Managua, Nicaragua
May 25, 1994

Mr. Michel Camdessus
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431

Dear Mr. Camdessus:

1. When the administration of President Chamorro took office in April 1990, Nicaragua's macroeconomic situation had weakened markedly as a result of inadequate economic policies, adverse external developments (including a deterioration in the terms of trade and the U.S. trade embargo), and civil war. Real GDP had declined in every single year since 1984, the rate of price increase had accelerated sharply, and the size of the public sector had grown considerably. At the same time. official international reserves were virtually depleted. exports had fallen to half their pre-1980 level, and the country had accumulated an external debt (including arrears) of US$10.7 billion, equivalent to nine times its GDP and forty times its exports.

2. Following the adoption of a number of tax measures in late 1990, in March 1991 the Government launched a comprehensive stabilization effort involving a substantial reduction in military outlays and government employment, adjustments in public prices, prudent wage and credit policies, and a devaluation of the cordoba from C$1 to C$5 per U.S. dollar. This program, which was supported by an 18-month stand-by arrangement from the Fund that was approved in September 1991, succeeded-in achieving a rapid stabilization of the economy. The 12-month rate of inflation fell from 13,500 percent during 1990 to an annual rate of 4-1/2 percent in the post-devaluation period May-December 1991, and to 3 1/2 percent during 1992. Real GDP declined by 0.2 percent in 1991, in part because of a severe draught that affected agricultural production, and increased by only 0.4 percent in 1992 because of a slump in the international prices of some major export crops (export prices fell by 10 percent in 1992), shortfalls in external assistance, and problems of insecurity and disputed land rights in the countryside.

3. As a result of the revenue and expenditure measures adopted in late 1990 and during 1991, public sector dissavings declined sharply by 26 1/2 percentage points of GDP to about 3 percent of GDP in 1991, and the overall cash deficit of the public sector before grants (including the losses of the Central Bank) was reduced from 31 1/2 percent of GDP in 1990

to 8 1/2 percent of GDP in 1991. Notwithstanding some overruns in noninterest current expenditure during the second half of the year, the public sector savings position shifted to a surplus of 0.3 percent of GDP in 1992, while the overall deficit rose to about 10 percent of GDP because of a significant increase in public investment. Military and internal security outlays declined from 22 percent of GDP in 1990 to less than 4 percent of GDP in 1992 as the number of military personnel was reduced by 83,000 to about 15,000 at end-1992 through the demobilization of troops. The improvement in macroeconomic conditions and the increase in real interest rates that followed the adoption of market-determined interest rates contributed to a substantial remonetization of the economy in April 1991-December 1992, which was reflected in an increase of 130 percent in money and quasi-money denominated in local currency over the period, while inflation remained low.

4. In parallel with its stabilization effort, the Government embarked on a structural reform program to transform the economy from a centrally planned to a market oriented system. The Government's program was aimed at eliminating distortions and reducing state intervention, reforming the financial system, and liberalizing foreign trade. In September 1991 these efforts were supported by an Economic Recovery Credit I from the World Bank and a Trade and Finance Loan from the IDB. In the context of this program, the Government took steps to allow the operation of private banks (seven private banks have already opened their doors to the public) and established the Superintendency of Banks, enacted a new foreign investment law that, facilitated the gradual resumption of foreign investment; implemented measures to reduce the operating costs of the state-owned banks, initiated the divestiture of 351 public entities under the National Corporation of Public Enterprises (CORNAP), and lowered most import taxes from a range of 4-253 percent in 1989 to 10-40 percent in 1992.

5. Confronted with a reduction in external assistance after the substantial support received in 1991-92, in January 1993 the Government announced a package of measures to reinforce its macroeconomic policies, The package included (i.) a number of fiscal actions aimed at strengthening public sector savings by 5 percentage points of GDP in 1993; and (ii) a devaluation of the cordoba from C$5 per U.S. dollar to C$6 per U.S. dollar, followed by the adoption of a crawling peg system. The fiscal package contemplated a new tax on luxury consumption; the introduction of license tag fees and a tax on motor vehicles; an increase in stamp duties on imports; adjustments in public prices: and cuts in current and capital outlays.

6. Real GDP declined by 0.9 percent in 1993. Agricultural production grew by only 1 percent because of a further decline in coffee prices (the price of Nicaraguan coffee fell by 35 percent between 1990 and 1993) and some problems of lack of security in the countryside, while the commercial and services sectors registered a decline associated with lover import activity. Following the currency devaluation of January 1993, consumer prices increased by almost 18 percent in January-February, but rose by only 1 1/2 percent during the rest of the year. On the external front, a substantial reduction in the external current account deficit (excluding

official transfers and interest obligations) from US$570 million in 1992 (31 percent of GDP) to US$430 million in 1993 (24 percent of GDP) was more than offset by a sharp decline in external assistance (total disbursements of loans and grants dropped from US$700 million in 1992 to US$390 million in 1993). As a result, net international reserves fell by US$100 million during the year and at end-1993 freeiy usable reserves amounted to less than one month of imports of goods and nonfactor services. Exports in U.S. dollars increased by about 20 percent in 1993 because of the sale of two years of gold production and a rapid increase in non-traditional exports, while imports fell by 12 percent as credit policy was tightened to compensate in part for the reduction in external assistance. Private capital inflows are estimated to have increased to some US$140 million in 1993, representing mostly direct investment and trade credits.

7. Several factors precluded the achievement of the fiscal objectives in 1993, including the postponement of some revenue measures, the effect of sluggish economic activity on tax revenue, an unplanned rise in pension payments sanctioned by the National Assembly, and a lower operating surplus of the public utilities. Notwithstanding these problems, public sector savings increased from 0.3 percent of GDP in 1992 to 1.9 percent of GDP in 1993, which permitted an increase in public investment. As a result, the overall cash deficit of the public sector before grants (including the losses of the central bank) remained unchanged compared with the previous year at about 10 percent of GDP.

8. As described above, the government has made substantial progress over the last three years in improving the public finances, reducing inflation sharply and keeping it low, re-establishing relations with external creditors and multilateral agencies, and carrying out structural reforms. However, the external situation remains weak and highly dependent on concessional financing, the public sector needs to be streamlined further, and better conditions must be created to foster private investment, employment, and productivity growth. The Covernment is firmly committed to address these problems and has embarked on a comprehensive medium-term program for 1994-97, which is aimed at consolidating the gains already achieved in the area of macroeconomic stabilization, intensifying the process of structural reform, and moving further toward the attainment of external viability.

9. The Government's strategy puts particular emphasis on expanding employment in productive activities, alleviating poverty, and improving the management of the country's natural resources. The main objectives of the program are: (i) to lay the basis for a sustainable growth in real per capita income of 1 to 1 1/2 percent a year by 1996 (with real GDP growth of 2-percent in 1994, 3 percent in 1995 and 4 1/2 percent in 1996-97); (ii) to reduce inflation to about 5 percent a year by 1997 (the 12-month rate of inflation will be limited to 10 percent during 1994 and will be reduced to below 8 percent by end-1995, and to 6 percent by end-1996); and (iii) to strengthen the reserve position of the Central Bank, with gross reserves increasing to the equivalent of 3 1/2 months of imports of goods and nonfactor services by the end of 1996. Central to the attainment of these

objectives will be an improvement in the savings position of the public sector (including net interest paid) of 5.8 percentage points of GDP over 1994-97, the redeployment of public assets to more productive uses through privatization, and the creation of an environment conducive to the growth of domestic savings and private sector investment.

10. On the fiscal side, the program aims at increasing public sector savings (excluding net interest paid) by 3.2 percentage points of GDP to 9.4 percent of GDP in 1994. After interest, public sector savings are projected to rise by 2.3 percentage points of GDP to 4.2 percent of GDP in 1994. Capital expenditure is projected to rise by 2.1 percent of GDP in 1994 (mostly because of an increase in the implementation of projects tied to external loans and grants). and the overall cash deficit of the public sector before grants (including the losses of the Central Bank) would decline slightly to 9.7 percent of GDP. Public sector savings after interest will rise further by 1 1/2 percentage points of GDP in 1995 and by an additional 1 1/2 percentage points of GDP in 1996. On the assumption that project financing remains at about the same level in 1995-96 as in 1994, the overall cash deficit of the public sector would decline to 7.2 percent of GDP in 1995, and to 6.3 percent of GDP in 1996.

11. Current revenue of the General Government is projected to increase by close to 1 1/2 percentage points of GDP in 1994. To that end, the Government has adopted a number of revenue actions consisting of a reduction in import duty exemptions, including those applicable to government entities (implemented in November 1993); a widening of the base of the tax on luxury consumption (implemented in November 1993); an increase in the fees charged for the issuance of visas, passports, driver's licenses, and the licensing of forestry activities (implemented during the first four months of 1994); and stiffer penalties for tax arrears. In addition, starting June 1, 1994 the Government will adopt a mechanism of monthly adjustments in gasoline prices, aimed at keeping these prices unchanged in U.S. dollar terms (gasoline prices were raised by 25 percent in the period July-August 1993 and by a further 2 percent in January 1994). The functioning of this mechanism will be reviewed at the time of the review of the first-year ESAF program. The Government also will continue to implement administrative actions to enforce tax compliance outside Managua, especially as regards payments of the general sales tax (at present more than 90 percent of the receipts from this tax are collected in the Hanagua area). Tax administration improvements will be supported by a comprehensive technical assistance program provided by the Fiscal Affairs Department of the Fund and financed by the IDB, while the Customs Office will benefit from technical assistance from the IDB starting in July 1994.

12. Noninterest current expenditure is programmed to decline by 1.3 percent of GDP in 1994. The expenditure measures include a reduction in the number of public sector employees by 13,500 in 1994-97, or about 13 percent of total public sector employment, through the implementation of a voluntary employment reduction program (within this total the reduction in 1994 would amount to 7,000). In addition, the program for 1994 contemplates a freeze

on public sector wages and salaries (except for selective adjustments to a small group of Central Government employees), the closing and streamlining of certain government entities, a further reduction in the number of military and internal security personnel by about 600 people, and the containment of transfers to health and education by broadening the application of fees on a selective basis (according to income) on certain services. The wage bill of the Central Government (including severance payments) is projected to decline from 7.4 percent of GDP in 1993 to 6.9 percent of GDP in 1994. To carry out the voluntary employment reduction program, the Government will receive technical support from the World Bank in the context of a Technical Assistance Credit.

13. Notwithstanding the envisaged partial privatization of the telecommunications company (TELCOR) scheduled for October 1994, the operating surplus of the public enterprises is projected to improve by 0.4 percentage points of GDP to 4.7 percent of GDP in 1994. This will be achieved through adjustments in public sector prices, implementation of the voluntary employment reduction program, and reductions in other operating expenditures. Domestic telephone tariffs were adjusted by 240 percent in January 1994; water and sewerage charges will be raised by 5 percent before end-August 1994; and electricity tariffs are being adjusted by 1 percent a month. In addition, the losses of the Central Bank will be reduced from 1.4 percent of GDP in 1993 to 0.9 percent of GDP in 1994 through a mechanism of automatic debiting of interest payments from the accounts of the commercial banks at the Central Bank (which became effective on April lst, 1994), the alignment of central bank interest rates according to market developments, the receipts from a commission of 1 percent on all sales of foreign exchange by the Central Bank (implemented on May 1, 1994), and actions to improve interest recovery from the National Investment Fund (FNI).

14. In light of the prospects for a decline in external aid, achievement of the objectives of the program requires an additional increase in public sector savings of 1 1/2 percent of GDP in 1995. To this end, current revenue of the General Government will be increased by about 1 percent of GDP in 1995 through a further reduction in indirect tax exemptions, taxation of the telephone company and other enterprises following their privatization, administrative measures to broaden the base of the income tax, and the strengthening of tax enforcement in the interior of the country. The envisaged improvement in tax revenue is expected to offset in part a reduction of 1 1/2 percent of GDP in the consolidated operating surplus of the public enterprises, as a result of the privatization of TELCOR (the operating surpluses of the Nicaraguan Energy Institute (INE) and the Nicaraguan Water and Sewerage Institute (INAA) are expected to remain unchanged in 1995 through the-continued pursuit of an appropriate tariff policy). Non-interest current expenditure will be reduced further by 2 percentage points of GDP in 1995 through the continued implementation of the voluntary employment reduction program (the number of public sector employees will be reduced further by 4,000 in 1995); the maintenance of the freeze on wages and salaries; the containment of pension payments; a lowering of expenditure in some Ministries, including defense, and in general services and administration; and

the non-recurrence of some extraordinary outlays (related to regional elections) incurred in 1994. Also, total education expenditure will be reviewed giving priority to primary education and reducing subsidies to secondary and higher education. In addition, the losses of the Central Bank will be reduced further by 1/2 of i percentage point of GDP in 1995 as a result of the full-year effect of the measures introduced in 1994.

15. In line vith the fiscal objectives described above, quarterly limits on both central government current expenditure (Table 1) and the use of net domestic bank and nonbank financing by the public sector (Table 2) have been established for the first year of the program.

16. The envisaged fiscal adjustment will facilitate the implementation of monetary and credit policies consistent with the growth, inflation, and external objectives of the program for 1994-95. Partly in reflection of prevailing uncertainties, the demand for domestic financial assets declined in real terms during 1993. The program envisages that broad money denominated in local currency will remain constant in real terms during 1994 and will recover somewhat in 1995. Credit to the private sector is projected to increase by about 10 percent a year in'real terms in 1994-95 (compared with a decline of 3 1/2 percent in 1993). on account of the envisaged reduction in the net indebtedness of the public sector with the financial system and the re-lending of resources to be provided by the Central American Bank for Economic Integration (BCIE) and other external creditors for the financing of specific programs. The net international reserves of the Central Bank are projected to increase by US$45 million in 1994 and by an additional US$35 million in 1995. Central bank credit to the private banks, reserve requirements, and the deposits of the public enterprises and the Social Security System with the commercial banks will be managed in a manner consistent with the attainment of the monetary and balance of payments targets of the program. Starting in 1995 the Central Bank intends to use open market operations as an instrument of monetary control on a more regular basis. In line with these aims, quarterly limits on the net domestic assets of the Central Bank (Table 3) and targets on the net international reserves of the Central Bank (Table 4) have been established for the first year of the program.

17. Starting in 1994 there will be no further central bank financing of the state-owned banks on a net basis (although financing could change during the year because of seasonal reasons). The state-owned banks will need to finance new credits through improved loan recoveries, increased deposits, and the external resources that they could channel without violating the prudential norms of the Superintendency of Banks (the private banks will be given priority for channeling these resources). Moreover, central bank incremental financing of the FNI will be limited to the re-lending of external resources provided by regional institutions and external donors for specific programs, net of programmer! repayments to the Central Bank (for program purposes these repayments arc projected at C$ 35 million a year in 1994-95).

18. Interest rates on bank loans and deposits will be kept free of controls during the program period. In late December 1993 the Central Bank took steps to realign the structure of its interest rates with the market. According to the new policy, central bank interest rates are set quarterly on the basis of an average of the rates offered by commercial banks on 30-day deposits plus a spread of 1/4 of one percentage point. A portion of the credit operation? of the Central Bank still takes place at below market rates but the application of the new interest rate policy will be broadened to all central bank operations (short and long-term), with the exception of contracts made under the old system. before presentation of the first year program to the Executive Board of the Fund.

19. The exchange value of the cordoba registered a slight appreciation in real effective terms between the second quarter of 1991 (after the major devaluation of March 1991) and the fourth quarter of 1992. Following the devaluation of January 1993 the Government adopted a crawling peg with an annual rate of depreciation of 5 percent vis-a-vis the U.S. dollar, and the exchange rate crawl was accelerated to 12 percent a year in November 1993. As a result of these actions and the pursuit of a prudent wage policy during 1993, the cordoba has depreciated in real terms by about 6 percent since end-1992, consistent with the Government's policy to promote export growth. During the program period the Government is committed to keep exchange rate policy under close surveillance to ensure that the balance of payments objectives of the program are achieved.

20. As a step in the direction of liberalizing foreign exchange transactions for invisibles and capital flows, in October 1991 the Central Bank of Nicaragua authorized the establishment of foreign exchange houses that operate at market-determined rates. Most export receipts, official receipts and payments, import payments and foreign remittances are transacted in the official market, while certain operations for invisibles and capital transactions take place in the free market. Following a tightening of credit policy, the spread between the exchange rate in the free market (mid-point) and the official exchange rate (mid-point) has declined to less than 2 percent in recent months. Given the fragile external situation, the Government is not in a position to proceed with an immediate unification of the exchange markets. However, the government is committed to eliminate the multiple currency practice arising from the operation of the exchange houses through the full unification of the exchange markets (including capital transactions) before June 30, 1995.

21. Since April 1990 Nicaragua has made considerable progress in reducing exchange and trade restrictions. However, it still maintains some restrictions on the making of payments and transfers for current international transactions, including those evidenced by certain external payments arrears. These comprise debt service arrears, arrears of domestic importers (trade arrears), and nondebt service arrears (profit remittances) incurred by the previous administration. The Government is committed to the gradual elimination of these restrictions as the country's external situation improves. As a first step in that direction, by the time of the review under

the first -year ESAF arrangement, the Government intends to lift the existing restrictions on the making of payments for certain invisibles (education, health, and travel expenses) through the official market. Regarding the trade arrears and the nondebt service arrears, the Government is not in a position to proceed with their settlement in cash. However, the Government is engaged in bilateral negotiations with importers and external suppliers to obtain a rescheduling and/or reduction of trade arrears, and is negotiating with foreign companies on the issue of profit remittances.

22. The implementation of the policies described above is expected to contribute to a reduction in the external current account deficit (excluding official transfers and interest obligations) from 24 percent of GDP in 1993 to 22 1/2 percent of GDP in 1994, and to around 20 percent of GDP in 1995. Exports in U.S. dollars are projected to increase at an average rate of 11 percent a year during 1994-95 as a result of higher international prices for coffee, and the continued strength of seafood, cotton-substituting crops, and nontraditional exports. Imports are projected to remain about unchanged in 1994 as a result of lower import prices, and to increase by 5 percent in 1995.

23. The Government's program contemplates wide-ranging structural reforms in the areas of property rights, privatization, the financial system, the labor market, and trade, which are described in detail in the Policy Framework Paper (PFP) prepared in collaboration with Fund and Bank Staff. Moreover, a number of structural benchmarks are set out in Table 7 attached.

24. The Government is conscious that a rapid resolution of the property rights issue is essential to establish the basis for private investment and the growth of production and exports. To that effect, it has formulated a plan to complete the administrative revision of claims corresponding to properties confiscated and allocated by the previous administration after the last presidential elections, and to extend an adequate offer of compensation or return the property to legitimate claimants. The Government's plan is described in detail in the PFP (dissatisfied claimants can pursue their claims through the judicial system). Moreover, the Government intends to propose and promote mechanisms to accelerate the judicial resolution of property claims. Compensation payments are being financed with 20-year government bonds, part of which will be redeemed with the resources obtained from the privatization of public entities. The Government intends to explore options, including the use of proceeds from further sales of state-owned assets, to increase the market value of these bonds. Available options will be reviewed carefully to ensure consistency with the fiscal targets of the program.

25. In the area of privatization, before end-October 1994 the Government will offer for sale at least 40 percent of the shares of the state-owned telecommunications company (TELCOR), including a management contract (the net proceeds from the privatization will be used to redeem compensation bonds). To that effect, no later than end-July 1994 the Government will proceed with the issuance of regulations pertaining to the privatization law

and will present to the National Assembly a draft law for the telecommunications sector permitting the privatization of TELCOR.

26. The Government also will divest two subsidiaries of INE (ENIGAS and LUBNICA) before end-May 1994; and will offer for sale, offer for lease to the private sector, or cease the operations of all but 39 enterprises still managed by CORNAP before end-May 1994, and at least another 33 CORNAP enterprises as well as one enterprise under the Hinistry of Construction and Transport before end-1994. The Government also will divest some of the activities of the state oil company (PETRONIC), including its gas stations, and vi.11 separate its regulatory from its operational functions before end-June 1995. Moreover, in the context of the Public Utilities Reform Loan from the IDB, before end-1994 the Government will present draft legislation to the National Assembly allowing private sector participation in the hydrocarbon and electricity sectors. The targets on the net international reserves of the Central Bank will be adjusted upwards for the full difference between the net proceeds obtained from TELCOR's partial privatization and the amount of such proceeds used co redeem compensation bonds.

27. To address the problems of high operating costs and poor loan recoveries of the official banks, in mid-1993 the Government embarked on a plan to restructure BANADES (the largest state-owned bank) with technical support from the IDB. The plan contemplates steps to reduce further the bank's staff and the number of-its branch offices and to enforce new loan and loan recovery guidelines. In the case of BANIC (the second-largest state-o-d bank), early this year the Government replaced the management and some of the Directors of the bank. In addition, a plan to improve loan recovery, cut operating costs, and reduce loan concentration will be prepared before presentation of the first-year ESAF supported program to the Executive Board of the Fund. Subject to a more detailed analysis of the situation of the bank, the new management intends to reduce BANIC's operating losses (defined as excluding gains from exchange rate corrections) in 1994 by at least half of the level registered in 1993 (estimated at C$ 12-13 million), and eliminate them altogether in 1995. Both banks will continue to comply with the norms established by the Superintendency, any recapitalization of either bank with government resources will be avoided, and any revaluation of the banks' assets will be limited to cover a deficit in loan provision requirements and/or the indemnization expenses that could arise as a result of the downsizing of the banks' structure.

28. The Government also intends to strengthen the FNI's loan recovery procedures and avoid generalized restructuring of commercial bank loans, and will proceed with the recapitalization of the Central Bank before end-June 1995. Several actions are also being taken to strengthen the role of tie Superintendency of Banks, including the issuance before end-nay 1994 of revired prudential norms on loan classification and provisioning of restructured loans. Other actions to be adopted by December 1994 include the issuance of a decree or, if necessary, the presentation of legislation to the National Assembly increasing penalties for non-compliance with prudential

norms, and the inclusion of the MI and the Nicaraguan Insurance Institute (INISER) in the Superintendency's inspection program.

29. The Government is of the view that achieving a more efficient and flexible operation of the labor market in Nicaragua is crucial for increasing productivity, improving external competitiveness, and reducing unemployment. The National Assembly is currently discussing reforms to the labor code and, in the context of these discussions, the Government has presented draft legislation aimed at permitting temporary contracts as an important step to reduce entry-exit barriers, developing more balanced strike regulations. reducing severance payments, and giving powers to the Ministry of Labor (MITRAB) to pronounce on the legality of strikes. The Government's policy intentions in this area are described in detail in a letter of Labor Policy that was prepared in April 1994. During the program period the Government intends to follow the principles and procedures established in this letter.

30. In the trade area, the Government intends to proceed with its liberalization program at a somewhat more gradual pace than had been envisaged previously, partly because of fiscal considerations. To render the trade system more transparent, the Government has abolished the selective consumption tax (ISC) and the luxury consumption tax (IBS) and has replaced them by a temporary tariff (applying to 750 import items) and a specific consumption tax (applying to all products previously subject to the ISC and the IBS, but without discriminating against imports in favor of domestic goods). The Government's program contemplates a reduction of import taxes from the present range of 10-40 percent to 10-37 percent by June 1995, 10-35 percent by January 1996. and 10-32 percent by January 1997, without precluding the possibility of applying compensatory tariffs in cases of dumping as permitted by GATT agreements. All imports will be subject to this general reduction, with the exception of the items denoted "fiscal industries", pending review of the fiscal implications of this measure. During the program period the Government will refrain from introducing any non-tariff barriers on exports or imports not justified by health or security reasons.

31. Given the country's critical social indicators, the Government places a high priority on strengthening its social program for 1994-97. To facilitate the execution of its social strategy, in January 1993 the Government created the Ministry of Social Action (HAS). The Government's social strategy consists of two components. The first component concentrates on medium-term reforms in the line Hinistries to improve the provision of basic social services, particularly primary health care and primary education, while the second component focuses on poverty alleviation programs targeted to the most vulnerable groups. These programs include: (i) the Emergency Social Investment Fund (FISE), which aims to rehabilitate economic and social infrastructure and to provide temporary employment in poor areas; and (ii) the National Reconciliation and Rehabilitation Program (PRRN), which supports vulnerable groups in regions affected by the war. In addition, in January 1993 the Government created the Community Employment Fund, which provides temporary employment in local communities. In 1994-96 FISE is expected to

double its expenditures tied to external financing to about US$75 million, compared with US$37 million in 1991-93. This is expected to allow for the creation of almost 20,000 jobs in 1994-95. Also, the public employment reduction program to be implemented in 1994-96 contemplates that employees leaving public service would continue to draw their full salary for up to three years, depending on length of service in the public sector.

32. The two major environmental issues in Nicaragua are water pollution and deforestation. Other problems include soil erosion in the North Pacific region, pesticide poisoning, and the deterioration of coastal and marine ecosystems. To address these problems, the Government has prepared an Environmental Action Plan, which is being implemented with donor support. and will prepare environmental norms and regulations for water, fisheries and mining before end-1994. Deforestation problems will be addressed by eliminating uncertainty about land rights and expanding private sector participation in the forestry industry under a clearly defined regulatory framework, which will be ready before end-1994. Water pollution problems are being tackled within the framework of an IDB project and an IDA Water and Sewerage Project. Soil erosion is being addressed by incorporating soil conservation practices in research and extension programs supported by an IDA agricultural credit.

33. The success of the adjustment effort and the resumption of sustained growth will depend, to a large extent, on the level of support from the international financial community. The program is based on a level of external grants and credits (project and non-project related) of at least US$560 million in 1994 and US$520 million in 1995. Total disbursements of nonproject-related loans and grants (excluding disbursements from the Fund, and loans from BCIE and the IDB to finance credit operations of the FNI) are projected at US$224 million in 1994 and US$176 million in 1995. Disbursements of non-project related loans and grants in 1994 include US$52 million from the World Bank under an Economic Recovery Credit II and IDA reflows; US$40 million from the IDB under a Public Sector Utilities Loan; US$30 million from Taiwan; and US$102 million corresponding to cofinancing of the Economic Recovery Credit II and other donor assistance. Disbursements of non-project related loans and grants in 1995 include US$42 million from the World Bank under the Economic Recovery Credit II and a subsequent Economic Recovery Credit III; US$50 million from the IDB under the Public Sector Utilities Loan and an Investment Sector Loan; and US$84 million corresponding to cofinancing of the Economic Recovery Credit II and financial assistance from Taiwan and donor countries. To obtain the support of donors and creditors the Government has convened a Consultative Group Meeting to be sponsored by the World Bank. which will be held in Paris on June 16, 1994.

34. Debt management will seek to improve the terms and maturity structure of Nicaragua's external debt. To this end, during the program period the Government intends to rely on concessional credit and to minimize borrowing on nonconcassional terms. Accordingly, Table 5 specifies limits on the net disbursements of public and publicly guaranteed debt with a maturity of less than one year, of one to five years, and of five to twelve years.

35. The targets for the net international reserves of the Central Bank of Nicaragua will be adjusted upward/downward by the full amount by which non-project grants and credits exceed/fall-short, or actual debt service payments fall-short/exceed, the cumulative amounts shown in the attached Schedule I (total debt service payments, including payments of arrears, are projected at US$249 million in 1994 and at US$257 million in 1995). The combined upward adjustments would be limited to US$20 million (additional disbursements and/or lower debt service payments in excess of this amount will be used to finance credit to the private sector through the private banks), while the combined downvard adjustments would be limited to US$15 million (any shortfall in excess of this amount would be offset through the adoption of further adjustment measures, including fiscal actions and a tightening of credit to the private sector).

36. Given Nicaragua's heavy debt service burden, the exceptional financing needs for the period 1994-95 will be substantial. Based on the program, these needs are projected at about US$1,220 million in 1994 and at US$560 million in 1995, excluding the rescheduling of arrears with official bilateral creditors and the resources that would be needed for debt reduction operations with the commercial banks: (The exceptional financing needs for 1994, including the rescheduling of arrears with official bilateral creditors, would amount to US$4,180 million.) The program assumes no payments to non-Paris Club official bilateral creditors and to commercial banks prior to the conclusion of the negotiations with these creditors. Filling the exceptional financing needs for 1994-95 would require concessional rescheduling from Paris Club official bilateral creditors, and debt relief from non-Paris Club official bilateral creditors on terms comparable to those obtained from Argentina, Mexico, Venezuela, and other Latin American countries, which provided for debt cancellation equivalent to 90-95 percent in present value terms.

37. The Government will request that a Paris Club meeting be held after Fund approval of the ESAF arrangement in order to consider a nev rescheduling of its obligations and the matter of its debt stock. In the meantime, the Government intends to continue making its best efforts to conclude two bilateral agreements that are still pending from the Paris Club Minute agreed in December 1991. Efforts also Will continue to reach understandings with non-Paris Club official bilateral creditors on a comprehensive solution of Nicaragua's external debt problem. To that end, a Nicaraguan delegation is expected to visit the Russian Federation following the negotiations with Paris Club creditors. Regarding the external debt with the commercial banks, IDA has committed US.925 million under its debt reduction facility for possible debt reduction operations and the Swiss Government has hosted an informal donors meeting to initiate the process of seeking additional concessional assistance. The Government is now intensifying its bilateral contacts with donor countries to obtain the resources required for debt-reduction operations and intends to make a new appeal on this matter to the international financial community in the context of the upcoming Consultative Group Meeting.

38. Nicaragua's difficult balance of payments situation has resulted in the buildup of a large amount of external debt service arrears. As of end-December 1993 total external debt service arrears (excluding arrears to commercial bank creditors) were estimated at about US$3.1 billion. of which US$2.8 billion were arrears to non-Paris Club official bilateral creditors, mostly of the debt incurred by the previous administration. Some small arrears to the World Bank and the IDB have been cleared and all arrears on post-cut-off date debt and other nonreschedulable arrears to Paris Club creditors will be settled before the date of the next Paris Club meeting. Moreover, before June lst, 1994. the Government will proceed to make a provision of US$8 million in an earmarked account as a sign of goodwill to cover possible payments on the 1991 rescheduling with tbe two Paris Club creditors with whom bilateral agreements have not yet been concluded. With regard to non-Paris Club official bilateral creditors, all arrears are assumed to be settled in the context of the negotiations with these creditors. In addition, the Government is committed to making all current debt service payments on a timely basis except for those pending renegotiation and to avoid the accumulation of new arrears during the program period. Based on the projected flows of foreign financing, a schedule for the settlement of all debt service arrears except for those pexiing renegotiation has been set out in Table 6 attached.

39. The Government of Nicaragua believes that the policies set forth in this letter are adequate to achieve the objectives of the program and will take any further measures that may become appropriate for this purpose. To support its medium-term program during the period 1994-93, the Government hereby requests from the Fund a three-year arrangement mder the Enhanced Structural Adjustment Facility in a total amount equivalent to SDR 120.12 million (125 percent of quota); and the first annual arrangement thereunder in an amount equivalent to SDR 40.04 million (41.66 percent of quota). During the period of the first annual arrangement. the Government of Nicaragua will consult with the Fund on the adoption of any measures that may be appropriate, at the initiative of the Government or whenever the Managing Director of the Fund requests such consultation. Moreover. after the period of the first annual arrangement and while Nicaragua has outstanding financial obligations to the Fund arising from loans under the arrangement, the Government will consult vith the Fund from time to time, at the initiative of the Government or whenever the Managing Director requests consultation on Nicaragua's economic and financial policies. Nicaragua is committed to provide the Fund with such information as the Fund requests on the progress made in policy implementation and the achievement of the program objectives.

40. In addition, the Government will conduct with the Fund a mid-term review of the first annual program, to be completed not later than February 28, i995.

Sincerely yours,

Jose Evenor Taboada A.
Minister President
Central Bank of Nicaragua

Emilio Pereira A.
Minister of Finance

Attachments

Table 1. Nicaragua: Limits on Central Government Current Expenditures 1/2/3/

(In millions of cordobas)

Period	Limits	
Cumulative change from December 31. 1993		
Through March 31, 1994	646	(projected)
Through June 30, 1994	1,227	(projected)
Through September 30, 1994	1,827	
Through December 31, 1994	2,521	
Cumulative change from December 31, 1994		
Through March 31, 1995	690	
Through June 30, 1995	1,323	

1/ Defined to include budgetary and extrabudgetary operational expenditures (including severance payments related to the employment reduction program), current transfers, and domestic and external interest payments. These limits will be adjusted upward/downward by the amount by which current external interest payments exceed/fall short of the amounts shown in column (3) of the attached Schedule II. The upward adjustments will be limited to US$7 million.

2/ The September 30, 1994 and the December 31, 1994 ceilings will be adjusted downward by the full amount by which domestic interest payments fall short of the amounts contemplated in the program, which are C$5 million through end-September 1994. and C$48 million through end-1994.

3/ The ceiling for December 31. 1994 constitutes a performance criterion of the program. All other ceilings are quantitative benchmarks.

Table 2. Nicaragua: Limits on the Net Domestic Financing of the Combined Public Sector 1/2/3/

(In millions of cordobas)

Period	Limits
Cumulative change from December 31, 1993	
Through March 31, 1994	-50 (actual)
Through June 30, 1994	164 (projected) 4/
Through September 30, 1994	-287
Through December 31, 1994	-621
Cumulative change from December 31, 1994	
Through March 31, 1995	125
Through June 30, 1995	72

1/ Includes bank and nonbank financing of the nonfinancial public sector as well as the operational losses of the Central Bank of Nicaragua. Nonbank financing of the nonfinancial public sector includes domestic bond placements outside the financial system (excluding placements of compensation bonds) and any change in outstanding domestic obligations, including suppliers' credits. The nonfinancial public sector is defined to include the Central Government, the Municipality of Managua, the Social Security Institute (INSSBI), the Nicaraguan Electricity Institute (INE), the Water and Sewerage Institute (INAA), and the Telecommunications Company (TELCDR) (telephone operations will be included until end-September 1994). Disbursements and amortization payments in foreign currency will be converted to cordobas at C$6.8 per U.S. dollar during 1994, and at C$7.6 per U.S. dollar from January 1 through June 30, 1995.

2/ These limits will be adjusted: a) upward/downward by the full amount by which non-project grants and loans fall short/exceed, or actual debt service payments exceed/fall-short of, the amounts shown in columns (1) and (2) of the attached Schedule II (the combined upward adjustment will be limited to US$15 million); b) downward by the full difference betveen the net proceeds obtained from TELCOR's partial privatization and the amount of such proceeds used to redeem compensation bonds; and c) upward/downward by the full amount by which non-project grants and loans assumed in the program to be disbursed to the nonfinancial public sector/the Central Bank are disbursed to the Central Bank or viceversa.

3/ The ceiling for December 31, 1994 constitutes a performance criterion of the program. All other ceilings are quantitative benchmarks.

4/ The outcome for June 30, 1994 could be up to C$109 million higher than this projection depending on the result of negotiations with the Central American Bank for Economic Integration (BCIE) and other external creditors regarding the distribution of payments between the second and third quarters.

Table 3. Nicaragua: Ceilings on the Cumulative Change in the Net Domestic Assets of the Central Bank 1/2/3/4/

(In millions of cordobas)

Period	Limits
December 31, 1993-March 31, 1994	-226 (actual)
December 31, 1993-June 30, 1994	-33 (projected) 5/
December 31, 1993-September 30, 1994	-146
December 31, 1993-December 31. 1994	-255
December 31, 1993-March 31, 1995	-85
December 31, 1993-June 30, 1995	-179

1/ Net domestic assets are defined as the difference between currency in circulation and the net international reserves of the Central Bank (as defined in Table 4).

2/ Amounts denominated in foreign currency will be converted to cordobas at C$ 6.8 per U.S. dollar during 1994, and at C$ 7.6 per U.S. dollar from January 1 through June 30, 1995.

3/ These limits will be adjusted: a) upward/downward by the full amount by which nonproject grants and loans fall-short/exceed, or actual debt service payments exceed/fall-short, of the amounts shown in columns (1) and (2) of the attached Schedule I (the combined upward adjustment will be limited to US$15 million, while the combined downward adjustment will be limited to US$20 million); and b) downward by the full difference between the net proceeds obtained from TELCOR's partial privatization and the amount of such proceeds used to redeem compensation bon&. Additional disbursements and/or lower debt service payments in excess of the US$20 million referred to in (a) will be used only to finance credit to the private sector through the private banks.

4/ The ceiling for December 31, 1994 constitutes a performance criterion of the program. All other ceilings are quantitative benchmarks.

5/ The outcome for June 30, 1994 could be up to C$143 million higher than this projection depending on the result of negotiations with the Central American Bank for Economic Integration (BCIE) and other external creditors regarding the distribution of payments between the second and third quarters.

Table 4. Nicaragua: Targets for the Stock of Net International Reserves of the Central Bank 1/2/3/

(In millions of U.S. dollars)

Period	Floors
December 31, 1993	5.5 (actual)
March 31, 1994	40.9 (actual)
June 30, 1994	10.2 (projected) 4/
September 31, 1994	27.9
December 31, 1994	50.5
March 31, 1995	30.5
June 30. 1995	40.5

1/ Defined as the difference between the gross foreign assets and the short term foreign liabilities including the net IHF position. The SDR is to be converted at US$1.35-SDR 1 and gold holdings of the Central Bank are to be valued at US$360 per troy ounce. These targets will be adjusted in case that the figure for the net international reserves of the Central Bank as of December 31, 1993 is revised, in order to maintain the quarterly flows during the program period.

2 These targets will be adjusted: a) upward/downward by the full amount by which non-project grants and loans exceed/fall-short, or actual debt service paymen.s fall-short/exceed, the amounts shown in columns (1) and (2) in the attached Schedule I (the combined upward adjustments will be limited to US$20 million, while the combined dovnvard adjustment vill be limited to US$15 million); and b) upvard for the full difference between the net proceeds obtained from TELCOR's partial privatization and the amount of such proceeds used to redeem compensation bonds.

3/ The target for December 31, 1994 constitutes a performance criterion of the program. All other targets are quantitative benchmarks.

4/ The level of NIR for June 30, 1994 could be up to US$21 million below this projection depending on the outcome of negotiations with the Central American Bank for Economic Integration (BCIE) and other external creditors regarding the distribution of payments between the second and third quarters.

Table 5. Nicaragua: Limits on Net Disbursements of External Loans Contracted or Guaranteed by the Public Sector 1/

(In million of U.S. dollars)

Period	Limits
Cumulative from December 31, 1993	
a) Debt with a maturity of l-12 years:	
Through June 30, 1994	50
Through September 30, 1994	65
Through December 31, 1994	75
Through March 31, 1995	95
Through June 30, 1995	110
b) Debt with a maturity of l-5 years:	
Through June 30, 1994	10
Through September 30, 1994	15
Through December 31, 1994	15
Through March 31, 1995	20
Through June 30, 1995	25
c) Debt with a maturity of less than 1 year 2/	
Through June 30, 1994	--
Through September 30, 1994	--
Through December 31, 1994	--
Through March 31, 1995	--
Through June 30, 1995	--

1/ The limits for December 1994 constitute a performance criterion of the program. All other targets are quantitative benchmarks.

2/ Excluding normal Import-related credits and reserve liabilities of the Central Bank.

Table 6. Nicaragua: Limits on the Stock of External Payments Arrears 1/2/3/

(in millions of U.S. dollars)

Period	Limits
December 31, 1993 (estimate)	23
March 31, 1994 (estimate)	47
June 30, 1994	42 (projected) 4/
September 30, 1994	10
December 31, 1994	--
March 31, 1995	--
June 30. 1995	--

1/ No new arrears will be incurred within the program period.
2/ Includes debt service arrears only. Excludes arrears pending renegotiation.
3/ The limits for December 31, 1994 constitute a performance criterion of the program. All other targets are quantitative benchmarks.
4/ The outcome for June 30, 1994 could be up to US$21 million lower than this projection depending on the result of negotiations with the Central American Bank for Economic Integration (BCIE) and other external creditors regarding the distribution of payments between the second and third quarters.

Table 7. Nicaragua: Structural Benchmarks Under the First Annual Arrangement Under the Enhanced Structural Adjustment Facility

Benchmarks		Timetable
1. Public		
(i)	Implement the voluntary employment reduction program to reduce the number of public sector employees by 7,000.	Through-end 1994
(ii)	Implement the voluntary employment reduction program to reduce the number of public sector employees by an additional 2,000.	January 1, 1995-June 30, 1995
2. Credit		
(i)	Eliminate central bank financing of the state-owned banks on a net basis (financing could change during the year because of seasonal reasons). 2/	Throughout program period 1/
(ii)	Limit incremental central bank financing of the FNI to the re-lending of the external resources provided by regional institutions and external donors for specific programs, net of programmed repayments to the Central Bank. 3/	Throughout program period 1/

1/ Constitute structural performance criteria of the program for the period January 1, 1994-December 31, 1994, to be measured on an end-of-yea- basis.
2/ Net central bank financing of the state-owned banks (disbursements minus repayments) will be zero in calendar year 1994. This limit will be adjusted downward fnr any sale of portfolio of the state-owned banks to the private banks that could result in a reduction of central bank claims vis-a-vis the state-owned banks.
3/ Repayments to the Central Bank are programmed at C$35 million in 1994.

Table 7. Nicaragua: Structural Benchmarks Under the First Annual Arrangement Under the Enhanced Structural Adjustment Facility (Continued')

Benchmarks		Timetable
3.	Interest Rates	
	Maintain the mechanism by which central bank interest rates (short- and long-term) are set quarterly on the basis of an average of the rates on 30-day deposits plus a spread of 1/4 of one percentage point.	Throughout program period 1/
4.	Financial Sector Reform	
(i)	Avoid any recapitalization of BANADES or BANIC with government resources. Any revaluation of the banks' assets will be limited to cover a deficit in loan provision requirements and/or indemnization expenses to personnel, and their continued compliance with the prudential norms of the Superintendency will be enforced.	Throughout program period
(ii)	Reduce BANIC's operating losses (excluding gains from exchange rate corrections) by at least half of the 1993 level (estimated at C$ 12-13 million).	January 1st, 1994-December 31, 1994
5.	Privatization	
(i)	Proceed with the issuance of regulations pertaining to the privatization law and present to the National Assembly a draft Law for the telecommunications sector permitting the privatization- of TELCOR.	No later than end-July 1994
(ii)	Offer for sale at least 40 percent of the shares of the state-owned telecommunications company (TELCOR), including a management contract.	End-October 1994 2/
(iii)	Offer for sale, offer for Lease to the private sector, or cease the operations of all but 39 enterprises still managed by CORNAP.	End-Hay 1994

1/ Constitutes a structural performance criterion for the period through December 31. 1994. Compliance with this performance criterion will be determined on the basis of the Technical Memorandum of Understanding.

2/ Constitutes a structural performance criterion under the program.

Table 7. Nicaragua: Structural Benchmarks Under the First Annual Arrangement Under the Enhanced Structural Adjustment Facility (Concluded)

Benchmarks		Timetable
(iv)	Offer for sale, offer for lease to the private sector, or cease the operations of at least another 33 enterprises still managed by CORNAP.	End-1994 1/2/
(v)	Present draft Legislation to the National Assembly allowing private sector participation in the hydrocarbon and electricity sectors.	End-1994
6. Exchange and Trade Policy		
(i)	Lift existing restrictions on the making of payments for education, health, and travel expenses through the official market.	February 28. 1445
(ii)	Eliminate multiple currency practice through full unification of the exchange markets (including capital transactions).	June 30, 1995
(iii)	Refrain from introducing any non-tariff barriers on exports or imports not justified by health or security reasons.	Through June 30, 1995

1/ Constitutes a structural performance criterion under the program.
2/ This implies that all but six enterprises still managed by CORNAP will be offered for sale, offered for Lease, or cease their operations before end-1994.

SCHEDULE

Cumulative Clsbursements of Nonproject-Related
Grants and Loans 1/

(In millions of U.S. dollars)

	Total Public Sector (1)
December 31. 1993-June 30, 1994	73
December 31, 1993-September 30, 1994	146
December 31, 1993-December 31, 1494	224
December 31, 1993-March 31. 1995	
December 31, 1993-June 30, 1995	289

Programmed cash debt service payments
(including debt service arrears)

	Total Public Sector (2)
December 31, 1993-June 30, 1994	95
December 31, 1993-September 30, 1994	175
December 31, 1993-December 31, 1994	249
December 31. 1993-March 31, 1995	301
December 31, 1993-June 30, 1995	371

1/ Excludes disbursements by BCIE and FIV and the non-convention&! credit line from the IDB.

SCHEDULE II

Cumulative disbursements of non-project related grants and loans 1/

(In millions of U.S. dollars)

	Total Nonfinancial Public Sector (1)
December 31, 1993-June 30, 1994	16
December 31, 1993-September 30, 1994	a9
December 31, 1993-December 31, 1994	167
December 31, 1994-March 31, 1995	6
December 31, 1994-June 30, 1995	29

Programmed cash debt service payments

	Total Debt Service of Nonfinancial Public Sector plus Central Bank Interest Payments (2) 2/	Central Government Interest Payments (3)
December 31, 1993-June 30, 1994	85	37
December 31, 1993-September 30, 1994	149	59
December 31, 1993-December 31, 1994	204	80
December 31, 1994-March 31, 1995	47	24
December 31, 1994-June 30, 1995	105	46

1/ Excludes disbursements by BCIE and FIV.
2/ Includes debt service arrears.