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UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D. C. 20523

NICARAGUA

PROJECT PAPER

ECONOMIC STABLIZATION & RECOVERY II

AID/LAC/P-557

Project Number: 524-0311
Grant Number: 524-K-602

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AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number: 524-0311 524-K-602

2. Country: NICARAGUA

3. Category: CASH TRANSFER

4. Date: September 25, 1990

5. To: AA/LAC, James H. Michel

6. OYB Change Number: N/A

7. From: LAC/DR, Peter J. Bloom *for M Silverman*

8. OYB Increase: NONE

To be taken from: ECONOMIC SUPPORT FUNDS(ESF)

9. Approval Requested for Commitment of: $118,000,000

10. Appropriation Budget Plan Code: LES090-35524-IG31;070-65-524-01-50-01

11. Type Funding: ☐ Loan ☒ Grant

12. Local Currency Arrangement: ☐ Informal ☐ Formal ☒ None

13. Estimated Delivery Period: FY 1990/1991

14. Transaction Eligibility Date:

15. Commodities Financed

Best Available Copy

16. Permitted Source		17. Estimated Source	
U.S. only		U.S.	
Limited F.W.		Industrialized Countries	
Free World		Local	
Cash	$118,000,000	Other	

18. Summary Description

This $118 million ESF balance of payments program for FY 1990 will facilitate the efforts of the Government of Nicaragua (GON) to: 1) establish monetary and fiscal controls; 2) restructure the financial system; 3) eliminate barriers to international trade; 4) re-privatize segments of the economy; and, 5) establish a comprehensive and workable multi-donor arrangement to clear arrears with the IBRD and IDB. ESF dollars will be disbursed in four tranches into a separate, non-commingled interest-bearing account based on conditionality in these five priority areas in accordance with Section 4 of the PAAD. In addition, the GON will covenant to: 1) provide, over a three-year period, the equivalent of $5 million in cordoba oro for the OE trust fund to help defray Mission operating expenses; 2) ensure an adequate expansion in real credit to the private sector, in part through private financieras and/or banks; and, 3) search for alternative financing for petroleum imports, in the understanding that no more than $45 million under this ESF program may be used for this purpose.

The funds provided will be used to 1) help clear arrearages to the IBRD and the IDB ($50 million); 2) finance private sector imports of productive goods from the U.S. and Central America ($23 million minimum); and, 3) finance petroleum imports from A.I.D. Geographic Code 941 countries, the Netherlands Antilles and Curacao ($45 million maximum). Given the hyper-inflationary situation in Nicaragua, no local currencies other than that provided for the Mission operating expense trust fund will be generated under this program.

19. Clearances		Date
LAC/DP:BSchouten	B.S	9/25/90
PPC/PB:TBarker		9/25/90
GC/LAC:KHansen	MS	9/25/90
LAC/DR:MSilverman	MS	9/25/90
ARA/ECP:CBryant		9/25/90
M/PFM/A:RBonnaffon		9/25/90
LAC/GEN:TC Hansen		9/25/90

20. Action

☑ APPROVED ☐ DISAPPROVED

Authorized Signature: *James H Michel*

Date: 25 Sept, 199[illegible]

Title: ASSISTANT ADMINISTRATOR, LAC

Approval of Methods of Financing

This PAAD complies with current Agency guidance on methods of financing and has provided for adequate audit coverage in accordance with the Payment Verification Policy Implementation Guidance.

E. Cecile Adams, Controller, LAC

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I. SUMMARY

The new government of Violeta Barrios de Chamorro inherited an economy in ruins, with per capita output about 60 percent below its level of 12 years ago and export earnings reduced by 50 percent over the same period. It faced an economy characterized by deteriorated infrastructure, badly functioning and politicized health and educational services, and the simplest private economic transaction encumbered by political agendas and red tape. Private property was subject to expropriation on the slightest pretext. Moreover, although the election revealed the Sandinistas to be a minority, they are a committed and well-organized minority, capable of causing serious mischief both in the capital and in the countryside, by obstructing the efforts of the new government to reconstruct the economy they destroyed.

A. Challenge Facing the New Government

Even in the absence of such opposition, the new government faced a formidable task. Government salary expenditures had been boosted, in real terms, to two and a half times their level of only a few months before; revenues had been eroded by inflation; the exchange rate was grossly overvalued; the financial system, dominated by state banks was essentially a retailer of Central Bank lines of credit with little independent capability for financial analysis and, in any case, a very small deposit base. Finally, approximately 450 state enterprises dominated key areas of the economy--with legally established monopolies in many cases--and remained firmly under the control of the Sandinistas.

The new government moved quickly to develop and implement a recovery program. Key parts of that program were implemented in the government's first few weeks in office. These parts included:

(1) the devaluation and unification of the exchange rate, so that, by late June, the official rate was only 15 percent below the black market rate;

(2) the subsequent, frequent devaluation of the exchange rate to maintain the real exchange rate;

(3) the denomination of banking system loans in "cordobas oro" (equal to one U.S. dollar) thus establishing positive real lending interest rates for both private and public sector borrowers;

(4) the offering of "cordoba oro" denominated bank deposits, which offered savers an asset which outperforms dollar currency;

(5) the indexing of taxes and public utility payments by denominating them in cordobas oro, thus stabilizing key elements of public sector revenue;

(6) the reform of the tax system, establishing a top marginal rate of 38.5 percent for the income tax and drastically reducing rates for import duties and the selective consumptions tax; and

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(7) resuming current payments to multilateral creditors and beginning a process of regularizing the country's external financial obligations.

The new government faces four additional essential tasks which must be accomplished successfully if the economy is to realize stability and renewed growth. These are:

(1) the restoration of fiscal and monetary stability in order to permit reestablishment of reasonable price level stability and an adequate rate of growth in credit to the productive sectors;
(2) the reestablishment of a functioning financial system, whose institutions take deposits paying positive real rates of interest, assess the credit worthiness of loans based on their intrinsic merits, provide related financial services as demanded by its customers, and earn a profit in the process;
(3) the removal of administrative and bureaucratic impediments to export expansion; and
(4) re-privatization of the economy, requiring those enterprises remaining under government control to repay loans and meet their other obligations in a competitive market, as if they were private, and ultimately, returning the bulk of them to private ownership and control.

To date, the government's success in achieving these four essential tasks has been limited. There have been delays and setbacks caused by a combination of Sandinista intransigence and by confusion and disagreement among various actors within the government. The Sandinista-led general strikes in May and July have thrown the GON's program of expenditure control well off course, producing continuing hyperinflation. The public sector financial system is overmanned, bureaucratic, and inefficient, even when it is not a Sandinista-sympathizing hostile force. Efforts to authorize and license privately owned non-bank financial intermediaries to act as competitors to and possibly replacements for the state banks have not yet been acted on. Finally, efforts to return public sector enterprises to private ownership and control have foundered on the sheer complexity of attempting to sell over 400 state enterprises, and on fear of possible Sandinista-employee reaction.

The GON has accomplished more than is generally appreciated in its first four months in office, but the remaining task is daunting, both because of political opposition and because the remaining tasks are complex. Moreover the election mandate to carry out a fundamental restructuring of Nicaragua will not last very long. If the major elements of that restructuring are not completed by the end of the government's first year, there is a significant likelihood that they will not be achieved at all.

B. U.S. Interests

During the last ten years, the USG has devoted considerable effort and expenditure to bringing about a restoration of democratic government and a market economy to Nicaragua. On February 25, the people of Nicaragua overwhelmingly chose the path of pluralism, democracy, and free individual choice, represented by President Chamorro, over a Soviet-style system, despite the Sandinistas' use of all the governmental resources available to a police state to achieve the opposite outcome. U.S. assistance for Nicaragua's economic recovery is designed to support the government's efforts to democratize, demilitarize, and develop the economy. This requires a commitment on our part to help Nicaragua both to achieve short-term stabilization of its economy and to improve its medium term growth prospects, and provide productive employment.

During the 1960s and 1970s, Nicaragua had one of the most dynamic and productive economies in Central America, despite the kleptocracy which governed it. Eleven years of Sandinista mismanagement has reduced production per capita to slightly more than 40 percent of its 1977 level, while the rest of Central America has made significant technological and institutional strides, while improving their integration in the world economy. U.S. interests in the peace, democracy, and prosperity of the region require that Nicaragua make up lost ground and take its rightful place in the democratic, prosperous, and free-market oriented region.

C. Rationale for Assistance

U.S. balance of payments support is designed to provide the Nicaraguan economy with assured access to fuel, raw materials, semi-finished goods, spare parts, and new capital goods during a transition period in which stabilization and structural reform measures are put into place. The economic program presented by the GON to the donors in Rome in June was widely regarded as providing an accurate assessment of the needs of the economy and an appropriate, if ambitious, set of measures to meet those needs. Our first cash grant was designed simply to support the program of the GON as presented.

The GON's implementation of this program, in many respects, has been impressive. The exchange rate has been devalued and unified, positive real interest rates have been established, major parts of the public revenue system have been indexed to inflation, the tax system has been drastically reformed to reduce marginal income tax rates to reasonable levels and to reduce import duties, in general, to not more than 40 percent.

The assistance provided in this agreement will assist the government in carrying out its own program in four critical areas:

-- expenditure and monetary control,
-- restructuring of the financial system,
-- elimination of barriers to entry into international trade,
-- reestablishing normal relationships with multilateral development institutions, and
-- privatization of the economy.

If these elements of the program are successfully implemented, the GON will have achieved the major preconditions for stabilization and economic recovery.

D. Program Description

There will be two major disbursements of funds. One will consist of three tranches related to the implementation of fiscal, monetary, trade, and privatization policy. The second disbursement will consist of one tranche of $50 million to clear debt arrears to multilateral institutions.

1. **Conditionality.** The program will provide conditionality in several areas. These are:

a. **Expenditure Reduction and Monetary Control.**

For the first tranche, the Government of Nicaragua will be asked to:

-- produce a detailed economic program, including specific expenditure measures and expenditure and deficit targets, to reduce the monthly fiscal deficit to a level which can be financed entirely by external resources. The plan will include a corresponding monetary program which will reduce the growth rate of liquidity in the economy to a level consistent with price level stability.

The corresponding condition precedent for release of the second and third tranches will be:

-- The Government of Nicaragua will substantially comply with the fiscal and monetary targets set forth in its economic program.

b. **Restructuring of the Financial System.**

Our proposed condition for the third tranche is that:

-- the government of Nicaragua license privately-owned financial intermediaries.

c. **Elimination of Trade Monopolies**

The condition for the second tranche will be that:

-- the Government of Nicaragua license the participation of private operators in foreign trade activities that are currently state monopolies.

d. **Privatization.**

For the third tranche, we will ask that:

-- the Government establish a regulatory framework for the privatization of state-owned enterprises.

d. **Operating Expense Trust Fund.** The Government of Nicaragua will covenant that:

-- The Government of Nicaragua will provide upon request to the USAID Mission to Nicaragua, an amount of five million cordobas oro, in trust, which shall be used over a three year period for the operating expenses of the AID program in Nicaragua.

e. **Other Conditions**

-- The Government of Nicaragua will execute a trust agreement with the USAID Mission to Nicaragua prior to the disbursement of the first tranche.

-- No more than $45 million disbursed under this agreement shall be used for the importation of petroleum and refined products.

-- Prior to the disbursement of the $50 million destined for the repayment of multilateral arrears, the GON will provide evidence that a comprehensive and workable arrangement has been made for the elimination of arrears to the IBRD and IDB.

2. **Use of ESF Dollar Resources**

This agreement proposes an additional $118 million in FY 1990 ESF to support the GON's comprehensive economic stabilization, structural adjustment and recovery program. With this addition, the total amount of ESF cash grants, obligated this fiscal year, will total $178 million. The $118 million will be provided in two disbursements. One disbursement, of $68 million, will be provided, in three tranches of $20 million, $24 million, and $24 million respectively, upon satisfaction of the corresponding conditions, to meet the requirements of the Nicaraguan economy for petroleum and refined products and to provide capital goods, spare parts, raw materials, intermediate inputs, and agricultural inputs to private sector importers. The other disbursement, of $50 million will be disbursed to the GON when a comprehensive and workable arrangement has been made for the elimination of arrears to the IBRD and IDB.

D. Local Currency

The generation and programming of local currency requires a great deal of caution in present-day Nicaragua. The monetary base, in real terms, has been so deteriorated by hyperinflation, that the portion of this grant to be used to finance imports is greater than the foreign exchange value of the narrowly defined money supply, and almost equal to the total domestic liabilities of the banking system. In these circumstances, the spending of local currency has major potential for undermining the GON's anti-inflationary efforts. We propose to continue the practice begun under the first FY 1990 ESF cash transfer, of generating no local currency from this cash transfer, apart from a small local currency trust fund for the operating requirements of the Mission.

II. Economic Situation and Developments

A. Situation up to April 25, 1990

In discussing the economic situation of Nicaragua in the period prior to the change of government on April 25, it is common, and indeed necessary to dwell on fiscal and monetary mismanagement, the destruction of the financial system, and the resulting astronomical levels of inflation. What should not be lost sight of in this discussion is the impact that this situation has had on the standard of living of the average Nicaraguan. During the 12 year period from 1977 to 1989, Nicaraguan GDP declined by 37.8 percent. Since population growth during this period averaged 3.3 percent, GDP per capita, and thus the living standard of the average Nicaraguan, declined by 58.2 percent.

The reasons for the dismal economic performance of Nicaragua under the previous government are several and include the war and U.S. economic sanctions. The most important reason, however, was the incredible economic mismanagement of that government and its often bizarre approach to fiscal and monetary matters. As a result of the monetization of central government deficits, compounded by even larger operating losses of state enterprises and losses of the financial system itself, inflation accelerated to a peak of 33,654 percent in 1988. Compounding this, the previous government attempted to maintain fixed exchange rates and controlled interest rates in this hyper-inflationary environment. The consequence of the attempt to maintain a fixed exchange rate under highly inflationary circumstances was a wildly gyrating real exchange rate under which exports became a highly risky and generally dubious activity. At the same time, access to highly overvalued dollars by certain individuals and enterprises produced windfall profits and masked the mismanagement of the favored firms. As a result, exports steadily deteriorated throughout the 1980s, declining from $646 million in 1978 to a low of $236 million in 1988, before recovering slightly in 1989.

Even more serious than the impact of the previous government's policies on the external sector were their impact on the financial system. Prior to the Sandinista triumph in July 1979, Nicaragua had a large number of privately owned commercial banks. However, these banks had borrowed heavily in the United States to lend in Nicaragua and they were all bankrupted by the 1979 devaluation of the Cordoba from 7 to 10 to the dollar. Subsequently, they were nationalized and reorganized as four state banks along sectoral lines (only two of which are currently operating). In an environment in which deposit interest rates were well below the accelerating rate of inflation, the term deposit base of these institutions steadily eroded until, by 1988, only 5.6 percent of M2 consisted of bank deposits. In these circumstances, the commercial banks operated essentially as retailers of central bank lines of credit. The central bank provided detailed direction as to the destination and terms of all loans. Credit flows were directed heavily to the state enterprises (particularly the non-utility enterprises, the so-called Area del Propiedad del Pueblo or APP). By early this year, BANIC, the largest of the banks had 90 percent of its portfolio in loans to the APP enterprises.

The effect of these developments on the banks as institutions was catastrophic. With credit lines allocated in considerable detail by the central bank, the quality of loan portfolios, in any case, largely irrelevant in an environment of highly negative real loan interest rates, and with many ancillary financial services, such as letters of credit, operated directly from the central bank, the commercial banks had little substantive work to do. In effect, the operations of the commercial banks consisted of taking currency from the central bank and giving it away (in the form of highly concessional loans) to persons and institutions designated by the central bank. The effect of these patterns of operations on the banks as institutions has been devastating in terms of professional qualifications of personnel and operating systems. It is not at all clear that these institutions can be restored to effectively operating banks.

The state of the non-financial state enterprises was almost as bad. There is ample, although largely anecdotal, evidence that these entities are grossly mismanaged. These enterprises are characterized by management inefficiencies, lack of financial discipline, inability to correctly evaluate investment decisions, and by an almost complete lack of the most minimal accounting systems. This is particularly a problem in that certain key areas of the economy are dominated by APP firms. APP enterprises make up 35 to 40 percent of industrial GDP, 60 percent of tobacco production, 25 to 30 percent of forestry production, 20 percent of coffee production, 100 percent of irrigated rice, and virtually all of the major export activities through the "Empresas de Comercio Exterior". In all there were at least 450 state-owned enterprises.

Finally, the previous government left behind an almost impossible external debt situation. The total external debt of Nicaragua, as of the end of 1989, was $9.741 billion. Amounts in arrears alone totaled $3.1 billion. This should be compared with an estimated dollar value of GDP of approximately $1.8 billion. Current amounts due on this debt for 1990 were $590.6 million in amortization and $234.5 million in interest.

Of the debt in arrears, the most difficult are the $209.8 million owed to the IBRD and the IDB. Unless some way can be found to clear these amounts, neither these institutions nor the IMF, will be able to play a major role in the recovery and renewed development Nicaragua.

TABLE 1
DEBT SITUATION OF NICARAGUA
(Million U.S. dollars)

CREDITOR	OUTSTAND. DEBT 12/31/89	ACCUM. ARREARS 12/31/89	SCHEDULE AMORT. 1990	SCHEDULE INTEREST 1990
MULTILATERAL INST.	1,151.2	302.0	36.5	39.5
IBRD	310.2	157.0	7.7	21.3
IDB	421.1	52.8	12.6	12.6
OPEC	36.6	26.5	3.9	0.4
CENTRAL AMERICAN INSTITUTIONS	319.5	21.0	11.6	2.6
OTHER	63.8	44.7	0.7	2.6
BILATERAL CREDITOR	6,316.2	1,465.1	234.1	126.5
UNITED STATES	274.7	102.2	8.3	6.0
USSR	2,258.2	23.9	50.2	19.4
MEXICO	960.3	421.4	51.9	32.9
CENTRAL AMERICA	646.8	55.2	27.6	38.5
EAST GERMANY	490.0	0.0	15.8	0.9
OTHER	1,686.2	862.4	80.3	28.8
COMMERCIAL BANKS	1,806.5	1,144.7	179.4	58.8
PREFINANCING OF EXPORTS	145.6	0.0	118.3	5.5
SUPPLIERS AND OTHER COMMERCIAL DEBTS	321.2	175.8	22.3	4.2
TOTAL	9,740.7	3,087.6	590.6	234.5

Source: Document Presented by the Government of Nicaragua to the Donors Conference in Rome, June 1990, Table 2.

The problems facing the Chamorro government were compounded by the actions of the outgoing government in its last two months. The outgoing government concluded its tenure with an enormous burst of spending while holding the exchange rates constant. The result was that the new government faced an even more overvalued exchange rate and inflation on a rising trend.

B. Economic Program of the Chamorro Government

The new government moved quickly to put into place a reform program to reestablish fiscal and monetary discipline, reform the financial system, and privatize state-owned enterprises. This program was reviewed by AID, other donors, and a prominent academic economist. All found the GON program to be a comprehensive, imaginative, and workable solution to the enormous problems facing the Nicaraguan economy. The program was summarized in a document presented to donors at a meeting in Rome in early June and received a favorable response in that forum.

The program set out three objectives: (1) to stop inflation, (2) to reactivate agriculture, and (3) to undertake major structural reforms to fully utilize the capacity of the Nicaraguan economy. A key, and highly controversial, aspect of the program is the introduction of a new currency unit, the "cordoba oro" equal in value to one U.S. dollar. The program proposed to introduce the new currency initially as a unit of account, in a subsequent phase, the new currency would be gradually introduced in parallel with the old cordoba, beginning with large denomination bills, and finally, once fiscal and monetary discipline had been definitively established, the old currency would be withdrawn.

Much of the controversy surrounding the cordoba oro resulted from the confusion of its role as a unit of account in the beginning of the program with its later introduction as a circulating medium. The former was intended as a way of stabilizing the revenue side of the fiscal system and introducing positive real interest rates for the financial system.

In its first day in office, the new government enacted a maxi-devaluation to begin to correct for the accumulated inflation of the prior two months and to close the three hundred percent gap which had opened up between the official exchange rate, at which most trade transactions were conducted, and the black market rate. The government's program proposed a gradual adjustment of the official and parallel exchange rates, both to ensure the real effect of the initial devaluation and to unify the rates at a market clearing level within the space of a few weeks.

During this same initial period, the program proposed to adjust government controlled prices, in particular public utility prices, to reduce the fiscal gap and to fix those prices in terms of cordobas oro, in order to prevent their subsequent erosion by inflation.

In recognition of the key role played by public expenditure in generating inflationary pressure, the GON program proposed that government expenditure be cut through "careful regulation of public sector wages and a general austerity program." Within these parameters and with an indexing of tax collections through denominating them in cordobas oro, the program projected to restore real tax collections to their level of 1989 and early 1990, approximately 18 percent of GDP. The target for central government expenditure was to be 23 percent of GDP, leaving a deficit of approximately $10 million (or rather 10 million cordobas oro) which, it was estimated could be financed from external sources.

The timing of the inauguration of the new government coincided with the beginning of the rainy season in Nicaragua and the principal growing season. Hence the government was seriously concerned that producers have adequate incentives and resources to assure a successful agricultural season. To achieve this, the government assured all producers that they would receive prevailing world prices for their output, either world prices, in the case of export crops, or prices in neighboring countries in the case of basic grains. Similarly, central bank discount lines would be used to provide crop credit over the growing season. These loans, like all other banking system loans, would be denominated in cordobas oro and would carry significant interest rates.

Finally, the government initiated a process to review expropriations made after July 19, 1979. Properties found to have been unjustly confiscated, except for agricultural land distributed to peasants or cooperatives, would be returned to their rightful owners. In the case of agricultural land already distributed, the government would issue certificates which could b redeemed for other properties to be sold by the state under the privatization program.

Thus, the first phase of the government's program would concentrate on introduction of the cordoba oro as a unit of account for bank loans and for public and parastatal revenues, establishing expenditure discipline for the central government itself, returning improperly confiscated properties to their rightful owners, and attempting to provide adequate resources and incentives to agricultural producers.

The second phase of the program proposed the introduction of large denomination of cordoba oro bills, with the seignorage associated with their introduction providing additional support for fiscal adjustment and the expansion of productive credit. During this second phase, the government would attempt to reorder the structure of public expenditure, beginning with a gradual and orderly reduction of military expenditures. This would allow a an expansion of badly needed infrastructure and social expenditures. Simultaneously, the government would begin to adopt policies of a more structural nature in the areas of tax and tariff reform and in the privatization of state enterprises.

The most complex aspect of structural transformation to be addressed during the second phase would be the restructuring of state enterprises. Under this, "the government will initiate an orderly process of privatization of its productive assets." This was to include an auction of all transport and agricultural equipment currently under-utilized, as well as assets of small state enterprises in service sectors. Idle land was to be rented. Those enterprises remaining (temporarily or permanently) under government control were to be subjected to firm financial discipline.

A key aspect of privatization was to be the authorization of privately owned non-bank financial intermediaries. These could be privately owned, mixed private and public, or foreign-owned. They would operate under strict supervision of a Superintendent of Financial Institutions. Eventually, these institutions would be allowed to accept sight deposits, to become banks in all but name (the Constitution appears to prohibit privately-owned banks).

Next, the structural transformation phase of the GON program promises a comprehensive reform of the tax system. High nominal rates are to be reduced and the entire system would be denominated in cordobas oro to adjust for inflation. In addition, the GON would simplify indirect taxes, reducing excessive rates (particularly tariffs and selective consumption taxes) as it reduced and rationalized the multiple exemptions which previously existed.

Finally, the GON program declared, "its firm decision to normalize its external financial relations." The document requested favorable treatment for those debts which could be rescheduled, while requesting assistance from the donor community to deal with those arrearage to multilateral institutions which could not be rescheduled.

The GON program proposed a number of elements to address the problems of introducing a program in a context of considerable social turmoil. The program proposed the creation of a three-way negotiating mechanism, representing workers, employers, and government, to negotiate worker profit sharing and determine the minimum wage. The program also outlined a Social Emergency Fund to create temporary employment opportunities rehabilitating the country's infrastructure during the adjustment process. Another program proposed by the GON would foster small business development through quick-disbursing emergency credits.

In all, the program presented to donors in Rome appeared to contain all the elements necessary for a successful stabilization and structural adjustment effort, while showing sensitivity to possible adverse impacts on low income groups. It was, in many respects however a complicated program and one which would be difficult to implement even in a political atmosphere much less charged than that of contemporary Nicaragua.

C. <u>Progress to Date in Implementing the Recovery Program</u>

After four months of effort, the new Government of Nicaragua has achieved many significant successes in implementing its reform program. In other areas, there have been setbacks resulting from Sandinista opposition. In still other areas, the GON has simply found that reforms took longer than anticipated or there have been disagreements on precisely how to proceed. The most significant successes have been in the areas of exchange rate adjustment, indexing of financial system accounts to the new cordoba oro, thus restoring positive real interest rates for both loans and deposits, indexing the revenue system of the government and of key public utilities through pricing in cordobas oro, tariff reform, and regularizing external financial obligations.

Less success has been achieved in areas where Sandinista cooperation, or at least acquiescence, has been required. Chief among the areas affected by active Sandinista opposition has been the control of the fiscal deficit. In other cases, reform appears to have been delayed less by active opposition than by confusion and lack of consensus within the government itself on exactly how to proceed. Examples of this have been privatization, financial system reform, and elimination of state trading monopolies.

1. Unification of the Exchange Rate at Realistic levels

The exchange regime inherited by the new government consisted of three rates: the official rate at which most trade transactions took place, the parallel rate for tourists and technically for capital transactions, and the black market rate, technically illegal but widely used for tourist and small capital transactions. On April 25, the official exchange rate stood at 46,380 per dollar, the parallel rate at 58,250, and the black market at approximately 125,000. Immediately on assuming office, the GON raised the official rate to 70,000, and the parallel rate to 140,000. However, continuing inflationary pressures from the previous months' monetary expansion quickly pushed the black market rate to 200,000. Subsequently , the Central Bank began a series of frequent adjustments of the controlled rates with the official rate adjustment about twice that of the parallel rate. This was done with the stated objective of unifying the controlled rates by early June.

The two controlled rates were, as planned, unified in early June, and the rates continued to be adjusted frequently to narrow the gap between the official and black market rates
By the end of June, the official/parallel market buying rate stood at 340,000, while the black market rate had reached 400,000, a premium on the black market of only 15 percent. This relationship was maintained during the month of July.

In early August, the black market rate softened briefly, narrowing the gap to only 3 percent. When the market tightened again in the second week of August, this narrower gap was maintained so that, by the end of the third week in August, the gap was only slightly more than five percent of the black market rate. Thus, by the end of August, the GON has achieved a major objective of its policy, the establishment of a unified, market clearing exchange rate.

Table 2

Exchange Rate Developments--April to August 1990

Period (end-of-period)	Official Rate	Parallel Rate (buying)	Black Market Rate	Exchange Rate Gap (official vs. Black)
April	70000	140000	200000	-65.00
May	160000	220000	260000	-38.46
June	340000	340000	400000	-15.00
July	560000	560000	670000	-16.42
August 21	761429	761429	802857	-5.16

2. Indexing of Financial System Accounts

The second major accomplishment of the new government was the conversion of banking system assets and a large portion of its liabilities into cordobas oro as a unit of account. As of May 1, all new loans, both to the public and private sector, were denominated in the new monetary unit. At the same time, the banks offered deposits with an original maturity of three months or more in these units. Thus, at a stroke, all bank lending was made at positive real interest rates, while depositors were offered interest-bearing accounts whose value was guaranteed in dollar terms.

The effect of this change on the availability of deposits to the banking system has, thus far, been limited. The public's holding of cordoba oro deposits has grown slowly but steadily since their introduction on May 1. Cordoba oro deposits rose to 5.7 million at the end of May, 9.0 million by the end of June, 12.7 million by the end of July, and reached 14.2 million by the end of the first week in August. This growth is evidence of increasing public confidence in the value and credibility of the cordoba oro. On the other hand, the total value of such deposits is still less than one percent of GDP. Overall, the real liquidity base of the economy has continued to decline, as the declining public real holdings of cordoba currency and non-cordoba oro deposits has offset the rise in cordoba oro deposits. Total M2, after rising from 74.2 million at the end of April to 102.9 million at the end of June, declined to 68.3 million by the end of the first week in August, apparently reflecting lessened public confidence as a result of July's disturbances.

The basic remaining problem remains the poorly functioning -- almost non-functioning -- banking system. Positive real interest on loans and deposits, in this environment, have not improved resource mobilization and allocation.

3. Indexing of Revenues and Public Sector Pricing

At this point, perhaps more important than the introduction of cordoba oro loans and deposits, has been the denomination of most tax liabilities and key public enterprise tariffs in cordobas oro. This has eliminated the "Tanzi Effect", under which, in times of hyperinflation, public sector revenues tend to erode because of the loss in the value of money between the time an economic transaction takes place and the time when tax payments must be made.

Two other effects may be equally important. First, by automatically escalating public sector prices, the cordoba oro pricing has had the effect of depoliticizing the upward adjustment of these prices in a highly politically charged atmosphere. Second, it has raised public consciousness of the fact that it is not prices that are rising but the old cordoba that is falling in value, and increased public awareness of the tight connection between government spending (and public enterprise losses) and the ongoing inflation.

4. Tax and Tariff Reform

One serious obstacle to the recovery of the Nicaraguan economy was the high, politically motivated, income tax rates, very high rates of tax on "luxuries" through the selective consumption tax, and generally very high levels of import duties, which, however, yielded very little revenue because of widespread exonerations for the government and parastatal importers. The GON, at the end of June, decreed reduced income tax rates to a maximum of 38.5 percent, and, on August 27, decreed a sweeping reform of the selective consumption tax and import duties. Import duties, with certain exceptions for alcohol, tobacco products, etc., have been systematically reduced from rates of more than 100 percent to a maximum of 40 percent. It is expected that removal of exonerations and more vigorous enforcement will prevent any loss of revenue from these measures.

5. Regularization of Relationships with External Creditors

The previous regime destroyed the nation's credit, not only with multilateral institutions and major bilateral donors, but also with friendly regional suppliers, including Venezuela and Mexico. The process of restoring these relationships will be long and arduous. The basic numbers are staggering. Nicaragua's total debt outstanding is more than five times GDP. Debt in arrears, as of the end of 1989 was more than one and a half times GDP.

Amortization and interest coming due in 1990 are equal to about one-half GDP. Nonetheless, the GON has made a commendable start. It has resumed payment of current principal and interest to its multilateral creditors and asked for the formation of a support group to assist it in becoming current in its multilateral obligations. Once that is achieved and an expected IMF agreement is signed, it is likely that a Paris Club rescheduling will be arranged. The problem of dealing with $1.1 billion in commercial bank arrears will be more difficult. Nonetheless, the GON has taken advantage of widespread goodwill toward the new government to make constructive and forthcoming proposals to restore its position with international creditors.

D. Setbacks and Delays in Implementing the Recovery Program

1. The Fiscal Deficit

While there has been considerable success in implementing the GON's recovery program, there have also been serious setbacks. The most important of these has been higher than planned fiscal deficits, together with less than expected external financing to cope with them. The increased deficits have been a direct result of the disturbances of May and especially July. The GON's recovery program projected a deficit of $10 million per month for late 1990. It was estimated in the Rome document that such a deficit could be financed entirely through donor sources (primarily the AID cash grants).[1] Two things have happened to defeat this intention. First, and most important, government expenditures were raised significantly as a result of the strike settlements. Central Government expenditures increased from 27.9 million cordobas oro in May to 34.3 million in June, then to 38.5 million in July. During this same time period, there was considerable success in increasing government revenues. These increased from 12.3 million cordobas oro in May to 18.4 million in July as a result of tax indexing. Despite this revenue performance, the deficit to be financed increased from 15.6 million cordobas oro in May to 20.1 million in July. It should be pointed out that if May's level of expenditures had merely been held constant, improved revenue would have reduced the deficit below the projected 10 million per month by July.

The second source of higher than projected inflationary pressures has been the unavailability of expected external financing. This primarily results from initially slower than planned disbursements from the ESF special account. This question is discussed in detail elsewhere. The monetary effect, however,

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[1]. This was, broadly speaking, a reasonable projection given AID cash transfers of $178 million, of which (at that time) $50 million was to be used for repayments of multilateral arrears and thus would not be available to absorb a corresponding amount of domestic liquidity.

has been that, for example, in July, only \$1.2 million in external financing was available to provide transitional deficit financing.

The net result was that liquidity (M2), far from stabilizing, increased by 54.1 percent in July. Until the government spending problem can be solved, price level stability cannot be achieved in Nicaragua.

2. Privatization

A major initiative of the new government was a commitment to return the estimated 450 state enterprises to private ownership and control. The first step was a decree, issued in early May, providing for a review process to return private business and other properties which had been improperly seized, to their rightful owners. Since this decree gave owners six months to lodge their appeals, the result has been, unintentionally, to delay the process of privatization. Beyond this, the privatization process is an extremely complex one and probably the single most politically contentious faced by the government. The GON has begun by organizing the firms into a single holding company, CORNAP, under the direction of the Vice Minister of the Presidency. AID, the IDB, and UNDP are currently providing technical assistance to the Ministry and CORNAP on how to proceed.

While some progress has been made, the fact is that momentum has been lost. While recognizing that the actual process of returning firms to private ownership is complex, there are things the GON can do in the interim. These include, eliminating the legislated monopoly position of those parastatals that have it, chiefly those involved in international trade and, in some cases, domestic trade. Second, financial discipline needs to be imposed on state enterprises while they remain in public hands to make them act, insofar as possible, as if they were private. The GON has yet to take these measures.

3. Financial System Reforms

Perhaps more important than the elimination of the fiscal deficit, Nicaragua's economic recovery requires the reestablishment of a functioning financial system, with institutions relying primarily on deposits for lending resources, making lending decisions based on competent analysis of ability to repay, and earning a profit in the process. Whether the existing state-owned commercial banks can ever fulfill this function is an open question. In any case, the GON program proposed to license privately-owned financieras. This process has been delayed by a number of considerations. One is the legal question of how the establishment of a legal basis for the establishment of financieras should be accomplished. One school of thought holds that there is no legal obstacle to the licensing of such institutions at present, since there is no explicit legal prohibition of them, and, in fact, pre-Sandinista legislation concerning the licensing and regulation of such institutions appears to be still in force. Others argue that a Presidential decree or even legislation should be used to provide a clear and unambiguous legal basis for these new institutions. Another issue is whether the licensing of financieras should be delayed until an adequately functioning Superintendency of Financial Institutions can be established. Our own view is that such an institution, to provide adequate prudential supervision of banks and financieras alike, is vitally needed, but that its establishment should not delay the licensing of financieras, which are urgently needed if economic recovery is to be achieved.

E. Economic Outlook

The short-term economic outlook for Nicaragua is guarded. To date, four months into the stabilization/economic recovery program, there is little evidence of either a lessening of inflationary pressures or a recovery of economic activity more generally. While it is too early to see any significant recovery in official statistics, which are, in any case, suspect, the usual indicators of recovery or decline do not suggest any significant movement in either direction. The Central Bank continues to project three percent growth for 1990. However, given the disruptions caused by the general strikes of May and July, the adverse effects on agriculture of late and still inadequate rains, the impact of much higher world petroleum prices, and slow disbursements of AID ESF dollars, a range from one percent decline to one percent growth appears more realistic.

On the positive side, import supplies, aided by our ESF dollars appear now to be freely available, and producers for export, particularly those engaged in agriculture and agricultural processing, are prominent on the list of importers using our ESF dollars. Should domestic economic activity recover and export constraints be overcome, the domestic economy appears poised to respond quickly.

Similarly, a number of groups of foreign and Nicaraguan expatriate investors have made exploratory visits to Nicaragua. However, we know of very few firm commitments.

The outlook for the balance of payments appears reasonably good in the short term, as trade and financing relationships are being reestablished with American suppliers and financial institutions. However, the requirement for Nicaragua to begin to attend to at least some of its debt service obligations has introduced an additional demand for foreign exchange which has been difficult to meet. The most recent projection for the balance of payments, as well as a comparison with the previous five years, is shown on Table 3. It will be seen that imports are expected to be little changed in the second half of 1990 from the first half and that the overall import level for the year is little changed from 1989. A number of factors are at work here. First, the

Table 3
NICARAGUA: BALANCE OF PAYMENTS SUMMARY
(million U.S. dollars)

	1985	1986	1987	1988	1989	1990 1st Hal	1990 2nd Hal
CURRENT ACCOUNT	-726	-688	-679	-715	-457.3	-85.8	-217.2
TRADE BALANCE	-562	-495	-522	-562	-342.5	-112.7	-201.3
EXPORTS fob	305	258	295	236	290.1	212.2	109.3
IMPORTS cif	867	753	817	798	632.6	324.9	310.6
SERVICES (net)	-291	-308	-292	-283	-283.7	-117.3	-183.3
NON-FIN. (net)					-77.4	-47.6	-24.8
FINANCIAL (net)					-206.3	-69.7	-158.5
INT. RECEIVED					6.8	6.1	0.7
INTEREST PAID					-7.5	-4.2	-35
INT. IN ARREARS					-205.6	-71.6	-124.2
PRIVATE TRANSFER	14	0	0	0	0	0	0
OFFICIAL TRANSFE (INCL. ESF CASH GRANTS)	113	115	135	130	168.9	144.2	167.4
CAPITAL ACCOUNT	309	-255	-36	148	-194.7	-53.5	-253
NONFIN PUB SEC	402	467	402	377	278.4	98.8	19.5
FIN PUB SECT	173	130	60	47			
UNPAID AMORT.	-169	-677	-407	-319	-378.7	-82.1	-290.6
RESCHEDULING	129	19	1	7			
ALLOC. OF SDR & OTHER		0	0	0	0	0	0
PRIVATE AND ER AND OMISSIONS	-226	-194	-92	36	-94.4	-70.2	18.1
OVERALL BALANCE	-417	-943	-715	-567	-652	-139.3	-470.2

delays in opening ESF-funded letters of credit, although now apparently resolved, mean that many of the goods ordered will not arrive until late in the year or early next year. More important, many of the ESF-funded imports are, in effect, replacements for imports previously funded from Eastern Block sources. This is most notably the case for petroleum (and 83 percent of the ESF dollars used as of August 21 have been to fund imports of petroleum and derivatives.

The news here is not all bad. The reopening of the American market as a source of supplies and the market-directed allocation of foreign exchange for imports mean that the same dollar expenditure on imports represents a higher real value of imports. Nonetheless, the overall expansion of import capacity has not been great. Clearly the GON policy of concentrating in the short run on agricultural export recovery as the most likely source of improved import capacity, is the correct one.

The other significant current account development is the increase in interest paid on external debt which will rise from only $7.5 million in 1989 to $39.2 million in 1990. Virtually all of this increase represents the resumption of current debt service payments to multilateral institutions as the first step in the resolution of the overall problem of arrears to these institutions. The increase in official transfers represents almost entirely the two AID ESF cash grants totaling $178 million. This line item, which was $168.9 million in 1989, again demonstrates the extent to which our assistance has, in practice, substituted for East Block assistance provided in past years.

In the capital account, two items are of interest. First, the resumption of $32 million in current amortization payments to the multilaterals will reduce official capital inflows to almost zero. Offsetting this somewhat is an apparent turnaround in private capital and errors and omissions. This, if it continues, is evidence of some return of confidence in the Nicaraguan economy.

For the longer term, the outlook for the Nicaraguan external accounts is difficult but far from hopeless. Clearly, the recovery of exports in the medium term is the key to any sustained improvement in output and regularization of the debt situation. Our own cash resources primarily serve as a temporary stopgap. A medium-term recovery is clearly possible. Exports, primarily agricultural exports, were more than twice their current levels in the late 1970s. However, the deteriorated levels of technology will require time to overcome. Still, it is possible to imagine a trade deficit in two to three years come reduced to $100-150 million per year and financed by a combination of normal donor and private financial flows.

IV. ESF PROGRAM

The program will consist of two disbursements of $68 million and $50 million respectively. The first disbursement will be made in three tranches and will be used to finance imports of petroleum and refined products and the import requirements of the private sector. The second disbursement will be made as a part of a comprehensive and workable multidonor effort to assist the GON to eliminate its arrears to multilateral institutions.

A. Conditionality

The conditionality we have proposed for this program is derived directly from the economic program presented by the GON to the donors at the Rome conference. However, in the period since that meeting, a good deal of momentum has been lost. We want to encourage the GON to stick with the key elements of their own program, while recognizing that accommodations will have to be made to political and other necessities and that some details of their proposed program will simply be overtaken by events. We are proposing conditionality in four areas. These areas are:

-- (1) fiscal and monetary control in order to achieve price level stability and an adequate rate of growth of credit in the financial system to sustain economic recovery;
-- (2) restructuring of the financial system so as to permit the establishment of viable, deposit taking, risk assessing, and profit making financial intermediaries, providing a full range of financial services to all sectors of the economy;
-- (3) an elimination of the parastatal monopolies which act as an obstacle to the recovery of Nicaraguan exports, and
-- (4) a systematic and practical approach to privatization of the estimated 450 state enterprises currently in the GON's portfolio and, more broadly, the opening up of all sectors of the economy to competition and market forces.

In addition, the disbursement of the funds for the elimination of arrears to multilateral institutions will depend upon the achievement of a comprehensive and workable agreement for the elimination of such arrears.

1. **Fiscal and Monetary Control.** Our approach to fiscal and monetary control begins with a frank recognition that the source of the inflation problem is the expenditure side of the central government itself (and, to a lesser extent, the continuing losses of the state enterprises). These excessive expenditures results from overmanning and excessive wage levels forced on the government by Sandinista unions and by the continuing high levels of military expenditure. While this is clearly an extremely delicate and contentious problem, it is one which must be resolved and resolved quickly if price level stability is to be achieved. We propose, then, that a condition precedent for the release of the first tranche will be that:

-- The Government of Nicaragua will produce a detailed economic program, including specific expenditure measures and expenditure and deficit targets, to reduce the monthly fiscal deficit to a level which can be financed entirely by external resources. The plan will include a corresponding monetary program which will reduce the growth rate of liquidity in the economy to a level consistent with price level stability.

The corresponding condition for release of the second and third tranches will be:

-- The Government of Nicaragua will substantially comply with the fiscal and monetary targets set forth in its economic program.

The use of virtually all external financial resources to finance the fiscal deficit, while an ambitious accomplishment in the present circumstances, is far from ideal as a permanent arrangement. Therefore we will encourage the government to move beyond this by requiring as a covenant that:

-- The Government will provide an adequate expansion in real credit to the private sector consistent with the Government's monetary program, and to provide access for private financial intermediaries to the lending resources of the Central Bank, either in the form of discount lines or direct deposits.

2. **Restructuring of the Financial System.** The conditionality here relates to the authorization and subsequent licensing of privately-owned non-bank financial intermediaries. Again, this is a key component of the GON's own program which has been delayed by disagreements over exactly how to proceed. We do not propose to take sides on that issue; merely to suggest that the GON resolve it and move ahead as quickly as possible with the actual authorization and licensing of these institutions. Since this will require some time, we have proposed the following condition precedent to the third tranche:

-- the government of Nicaragua will license privately-owned financial intermediaries.

3. **Elimination of Trade Monopolies.** The conditionality here relates to the elimination of a large number of monopolies established by the previous government. Although the constitution reserves the control of international trade (along with banking and insurance) to the state, the Sandinista government itself frequently licensed private firms to carry out trade. Therefore, there appears to be no reason why the government cannot establish an open, general licensing system for all but a few lines of domestic and international trade. At the same time, the GON finds itself faced with a number of contractual arrangements which will have to be terminated in an orderly manner. Therefore, for the second tranche, the GON will agree that:

-- the Government of Nicaragua will license the participation of private operators in foreign trade activities that are currently state monopolies.

4. **Privatization.** The GON appears to be bogged down in mechanics of divesting state-owned assets. We, the IDB, and the UNDP are providing technical assistance to help the government develop an approach.

For the third tranche:

-- the Government will establish a regulatory framework for the privatization of state-owned enterprises.

In addition to these conditions, we will have as a CP to first disbursement that the GON execute a trust agreement for an OE trust fund. Finally, the agreement will have covenants restricting the use of dollars from the special account to no more than $45 million for petroleum imports.

B. Use of ESF Dollar Resources

This agreement proposes an additional $118 million in FY 1990 ESF to support the GON's comprehensive economic stabilization, structural adjustment and recovery program. With this addition, the total amount of ESF obligated under FY 1990 cash grants will total $178 million.

The $ 118 million available will be used for 1) clearing arrearages with the IBRD and IDB as part of a multi-donor package of cash assistance to enable Nicaragua to normalize relations with the international financial institutions ($50 million), 2) to finance productive imports necessary to reactivate the economy. Financing will be made available for the import of petroleum and its derivatives, while raw materials, intermediate goods, agricultural inputs, and spare parts will be financed for the private sector. The GON is particularly interested in restoring the capacity of the agricultural sector of the economy through financing agricultural inputs, key equipment and materials requirements.

The Central Bank will continue to be the GON agency responsible for managing the program. Eligible transactions include the importation of raw materials, intermediate goods, spare parts, agricultural inputs and capital goods from the U.S. and the member states of the Central American Common Market, and petroleum and its derivatives from A.I.D. Geographic Code 941 countries and the Netherlands Antilles and Curacao (which refine petroleum from Venezuela, a Code 941 country).

C. Justification for Financing of Imports from other Central American Countries

A major result of 11 years of Sandinista rule was the severing of normal trade ties with other countries of the region. This severing resulted from that government's monopolization of international trade, its barter trading arrangements with the Soviet Block, and its restricting of free access to foreign exchange to small producers who are the natural suppliers and customers of the other countries in the region.

A major objective of U.S. policy in Nicaragua is the reintegration of Nicaragua into the regional economic and political system. This objective has both an economic and a political aspect. On economic considerations, Nicaragua, which was once one of the most prosperous countries in the region, is now one of the two poorest. In the ten years in which Nicaragua has been losing ground economically, the remaining countries, particularly Costa Rica, have been making great advances by following a market-oriented and outward oriented set of policies. By encouraging the renewal of economic contacts with these other countries, Nicaragua will achieve the gains from trade, but more important, the impetus to follow similar policies in Nicaragua will be strengthened. Finally, the increased integration of Nicaragua into the Central American system cannot help but strengthen democratic institutions in Nicaragua, through increased ties to those functioning democracies.

The purpose of this assistance is to support the market-oriented reforms of the Chamorro Government so that Nicaragua can achieve price and balance of payments stabilization and renewed, broad-based economic growth. We believe that the reestablishment of trading ties with regional trading partners is critical to the success of these efforts. Therefore, the reestablishment of regional trading ties is critical to the success of project objectives. At the present moment, foreign exchange is very tight in Nicaragua and will continue to be until the government's reform policies have their desired effect. The AID cash transfer dollars are the most important source of foreign exchange available to private sector producers. Therefore, the availability of imports from regional trading partners depends on our willingness, in the short run, to provide foreign exchange for them.

Similarly, as argued above, the strengthening of trade ties will play an important role in the reintegration of Nicaragua in the democratic mainstream of Central America. We believe that this is a "persuasive political consideration," a criterion given in Handbook 1B justifying a broadening of source/origin criteria.

D. Accountability:

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The Central Bank has in place a detailed set of operational procedures approved by A.I.D. which govern the use of the $60 million first tranche of ESF. The procedures include among other things all of the documentation to be reviewed at the Central Bank to determine eligibility of the transactions. A description of these procedures is contained as annex B to this Agreement.

The Central Bank is doing a good job managing the resources in the Separate account under the current program and we do not expect problems to arise with the addition of the proposed $118 million. The Supervisory Program Officer will be the officer responsible for the overall management of the program, assisted by the USAID Controller in the monitoring of the dollars transferred to the Government of Nicaragua.

E. Audit

Under the Supplemental Appropriations Act of 1990, the Inspector General of A.I.D. (RIG) is required to conduct semi-annual reviews of the ESF program in Nicaragua. In performing these functions the RIG in coordination with the Mission will oversee the overall financial management aspects of the program and will schedule audits to determine compliance with the terms of the agreement and proper use of the funds. The RIG will obtain the services of a qualified external CPA firm assist in performing the concurrent financial management oversight responsibility. Funding for the non-federal portion of the oversight role will be obtained from either the soon to be authorized Public Sector Support component or Project Development and Support funds (PD&S).

The Office of the Controller performed a limited internal controls review of the Central Bank's operating mechanisms to see if they were adequate to manage the ESF dollar transfers. In general it was found that the Central Bank had adequate procedures in place to manage and account for the dollar transfers. The Controller's Report noted seven recommendations to improve the internal controls over foreign exchange transactions. The Central Bank has fully implemented six of the seven recommendations.

The last recommendation, related to the establishment of a price checking unit, has been overtaken by events. Since the gap between the official and black market exchange rate has been reduced to less than 10 percent, and since a price checking unit is unlikely to be able to detect overinvoicing of that magnitude, we will consider dropping the recommendation that such a unit be established.

3(A)2 - NONPROJECT ASSISTANCE CHECKLIST

The criteria listed in Part A are applicable generally to FAA funds, and should be used irrespective of the program's funding source. In Part B a distinction is made between the criteria applicable to Economic Support Fund assistance and the criteria applicable to Development Assistance. Selection of the criteria will depend on the funding source for the program.

CROSS REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? HAS STANDARD ITEM CHECKLIST BEEN REVIEWED?

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1. FY 1990 Appropriations Act Sec. 523; FAA Sec. 634A. Describe how authorization and appropriations committees of Senate and House have been or will be notified concerning the project.

   A CN was submitted on April 6, 1990. The Congressional Hold was lifted on May 25, 1990.

2. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?

   Addressed in PAAD.

3. FAA Sec. 209. Is assistance more efficiently and effectively provided through regional or multilateral organizations? If so, why is assistance not so provided? Information and conclusions on whether assistance will encourage developing countries to cooperate in regional development programs.

   Nicaragua is not currently eligible for assistance from multilateral organizations. Program will finance productive imports from CACM countries as well as U.S., and encourage clearance of arrears to IFIs and CABEI.

4. FAA Sec. 601(a). Information and conclusions on whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.

Will be encouraged through policy reform dialogue and financing of international trade. Details outlined in PAAD.

5. FAA Sec. 601(b). Information and conclusions on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

Increased availability of hard currency for imports from the U.S. and improved policy environment will encourage U.S. private trade and investment.

6. FAA Sec. 121(d). If assistance is being furnished under the Sahel Development Program, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of A.I.D. funds?

N/A.

FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Economic Support Fund

a. FAA Sec. 531(a). Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of Part I of the FAA?

Yes.

b. FAA Sec. 531(e). Will assistance under this chapter be used for military or paramilitary activities?

No.

c. FAA Sec. 531(d). Will ESF funds made available for commodity import programs or other program assistance be used to generate local currencies? If so, will at least 50 percent of such local currencies be available to support activities consistent with the objectives of FAA sections 103 through 106?

Other than a small OE Trust Fund, no local currencies will be generated.

d. FAA Sec. 609. If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made?

N/A.

e. FY 1990 Appropriations Act, Title II, under heading "Economic Support Fund," and Sec. 592. If assistance is in the form of a cash transfer: (a) Are all such cash payments to be maintained by the country in a separate account and not to be commingled with any other funds? (b) Will all local currencies that may be generated with funds provided as a cash transfer to such a country also be deposited in a special account, and has A.I.D. entered into an agreement with that government setting forth the amount of the local currencies to be generated, the terms and conditions under which they are to be used, and the responsibilities of A.I.D. and that government to monitor and account for deposits and disbursements? (c) Will all such local currencies also be used in accordance with FAA Section 609, which requires such local currencies to be made available to the U.S. government as the U.S. determines necessary for the requirements of the U.S. Government, and which requires the remainder to be used for programs agreed to by the U.S. Government to carry out the purposes for which new funds authorized by the FAA would themselves be available? (d) Has Congress received prior notification providing in detail how the funds will be used, including the U.S. interests that will be served by the assistance, and, as appropriate, the economic policy reforms that will be promoted by the cash transfer assistance?

Yes.

2. Nonproject Criteria for Development Assistance

N/A - ESF FUNDED

a. FAA Secs. 102(a), 111, 113, 281(a). Extent to which activity will: (1) effectively involve the poor in development, by expanding access to economy at local level, increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (2) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local governmental institutions; (3) support the self-help efforts of developing countries; (4) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (5) utilize and encourage regional cooperation by developing countries?

b. FAA Secs. 103, 103A, 104, 105, 106, 120-21. Is assistance being made available (include only applicable paragraph which corresponds to source of funds used; if more than one fund source is used for assistance, include relevant paragraph for each fund source):

(1) [103] for agriculture, rural development or nutrition; if so (a) extent to which activity is specifically designed to increase productivity and income of rural poor; [103A] if for agricultural research, account shall be taken of the needs of small farmers, and extensive use of field testing to adapt basic research to local conditions shall be made; (b) extent to which assistance is used in coordination with efforts carried out

under Sec. 104 to help improve nutrition of the people of developing countries through encouragement of increased production of crops with greater nutritional value; improvement of planning, research, and education with respect to nutrition, particularly with reference to improvement and expanded use of indigenously produced foodstuffs; and the undertaking of pilot or demonstration programs explicitly addressing the problem of malnutrition of poor and vulnerable people; and (c) extent to which activity increases national food security by improving food policies and management and by strengthening national food reserves, with particular concern for the needs of the poor, through measures encouraging domestic production, building national food reserves, expanding available storage facilities, reducing post harvest food losses, and improving food distribution.

(2) [104] for population planning under Sec. 104(b) or health under Sec. 104(c); if so, extent to which activity emphasizes low-cost, integrated delivery systems for health, nutrition and family planning for the poorest people, with particular attention to the needs of mothers and young children, using paramedical and auxiliary medical personnel, clinics and health posts, commercial distribution systems, and other modes of community outreach.

(3) [105] for education, public administration, or human resources development; if so, (a) extent to which activity strengthens nonformal education, makes formal education more relevant, especially for rural families and urban poor, and strengthens management capability of institutions enabling the poor to participate in development; and (b) extent to which assistance provides advanced education

and training of people of developing countries in such disciplines as are required for planning and implementation of public and private development activities.

(4) [106] for energy, private voluntary organizations, and selected development problems; if so, extent activity is:

(i)(a) concerned with data collection and analysis, the training of skilled personnel, research on and development of suitable energy sources, and pilot projects to test new methods of energy production; and (b) facilitative of research on and development and use of small-scale, decentralized, renewable energy sources for rural areas, emphasizing development of energy resources which are environmentally acceptable and require minimum capital investment;

(ii) concerned with technical cooperation and development, especially with U.S. private and voluntary, or regional and international development, organizations;

(iii) research into, and evaluation of, economic development processes and techniques;

(iv) reconstruction after natural or manmade disaster and programs of disaster preparedness;

(v) for special development problems, and to enable proper utilization of infrastructure and related projects funded with earlier U.S. assistance;

(vi) for urban development, especially small, labor-intensive enterprises, marketing systems for small producers, and financial or other institutions to help urban poor participate in economic and social development.

(5) [120-21] for the Sahelian region; if so, (a) extent to which there is international coordination in planning and implementation; participation and support by African countries and organizations in determining development priorities; and a long-term, multidonor development plan which calls for equitable burden-sharing with other donors; (b) has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of projects funds (dollars or local currency generated therefrom)?

AFTER:GC/LP:EHonnold:3/20/90:2169J

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

LAC-IEE-90-58

ENVIRONMENTAL THRESHOLD DECISION

Project Location	:	Nicaragua
Project Title	:	Economic Stabilization and Recovery Program
Project Number	:	524-0311
Funding	:	$118 Million
Life of Project	:	One Year
IEE Prepared by	:	Richard L. Owens Usaid/Nicaragua
Recommended Threshold Decision	:	Categorical Exclusion
Bureau Threshold Decision	:	Conditional Concurrence
Comments	:	The GON's stated interest of focusing the program's funds on restoring the agricultural sector through financing agriculture inputs, key equipment, and materials, raises environmental concerns about pesticides and tropical deforestation. Section 216.2 (d) (e) of A.I.D.'s environmental regulations states that categorical exclusions are not applicable to assistance for the procurement or use of pesticides; and the Congressional Act providing for this ESF program instructs that the appropriated funds shall not be used in a way that would result in any significant loss of tropical forests. Therefore, approval of a Categorical Exclusion is granted on the condition that the program agreement between the GON and A.I.D. has in it the following

restrictions on the use of the program's funds: Under the program there will be neither (1) the procurement or use of pesticides, nor (2) support of activities or the procurement or use of materials and equipment that could lead to significant tropical deforestation, without first the LAC Bureau Environmental Officer's approval of appropriate environmental assessments.

Copy to Janet Ballantyne, Director
USAID/Nicaragua

Copy to : John Cloutier, USAID/Nicaragua

Copy to : Tom Delaney, LAC/DR/CEN

Copy to : Regional Environmental Advisor
USAID/ROCAP

Copy to : IEE File

James S. Hester Date SEP 25 1990

James S. Hester
Chief Environmental Officer
Bureau for Latin America
and the Caribbean

INITIAL ENVIRONMENTAL EXAMINATION

Project:	Nicaragua
Project Title:	Economic Stabilization and Recovery (FY 90 ESF Balance of Payments Program)
Project Number:	532-0311
Funding	$ 118 million (ESF)
Life of Project:	One Year
IEE Prepared by:	Richard L. Owens USAID/Nicaragua.

RECOMMENDED THRESHOLD DECISION:

a. Recommendation:

The project consists of $ 118 million for assistance in support of the Government of Nicaragua (GON) Economic Stabilization and Recovery Program. The resources will be made available to the GON in two separate disbursements. The first disbursement will total $68 million, which will be made available in one tranche of $20 million and two subsequent tranches of $24 million each for the financing of eligible imports. The second disbursement will be made available in one tranche of $50 million for the repayment of obligations to multilateral development institutions.

"A.I.D. does not have knowledge of or control over, and the objective of A.I.D. in furnishing assistance does not require, either prior to approval of financing or prior to implementation of specific activities, knowledge of or control over, the details of the specific activities that, have an effect on the physical and natural environment for which financing is approved by A.I.D."

Morever, Handbook 3, Chapter 2, Appendix 20, Section 216.2 (C) (2) vi) states that "Contributions to international, regional or national organizations by the United States which are not for the purpose of carrying out a specifically indentifiable project or projects" are not subject to A.I.D.'s environmental procedures. The above exeptions do not apply, however, to assistance for the procurement or use of pesticides.

This Program will not provide support for the import, purchase or use of pesticides. A condition will be placed in the program agreement between the GON and A.I.D. that no pesticides will be procured or used without first doing an Environmental Assessment and having it approved by the LAC Bureau Environmental Officer.

Based on A.I.D. regulations in Handbook 3, Chapter 2, it is recommended that no further environmental study be undertaken for this PAAD and that a "Categorical Exclusion" be approved.

Concurrence: Janet Ballantyne
Janet Ballantyne
Mission Director
USAID/Nicaragua

Dated: 21 SEPT 1990

LAC-IEE ________

ENVIRONMENTAL THRESHOLD DECISION

PROJECT LOCATION	: NICARAGUA
PROJECT TITLE	: ECONOMIC STABILIZATION AND RECOVERY PROGRAM
PROJECT NUMBER	: 524-0311
FUNDING	: $118 MILLION
LIFE OF PROJECT	: ONE YEAR
IEE PREPARED BY	: RICHARD L. OWENS USAID/NICARAGUA
RECOMMENDED THRESHOLD DECISION	: CATEGORICAL EXCLUSION
BUREAU THRESHOLD DECISION	: CONCUR WITH RECOMMENDATION
COMMENTS	: NONE
COPY TO	: JANET BALLANTYNE, DIRECTOR USAID/NICARAGUA
COPY TO	: JOHN CLOUTIER, USAID/NICARAGUA
COPY TO	: TOM DELANEY, LAC/DR/CEN
COPY TO	: IEE FILE

Janet Ballantyne DATE 9/20/90

JANET C. BALLANTYNE
MISSION DIRECTOR
USAID/NICARAGUA

________ DATE ________

JAMES S. HESTOR
CHIEF ENVIRONMENTAL OFFICER
BUREAU FOR LATIN AMERICAN
AND THE CARIBBEAN