International Monetary Fund

Nicaragua and the IMF

Press Release:

IMF Executive Board Approves Seventh, Eighth and Ninth Reviews Under Nicaragua's PRGF Arrangement
January 18, 2006

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Nicaragua: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

December 27, 2005

The following item is a Letter of Intent of the government of Nicaragua, which describes the policies that Nicaragua intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Nicaragua, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Managua, December 27, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Rato:

We reaffirm our strong commitment to our poverty reduction strategy and the program supported by the Poverty Reduction and Growth Facility (PRGF). We would like to ask for a completion of the pending reviews under the program, and that the PRGF arrangement be extended through December 12, 2006. This will help support our macroeconomic policy framework in the run-up to the November 2006 elections. The attached Supplementary Memorandum of Economic and Financial Policies (SMEFP) outlines the economic policies and objectives of the Government of Nicaragua for the year 2006. Also attached is a Technical Memorandum of Understanding (TMU).

Macroeconomic developments in 2004 were positive. Growth accelerated and inflation remained in single digits, while most key program quantitative targets were met. Nicaragua also reached the HIPC completion point in January 2004. The 5th and 6th reviews under the PRGF were completed in September 2004.

In 2005, Nicaragua's macroeconomic framework has been broadly stable, but has come under pressure. This reflects the substantial challenges presented by higher international oil prices, but also delays in the structural reform agenda. Combined with approval of a 2005 budget that widened the deficit relative to the executive's proposal and included significant public sector wage increases, this has prevented completion of program reviews in the past year. Accordingly, we have taken steps to strengthen the 2005 fiscal framework. In the context of a renewed national dialogue involving all political parties, we have also reinvigorated our structural reform agenda through the passage of several key laws. With these measures, we are confident that the economy will continue to grow, that inflation will gradually subside, and that the fiscal program will remain on track. New performance criteria are being established to help maintain stability, and set a roadmap for carrying the reform agenda forward.

We have continued to maintain a close policy dialogue with the Fund in the past year. With regards program performance in 2004 (no performance criteria have been established for 2005), we have met all quantitative performance criteria for end-June and end-September but missed the performance criteria on the central government overall balance (after grants) for end-December by a narrow margin. We have also been unable to submit a fiscal responsibility law to the National Assembly by October 15, 2004, but propose corrective action in the attached memorandum (¶12-13). We therefore, request waivers for nonobservance of these two performance criteria and the completion of the 7th, 8th, and 9th reviews under the program, rephasing of amounts committed, and an extension of the arrangement through December 12, 2006. To ensure continued good macroeconomic performance, the national assembly has approved a 2006 budget consistent with our PRGF-supported program.

We would like to take this opportunity to mention that even after reaching the HIPC completion point, Nicaragua's debt obligations remain large. Participation in the Multilateral Debt Reduction Initiative (MDRI) is very important for Nicaragua, as this additional relief would release resources for poverty reducing spending supporting our efforts to meet the Millennium Development Goals. We welcome this initiative and look forward to benefit from it at an early point.

The request for completion of the financing assurances review is based on satisfactory assurances of external financing evidenced by recent pledges of budget support by donors, and on our intent to use the IDA Debt Reduction Facility to resolve our outstanding obligations to commercial creditors. We are committed to continue good faith negotiations with all non–Paris Club official and private creditors to seek debt relief in line with the principle of equitable burden sharing among creditors under the enhanced HIPC Initiative.

We propose that the Fund carry out program reviews by June 2006 and September 2006, based on the observance, respectively, of end-March 2006, and end-June 2006 quantitative and structural performance criteria, as well as end-August structural performance criteria established in Tables 1 and 3 of the attached memorandum.

The government of Nicaragua remains fully committed to the implementation of the Fund supported program and is confident that the policies and measures set forth in the attached memorandum are adequate to achieve the program's objectives under the PRGF arrangement. Nevertheless, we stand ready to take, in consultation with Fund staff, any additional steps that may be needed to keep our program on track. Recognizing the need for transparency, we intend to publish the staff report and to continue to periodically inform the public on progress under the program through various channels.

Sincerely yours,

/s/	/s/
Mario B. Alonso I.	Mario Arana S.
President, Central Bank of Nicaragua	Minister of Finance

SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

The Macroeconomic Policy Framework

1. **Macroeconomic developments in 2004 were positive**. Real GDP growth accelerated to 5.1 percent driven by a strong recovery in exports, higher commodity prices and booming remittances. Inflation remained in single digits. Nicaragua reached the HIPC completion point in January 2004, leading to external debt relief of about US$ 4½ billions in NPV terms.

2. **The macroeconomic framework in 2005 has been broadly stable, but has come under pressure, reflecting in part the impact of higher oil prices.** The economy is expanding but at a slower pace reflecting weaker external demand and higher oil prices. We expect real GDP growth in 2005 to moderate to 4 percent and believe this pace of growth would slow further to 3¾ percent in 2006. Inflation is expected to reach 10½ percent y/y at end-2005 reflecting mainly higher oil prices. We are committed to fighting the second-round impact of these supply shocks and anticipate our policy efforts will guide inflation down towards 7¼ percent by end-2006.

Nicaragua: Key Macroeconomic Objectives, 2004-2006
(annual percent change, unless otherwise indicated)

	2004	2005 Proj.	2006 Proj.
Real GDP growth	5.1	4.0	3.7
Inflation (eop)	9.3	10.5	7.3
Gross international reserves (US$ millions)	670	648	776
Net international reserves (US$ millions)	211	226	311
CPS balance after grants (in percent of GDP)	-2.8	-2.2	-2.2

Sources: Central Bank of Nicaragua; Ministry of Finance; and Fund staff estimates/projections

Fiscal Policy

3. **We have taken steps to strengthen the fiscal policy framework following passage of the weakened 2005 budget late last year**. The executive's proposal targeted a reduction in the CPS deficit relative to the expected 2004 outcome. However, the budget approved by the National Assembly implied instead a smaller adjustment, and included an increase in the total wage bill of some 21 percent. Most of this wage increase was received by health workers and teachers. Accordingly, we have implemented revenue measures expected to yield about ½ percent of GDP on a full year basis to bring the fiscal program back on track. As a result, revenue growth this year has been strong, also reflecting continued improvements in tax administration and a surge in taxes on imports. Combined with higher-than-originally-budgeted foreign grants, this has facilitated approval of a revised budget increasing capital spending consistent with a projected CPS deficit of 2.2 percent of GDP in 2005.

4. **The 2006 budget approved by the National Assembly targets a CPS deficit (after grants) of 2.2 percent of GDP, unchanged with respect to the estimate for 2005.** However, the underlying fiscal position would improve still further as the 2006 budget includes one-time costs of about 1 percent of GDP related to the national and regional elections. The underlying fiscal adjustment is consistent with our longstanding policy of steadily increasing domestic savings and reducing the high public debt. The budget envisages that tax revenues will be maintained at 17.6 percent of GDP. We remain committed to

avoiding any increases in tax exemptions, and to lowering these over the medium term, to support our efforts in increasing poverty reduction spending. The budget prioritizes outlays in a manner that protects crucial spending on human and physical capital accumulation. As a result, despite additional one-time expenses on elections, we are maintaining poverty-reducing spending at the 2005 level of 13.4 percent of GDP.

5. **The government sought in the 2006 budget to hold the increase in the wage bill to no more than expected inflation to protect poverty-reducing spending and competitiveness**. Total central government compensation in 2005 is approaching 7 percent of GDP and accounts for more than 1/3 of primary spending. Moreover, real public wages are increasing faster than in the private sector. We are concerned that continuation of rapid wage increases in the public sector will put pressures on private sector wages and ultimately on inflation and competitiveness. However, we are committed to preserving the fiscal space for poverty reducing programs. Hence, the budgetary wage bill has been increased by 9.7 percent y/y, slightly higher than expected 2006 inflation of 8.8 percent y/y. Indeed, in support of our efforts to control the wage bill the program is establishing a quantitative performance criterion on wage expenditures, comprising the bulk of the budgetary wage bill that can be readily monitored and directly controlled.[1]

6. **We have begun increasing electricity rates to eliminate quasi-fiscal losses in the sector.** Oil fuelled plants account for about 80 percent of electricity generated in Nicaragua, and the sector has been heavily affected by rising international petroleum prices. To begin the process of eliminating these losses, we have increased rates by about 20 percent between July and December 2005. We are committed to further price adjustments by June 2006 required in order to eliminate quasi-fiscal losses in the sector by December 2006. To support achieving these goals, the program includes a performance criterion on further increases in average tariff prices. In line with this, we have estimated that average tariff prices will need to be raised by an additional 6½ percent before June next year, to reach a level of 0.1588 US$/KWh. We will review in coordination with the energy regulator, the need for action depending upon actual developments in real input costs. Moreover, we intend to introduce by June 2006 a mechanism for automatic adjustment of tariffs with fluctuations with real input costs to avoid a repetition of the recent crisis in the sector. We will continue the policy of targeted subsidies to protect low usage consumers from tariff increases.

Monetary and Exchange rate policies

7. **We are tightening monetary conditions to signal our determination to protect reserves, support the crawling peg and help keep inflation under control**. After over-performing in 2004, international reserves have been broadly in line with our 2005 monetary program despite delays in disbursements of external funds. However, we are concerned that

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[1] See ¶9 of the attached Technical Memorandum of Understanding (TMU) for definitions of the wage bill that will be monitored under our program.

the increase in inflation could reflect second-round effects of high oil prices and demand pressures that may negatively affect international reserves. Accordingly, in an early move, we started tightening monetary policy in November this year. Furthermore, we will continue supporting the monetary stance by increasing central government deposits at the central bank in 2006. As such, we are targeting a reduction in NDA of C$974 million and an increase in NIR of US$85 million in 2006.

8. **Keeping the rate of crawl of the exchange rate peg unchanged at 5 percent in 2006 will appropriately balance stability and competitiveness**. In recent years, a key objective of our program has been to gradually slow the rate of crawl to help to reduce inflation, reflecting the high pass through of the exchange rate to prices. However, given election related uncertainties, keeping the rate of crawl unchanged in 2006 will buffer shocks and will help protect competitiveness.

Structural policies

9. **We are committed to further strengthening the fiscal framework including by reducing budget rigidities**, which are creating significant problems for fiscal management. Significant earmarking of public spending is a key source of pressure on the budget, crowding out poverty reducing spending, and distorting incentives. The government is constitutionally required to transfer 6 percent of expenditures to universities and 4 percent of expenditures to the judiciary. Combined with transfers to municipalities within the current decentralization framework, they hamper fiscal management. We will seek to raise public awareness of these constraints, and their implications for sustaining poverty reducing spending, as we develop our plans to strengthen the fiscal framework that are outlined in the next paragraphs.

10. **The government remains committed to achieving effective decentralization.** It has proven difficult to match devolved revenues and expenditures across municipalities. Under the current legal framework, revenue transfers to municipalities are not linked to expenditure responsibilities. As such, achieving effective decentralization will require changing the municipal transfer law, the municipality law and other related laws. To accomplish this, we have reached an understanding with the political parties to amend the municipal transfer and municipality laws next year, to devolve expenditure responsibilities to municipalities in line with revenues transferred to them and make other associated changes to the overall decentralization framework. We are committed to these reforms and the program establishes as a structural benchmark that revisions of the concerned laws be submitted to the National Assembly by June 2006 (¶28 of the TMU).

11. **We have taken measures to achieve some devolution in the 2006 budget and delay increases in transfers to municipalities**. To achieve some devolution of spending responsibilities, and to protect fiscal neutrality, the 2006 budget cuts capital spending on municipalities by the equivalent of half of revenue transfers. To support implementation of this budgetary provision, we have also issued a decree that curtails central government spending in areas that are the responsibility of municipalities. The World Bank is providing

technical assistance to design appropriate incentive systems to ensure that expenditures at the local level are consistent with national priorities. We are also working in partnership with decentralized agencies to use existing central government budget execution mechanisms to undertake projects on behalf of the municipalities. The 2006 budget maintains the transfers to municipalities at 6 percent of government's revenues and the assembly has amended the transfer law such that the previously legislated increase in transfers to 10 percent of government revenues in 2007 will be delayed. Instead, transfers will be increased to 7 percent of revenues in 2007, and another percentage point each year until reaching 10 percent of revenue in 2010 (however, transfers can be increased to 10 percent as soon as laws referred to in ¶10 are passed consistent with the devolution of spending responsibilities corresponding to the envisaged rise in transfers).

12. **Passage of a fiscal responsibility law (FRL) has been delayed but we have approved a financial administration law (FAL) to strengthen the budget framework.** Approval of an FRL was a structural performance criterion for October 15, 2004. We prepared a preliminary draft FRL that aimed to facilitate a sustained improvement of the fiscal position, reduce the public debt, and increase transparency and accountability. However, international experience indicates that FRLs have typically been successful where they are accompanied by a national consensus on both their importance and their content. We believe that we will need more time to build such a consensus before submitting the FRL to the national assembly. Instead, we proceeded with the FAL that seeks to address concerns regarding the budget process and framework. It provides for: (i) strengthening the monitoring and control systems of the public sector; (ii) approval of all budgetary expenditures by the assembly (including any financed with concessional resources); (iii) more clearly identifying the roles of the ministry of finance and other government agencies in preparing the capital expenditure budget of the public sector; (iv) establishment of a consensus-building committee comprising representatives from the National Assembly and Ministry of Finance to assess the feasibility of financing intended increases in overall budgetary expenditures; and (v) placing time-limits on the assembly's review of the budget.

13. **Developing a road-map for moving in the direction of introducing an FRL and strengthening further the FAL is crucial**. As such, the program introduces a structural performance criterion on preparing a roadmap to strengthen the fiscal responsibility framework (¶29 of the TMU) by August 2006, for consideration by the administration that would assume office in January 2007. Such a road-map should aim to facilitate a sustained improvement of the fiscal position, reduce the public debt, and increase transparency and accountability. The proposal will also seek to expand the coverage of the budget to the entire non-financial public sector and constrain the use of escape clauses to emergency situations only (¶29 item 4 in the TMU). The road-map should include an evaluation of any constitutional amendments that may be needed to achieve these reforms and recommend a strategy moving forward.

14. **Reforming the pension system is also a key policy priority.** A thorough revision of the framework is needed to solve the actuarial insolvency of the current pay-as-you-go pension system, which will begin to incur significant cash deficits in the medium term. A

high-level, presidentially–appointed commission had worked on a revised strategy for pension reform. Recognizing that our original reform strategy, of moving to a fully funded system, would have been prohibitively costly, the commission studied different options and had open discussions with a broad segment of society and international specialists to arrive at a concrete proposal. It is clear that difficult decisions will need to be made to make the pension system sustainable. However, the National Assembly approved a reform of the social security system on May 2005 that, if implemented, would accelerate the onset of the pension system's cash-flow problems and weaken the institutional framework for the system. As part of a process of developing internal consensus for reforms, we reached agreement with the political parties to postpone implementation of this law until after January 2007. This gives us time to prepare a detailed roadmap spelling out how to bring Nicaragua's pension system back into actuarial solvency without relying on government financing beyond the coverage of transitional costs. A structural performance criterion has been established under the program to have this plan (¶30 of the TMU) prepared by June 2006 for discussion with interested parties and consideration by the government after the elections.

15. **A new tax code was approved in October 2005, but with significant weaknesses that we intend to address**. Introducing a tax code to strengthen tax administration in line with international best practices has been a key policy priority, with particular emphasis on auditing, payment enforcement and sanctions. However, the version of the law that has been passed has a number of crucial weaknesses that need to be addressed urgently. These included: (i) limitations on the capacity of the tax administration (DGI) to request information from tax payers, (ii) excessive discretion for the DGI to waive sanctions, (iii) an overly time consuming system of appeals against the DGI's findings on tax liabilities, (iv) a tax audit system that in practice would prevent the DGI from conducting "desk audits," (v) introduction of limitations on tax payers' liability in cases where returns are audited by third parties ("*dictamen fiscal*"), (vi) inclusion of a "positive silence rule" together with a relatively short statutory period for DGI's rulings, (vii) lack of penalties for filing amended tax returns when this is done within a 30-day period, and (viii) too rigid a system for dealing with delays in the collection of tax liabilities ("*efectos de mora*"). Given the risks to the continued effectiveness of the DGI, we intend to move quickly to strengthen the law. The program includes an end-March 2006 performance criterion that the tax code be amended by the National Assembly to address the concerns discussed here (TMU ¶27). These amendments are crucial to give the tax administration the powers it needs to administer effectively the tax system and to help raise taxpayers' compliance levels.

16. **We are committed to reform the framework for the energy sector and strengthen the recently approved Energy Stability Law (ESL)**. Encouraging investment in the power sector to develop alternative energy sources and foster competition are key elements of our strategy. In response to the crisis in the power sector, the ESL was approved in September 2005, but, however, needs strengthening. The ESL provides the basis for the regulator to adjust electricity rates on a high frequency basis (the previous framework allowed adjustments only once per year). However, this law includes the capping of electricity spot market prices and interventions in the market for petroleum products. There are reasons for concern that these measures might create disincentives for future investment

and there is a need to review their potential distortionary effects. However, we need time to conduct a thorough assessment of the options for further reform of the sector. As a first step in this direction, the program will introduce as a structural performance criterion for end-August 2006 that the ESL be amended to eliminate distortions (¶32 in the TMU).

17. **We have made substantial progress in strengthening the financial sector framework in line with FSAP recommendations**. The national assembly this year approved a new banking law, and laws for the superintendency of banks and deposit insurance scheme (FOGADE). Together, these laws embody several key reforms, including: (i) strengthening the independence of the Superintendency; (ii) strengthening the legal framework for consolidated supervision; (iii) improving banking resolution procedures; (iv) enhancing the deposit insurance scheme; and, (v) reducing excessive scope for banking secrecy. We have made further amendments to these laws to strengthen the intervention process and increase safeguards against political interference in the day-to-day operations of the superintendency.

18. **Following on this, we intend to prepare a roadmap for further financial sector reform for consideration by the next government**. Core elements of this plan will be to advance on the remaining key FSAP recommendations and especially to develop steps for supporting the development of the domestic capital markets. Important outstanding FSAP recommendations that the roadmap will cover include: strengthening the independence and financial position of the central bank, continuing reforms of the judicial framework for the financial sector, strengthening the framework for management of land titles, and eliminating maximum lending interest rates of micro-finance companies. Advancing in these areas will require legislative measures including passage of the Law's on Capital Markets, Microfinance, Warehouse Deposits as well as reforms of the laws on the Central Bank and Insurance. The program includes a structural benchmark on presentation of the roadmap to the economic cabinet by August 2006 (¶31 of the TMU).

19. **A key area for future reform will be strengthening legal protection afforded to bank supervisors, which is currently insufficient**. After a comprehensive review of the legal options to extend the protection of bank supervisors to include criminal liability, we have found the avenues for progress in this area to be limited by constitutional considerations. We intend, however, to continue to work on this issue, in order to identify concrete measures to protect bank supervisors from criminal suits for actions undertaken in the course of their duties and will prepare options for consideration by the new government after the elections in the context of the roadmap for financial sector reform.

20. **Poverty reduction remains a critical and central element of our policy platform.** We have prepared a document to implement the Government's National Development Plan (PRSP-II), which undertakes a major review of our first Poverty Reduction Strategy Paper (PRSP-I). The PRSP-II emerged from a broad participatory process comprising the poverty reduction plans at the sub-national level. Critical to our policy platform are the objectives of poverty reduction and achievement of the Millennium Development Goals through economic growth, employment generation, increased investment and export promotion. Additional

strategic areas emphasized in the PRSP-II are: human capital development and social protection, productive and social public infrastructure, and good governance and state reforms. The government will sustain poverty spending at 13.4 percent of GDP in the 2005 budget and a similar percentage for 2006.

Other Issues

21. **The government is committed to strengthening debt management to support long term fiscal sustainability**. In addition to the implementation of sound macroeconomic policies, including fiscal consolidation as described above, we have continued active negotiations for debt relief, in good faith, with all our creditors in the context of the HIPC initiative. Negotiations have been completed with all our Paris-Club and almost all our multilateral creditors, as well as a number of non-Paris Club creditors. However, negotiations have proven difficult with several other non-Paris Club creditors. We have hired financial and legal advisors to help us negotiate debt relief from our commercial creditors, with whom we aim to settle claims through the IDA Debt Reduction Facility. Even after full delivery by all creditors of all expected HIPC relief, our debt level will remain above internationally recognized sustainability thresholds. In that context, we welcome the recent Multilateral Debt Relief Initiative (MDRI) to provide further relief on debt outstanding to the Fund and IDA, and we look forward to benefiting from it at an early point. Finally, we also enhanced our debt monitoring system by publishing a quarterly report on external and domestic debt.

22. **We plan to further strengthen the monitoring of fiscal performance.** We are working to shift the fiscal accounts (including debt service) to a modified accrual basis. We will begin to monitor central government transactions on an accrual budgetary basis (defined under the FAL) from January 2006. In order to eventually move toward accrual accounting, we will prepare by June 2006, a budgetary classification manual of the nonfinancial public sector. We also plan to strengthen our capacity to monitor the fiscal accounts from the financing side to ensure consistency of financial data with the fiscal statistics derived from the CPS data. The program introduces structural benchmarks on both these measures (¶'s 33 and 34 of the TMU).

Program Issues

23. **We are requesting a simplification of the quantitative program conditionality for 2006 to improve program monitoring, eliminate redundancies and increase transparency.** We believe that the performance criteria on the central government overall balance (after grants) and on repayment of BCN and central government debt are no longer necessary, given the broader fiscal target on the combined public sector. However, given recent challenges, new performance criteria on the central government wage bill and the level of electricity tariffs are being introduced. We would like to make the primary balance of the central government a new indicative target, to maintain the focus on the central government's medium-term debt dynamics. We believe also that the indicative targets on primary spending of the central government, net domestic financing to the nonfinancial public sector, savings

of the combined public sector, and the overall balance of the combined public sector (before grants) are no longer needed.

24. **We believe that a number of definitions of program targets should be changed**. In that context we are requesting that the fiscal program targets be defined on a basis that is consistent with our budget presentation. We therefore request that the past program convention of including HIPC relief from multilaterals in the fiscal accounts as grants be discontinued. Program fiscal targets for 2006 should be set based on this revised treatment. Also, we are considering for future programs strengthening the definition of adjusted NIR by not counting foreign currency reserves of the deposit insurance fund that are maintained at the central bank and currently added to adjusted NIR.

25. **We also request that the program quantitative targets be adjusted once we are able to receive relief under the MDRI** to: (i) allow an increase in poverty-reducing spending by the amount of the debt service that would not be made as a result of the implementation of the MDRI (the fiscal deficit targets would be relaxed accordingly by the amount of debt relief which applies to principal payments); and (ii) account for the change in BCN short term external liabilities resulting from any write off of the stock of debt to the Fund.

26. **Implementation of the 2006 program under the PRGF arrangement will be monitored** through quarterly reviews based on the observance of quarterly quantitative performance criteria, indicative targets and benchmarks (end-March 2006 and end-June 2006) as well as relevant structural performance criteria for end-March 2006 and end-August 2006. Quantitative and structural performance criteria are presented in Tables 1 and 2, and defined in the attached Technical Memorandum of Understanding.

Table 1. Nicaragua—Prior Actions, Structural Performance Criteria, and Benchmarks for Completion of Reviews

Measure	Status	Date of Implementation
I. Prior Actions for Completion of Reviews		
• Passage of 2006 budget consistent with the program including a CPS deficit (after grants) of 2.2 percentage points of GDP.	Done.	November 2005
• 2006 budgetary wage bill consistent with expected average inflation.	Wage bill grows slightly above expected average inflation.	November 2005
• Decentralization - devolution of expenditures equivalent to half of revenue transfer to municipalities	Done.	November 2005
• Passage of a satisfactory law on financial administration (FAL)	Done. Law was amended to strengthen	August 2005
• Passage of a satisfactory banking law	Done.	November 2005
• Passage of a satisfactory deposit insurance law.	Done. Law was amended to strengthen	November 2005
• Passage of satisfactory superintendency law	Done. Law was amended to strengthen	November 2005
• Defer implementation of social security law pending for review by new government after election	Done.	October 2005
• Electricity tariff adjustment of at least 10 percent	Done.	October-December 2005
II. Performance Criteria		
• Passage of a satisfactory tax code, that strengthens administration, including auditing, payment enforcement and sanctions (TMU ¶27).		March 31, 2006
• Preparation of a detailed strategy and implementation plan on pension reform (TMU ¶ 30)		June 30, 2006
• Publication of a detailed implementation plan spelling out the roadmap toward adoption of a Fiscal Responsibility Law in 2007 (TMU ¶29).		August 31, 2006
• Energy stability law amended to eliminate distortions (TMU ¶32)		August 31, 2006

Table 1. Nicaragua—Prior Actions, Structural Performance Criteria, and Benchmarks for Completion of Reviews		
Measure	**Status**	**Date of Implementation**
III. Benchmarks		
• To achieve effective decentralization with devolution of responsibilities to municipalities a revision to the relevant laws will be submitted to National Assembly (TMU ¶28)		June 30, 2006
• Preparation of a budgetary classification manual of the total NFPS with the objective to move accounting of the budget into an accrual basis (TMU ¶33)		June 30, 2006
• Measurement of the execution of the budget from the financing side (TMU ¶34)		June 30, 2006
• Present to the economic cabinet roadmap for further financial sector reform (TMU ¶31)		August 31, 2006

1/ The specific requirements for the implementation of these measures are specified in the TMU.

Table 2. Nicaragua: Quantitative Performance Criteria

	2004					
	end-June		end-September		end-December	
	Program	Actual	Program	Actual	Program	Actual
	(In millions of cordobas)					
Performance Criteria						
Net domestic financing of the combined public sector (ceiling)	-1,146	-3,067	-2,636	-2,836	-2,884	-3,297
Savings of the combined public sector (floor)	1,199	1,753	...	...	...	...
Net domestic assets of the central bank (ceiling)	-308	-1,800	-867	-1,289	-91	-1,446
Central government overall balance, after grants (floor) 2/	...	...	-581	-499	-572	-1,060
Combined public sector overall balance, after grants (floor) 2/	...	...	-1,517	-797	-2,087	-1,591
	(In millions of U.S. dollars)					
Net international reserves of the central bank (floor)	5	101	37	73	20	128
Net repayment of public domestic debt (+) (floor) 3/	47	48	64	64	-9	101
Disbursements of nonconcessional external debt contracted or guaranteed by the public sector (ceiling) 1/	0	0	0	0	0	0
Stock of external payments arrears (ceiling) 1/	0	0	0	0	0	0
	(In millions of cordobas)					
Indicative targets						
Savings of the combined public sector (floor)	...	...	1,415	2,030	1,645	2,523
Tax revenue of the central government (floor)	5,412	5,624	8,511	8,648	11,416	11,798
Total primary expenditure of the central government (ceiling) 2/	6,109	6,232	10,207	9,935	13,676	14,721
Overall balance of the combined public sector, before grants (floor) 2/	-2,018	-1,373	-4,186	-2,965	-5,758	-5,204
Net domestic financing of the nonfinancial public sector (ceiling) 2/	-1,884	-3,697	-3,712	-3,699	-4,374	-4,329
Memorandum items (millions of US$):						
Privatization	51	50	51	51	61	64
BOP support	50	...	65	50	80	95
WB-IDB project disbursements	102	...	727	135	125	227

Sources: Central Bank of Nicaragua; Ministry of Finance; and Fund staff estimates/projections.

1/ Continuous performance criteria.

2/ Includes WB/IDB investment adjustor for C$611 and C$886 million for September and December of 2004, respectively.

3/ Includes adjustor for US$123 in 2004, as a result of accumulatring NIR and BOP support disbursements higher than program targets.

Table 3. Nicaragua: Quantitative Performance Criteria, 2006

	2006	
	End-March	End-June
	Program	Program
	(In millions of cordobas, unless otherwise indicated)	
Performance Criteria		
Net domestic financing of the combined public sector (ceiling) 1/	-1,449	-2,183
Net domestic assets of the central bank (ceiling) 1/	-810	-1,477
Combined public sector overall balance, after grants (floor) 1/	-1,594	-1,984
Total wage expenditure 2/	1,485	3,031
Average electricity tariff price (US$ Kwh)	0.1478	0.1588
Net international reserves of the central bank (in US$ million; floor) 1/	83.7	111.2
Nonconcessional external debt contracted or guaranteed by the combined public sector (ceilings) 3/	0	0
Stock of external payment arrears (ceilings) 3/	0	0
Indicative targets		
Tax revenue of the central government (floor) 1/	10,748	14,470
Primary balance of the central government, after grants (floor) 1/	369	379

Sources: Central Bank of Nicaragua; Ministry of Finance; and Fund staff estimates/projections.
1/ Cumulative flows starting July 1, 2005.
2/ Cumulative flows starting January 1, 2006
3/ In US dollars. Measured on a continuous basis

NICARAGUA—TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This technical memorandum summarizes the understandings between the Fund and the Nicaraguan authorities relating to the monitoring of the Poverty Reduction and Growth Facility (PRGF) arrangement. For program purposes, all quantitative performance criteria and indicative targets will be defined as cumulative flows from June 30, 2005.

A. Definitions

Fiscal Targets

2. Coverage of the fiscal accounts:

a. **Nonfinancial Public Sector (NFPS)** includes the central government (CG), the social security institute (INSS), the municipality of Managua (ALMA), the electricity transmission public enterprise (ENTRESA), the water and sewerage company (ENACAL), the electricity holding company (ENEL), the telecommunications regulatory agency (TELCOR) and the port company (EPN).

b. **The Combined Public Sector (CPS)** includes the NFPS and the Central Bank of Nicaragua (BCN).

3. **Central Government Overall Balance** is defined as the total revenues of the CG minus primary expenditures of the CG and minus domestic and external interest expenditures of the CG.

a. **Total revenues of the CG** are defined on a cash basis as the sum of revenues from tax collections, nontax revenues, capital revenues, and current transfers.

b. **Primary expenditures of the CG** are defined on a cash basis as the sum of wages and salaries, other goods and services, current and capital transfers, capital expenditure, and net lending.

c. **Interests on domestic and external debt** are registered on a cash basis for program purposes.

4. **Foreign Grants to the Central Government** are equal, for program purposes, to total tied and untied grants to the CG.

5. **Overall Balance of the Central Government (after grants)** is equal to the overall balance of the CG plus foreign grants to the CG.

6. **Primary Balance of the Central Government (after grants)** is equal to the overall balance of the CG (after grants) plus interests on total debt of the CG.

7. **Overall Balance of the Combined Public Sector (after grants)** is defined as the CG overall balance *plus* the operating result of the BCN *plus* the overall balances of INSS, ALMA and the public enterprises included in the definition of the CPS, plus foreign grants to the CPS.

8. **The Net Domestic Financing of the Combined Public Sector** comprises the operating result of the BCN and the change from their respective stocks at end-June 2005 of the sum of (a) the outstanding stock of debt of the NFPS to the domestic financial system (BCN, commercial banks, and the *Fondo Nicaragüense de Inversiones*–FNI) net of deposits (including arrears that correspond to obligations considered eligible for refinancing or rescheduling, or other debt reduction mechanisms) with the foreign currency part of the net debt to the banking system converted into córdobas at the program exchange rate; (b) the outstanding stock of domestically-issued public sector debt held by private residents or nonresidents with the foreign currency part converted into córdobas at the program exchange rate; (c) the outstanding stock of suppliers' credit; and (d) the outstanding stock of floating debt.

9. **Total wage expenditures, which will be monitored under the quantitative performance criterion, should grow by no more than 9.7 percent in 2006 relative to 2005,** and is defined as the sum of personnel expenditures (Budgetary classifications line item 01 of expenditures and line item 05 of Ministry of Education, Culture, and Sports) of current and capital expenditures of most central government entities included in the budget. The entities included are the following: National Assembly, Supreme Court of Justice, Supreme Electoral Council, Comptroller of the Republic of Nicaragua, Presidency and Vice-presidency of the Republic of Nicaragua, Ministry of Labor, Ministry of Finance, Ministry of Industry and Commerce, Ministry of Transportation and Infrastructure, Ministry of Agriculture and Forestry, Ministry of Foreign Affairs, Ministry of Environment and Natural Resources, Ministry of the Family, Ministry of Education, Culture, and Sports, Decentralized and Autonomous Education Institutions, Ministry of Health, Ministry of the Interior, Ministry of Defense (including the army), Attorney General of the Republic of Nicaragua.

10. **Electricity tariffs, which will be monitored under the quantitative performance criterion** are defined as the average tariff price charged by the electricity distributor to consumers. The energy purchase reference price is defined as the generation component of the average tariff price. Based on the end-October tariff price, which was 0.1353 US$/KWh, tariffs will be further increased up to an average tariff of 0.1588 US$/KWh.

Electricity tariffs: 2005

	1-Jan-05	16-Jul-05	16-Aug-05	1-Oct-05	31-Dec-05
Reference price (US$/MWh)	71.74	78.14	79.84	82.43	84.90
Average tariff price (US$/KWh)	0.1230	0.1304	0.1324	0.1353	0.1394
Tariff adjustment	0.00	5.98%	1.50%	2.25%	3.00%

Monetary Targets

11. **Adjusted Net International Reserves (NIR) of the BCN** are defined as

   a. Gross foreign assets of the BCN that are readily available (which exclude those that are pledged or otherwise encumbered including, but not limited to, reserve assets used as collateral or guarantee for a third-party external liability;

   b. *Minus* short term reserve liabilities of the BCN including purchases and credits from the IMF;

   c. *Minus* foreign currency reserve requirement deposits of the commercial banks at the BCN.

12. The **Net Domestic Assets (NDA) of the BCN target under the program is defined as the difference between the change in the stock of currency issued and the change in NIR** valued at the program exchange rate.

13. For 2006, the program exchange rate is 17.6 córdobas for one US dollar.

External Sector Targets

14. **Non-concessional debt of the combined public sector** will be defined as the contracting or guaranteeing of non-concessional external debt of the CPS, or by any other agencies on behalf of the CPS. This limit applies not only to debt as defined in Point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted by the IMF on August 24, 2000, but also to commitments contracted or guaranteed for which value has not been received. External debt includes all current liabilities with a nonresident party, which are created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, at some future point(s) in time to discharge the principal and/or interest liabilities under the contract. This definition includes loans, suppliers' credits, and leases (operational and financial leases). The ceiling on contracting of non-concessional external debt applies both to medium-and long-term debt defined as debt with maturity of one year or longer, as well as to short-term debt, defined as debt with maturity of less than one year. For program purposes, BCN instruments placed in the domestic market held by nonresidents, will be excluded from the ceiling on the contracting of non-concessional external debt. Debt with a maturity of less than one year for import related credits, BCN reserve liabilities of less than one year, and borrowing from the Fund are excluded from the ceiling.

15. **Concessionality** will be based on currency-specific discount rate on the 10 year average of the OECD's commercial interest reference rates (CIRR) for loans or leases with maturities greater than 15 years and on the six-month average CIRR for loans or leases maturing in less than 15 years. Maturity will be determined based on the original loan

contract. Under this definition of concessionality, only debt with a grant element equivalent to 35 percent or more will be excluded from the debt limits.

16. **External Payment Arrears** are defined as debt service obligations arising from external debt contracted or guaranteed by the public sector overdue by more than 15 days, except on external debt subject to rescheduling or restructuring.

17. **Balance of Payments or Budget Support** is defined as official external untied financial assistance from loans and grants provided by foreign official entities that are received by the government for unrestricted budgetary use.

B. Reporting

18. The BCN will send to the IMF by electronic mail:

a. A daily report containing information on the daily accounts of the BCN with a two day lag (stocks and flows);

b. A monthly report with information on the monthly accounts of the BCN within four weeks and commercial banks, and FNI (stocks and flows) within six weeks of the end of the month;

c. Quarterly accounts of the BCN within four weeks of the end of the quarter and commercial banks, and FNI (stocks and flows) within six weeks of the end of the quarter.

d. Monthly information on the detailed operations of the combined public sector no later than five weeks after the end of each month.

e. Monthly information on the accounting of non-reschedulable external arrears by creditor (if any), with detailed explanations, within four weeks of the end of each month.

f. Monthly information on the accounting of domestic arrears by creditor (if any), with detailed explanations, within four weeks of the end of each month.

19. The Ministry of Finance will send to the IMF by e-mail the following information:

a. Quarterly information on loan-by-loan accounting of all new loans contracted or guaranteed by the public sector—including detailed information on the amounts, currencies, and terms and conditions, as well as relevant supporting materials—within four weeks of the end of each quarter.

b. Quarterly information on issuance and redemption of BPIs within four weeks of the end of each quarter.

c. Monthly information on exonerations and exemptions granted by the customs administration (DGA) by type of tax no later than five weeks after the end of each month, and quarterly information on exonerations and exemptions granted by the internal revenue administration (DGI) by type of tax no later than six weeks after the end of each quarter.

C. Adjustors

20. **The Overall Balance of the Combined Public Sector (after grants)** target will be adjusted *downwards* by the amount of principal payments to IDA and the IMF that would not have to be made as a result of the possible implementation of the Multilateral Debt Relief Initiative (MDRI).

21. **The Primary Balance of the Central Government** targets will be adjusted *downwards* by the amount of total debt service of the government and central bank that would not have to be made as a result of the possible implementation of the MDRI.

22. **The net domestic financing of the combined public sector** target will be adjusted *upwards* by the amount of principal payment to the IMF that would not have to be made as a result of the possible implementation of the MDRI.

23. In the event that the MDRI is implemented, the **NIR** target will be adjusted *upwards* by the amount of stock of debt subject to IMF cancellation, minus any principal payment (including those covered by HIPC relief) that would have been scheduled in the absence of the MDRI between the date of implementation of the MDRI and the test date.

24. In the event that the MDRI is implemented, the **NDA** target will be adjusted *downwards* by the amount of stock of debt subject to IMF cancellation, minus any principal payment (including those covered by HIPC relief) that would have been scheduled in the absence of the MDRI between the date of implementation of the MDRI and the test date.

25. The **NIR** target will be adjusted *downwards* (respectively upwards) by the cumulative amount of any shortfall (respectively excess), up to a maximum total of US$ 25 million, in balance of payments/budget support loans disbursed by the World Bank and the Interamerican Development Bank as specified in Table 1.

26. **The net domestic financing of the combined public sector** and **NDA** targets will be adjusted *upwards* (respectively downwards) by the cumulative amount of any shortfall (respectively excess), up to a maximum total of US$ 25 million, in balance of payments/budget support loans disbursed by the World Bank and the Interamerican Development Bank as specified in Table 1.

Table 1. Expected World Bank and IDB budgetary/balance of payment support loans
(Cumulative flows since end-June 2005, millions of US$)

	2006Q1	2006Q2
Total	65	75
World Bank	35	35
IDB	30	40

D. Structural Conditionality

Tax code (performance criterion)

27. **The amendments to the tax code, which will be discussed with Fund staff before being submitted to the National Assembly, should include, but not be limited to the following**:

- **Tax administration power to request information**. All taxpayers and government entities should, for tax purposes, supply the information the tax administration requests in the form and time frame that the tax administration deems necessary. To this purpose there should be no need for a prior judicial order (Art. 27 of the tax code (TPC));

- **Ability to conduct off-site audits**: The tax administration should have the authority to audit taxpayers at their legal address as well as in the tax administrations' office and other sites that it may deem appropriate. (Art. 67, Art. 27, and Art. 103, Num. 10 TPC);

- **Administrative silence**. If the tax administration or the tax tribunal does not issue a ruling on a case initiated by the taxpayer within the statutory time frame, this "silence" should be interpreted as a negative answer to the petition and the taxpayer would then have the option to either appeal that tacit ruling or wait until the ruling is actually issued (Arts. 97, 98 and 99 TPC);

- **Suspension of the collection enforcement process**. A system of guarantees to be provided by the tax payer with tax obligations above a threshold that will be defined in the law, should be established, in order to defer collection action by the tax administration against tax payers with regards disputed tax claims (Art. 95 TPC);

- **Discretion to Waive Sanctions**. The tax administration should not have the power to waive sanctions and penalties for non-compliance (Arts. 129 and 137 TPC);

- **Audit Certification ("*Dictamen Fiscal*")**. The *Dictamen Fiscal* should not limit the audit powers of the tax administration. Further, even if the taxpayer uses the audit certification, he/she should continue to be responsible for any error or omissions in the tax return. (Art. 156 TPC).

Decentralization (benchmark)

28. **Amendments to the municipal transfer and municipality laws next year should** be made to achieve fiscal neutrality by explicitly linking revenues transferred to municipalities to expenditure responsibilities that have been devolved to them. The amendments should also make clearer the specific nature and modalities of the expenditure responsibilities that are devolved to municipalities and make other associated changes to the overall decentralization and budgetary framework, to support the achievement of effective decentralization.

Fiscal Responsibility Framework (performance criterion)

29. **The roadmap to achieve an effective framework for fiscal responsibility** should include, but not be limited to, a discussion of the following key elements:

1) **Ministry of Finance (MHCP)'s increased control over the design and execution of the budget.** The roadmap should explore the following issues:

    a. **Expand coverage of entities covered in the budget** such that decentralized agencies by function are fully integrated into the annual budget.

    b. **Increase expenditure flexibility, including by addressing earmarking**. A large percentage of expenditures are currently earmarked, which hampers the ability of the ministry of finance to achieve effective fiscal management.

    c. **Complete the process of centralizing budget functions** to strengthen the MHCP's control of expenditure ceilings of decentralized agencies, as well as the capital budget.

2) **Development of a Multiyear Macroeconomic Plan (MMP).** The roadmap will discuss what should be the key features of the MMP in the context of international experience with fiscal responsibility laws. These features could include: (i) statement of the principles of fiscal policy that the government will pursue (including management of unexpected revenues), (ii) presentation of key macroeconomic targets (such as annual reductions in the public debt-to-GDP ratio, medium-term primary surplus targets for the central government, as well as debt ceilings for local governments, and state-owned enterprises), (iii) responsibility for preparation of the MMP, (iv) macroeconomic projections for the current year and the subsequent three years, and (v) link to targets of the Annual Budget Law as well as its modifications during the year.

3) **Monitoring and corrective action clauses**. The roadmap should study how the implementation of the MMPs targets will be assessed and reported on during the course

of the year. A discussion should be included regarding who would be responsible for achieving the agreed targets.

4) **Escape clause**. The roadmap should note that appropriate circumstances for deviating from the MMPs targets should relate to emergency situations only (such as in cases of national emergency defined under the Law, including outbreaks of epidemic diseases, natural disasters, and war), and discuss who could grant these waivers (in case waivers are to be granted by the National Assembly, the law should clearly constrain the circumstances when these can be granted).

5) **Sanctions for noncompliance**. The roadmap will discuss: (i) accountability for meeting the MMP targets, (ii) sanctions for non-compliance against those judged responsible as well as responsibility for assessing and enforcing sanctions. The plan should study the trade-offs between stronger sanctions and pressures to include multiple escape clauses and a narrower coverage of the public sector in the fiscal framework.

6) **Inclusion of local governments.** As local governments play an increasingly important fiscal role in Nicaragua, the fiscal responsibility framework should consider a timetable and outline the necessary conditions for their incorporation into the framework.

7) **Role of political consensus.** The roadmap should discuss a strategy for developing consensus and political support for adoption of the fiscal responsibility framework.

8) **Assess the constitutional implications of the fiscal responsibility framework including the recently approved FAL.** The roadmap should assess what changes to the FAL and what constitutional amendments may be needed for a credible fiscal responsibility framework.

9) **Timeframe.** The roadmap should spell out the timeframe for adopting the fiscal responsibility framework and the sequencing of the needed reforms.

10) **Modalities**. The roadmap should be prepared by a committee appointed by the Minister of Finance and including high level representatives from the MHCP, Central Bank of Nicaragua and the Economic Commission of the National Assembly and be ready by end-June 2006.

Pension Reform (performance criterion)

30. **The Pension Reform Plan should estimate the fiscal costs of the various alternatives currently being considered and recommend a specific strategy to bring the pension system into actuarial solvency.** The analysis should include, but not necessarily be limited to, sensitivity analyses on parametric reforms (such as changes to the retirement age, minimum number of contributions, minimum pension, replacement rate), the relative advantages and disadvantages of alternative pension schemes, and the different parameters used in the estimation of the transition costs. The plan should include a specific recommendation of a scheme that would move Nicaragua's pension system into actuarial

solvency without relying on any government financing beyond the coverage of possible transition costs. It should include the steps and timeline for implementation of the pension reform, including the needed parametric reforms, which could be carried out as a first, step, and also include time for discussion among all stakeholders and a schedule for introducing the reforms. The plan should be prepared by a new commission appointed by the Minister of Finance and including high level representatives from the MHCP, Social Security Institute, Central Bank of Nicaragua and the Economic Commission of the National Assembly, and be ready by end-June 2006.

Financial Sector Reform (benchmark)

31. **The roadmap for future financial reform** should be prepared by a committee including representatives from MHCP, the Superintendency, the Central Bank and FOGADE and include, but not necessarily be limited to, the following key elements: strengthening the financial position of the central bank, strengthening the framework for management of land titles, and eliminating maximum lending interest rates of micro-finance companies. The roadmap should include a timetable for passage and a discussion of the main content of key laws including: (i) Capital Markets Law, (ii) Central Bank Charter, (iii)Microfinance Law, (iv) Warehouse Deposits Law, and (v) a General Insurance Law. The roadmap should also include a discussion of needed reform of the judicial framework for the financial sector.

Energy Stability Law (ESL) (performance criterion)

32. The ESL will be amended to: (i) strengthen the regulation of the electricity spot market while eliminating controls on spot market prices for electricity, and (ii) strengthen the regulatory framework for fostering competition in the market for petroleum products while eliminating the possibility of introducing price controls and other arbitrary interventions in this market.

Public Expenditure Management (benchmarks)

33. With a view to eventually moving to the **accounting of the budget on an accrual basis,** a budgetary classification manual of the total NFPS will be prepared by end-June 2006 as a structural benchmark under the program**.**

34. With a view to eventually **measuring the execution of the budget from the financing side** (below the line), a study will be prepared to: (i) assess the problems that are currently preventing the computation of the below-the-line-financing, and (ii) recommend ways to address this problem, including a timeframe for implementing the recommendations. The finalization of this study by end-June 2006 will be a structural benchmark under the program**.**

E. Safeguards Assessment

35. To address the vulnerabilities identified during the safeguards assessment of the BCN completed in August 2003, we propose the following timetable:

Measures	Expected Date of Implementation	Status
1. International Financial Reporting Standards (IFRS)		
a. Disclose the differences between IFRS and the BCN accounting practices:		
(i) in the 2002 financial statements.	October 2003	Done
(ii) in the 2003 financial statements.	end-June 2004	Done
(iii) in the 2004 financial statements.	End-June 2005	Done
(iv) in the 2005 financial statements.	End-June 2006	
(v) in the 2006 financial statements.	End-June 2007	
b. Full adoption of IFRS (beginning with the 2007 financial statements).		
– Initiate migration to IFRS.	2007	Awaiting recommendations from external auditors
– Complete migration of IFRS.	2008	
2. Cleaning of Central bank's general balance	December 2006	In process
3. Improve structure of accounting rules	August 2006	In process
4. Establish methodology for accounting of standardized bonds on an accrual basis	October, 2005	Done
5. Improve presentation of central bank's financial reports	June 2006	In process
6. Staff training to implement the IFRS	December 2006	Pending

In order to adopt IFRS, the BCN hired a new external auditor in April 2004 for a three-year period and established a program to ensure adequate training for the staff of the accounting department and to identify the necessary changes to the central bank law. The auditor performed the reconciliation of the 2003 financial statements and prepared a report that facilitated the establishment of a plan to initiate migration from Nicaraguan accounting standards to IFRS by the end of the year 2006.