USAID/Nicaragua

Economic Recovery and Development—I

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Concept Paper

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I. Introduction and Executive Summary

In this Concept Paper, USAID/Nicaragua proposes the Economic Recovery and Development Program I (ERD-I), a cash transfer of $45 million in FY93 ESF, for balance-of-payments (BOP) assistance. Disbursement of this assistance will be subject to conditions precedent relating to natural resource management and macroeconomic adjustment, as described below.

ERD-I is an integral part of the Mission's multi-year assistance strategy reaffirmed by AID/Washington in February 1993. It contributes directly to meeting the Mission's Strategic Objectives of increasing investment, increasing participation in the economy, and increasing the use of environmentally sound productive and extractive practices.

BOP assistance continues to be vital in Nicaragua's current circumstances. Nicaragua's import bill in 1992 was more than triple the size of export revenues (see the Balance of Payments table below on page 39), and the IMF projects that large BOP deficits will continue to require financing through the end of the decade. Too-rapid reduction in BOP assistance in this situation could jeopardize economic and political stability, which must be maintained for private investment to return to Nicaragua and for democratic institutions to be solidified. BOP assistance is also needed to attenuate the substantial human hardship already being experienced in Nicaragua as a result of economic disruption of the decade of the 1980s. The net benefits at the grass-roots level of BOP assistance will be evaluated in more detail in the course of ERD-I.

Continued support for policy reforms, supported by substantial aid resources, is needed to ensure that the GON is able to follow through on its commitment to maintain and deepen economic and legal reforms. Since 1991 the GON has substantial achievements to its credit in reducing the fiscal deficit and inflation, liberalizing and privatizing the financial sector, and liberalizing foreign trade and the exchange-rate regime. Since mid-1992, the GON has also revitalized its effort to re-establish property rights and security in Nicaragua. The policy leverage of U.S. BOP assistance has been instrumental in achieving these reforms.

The reform program must continue and be deepened if it is ultimately to be effective in bringing about sustainable economic growth, secure property rights, and consolidated democracy. In macroeconomic reforms, the GON needs to take concrete additional steps to further reduce the fiscal deficit, to rationalize tax administration, to adjust the exchange rate, and to further open banking and insurance to private entry and expansion. In the natural-resource area, land-use law must be put on a sound footing. Carrying this overall reform effort through to fruition will be a multi-year effort on the part of the GON.

However, many of the reforms achieved in recent years are coming under political pressure due to the frustration produced by continual belt-tightening and the persistence of political demands for subsidies and renewed governmental control of the economy. U.S. interests in democracy and economic development in Nicaragua would be substantially harmed if these pressures forced the GON to change course. The policy conditionality of ERD-I will support the U.S. interest in the continuation of the GON's reform program. For a summary of ERD-I's policy conditionality, see page 36.

ERD-I's dollars will be disbursed to a Separate Account owned by the Central Bank of Nicaragua (BCN) in the Federal Reserve Bank of New York for use in paying GON debt owed to multilateral official credit institutions and in financing private import transactions handled by Nicaragua's private commercial banks. This import financing will be monitored by USAID/Nicaragua.

If the World Bank, through the IDA, succeeds in organizing a debt buy-back to eliminate the GON's foreign commercial debt, USAID would consider contributing a portion of ERD-I's dollars to this effort. This use of dollars, with its promise of future benefits in terms of reintegrating Nicaragua into world financial markets, would have to be carefully balanced against the short-term costs of diverting funds from immediate import financing.

The local-currency equivalent of the dollars used for imports will be deposited by the GON in a Separate Account in the Central Bank of Nicaragua (the BCN). Local currency will be made available to increase the GON's contributions to USAID's Program Trust Fund, to finance limited project activities selected on a case-by-case basis, and to retire existing GON obligations to the Central Bank and the Central Bank's existing stock of foreign-exchange losses.

II. Relationship to USAID's Strategy

The continuation of policy-based, BOP assistance is emphasized in the Program Strategy Review submitted to AID/W in February 1993 and in the FY1994 Action Plan. ERD-I will contribute to achieving the Mission's Strategic Objective of promoting a greater consensus on democratic values through conditionality relating to resolution of private property claims and election of a GON Controller General, as well as through the socially stabilizing effects of BOP assistance, which increases the availability of both imported consumption goods and imported production inputs, thus helping to maintain employment levels.

ERD-I's macroeconomic elements support the Mission's Strategic Objectives of (1) increasing foreign and domestic investment (through improving the investment policy framework, stabilizing the economic environment, and revitalizing the banking and financial markets) and (2) increasing competitiveness, diversification, and participation in the economy (through removing barriers to competition and reducing state participation in the economy).

Finally, the natural-resource component of ERD-I will advance the Mission's Strategic Objective of increased use of environmentally sound productive and extractive practices, through contributing to the adoption and implementation of improved resource-use policies and regulations. The 1991-96 CDSS set out policy dialogue as one of the activities the Mission would undertake to support the conservation and rational exploitation of natural resources. ERD-I will support the adoption of policy changes recommended by analysis done in previous years.

III. The Impact of BOP Assistance

The following section reviews important benefits generated by USAID's cash transfers in Nicaragua to address concerns about the social impact of this assistance. First, macroeconomic impacts are described, followed by an explanation of the social impact of these changes.

A. Macroeconomic Impact

1. Price Stability

The GON has made a commitment to a sound monetary policy under which monetary emission would be backed by reserves. USAID's cash transfer provides foreign-exchange reserves that are needed in this system to support growth in the monetary base without inflation. Without this type of assistance, Nicaragua would not have the resources it needs to back its money supply at the levels consistent with its economic growth targets.

Stabilization also resulted in declines in pricing margins that had been based on inflationary expectations, increasing purchasing power of the public and increasing consumption.

2. Private Credit

USAID's cash transfers have also leveraged policies that allowed credit to Nicaragua's private sector to increase. With longer-run expansion in the private banking system and private deposit and lending activity, a broader group of people has access to savings through the financial system for business development and investment. Development of a private financial system implies that decisions will be based on a generalized set of business rules, rather than on political clout. Benefits to the public will be more widely distributed under such a system, as investment decisions are more likely to be based on economic criteria.

This impact is reinforced by the financial-sector reforms that the cash transfer program supports. Without the policy reforms, the public would not have viable private banks to provide financial services needed in a growing economy, and would not have the prudential norms and regulations that are being established through the Superintendency of Banks.

3. Imported Inputs

USAID's cash transfers have financed imported inputs essential for production and employment. Imported inputs used in Nicaraguan industry and construction increased in 1991 and 1992, with raw materials and intermediate goods for use in production or construction, including petroleum, comprising about 40% of total imports in 1992. Imports of agricultural inputs declined in 1992 largely due to the drastic decline in the area devoted to cotton and coffee production.

Annual Increase in Raw material & Intermediate Imports

	Industry	Construction	Agriculture	Petroleum
1991	44%	43%	28%	-7%
1992	19%	35%	-60%	2%

USAID's cash transfers financed 12% of raw materials and intermediate inputs in 1992. This does not include funding for petroleum imports which was not available during this period. (Funding through ESR-III for petroleum imports reached its limit of $60 million in 1991.)

4. Imported Capital Goods and Increased Investment

USAID's cash transfers have a direct impact on investment in Nicaragua by financing imports of capital goods. Capital imports for industry increased in 1991 and by a larger margin in 1992, while capital imports for agriculture increased in 1991 and were stable in 1992. Overall, imports of capital goods maintained a 25% share of total imports in both 1991 and 1992, even as total imports increased rapidly. The increase in imports of capital goods is one sign that investments are being made, even if the impact is not yet visible in GDP data.

The share of capital imports financed by U.S. assistance were 13% in the last quarter of 1991, 2.5% in the first quarter of 1992, and 4% in the third quarter.

(No funds were available in the fourth quarter because signing and implementation of the ESR-IV program was delayed.)

5. Impact on Donor Assistance

The IMF, World Bank, and IDB were not able to return to Nicaragua until the GON's arrears in payments on their previous loans were cleared. U.S. cash transfers contributed a crucial $75 million to GON repayments, without which the arrears clearing would not have been manageable. Since then the World Bank and IDB have provided structural-adjustment loans for $110 million as well as a number of project loans. The World Bank is now developing a second structural-adjustment loan. The IMF has assisted the GON with an 18-month Stand-By arrangement and is negotiating a three-year Enhanced Structural Adjustment Facility (ESAF), which is expected to begin late in 1993.

In addition, cash transfers were crucial to the success of the GON in meeting the macroeconomic targets under the Stand-By agreement with the IMF. Many other donors' loans would not have been approved if the stabilization targets and other economic policy-reform commitments had not been met.

B. Social Impact

1. Increased Imports and Consumption

Increases in consumption are an indication of increases in income and improvement of the well-being of the population. A major source of increased consumption in Nicaragua was increased consumer imports during 1991 and 1992. While foreign financing of such imports is meant to be a temporary measure, it does allow increased consumption and well-being in the short term, until increased investment pays off with increased output in the future.

Consumer imports, which represented 34% of total imports in 1992, include non-durable goods such as food and beverage products, pharmaceuticals, and clothing, as well as durables such as household appliances, furniture, and vehicles. Cash transfers, which financed 16% of consumer imports in 1992, have substantially increased the levels and variety of consumption of the population.

2. Employment

Cash transfers raise employment, both through improvements in the business climate that result from successful economic stabilization, and by financing imports of on-going firms and new businesses. Without resources to import, many of these firms would have to cut back on business activity and employment.

3. Stabilization

Stabilization has important effects on people's daily lives. Lowering inflation is one example. It is widely perceived that inflation is a tax on the poor. The wealthy can afford to protect their assets by hedging or investing in other currencies while the poor lose purchasing power daily. Also, retail margins increase and the poor pay higher real prices to merchants, who themselves anticipate future price increases, as well as compensate for past ones.

4. Public-Sector Spending

In Nicaragua, the social-sector Ministries are highly funded relative to the level and quality of services delivered. Given the realities of resource availabilities, it is critical that expenditure policy be restructured to increase the effectiveness with which services are targeted and delivered.

Health and Education are the two largest civilian ministries in the GON. Both Ministries received an increasing share of the central government budget in 1991 and 1992. For example, in response to a campaign by the Sandinista Front, the Ministry of Education's 1992 budget included a large increase for universities, thus restricting the availability of funds needed for broad-based education programs at the grass-roots level. Thus, despite claims that policy reform sacrifices the interests of the poor, policy reform is in fact needed in Nicaragua to make sure that public spending priorities do not neglect the poor.

IV. Macroeconomic Developments in 1992-93

Overall macroeconomic results for 1992 and indications for 1993 are presented in this section. The GON's policy changes that contributed to these results are discussed in section V.

A. National Output and Spending

While aggregate economic statistics are always imprecise in countries that can afford only limited statistic gathering, Nicaragua's official data on GDP (national output) appears to require more than the usual caution, as official estimates of GDP and population imply a level of GDP per capita that is not consistent with available wage data. According to two independent labor-market studies commissioned by USAID and the World Bank, GDP appears to be underestimated by at least 10% and perhaps by as much as 100%. Furthermore, labor-market statistics identify only about 80% of the labor-force that one would reasonably expect in a country with Nicaragua's population.

Nonetheless, official data appear to confirm that the decline in GDP did essentially stop in 1991, as output was down by only 0.2%, and was reversed in 1992, as output rose by about 0.8% compared with 1991. This was achieved despite the collapse of the cotton sector, which lost its cost competitiveness in the world market. Also, with the full amount of foreign aid originally expected in 1992, output might have been two or more percentage points higher (based on calculations in USAID's 1992 PAAD for ESR-IV).

First-quarter industrial production figures and anecdotal information about retail sales in the first months of 1993 suggests that the tighter foreign-exchange supply has contributed to a new recession. As Nicaragua's economy is heavily influenced by agricultural production over the May-November season, however, it is much too early to begin to compare 1993 with 1992.

Sectoral analysis of national income could be highly sensitive to the data problems mentioned above. However, based on GON data the trends in 1992 for sectoral shares of value-added to output (equal to the shares in total resources used) are as follows. (See the table, "National Product by Sector", page 37.)

- Commerce (the value-added by retailers and wholesalers) continued to outperform other sectors, perhaps due to the large volume of imported commodities bought with foreign aid. However, its share in the economy is still much lower than it was in the 1970s.

- Manufacturing underperformed the rest of the economy, perhaps held back by its links with the troubled cotton sector, by the availability of imported consumer goods, by the lack of confidence among investors, and by disruptions related to the privatization process.

- Agriculture as a whole, including the relatively healthy cattle and fishing subsectors, grew at an intermediate pace.

- The share of national resources used in the Government remained about the same as in 1991, which is lower than its peak in the late 1980s but still much higher than in the 1970s.

In terms of what national output was used for, the first point to notice is that Nicaragua's domestic expenditures were actually 35% more than domestic production in 1992, thanks to net inflows of foreign aid and remittances from Nicaraguans overseas. In 1991, spending exceeded production by a slightly smaller margin, 29%.

Despite this increase in use of goods and services in 1992, it is estimated that uses of goods and services by government and investment both fell in absolute terms. The trends in shares in 1992 were as follows. (See the table, "National Expenditure", page 38.)

- Consumption spending continued to boom in 1992. After rising from 67% of GDP in 1990 to 89% in 1991, it reached 98% in 1992.

- The Investment rate was lower than in the 1970s and was at a level that, while it should lead to 5-6% growth in output, was still lower than in rapidly growing low- or middle-income economies. These are somewhat discouraging findings for an economy that should be in a reconstruction phase, with a high rate of investment. (However, the likely imprecision in both GDP and investment data makes these calculations slippery.)

- While falling in 1992, Government spending as a share of total spending is still much higher than in the 1970s.

Labor-market conditions are difficult to gauge, not only because of the shortcomings of the data available but also for conceptual reasons. Self-employment is very common in low-income countries. Therefore, the fact that a person is not working for an employer is not a dependable indicator of unemployment. Also, the practice of giving low-income people what appear to be unproductive positions in the organized sectors implies that being on a payroll should perhaps not be automatically accepted as "employment".

In one sense, the best indicator of "employment" is the output and income actually generated, rather than the institutional form in which the labor-time is organized. In this sense, perhaps the majority of laborers in Nicaragua working full-time but producing only marginal results may be considered "underemployed".

In the distributional sense, however, the institutional form of employment may be a critical determinant of the individual's entitlement to a share in the social division of income. In this sense also, it is probable that the unemployment and underemployment rates are high and perhaps even rising in 1992 and early 1993, as Nicaragua is suffering in a distributional sense from large dislocations in employment.

Large numbers of former soldiers have left the military since 1990. Furthermore, under the Occupational Conversion Program the civilian employment rolls of the central government fell by over 27,000 in 1990-92, equal to over 20% of initial government workforce of 120,000, and 2% of Nicaragua's estimated total labor force of 1,400,000. However, these dislocated employees have at least had access to support under public programs. This has not generally been the case for those affected by the contraction of demand for labor in the cotton and coffee sectors, which has been significant on the national scale, and devastating in some regions specialized in cotton (such as *Occidente*).

Unemployment has probably grown most among lower-income workers, judging from anecdotal accounts that employers are hoarding workers in the higher skill categories and letting go more easily replaced low-wage workers.

B. Foreign Trade and the Balance of Payments

Export revenues were disastrous in 1992. (See the table, "Balance of Payments", page 39.) To give a point of historical reference, export revenues in 1977 were about $1.0 billion (in terms of purchasing power in 1992 prices). By 1990, misgovernment, mismanagement, war, and embargo had cut exports to $353 million. The 1991 and 1992 figures were $276 million and $224 million. This is a compound rate of decline of 9.5% a year for a period of 15 years — 18.8% in 1992 alone. (Every $18 million decline equals 1% of official GDP in 1992.)

Cotton and banana export revenues each fell by about $20 million in 1992, making up about 80% of the lost revenue. Lower world prices in 1992 explain much of the decline in export revenues from these and other agricultural commodities. While bananas are expected to recover in 1993, cotton's lack of profitability in world markets virtually eliminated cotton planting in 1992, ensuring an **additional** drop of over $20 million in export revenues from cotton in 1993.

Despite this depressing export performance, imports rose from $683 million to $757 million in 1992. However, current import levels are still much less than the $1.1 billion of imports made in 1977, despite a 40% increase in population in the intervening 15 years.

Increases in non-durable consumer goods made up the bulk of the increase in imports, although a 25% increase in capital goods for industry is also notable. This latter increase, more than 1% of official GDP, is not necessarily inconsistent with the falling investment-to-GDP ratio reported above, but it is another reminder of the possible inaccuracy of some of the data.

Obviously, the huge gap between imports and exports is mainly dependent on net inflows of foreign aid, although private inward transfers between relatives plays some role also.

C. Money, Finance, Inflation, and Exchange Rates

By the first quarter of 1993, the GON had gotten the monetary sector largely under control. The ratio of M1 (circulating currency plus demand deposits) to nominal GDP had stabilized at 10%, which is a bit below the average for the region.

The economy's inflationary potential in 1992 was disguised through the substantial gap that was allowed to develop between the official exchange rate and market exchange rate in the middle of the year. This resulted in a substantial shift in the demand for money balances away from the córdoba and to the dollar. Dollar-denominated deposits in the banking system rose 55% to become the largest component of M3 (currency plus all bank deposits), ahead of currency, demand deposits, and time deposits. (M1 increased by 16% in 1992 and M3 by 30%. See the tables on pages 42 and 43.)

The 20% devaluation of January 10, 1993 immediately raised the relative price of directly tradable goods by 20% and, through the impact it had on dollar-denominated deposits, expanded the córdoba value of M3 by almost 7%. The reported consumer price index rose by 9.3% in January and by 7.8% again in February. It has stabilized since, as the credit supply has been restrained in accordance with real resource availability. Since January 10, 1993, the official exchange rate has kept within about 1% of the market rate through a daily crawl at a 5% annual rate.

Contrary to some fears, there has not so far been much pressure to raise nominal wage rates to keep up with the 20% devaluation and the 18% inflation in January-February 1993. In fact, after rising by 13% in 1992, official data show no increase in nominal wage rates between December 1992 and March 1993. (See the table, "Consumer Prices and Wage Rates", page 44.)

Agricultural credit in Nicaragua is under very heavy pressure to expand, but at the same time is in organizational crisis, for a number of reasons. The traditional financiers, the state-owned banks, remain insolvent and unprofitable despite restructuring attempts so far. Private banks, with their modest capital base, have so far been very cautious about lending to agriculture, due to the high risks created by recent events (including the fall in world cotton and coffee prices, poor rains in 1992, continuing insecurity in rural areas, both for person and for title to property and so forth). A number of special schemes (the "Bank Guarantee" program, cooperative credit programs) are coming under heavy criticism from all sides.

D. Public-Sector Finances

A marked increase in public-sector revenues in 1992, equal to 5% of GDP, resulted mainly from an increase in the sales tax rate. This gain, however, was entirely spent by the government sector in a doubling of fixed capital formation. In fact, despite the higher revenues the public-sector deficit actually increased from 8% of GDP to 10%. (See the table on "Fiscal Balance: Non-Financial Public Sector", page 45.)

However, financing this deficit was no problem, as foreign grants and loans rose from 14% of GDP to 19%. As a result, in 1992 the GON was able for the second year in a row to retire debts owed internally in Nicaragua, in an amount equivalent to 9% of GDP (compared to 5% in 1991). However, since in 1992 foreign loans amounted to 13% of GDP, compared with only 1% in 1991, the implications for future external debt service are considerably more serious. Financing future deficits may also be complicated by the continued decrease of projected net foreign-aid inflows.

V. Economic Policy Reforms in 1992-93

A. The Productive Framework

1. Property Rights

Under the Sandinista government, a large number of properties were seized from former owners and administered privately, rather than being nationalized as government property. Shortly before ceding authority to the incoming Chamorro government in April 1990, the Sandinista administration tried to legalize the beneficiaries' possession of these properties, in what became known as the "piñata" (a grab-bag of gifts that shower down on children in a fiesta).

In an effort to resolve the claims of the thousands of property owners adversely affected by these "piñata laws" and the Sandinistas' original confiscation decrees, the Chamorro administration established by Decree 11-90 the "National Review Commission", which accepted claims from 5,400 individuals relating to approximately 17,000 properties, with it planned to resolve by administrative determinations to return properties. In June 1991, however, Nicaragua's Supreme Court ruled that the Commission lacked authority to resolve cases administratively. As a result of this legal obstacle, the GON's property resolution system was moribund for over a year.

However, a revised approach to resolving the thorny issue of property claims began to take shape in late 1992 and early 1993. The initial step is an accelerated review of property disputes by a modified National Review Commission. The Commission's reviews can lead to the return to the previous owners of improperly confiscated properties, or the confirmation of legal title to current occupants and compensation of previous owners. ERD-I's Policy Condition A.1 will help ensure that implementation of this program stays on schedule. (See page 21 below.)

The amount of compensation offered is established administratively by the Ministry of Finance. A system of arbitration that meets international standards has been established to respond to disputes relating to the valuations of properties.

Compensation is paid in the form of 20-year zero-coupon bonds. The bonds are transferable and can be used to purchase shares of some of the state-owned companies that are being privatized or that are in the hands of the state-owned banks. Bondholders will also be able to cash bonds early by selling them in GON-sponsored auctions, which the GON will finance in part from the cash proceeds of privatizations. ERD-I's Policy Condition A.2 will help ensure that this element of the program continues to be implemented. (See page 21 below.)

2. Privatization

During 1992 and early 1993, the GON's holding company for nationalized industry, CORNAP, continued to make steady progress in privatizing the firms under its control. From January 1992 to March 1993, 77 CORNAP companies were privatized, liquidated, or returned to their original owners, so that by March 1993 only 114 of the original 351 companies remained to be divested. Two prominent divestitures that yielded substantial cash payments were the 'Montelimar' Pacific-coast beach resort and the Intercontinental Hotel in Managua.

In addition to the progress made with CORNAP companies, the GON has also recently begun to plan the privatization of major state-owned companies that are not a part of the CORNAP group, such as the state telecommunications company, TELCOR.

3. Foreign Private Investment

In addition to shedding state-owned companies, the GON also took steps in 1992 to promote greater private participation in the economy by establishing laws designed to promote foreign investment in Nicaragua. While legal requirements and bureaucratic red tape still affect potential foreign investors, the new Foreign Investment Law and Free Zone Law do substantially simplify and clarify the process of foreign investment.

4. Infrastructure

Public-sector management of infrastructure such as water and energy made little progress during 1992 and early 1993. Large-scale electric power rationing occurred during portions of both 1992 and early 1993, reflecting:

- Inadequate maintenance of existing generating and transmission facilities.

- Inadequate investment in new generating capacity.

- The failure of the national energy company (INE) to charge electric power tariffs that were consistent with marginal supply costs (which would have curtailed power demand and provided higher revenues to pay for more power imports).

The water utility company (INAA) also failed to recover its supply costs. Together, INE and INAA are experiencing a growing gap between operating revenues on the one hand and operating and capital expenditures on the other. The gap rose from 0.9% of GDP in 1991, to 1.4% in 1992 and a projected 1.5% in 1993.

Among distilled petroleum products, only the price of gasoline rose faster than the CPI in 1992, while diesel, LPG, and fuel oil prices fell relative to the CPI through February 1993. Electricity tariffs kept up with the CPI, but water rates fell in relative terms. Since prices of imports such as petroleum-based products should be rising in relative terms, so as to encourage conservation and close the foreign-exchange gap, the fact that they are actually lagging behind is even more regrettable.

5. Natural Resource Management

In November 1992, a Presidential Decree established the technical recommendations of the Forestry Action Plan ("PAF" in Spanish) as GON policy. The PAF recommends: (1) that the owner of the land also be the owner of the forest; (2) a commitment to manage forested lands consistent with use capability; and (3) enactment of a legal framework for management, protection, and use of forest lands.

In addition, mounting pressure to lift the current moratorium on timber harvesting is creating support for an interim Presidential Decree to address inconsistencies in existing forest legislation. An analysis of this interim decree done by USAID and ROCAP indicates that the substantive content of the decree would not realize the sustainable-use objectives intended by the legislative drafters and would rapidly create interests vested in maintaining many of the policy incentives that have led to over-exploitation and degradation of forest resources in Nicaragua and elsewhere in Central America.

As a result of this analysis, the GON's environmental agency (IRENA) has expressed interest in developing a permanent forest law that avoids the pitfalls of existing regulation and is based on the recommendations of the PAF. The Chairman of the National Assembly's Committee on Natural Resources and the Environment is also committed to an open, non-partisan process to develop and enact a new Forest Law. However, there is also some concern that vested interests favored by the existing inadequate laws may prevent this process from going forward.

B. International Trade Policies

1. Private Participation in International Trade

Following the reforms of 1991, which abolished state trading monopolies, the GON took a number of steps during 1992 to further liberalize and clarify trade policies. In particular, the GON eliminated the requirement that exporters surrender foreign-exchange earnings to the Central Bank, as well as the requirement that importers receive prior approval from the Central Bank for foreign-exchange purchases. Exporters and importers can now complete these transactions entirely within the commercial banks (which, however, are technically acting only as the agents of the Central Bank for these purposes).

2. Tariff Protection

The GON made major reductions to its import tariff levels in 1992 and early 1993. In early 1991, the import tariff range was from 3 to 143% and averaged 18%. By the end of 1991 the range was brought down to 10-50% for most products. In 1992 the range for most products was further narrowed with the imposition of a 20% ceiling on tariffs for most products. As of this writing, an additional selective consumption tax is also levied on many imports.

3. Import and Export Procedures

Despite significant reductions in official trade barriers, many exporters complain that exporting can be far more burdensome in practice than is apparent from the letter of the law. Although export-processing procedures have been streamlined, the so-called "one-stop" window for exports currently requires no less than 10 steps.

Fulfilling the required export procedures can require 1-2 weeks or more, plus an additional 2-3 weeks to obtain the tariff rebates granted under the export promotion law. For exporters of perishables, which include some of Nicaragua's promising nontraditional seafood, fruit, and vegetable exports, even one week is obviously a significant delay.

Many of the steps required are modified versions of procedures that were initiated under the Sandinista regime to control international trade, not facilitate it. Importers and exporters complain that they continue to encounter negative bureaucratic attitudes regarding foreign trade in general.

4. Export Bans

In 1992 the GON eliminated the ban on the exports of basic staples: maize, sorghum, rice, and beans. Very few export bans remain. However, gold and silver exports are still subject to government control, and exports of wood products are restricted.

C. Monetary and Financial Policies

1. Controlling Aggregate Money and Credit

Nicaragua has continued a highly restrictive monetary policy that, given a lack of other monetary instruments, is implemented through adjusting the volume of Central Bank lending to the commercial banks. The tightness of credit is evidenced by the fact that M1 grew at a trend rate 7% slower than the Consumer Price Index from March 1992 to March 1993. This also implies that credit policy and exchange-rate policy (the 20% devaluation of the official exchange rate on January 10, 1993) were together successful in bringing about a real devaluation in early 1993.

The Central Bank also took the first steps toward creating a more neutral market mechanism for controlling aggregate liquidity, when in March 1993 it authorized the emission of "Monetary Stabilization Letters" (LEMOs). LEMOs will be short-term interest-bearing notes whose purchase and sale by the Central Bank in the open market will increase and decrease the volume of liquidity supplied by the Central Bank to the banking system, without involving the Central Bank in discounting commercial-bank assets. This will help disentangle the Central Bank's vital role in setting and implementing monetary policy from its past role in directed credit programs, which are being wound down.

2. The Efficiency of Credit Allocation

In 1992 and early 1993 the GON took major actions to increase the efficiency of allocation of credit in the economy.

- As of November 1992, the Central Bank ceased to provide credit directly to end-users.

- The dependency of state-owned banks on Central-Bank credit was reduced. The GON is in the final stages of an operation in which the Ministry of Finance bought $150 million worth of the state-owned banks' worst loans, as well as enough additional loans to constitute both an adequate loan-loss provision for low-grade assets in the remaining portfolio and an adequate capital base for a 'fresh start' as financially responsible commercial banks operating under the standards established by the Superintendency. (The Ministry financed this operation through the Central Bank, which the Ministry will compensate by assuming some of the Central Bank's foreign debt obligations.) The GON also established the policy that it would not provide any additional capital to the state-owned banks. The objective of this restructuring is to allow the state-owned banks to operate profitably on the basis of their own capital, without depending on constant inflows of liquidity from the Central Bank.

- The Central Bank started providing medium-term (5-year and over) resources to the private commercial banks, in order to broaden the new private commercial bank sector's range of activities. (ERD-I's Policy Condition E.1 will build on this progress. See page 23 below.)

The private banking system also continued to grow. Three new private banks were established, making a total of seven, and two more bank applications are currently pending with the Superintendency. The private banks are meeting all prudential requirements and following relatively cautious policies, compared with the state-owned banks.

The state-owned commercial banks have made considerable efforts to improve their performance, in the context of the restructuring of their assets as described above. The largest bank, the agriculture-oriented National Bank for Development (BND), has been especially energetic in cutting operating expenditures, reducing its staff by 61% and the number of branch offices by 46% by the end of 1992.

Partly as a result of these reforms and partly due to privatization, the private sector's share in the total credit provided by the financial system has continued to increase, from 42% after the state-owned banks' portfolios were restructured in June 1992 to 63% in March 1993, as credit to the private sector grew while credit to the public sector contracted.

However, the state-owned banks continue nevertheless to be in a difficult position. Due to popular political demands, the GON frequently pressures the state-owned banks to make relief-oriented loans to borrowers who are in many cases unable to repay, and given little incentive to do so by the well publicized governmental pressure on the banks on their behalf. Pressures are often strongest on BND, particularly with respect to the plight of the unemployed cotton workers, a situation heavily exploited by the Sandinista Front at the Chamorro Government's (and potentially the BND's) expense.

At the beginning of the agricultural season in May 1993, the GON was maneuvered into promising that the BND would ignore that cotton growers were defaulting on past loans and "loan" money again for production known in advance to be unprofitable. However, the BND and the rest of the banking system is attempting to find ways to meet the spirit of the Government's promises while avoiding unsound practices. The Central Bank also believes that aggregate credit limits consistent with resource availability can still be respected.

Nonetheless, the state-owned banks are still incurring operating losses, which imply a reduction in a bank's capital, and, due to prudential regulations requiring minimum capital-adequacy levels, a reduction the bank's capacity to extend loans. However, due to the large volume of non-indexed loans the state-owned banks have received from the Central Bank, the January 10th devaluation generated extraordinary exchange-rate gains for the state-owned banks. Furthermore, the Ministers of Economy and Finance, from their positions on the Board of Directors of the Superintendency, have encouraged the Superintendent to be 'flexible' in applying prudential norms in order to avoid additional tightness in credit.

ERD-I proposes two Policy Conditions, E.2 and E.3, that will support short- and long-term measures to reduce the GON's control over the commercial banking sector and to make its regulatory function more professional and transparent. (See pages 24ff. below.)

3. Broadening the Financial Sector

In addition to the reforms of the banking sector discussed above, the GON has also committed itself to making the legal reforms necessary to permit the re-entry of private firms into the insurance sector, and is considering decrees that would permit the creation of a private stock-exchange. ERD-I Policy Conditions E.5 and E.6 will support implementation of these reforms. (See pages 26ff below.)

4. Foreign Exchange

Significant changes occurred in 1992 in the policies governing the foreign-exchange market.

- By September 1992 all state-owned foreign-exchange houses had ceased operations, leaving the exchange houses entirely in private hands.

- Commercial banks were permitted, for the first time, to freely purchase foreign exchange from exporters and sell it to importers during the course of a business day (with the requirement that any residual foreign exchange be sold to the Central Bank at the end of the day).

- Starting in early 1993 commercial banks were theoretically given the right to buy and sell foreign exchange at the exchange-house (market) rate, although the implementation details are not yet in place.

- In January 1993 the GON altered the exchange-rate regime by announcing that the official exchange rate would follow a continuous devaluation instead of a rigidly fixed rate. The crawl was initially set at a 5% annual rate. However, the GON stated that it might have to alter this rate and that it was not committed to it for any fixed period of time.

- In March 1993, the BCN's Board of Directors approved the issuance of foreign-exchange bonds ("BOMEX") by the Central Bank, which are currently beginning to be traded. These will eventually provide a mechanism for open-market methods of managing the availability of foreign exchange.

ERD-I's Policy Condition C.1 will ensure that the GON continues to adjust its official exchange rate to meet both the short-term goal of maintaining price stability and the long-term goal of reducing the structural gap in the balance of payments. (See page 23 below.) In addition, Condition E.4 will support longer-term measures for improving the management of foreign exchange. (See page 25 below.)

D. Fiscal Policies

Little progress was made in fiscal stabilization during the latter half of 1992 and the beginning of 1993. While overall tax revenues of the public sector continued to strengthen in 1992 and 1993, largely as a result of a rate increase in the sales tax (IGV) in October 1992, public-sector expenditures rose even more sharply, largely due to increased capital expenditures by the public utilities, which together accounted for more than 50% of the increase.

In early 1993 the trends that had begun in 1992 became more pronounced. On January 10th the GON announced fiscal measures (an increase in luxury taxes, an increase in stamp taxes, an increase in license fees in the transportation sector, a reduction in import tax exemptions, and measures to improve tax administration) which further increased government revenues. At the same time, however, it announced increased spending plans for the social sector. This increased spending, combined with a 1993 Central Government budget that failed to curb spending in other areas to compensate for the increases, and a slight reduction in selected taxes that was announced in March, resulted in a projected Central Government deficit in 1993 of approximately 3% of GDP.

Following the April 2nd meeting of the Consultative Group, however, it became clear that external resource availability would be less than the GON had hoped for, and that further reductions in the fiscal deficit would be needed. The GON has therefore been working internally and with advisors from the IMF and World Bank, in the context of developing the macroeconomic program to support an ESAF, to define the amount and shape of additional fiscal cuts, which will probably be equivalent to about 3% of GDP.

ERD-I's Policy Condition C.1 will ensure that the GON be committed to a realistic program for reducing the fiscal deficit. (See page 23 below.) Condition D.1 will support policy reforms in tax administration, with longer-term impacts on both fiscal stabilization measures and GON investments in public-service programs. (See page 23 below.) Finally, Condition B.1 will help ensure that the GON improves its internal financial management and accountability. (See page 22 below.)

VI. The GON's Medium-Term Development Policy

In its presentation to the Consultative Group meeting in Paris, on April 2, 1993, the GON described its plans for in the following terms:

> "The program puts particular emphasis on reestablishing basic macroeconomic balances ... . The Government's three-year program will aim at expanding traditional exports such as coffee, fish products and beef and developing the necessary conditions for the growth of nontraditional exports. The authorities plan to achieve this objective through a rapid resolution of the property rights issue, an improvement in external competitiveness through an adequate exchange rate policy, a tight wage policy, the adoption of measures to improve labor productivity through adequate technology, and measures to add flexibility to labor market regulations, a continuation of the process of trade liberalization, and a substantial increase in public sector savings to finance the reconstruction of infrastructure in the productive areas."

Details within these overall themes are emerging from an in-depth process of consultation between the GON and Nicaragua's political parties and between the GON and the donor community. Clear-cut directions have been slow to emerge because of the reduction in external resources available in 1993 compared to 1992. As the import level is projected to fall by over 10%, the GON must plan for large reductions in public-sector spending (through budgetary revisions) and private spending (through upward revisions in the prices of tradable goods, the prices of public services, and taxation, and through limitations on aggregate credit). Obviously, public consensus on such austerity measures is hard to achieve, despite the ample discussions that have been undertaken.

It is currently hoped that an overall macroeconomic program and a Policy Framework Paper can be agreed upon by the GON, the IMF, and the World Bank by the end of June 1993. This would open the way to an ESAF and a second IDA adjustment credit (ERC-II). ERD-I's Policy Condition C.1 will ensure that an ESAF agreement is reached before AID's BOP assistance is disbursed. (See page 23 below.)

The GON's track record shows a commitment to stabilization, liberalization, and privatization surpassed by few countries in recent history. Hyperinflation was eliminated, a large number of state-owned companies rapidly divested, and vigorous steps taken to overcome inherited Constitutional and legal obstacles, as well as continuing political opposition, to private-sector development.

However, the GON remains dependent on external assistance for the definition and support of its reform program's details. Thus, Nicaragua represents one of the most fertile areas in the low-income world for donor technical and financial assistance to collaborate with a committed government to overcome past mismanagement and establish pre-conditions for the turn-around of a tragic decline in economic, social, and democratic standards.

VII. ERD-I's Policy Reform Program

For balance-of-payments assistance to be justified, the recipient must be taking measures that will make it more self-reliant in the future, and the financial assistance must facilitate the implementation of these measures and make them more effective. In Nicaragua in particular, the principal national economic challenge for the medium term is to raise production of exports and import substitutes so as to lower the excess demand for imports that can only be met at present by large net inflows of foreign aid. In the short term, measures are needed to efficiently reduce the demand for imports to the financing available.

However, an attempt to adjust the shortfall in external resources that relied solely on adjusting relative prices through "devaluation" (setting far higher prices for foreign currencies like the dollar) would strongly risk creating renewed hyperinflation, due to the unwillingness in the short-term to allow relative prices to change (*e.g.*, unwillingness to allow real wages to fall). There is also a strong possibility that foreign exchange shortages would quickly lead to strong, intrusive, and essentially arbitrary governmental controls over the economy.

Therefore, a broad program responding to real resource shortages is needed to avoid the risks of short-term destabilization and accelerated inflation, as well as risks of long-term stagnation in an economy dominated by government controls and protection. The measures that ERD-I will support include both measures needed for short-term stabilization and measures that, although possibly complicating the GON's task in the short term, are needed to establish a base for long-term growth.

An overall summary of ERD-I's policy conditionality is presented in the table on page 36.

A. Resolution of Property Claims

Condition A.1: Issuance by the Ministry of Finance's Office of Compensation Valuation (*OCI*) of a cumulative total of at least 800 property valuation resolutions, of which not less that 80 must name U.S. citizens as claimants.

Discussion: Timely compliance with its recently announced plan to resolve outstanding disputes relating to property rights is critical to the GON's ability to effect a reactivation of the nation's economic growth and development. While the issue transcends economics, from an economic perspective resolution of the property issue is a necessary condition for significant levels of new investment to occur in Nicaragua.

Meeting the above condition precedent will imply that the GON is on track with its September 1993 targets for progressively resolving all OCI's potential claimant universe of 5,384 individuals whose property may be legally assigned to the current occupants and whose original owners are therefore due compensation.

A benchmark relating to the OCI's valuation resolutions was chosen because these resolutions are important decision points, and potential bottlenecks, in the claims-resolution process. The issuance of a valuation resolution shows that the National Review Commission has reviewed the case and decided that the property cannot be returned and that therefore compensation should be offered. Furthermore, a resolution's issuance shows that OCI has dealt with numerous possible questions relating to the inherent value of the property and other claims on it that may affect the original owner's net equity. The resolution's issuance is also a verifiable administrative action upon which USAID can base an accountable disbursement decision.

If the timing of ERD-I's authorization is different that currently anticipated, the benchmark for the number of valuation resolutions handed down will be adjusted accordingly.

Condition A.2: Commitment by the GON to implement Decree 56-92 where it states that the net cash proceeds from privatization of the telecommunications functions of TELCOR will be applied to redemption of bonds received in compensation for lost property.

Discussion: A key requirement to resolve property disputes is that the GON have liquid financial resources available to provide a backing to the compensation bonds issued by the GON's Treasury. In 1992, the GON issued a decree stating that the net resources generated from the privatization of TELCOR's telecommunications functions would be used to compensate bondholders. This would maintain the value of compensation bonds in the secondary market and permit a larger volume of early redemptions by the GON. Without such backing, the value of the bonds could fall to a level at which claimants could reasonably assert that adequate compensation has not been provided, thereby jeopardizing the success of the entire claims-resolution process.

TELCOR's privatization is still in the planning phase and, with technical assistance financed by USAID, will probably be completed in 1994. ERD-I's policy condition will emphasize the importance of implementing the planned link with compensation for property claims when funds from privatizations are available.

B. Accountability in the Public Sector

Condition B.1: Election of a fair and impartial GON Controller General.

Discussion: For most of the past year, the position of the GON's chief audit and financial accounting officer, the Controller General, has been vacant due to the politically controversial dismissal of the previous incumbent. To fill this position, the President must nominate three candidates, of which the National Assembly elects one. To date, however, no nominations have been made.

The absence of a Controller General is unacceptable. In order for there to be the transparency in governance that is essential to the democratic process, the Government needs to be accountable for resource use through a system of checks and balances. Furthermore, although the public sector is far smaller than it was under Sandinista rule, it remains a major component of Nicaragua's economy in terms of national expenditure, investment, and employment. From an economic perspective, it is essential that government resources be used as efficiently as possible, which requires that the GON have the internal capacity to critically monitor cash flows.

USAID is prepared to finance technical assistance in these areas and to help lay the groundwork for a modern system of public-sector accounting and financial management, through the Public-Sector Financial Management Reform project, but only when the GON has put a competent and impartial Controller General in place. ERD-I's policy condition will help ensure that this long-standing issue is resolved in a timely way.

C. Macroeconomic Stabilization

Condition C.1: Approval by the IMF's Board of an Enhanced Structural Adjustment Facility (ESAF) agreement with the GON that includes among its provisions appropriate plans for fiscal deficit reduction and adjustment of the exchange rate.

Discussion: Approval by the IMF's Board of an ESAF agreement is the appropriate public benchmark to verify that the GON has committed itself to an adequate macroeconomic framework for USAID's BOP assistance. The Policy Framework Paper covers a broad spectrum of stabilization and development issues. In addition to financial targets similar to those of an IMF Stand-By program, the Paper covers structural reforms in several sectors, including industry and infrastructure as well as banking and finance. Property issues will also figure in the agreement.

It is currently hoped that a Policy Framework Paper can be agreed upon by the GON, the IMF, and the World Bank by the end of June 1993, with Board approval from both international institutions by early fall. This would open the way to an ESAF loan from the IMF and a second adjustment credit (ERC-II) from the IDA, as well as being a condition precedent for ERD-I.

D. Fiscal Reform

Condition D.1: A plan to improve tax administration (including administration of the customs office) and to transform the sales tax (IGV) into a value-added tax.

Discussion: Given the fact that donor assistance to Nicaragua in the foreseeable future is almost certain to continue to fall, it is critical for the GON to increase the efficiency of its fiscal policies. In particular, in addition to sharply reducing public-sector expenditures, the GON must significantly improve the efficiency and neutrality of its tax administration. Taxes need to be more neutrally administered. For example, the current sales tax (IGV) places a greater tax burden on businesses that rely relatively more on the purchase of inputs that already have an IGV tax associated with them (e.g. flour purchases by bread producers) than business that rely less on such input purchases. A value-added tax system that replaces the IGV sales tax would eliminate this bias.

E. Financial-Sector Reform

Condition E.1: A plan to increase the volume of medium-term resources provided by the Central Bank to the private commercial banks by the equivalent of $20 million, through instruments (*e.g.*, bonds) with an original maturity of not less than five years.

Discussion: The structural development of banking in Nicaragua needs to continue to emphasize the private sector and, within the private sector, the broadening of the role of private banks into the full range of financial services appropriate for Nicaragua's economy at this time. This range includes medium-term lending as well as lending to productive sectors that have, up to now, been served almost exclusively by state-owned banks.

The continued availability of ample medium-term resources to the private banking sector can be a powerful incentive for this structural change to move ahead. At the same time, this tool needs to be complemented by direct measures to downsize the state-owned sector as well as a more efficient incentive structure for the private banks to widen their sources and uses of funds. USAID's continuing policy dialogue will pursue these issues in the context of this condition.

Condition E.2: A commitment by the GON to the independence of the Superintendency of Banks in supervising the state-owned commercial banks.

Discussion: The Superintendency's Board of Directors includes both the Minister of Finance, whose Ministry directs the state-owned commercial banks that the Superintendency supervises, and (as Chairman) the Minister of Economy, whose Ministry supervises state-owned companies that are financed by state-owned banks.

The potential conflict of interest inherent in these relationships is clearly unhealthy and, in the case of private banks, is frequently prohibited by regulations concerning interlocking ownership and bank lending to related companies. This conflict is especially critical at the present time, as state-owned banks' capital adequacy needs to be closely monitored, while the GON is under intense political pressure to increase lending from state-owned banks.

This conflict should ultimately be resolved by divestiture of state ownership in commercial banking. In the interim, the independent prudential supervision of the state-owned banks by the Superintendency of Banks needs to be ensured by a commitment from the GON to refrain from direct involvement at the political level in the Superintendency's responsibilities. a formal delegation of authority from the Superintendency's Board of Directors to the Superintendent as one possible form for this commitment.

Condition E.3: A plan for the divestiture of government ownership in BANIC.

Discussion: In the conflict between social safety-net and stabilization objectives, it has become clear that the conflict of interest inherent in the Government's being the owner, supervisor, and client of the state-owned banks is unmanageable. Use of the banking system for political purposes not only ultimately expands the fiscal deficit, but also wastes very scarce resources on dead-end uses. Finally, the banking sector itself is handicapped by the burden of past loan failures, which tends to distort current lending (*e.g.*, the "throwing good money after bad" syndrome).

On-budget relief programs need to be devised to substitute for pseudo-credit programs and new social-sector agencies should take the place of the banks in relief work. The GON should then withdraw from ownership and political involvement in commercial banking. This could involve a variety of measures: (1) continuing to improve the state-owned commercial banks' loan selection and collection, (2) divesting state-owned commercial banks of their commercial-bank functions (deposit-taking, making payments, opening letters of credit) and restricting them to "development" banking, (3) cutting state-owned development banks off from financing from the Central Bank (they would keep their accounts in private commercial banks), (4) privatization, and (5) liquidation.

The GON has achieved some progress in slimming down the state-owned banks. The BND in particular has made a major effort. Its management appears to be committed to minimizing its competition with the private sector. Furthermore, given its size (the largest bank in Nicaragua) and the fact that its business is concentrated in agriculture, the sector that the private banks' managements have targeted least, there is at least in the short term an argument for BND to continue to complement the private sector.

The other major state-owned commercial bank, BANIC, is smaller and dedicated to the industrial and commercial clientele that the private sector is now increasingly serving. Furthermore, BANIC's management is more competitive with the private banks. There is a growing consensus that BANIC no longer has an appropriate role as a state-owned institution in the emerging structure of the banking system.

Therefore, ERD-I's disbursement will be conditioned on adoption by the GON of a plan to divest itself of ownership control of BANIC.

Condition E.4: Issuance of a plan to shift all foreign-exchange transactions to the market exchange rate.

Discussion: The purpose of stabilizing the foreign-exchange rate is basically to facilitate international trade, both by eliminating exchange-rate uncertainty and by eliminating the 'stop-go' monetary policies and intrusive administrative measures that inevitably characterize short-term efforts to react to exchange-rate fluctuations. In the long term, the GON should consider adoption of more fundamental structural changes in the exchange-rate and monetary regimes to deal with these problems.

The first step would be, as posited in this condition precedent, to plan a strategy for moving all transactions to the market rate, with GON foreign-exchange transactions taking place as 'open-market operations', which would be efficient both for the GON's own operational needs for foreign exchange and for intervening in the market.

Longer-term measures that should eventually follow would include:

- Removing all barriers to international capital flows, increasing dollarization of financial transactions, and increasing foreign investment in banking.

- Ultimately, joining the United States and other trading partners in a unified currency area.

The GON has already taken preliminary steps in these directions by (1) choosing the U.S. dollar as its "nominal anchor" in establishing the new currency, the "córdoba oro", in 1991, (2) permitting dollar-denominated deposits in the banking system, (3) permitting widespread indexing of córdoba assets and liabilities to the U.S. dollar exchange rate, and (4) basing increases in credit on increases in international (mainly, dollar) reserves.

However, the credibility of these half-measures can never be complete (especially with such a large current-account deficit in the balance of payments). Furthermore, the GON's official policy still imposes numerous onerous restrictions on ordinary commodity trade in order to regulate (prevent) international capital transactions. The law also still provides that transactions should be in córdobas. Such policies create substantial increases in transaction costs for exporters and importers, especially because of the opportunities they afford for abusive implementation by governmental staff with bureaucratic and rent-seeking attitudes.

The GON should proceed to flesh out a medium-term implementation plan for the objectives outlined above. Policy dialogue under the implementation of this cash transfer would pursue planning for long-term solutions to foreign-exchange management.

Condition E.5: Issuance of definitive legal reforms and implementing regulations allowing private entry into the insurance sector, without unreasonable capital requirements and on an equal footing with any state-owned firms.

Discussion: In the 15 years since the formerly private industry was nationalized, the insurance coverage in Nicaragua has fallen to approximately a third its former value. In other countries of the region, coverage of comparable risks is as much as ten times higher.

The GON has realized clearly that continuing the monopoly of the parastatal INISER is counterproductive for the protection of Nicaragua's families and capital investments against various risks. As a condition precedent to disbursement of ESR-IVA (524-0325A), the GON committed itself to a plan for bringing the private sector back into the insurance sector.

However, actions that could be interpreted as prejudicial to entrenched interests, including labor interests, are always sensitive, and the GON has, in the past, hesitated to act in some instances. USAID's support through policy dialogue, technical assistance to the Superintendency of Banks and Other Financial Institutions (including insurance), and this policy condition will continue to support Nicaragua's long-term interest in rehabilitation of its private insurance sector.

Condition E.6: Issuance of a Presidential decree and implementing regulations enabling the establishment of a Stock Market.

Discussion: As Nicaragua continues to move toward a market-based economy, the establishment of viable capital markets becomes increasingly important to the nation's ability to raise capital for investment, a key component in the country's prospects for long-term economic growth. A functioning stock market would represent an important step in the establishment of capital markets. Among other things, it would serve as a clearing mechanism for compensation bonds in the property-claims resolution system.

F. Natural Resource Management

Condition F.1: Issuance of a Presidential Decree establishing as GON policy that "land use capability" shall form the basis for all GON rural-sector programs.

Discussion: The 37% of Nicaragua's land area that can sustain forest production represents one of the most important natural resources on which Nicaragua can build sustainable economic growth. However, traditional policies militate against proper forest management, resulting in the systematic mining of the natural resource base. For example, forestry legislation:

(1) Inefficiently treats all users and land types as if they require maximum oversight and control;

(2) Does not establish secure use-rights;

(3) Requires unrealistic levels of technical support and control;

(4) Attempts to regulate behavior that cannot be policed;

(5) Imposes tremendous information and management costs on users and regulators creating fertile opportunities for corruption;

(6) Does not convert economic rents into economic incentives for encouraging self-regulating sustainable exploitation; and

(7) Does not treat reforestation as a business investment.

These failures have resulted in the systematic mining of the natural resource base. Many of these policies reflect a cultural value, widely held attitude among rural inhabitants, that trees are only a barrier to agriculture or grazing. For example, farmers seeking an agricultural loan are asked by the bank if the land has been cleared (even though a provision of the 1977 Bank Security Statute provides that the value of trees may be used as security for loans).

The disbursement condition proposed for ERD-I is the issuance of a Presidential Decree that will protect forests by establishing as GON policy that "land-use capability" forms the basis for all GON rural programs, including management of state forests, fiscal incentives, and technical assistance to private landowners. Costa Rica has recently adopted an official land use capability classification system, based on Holdridge's Life Zone system and adapted to the local ecological and technological conditions. Ten use-classes are recognized, of which four are for forestry, including protected areas. This system could be adopted by Nicaragua as official policy under a Presidential Decree in the timeframe projected for disbursement of BOP assistance under ERD-I. The decree will also establish as policy that forests have value, and thus reverse various policies that promote deforestation.

This policy condition is closely coordinated with two USAID technical assistance activities. The first is a six-month joint venture with the RENARM project to provide technical assistance to IRENA to carry out a participatory, analysis-based, and transparent legislative drafting process to produce a new forest law. The second is the Mission's Natural Resource Management Project (524-0314), which includes as a major objective the development and implementation of comprehensive forestry and natural-resources legislation. The policy and institutional strengthening activities of this project will ensure that the anticipated benefits from legal reforms are realized and can be monitored and evaluated.

Ultimately, the Presidential Decree and USAID's technical assistance should lead to enactment of a new Forestry Law that would establish a strategy of economic incentives and local empowerment (rather than government enforcement requiring high recurrent costs and facilitating corruption). The law should provide that:

(1) A permanent forest estate will authorized, comprising the remaining state forest lands, after traditional communal and private holdings are demarcated and titled.

(2) Trees on private lands, including indigenous communal lands, should be the property of the landowner.

(3) The land-use capability policies of the Presidential Decree be enacted into law.

The ERD-I Grant Agreement will therefore include a covenant that the GON will enact a new forestry bill to permanently establish the decree's policy in law. Key representatives of both the executive and legislative branches of the GON have indicated a high likelihood of enactment of a new Forestry Law within a year. An appropriate benchmark in the process of adoption of such a law will be considered for inclusion in any FY 1994 policy-based BOP assistance.

VIII. Dollar Uses

A. Proposed Disbursement Plan

Two independent tranches of cash-transfer assistance are proposed:

- A tranche of $40 million based on fulfillment of the macroeconomic conditions precedent discussed above.

- A tranche of $5 million would be disbursed when the condition pertaining to natural resources management is met.

The cash transfers will be used to finance debt service payments to official multilateral organizations, such as the World Bank, the IDB, and the IMF, and to finance productive imports from the United States under operating procedures similar to those established for ESR-IVA (524-0325A). Only import transactions handled by private commercial banks will be eligible.

If the World Bank, through the IDA, succeeds in organizing a debt buy-back to eliminate the GON's debt to foreign commercial banks (not to be confused with debt payments to official multilateral institutions), USAID will consider contributing a portion of ERD-I's dollars to this effort. This use of dollars, with its promise of future benefits in terms of reintegrating Nicaragua into world financial markets, would have to be carefully balanced against the short-term costs of diverting funds from immediate import financing.

B. Separate Account Criteria and Operating Procedures

1. Accountability

The Central Bank of Nicaragua was required, as a condition precedent of the ESR-IV-A program, to present a detailed set of operational procedures governing the use of the dollar resources destined for eligible import transactions and debt service. These procedures include approved disbursement mechanisms, separate dollar account(s) requirements, import eligibility criteria, and reporting requirements. Similar procedures will be used for ERD-I.

The unit responsible for managing the cash transfers will be the International Division of the Central Bank of Nicaragua (BCN). The management capabilities of the BCN have been evaluated by USAID personnel, professional management firms (Robert Nathan and Ernst and Young) and Price Waterhouse and Peat Marwick and Mitchell under the Regional Inspector General (RIG) Non-Federal Audit Program. In addition to a RIG audit of the ESF Program in Nicaragua dated 2/28/91 and a RIG supervised award survey of the BCN dated 5/22/91 several additional audits of our ESF Programs have been completed.

These Federal and Non-Federal audits identified several areas requiring action by the Central Bank related to the administration, reporting and approval of import transactions under our ESR assistance. The Mission brought these weaknesses to the attention of the appropriate Central Bank officials. Actions taken by the Central Bank to correct the deficiencies noted by the audit have been monitored by Mission personnel and will be evaluated in the course of the continuous audit of the program.

Based on the results of these reviews, the Mission can reasonably conclude that the BCN has the capability and sufficient span of control to adequately manage the cash transfer activities under the proposed ERD-I program.

USAID's Program Economics Officer will be responsible for overall management of the program, assisted by the USAID/Nicaragua Controller in the oversight of the cash transfers.

2. Audit

The RIG is required to conduct regular reviews of cash transfers in Nicaragua. In performing these functions, the RIG, in coordination with the Mission, oversees the overall financial management aspects of the program and schedules audits to determine compliance with the terms of the agreement and proper use of funds. The RIG obtains the services of a qualified external CPA firm to assist in meeting this responsibility. Funding for Non-Federal audits of the ERD-I program may be obtained from Project Development and Support (PD&S) funds (524-0000 (*sic*)) or from USAID's Program Trust Fund.

In addition, the Office of the USAID/Nicaragua Controller will perform periodic financial reviews in order to ensure that the Program's funds are properly managed and accounted for.

IX. Uses of Local-Currency Generations

A. Programming

Host-Country Owned Local Currency (HCOLC) will be generated by ERD-I as the accounting counterpart of the cash transfer at the time USAID approves use of dollars for payment or reimbursement of imports, using the highest rate of exchange not unlawful that is in effect in Nicaragua. These generations will be deposited into an interest-bearing Separate Account in the Central Bank.

HCOLC will be jointly released by the GON and USAID for the following purposes.

(1) To increase the GON's contribution to USAID's Program Trust Fund.

USAID's Program Trust Fund is used to finance the supplies, equipment, salaries, and techncal assistance expenses of ensuring the proper administration, control, and audit of AID assistance in Nicaragua.

(2) To finance the local costs of limited project activities.

HCOLC may also be made available for high-priority local-cost activities, such as AIFLD'S home-improvement program, on a case-by-case basis.

(3) To pay existing GON debts to the Central Bank and to offset accumulated foreign-exchange losses of the Central Bank.

The Central Bank is technically insolvent because in the 1980s, under the previous government, it financed fiscal deficits and, more importantly, assumed foreign-currency liabilities in return for local-currency assets. This currency mismatch has resulted in the Central Bank suffering exchange losses in each devaluation. These accumulated losses are now several times the domestic liabilities of the Bank.

Using HCOLC to offset these debts and foreign-exchange losses allows the Central Bank to make available a correspondingly larger volume of liquidity to the economy through the banking system. As discussed in various paragraphs above, a number of reforms have been instituted and are being deepened in order to improve the efficiency of the allocation of credit by the banking system.

- The state-owned Central Bank no longer lends directly to productive sectors. Rather, liquidity is supplied to the economy indirectly through the commercial banks.
- Furthermore, the mechanism for supplying liquidity to the commercial banks will gradually be shifted to open-market methods, which avoid even the appearance of directed credit by the Central Bank.
- The state-owned commercial banks are being downsized (or privatized).
- The state-owned banks are also cutting costs so as to improve operating results and to become more commercial in their orientation and less dependent on Central Bank financing.
- The private banks are profitable, are attracting deposits, and are continuing to grow.
- The Central Bank is providing substantial medium-term resources to the private banks through purchasing bonds issued by the banks.
- The share of bank credit going to private enterprise has expanded greatly.

While the continuing shortcomings of the financial sector have been discussed in detail above, the availability of liquidity to the banks remains vital to the functioning of Nicaragua's private productive sectors. A major objective of ERD-I's cash grants is to provide the hard-currency backing for the increased liquidity that will support increased production. In this context it is appropriate and indeed necessary that the financial system be afforded the flexibility to expand liquidity in the amounts equivalent to these increased external resources.

B. Accountability

As a condition precedent to the use of HCOLC, the BCN will establish operating procedures for the separate account(s). An Annex to the Memorandum of Understanding on local currency will detail those procedures, as well as accountability and monitoring responsibilities of AID and the GON relating to deposits into and disbursements from the HCOLC separate account(s).

Prior to being transferred to end uses, the HCOLC will be deposited in separate non-commingled accounts in the Central Bank of Nicaragua. These accounts will earn interest based on the highest interest rate for six-month certificates of deposit in effect on the first day of each month in Nicaragua's commercial banks.

The statements of HCOLC accounts, as well as records of supporting transactions, will be available for review and audit by AID and will be included under the audit of USAID/Nicaragua's programs.

HCOLC contributed to USAID/Nicaragua's Program Trust Fund will be managed by the USAID Controller's office through RAMC Mexico using equally rigorous procedures as for appropriated dollars. Similarly, implementing agencies that use HCOLC in project activities will be subject to USAID project implementation controls, including all applicable audit requirements.

Appendixes

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ERD-I's Policy Conditions

A. Resolution of Property Claims

A.1. Issuance by the Ministry of Finance's Office of Compensation Valuation (*OCI*) of a cumulative total of at least 800 property valuation resolutions, of which not less that 80 must name U.S. citizens as claimants.

A.2. Commitment by the GON to implement Decree 56-92 where it states that the net cash proceeds from privatization of the telecommunications functions of TELCOR will be applied to redemption of bonds received in compensation for lost property.

B. Accountability in the Public Sector

B.1. Election of a fair and impartial Controller General.

C. Macroeconomic Stabilization

C.1. Approval by the IMF's Board of an ESAF.

D. Fiscal Reform

D.1. A plan to improve tax administration (including administration of the customs office) and to transform the sales tax (IGV) into a value-added tax.

E. Financial Sector Reform

E.1. A plan to increase the volume of medium-term resources provided by the Central Bank to the private commercial banks by the equivalent of $20 million, through instruments (*e.g.*, bonds) with an original maturity of not less than five years.

E.2. Limitation of the role of the Board of Directors of the Superintendency of Banks exclusively to the approval of new banks and the liquidation of and intervention in existing banks.

E.3. A plan for the divestiture of government ownership in BANIC.

E.4 Issuance of a plan to shift all foreign-exchange transactions to the market exchange rate.

E.5 Issuance of definitive legal reforms and implementing regulations allowing private entry into the insurance sector, without unreasonable capital requirements and on an equal footing with any state-owned firms.

E.6 Issuance of a Presidential decree and implementing regulations enabling the establishment of a Stock Market.

F. Natural Resource Management (Separate Tranche of Funding)

F.1. Issuance of a Presidential Decree establishing as GON policy that "land use capability" shall form the basis for all GON rural-sector programs.

National Product by Sector
(% of GDP)

	1977	1990	1991	prel. 1992	proj. 1993
Primary Sector	22	24	24	24	24
Agriculture	14	16	15	15	15
Livestock	6	8	8	8	8
Forestry	1	NA	NA	NA	NA
Other	1	0	0	0	0
Secondary Sector	29	26	27	26	27
Manufacturing	23	22	24	22	23
Construction	5	3	3	3	3
Mining	0	1	1	1	1
Tertiary Sector	49	50	49	50	51
Commerce	22	17	18	19	19
General Government	5	13	11	11	11
Transportation & Communication	5	5	5	5	5
Finance	3	3	3	3	3
Public Utilities	3	3	3	3	3
Housing	5	4	4	4	4
Other Services	6	4	4	4	5
Memo Item: Real GDP Growth	8.4	-0.6	-0.2	0.8	2.1

"NA" = Data not available.
Sector elements may not sum to sector totals due to rounding.

National Expenditure
(% of GDP)

	1977	1990	1991	prel. 1992	proj. 1993
Net Exports	-5	-18	-29	-35	-28
Exports	34	25	21	16	19
Imports	40	44	50	52	47
Consumption	70	67	89	98	89
Government Spending	10	33	20	19	18
Gross Domestic Investment	24	19	20	18	21

Balance of Payments
(Millions of 1992 Dollars)

	1977	1990	1991	prel. 1992	proj. 1993
Current Account	-303	-541	-936	-1,061	-951
Excluding official interest due	na	-294	-484	-616	-495
Trade Balance	-107	-251	-405	-533	-437
Exports, f.o.b.	1,003	352	275	224	251
Imports, f.o.b.	-1,110	-603	-680	-757	-688
Other services & private transfers net	-180	-43	-79	-83	-58
Official interest payments due	na	-248	-452	-445	-456
Capital Account	317	-299	-145	-105	-17
Official	244	-24	-207	-222	-97
Official transfers	17	215	496	277	313
Loan disbursements	270	235	235	365	239
Amortization	-43	-474	-938	-864	-648
Other Capital, net errors & omissions	73	-274	63	117	79
Overall Balance	14	-840	-1,081	-1,166	-968
Financing	-14	840	1081	1,166	968
Net reserve change	14	211	-16	15	-10
Clearance of outstanding arrears		0	-1,850	-427	-2,236
Exceptional financing		631	2,949	1,578	3,077
Consultative Group		0	326	0	0
Mex/Ven/Col/U.S. rescheduling		0	920	354	0
Paris Club rescheduling		0	626	66	29
Other proposed rescheduling		0	0	3	3,048
Increase in other arrears		631	1,077	1,155	0
Financing gap	0	0	0	0	136

Exports (FOB) by Major Category

(Millions of 1992 Dollars)

	1990	1991	1992	1993
Traditional	278	217	169	189
Coffee	76	37	45	51
Cotton	40	46	26	2
Sesame	7	7	5	7
Sugar	41	32	22	20
Molasses	2	3	5	4
Meat	61	38	40	43
Seafood	9	13	17	24
Bananas	29	29	10	25
Gold	15	10	0	12
Silver	0	0	0	0
Non-Traditional	73	65	55	58
Agricultural	20	18	19	19
Industrial	53	47	36	39
Total	352	282	224	247

Sector elements may not sum to sector totals due to rounding.

Imports (CIF) by Major Category

(Millions of 1992 Dollars)

	1990	1991	1992	1993
Consumption	169	229	292	215
Non-durables	137	183	243	na
Durables	32	46	49	na
Petroleum	131	118	116	102
Petroleum	112	100	97	na
Derivatives	19	17	19	na
Raw Materials and Intermediates	169	228	234	250
Agriculture	37	46	18	na
Industry	110	153	178	na
Construction	21	29	38	na
Capital	210	196	214	215
Agriculture	13	14	14	na
Industry	84	96	120	na
Transportation	113	86	80	na
Various	0	0	1	1
Total	678	771	858	783

Elements may not sum to totals due to rounding.

Monetary Accounts of the Financial System

	C$5 per US$			C$6.3 per US$		
	actual Dec. 1991	prel. Dec. 1992	Change 1991-92	prel. Dec. 1992	proj. Dec. 1993	Change 1992-93
	(C$ millions)		(%)	(C$ millions)		(%)
M3	1271	1649	30%	1855	2081	12%
Foreign Currency Deposits	365	564	55%	707	801	13%
M2	906	1086	20%	1148	1280	12%
Saving Deposits	183	245	34%	307	313	2%
M1	723	841	16%	841	967	15%
Currency	398	469	18%	469	540	15%
Demand Deposits	325	372	14%	372	427	15%
less **Net International Reserves**	630	635	1%	796	921	16%
equals **Net Domestic Assets**	641	1015	58%	1059	1160	10%

(Elements may not sum to totals due to rounding.)

Notes: M1 equals Currency plus Demand Deposits.
M2 equals M1 plus Saving Deposits.
M3 equals M2 plus Foreign Currency Deposits.
Net Domestic Assets is defined as M3 less Net International Reserves.

Monetary Accounts of the Financial System

(% of GDP)

	C$5 per $US		C$6.3 per $US	
	actual Dec. 1991	prel. Dec. 1992	prel. Dec. 1992	proj. Dec. 1993
M3	18	20	22	20
Foreign Currency Deposits	5	7	8	8
M2	13	13	14	12
Saving Deposits	3	3	4	3
M1	10	10	10	9
Currency	6	6	6	5
Demand Deposits	5	4	4	4
less **Net International Reserves**	9	8	9	9
equals **Net Domestic Assets**	9	12	13	11

Notes: M1 equals Currency plus Demand Deposits.
M2 equals M1 plus Saving Deposits.
M3 equals M2 plus Foreign Currency Deposits.
Net Domestic Assets is defined as M3 less Net International Reserves.

Consumer Prices and Wage Rates

	% Change from Previous Month	
	CPI	Wage Rates
Dec 91	-0.1%	1.9%
Jan 92	1.1%	1.0%
Feb 92	-0.7%	2.3%
Mar 92	0.0%	2.0%
Apr 92	0.5%	2.2%
May 92	1.5%	0.4%
Jun 92	-0.9%	1.6%
Jul 92	-0.9%	0.7%
Aug 92	-0.5%	0.5%
Sept 92	-0.2%	0.3%
Oct 92	1.2%	0.8%
Nov 92	1.9%	0.4%
Dec 92	0.4%	0.4%
Jan 93	9.3%	0.0%
Feb 93	7.8%	0.0%
Mar 93	-0.6%	0.0%

Trend rate of increase, December 1991 to December 1992:
(calculated by regression)

CPI — 12.2%
Wages — 13.3%

Fiscal Balance: Non-Financial Public Sector

(% of GDP)

	1977	1988	1989	1990	1991	prel. 1992	proj. 1993
Total revenue	22	22	28	19	27	32	33
Tax revenue of general govt.	na	21	25	16	23	27	26
Operational surplus of utilities	na	0	0	1	1	2	5
Nontax revenue	na	1	2	1	2	2	2
Current transfers	na	0	0	0	0	0	0
Capital revenue	2	0	0	0	0	0	0
Total Expenditure	32	48	34	47	35	41	41
Current expenditure	17	41	30	46	29	30	26
Capital expenditure & net lending	15	7	4	2	6	12	15
Fixed capital formation	na	4	3	1	5	10	10
Financial investment	na	0	0	0	0	0	0
Capital transfers	na	3	1	0	0	1	5
Net lending	na	0	0	0	1	1	0
(Current account surplus or deficit)	3	-19	-2	-27	-3	2	7
Overall deficit before grants	-10	-26	-6	-28	-8	-10	-8
Foreign grants	0	1	3	15	13	6	7
Overall deficit after grants	-10	-26	-3	-14	5	-4	-0
Financing	10	26	3	14	-5	4	1
External financing	na	1	0	0	1	13	3
Internal financing	na	25	3	14	-5	-9	-3

(Elements may not sum to totals due to rounding.)

Note: The projection for 1993 does not include adjustments under discussion as of June.

Fiscal Balance: Total Public Sector

(% of GDP — Before Grants)

	1988	1989	1990	1991	prel. 1992	proj. 1993
Overall balance	-34	-20	-31	-9	-11	-9
Non-financial public sector	-26	-6	-28	-8	-10	-8
Central government	-27	-7	-29	-8	-9	-6
Rest of general government	0	1	0	1	1	1
Public Utilities	0	-1	1	-1	-3	-2
Intragovernmental transfers	0	-0	0	0	0	0
Central bank losses	-8	-14	-3	-1	-1	-1

Note: The projection for 1993 does not include adjustments under discussion as of June.