must resort to leasing, selling shares to workers or peasants on long-term credit, or financing outright sales itself, the proceeds of divestiture will be reduced and their collection will be delayed. So far as the evaluation team was able to determine, no projection of potential revenue from this source for 1992 and 1993 has been developed. This would be a highly useful exercise, in part because it would force CORNAP analysts to think through their assumptions concerning the firms they are seeking to privatize to meet certain targets (see below and Appendix E).

To date, the ESR programs have not mandated numerical goals for privatization. Nicaragua agreed with the World Bank in September, however, when signing its first IDA credit, that as a condition for release of the second tranche in March 1992, it would completely privatize 25 more enterprises in addition to the three already sold (by procedures no longer considered acceptable). This process will apply to only 152 companies; the rest will be returned to original owners, liquidated, or attached to ministries operating in their sector of activity. The expressed targets are an excellent means of accelerating the process and concentrating CORNAP on specific companies. The danger is that in order to reach these targets, CORNAP may resort too frequently to leasing or worker buyouts, which might bring short-term benefits in the form of better management but might delay the real privatization decision until later, when the climate may be less propitious. A similar pressure could exist in the agricultural sector, where new and complex ownership patterns, with political considerations controlling, offer little basis for belief that efficiency in responding to market forces will be noticeably enhanced by the transfer of ownership.

In conclusion, privatization has progressed to a reasonable extent under CORNAP, with support and conditionality from the ESR programs. Setting specific targets, however, has been left to the World Bank, with A.I.D. conditionality concentrating on planning and support. At this stage, target setting involves several risks, and USAID/Nicaragua may be well advised to consider supporting studies and projections before arriving at specific divestiture targets.

Recommendations for Future Policy Conditionality

The major policy reforms constituting initial USAID/Nicaragua ESR conditionality—stabilization measures, elimination of state trading, private banking, privatization, and trade liberalization—are all under way, and some have become part of the conditionality of the multilateral organizations, including the IMF, the IDB, and the World Bank. These reforms are still at early stages and will require careful monitoring for the next few years, which in itself could occupy a significant portion of any future ESR conditionality. In addition, USAID/Nicaragua could maintain the policy reform lead by developing new policies appropriate to the next stage of the stabilization process, facilitating the resumption of growth.

In terms of reinforcing current conditionality policy, four areas will require special attention: (1) public sector employment reduction; (2) privatization; (3) financial sector reform; and (4) improving tax and custom revenues. Concerning employment reduction, and in view of the success of the Occupational Conversion Program thus far, the obvious recommendation is to continue the PCO or a similar mechanism, with attention to specific employment targets. The goal should be to reduce the public sector proportion of total employment to an acceptable level by regional standards, while increasing the minimum standard of public sector productivity.

The Government of Nicaragua should neither consider CORNAP as a long-term revenue earner nor base current expenditure projections on the prospect of CORNAP earnings. However, in terms of privatization, CORNAP should consider its intermediate-term revenue prospects from both the proceeds of sales and leases and the efficient management of the enterprises under its control. Additionally, the Government of Nicaragua should plan to increase the pace of actual divestiture. These requirements could lead to a three-part ESR condition:

- Develop a realistic projection of revenue expected from the sale and lease of the firms earmarked for privatization.
- Design a budget and intermediate-term management plan for the remaining portfolio, indicating gross sales, operating expenses, and capital requirements, separating profitable firms from loss-producing firms.
- Develop separate divestiture and financing strategies for the above classes of firms, setting concrete schedules and targets for sales.

The restructuring of the financial system, and the state banks in particular, is a monumental undertaking. While the World Bank has a phased action plan, it is doubtful whether the Government of Nicaragua will be able to complete the required tasks with currently available technical assistance. Examples of areas in which support and corresponding conditionality would be helpful are as follows:

- Reform the state banks' accounting systems, assessing their true financial position. Identify nonperforming loans, prevent interest accruals on them, and build up loan loss reserves.

- Develop systems and procedures for the entire loan cycle—appraisal, scheduling, and follow-up.
- Develop acceptable cash management procedures.
- Assess the feasibility of simply allowing the state banks to fail, addressing both the economic costs involved and the prospective legal ramifications.
- Provide parallel assistance to private commercial banks and, in general, show no favoritism at any level to state banks.

Reforming a state-dominated financial system, even to the limited extent described above, will require significant technical assistance, as A.I.D.'s project experience in Bangladesh and other countries has shown. Lessons learned from those projects could be applied to the design of future ESR conditionality and related support.

Conditionality and related support for improving tax administration could also draw on expertise provided by A.I.D. to other countries, in terms of taxpayer identification to link different tax records, modernization of taxpayer rolls, and computerization. Past USAID projects in Ecuador and Guatemala, for instance, should be applicable in Nicaragua. The intermediate goals of such reform should be to increase taxpayer participation rates for all taxes to acceptable levels and to expand the tax base in general, with an equitable mix of tax sources. The specific elements of conditionality involved should be determined in close coordination with MIFIN officials, in order to avoid the mixed signals characteristic of certain other ESF programs (see Nathan Associates evaluation of the Philippine-program, Appendix B).

Areas in which new policy reform and related support will be necessary include (1) small business development, (2) export promotion, and (3) provision of medium-term credit. All three areas are crucial to the intermediate-term development of the Nicaraguan economy and would serve to improve the balance of payments situation in the medium term. A rapid increase of export earnings—in tandem with a growing, export-oriented small business sector—would be an effective way to promote growth and economywide efficiency. As shown in other sections of this report, however, such development will require medium-term credit, which is not currently being provided by the financial. system.

The A.I.D. export and investment promotion programs in Central America and the Caribbean have provided a wealth of experience and lessons learned in this field, and the design of Nicaragua's system should take these lessons into account (see the Nathan Associates/CDIE evaluation cited in Appendix B). An export promotion center, a joint effort of the Government of Nicaragua and COSEP, is already under way, and laws are being drafted to provide incentives to foreign investors, including Nicaraguans residing abroad. Although a full assessment of this effort is outside the scope of the current report, the evaluation team has reviewed the preliminary planning documents and legislation and has concluded that the export/investment promotion effort may require additional support, and perhaps conditionality, in the following areas:

- A.I.D. should require a survey of the obstacles to export promotion in Nicaragua, including public policies such as trade protection, state trading, taxes, investment permits, and exchange rate management. The survey team should also address infrastructural and micro-level impediments to exportation, although policy-level barriers have proved to be most important. The study should be supplemented by a comparison with the promotion programs and general export competitiveness of Nicaragua's neighbors.

- The Government of Nicaragua should carefully re-evaluate the intent and strategy of its investment and export promotion laws. The opinion of the evaluation team is that the tenor and content of these initial efforts are not competitive with other regional programs, especially those of Costa Rica and Mexico. In particular, the Government of Nicaragua should re-evaluate: (1) restrictions on repatriation of capital and earnings, (2) foreign exchange restrictions on investors, (3) guarantees against expropriation, (3) the need for tax exemption, (4) the administrative procedures for approving foreign investments and export grants, and (5) the need to specify time limits for official decisions.

The initial A.I.D.-supported study of obstacles to export promotion should specify concrete elements of ESR conditionality for a continuing export/investment promotion program.

The final area in which ESR support may be required is that of provision of medium-term credit, an issue mentioned by several investors interviewed by the evaluation team (see Chapter 6) and one likely to increase in importance as the economy improves. Although such credit should normally be forthcoming from the medium-term liabilities or paid-in capital of private financial institutions, such sources are understandably scarce in Nicaragua. In the longer term, the ongoing development of the financial sector (perhaps supported by a USAID project in this field) will provide a basis for increased investment credits, but for the immediate future, donor credit may be required. USAID/Nicaragua should consider providing medium-term credit to private sector financial institutions through the BCN, after sufficient feasibility studies are undertaken and technical assistance is provided to the banking subsector. The intention of the technical assistance should be that the banks and borrowers conceive of these credits as loans to be repaid, and that they understand the corresponding loan administration. At all costs, USAID/Nicaragua should avoid promoting the attitude engendered under the Sandinista regime that bank credit is a gift. The studies and prior technical assistance could provide elements of conditionality for the corresponding ESR tranche releases.

As a final comment concerning ESR conditionality and policy dialogue, the evaluation team recommends that USAID/Nicaragua continue the "positive and collegial" approach to policy design mentioned in Chapter 2. In certain other ESF programs evaluated by this team, the policy dialogue has proceeded in a rather different manner, with negative consequences for policy reform (see selected evaluations by Nathan Associates listed in Appendix B). At this point, USAID and Government of Nicaragua officials are participants in the policy formulation process, and conditionality is not viewed as an imposition of an external viewpoint but rather as support of Government of Nicaragua policy reform; that attitude should continue.

Chapter 4

IMPACT OF PERFORMANCE-BASED DISBURSEMENT ON OCCUPATIONAL CONVERSION

In March 1991, as part of a comprehensive public sector restructuring effort, the Government of Nicaragua initiated the implementation of an Occupational Conversion Program (Programa de Conversión Ocupacional—PCO), a euphemism for employment reduction. The budgetary costs of this program (indemnization payments) through September 1991 have largely been financed by ESR III releases, and corresponding conditionality has been established. The analysis presented below indicates that ESR conditionality with respect to public sector employment reduction has been fulfilled and that significant budgetary savings should be realized from 1992 onward. This chapter is devoted to an analysis of the contribution of the PCO to the reduction of the budget deficit and hence to the success of the stabilization program. The first section of the chapter describes the PCO, while its budgetary impact is estimated in the second section. The final section of the chapter presents the conclusions in terms of the budgetary and macroeconomic impact of the net savings. General information concerning Nicaraguan public sector employment and detailed calculations of costs and benefits of PCO are presented in Appendix F.

Description of the Occupational Conversion Program

The Occupational Conversion Program was initiated in March 1991 as part of the Government of Nicaragua macroeconomic and structural adjustment program, providing incentives for the voluntary departure of employees from the public sector payroll. The PCO has the following objectives:

- Reduce the size of the public sector and thus improve public sector efficiency;

- Reduce the budget deficit through cuts in current expenditures and thus contribute to the containment of inflation;

- Create jobs in the private sector by offering incentives for private employers to hire PCO optees;

- Encourage the departing public sector employees to undertake productive activities, in order to rehabilitate and expand the network of microenterprises and thus contribute to economic recovery; and

- Facilitate the privatization of specific services such as security service, food service, and maintenance of installations, offices, vehicles, and equipment.

The basic mechanism of the PCO is to make it attractive for employees to leave public service voluntarily by choosing one of four options. All posts rendered vacant as a result of the departure of PCO optees will to be eliminated immediately. All civilian public sector employees in good standing, with more than 6 months of service on January 1, 1991, are eligible to subscribe to this program and avail themselves of one of the options, subject to the approval of the head of the institution. (Such approval would be given routinely unless the departure of the employee would endanger the basic functioning of the institution.) A key condition is that a PCO optee shall not return to work in a public sector institution for 4 years unless the optee pays back all the benefits received. The PCO does not cover military personnel, whose numbers are being reduced under a separate program run by the Ministry of Defense.

The four options are as follows:

Option A (private sector option): Payment of indemnization in the form of a lump sum of up to 12 months' salary, subject to a limit of CO$7,800. In addition, if the optee secures employment in the private sector, the private employer will receive a tax credit for 50 percent of the salary paid to the optee for 12 months, subject to a limit of CO$7,800.

Option B (private sector option): Payment of indemnization in the form of a lump sum of up to 12 months' salary, subject to a limit of CO$7,800. In addition, if the optee starts his/her own business (microenterprise), he/she will receive bank credit from Banco de Crédito Popular in an amount up to 24 months' salary, subject to a maximum of CO$15,600.

Option C (free option): Payment of indemnization in the form of a lump sum of up to 20 months' salary, subject to a limit of CO$10,000.

Option D (free option): Payment of indemnization of up to 30 months' salary to be disbursed in 10 monthly installments, subject to a limit of CO$10,000.

As expected, given the suffocation of entrepreneurial initiative during the Sandinista regime, over 99 percent of the optees chose Option C. However, it is known that many of the optees have used the lump sum payment to start microenterprises. Even the *Barricada*, the Sandinista daily, has disapprovingly cited the "ephemeral" burst of entrepreneurial activity as a result of the PCO.

The implementation of the PCO was undertaken in five phases of 1 to 2 months each during the period March-September 1991: Phase I, March 1-April 15; Phase II, April 16-May 14; Phase III, May 15-June 30; Phase IV, July 1-July 31; and Phase V, August 1-September 30.

Cost and Savings of Occupational Conversion

Since the costs of the PCO as currently envisaged are likely to be short term, while most of the benefits are medium to long term, a clear net comparison requires careful specification of the periods involved. As shown below, however, the positive net impact of the program is never in doubt from the second year onward. (See Appendix F for detailed calculations. The figures cited here are taken from the tables in that appendix.) The short-term cost of the PCO is considered to be essentially the same as the indemnization paid. Since 99.1 percent of the optees chose Option C, short-term costs incurred in other options are negligible. Since it appears certain that there were very few, if any, PCO optees 56 years or older who would reach the retirement age of 60 prior to 1993, the indemnization payments are deemed to represent the full cost of the PCO.

The number of central government optees was predominant in the first two phases but declined rapidly in the last three phases. The number of PCO participants from autonomous public enterprises became significant in the second, third, and fourth phases. Optees from CORNAP enterprises constituted the bulk of retirees in the fifth phase. Of the March-September 1991 total, the share for central government was 51 percent, while autonomous public enterprises accounted for 23 percent and CORNAP enterprises registered 20 percent. The shares of INSSBI and public financial institutions were small, and municipalities were not participants in the programs.

The reduction in central government employment as a result of the PCO amounted to a little under 13 percent of the "nómina fiscal" at the end of March 1991, as defined in Appendix F on public sector employment. For other public sector components, the reductions in their work force at the end of March 1991 were as follows: INSSBI, 18 percent; autonomous public enterprises, 27 percent; public financial institutions, 4 percent; and CORNAP enterprises, 21 percent (of the staff of CORNAP enterprises participating in the program). These figures show that the implementation of the PCO has already had a significant impact in terms of reduction in public sector employment.

For the public sector as whole, net savings were predicted to be negative in 1991 but slightly positive in 1992. For 1993, gross savings were predicted to be large owing to the cumulative effect of savings resulting from actual PCO operations in 1991 and planned PCO operations in 1992. Since there would be no PCO costs in 1993, net savings would be the same as gross savings. Assuming no new PCO programs, as well all other things being equal, the savings registered in 1993 would continue at the same level in 1994 and beyond. These PCO-generated net savings will have far-reaching budgetary and macroeconomic implications, as analyzed below.

Budgetary and Macroeconomic Impact of Net Savings as a Result of Occupational Conversion

The impact of the PCO on public sector finances can be measured by the net savings, as presented in Table 4-1 (See Tables F-1 to F-6 in Appendix F for detailed calculations). For central government, there would be negative savings (i.e., increased expenditures) of 0.4 percent of estimated 1991 GDP in 1991 and savings of 0.4 percent of projected 1992 GDP in 1992—or an improvement of 0.8 percent of GDP in 1992. In 1993 and in subsequent years, the Government of Nicaragua would reap savings of 0.6 percent of projected 1992 GDP. For the nonfinancial public sector, there would be negative savings (increased expenditures) of 0.7 percent of estimated 1991 GDP in 1991, savings of 0.7 percent of projected 1992 GDP in 1992, and savings of 1.1 percent of projected 1992 GDP in 1993 and beyond. It must be reiterated that the negative savings (increased expenditures) are notional to the extent that they are financed by ESR releases.

Thus, the improvement in NFPS performance that can be ascribed to the PCO would be substantial in 1993 and subsequent years. In order to give an idea of the order of magnitude of the improvement, the 1991 NFPS deficit (after grants and including unpaid, scheduled foreign interest) is estimated at 16.2 percent of 1990 GDP in the IMF program. For the public sector as a whole, there would be negative savings (increased expenditures) of 0.9 percent of estimated 1991 GDP in 1991 and savings of 0.8 percent of projected 1992 GDP in 1992 and 2.1 percent of projected 1992 GDP in 1993 and in

Table 4-1. Estimated Cost, Gross Savings, and Net Savings, 1991-1993 (thousands of córdobas oro)

	Cost			Gross Savings			Net Savings		
	1991	1992	1993	1991	1992	1993	1991	1992	1993
Nonfinancial public sector	99,133	22,200	-	52,142	89,484	98,484	(46,991)	67,284	98,484
General Government	68,123	14,200	-	35,805	58,044	63,444	(32,318)	43,844	63,444
Central Government	61,889	14,200	-	31,854	51,984	57,384	(30,035)	37,784	57,384
INSSBI	6,234	-	-	3,951	6,060	6,060	(2,283)	6,060	6,060
Municipalities	-	-	-	-	-	-	-	-	-
Autonomous Public Enterprises	31,010	8,000	-	16,337	31,440	35,040	(14,673)	23,440	35,040
Public Financial Institutions	3,121	36,600	-	2,069	22,428	41,628	(1,052)	(14,172)	41,628
Cornap Enterprises	27,070	24,300	-	12,225	40,632	53,232	(14,845)	16,332	53,232
Total Public Sector	129,324	83,100	-	66,436	152,544	193,344	(62,888)	69,444	193,344

Note: The columns in this table represent the sums of the corresponding columns of Tables F-4 and F-5; thus, this table takes into account PCO implementation results for March-September 1991, as well as planned PCO implementation during 1992.
Source: Tables F-4 and F-5. Figures are derived from GDP estimates by BCN (October 1991): 1990 - 1,488,400 and 1991 - 6,751,800; and IMF mission (August 1991): 1991 - 6,751,800 and 1992 - 9,275,000. Note that estimates are identical for both sources.

subsequent years. The size of the expected public sector savings during 1993 and beyond is much larger than that for NFPS because of the large number of optees from public financial institutions and CORNAP enterprises in the fifth phase of the 1991 PCO and the planned 1992 PCO. Tentative plans for the 1992 PCO involve a total of 10,000 employees classified as follows: central government, 2,000; autonomous public enterprises, 1,000; public financial institutions, 4,000; and CORNAP enterprises, 3,000. This plan may be compared with actual PCO operations during March-September 1991 that involved almost 17,000 employees classified as follows: central government, 8,700; INSSBI, 700; autonomous public enterprises, 3,900; public financial institutions, 300; and CORNAP enterprises, 3,400 (see Table F-1 in Appendix F).

The negative savings (increased expenditures) in 1991, resulting from PCO implementation, should not be a cause for concern, since the cost of PCO is being financed through USAID grants. Under the ESR program, USAID has provided accelerated import financing for policy-based disbursement amounting to $22.5 million. Of this amount, $20 million has been released in four tranches of $5 million each, with each tranche representing an advance payment for the reduction of 2,500 employees. The balance of $2.5 million, plus additional amounts to be allocated later by USAID, will support the planned continuation of the PCO in 1992. As mentioned above, after termination of the fifth phase at the end of September 1991, PCO implementation will have been put on hold by MIFIN for the rest of this year, owing to lack of external financing.

As demonstrated in Appendix F, there was a reduction of 19,039 in public sector employment (excluding ministries of Interior and Defense) during the period March-September 1991, which exceeds the PCO reductions in the same period by 2,053. The additional reduction is due to the operation of factors other than the PCO, such as the freezing of positions and non-filling of vacancies adopted by the Government of Nicaragua in November 1990. In addition to these numbers, there was a reduction in military personnel of the Ministry of Defense of 5,000 in March 1991 and of 2,732 in August 1991, as well as a reduction of 393 in the civilian personnel of the Ministry of Defense in August 1991.

Two notes may be added to the above discussion. First, the evaluation of the budgetary impact of PCO implementation is not affected by the general salary adjustments granted in March and June 1991, since these adjustments have already been taken into account in the monthly budgetary planning for 1991. As shown in Appendix D on recent wage developments, the sectoral wage increases granted in recent weeks have so far not been large enough to warrant a re-examination. However, given the recent accentuation of pressures for wage increases, the public sector wage bill must be kept under continuing review. Second, since the cost of PCO is being financed through ESR releases, it may be argued that the gross savings figures in Table 4-1 are really equivalent to net savings from the Government of Nicaragua's budgetary point of view.

Chapter 5

EFFECTS OF ESR-PROVIDED FOREIGN EXCHANGE ON IMPORT ACTIVITY

This chapter is intended to compare ESR-supported imports with total Nicaraguan imports in terms of their economic use, their geographical origin, and the sector to which they are destined. The chapter also examines the utilization rate of ESR funds during 1991 to determine the relative roles of internal demand, Central Bank foreign exchange management, and U.S. administrative procedures (which is addressed in more detail in Chapter 6). Appendix G contains an analysis of Nicaragua's demand for general imports (excluding those associated with external project financing), in order to establish an economic context in which to analyze the demand for ESR-financed imports. The direction of Nicaraguan exports and imports is also analyzed in that appendix. The general conclusion of this analysis is that the trade-related objectives of the ESR programs—promoting private sector imports, promoting U.S. imports, and delivering fast-disbursing aid in support of Nicaraguan stabilization goals—are largely being met.

Overall Imports by Economic Purpose

In this section total imports are compared with that proportion funded by the ESR-BOP support programs, by economic purpose. The proportion of total imports ordered by the public and private sectors can be determined for ESR imports but not for the total. Table 5-1 presents total imports by economic purpose, as a starting point to comparing them with the A.I.D. balance-of-payments support program.

Table 5-1. Total Imports
(US$ millions)

	1989	1990	1990/I	1991/I	1990/91
Consumer	102	163	65	70	168
Nondurable	90	140	57	54	137
Durable	18	33	8	16	41
Petroleum	94	129	46	54	122
Crude	81	109	42	50	117
By-products	13	20	4	4	5
Intermediate	213	160	62	65	163
Agriculture	65	25	12	10	23
Industry	125	109	40	47	116
Construction	23	27	9	8	26
Investment	200	188	103	83	160
Agriculture	12	12	7	5	10
Industry	95	79	37	41	83
Transportation	93	97	58	37	76
Total imports, c.i.f.[a]	615	665	276	272	661

[a] Components do not add up to totals because of adjustments between Central Bank and Customs data that are not broken down by category.
Source: Central Bank.

The last column in the table represents the 12 months ending in June 1991. The apparent stability of overall imports is the product of a flat trend for intermediate imports (raw materials and semifinished inputs) and a declining one for those oriented to investment and growth in consumer goods, particularly durables. The decline in the investment category is concentrated in the transport sector. Currently, each of the major categories is slightly larger than 25 percent of total imports, while crude oil and products account for about 20 percent of the total.

The next relevant comparison is between the product breakdown of ESR-supported imports and that of total imports, inasmuch as the available data allow (A.I.D.-supported import data are not available by month and by economic use). ESR Grant Agreements I, II, and III have provided Nicaragua with $340.5 million, including $75 million for payment of multilateral arrears, since the first payment was made in June 1990, through the end of September 1991. Disbursements as of that date have equaled $224 million. The table is based on central bank data for actual ESR-supported imports and thus reports smaller magnitudes than the total disbursements cited above. The table below assumes that the cumulative disbursements that took place between June 1990 and September 1991 have the appropriate timing and size to make a realistic comparison of commodity composition with total imports in the 12 months ending June 1991.

Table 5-2. Comparison of ESR-Supported and Total Imports, by Product

	E.S.R.-Supported Imports			
	US$ millions	(Percentage of Program)	(Percentage of All Imports in Category)	Total Imports (US$ millions)
Consumer	0.6	1	0.4	168
Petroleum	114	81	93	122
Intermediate	19	14	12	163
Investment	6	4	6	160
Total	140	100	21	661

Source: Estimates based on Central Bank data.

The A.I.D. program is equal to 21 percent of all imports, but because of its concentration in petroleum products, it pays for the equivalent of 93 percent of all imports of that type. In the intermediate category, ESR funding supports 12 percent of imports, while it supports 6 percent of investment category imports. The following table breaks down imports further, by the sector of destination (public or private) of ESR-supported imports. The entries are somewhat smaller than for the table above, totaling $119.4 million, because they relate only to cumulative disbursements through August 31, 1991.

Table 5-3. Sectoral Distribution of ESR-Supported Imports, by Product

	Public Sector		Private Sector	
	US$ millions	Percentage of Sector Total	US$ millions	Percentage of Sector Total
Consumer	0.1	0	0.7	6
Petroleum	98.3	91	0.6	5
Intermediate	8.8	8	7.5	64
Capital	0.5	0.4	2.9	25
Total	107.7	100	11.7	100

Source: Estimates based on Central Bank data.

Private sector imports have predominated in the nonpetroleum ESR-supported category, accounting for 55 percent of the total. Because petroleum imports are so extensive, however, and because they are an almost complete monopoly of the state enterprise (Petronic) 90 percent of total ESR imports have gone to the public sector. The evaluation team does not consider this proportion to be out of keeping with ESR goals and objectives, however, because petroleum imports are indispensable for the economic recovery of the country and because these imports are for private sector end users. Petroleum products are justifiably exempted from the general orientation toward promoting private sector imports. During ESR II, only the private sector imported goods other than oil. Under ESR III the public sector is

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Chapter 6

MANAGEMENT OF U.S. DOLLAR FUNDING UNDER THE ESR PROGRAMS

This chapter examines in detail the administrative procedures used by USAID/Nicaragua and the Government of Nicaragua for managing U.S. dollar funds under the ESR programs. A major contextual criterion for this examination is the joint USAID and Government of Nicaragua objective of moving the ESR funds as quickly and efficiently as possible within the framework of USAID regulations, consistent with objectives of the Economic Stabilization Program. In general the evaluation team has found that since the BCN reforms of September 2, 1991, administrative procedures have performed in this manner, although improvements are still possible.

The first section of the chapter examines the procedures implemented at the outset of the ESR programs and the changes that subsequently took place as a consequence of the reorganization of Central Bank personnel. It also examines the current Central Bank proposal to liberalize the foreign exchange market. The second section analyzes the methods of trade finance utilized by importers under the program, and the third section addresses the opinions of system users collected through interviews during the evaluation. The final section presents the team's specific program recommendations and a recommended plan of action to expedite fund utilization through the commercial banking system. Further operational details on the administrative systems addressed in this chapter are presented in Appendix H.

Review of Administrative Procedures for the Disbursement and Tracking of U.S. Dollar Trade Credit

Existing Procedures for Funds Transfer

Current requirements can be broken down into three phases of application: Phase I regulates the disbursement of A.I.D. funds to the separate account established by Government of Nicaragua in the Federal Reserve Bank of New York; Phase II governs the transfer of funds by the Government of lost market share and that consumers have become used to alternative non-U.S. products. The team found no evidence to support this claim, and the analysis of Chapter 5, as well as casual observation of imported goods, tends to contradict it. As noted above, however, improved access to information concerning U.S. products would help belie the claim.

Very few interviewees mentioned the three proforma price quotation requirement or the certificate of origin or any other ESR requirement as real obstacles to the utilization of ESR funds. Nevertheless, the three-quote requirement could be an imposition once trade accelerates. Although most traders customarily request quotes, they cease doing so after stable relationships are established. In addition, one may question why such quotes should be required, if importers are spending their own córdoba funds: it is in their own interest to have determined that the prices paid are fair, with or without formal quotes. There is no current problem in Nicaragua with capital flight, and thus there is no reason for public sector interference in a private sector pricing decision. Requiring three price quotes unnecessarily encumbers the ESR system.[5]

In the evaluators' opinion, even the valid interviewee complaints expressed above are being overtaken by events: (1) the U.S. market is becoming more accessible and supplier relationships are being re-established; (2) after the initial resistance of BCN, supplier's credit is being used by Nicaraguan importers; (3) the emergence of a responsible private banking system will improve importers' access to credit; and (4) the Nicaraguan market is readily accepting U.S. products despite the availability of alternatives from other sources. One example is the availability of a $3 million line of credit from Spain for the import into Nicaragua of hardware: importers have not used it, preferring better known U.S. products.

Several suggestions for alternative means of implementation were presented by the president of the Chamber of Commerce and by individual smaller importers interviewed during the assignment, including the following:

- Expand the base of utilization and motivate smaller importers to formalize their activities, reducing the minimum import amount to $5,000. This amount is the median single import amount of all registered importers.

- Accept the importation of used or factory reconditioned products. Because of financial limitations and availability, some manufacturers are buying used and reconditioned equipment in the United States, including water pumps, diesel engines,

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[5]For the same reasons, a price checking unit for Nicaraguan imports would be entirely out of place. Such a bureaucratic horror would have the effect of countering the private-sector-oriented intent of the ESR programs.

equipment for shoe manufacturing and tire retreading. Such used and reconditioned equipment is eligible under the TCIP.

- Permit the use of advance draft and term credit. Smaller importers claim that the former will expedite shipments and the latter will permit them to consolidate their supplier's credit.

- Establish a payment system similar to the Central American Payment System in which the importer, after possessing the merchandise, receives a check made out to the exporter's name and is responsible for mailing it. Smaller importers claim that this system effectively expedites shipments.

With regard to this list of suggestions, the evaluators' point of view can be summarized as follows: (1) Although the team sympathizes with small merchants, lowering the minimum transaction amount would overload the program with many small transactions that would complicate the authorization and tracking system. (2) The team found merit to the suggestion of making eligible used and reconditioned equipment, products such as diesel engines and water pumps have increased in price considerably in the past 5 years. There is great pent-up demand for these products and users are not sufficiently strong financially to afford them. (3) The team does not recommend advance draft payment because it is difficult to ascertain that the foreign exchange is utilized for the intended purpose. Neither the team nor A.I.D. has objections to supplier's credit, however. (4) An arrangement like the Central American Payment System implies a guarantee of payment to the supplier by the program's sponsor, and this element is not present in the ESR program. Furthermore, issuing checks to importers and having them mail them to suppliers is not common in international trade. The Central American Payment System will probably be replaced as soon as Nicaragua's banking relationships improve.

Recommendations

The following recommendations and action plan are based on the analysis of this chapter and that of Appendix H; they cover the areas of approval and implementation and expansion of the base of ESR users. In order to streamline the authorization process and to minimize the number of ineligible transactions, the team recommends the following actions:

- BCN should allocate ESR funds to the commercial banks on a first-come, first-served basis, but continue to be involved in the prescreening of import eligibility as outlined above. (The initial ESR allocation of $8 million to each commercial bank is not a violation of this principle, being necessary to start the allocation process.)

- BCN should encourage the use of ESR funds to back up supplier's credit for eligible import transactions completed after the effective date of the covenants. This measure is consistent with the objective of strengthening trade relations and would free reserves for additional imports.

- BCN should establish a centralized unit for monitoring the foreign exchange authorization procedure under the A.I.D. program. Currently, monitoring responsibility is shared by the three vice-presidencies: International Banking Operations, Foreign Trade, and Internal Control.

- USAID should approve the procedures proposed by BCN for foreign exchange authorization for ESR imports with the following exceptions:

  1. BCN should withdraw the authorization given to the U.S. correspondent banks to accept debit instructions directly from the local commercial banks;

  2. BCN should still review the eligibility of the transaction before authorizing the debiting of the separate accounts for the purpose of providing collateral for the letter of credit and;

  3. BCN should assign responsibility for the eligibility review to the vice-presidency of Foreign Trade and make it non-delegable.

- To expedite the eligibility review for approval of imports, BCN should initiate formal and informal consultation processes with the commercial banks. This procedure should be similar to that in place between BCN and USAID.

The evaluation team recommends the following steps in order to further expedite specific transactions:

- Although most importers are able to obtain three proforma invoices or a justification for not presenting them, in order to decrease the bureaucratic procedures associated with ESR requirements and to make them consistent with BCN requirements for other imports, decrease the number of required invoices to one.

- Make the presentation of the certificate of source and origin by the exporter to the U.S. correspondent bank a requirement for the negotiation of the letter of credit. The team understands BCN utilized this procedure in some of its letters of credit and, as a result of progress reports held during this evaluation, USAID reminded BCN of this fact in a memorandum dated October 22, 1991.

- Supply to BCN and the commercial banks a Spanish translation of the eligibility list in A.I.D. Handbook 1, Supplement B, Chapter 4D.

- Improve access to information on U.S. products. USAID donations of Thomas Registries to institutions such as the Nicaraguan Chamber of Commerce or the Central Bank Library will be very effective.

The following recommendations would lead to an expansion of the base of program users:

- USAID and BCN should sponsor the training of small importers in management and accounting, perhaps as part of a small business development project. Such training would permit them to utilize the banking system for their imports and to improve the efficiency of their operations. In turn they will be able to increase the size of their individual transactions, in order to be eligible for ESR funds. This activity should be coordinated with the Chamber of Industry (CADIN) and the Chamber of Commerce. Initially, training seminars should be organized to cover the most important topics and should be offered for a fee.

- USAID should make used and reconditioned U.S. and Central American products eligible for importation using ESR funds.

Following is a recommended plan of action for USAID and BCN to ensure prompt and efficient use of the A.I.D. funds assigned to the commercial banks for the importation of U.S. goods:

- Complete the present USAID-BCN negotiations concerning operating procedures. This step includes the resolution of all previous claims and counterclaims about ineligible transactions, commingling of funds, and unauthorized transfer of funds.

- Disseminate the information about the new operating procedures among all participants: BCN officers, commercial bank officers, institutional representatives of prospective users. Ensure that everyone is clear on the program operation.

- Organize a training seminar for commercial bank officers involved in the authorization process. It is reasonable to assume that the foreign exchange market will soon be operated largely by the commercial banks with little BCN interference.

- Ensure that importers have access to information on U.S. products and U.S. channels of commercialization. Access through the U.S. Embassy is not sufficient.

- Although the Central Bank has the final responsibility for the utilization of funds, the BCN should make commercial banks jointly responsible for the reimbursement of funds if, after the authorization process becomes more decentralized, ineligible transactions are detected by the external auditors. This measure will motivate the commercial banks to thoroughly review documentation before approving transactions.

Appendix A

STATEMENT OF WORK

This evaluation of the Economic Stabilization and Recovery I, II, and III programs will address the following key questions:

A. How has U.S. balance of payments support under these programs contributed to economic stabilization and recovery in Nicaragua?

The team will:

1. Analyze the economic stabilization program of the Government of Nicaragua and assess the role of ESR support in the overall plan.

2. Assess the relative importance of various aspects of the ESR program (e.g. use of dollars, disbursement schedule, policy dialogue, absence of mechanism for local currency generation, etc.) in contributing to progress in economic stabilization.

B. Has the policy conditionality in ESR II been effective in promoting economic recovery in Nicaragua? The effects of policy change on long-term economic recovery will be difficult to assess in the short-term. Nevertheless it is important at this stage to identify what policy changes the program has supported and how have they been implemented.

Are there policy areas where follow-up through on-going policy dialogue or future conditionality would be useful?

The team will:

1. Identify what reforms have actually resulted from ESR I and II in the area of demand management, trade and foreign exchange liberalization, financial market reform, and privatization.

2. Make initial determinations as to how these reforms are expected to affect economic decisions by business owners, potential investors, and traders.

3. Suggest policy areas addressed under ESR II which might benefit from follow-up or future conditionality.

C. <u>What is the short and long-term impact of accelerated import financing made available under the program in support of occupational conversion?</u> What has been the short-term cost of the economic conversion program to the government? What is likely to be the long-term budgetary effect of occupational conversion?

The team will:

1. Determine the short-term budgetary costs to the Nicaraguan government of its occupational conversion program and projections of the effects of the program on future budgets.

2. Analyze the budgetary effects of the GON's program in relation to potential future inflationary pressure on the economy due to budget deficits.

D. <u>What effect has the foreign exchange made available under the program had on business activity?</u> Have total imports increased due to the availability of ESR foreign exchange at a market-clearing price or has the trade pattern changed? In either case, has the program stimulated greater trade with the U.S. and/or Central American countries? What types of imports have been made using program resources; what trends can be discerned?

The team will:

1. Analyze the imports undertaken by both the public and private sector under the programs in relation to total imports and determine what effects the program has had on trade relationships and overall import activity, including assessments of import demand by economic activity. Has the principal effect been to provide direct inputs into the production process or to improve the overall availability of goods in the Nicaraguan economy?

E. <u>Evaluate the management of U.S. dollars under the program.</u>

Current legislation requires that cash transfer dollars be kept in a segregated account and be tracked to their "end use". AID policy further restricts both the nature of the imports financed and their source and origin and requires evidence that imports financed have actually entered the country. These requirements are clearly somewhat inconsistent with the establishment of a completely free and open market in foreign exchange which is a goal of A.I.D. policy in Nicaragua. How important this inconsistency is and how it can be reconciled will be a major design issue in the preparation of ESR IV.

The team will:

1. Review the administrative procedures for use of dollars under the program, including restrictions on the nature of the commodities, source/origin requirements, and the requirement that importers obtain three pro forma invoices. Assess to what extent these requirements have added to importer costs over and above what those costs would have been in a completely liberalized foreign exchange regime and evaluate the extent to which each of these restrictions are potentially inconsistent with a totally liberalized foreign exchange system.

2. To date, ESF dollars have been provided on a cash basis. The team should assess the extent to which this method of disbursement interferes with the efficient use of trade credit by importers and, if appropriate suggest programmatic alternatives.

3. Interview program managers, both in A.I.D. and in the Central Bank of Nicaragua, and users to determine what difficulties they face working with the program. Suggest alternative means of implementation to address any such difficulties.

Reports

The vendor will deliver to USAID/Nicaragua a draft report at the end of their in-country study.

The vendor will deliver 10 copies of the final report in English to USAID/Nicaragua, no later than 2 weeks after the in-country period is concluded, discussing the impact of balance of payment support and dollar financing on the macro-economic situation and on sectoral policy reforms.

A. Submission of Work Plan, including methodology and schedule of activities, within one week of the effective date of this work order.

B. Mid-way Briefing for USAID/Nicaragua and Nicaraguan government counterparts on progress and initial findings.

C. Submission of Draft Report—the draft report should be delivered before the team's departure from Nicaragua. Ten days will be provided for A.I.D. and Nicaraguan government officials to provide comments.

D. Submission of Final Report—the final report incorporating comments, responding to questions posed in the Statement of Work, and outlining findings, conclusions, and recommendations after receipt of USAID/Nicaragua and Government of Nicaragua comments.

E. Format of Report—the following outline is recommended:

- Executive Summary—2-3 pages, single spaced.

- Statement of Conclusions and Recommendations—conclusions should be short and succinct, with the topic identified by a short sub-heading related to the questions posed in the Statement of Work. Recommendations should correspond to the conclusions; whenever possible, the recommendations should specify who, or what office or agency, should take the recommended actions.

- Body of the Report—the report is to include a description of the context in which the project was developed and carried out, and provide the information (evidence and analysis) on which the conclusions and recommendations are based. The body of the report should be no more than thirty (30) pages. More detailed analysis should be placed as an appendix.

- Appendices—These are to include, at a minimum, the following:

    - The Evaluation Scope of Work

    - A description of the methodology used in the evaluation (e.g. the research approach or design, the types of indicators used to measure change or the direction/trend of impacts, how external factors were treated in the analysis). Evaluators may offer methodological recommendations for future evaluations

    - Full analysis of any topics which, due to space limitation in the body of the report, should be summarized there

    - A bibliography of documents consulted and list of interviews held

F. Final debriefing for USAID and Nicaraguan government officials

Appendix B

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Appendix C

PERSONS INTERVIEWED BY EVALUATION TEAM

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Pablo Pereira, Vice Minister
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Ministry of Finance

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Private Sector

CADIN

Jaime Bengoechea, Presidente
Gilberto Solis Cuadra, Executive Secretary
Ramiro Cerna Bárcenas, Technical Advisor
José E Rodriguez, Board Member
Julio Sequeira, Board Member
Augusto C Hasbani, Board Member
Gabriel Pasos Lacayo, Board Member

Chamber of Commerce

Juan López Zeledón, President

Banco Mercatil

Nelsón Estrada Solórzano, General Manager
Juan Carlos Sansón, Treasurer
Sandra Darío Lacayo, Credit Manager
Ana María Vado, Letters of Credit

Banco de Credito Centroamericano

Eduardo Montealegre, General Manager

Individual Investors

Pastor Torres, Interlatina SA de CV
Sergio Narvaez, Narvaez y Raven SA
Roberto Duarte, Uniglobe
Silvio Guardian, Gurdian SA

Appendix D

SUPPLEMENTARY INFORMATION AND ANALYSIS CONCERNING THE STABILIZATION PROGRAM AND ESR SUPPORT

This appendix provides supplementary information in four sections about the stabilization program and ESR support for the program. The first section analyzes stabilization policies followed by the newly elected government in the second half of 1990 as a background to the adoption of the March 1991 stabilization program. The second section provides information about wage developments during the period between March and October 1991. The third section describes the near-term balance of payments prospects, and the last section analyzes the balance of payments implications of ESR dollar aid.

Stabilization Policies in 1990

At the time of the transfer of power in April 1990 from the Sandinista regime to the newly elected government, the Nicaraguan economic situation was undergoing the convulsions of an explosive hyperinflationary process, set in motion by fiscal and monetary excesses and aggravated by a breakdown of the financial system, a balance of payments crisis, and the exhaustion of foreign exchange reserves.

This was not the country's first experience with hyperinflation. The hyperinflationary process had started gathering momentum from 1985 and reached a climax in 1988 (with the December to December inflation rates rising from 335 percent in 1985 to 33,657 percent in 1988), fueled principally by large deficits of the nonfinancial public sector (which averaged 20 percent of GDP during the period between 1984 and 1988, reaching a high of 26 percent of GDP in 1988) financed almost entirely by the Central Bank. The Sandinista regime was able, through the adoption of measures of fiscal and monetary contraction in 1988, to reduce the NFPS deficit to 5 percent of GDP and the inflation rate to 1,689 percent in 1989. However, during the first 4 months of 1990, the Sandinista regime reverted to highly expansionary fiscal, monetary, and incomes policies (for example, wage increases of some 800 percent to

Central Government employees and freezing of the exchange rate and public sector prices) and established regulations to make it difficult to lay off workers and to privatize state enterprises, thus leaving a difficult legacy for the incoming democratic government.

Faced with this highly volatile situation, the highest priority had to be accorded to crisis management such as control of hyperinflation, reduction of the fiscal deficit, build-up of foreign exchange reserves, and restoration of confidence in the currency. The crux of the antihyperinflation policies was seen as effective demand management through a massive exchange rate devaluation and a currency reform supported by drastic measures to impose fiscal and monetary discipline in a short time, the so called "shock" treatment, in order to reverse the inflationary expectations quickly. Clearly, the success of demand management policies called for structural reform policies such as tax reform, trade and tariff reform, financial sector reform; deregulation of the economy, and privatization.

The cooperation of external donors, particularly A.I.D. and the international financial institutions, has been crucial to the formulation and implementation of the stabilization program adopted by the Chamorro Government. A.I.D. was the first on the scene with both technical and financial assistance. In fact, A.I.D. initiated policy dialogue with the transition team even before the assumption of office by President Chamorro. The policy dialogue, which included several visits by Dr. Arnold Harberger during April and May 1991, influenced the direction and substance of the immediate economic measures adopted by the new government.

A.I.D. was also able to move quickly with financial assistance. The Grant Agreement for ESR I was signed on May 31, 1990, and the entire amount of $60 million was disbursed on the same date to meet emergency foreign exchange needs of the new government because the foreign exchange reserves had been spent by the outgoing Sandinista regime. Technical assistance from the IFIs, particularly the IMF, also came quickly, but the IFIs were not able to provide financial assistance until the arrears to IFIs were cleared (with help from U.S. and other donors) in September 1991. A.I.D. technical and financial assistance for Nicaragua's stabilization and structural adjustment program has been maintained through ESR II and III.

In accordance with the strategy of giving priority to measures of fiscal, monetary, and exchange rate adjustment, the new administration implemented a combination of tax increases, expenditure cuts, and higher public enterprise tariffs, designed to reduce the fiscal deficit. A major tax reform introduced late in 1990 aimed at reducing tax rates, expanding the tax base through elimination of exemptions, simplifying the tax structure for better collection, removing distortions, and improving incentives for investment. The reform included reduction and simplification of income tax rates, elimination of certain consumption and indirect taxes that yielded little revenue, and the reduction of import tariffs to a range of 0 to 20 percent for most goods.

Although the tax reform came too late to have any effect in 1990, its substantial long-term impact will be felt in 1992 and beyond because 1991 would still be a year of transition as a result of major macroeconomic adjustments and changes in price relationships. In addition to the tax reform, there were increases in several tax rates (particularly the general sales tax), and measures to improve tax administration were steadily implemented during the second half of 1990. All taxes were indexed to the *córdoba oro*. Efforts were initiated to tighten spending controls in all Central Government agencies, and the number of security forces personnel was cut by 60 percent to 28,000 by the end of 1990.

As a result of these efforts, the increase in Central Government expenditures was contained to 2 percent of GDP[1] in spite of the doubling of the outlays on wages and salaries as a result of the previously mentioned 800 percent wage increase granted by the outgoing Sandinista regime. Public enterprise tariffs were sharply increased and indexed to the U.S. dollar, and as a result, the public enterprise balance improved by 1 percent, shifting from a minor deficit to a small surplus. The operational losses of the Central Bank (part of the consolidated public sector deficit according to the IMF presentation) were reduced dramatically by 11 percent of GDP as a result of the elimination of exchange rate guarantees and the termination of the practice of forgiveness of outstanding bank loans.

The exchange rate was adjusted frequently and the official and legal parallel market rates were unified. However, the devaluation did not keep pace with inflation, resulting in substantial real effective appreciation of the *córdoba*. The procedures for obtaining foreign exchange were simplified.

In May 1990, the Government of Nicaragua introduced a second currency, the *córdoba oro* (CO), pegged at par to the U.S. dollar. It was used initially as a unit of account but was subsequently used to pay a part of public sector wages. Interest rates, although still subject to controls, were made more flexible by indexing to the CO, and they became less negative in real terms because the *córdoba* was devalued weekly against the U.S. dollar and the CO. However, the introduction of the CO in an inflationary environment complicated monetary management, and the defense of its convertibility at par with the U.S. dollar, amidst lax financial policies and accelerating inflation, led to loss of reserves. Quantitative import restrictions on many items were eliminated.

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[1]Excluding extra-budgetary military outlays of 12-13.5 percent of GDP financed with grants from Eastern European countries. Data for these expenditures are not available for earlier years. The data for 1990 are not easy to compile; even the IMF and World Bank estimates differ on this point. This problem does not arise after 1990 because all military outlays have since been incorporated in the budget.

Perhaps equally significant was the conclusion of a *Concertacion Economica y Social* between the Government and representatives of workers and employees, which represented a broad national consensus on the main thrust of the government's policy reforms including trade liberalization, elimination of state monopolies in the financial and foreign trade sectors, and return of expropriated properties to the former owners. Although there are disputes about interpretation as well as strikes and demonstrations, the level of confrontation and rhetoric is less intense now than last year.

Even the wide-ranging and significant policy measures adopted in the second half of 1990 did not prove adequate to the degree of adjustment needed, in view of the legacy left by the Sandinista regime and the momentum of the hyperinflationary process itself. The economic performance in 1990 was disappointing. Real GDP stagnated (which may be called an improvement compared with the sustained decline in GDP since 1979), the December to December inflation rate rose to 13,490 percent (the second highest inflation rate ever, after 1988), the NFPS deficit (all of it financed by Central Bank) rose to 14 percent of GDP, and the overall balance of payments deficit was $812 million (almost $200 million greater than the 1989 deficit), financed in large part by the accumulation of arrears. The foreign exchange reserves of the Central Bank fell by $218 million. At the end of 1990, the stock of accumulated arrears was some $4 billion, almost 4 times greater than GDP, and outstanding external debt was $10 billion, 9 times greater than GDP.

Recent Wage Developments

The following information applies to public sector employees only.

A. General Wage Increases

1. March 1991: 160 percent to all public sector employees.

2. June 1991: 20.15 percent to all civilian public sector employees except teachers and Ministries of Education, Health, Interior and Defense.

B. Selective Wage Increases

1. March 1991: 35 percent to teachers and Ministry of Education.

2. March 1991: 55 percent to Ministry of Health.

3. June 1991: 20 percent to teachers.

4. August 1991: 5 percent to teachers.

5. Judges and magistrates (313 persons) 37 percent. Monthly cost (including 9 percent "Antiguedad"), C$174,000 in October 1991.

6. Customs (836 employees). Technicians, 22 percent in October 1991 and 22 percent in November 1991. Administrative staff 10 percent in October 1991 and 10 percent in November 1991. Average 40 percent (including 9 percent "Antiguedad").

7. Exmilitary personnel received 15 months' salary as separation payment. 50 percent (C$20 million) in August 1991 and 50 percent (C$20 million) in October 1991. Already provided in Budget.

8. "Procuraduria" (62 persons). About C$181,600 monthly wage increase, financed by expenditure cuts within agency.

9. INRA. C$24,000 monthly increase, financed by expenditure cuts within agency.

10. INIRR. C$70,000 monthly increase, financed by expenditure cuts within agency.

11. Ministry of Interior (10,800 employees). 20 percent in June 1991 and 6.5 percent in August 1991. Cost C$5.6 million per month, (including benefits).

C. Wage Demands (Current)

1. Judiciary personnel—1,350—want same increase as judges.

2. Other customs employees want same wage increase as technicians.

3. Teachers and Ministries of Education, Agriculture, and Health staff want 30 to 40 percent wage increase (plus 10 percent benefits).

4. Many other public sector unions are demanding up to 100 percent wage increase.

5. Rise in minimum wage is being negotiated. Unions demanding more than 100 percent increase. Any increase will raise average wage level.

D. Other

Earlier system of payment in kind (5 lb. rice, 5 lb. sugar, 10 lb. beans) per employee per month has been replaced in September 1991 by a cash payment of C$22 per employee per month.

Near-term Balance of Payments Prospects

The balance of payments for the first half of 1991, the latest data available, does not yet fully reflect the impact of the stabilization program, but it does show how foreign aid has increased reserves in preparation for higher imports later this year and next. The following table is a simplified balance of payments concentrating on the trade account and other selected entries related to import financing.

Table D-1. Balance of Payments
(millions of dollars)

	1989	1990	1990/I	1991/I
1. Exports, f.o.b.	290	327	213	184
2. Imports, f.o.b.	547	568	246	242
3. Trade Balance	-257	-241	-33	-58
4. Services[a]	-69	-76	-50	-58
5. Current Balance (3+4)[b]	-326	-317	-83	-116
6. Grants	169	202	147	242
7. Errors and Omissions	-168	-217	-106	-54
8. Loans, net	268	209	99	78
Drawings	276	214	101	92
Repayments[c]	8	5	2	14
9. Capital Balance (6+7+8)	269	194	140	266
10. Overall Balance (5+9)	-57	-152	57	150

[a]Excludes unpaid interest
[b]Excludes grants
[c]Excludes unpaid amortization
Source: Central Bank

The advantage of this scheme is that it eliminates the clutter of unpaid debt service in the standard IMF format and allows a direct comparison between the demand for current goods and services and the means to pay for them.

Exports in 1991 will probably fall below 1989 levels judging from the performance of the first half of 1991. External price change played almost no role in the decline in the value of exports, compared with the first half of 1990. The quantity exported of each of the agricultural products fell or remained the same except for bananas and seafood, where there were notable increases. The reason for the decline seems to have been the prior (1990) decline in domestic production, which provides the bulk of the 1991 exports. The volume of coffee and meat fell about 40 percent, while that of cotton and sugar are unchanged. The value of nontraditional manufactures also declined by one-third. Imports in the 1991 first half are roughly the same as the year before. Services are little changed because when debt service is excluded, they are mostly linked to merchandise trade. First half comparisons are a better guide to annual exports, which are concentrated in that part of the year, than for annual imports, where a larger proportion arrive in the second half. Annual imports are expected to rise 3 percent.

With respect to capital transactions, the volume of grants and net loan drawings, which was between $400 million and $425 million in 1989-1990, rose about 30 percent in 1991 if we extrapolate the first half trend. The other variable is the "errors and omissions" item, which is also a proxy for estimates of unrecorded capital movements. One would expect that capital flight would be reduced after the stabilization plan was put into effect in March, both because there would be favorable changes in expectations and because tight credit would make it more difficult. Second, the return of nationals from abroad would be accompanied by some inflow of funds.

The "overall balance," an approximate guide to reserve changes, which sums up net change in the balance of payments, is far more favorable in 1991 because official capital inflow and a smaller unrecorded net capital outflow more than compensated for the export decline.

Balance of Payments Implications of ESR Dollar Aid

To understand the role of ESR dollar funding, one must compare it with foreign assistance as a whole and especially with other forms of balance of payments aid. The following tables describe the situation for 1991 and the present state of planning from the BCN perspective.

Aid to Nicaragua in 1991

According to Central Bank calculations, Nicaragua had available, in the form of both loans and grants, $725 million for the financing of imports in 1991, excluding the grants and loans designed to wipe out arrears to the World Bank and the IDB and short term credits of $71 million that roll over during the year. The Bank classifies loans and grants as either *liquido* or *atado*. *Liquido* loans and grants are a general import line, and *atado* loans and grants are is "tied" to payments for a particular project. Liquid funds enter the Bank's general reserves in the same way as export and other earnings would. In the case of projects, resources are transferred to Nicaragua in the form of goods and services that are paid for directly by the donor. The A.I.D. balance of payments program is an example of liquid assistance while other A.I.D. projects fall into the tied group.

Assistance comes from about 15 countries and perhaps 20 multilateral organizations. All these sources provide project aid but only a small number provide fairly unrestricted cash, comparable to the ESR program. Of Nicaragua's former friends, there is only the small remainder of a loan from the Soviet Union that was completely disbursed in the first half of 1991. The following table summarizes aid from all sources. Amounts are presented in millions of dollars.

Programmed Assistance	*Disbursed 1991/I*	*Available 1991/II*	*Balance*
A. Overall			
1. Loans			
Liquid	120	78	42
Tied	59	14	45
Total	179	92	87
2. Grants			
Liquid	196	102	94
Tied[a]	350	115[a]	235
Total	546	237	329
Total	725	329	396
B. Balance of Payments Support			
1. Total(A.1+A.2) of which:	316	180	136
U.S.	183	99	84
Taiwan	60	60	0
Venezuela	40	10	30
Germany	15	8	6
Sweden	10	0	10
OPEC	5	0	5
Spain	3	3	0

[a]Includes 53 million from A.I.D. non-ESR projects of which 33 million has been used.
Source: Central Bank

Balance of payments aid has been disbursed much faster than project aid, not only for the usual reason that it is subject to fewer conditions, but also because in the Central Bank's accounting, disbursement means transfer to Nicaragua, not expenditure on imports. A.I.D's program accounts for about 60 percent of this aid category and about 55 percent of the transfers in the first half of 1991.

The Taiwan line has apparently been expended rapidly because it has no restrictions on its use and can be assimilated by the Central Bank to income in foreign exchange. The Venezuela line appears to be in part for oil imports and in part for the purchase of zero coupon bonds as part of the settlement of the old defaulted line of credit.

Estimated Assistance in 1992 and the Balance of Payments Problem

Assistance in 1992 is now expected be almost exactly the same as in 1991, $724 million, excluding $31 million in short-term credits. The following table provides the details of estimated assistance to Nicaragua in 1992 from all sources. Amounts are presented in millions of dollars.

1. Loans	372
a. liquid	268
b. tied	84
2. Grants	352
a. liquid	135
b. tied	217
Total	724
3. Balance of Payments (1.a+2.a) of which:	403
a. A.I.D	125
b. IDA	55
c. IDB	55
d. World Bank	51
e. IMF	22
f. Japan	35
g. Taiwan	30
h. Venezuela	19
i. Finland	10

Source: Central Bank

Balance of payments assistance in 1992 is expected to be $100 million more than in 1991, and the number of contributors has risen. The ESR share, at 30 percent, is one half of that of 1991. Especially important is the return of the multilaterals to lending after a decade, made possible by the settlement of their arrears through ESR disbursement. While the shape of the 1992 balance of payments (BOP) is still not determined, certain elements are clear. The IMF is predicting a trade deficit $50 to $60 million larger than this year, resulting from a 10 percent increase of imports and related invisibles. Debt service to the multilaterals and Venezuela will increase now that Nicaragua's position has been regularized, and other external debt obligations such as a Paris Club settlement may be picked up as that process continues. An expected minimum increase of $50 million for interest and amortization would exhaust the rest of the additional BOP aid.

There is no allowance for adverse contingencies such as a shortfall in exports, speculation against devaluation, or a more rapid rise of imports. On the other hand, more private capital might be received or world commodity prices might rise. All this implies that much of the country's other debt service can be put off or forgiven. It would be prudent and realistic to assume that adverse rather than favorable circumstances would prevail. Therefore, a shortage of exchange with its threat to Nicaragua's open import system is the more likely possibility. As a consequence, A.I.D.'s desire to shift more of its aid to project and away from balance of payments may not be feasible.

Appendix E

SUPPLEMENTARY INFORMATION ON AND ANALYSIS OF THE EFFECTIVENESS OF ESR CONDITIONALITY

This appendix provides information in three sections concerning the effectiveness of ESR conditionality. The first section contains a summary of demand management measures implemented during the period between March and October 1991. The second section deals with trade policy measures—state trading, tariffs and taxes, and quantitative restrictions. The last section describes the implementation of financial sector reform.

Summary of Demand Management Measures, March-October 1991

The following paragraphs summarize the measures implemented up to mid-October 1991 for each of the above policy areas under the March 1991 program and policy commitments given to the IMF under the standby arrangement.

Exchange System Policy

As of March 3, 1991, the *córdoba oro* (CO) was devalued from parity with the U.S. dollar to CO 5 per U.S. dollar and was made convertible for trade-related transactions. The old *córdoba* was exchanged for the *córdoba oro* at the rate of C$5 million for CO 1 and phased out by the end of April 1990. The Nicaraguan authorities intend to keep the exchange rate unchanged over the period of the standby program. The street and private *casa de cambio* rate in October was generally about CO 5.2 to CO 5.25 per U.S. dollar (buying). The exchange system is free of restrictions on trade-related transactions. Foreign exchange is freely available for import-related payments up to $50,000; imports above this limit are allowed subject to the use of letters of credit or other import lines of credit. Service payments are allowed up to a limit of $5,000 per transaction. Important measures have been taken to liberalize exchange markets. Commercial banks have been authorized to buy and sell foreign exchange, and the Central Bank's trade-related foreign exchange operations have been transferred to commercial banks. Four private exchange houses have been authorized.

Fiscal Policy

The cornerstone of the program is to keep the fiscal deficit at a level that can be financed with external grants and concessional credits in order to eliminate the NFPS need for domestic financing and to limit expenditures to available funds through cash budgeting. This policy was already successfully implemented in the first quarter of 1991. The target continued to be met through September, according to preliminary indications.

Tax Measures

Tax measures implemented in late 1990 and the first half of 1991 include unification of the general sales tax at the highest rate of 15 percent and increases of excise taxes on *industria fiscal* with a shift to an ad valorem basis. Improvements in tax administration include expanding the number of taxpayers and implementing the *grandes contribuyentes* program. This program, which has been in operation only since May 1991, has already produced significant increases in the yield of internal taxes (indirect domestic taxes). Tax measures taken since the second half of 1990 already seem to be yielding good results. On the basis of actual revenue performance through September 1991, the IMF projection of tax revenue increase (5 percent of GDP in 1992 over 1990) is likely to be more than fulfilled. The revenue projections for 1991 and 1992 do not take into account possible windfall receipts for the central government representing the potential proceeds of privatization.

The Expenditure Policy

The expenditure policy is to maintain in place the expenditure control measures adopted since mid-1990 (reduction in work force, wage restraint, and tight control of nonwage outlays). While an up-front general wage increase of 160 percent to public sector employees has already been granted in 1991 as part of a strike settlement followed by another general increase of 20 percent (with some exceptions) in June 1991, the government plans no further general salary adjustments for public sector employees in 1991 and expects to limit such adjustments to 10 to 12 percent in 1992. There have, however, been strikes in various parts of the public sector and some wage increases have recently been granted according to the press (see Appendix D for recent wage developments). Over the next several years the wage bill will be constrained by a major program of employment reduction, the Occupational Conversion Program (PCO), details of which are given in Chapter 4. But the implementation of the PCO will increase NFPS expenditures by 0.7 percent of GDP in 1991 because of incentive payments for voluntary separation, but then it will reduce them by 0.7 percent of GDP in

1992 and 1.1 percent of GDP per year in 1993 and subsequent years. Preliminary figures for actual expenditure performance through September 1991 show that central government current expenditures were well within the IMF ceiling for the end of September 1991.

Program for Public Utility Enterprises

The program for public utility enterprises provides that the enterprises are to be placed under strict financial discipline, so that they can generate the necessary savings to meet the critical need for replacing capital equipment by employment reduction. Tariff rates will be kept in line with inflation. Executive boards will be established, with World Bank assistance, to perform oversight functions over the operational procedures and expenditure plans of the enterprises. Before March 1992, the Government will initiate a donor-financed study that will recommend major restructuring of public utility enterprises, establishment of a regulatory framework based on autonomy and accountability, introduction of efficient pricing policies, upgrading of management capabilities, and formulation of an investment program to improve production possibilities. Public utility and other public enterprises will also implement the following measures: (1) a 12-month freeze on new investment projects, except in public utilities; (2) transparent financing of losses through the central government budget; (3) repayment of loans received from banks; (4) quick action on restructuring, privatization or liquidation in case of enterprises in financial crisis; (5) acceleration of the privatization process in general.

A major component of the consolidated public sector deficit in the past, namely, Central Bank exchange losses, is expected to be eliminated in 1991 and 1992 as a result of the unification of the dual exchange rate system and the termination of exchange rate guarantees. As a result of the fiscal policy measures, Nicaragua has been able, according to preliminary calculations, to comply with the IMF ceiling on net domestic bank credit to the nonfinancial public sector for the end of September 1991.

Monetary and Credit Policy

The March 3 economic program includes policy commitments to eliminate Central Bank net financing of government, enforce strict ceilings on Central Bank net credit to financial institutions, maintain positive real interest rates, and rigorously limit domestic credit expansion to real growth in demand for domestic financial assets. The monetary authorities will strictly monitor compliance with legal reserve requirements, impose heavy penalties for noncompliance, and continue to enforce repayment of bank loans and ensure credit denial to delinquent borrowers. The rediscount facility will be limited to the intermediation of funds channeled through the Central Bank by external donors and creditors. The rediscount rate will be set no lower than the 30-day deposit rate or the average cost of funds obtained by the financial system, whichever is higher. Eventually, the allocative credit mechanism will be phased out and the cost and availability of Central Bank rediscounts will be determined by market forces. All these commitments, with the exception of the last, have been fulfilled through the end of September 1991. As a result of the implementation of the policy measures, Central Bank net domestic assets are within the IMF ceiling for the end of September 1991, according to preliminary calculations.

State Trading, Tariffs/taxes and Quantitative Restrictions

State Trading

State trading dominated international trade under the Sandinistas, accounting for more than 90 percent of exports and 50 percent of imports. All the traditional exports—cotton, coffee, sugar, meat, sesame, and others—were each organized into separate companies and given the monopoly of their respective trades. Selected but important imports were also monopolized in the same way—petroleum, chemical inputs for agriculture, medicine and machinery.

The approach of the present government has been to open each of these subsectors except petroleum to private traders. Because the constitution inherited from the previous regime gives a monopoly of foreign trade in the traditional agricultural commodities to the public sector, the present administration cannot simply abolish state trading but can only establish a framework in which it hopes that private competition will do so. For the traditional products, export licenses are required, and 62 had been issued by the first week of August. Progress in increasing the private share of trade in each sector has been uneven. There seems to be little interest in the cotton trade by private business (2). In the cases of meat (4) and sugar (1), the trade is free but the processors are still largely government corporations, so that change will depend on carrying out their intended privatization. The first sugar mill will be returned to its original owner in October. The coffee corporation (9) has become more efficient and still dominates three-quarters of the trade. But in the areas of seafood (25) and sesame (19), the private sector is predominant.

With respect to imports, all the former state companies have only small portions of their respective markets.

For the major projects—coffee, cotton, sugar, and meat—the process may last some time. The private traders face not only the usual economic problems, but entrenched Sandinista vested interests in the producing companies, who may be able to use the labor unions to resist losing the enterprises through privatization.

Tariffs/taxes

The protective tariff and tax system consists of three components: the tariff, selective consumer taxes levied on imports, and a stamp tax. The three together constitute the nominal level of protection. The following table provides summary measures of changes since January 1990.

Table E-1. Protection by Type of Commodity (percent)

	Average			Minimum			Maximum		
Type	1/90	4/91	9/91	1/90	4/91	9/91	1/90	4/91	9/91
Consumer	80	28	19	3	4	10	303	303	60
Intermediate	28	12	12	4	3	10	203	123	40
Capital	31	16	13	4	4	10	203	140	35
Excise[a]	164	138	61	9	9	10	403	403	130

[a]*Bienes fiscales* and vehicles
Source: *Informe sobre las Medidas de Reforma Arancelaria*, Lankes

The first column represents the situation before the Chamorro government took office. The initial reform in 1990 removed some of the extremely high rates of protection for intermediate, capital, and selected consumer goods, resulting in column (2), the position when the current stabilization program was put into effect. At that time a new and more ambitious program was worked out, the first stage of which was effective in September 1991. Other cuts are planned for March 1992 and December 1993.

Lowering averages means little as a measure of changing tariff protection; a considerable decrease can be quite compatible with high protection where there is potential competition between domestic and foreign products. The reduction of ceiling rates is a better indicator. Of particular interest are those for consumer goods, which, as in other Central American countries, are the most heavily protected. The highest category fell from 303 percent to 60 percent in September. For fiscal reasons, the excise category—alcoholic beverages, soft drinks, tobacco, and gasoline—remains the most heavily protected.

The tariff proper has already been reduced to a ceiling rate of 20 percent in accordance with the recently adopted Central American criteria of keeping tariff rate categories between 5 and 20 percent. The level of nominal protection now depends more on the selective consumption tax, which currently has rates as high as 40 percent on commodities outside the excise sectors. The tax is now solely a protective device, levied only on imports except for excise products that are taxed at lower levels on domestic production than for imports. For example, local beer pays 35 percent while imported beer carries a 100 percent rate.

The level of protection is of more relevance to industry than to agriculture, which is either internationally more competitive, or where it is not, is totally protected by quantitative restrictions. Even in agriculture, competitive position at the margin and profits are effected by the tariffs and taxes levied on imported machinery and intermediate goods.

Finally, nominal tariffs and taxes on imports are really not full measures of protection. A more complete measure of effective protection would take into account the tariff on the final product, the tariffs on imported components, and the proportion of value-added domestically. Nominal and effective protection would be the same for a product produced in Nicaragua entirely from local materials. But a nominal rate of 60 percent would be equal to 100 percent in the following example: imported inputs, which constitute half the selling price, pay 10 percent so that net protection is 55 percent (60 percent-[10 percent x .5]) which, when related to the other half of the selling price, is equal to effective protection of 110 percent. For a product with a smaller percentage of value added locally the effective protection rate would be higher.

Quantitative Restrictions

Quantitative restrictions (QRs) now apply only to rice, beans, sugar, cattle, meat, eggs, and chickens, whether exported or imported. They give the government the means to attempt to reconcile the conflicting objectives of giving domestic producers sufficient incentives to bring their commodities to market and preventing their retail prices from soaring out of reach of the low-income urban consumer. Currently, for example, beans could be exported to other Central American markets, but it is the policy of the Ministry of Economy not to grant export licenses to avoid local price increases. Conversely, imports of chickens and eggs are being restricted to prevent damage to producers.

This technique might be justified as a measure to manage the transition from inflation to stability but its continued use is an arbitrary distortion of relative prices. Even the replacement of QRs on imports by a variable rate levy, part of the commitment to the World Bank, is only a slightly more efficient method of keeping government control over the market.

Financial Sector Reform

The following progress has been made this year in the implementation of financial sector reform.

- The BCN's involvement in commercial operations, particularly its monopoly over external trade and financial transactions, has been terminated.

- The law creating the Superintendency of Financial Institutions and authorizing the establishment of private banks and finance companies, was approved by the Assembly in March 1991.

- One private bank started operations in August 1991 and four others have been licensed. The private banks are authorized to buy and sell foreign exchange, to offer letters of credit and to accept demand deposits.

- The Government of Nicaragua has taken the actions required before July and October 1991 under the World Bank's ERC regarding the operation of the Superintendency: to name the superintendent, promulgate regulations, begin activities, and draw up an action plan to restructure the state banks and withdraw Central Bank subsidies.

- In addition, a draft Organic Law of the Central Bank of Nicaragua and a comprehensive draft general Law of Banks and Other Institutions have been prepared and sent to the IMF CBD for review. A CBD mission is expected here in November 1991 to discuss the drafts. The CBD resident advisor believes that these laws, are legalistic, old-fashioned, that the Central Bank law gives the Central Bank too much power, and that the banking law is too conservative and will inhibit the banks from providing a full range of financial services in the years to come. He also believes that the Superintendency Law and the proposed Central Bank law do not make clear the dividing line between the prudential regulation of banks by the Superintendency for solvency and liquidity and Central Bank regulation of banks for monetary control.

- The interest rate policy has been progressively liberalized and the Central Bank has actively pursued a policy of maintaining positive real interest rates in fixing interest rate limits. As of October 1 1991, the lending and deposit rates were changed from fixed limits to minimum rates and new variable lending rates of 16 percent short-term and 12 percent long-term were introduced. The rediscount rate applicable to the variable rate transactions would be 3 percent below the variable rate charged by banks. The two innovations, the introduction of minimum (in place of fixed) rates and variables rates, represent considerable liberalization whose importance will become evident when more private banks are established and there is greater competition among banks.

- The Central Bank has begun implementation of measures to improve loan recovery, including denial of credit to defaulting borrowers.

- The Central Bank has limited the use of its rediscount facility to the financing of specialized credit programs, in order to impose greater financial discipline on the state banks, which are now trying to adjust to this change by cutting expenditures through personnel reductions, closing of unprofitable branches and other matters.

- The restructuring of state banks, a major component of the financial sector reform program, is just getting started. The Immediate Action Program covers an audit of the loan portfolio to classify nonperforming loans, an effective loan recovery program, economies in operating expenses, cleaning up interbank liabilities, and options for capital replenishment.

  The audit of the loan portfolio of the Bank of Industry and Commerce (BANIC), the Mortgage Bank (BIN) and the People's Bank (BP) began in October to comply with the World Bank's ERC conditions.

The main accomplishments are as follows.

- The re-establishment of private banking and its regulatory framework, which is the conditionality for ESR III;

- The removal of the Central Bank from commercial operations;

- The beginning of the restructuring of the state banks which will be a lengthy process; and

- The institutional reorganization of the Central Bank and the role of commercial banking.

Appendix F

CALCULATION OF SAVINGS DERIVED FROM OCCUPATIONAL CONVERSION PROGRAM

General information concerning public sector employment is contained in the first section of this appendix, while the progress of the implementation of the PCO is detailed in subsequent sections. In Tables F-1 to F-6, available information is processed step by step to derive the figures for net savings resulting from the PCO. The cost and savings per optee for individual public sector components (which vary because of differences in salary scales and benefits) are shown in Footnotes 2 and 3 of Table F-5. These tables follow the concepts of the International Monetary Fund's Government Finance Statistics (GFS) Manual, which are presented in the IMF consultations and standby documents. In the case of Nicaragua, the general government consolidation consists of the central government plus the Social Security Institute (INSSBI) plus municipalities. The nonfinancial public sector (NFPS) consolidation covers the general government plus autonomous public enterprises (basically public utility enterprises, including INE, INAA, TELCOR and ENABUS). To derive the public sector consolidation, the IMF adds to NFPS the "rest of public sector" (RPS) category, which includes the state trading enterprises (ENABAS and foreign trading enterprises), the state oil company, expenditures of other public sector institutions financed by external credits, Central Bank losses, and unpaid or rescheduled foreign interest. Operations of the NFPS determine the fiscal impact in the context of the financial program supported by the IMF standby arrangement. The operations of the broader public sector are relevant for the determination of the macroeconomic impact.

Public Sector Employment

Although the precise extent of Nicaraguan public sector employment is difficult to determine from available information, several adjustments and aggregations allow a close approximation of its size. During 1990, the new post-Sandinista regime was busy with crisis management and was not able to devote much attention to the upgrading of statistics on public sector employment. While these statistics were available in various offices, they

Table F-1. Progress of Occupational Conversion Program, March-September 1991
(number of employees opting for program)

	Phase I 3/1 -- 4/15/91	Phase II 4/16 -- 5/14/91	Phase III 5/15 -- 6/30/91	Phase IV 7/1 -- 7/31/91	Phase V 8/1 -- 9/30/91	TOTAL 3/1 -- 9/30/91
A. Non-financial Public Sector	3,652	5,454	2,707	1,185	296	13,294
1. General Government	3,652	4,412	849	484	23	9,420
Central Government	3,652	3,829	746	484	23	8,734
INSSBI	---	583	103	---	---	686
Municipalities	---	---	---	---	---	---
2. Autonomous Public Enterprises 1/	---	1,042	1,858	701	273	3,874
B. Public Financial Institutions 2/	---	264	52	25	---	341
C. CORNAP Enterprises 3/	---	---	737	249	2,365	3,351
Total Public Sector	3,652	5,718	3,496	1,459	2,661	16,986

Source: MIFIN, Direccion de Politicas Presupuestaria, Table: Compensacion Salarial y Numero de Trabajadores Acogidos al PCO por Etapas, and Table: Personal Beneficiado con el PCO por Etapas y Oficinas.

1/ Includes INE, INAA, TELCOR, MAG-FDT, Centro Olof Palme, ENABAS, ENABUS, CERC.
2/ Includes Banco de Credito Popular, Banco Inmobiliario, BAVINIC.
3/ Includes CNC-CARNIC, CAN, CAN-CORNAP, Agroindustria Sebaco, Ing. Mater. y Suelo, SOVIPE, PROAGRO, Matadero Amer., Matad. Brasil, INPESCA, TURNICA, CNAC San Martin, CNC IGOSA, COPESCOSA, CORNAP CNC EMPANICSA, Azuc. Julio Buitrago, Ingenio Benjamin Zeledon, Ingenio German Pomares Ordonez, Ingenio JGB, Ingenio San Antonio, Ingenio Victoria de Julio, MADECASA (CORNAP).

Note: Nominal GDP (thousands of Cordobas oro); BCN estimate of October 1991 for 1990 and 1991; IMF August 1991 mission estimate for 1991 (same as that of BCN) and 1992.

1990 = 1,488,400 1991 = 6,751,800 1992= 9,275,000

Table F-2. Progress of PCO, March-September 1991, Estimated Cost of Indemnization1/ (thousands of córdobas oro)

	Phase I 3/1 -- 4/15/91	Phase II 4/16 -- 5/14/91	Phase III 5/15 -- 6/30/91	Phase IV 7/1 -- 7/31/91	Phase V 8/1 -- 9/30/91	TOTAL 3/1 -- 9/30/91
A. Non-financial Public Sector	26,185	39,909	22,437	8,701	1,901	99,133
1. General Government	26,185	31,101	6,648	3,987	202	68,123
Central Government	26,185	25,851	5,664	3,987	202	61,889
INSSBI	---	5,250	984	---	---	6,234
Municipalities	---	---		---	---	---
2. Autonomous Public Enterprises 2/	---	8,808	15,789	4,714	1,699	31,010
B. Public Financial Institutions 3/	---	2,387	489	245	---	3,121
C. CORNAP Enterprises 4/	---	---	5,585	1,818	19,667	27,070
Total Public Sector	26,185	42,296	28,511	10,764	21,568	129,324

Source: MIFIN, Direccion de Politicas Presupuestarias.
Table: Compensacion Salarial y Numero de Trabajadores Acogidos al P.C.O. por Etapas and
Table: Personal Beneficiado con el PCO en las Disintas Etapas y Opciones.

1/ The cost figures represent indemnization payments only. For a more accurate cost estimate, one must have information about the ages of the PCO retirees so as to include in the cost estimates, potential pension payments to the PCO retirees in the years ahead. This information has been requested. Since 99.1% of the PCO retirees opted for option C (lump sum payment of 20 months' salary with a maximum payment of CO$10,000), it is reasonable to assume that hardly any pension obligations for the PCO retirees will be incurred during 1991-93.
2/ Includes INE, INAA, TELCOR, MAG-FDT, Centro Olof Palme, ENABAS, ENABUS, CERC.
3/ Includes Banco de Credito Popular, Banco Inmobiliario, BAVINIC.
4/ Includes CNC-CARNIC, CAN, CAN-CORNAP, Agroindustria Sebaco, Ing. Mater. y Suelo, SOVIPE, PROAGRO, Matadero Amer., Matad. Brasil, INPESCA, TURNICA, CNAC San Martin, CNC IGOSA, COPESCOSA, CORNAP CNC EMPANICSA, Azuc. Julio Buitrago, Ingenio Benjamin Zeledon, Ingenio German Pomares Ordonez, Ingenio JGB, Ingenio San Antonio, Ingenio Victoria de Julio, MADECASA (CORNAP).
6/ Totals taken from Consolidated table produced in October 1991.

Note: Nominal GDP (thousands of Cordobas oro); BCN estimate of October 1991 for 1990 and 1991; IMF August 1991 mission estimate for 1991 (same as that of BCN) and 1992.

1990 = 1,488,400 1991 = 6,751,800 1992= 9,275,000

Table F-3. Progress of PCO, March-September 1991, Estimated Monthly Gross Savings[1/] (thousands of córdobas oro)

	Monthly Salaries							
	Phase I 3/1-4/15/91	Phase II 4/16-5/14/91	Phase III 5/15-6/30/91	Phase IV 7/1-7/31/91	Phase V 8/1-9/30/91	TOTAL 3/1-9/30/91	OTHER BENEFITS	TOTAL GROSS SAVINGS
A. Non-financial Public Sector	1,354	2,091	1,194	431	101	5,171	1,536	6707
1. General Government	1,354	1,566	342	194	13	3,469	918	4387
Central Government	1,354	1,261	280	194	13	3,102	780	3882
INSSBI	---	305	62	---	---	367	138	505
Municipalities	---	---	---	---	---	---	---	---
2. Autonomous Public Enterprises 2/	---	525	852	237	88	1,702	618	2320
B. Public Financial Institutions 3/	---	138	27	16	---	181	88	269
C. CORNAP Enterprises 4/	---	---	394	94	1,046	1,534	802	2336
Total Public Sector	1,354	2,229	1,615	541	1,147	6,886	2,426	9312

Source: MIFIN, Direccion de Politicas Presupuestarias.
Table: Compensacion Salarial y Numero de Trabajadores Acogidos al P.C.O. por Etapas and
Table: Personal Beneficiado con el PCO en las Distintas Etapas y Opciones.

1/ Gross savings estimates represent monthly salaries of PCO retirees, plus other benefits ("Otros Devengados").
2/ Includes INE, INAA, TELCOR, MAG-FDT, Centro Olof Palme, ENABAS, ENABUS, CERC.
3/ Includes Banco de Credito Popular, Banco Inmobiliario, BAVINIC.
4/ Includes CNC-CARNIC, CAN, CAN-CORNAP, Agroindustria Sebaco, Ing. Mater. y Suelo, SOVIPE, PROAGRO, Matadero Amer., Matad. Brasil, INPESCA, TURNICA, CNAC San Martin, CNC IGOSA, COPESCOSA, CORNAP, CNC EMPANICSA, Azuc. Julio Buitrago, Ingenio Benjamin Zeledon, Ingenio German Pamares Ordonez, Ingenio JGB, Ingenio San Antonio, Ingenio Victoria de Julio, MADECASA (CORNAP).

Note: Nominal GDP (thousands of Cordobas oro); BCN estimate of October 1991 for 1990 and 1991; IMF August 1991 mission estimate for 1991 (same as that of BCN) and 1992.

1990 = 1,488,400 1991 = 6,751,800 1992= 9,275,000

Table F-4. Estimated Cost, Gross Savings, and Net Savings, 1991-1992, Based on Implementation Results of PCO during March-September 1991 1/ (thousands of córdobas oro)

	Cost			Gross Savings 2/: Salaries			Gross Savings 2/: Others Benefits			Gross Savings 2/: Total			Net Savings		
	1991	1992	1993	1991	1992	1993	1991	1992	1993	1991	1992	1993	1991	1992	1993
A. Non-financial Public Sector	99,133	---	---	40,310	62,052	62,052	11,832	18,432	18,432	52,142	80,484	80,484	(46,991)	80,484	80,484
1. General Government	68,123	---	---	28,325	41,628	41,628	7,480	11,016	11,016	35,805	52,644	52,644	(32,318)	52,644	52,644
Central Government	61,889	---	---	25,454	37,224	37,224	6,400	9,360	9,360	31,854	46,584	46,584	(30,035)	46,584	46,584
INSSBI	6,234	---	---	2,871	4,404	4,404	1,080	1,656	1,656	3,951	6,060	6,060	(2,283)	6,060	6,060
Municipalities	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---
2. Autonomous Public Enterprises 3/	31,010	---	---	11,985	20,424	20,424	4,352	7,416	7,416	16,337	27,840	27,840	(14,673)	27,840	27,840
B. Public Financial Institutions 4/	3,121	---	---	1,392	2,172	2,172	677	1,056	1,056	2,069	3,228	3,228	(1,052)	3,228	3,228
C. CORNAP Enterprises 5/	27,070	---	---	8,028	18,408	18,408	4,197	9,624	9,624	12,225	28,032	28,032	(14,845)	28,032	28,032
Total Public Sector	129,324	---	---	49,730	82,632	82,632	16,706	29,112	29,112	66,436	111,744	111,744	(62,888)	111,744	111,744

Source: Tables IV-1,2, and 3.

1/ All 1991-93 figures are based on progress of PCO during March-September 1991. For lack of information, ongoing and planned PCO actions during October-December 1991 have not been taken into account. This information has been requested. Very little PCO activity is expected during October-December 1991.
2/ To calculate the 1991 salaries, Phase I salaries in Table IV-3 have been multiplied by 9, Phase II salaries by 8, Phase III salaries by 7, Phase IV salaries by 6, and Phase V salaries by 4.5. Other benefits for 1991 are calculated by maintaining the same ratio to salaries in this table as the ratio of other benefits to total salaries in Table IV-3. For 1992, multiply total salaries, other benefits, and total savings by 12.
3/ Includes INE, INAA, TELCOR, MAG-FDT, Centro Olof Palme, ENABAS, ENABUS, CERC.
4/ Includes Banco de Credito Popular, Banco Inmobiliario, BAVINIC.
5/ Includes CNC-CARNIC, CAN, CAN-CORNAP, Agroindustria Sebaco, Ingeneria Mater. y Suelo, SOVIPE, PROAGRO, Matadero Amer., Matad. Bras., INPESCA, TURNICA, COPESCOSA, CORNAP CNC EMPANICSA, Azuc. Julio Buitrago, Ingenio Benjamin Zeledon, Ingenio German Pomares Ordonez, Ingenio JGB, Ingenio San Antonio, Ingenio Victoria de Julio, MADECASA (CORNAP).

Note: Nominal GDP (thousands of Cordobas oro); BCN estimate of October 1991 for 1990 and 1991; IMF August 1991 mission estimate for 1991 (same as that of BCN) and 1992.

1990 = 1,488,400 1991 = 6,751,800 1992= 9,275,000

Table F-5. Estimated Cost, Gross Savings, and Net Savings, 1992-1993 1/
(thousands of córdobas oro)

	Cost 2/ 1992	Cost 2/ 1993	Gross Savings 3/ 1992	Gross Savings 3/ 1993	Net Savings 1992	Net Savings 1993
A. Non-financial Public Sector	22,200	---	9,000	18,000	(13,200)	18,000
1. General Government	14,200	---	5,400	10,800	(8,800)	10,800
Central Government	14,200	---	5,400	10,800	(8,800)	10,800
INSSBI	---	---	---	---	---	---
Municipalities	---	---	---	---	---	---
2. Autonomous Public Enterprises	8,000	---	3,600	7,200	(4,400)	7,200
B. Public Financial Institutions	36,600	---	19,200	38,400	(17,400)	38,400
C. CORNAP Enterprises	24,300	---	12,600	25,200	(11,700)	25,200
Total Public Sector	83,100	---	40,800	81,600	(42,300)	81,600

Source: Consultant Estimates.

1/Estimates for 1992-93 in this table take into account only the planned personnel reductions of 10,000 in 1992 (2,000 in Central Government, none in INSSBI and Municipalities, 1,000 in autonomous public enterprises, 4,000 in public financial institutions, and 3,000 in CORNAP enterprises), using cost and savings factors derived from the March-September 1991 PCO results (Tables IV-2 and 3). It is assumed that there will be so new PCO operations in 1993.
2/Cost per optee calculated of CO$7,100 for Central Government, zero for INSSBI and Municipalities, CO$8,000 for autonomous public enterprises, CO$9,150 for public financial institutions, CO$8,100 for CORNAP enterprises (derived from Tables IV-1 and IV-2). Also see footnote 1 above and footnote 1 of Table IV-2.
3/Includes salary plus other benefits per optee calculated at CO$450 per month for Central Government, zero for INSSBI and Municipalities, CO$600, for autonomous public enterprises, CO$800 for public financial institutions, and and CO$700 for CORNAP enterprises. Also see footnote 1 above and footnote 1 of table IV-3. For 1992, monthly gross savings are multiplied by 6 on the assumption of equal monthly personnel reductions in both Central Government and rest of public sector. For 1993, monthly savings are multiplied by 12.

Note: Nominal GDP (thousands of Cordobas oro); BCN estimate of October 1991 for 1990 and 1991; IMF August 1991 mission estimate for 1991 (same as that of BCN) and 1992.

1990 = 1,488,400 1991 = 6,751,800 1992= 9,275,000

Table F-6. Estimated Cost, Gross Savings, and Net Savings, 1991-1993[1/]
(thousands of córdobas oro)

	--- Cost ---			-- Gross Savings --			-- Net Savings --		
	1991	1992	1993	1991	1992	1993	1991	1992	1993
A. Non-financial Public Sector	99,133	22,200	---	52,142	89,484	98,484	(46,991)	67,284	98,484
1. General Government	68,123	14,200	---	35,805	58,044	63,444	(32,318)	43,844	63,444
Central Government	61,889	14,200	---	31,854	51,984	57,384	(30,035)	37,784	57,384
INSSBI	6,234	---	---	3,951	6,060	6,060	(2,283)	6,060	6,060
Municipalities	---	---	---	---	---	---	---	---	---
2. Autonomous Public Enterprises	31,010	8,000	---	16,337	31,440	35,040	(14,673)	23,440	35,040
B. Public Financial Institutions	3,121	36,600	---	2,069	22,428	41,628	(1,052)	(14,172)	41,628
C. CORNAP Enterprises	27,070	24,300	---	12,225	40,632	53,232	(14,845)	16,332	53,232
Total Public Sector	129,324	83,100	---	66,436	152,544	193,344	(62,888)	69,444	193,344

Source: Tables IV-4 and 5.
1/ The columns in this table represent the sums of the corresponding columns of Tables PCO-4 and 5. In other words, this table takes into account PCO implementation results, March-September 1991, as well as planned PCO implementation during 1992.

Note: Nominal GDP (thousands of Cordobas oro); BCN estimate of October 1991 for 1990 and 1991; IMF August 1991 mission estimate for 1991 (same as that of BCN) and 1992.

1990 = 1,488,400 1991 = 6,751,800 1992= 9,275,000

were not compiled in a systematic way and thus were incomplete and inconsistent. In the closing months of 1990, the Government of Nicaragua initiated a systematic compilation of public sector employment statistics. While considerable improvement has been registered, particularly during 1991, there are still gaps and inconsistencies. The data on central government employment have now been upgraded to an acceptable level, while those on the rest of the public sector are still unreliable.

Central government employment (*nomina fiscal*) rose from 50,271 employees at the end of 1980 to a peak of 78,831 in 1987 (an increase of 57 percent), then declined sharply to 70,047 in 1989 as a result of a massive employment reduction program (the *compactacion* program, summary dismissals without indemnization payments) implemented by the Sandinista regime. Central government employment tapered off to 68,736 at the end of 1990 as a result of expenditure containment measures adopted by the present government, including a freezing of vacancies, in November 1990. This figure remained practically unchanged at 68,759 at the end of March 1991, the starting point of the PCO. As a result of implementation of the PCO, central government employment was reduced to 59,315 at the end of September 1991.

The above figures on central government employment are not entirely comprehensive, but they are the only ones comparable with the long-term series available. The figures for the central government payroll exclude the personnel of the Ministry of the Interior (*Gobernacion*, approximately 10,800) and the Ministry of Defense (approximately 20,400). The personnel of the Interior Ministry were incorporated into the central government payroll between June and September (not yet reflected in the figures cited above), and the incorporation of the Defense Ministry personnel is expected by the end of 1991.

In addition to the *nomina fiscal*, there exists a *nomina interna* representing personnel working in various agencies on a temporary or informal basis whose salaries are paid out of the agencies' own funds. Their numbers (mostly teachers and Ministry of Education staff) declined from 1,214 at the end of December 1990 to 791 at the end of August 1991. Also part of central government but not included in the above total are three institutions newly created in the 1991 budget, whose total employment amounted to 580 at the end of August 1991.

At the end of August 1991, the numbers of employees of public sector components other than the central government were as follows: INSSBI, 3,041; autonomous public enterprises (INAA, INE, TELCOR, ENABUS, ENABAS), 11,503; public financial institutions, 8,192; 22 of the 300 CORNAP enterprises, 11,075; and two institutions attached to ministries, 3,884. Even this coverage is not complete. Besides the exclusion of most CORNAP enterprises, the list does not include the state trading enterprises. Nevertheless, total public sector employment, based on this somewhat more complete coverage, declined from

118,579 at the end of 1990 to 99,540 at the end of August 1991, as a result of the implementation of PCO and other factors.

Short-Term Costs of the Program

The short-term cost of the PCO is considered to be essentially the same as the indemnization paid. Since 99.1 percent of the optees chose Option C, short-term costs incurred in other options are negligible. Conceptually, a comprehensive notion of the cost of the program would include the potential cost represented by the vested pension rights of the PCO retirees. To calculate this potential cost, one must have the breakdown by age of the PCO retirees, information which is not readily available. In the light of interviews with the concerned officials in the Budget Office of the Ministry of Finance (MIFIN), however, it appears certain that there were very few, if any, PCO optees aged 56 or older who would reach the retirement age of 60 before 1993—the last year of the period covered by Tables F-1 to F-6. Hence, the indemnization payments are deemed to represent the full cost of the PCO.

The cost of the PCO as previously defined is detailed in Tables F-1 and F-2. Table F-1 shows the number of employees opting for the program, by major components of the public sector, in each of the five phases during March-September 1991, as well as the total for the entire period. The number of central government optees was predominant in the first two phases, but it declined rapidly in the last three phases. The number of PCO participants from autonomous public enterprises became significant in the second, third, and fourth phases. Optees from CORNAP enterprises constituted the bulk of retirees in the fifth phase. Of the March-September 1991 total, the share of central government was 51 percent, and autonomous public enterprises accounted for 23 percent and CORNAP enterprises registered 20 percent. The shares of INSSBI and public financial institutions were small, and municipalities were not participants in the programs.

Table F-2 shows the estimated cost of the program, following the format and coverage of Table F-1. The evolution of costs by major public sector components follows the same pattern as in Table F-1, with the difference that the costs per optee for autonomous public enterprises and CORNAP enterprises (based on larger salaries) were higher than in the case of the central government. The cost per PCO participant for public financial institutions, which had the smallest number of optees, was the highest. Of the total costs for the period March-September 1991, central government accounted for 48 percent, autonomous public enterprises 24 percent, and CORNAP enterprises 21 percent. The total indemnization paid, the cost of the PCO, during March-September 1991 amounted to 2.3 percent of 1990 GDP.

Gross Savings Under the Program

Table F-3 presents the gross savings resulting from the PCO. These savings have two components: (1) salaries that no longer must be paid and (2) other benefits (or *Otros Devengados*), including the "13th month's salary", bonuses, allowances, and employer's pension contributions. The results presented in this table confirm the findings of the preceding section, in that central government employees are the lowest paid, whereas those of public financial institutions have the highest emoluments in the public sector. Monthly gross savings (salaries plus other benefits) per PCO optee amounted to CO 444 for central government, CO 736 for INSSBI, CO 599 for autonomous public enterprises, CO 789 for public financial institutions, and CO 697 for CORNAP enterprises. The ratio of other benefits to total savings was approximately 26 percent for public sector optees as a whole, lowest (20 percent) for central government, about average (26-27 percent) for INSSBI and autonomous public enterprises, and highest (33-34 percent) for public financial institutions and CORNAP enterprises.

Net Short-term Savings of Occupational Conversion Program and Medium-term Projections

Net short- and medium-term savings for the period 1991-93 resulting from the implementation of the PCO during the period between March and September 1991 and its planned implementation in 1992, have been calculated sequentially in Tables F-4, F-5 and F-6, on the basis of inputs from Tables F-2 and F-3. Table F-4 presents the calculation of net savings for 1991-1993, based solely on the results of PCO implementation between March and September 1991. It is assumed (for this table only) that there are no plans for further PCO implementation after the termination of Phase V at the end of September 1991, an assumption which has held true for 1991.[1] Referring to the three columns in Table F-4 under the "cost" heading, the first column (for 1991) is the same as the last column (total) in Table F-2, while the second and third columns (for 1992 and 1993) have zero entries, meaning that no costs will be incurred in 1992 and 1993 because of the above assumption.

The costs and savings resulting from planned implementation of PCO during 1992 are calculated and illustrated in Table F-5. The "salaries" component of gross savings for 1991, shown in the fourth column, is derived from the "salaries monthly" columns for each of the five phases in Table F-3, by multiplying the salary savings for each phase with the corresponding number of months. The next column (for 1992 salary savings) is derived by

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[1]In the course of interviews in October 1991 with officials at the Budget Office of MIFIN, the evaluation team was informed that, owing to the lack of external financing, the implementation of the PCO has been put on hold for the rest of 1991.

multiplying the "total salaries (monthly)" column of Table F-3 by 12. The sixth column (for 1993) has the same figures as in the fifth column (for 1992) because of the assumption of no further PCO implementation. The same methodology is repeated in the next three columns to obtain the "other benefits" component of gross savings for 1991-1993. Total gross savings (salaries plus other benefits) for 1991-1992 and 1993 are entered in the tenth, eleventh, and twelfth columns respectively. Net savings (the difference between cost and total gross savings) are shown in the last three columns. As expected, substantial negative net savings in 1991 would give way to much larger positive savings in 1992-1993. All of these calculations are subject to the limiting assumption of no additional PCO operations after September 1991.

Planned PCO operations in 1992 are taken into account in the next two tables. Table F-5 lays out the estimated cost, gross savings, and net savings in 1992 and 1993 of planned PCO operations during 1992. It is assumed that there will be no new PCO operations in 1993. Of the planned personnel reductions of 10,000 during 1992 through the PCO mechanism, current plans envisage about 40 percent of these reductions to come from the CORNAP enterprises, 32 percent from the autonomous public enterprises, 20 percent from the central government, and 8 percent from public financial institutions.

As expected, the cost per optee, derived from Tables F-1 and F-2, is lowest for central government and highest for public financial institutions. Gross savings (salaries plus other benefits) per optee, derived from Table F-3 and F-4, are also lowest for central government and highest for public financial institutions. For 1992, monthly gross savings are multiplied by 6 on the assumption of equal monthly personnel reductions in the course of 1992. For 1993, monthly savings are multiplied by 12. Net savings, the difference between cost and gross savings, for 1992 and 1993 show substantial negative savings in 1992 and larger positive savings in 1993.

The results of Tables F-4 and F-5 are consolidated in Table F-6, which identical to text Table 4-1. The consolidated results are analyzed in Chapter 4 and need not be repeated here.

Appendix G

SUPPLEMENTARY INFORMATION ON AND ANALYSIS OF ESR IMPACT ON THE EXTERNAL SECTOR IN NICARAGUA

This appendix provides two sections of supplementary information concerning ESR impact on import demand in Nicaragua. The first section deals with the determinants of Nicaraguan import demand; the second describes the direction of Nicaraguan exports and imports.

Determinants of Import Demand in Nicaragua

The determinants of import demand can be divided into three categories.

- Resource requirements arising from economic activity
- The *córdoba* prices of foreign goods, as affected by the exchange rate, tariffs, and taxes
- The rationing effects of quantitative restrictions, the policies of state trading companies, the availability of domestic credit, and delays in receiving dollars

The issues in Chapters 2 and 3 will be discussed here from the point of view of import demand. Given that the stabilization program is only 6 months old, the analytic approach must be essentially a qualitative commentary on trends buttressed with statistics whenever available. The GNP of Nicaragua declined significantly between 1985 and 1989 at various annual rates and then stagnated in 1990. During 1991 a mild decline is expected, but rising activity in commerce and certain industrial subsectors, as well as the rebuilding of inventories, will have a positive effect on imports for the year as a whole. Consumption goods imports are rising but investment imports are at historically low levels in the first half of 1991. A combination of political uncertainty, the lack of secure property rights, and tight credit have resulted in particularly bad damage of private investment, other than commercial distribution. Public investment has been reduced to a minimum by the stabilization plan limits on public sector spending. In 1992 a 4 percent increase is projected by the Central Bank and accepted by the IMF (see Chapter 3 for further discussion).

A 20 percent effective depreciation of the exchange rate since the March devaluation is a further deterrent to buying abroad. The sharp cuts in tariffs have probably had little effect on demand because they were partly offset by the devaluation and left many tariffs still so high (300 percent) that the reduction had a negligible effect on demand. Further cuts in September 1991 may have some stimulating effects on imports but protection still remains very high. Some imports have been encouraged by temporary exemptions for vehicles, agricultural inputs, and related items.

The comprehensive nontariff control over imports through quantitative restrictions and the policies of state trading companies is being dismantled fairly rapidly. This policy, which should stimulate new orders, consists of two components: the entry of private traders who are now in a position to import most lines of goods and the elimination of quotas for most products other than selected basic foodstuffs.

Monetary policy is currently much stricter than during 1990. Since March 1991, loans have carried 18 to 20 percent interest rates, while prices have actually declined, clearly a deterrent to borrowing. While there are widespread complaints about lack of credit, credit demand is effectively constrained by depressed economic conditions, high interest rates, and new emphasis on credit discipline (loan recovery, stricter lending criteria). On the other hand, dollars for imports can be obtained fairly easily and rapidly from the banks and the *casas de cambio*, an impression confirmed by the small discount (currently 4 to 5 percent) for the *córdoba* in the informal parallel market.

The net effect of all these policies is to increase the potential demand for imports, because the ease with which dollars can be obtained for imports outweighs the higher costs arising from the devaluation and high interest rates.

Direction of Nicaraguan Exports and Imports

Through 1989, the direction of Nicaraguan exports and imports was strongly influenced by the embargo on trade with the United States and close economic relations with the Soviet Union and its allies. Conversely, from 1990, the lifting of the embargo on American trade and the practical cessation of aid from Eastern Europe was the dominant reason for the change in the geographical pattern. The following table highlights these shifts. Amounts are presented in percentages.

	1989		1990		1990/I		1991/I	
	Exports	*Imports*	*Exports*	*Imports*	*Exports*	*Imports*	*Exports*	*Imports*
United States	0	0	NA	NA	5	4	18	19
Canada	18	3	NA	NA	15	5	15	5
Central America	18	7	NA	NA	15	9	14	17
Panama	2	6	NA	NA	1	5	0	6
Mexico	1	2	NA	NA	6	2	3	2
Venezuela	0	NA	NA	NA	0	0	0	20
Ecuador	0	12	NA	NA	0	16	0	0
Western Europe	41	27	NA	NA	28	14	28	9
Socialist Countries	11	29	NA	NA	14	31	2	4
Japan	6	5	NA	NA	7	6	19	7
Other	3	9	NA	NA	9	8	1	11
Total	100	100	NA	NA	100	100	100	100

Note: NA is not applicable.
Source: Central Bank

The major changes in the geographical pattern of trade from 1989 through the first half of 1991 follow.

- The United States has gone from no trade to being a leading market and supplier.
- The Socialist countries as a group, which were the most important supplier and a major market, have fallen to a minor position on both scores.
- Japan has become an important market for Nicaraguan exports although its supplier position has changed little.
- The A.I.D. program has been a moderately important factor in increasing imports from the United States but a minor influence on Central American imports.
- Venezuela, rather than Ecuador, is currently the leading oil supplier.

Appendix H

ADMINISTRATIVE PROCEDURES UNDER ESR I, II, AND III

General

The ESR I Grant Agreement and Operating Procedures were signed by A.I.D. and the Nicaraguan Government on May 31, 1990, and the corresponding ESR II documents were signed by A.I.D. and the Nicaraguan Government on September 26, 1990, at which time the CBN was undergoing rapid organizational change. The decentralization of VPOIC activities created the Vice Presidency of International Banking Operations (VPOBI) and the Vice Presidency of International Treasury (VPTI). The exchange control section became the Vice Presidency of Foreign Trade (VPCE), and later the Vice Presidency of Internal Control (VPIC) was added. The ESR III Grant Agreement and Operating Procedures were signed by A.I.D. and the Nicaraguan Government on May 8, 1991. This agreement authorizes nonpetroleum imports by public institutions and state enterprises. However, before these imports can be authorized, the Government of Nicaragua is required to submit to A.I.D. procedures governing public sector competitive procurement.

Administrative Procedures Under ESR I

Requirements can be broken down into three phases of application: Phase I regulates the disbursement of A.I.D. funds to the separate account established by the Government of Nicaragua in the Federal Reserve Bank of New York (FED); Phase II governs the transfer of funds by the Government of Nicaragua to its separate accounts in U.S. commercial banks and Phase III involves the foreign exchange authorization procedure to importers for eligible goods.

Phase I involves the following steps.

- Using Form A.I.D. 1130-2 the Government of Nicaragua requests A.I.D. to disburse funds to the FED account.

- The Government of Nicaragua submits documentation and certifications that it is in compliance with the conditions applicable to the disbursement.

- A.I.D. reviews the documentation and, if it is found in compliance, issues a Project Implementation Letter (PIL) authorizing the transfer.

- The transfer of funds takes place. The FED notifies the Central Bank of Nicaragua (CBN) which in turns acknowledges receipt to A.I.D..

Phase II involves the following steps.

- CBN requests a disbursement from the FED account to its separate accounts in U.S. commercial banks to pay or to collateralize letters of credit opened to suppliers of authorized imports. These requests are made periodically and cover a group of letters of credit.

- A.I.D. authorizes the transfer of funds from the FED account to the U.S. commercial banks.

- The U.S. commercial bank confirms the transfer of funds.

- Periodically, A.I.D. verifies the eligibility of the imports made with the funds. If ineligible transactions are found, A.I.D. requests CBN to reimburse the corresponding amounts.

- CBN is obliged to reimburse the amount corresponding to ineligible transactions within 90 days of notification.

Phase III involves the following steps.

- The importer fills out an import declaration (Declaración de Importación) at the VPOIC located at CBN.

- For the A.I.D. program the importer presents three pro-forma invoices and a certificate of U.S. origin and source of the goods to be imported. Otherwise, only one pro-forma invoice is required.

- The VPOIC analyzes the importer's application. If the application is eligible the VPOIC executes a request for reservation of funds and notifies the importer. A Committee of Foreign Exchange authorizes the import request.

- The VPOIC opens a letter of credit to the importer on a U.S. commercial bank.
- The VPOIC authorizes the U.S. commercial bank to use funds from the CBN separate accounts as collateral for the letters of credit opened.
- The importer pays CBN the amount in local currency (LC) to cover the letter of credit. In addition the importer pays a 10 percent deposit that is held by CBN until the delivery of the paid custom's invoice.
- The CBN authorizes the U.S. commercial bank to make payment to the exporter upon embarkation of the merchandise.
- The exporter ships the merchandise to Nicaragua.
- The importer pays the import duty and transfers the merchandise from the custom's warehouse to his own depot.
- The importer presents the paid custom's invoice to CBN and recovers the 10 percent deposit.

Administrative Procedures Under ESR II and III

The administrative procedures for Phase III were modified for ESR II and III. In the modified procedures the following steps were prescribed to authorize foreign exchange for imports.

- The importer fills out the *Declaración de Importación* at the VPCE located at CBN.
- For the A.I.D. program the importer presents three pro-forma invoices and a certificate of U.S. origin and source of the goods to be imported. Otherwise, only one pro-forma invoice is required.
- The VPCE analyzes the importer's application. If the application is eligible the VPCE asks the VPOIB to execute a request for reservation of funds and notifies the importer.
- The importer pays CBN the amount in local currency (LC) to cover the letter of credit. In addition the importer pays a 10 percent deposit that is held by CBN until the delivery of the paid custom's invoice.

- The VPOIB opens a letter of credit to the importer on a U.S. commercial bank and asks the VPTI to guarantee it with the CBN's own funds.

- The VPTI authorizes the U.S. commercial bank to make payment to the exporter upon embarkation of the merchandise.

- The exporter ships the merchandise to Nicaragua.

- The importer pays the import duty and transfers the merchandise from the custom's warehouse to his own depot.

- The importer presents the paid custom's invoice to CBN and recovers the 10 percent deposit.

- Periodically, the VPTI requests A.I.D. to transfer funds from the FED account to the separate accounts in the U.S. commercial banks. This request is based on completed transactions.

- A.I.D. reviews the eligibility of the import transactions. A.I.D. authorizes the transfer of funds, for the eligible transactions only.

- The U.S. commercial bank confirms the transfer of funds.

- The VPIC sends A.I.D., on a monthly basis, a statement of all transactions completed and in process. VPIC also sends A.I.D. the reconciled balances of all U.S. Dollar accounts.

The Proposed Decentralized Administrative Procedures

The proposed decentralized procedures, of October 2, 1991, to obtain foreign exchange for private sector imports, under the A.I.D. ESR program, can be summarized as follows.

- The importer presents to the delegate of the CBN's VPCE, at any commercial bank, the import declaration, one pro-forma invoice and the certificate of U.S. origin and source.

- The delegate immediately determines the import eligibility and authorizes the transaction. The delegate also assigns the transaction to a project and to a separate account in one of the U.S. commercial banks used by CBN for this purpose.

- The importers pay the local currency equivalent of the letter of credit plus expenses. The commercial bank opens the letter of credit on the U.S. commercial bank assigned by the CBN delegate.

The importer can arrange credit with the local commercial bank to pay for the imports.

- The commercial bank maintains a local currency separate account at CBN. CBN debits this account for the letter of credit amount.
- Upon the debit of local currency in the separate CBN account, CBN authorizes its U.S. corresponding bank to debit, the U.S. Dollar separate account, the letter of credit amount.
- The exporter receives the irrevocable letter of credit.
- The exporter ships the merchandise to Nicaragua.
- The importer pays the import duty and transfers the merchandise from the custom's warehouse to his own depot.
- Once the merchandise arrives and the custom duties are paid, the importer should present the paid invoice to the local commercial bank.
- The CBN delegate at the local commercial bank advises the VPCE on a daily basis of all authorized transactions to keep a daily control on funds available. The delegate also informs of all completed transactions and when the funds available to the local commercial bank fall to $500,000.

On October 4, 1991, CBN further decentralized the authorization procedure by allowing the local commercial banks to issue direct debiting instructions to the separate accounts in the U.S. commercial banks.

Compliance with Separate Account Requirements

A thorough revision of CBN and A.I.D. files revealed that CBN complied with the separate account agreements by establishing at the Federal Reserve Bank of New York separate subaccounts for each operation. There is no evidence of commingling of funds with any other Government of Nicaragua funds kept at the Federal Reserve Bank of New York or between funds of the three ESR operations. CBN also complied with the separate account agreements by establishing separate accounts with two U.S. commercial banks for each ESR operation.

The separate accounts opened by CBN at the Federal Reserve Bank of New York are as follows.

- Account 0210-8695-1 for ESR I 524-0300