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

NICARAGUA

PROJECT PAPER

STABILIZATION AND RECOVERY PROGRAM

AID/LAC/P-519

Project Number: 524-0300
Grant Number: 524-K-601

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AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number	524-0300 524-K - 601
2. Country	NICARAGUA
3. Category	CASH TRANSFER
4. Date	MAY 15, 1990
To	AA/LAC, James H. Michel
6. OYB Change Number	N/A
From	LAC/DR, Terrence J. Brown
8. OYB Increase	NONE
To be taken from:	ECONOMIC SUPPORT FUNDS (ESF)
Approval Requested for Commitment of	$ 60,000,000
10. Appropriation Budget Plan Code	
Type Funding	☐ Loan ☒ Grant
12. Local Currency Arrangement	☒ Informal ☐ Formal ☐ None
13. Estimated Delivery Period	FY 1990
14. Transaction Eligibility Date	N/A
Commodities Financed	N/A

Permitted Source		17. Estimated Source	
U.S. only		U.S.	
Limited F.W.		Industrialized Countries	
Free World		Local	
Cash	$60,000,000	Other	LIST OF ELIGIBLE ITEMS

Summary Description

The purpose of this program is to provide balance of payments assistance to support economic stabilization and reforms which promote sustainable economic growth. The cash grant resources will facilitate implementation of the Government of Nicaragua's (GON) stabilization and recovery program.

Program funds will be deposited into a separate non-comingled ESF account or accounts in the U.S. from which payments for eligible foreign exchange transactions will be made. Eligible transactions include the importation of raw materials, intermediate goods, spare parts, agricultural inputs (excluding pesticides), and capital goods from the U.S. and the Central American Common Market (CACM), and petroleum from A.I.D. Geographic Code 941 countries and the Netherlands Antilles and Curacao. In addition, to be eligible, imports must be for public and private sector uses in the manufacturing, agricultural, agro-industrial, commercial, construction, transportation, services, and energy subsectors.

No local currency will be generated for this program.

Clearances	Date
LAC/CEN:CCostello	5/30/90
ARA/ECP:DMarshall (draft)	5/8/90
PPC/EA:JLaPittus (draft)	5/2/90
GC/LAC:KHansen (draft)	5/23/90
M/PFM/A:MJsnick	5/31/90
LAC/DP:BSchouten (draft)	5/30/90
DAA/LAC:FSchieck	

20. Action

☒ APPROVED ☐ DISAPPROVED

Authorized Signature: James H Michel Date: 5/31/90

Title: ASSISTANT ADMINISTRATOR, LAC

1120-1 (5-82)

CLASSIFICATION

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

FY 1990 ESF PAAD FOR NICARAGUA

May 30, 1990

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I. SUMMARY

The purpose of this PAAD is to establish a framework for a FY 1990 macroeconomic balance of payments assistance program for Nicaragua based on the analyses and policy measures proposed herein. Mrs. Violeta Chamorro assumed power as Nicaragua's democratically elected President on April 25, 1990. A.I.D. has already initiated negotiations on a Government of Nicaragua (GON) economic program with her economic advisors.

After the defeat of the Somoza Government in 1979, the Sandinista Front for National Liberation (FSLN) consolidated its power over other participants in the post-Somoza governing coalition. The FSLN nationalized a large proportion of the productive capacity of Nicaragua in the 1980s and experimented with a centrally controlled economy. The experience was not favorable and, consequently, economic performance by Nicaragua was inadequate in the 1980s.

A few statistics suffice to illustrate the depth of Nicaragua's economic decline. Real GDP fell by 34 percent from 1977 to 1988 with per capita GDP falling by more than 50 percent over the same period. Exports in current dollars dropped by almost two-thirds from 1977 to 1988 (They fell by even more in constant dollars). In 1988, the official inflation rate reached 33,654 percent -- an average of almost 140 percent monthly. In 1989, a stabilization program carried out by the Sandinista Government lowered the annual inflation rate to 1,689 percent (an average of about 85 percent monthly). Arrearages on external debt are over $2.5 billion or almost $700 per Nicaraguan. Total external debt, exceeding $8 billion, is three times GDP and almost ten times exports. In short, Sandinista economic policy has been a disaster.

The FY 1990 ESF Program will begin to address these problems. In order to be most effective, the program will be divided into two components:

1. Immediate Balance of Payments assistance in support of a rational economic program where dollars will be used to assure supplies of imports of urgently needed commodities during the initial months of the new government, and

2. Additional Balance of Payments assistance to support the new government's overall economic policy program to stabilize and reactivate the Nicaraguan economy.

The immediate assistance will be responsive to the new government's urgent call for help to show that it is, indeed, sensitive to the unsatisfied needs of the Nicaraguan people. The Balance of Payments assistance will increase the GON foreign reserves whose dollars will help meet the demand for essential commodities primarily for the private sector -- such as petroleum, agricultural inputs excluding pesticides, spare parts, intermediate goods, capital goods, and other private sector imports -- needed to keep the economy functioning in the first days and weeks of the new administration.

The success or failure of the Chamorro Government over the next six years will undoubtedly depend, in large part, on its ability to improve the performance of the Nicaraguan economy. ESF resources will be used to encourage the new government to develop an economic program capable of addressing and reversing the severe deterioration suffered by the Nicaraguan economy in the 1980s. As an incentive to implement its economic program, this component of the ESF program will link disbursement to economic policy performance by the GON.

2. RECENT NICARAGUAN ECONOMIC PERFORMANCE

Nicaraguan economic performance has deteriorated sharply in the 1980s. From 1977 to 1988, real GDP fell by 34 percent and likely fell again in 1989. Per capita GDP dropped by about 51 percent over this 11 year period. The official inflation rate was 33,654 percent in 1988 and, as a result of a stabilization program implemented by the Sandinista Government, declined to 1,689 percent in 1989.

The reasons for the Sandinista's economic difficulties are many. However, three stand out as especially important -- war, the economic boycott by the USG and gross economic mismanagement. The latter is accentuated by massive nationalization of the means of production, a highly inefficient utilization of these properties and an inadequate management of donor resources.

The 1980s were characterized by massive credit expansion by the Nicaraguan banking system. A large proportion of the credit expansion of the 1980s was channeled to the least productive parts of the economy -- to the central government and highly privileged public enterprises. One of the overriding causes of the hyperinflation in Nicaragua is excess public sector expenditures. In 1988, central government expenditures reached 45 percent of GDP (in the rest of Central America this percentage varies from about 11 to 26 percent of GDP). Central government revenues in Nicaragua were only 20 percent of GDP in 1988.

In addition to this central government deficit of 25 percent of GDP, the IMF estimated that the rest of the consolidated nonfinancial public sector (CNFPS) incurred a fiscal deficit of 35 percent, bringing the total deficit up to about 60 percent of GDP. The Sandinista Government claimed to have cut the central government fiscal deficit to 5 percent of GDP in 1989; however, no mention was made of the CNFPS deficit. There is reason to believe that a large part of the Sandinista deficit reduction was achieved by passing important central government expenditures off the central government budget -- to the budgets of the public enterprises. The CNFPS fiscal deficit was undoubtedly very large in 1989 (estimated informally at 35 percent by the IMF). Public enterprises were the likely recipients of the credit responsible for the inflation of 1989. It seems unlikely that the Sandinista Government would allocate enough credit to the private sector to undermine the stabilization program it tried to implement in 1989.

It is noteworthy that preliminary information shows half of the Sandinista central government expenditures have been channeled to the military in recent years. This implies that military outlays have claimed about 20 to 25 percent of GDP in 1988. The percentage was probably somewhat lower in 1989 as a result of the stabilization program implemented by the Sandinistas.

On the fiscal side, performance has been poor in recent years. As a proportion of GDP, fiscal revenues have declined every year since 1984. In that year they represented 30.7 percent of GDP, falling to 27.9 percent in 1985, 27.7 percent in 1986, 24.7 percent in 1987, 18.7 percent in 1988 and 17.7 percent in 1989.

In 1989, almost 75 percent of fiscal revenues were from indirect taxes. About 55 percent of the indirect taxes (41 percent of total tax revenues) are from selective consumption taxes, principally on petroleum, liquor, beer and cigarettes. The system of selective consumption taxes is complicated and difficult to administer. These taxes cover more than 700 items and contain differentiated rates for imported goods, confusing the selective consumption tax with import duties.

Despite high tariffs and wide dispersion in customs duties, barely 10 percent of fiscal revenues are from import taxes. This is because a large proportion of the value of imports (approximately 71 percent in 1989) is exempt from customs duties. The state, of course, is exonerated from paying customs duties. A sales tax -- sometimes called a value added tax -- accounted for just under 12 percent of fiscal revenues in 1989. This tax, with rates at 10 to 15 percent, is probably poorly administrated or subject to many exemptions. Otherwise, it would raise more revenue.

A poor exchange rate regime is a major reason for a drop in Nicaraguan exports by almost 70 percent from 1977 to 1988. The contrast between Nicaraguan and Costa Rican export performance is striking, with the latter showing large gains, especially in nontraditional exports. Costa Rica's economy has been bolstered by generally favorable economic policies. Nicaragua's overvalued exchange rate not only curtails exports, but it also encourages imports and leads to inefficient allocations of scarce foreign exchange, favoring the most privileged importers. The latter are probably dominated by public sector enterprises.

Exchange rate instability constitutes one of the greatest uncertainties facing exporters in Nicaragua. Between 1979 and April 1990, the official value of the Cordoba fell from 7 to the dollar to the equivalent of 47,000,000 to the dollar (three zeros were eliminated from the monetary unit in 1988). This represents an average devaluation of more than 270 percent annually over an eleven year period. At present, the parallel market rate is about 60,000 to the dollar while the black market rate varies from 120,000 to 150,000 to the dollar.

The exchange rate is arbitrarily manipulated to levy an implicit tax on exporters and to partially compensate for other subsidies, in particular for subsidies on credit (interest rates are generally negative in real terms and loan repayments are frequently forgiven). Throughout the Nicaraguan economy, an observer will notice that the economic authorities frequently try to offset the effects of one economic distortion by imposing a different distortion (or distortions). This causes enormous uncertainties to producers. Windfall gains and losses (more often losses) abound as inept authorities attempt to control production decisions and to collect revenues for the state.

At present, credit is guided to final users in Nicaragua in accordance with the decisions of central planners. A central planning council sets central bank lending policies, and in turn, the central bank tells the commercial banks who is to receive credit. The central bank also tells the commercial banks (which belong to the state) what interest rate to charge on loans. It often agrees to forgiveness on loan repayment -- especially in the case of agricultural borrowers. Evidence has been found that many public sector borrowers -- and a few private sector borrowers -- have benefited from loan forgiveness.

At present the commercial banks act as little more than branches of the central bank. Most of them went bankrupt in 1979 shortly after a devaluation from 7 to 10 Cordobas to the dollar. The collapse of these banks was due to their having heavy liabilities in dollars and assets in Cordobas. Shortly after failing, they were nationalized and combined into the large state banks which are now present in Nicaragua. At present, their basic function is to channel central bank lines of credit to the customers selected by the central bank. The interference of the central bank is so deep in their affairs, that it even dictates the salaries which can be paid by the commercial banks. A large commercial bank officer complained that he was paid $3,000 monthly (in dollars) by a private bank prior to its nationalization and now he receives a salary of $800 monthly paid in Cordobas at the official exchange rate.

Credit flows are heavily channeled to public sector parastatals ("Area de Propiedad del Pueblo" or APP). One of the two largest banks in Nicaragua, BANIC (the industrial bank), has 90 percent of its loan portfolio to the APP. Of this, 20 to 30 percent of its loans are to the sugar refineries and 20 percent to the National Basic Grains Company (ENABAS). Most of the institutions receiving credit are required to pay their debt service punctually. However, when the state sugar mills could not meet their debt service obligations two years ago, their debt was refinanced.

The other of the two largest banks, the Banco Nacional de Desarrollo, lends principally to agricultural producers. It has had more trouble than BANIC with collecting its loans. Several have been forgiven.

Domestic savings captured by the banking system have dropped precipitously from 1979 to 1988. In the former year they accounted for 38.6 percent of the money supply (M2), but were only 5.6 percent of M2 in 1988. This is the result of years of negative interest rates on deposits. In 1989, the Sandinista Government tried to generate internal savings by sharply increasing the interest on time deposits. Throughout the year, these interest rates varied from 16.4 to 63.5 percent monthly on one year time deposits (as previously reported, inflation averaged 85 percent monthly in 1989). This policy led to an increase in the proportion of quasimoney in the overall money supply to 17.8 percent by December 1989. However, it did not result in an overall increase in real savings. Even though the interest rates on deposits were higher than those on loans for the last seven months of 1989, all of these rates were generally negative in real terms. It should be noted that the central bank compensates commercial banks for losses incurred as a result of collecting lower interest rates on loans than they pay on deposits.

This scheme probably failed due to the maintenance of interest rates at highly negative real levels despite the high nominal rates. It has also been rather confusing because no clear formula for determining the interest rates has been published. Instead, the economic authorities have stated that these rates were determined by expected future levels of inflation. This was clearly not enough to significantly stimulate savings.

One of the most pressing problems facing the new government is the public enterprises (the APP entities). There is ample evidence that these entities are grossly mismanaged. In particular, it appears that the agricultural component of the APP system may be subject to especially severe inefficiencies (this, however, is not confirmed). To make matters worse, APP entities dominate production in Nicaragua, representing the following percentages of national production: 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 major export activities through the "Empresas de Comercio Exterior" It has been estimated that there exist at least 450 companies in the APP system.

Nicaragua's debt situation is appalling. At the end of 1988, it had a total foreign debt of about of $8 billion. This represents about $2,200 per capita, almost 3 times GDP and almost ten times exports. Of this debt, about $2.5 billion -- more than 30 percent -- is in arrears. About $1.2 billion of the total debt is short-term and the remaining $6.8 is medium- and long-term. The medium- and long-term component can be broken down into multilateral debt ($880 million), bilateral debt ($4.5 billion), commercial bank debt ($1.3 billion) and other ($100 million).

At the end of 1989, Nicaragua had arrears to the World Bank and IDB of about $233 million (of which $180 million was to the World Bank and $53 million to the IDB). Obligations coming due to the World Bank in 1990 are $17 million and, according to the IDB representative in Managua, about $22 million is coming due the IDB. Fortunately Nicaragua has no arrears to the IMF.

3. ECONOMIC DECISIONS FACING THE NEW GOVERNMENT

The new GON must now quickly face up to the disaster left them by the Sandinistas. The President and her cabinet appear determined to correct the errors of the past and to put the new government on firm economic footing.

To accomplish this, the new government urgently needs to begin developing its economic program as soon as possible. Big decisions must be taken fast. The new GON will have to decide immediately how it will deal with hyperinflation. Will public sector expenditures be cut to reduce aggregate demand down to a level commensurate with supply? If so, where will the cuts be made? Or will fiscal revenues be increased? If so, where? A clear and transparent exchange rate policy must be defined quickly. The government must also decide as soon as possible how it will manage its massive arrears. What will it tell donors who ask how their debts will be serviced? A failure to provide a well thought out answer to this question could cost the new government reductions in donor resources which it so urgently needs to reactivate its economy. An IMF team is scheduled to arrive in Managua in May. In order to quickly obtain an increase in donor resources, the new economic authorities must be prepared to talk and negotiate with the Fund. The new GON must also develop strategies for dealing with the IBRD, the IDB and bilateral donors. The new government should know that it is clearly insufficient to request donor help without defining and implementing concrete programs for putting its house in order. Programs are urgently needed -- even in the very short run -- to correct the gross inefficiencies of the nationalized companies ("Area de Propiedad del Pueblo"). Programs are also urgently needed to identify and break bottlenecks impeding increased production. Food aid and petroleum requirements must be identified immediately. An economic program must also chart out scenarios for recovery and, in the process, sketch out the policies needed to support the scenario chosen. The quicker this work is initiated in a serious manner, the quicker the new government may be successful in restoring the economy to a path of sustainable economic growth and development.

It is important that the new economic authorities start well. They must quickly identify key policy actions needed to improve the economic performance of the Nicaraguan economy and take the necessary actions in as expeditious a manner as possible. The recent history of successful economic reform efforts in Latin America clearly shows that the best time for implementing major economic measures is at the beginning of a new government (for example, consider the cases of Bolivia and Honduras). Once a government has been in power for several months, strong vested interests become firmly entrenched to resist a serious economic reform effort.

4. ELEMENTS OF A FY 1990 ESF PROGRAM

It is important that the USG, along with other donors, cooperate with the new economic authorities in improving the immediate economic situation of the local population. However, it is also important to realize that the key to the eventual success of the new government will almost certainly lie in its ability -- not to put into place a quick fix solution -- but to reestablish an efficient productive apparatus capable of sustaining economic growth and development. It is urgent that the USG, along with other donors, keep this in mind.

Repairing the damage done to the Nicaraguan economy by the Sandinistas will not be easy. The repair process can be divided into two basic components which will be supported by the FY 1990 ESF Program:

1. Immediate Balance of Payments assistance whose dollars will be used to assure supplies of imports of urgently needed commodities during the initial months of the new government, and

2. Balance of Payments assistance to support the new government's overall economic policy program to stabilize and reactivate the Nicaraguan economy.

The FY 1990 ESF Program will reflect this approach. This PAAD will be the basis to authorize an initial injection of balance of payments support of $60 million, to be amended subsequently based on the design and implementation of the government's economic program. Based on this initial authorization of $60 million, an assistance agreement will be signed in May. An amended PAAD for an additional $118 million will be prepared to provide support of a GON economic program for 1990. It is expected that the amended PAAD will be completed in late June or July 1990.

The immediate assistance will be responsive to the new government's urgent call for help in showing that it is, indeed, sensitive to the unsatisfied needs of the Nicaraguan people. This assistance supports the development of an economic plan and will help meet the demand for essential commodities for the private and public sectors -- such as petroleum, agricultural inputs, spare parts, intermediate goods and capital goods -- needed to keep the economy functioning in the first months of the new administration.

Undoubtedly, a large inflow of economic assistance which fails to support a strong economic recovery program could improve economic and social well-being of Nicaraguans in the short run. This, however, could foster complacency and reduce the perceived urgency in correcting the underlying causes responsible for past inadequate economic performance. It could also permit the growth of a strong constituency against urgently needed economic reforms and, in the process, preclude a medium and long term solution to Nicaragua's pressing economic problems.

The initial level of $60 million of immediate assistance was identified recognizing that it is important to avoid an excessive inflow of short-term economic assistance which lowers prices sufficiently to damage domestic producers. The Sandinistas have fallen into this trap on several occasions. (Once they imported powdered milk from the World Food Program to improve nutrition and lower milk prices -- as a result, dairy cattle were slaughtered and domestic milk production was undermined).

The second component of the FY 1990 ESF program will address a much more difficult problem -- reactivating the productive capacity of the Nicaraguan economy. The success or failure of the Government over the next six years will depend, in large part, on its ability to improve the performance of the Nicaraguan economy. ESF resources will be used to encourage the new government to develop an economic program capable of addressing and reversing the severe deterioration suffered by the Nicaraguan economy in the 1980s. This assistance will be conditioned upon the implementation of economic policies adequate to promote sustainable growth and development.

A GON economic program to be supported by ESF resources in FY 1990 would be expected to address at least some of the following issues:

A. Fiscal and Monetary Policies

Perhaps the most urgent economic decisions facing the new government concern its policies for stabilizing the Nicaraguan economy. A stabilization program for Nicaragua would focus heavily on its monetary, fiscal and exchange rate policies. A stabilization program is needed immediately for several important reasons: (1) to curb the damage of hyperinflation; (2) to promote production and economic efficiency; (3) to attract private investment and (4) to initiate broad donor support of the economic program. The monetary and fiscal aspects of a stabilization program are examined in this section while the exchange rate issue is discussed in the next.

Effective monetary and fiscal policies are urgently needed to bring aggregate demand and supply into balance. This would control the runaway inflation currently rampaging in Nicaragua, while also establishing the framework needed to regain confidence and attract private investment. Throughout most of the decade of the 1980s, demand outpaced supply, placing constant upward pressure on prices. This culminated in hyperinflation with the consumer price index reaching 33,654 percent in 1988 (almost 140 percent monthly). An attempt at stabilization reduced the increment in the consumer price index to 1,689 percent (about 85 percent monthly) in 1989, but this is clearly not enough.

It makes no sense to let the hyperinflation continue. In a relatively short time period -- a year or less -- the availability of goods and services to an economy is difficult to increase. Notwithstanding major changes in climatic conditions or in international assistance, the amount of domestic production and imports simply cannot be changed by large amounts. Any attempt by the economic authorities to allow demand to exceed the relatively fixed amount of goods and services available to the economy through monetary expansion (usually in the form of increased credit) can do nothing but create inflation. Of course, those with access to the extra credit will have greater purchasing power over the available goods and services. However, those without privileged access to credit will receive less than expected as the extra demand bids up prices through inflation. In other words, an excessive "running of the printing presses" does not increase the availability of goods and services. Instead, it reallocates them among persons and groups within the economy. This creates instability and uncertainty. It impedes investment and production decisions. Excessive monetary expansion represents poor economic programming. It would be much better to determine -- ahead of time -- how much credit expansion is consonant with the expected amount of goods and services (imported and domestic) available to an economy. This is a relatively easy exercise to carry out. There is simply no good reason to expand credit beyond the limits determined by a modest level of inflation. Sound monetary policy calls for the allocation of credit to the public and private sector as part of an economic program. It also calls for the strict avoidance of the temptation to respond to seemingly important public sector activities by acceding to ad hoc requests for supplemental expenditures and credit.

It is important that the new government review the proposed budget for 1990 as soon as possible. Even though hyperinflation impedes the process of preparing a budget (with hyperinflation, the relative allocation of expenditures and fiscal revenues among entities takes on more importance than the absolute Cordoba allocations), it is understood that the Sandinistas have made a first attempt at a 1990 budget. The transition team must obtain and examine this document as soon as possible. It must seek a balance between expenditures and revenues.

Under any circumstance, with the coming of peace to Nicaragua, cuts in military expenditures may be highly appropriate. In particular, it is understood that the elimination of the unpopular draft could also eliminate an expenditure that currently amounts to 1 to 2 percent of GDP. While the new government will probably not want to release large numbers of unemployed soldiers to the labor force in the short run, it may well consider releasing those soldiers who do not want to stay in the armed forces. A part of the UNO economic program contemplates using the army to assist in the reparation of infrastructure and in agricultural activities. Some nationalized lands may be given to former soldiers who agree to farm them.

On the revenue side, it is important that GON the improve revenue collections. Two technical personnel from the IMF conducted a careful review of the GON tax system in January 1990 and made many recommendations for important reforms. Apparently the IMF has not circulated the document widely. Nevertheless, the new GON should seek access to it as soon as possible and, after reviewing the proposed measures, prepare to expeditiously implement those which it believes are appropriate.

The new GON will have to grapple with the fiscal deficit of the parastatals ("Area de Propiedad del Pueblo" or APP) as soon as possible. The APP dominates productive activities. Key to the effective implementation of a stabilization program is the restriction of credit to the entities comprising the APP. Not only will the GON have to restrict the absolute amount of credit to these entities but, in the interest of efficiency and structural adjustment, it will have to ensure that this credit is effectively utilized for efficient productive activities. According to several well-informed sources, the APP entities are -- with few exceptions -- grossly mismanaged. The IMF's "Recent Economic Developments" of November 1989 and discussions with bankers indicate that the APP absorbs the bulk of banking system credit. As part of its economic program, the GON should consider an immediate cut off of credit to all APP entities, forcing them to make adjustments in their costs and in the prices they charge for goods and services.

The GON has indicated that it expects to stabilize the Nicaraguan economy through increased production. That is a worthy objective and, indeed, should form part of an economic program. Production can be increased, even in the short run, through carefully planned economic assistance. Once the increased production is achieved, the producers will be able to lift themselves up and depend less on external resources on the second round. All this is an admirable element of a program.

Nevertheless, the foregoing concept does not consider that the benefits of increased production will take time -- at least a year. In the meantime, it still makes no sense to let the hyperinflation continue. In fact, for reasons previously mentioned, it is imperative that it be stopped as soon as possible. Recent experience with economic reform programs in Latin America indicates that the best time to take them is probably early in the term of a new government.

The new economic authorities should also understand that nobody wants to see further drops in Nicaragua's GDP. A carefully programmed stabilization program could conceivably be attained with economic growth. We realize that per capita GDP in Nicaragua has fallen by more than 50 percent from 1977 to 1988, and that it probably fell again in 1989. It should not be permitted to continue falling. However, hyperinflation -- through the economic instability it engenders -- may well constitute one of the most serious threats to increased GDP in 1990. In fact, a failure to deal with the hyperinflation head on -- right away -- could well jeopardize the type of confidence the new government urgently needs to promote economic growth and development in 1990 and in later years. The new government should realize that appropriate monetary and fiscal policies are needed, not only to form a basis for the reactivation of production in Nicaragua, but also to permit ample donor support for the GON economic program. In particular, any agreement with the IMF must necessarily start with the design and implementation of sound monetary and fiscal policies.

B. Exchange Rate Policy

Another urgent stabilization issue facing the new economic authorities is the issue of the exchange rate. The key to maintaining a stable exchange rate is, of course, through the implementation of sound monetary and fiscal policies. As a solution to the weakness experienced by the Nicaraguan Cordoba, the new GON appears interested in replacing it with a new Cordoba, called a "Golden Cordoba". The Golden Cordoba would be pegged to the dollar and would be fully convertible into hard currency. It is expected that the Golden Cordoba would quickly drive out the old Cordoba (by Gresham's Law).

In principle, the concept could be made to work. However, given the widespread lack of confidence in the management of the Nicaraguan economy, it could easily be expected that the introduction of the Golden Cordoba would be accompanied by an attempted conversion of virtually all the Golden Cordobas into dollars (Gresham's Law again). Unless the emission of the Golden Cordobas were to be limited to reserves in dollars, the emission of the new money would probably not work. A complete dollarization of the economy would probably not work either -- there are too few dollars in circulation.

A better, and more workable solution to the golden Cordoba, might entail first stabilizing the value of the old Cordoba through appropriate monetary and fiscal policies. Once this is achieved, the economic authorities might consider creating a new monetary unit by removing zeros from the old unit. As an alternative, a new golden Cordoba type of monetary unit could be issued which is a multiple of the old Cordoba and approximately equal to the value of the dollar.

What is fundamental, however, is an expeditious solution to the exchange rate problem which permits the introduction of a new exchange rate regime, based on the principles of a transparent, unified, market-determined price of foreign exchange. In the context of clearly defined rules, all importers should have equal access to foreign exchange at the same exchange rate. The rate should maintain stability in relation to other currencies through the exercise of prudent monetary and fiscal policies.

C. <u>Credit and Financial Sector Policies</u>

There is a need for restructuring the relations of authority flowing from the planning council to the central bank and from the central bank to the commercial banks. It will be necessary to examine the legal basis of the current relationship and to seek changes which permit autonomy of the central bank from the planning authorities. It will also be necessary to relax the central bank's control over the commercial banks -- while, of course, maintaining appropriate regulatory oversight of banking operations.

As part of the new government's economic program, it must discuss what mechanism will be put in place to restructure the banking system and to guide credit allocation. The following issues must be addressed:

- The relationship between the central government and the central bank must be clearly defined. In addition, the relationship between the central bank and the rest of the banking system must also be clearly specified. A strong economic program would allow the central bank to operate autonomously, but in cooperation, with the central government. The new government will have to carefully examine possible changes in these institutional relationships within the context of the prevailing legal system.

- New criteria for credit allocation must be urgently identified. The new criteria should channel credit to activities which are financially viable. These are not necessarily public enterprises (the APP entities). It is important that interest rates on loans be positive in real terms and that these interest rates -- instead of subjective criteria -- be used to allocate credit among competing economic activities. Due to the weakness of the Cordoba, in the short run it might be advisable to use external resources to make dollar loans to exporters in order to facilitate procurement of inputs and working capital. These funds would be repaid in dollars at positive real interest rates when the exports are made. This would eliminate the dual distortions (concerning interest and exchange rates) currently facing exporters. However, it is important to avoid the use, other than on a very short-term emergency basis, of directed credit lines. The utilization of directed lines of credit is inadvisable because: (1) they discourage domestic savings by removing incentives for banks to capture savings, (2) they are often channeled to economically and financially nonviable activities and (3) as documented in AID and World Bank documents, they are often channeled to uses other than those which were targeted for privileged access to credit. Although externally financed directed credit lines should generally be avoided, any decision to use them on an emergency basis should be strictly temporary and must be accompanied by a specific program to phase them out in a relatively short time period.

- The banking system must be restructured to generate domestic savings. This is key to financing new investments. In order to attract savings, positive real interest rates must be paid on time deposits. To protect bank solvency, an appropriate spread must be maintained between deposit and lending rates with the latter, of course, exceeding the former.

D. Public Enterprise Policies

The new government must find a way to immediately cut the financial deficits and credit needs of public enterprises without substantially reducing production. Like the other economic decisions facing the new GON, the resolution of the APP problem will be exceedingly difficult. Nevertheless, a quick identification of actions is urgent. There will be no time to let the mismanagement of these entities continue to represent an onerous drag on the ability of the new GON to conduct sound monetary and fiscal policies.

Privatization appears to be clearly in order to improve the operation of the APP companies. It is important that the GON team review options to privatize as many of these companies in as short a time period as possible. Perhaps recent reforms of public enterprises in Poland could serve as an appropriate example for Nicaragua.

E. Strategy for Assuring Short-term Access to Vital Supplies

The GON team needs to conduct inventories of all supplies needed to keep the economy functioning in the short run. Some of this work has already started.

Of special importance is the need for assurances that oil supplies will not be interrupted shortly after the new government takes office. Even though discussions with the Soviet Embassy in Managua indicate that petroleum will continue to be sent to Nicaragua from Ecuador through mid-June, the exact amounts of these shipments have yet to be determined. It appears that the Soviets already shipped all their committed oil to Rotterdam, which in turn serves as the basis for shipments from Ecuador to Nicaragua.

It also appears that Nicaragua is trying to reach an agreement with Venezuela to renew petroleum shipments under the San Jose accord. This would probably be based on a plan to refinance Nicaraguan arrears to Venezuela summing to about $92 million (Nicaragua also appears to be in arrears to Mexico for $700 million for petroleum purchases).

F. Debt Policy

The government must decide how it will handle its debt burden. This too is an urgent issue. A serious proposal for coping with the problem is crucial in attracting renewed multilateral and bilateral resource flows to Nicaragua. There is no time to waste in defining how this issue will be handled. The IMF team scheduled to visit Managua in early May will certainly inquire how the new GON expects to approach this issue. Likewise, in a meeting with donors scheduled for Rome in late May or early June, the GON will again be asked how it plans to handle its massive debt and arrears.

G. Trade Policy

Another area where policies must be reviewed and improved quickly concerns trade policy. A uniform customs duty along with the elimination of numerous exemptions would serve to raise urgently needed fiscal revenues. At the same time, these measures would increase transparency. They would also form the basis for a new trade regime in line with others in Central America aimed at lowering effective protection. Moreover, it is possible that improvements in trade policies might provide the framework for World Bank structural or sectoral adjustment lending.

H. Policies on Subsidies and Pricing

At present, the Sandinistas maintain a widespread system of subsidies and price controls. The GON team appears committed to a market-oriented economy with a minimum of subsidies and price controls (see "The UNO Agenda for Economic Recovery"). Nevertheless, the GON has not yet refined its policies in this area. It must decide soon if it will completely dismantle the system of price controls imposed by the Sandinistas. It should be mentioned that the Sandinistas themselves began dismantling price controls when they put their stabilization program of 1988-1989 into effect.

It is important that the GON team identify subsidies and their respective magnitudes. This analysis should not only be limited to budgetary (or explicit) subsidies, but should also include hidden (or implicit) subsidies. The latter include the effects of using an overvalued exchange rate, artificially low interest rates, or selling public services for less than their value.

I. Strategy for Negotiating with Donors

In order to effectively gain access to the external resources needed to reactivate the Nicaraguan economy, it is important that the new government form a strategy for negotiating with donors. Two fundamental elements of this strategy have already been discussed -- the preparation of an economic program and a policy for dealing with arrearages. An effective approach for obtaining access to increased donor resources must also consider how to negotiate with international financial institutions.

These negotiations would almost certainly start with the IMF. Will the new government explore with the IMF the possibility of entering into a Standby Arrangement? Under the present requirements for such an arrangement, Nicaragua would be expected to implement an up front program for clearing its arrears to the World Bank and the IDB. This could conceivably be accomplished through the negotiation of new programs with these entities, and the clearance of World Bank and IDB arrearages through a combination of (1) bridging to disbursements by these institutions, (2) utilization of IMF purchases, and (3) A.I.D. resources programmed for clearing arrears.

However, the new GON may wish to consider other possible ways for dealing with the International Financial Institutions (IFIs). It may wish to enter into a shadow program with the Fund which might ease the way for ample bilateral donor support without seeking a formula to clear World Bank and IDB arrears (It might be mentioned that, to date, few successful shadow programs have been implemented). Another alternative might be to request an IMF Standby without an up front agreement with the World Bank and IDB. This approach (sometimes called "delinking" or "sequencing") has yet to be approved by the Board of Directors of the Fund. However, it is understood that pressures on the IFIs are building either to follow a delinking approach or to find another innovative manner of permitting a reform minded government to obtain IFI financial support. This is because several reform minded governments are in similar situations with inheritances of massive external debt arrears from their predecessors.

Whatever approach the new GON decides to take with the international donors, it is important that it begin considering its options soon. Otherwise it may suffer delays in obtaining urgently needed external financing.

5. LOCAL CURRENCY

Given the urgency of ending the hyperinflation in Nicaragua, monetization of local currencies generated by ESF dollars is inadvisable. As such, no local currency will be generated for this program.

6. UTILIZATION OF DOLLAR RESOURCES

The proposed ESF Program will consist of a $60 million grant to be obligated from FY 1990 funds. The funds will be disbursed into a separate, non-commingled special account in one tranche. The Mission requests approval for the dollar resources to be used to purchase raw materials, spare parts, intermediate goods and essential imported goods such as petroleum and its derivatives. The Agreement date is expected to be on or about the first of June 1990. The Banco Central de Nicaragua will be the GON Agency responsible for managing the program. The source of most of the imported commodities will be from the United States, including its possessions and the commonwealth of Puerto Rico. In the case of crude petroleum and its derivatives the source will be from countries which are specified in Geographic code 941, plus the Netherlands Antilles and Curacao.

The Mission proposes to use the Direct Payment and the Reimbursement Method of Payment for eligible goods. Both methods are preferred methods per A.I.D. guidance. Under the direct payment method the GON would utilize funds in the separate account upon presentation of eligible import documentation to the Bank under Letter of Credit instructions. The GON utilizes funds from the Separate Account(s) by authorizing commercial banks through instructions provided with the Letters of Credit to pay for eligible imports. A.I.D. and the GON agree that a re-deposit to the Separate Account(s) will be made for funds incorrectly applied to a disallowed use, thus permitting such funds to be reprogrammed for permitted uses. Under the reimbursement method of payment the Government would use its own funds to pay for eligible import transactions. Prior to withdrawing or transferring any funds from the dollar separate account(s), the Central Bank of Nicaragua (CBN), would submit to the Mission a list of paid transactions for which it requests reimbursement. The Mission would review and approve the transactions for financing. The CBN would then proceed to reimburse itself from the special dollar separate account(s) for approved transactions.

Prior to the disbursement of any dollars, the CBN will submit to the Mission the operating procedures for the separate bank account(s). The procedures will provide that the CBN has opened separate noncommingled dollar accounts in its correspondent U.S. banks or in a U.S. Federal Reserve Bank. As noted above, dollar withdrawals are to be made by direct payment or reimbursement. The Central Bank will submit monthly copies of correspondent's bank statement showing the accounts activities and a reconciliation with the Central Bank's accounting balance. The procedures also indicate the documencation required for supporting the disbursement from the separate dollar account(s). The Mission will receive periodic reports indicating the transactions paid from the dollar bank accounts. The transactions will be examined and verified by Mission personnel or its authorized representatives at the CBN. The CBN will be required to establish and maintain files for each of its transactions funded from the separate account(s). Each file will contain the documents supporting the transaction's eligibility, establish that payment has other made and demonstrate that the goods have been received in Nicaragua.

The documentation supporting the disbursements from the special accounts will be subject to review by authorized Mission personnel or its representatives. The CBN will furnish the Mission with quarterly reports detailing the use of the dollars deposited and interest, if any, generated.

Program Monitoring

A. Dollar Transfers

The Office of the Controller is responsible for the monitoring of the dollars transferred to the Government of Nicaragua. The Controller will verify the funds have been deposited in non-commingled special separate accounts. The Central Bank will submit, to the Mission, quarterly reports showing the use of the dollars. The Bank will furnish monthly bank reconciliations, supported with copies of bank statements, for each account. Periodically, the Central Bank's accounting and bank records will be examined to assure that only eligible transactions are being financed with the A.I.D. dollars as outlined in the first section above. The Controller will prepare and issue a financial report on the results of the examination.

Dollar funds provided by USAID for balance of payment support will be deposited into separate non-commingled account(s) in the designed bank(s). The separate account(s) in a commercial bank will be interest bearing account(s). However, any interest earned on the funds deposited in the separate account(s) will be used in the same manner and for the same purposes as the balance of payments support disbursement.

The use of the separate non-commingled account(s) complies with U.S. law and will provide accountability for these funds and precludes the commingling of balance of payments support funds with the Central Bank's other foreign exchange resources. Funds deposited in the separate account(s) and interest earnings generated by such funds may be used for financing transactions from one or more of the following eligible categories:

1) CIF value of commodities from the United States falling in the following classifications:

   a. agricultural inputs
   b. raw materials
   c. capital goods
   d. intermediate goods
   e. spare parts
   f. petroleum products

2) Crude petroleum and its derivatives imported from A.I.D. Geographic Code 941 countries plus Netherlands Antilles and Curacao.

B. Audits

The Inspector General of A.I.D. will be requested to schedule audits to determine compliance with the terms of the Agreement and proper use of the funds. The Office of the USAID Controller will make periodic financial reviews in order to ensure that the Project's funds are properly managed and accounted for. In addition, external auditors may be contracted to perform financial reviews or audits of the dollar transactions. Such audits must be performed annually and must be in accordance with GAO auditing standards. Funding for these audits may be obtained from a proposed Public Sector Support Project or Project Development and Support (PD&S).

The Office of the Controller performed a limited review of the Central Bank's operating procedures to determine if they were adequate to manage the ESF dollar transfers. In general, it was found that the Central Bank has procedures in place to manage and account for the dollar transfers. The Controller's Report has seven (7) recommendations to improve the internal controls over foreign exchange transactions. The Mission has followed up on the status of the recommendations. We found the Central Bank was in the process of resolving the recommended improvements. Mission staff will continue to monitor the progress toward compliance with the Controller's recommendations.

7. CONDITIONS PRECEDENT AND COVENANTS

A. Conditions Precedent

1. The Government of Nicaragua (GON) will establish a separate account in a Federal Reserve Bank in the United States. Funds in this account and interest earned on these funds may not be commingled with other funds of the GON.

2. Prior to disbursement of funds to the separate account, the GON must provide in form and substance satisfactory to A.I.D., a letter describing the mechanism by which funds will be disbursed from the account for approved private sector activities as well as the program procedures for including, among other things, selection criteria, monitoring, end-use and price checking of dollar-funded transactions and reporting requirements.

B. Covenant

1. The Grantee covenants to prepare and initiate implementation of an economic program for 1990 which will serve as the basis for continued ESF Balance of Payments support.

ANNEX 1

Agency for International Development
Washington, D.C. 20523

LAC-IEE-90-25

ENVIRONMENTAL THRESHOLD DECISION

Project Location	:	Nicaragua
Project Title	:	Economic Stabilization and Recovery (FY 90 ESF Balance of Payments Program)
Project Number	:	524-0300
Funding	:	$60 million (ESF)
Life of Project	:	1 year (FY 90)
IEE Prepared by	:	John O. Wilson LAC Deputy Environmental Officer
Recommended Threshold Decision	:	Categorical Exclusion
Bureau Threshold Decision	:	Concur with Recommendation
Comments	:	None
Copy to	:	Terrence Brown, Director Office of Development Resources
Copy to	:	Toni Wagner, LAC/CEN
Copy to	:	Mark Silverman, LAC/DR/CEN
Copy to	:	Lawrence Odle, LAC/DR/CEN
Copy to	:	IEE File

John O. Wilson Date APR 25 1990

John O. Wilson
Deputy Environmental Officer
Bureau for Latin America
and the Caribbean

Agency for International Development
Washington, D.C. 20523

INITIAL ENVIRONMENTAL EXAMINATION

Project Location:	Nicaragua
Project Title:	Economic Stabilization and Recovery (FY 90 ESF Balance of Payments Program)
Project Number:	524-0300
Funding:	$60 million (ESF)
Life of Project:	1 year (FY 90)
IEE Prepared by:	John O. Wilson LAC Deputy Environmental Officer

Recommended Threshold Decision:

a. Recommendation:

The project consists of a cash transfer to provide balance of payments assistance to support economic recovery in Nicaragua in FY 1990. Funds from this program provide balance of payments assistance in support of the Government of Nicaragua's economic stabilization and reactivation efforts. The dollars provided will be used to provide immediate assistance to assure supplies of imports of urgently needed commodities during the initial months of the new government. Given the urgency of ending hyperinflation in Nicaragua, monetization of local currencies generated by ESF dollars is inadvisable at this time, and all local currencies generated by the sales of goods brought in under the immediate assistance component of the ESF program will be permanently sterilized. Availability of funds under this program is made contingent upon compliance with the conditions mutually agreed upon between the GON and A.I.D. on the 1990 program.

Pursuant to A.I.D. environmental regulations [22 CFR 216.2(c)(1)(ii)], an IEE is generally not required when:

"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."

Moreover, Handbook 3, Chapter 2, Appendix 2D, 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 identifiable project or projects" are not subject to A.I.D.'s environmental procedures. The above exemptions do not apply, however, to assistance for the procurement or use of pesticides.

The FY 1990 Balance of Payments 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: T. J. B.
Terrence J. Brown, Director
Office of Development Resources