Document of
The World Bank

Report No. 25887

PROJECT PERFORMANCE ASSESSMENT REPORT

NICARAGUA

ECONOMIC RECOVERY CREDIT
(Credit No. 2302-NI)

and

SECOND ECONOMIC RECOVERY CREDIT
(Credit No. 2631-NI)

May 8, 2003

Country Evaluation and Regional Relations Group
Operations Evaluation Department

Currency Equivalents (annual averages)

Currency Unit = Córdoba Oro

1994	US$1.00 = 6.72			1998	US$1.00	=	C$10.58
1995	US$1.00 = 7.55			1999	US$1.00	=	C$11.81
1996	US$1.00 = 8.44			2000	US$1.00	=	C$12.68
1997	US$1.00 = 9.45			2001	US$1.00	=	C$13.37

Abbreviations and Acronyms

BANADES	Banco Nacional de Desarrollo
BANIC	Banco Nicaragüense de Industria y Comercio
BIN	Banco Inmobiliario
BP	Banco Popular
COBANICA	Junta liquidadora de activos de BANADES
CORFIN	Corporación Financiera de Nicaragua
CORNAP	Corporaciones Nacionales del Sector Público
ENEL	Empresa Nicaragüense de Electricidad
ENIGAS	Empresa Nicaragüense de Gas
ENITEL	Telecommunications Enterprise *(Empresa Nicaragüense de Telecomunicaciones)*
ERC	Economic Recovery Credit
ESAF	Enhanced Structural Adjustment Facility
GDP	Gross Domestic Product
ICR	Implementation Completion Report
IDA	International Development Association
IDB	Inter-American Development Bank
IMF	International Monetary Fund
INAA	Nicaraguan Institute for Water and Sewerage
INE	Nicaraguan Energy Institute
INIFOM	Instituto Nicaragüense de Fomento Municipal
INSS	Instituto Nicaragüense del Seguro Social
LUBNICA	Lubricantes de Nicaragua
MARENA	Ministry of Environment and Natural Resources
MCT	Ministry of Construction and Transportation
MEDC	Ministry of Education, Sports and Culture
MEDE	Ministry of Economy and Development
MIFIN	Ministry of Finance
NFPS	Non-financial public sector
OED	Operations Evaluation Department
PCR	Project Completion Report
PETRONIC	State Petroleum Company *(Empresa Nicaragüense del Petróleo)*
PPAR	Project Performance Assessment Report
SBIF	Superintendencia Bancaria y de Instituciones Financieras
TELCOR	Telecommunications and Postal Services Company

Fiscal Year

January 1 to December 31

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GREGORY K INGRAM
Office of the Director-General
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May 8, 2003

MEMORANDUM TO THE EXECUTIVE DIRECTOR AND THE PRESIDENT

SUBJECT: Project Performance Assessment Report on Nicaragua Economic Recovery Credit (Credit No. 2302-NI) and Second Economic Recovery Credit (Credit No. 2631-NI)

Attached is the Project Performance Assessment Report (PPAR) on the above credits to Nicaragua, made from 1991 to 1996. The main objectives of the two operations supported stabilization, adjustment and structural reforms. They intended to support the government's program to arrest the decline of GDP, to revive growth in a sustainable and equitable manner, and to achieve lasting price stability. Besides supporting the macroeconomic objectives, the Second Economic Recovery Credit aimed at helping the county adjust to lower levels of foreign aid and establishing conditions to revive the private sector.

The adjustment credits succeeded in achieving their objectives, especially the First Economic Recovery Credit, but it took beyond the implementation period to see their impact on the economy. The First Economic Recovery Credit met all the conditions and succeeded in bringing inflation down, from about 380 percent in 1991 to about 24 percent in 1992, and in arresting the decline in GDP. Its short term impact on output was below the strong and fast response that the authorities and IDA had expected when they agreed to the loan, but the higher growth rates since 1994 (above 4 percent) owe much to the large structural reforms and initial stabilization effort that ERC-I supported. After the political uncertainty about the direction of economic policy ended, investors and producers have responded as expected, and GDP has grown every year since 1994.

The PPAR rates the outcome of the Economic Recovery Credit I as *satisfactory*, higher than the marginally satisfactory of the ICR and the marginally unsatisfactory of OED's evaluation summary. The PPAR rates the sustainability of the ECR I as *likely*, higher than the uncertain of the evaluation summary, and institutional development impact as *substantial*, higher than the negligible of the evaluation summary. Borrower performance is rated satisfactory, as the evaluation summary. Bank performance is rated satisfactory, higher than the evaluation summary.

The Second Economic Recovery Credit met part of its goals for structural reform. The labor mobility program met its objective of reducing public sector employment, which fell more than its target of 13,500 positions (about 8 percent of public sector employment). The privatization program achieved most of its objectives, and the

Government divested 76 of the 89 enterprises that remained, but did not complete the transfer of ownership for all, especially two important ones, PETRONIC (petroleum) and TELCOR (telecommunications). The Government also began to improve the climate for private sector development; it advanced in resolving *property rights* disputes by, among others, reviewing more than 100,000 cases related to properties in the housing and rural sectors, and solving the disputes in 82 percent of rural cases and 98 percent of housing cases. The reform of the *financial system* fell short of plans, and the strategy for containing the growth of state banks was partially executed; two state banks continued dominating the banking sector, and were exempted from complying with prudential norms. On the positive side, the Government submitted to the Legislature a General Banking Law that aimed at strengthening the regulatory powers of the Superintendencia Bancaria y de Instituciones Financieras (SBIF).

The PPAR rates the outcome of the Economic Recovery Credit II as *satisfactory*, higher than OED's evaluation summary, the sustainability as *likely*, higher than the uncertain of the evaluation summary, and institutional development impact as substantial, higher than the evaluation summary. Borrower performance is rated *satisfactory*, as the evaluation summary. Bank performance is rated *satisfactory*, as the evaluation summary.

The main lessons derived are:

- IDA must tone down its expectations of what reforms can achieve in a short time. IDA identified correctly the nature of the risks of failure, but it overestimated the response to the reforms supported by both credits. IDA and the Borrower assumed unrealistically that stabilization could be achieved in two years, and that an economic recovery based on private sector growth would occur in parallel.

- An adjustment program that aims at private sector led growth should focus from the beginning on developing and guaranteeing property rights, which are critical to restoring confidence of private investors. ERC-I did not focus on the property rights issue and the desired response of the private sector did not materialize.

- When the adjustment program requires deep economic changes, problems that need long-run solutions must be tackled early, under a global strategy whose rationale, constraints and benefits must be understood and accepted prior to approval of the credit. IDA and the Borrower should work to prepare civil society for the changes needed and forthcoming, and whose benefits are not evident to the general public at first.

Gregory K. Ingram

OED Mission: Enhancing development effectiveness through excellence and independence in evaluation.

About this Report

The Operations Evaluation Department assesses the programs and activities of the World Bank for two purposes: first, to ensure the integrity of the Bank's self-evaluation process and to verify that the Bank's work is producing the expected results, and second, to help develop improved directions, policies, and procedures through the dissemination of lessons drawn from experience. As part of this work, OED annually assesses about 25 percent of the Bank's lending operations. In selecting operations for assessment, preference is given to those that are innovative, large, or complex; those that are relevant to upcoming studies or country evaluations; those for which Executive Directors or Bank management have requested assessments; and those that are likely to generate important lessons. The projects, topics, and analytical approaches selected for assessment support larger evaluation studies.

A Project Performance Assessment Report (PPAR) is based on a review of the Implementation Completion Report (a self-evaluation by the responsible Bank department) and fieldwork conducted by OED. To prepare PPARs, OED staff examine project files and other documents, interview operational staff, and in most cases visit the borrowing country for onsite discussions with project staff and beneficiaries. The PPAR thereby seeks to validate and augment the information provided in the ICR, as well as examine issues of special interest to broader OED studies.

Each PPAR is subject to a peer review process and OED management approval. Once cleared internally, the PPAR is reviewed by the responsible Bank department and amended as necessary. The completed PPAR is then sent to the borrower for review; the borrowers' comments are attached to the document that is sent to the Bank's Board of Executive Directors. After an assessment report has been sent to the Board, it is disclosed to the public.

About the OED Rating System

The time-tested evaluation methods used by OED are suited to the broad range of the World Bank's work. The methods offer both rigor and a necessary level of flexibility to adapt to lending instrument, project design, or sectoral approach. OED evaluators all apply the same basic method to arrive at their project ratings. Following is the definition and rating scale used for each evaluation criterion (more information is available on the OED website: http://worldbank.org/oed/eta-mainpage.html).

Relevance of Objectives: The extent to which the project's objectives are consistent with the country's current development priorities and with current Bank country and sectoral assistance strategies and corporate goals (expressed in Poverty Reduction Strategy Papers, Country Assistance Strategies, Sector Strategy Papers, Operational Policies). *Possible ratings:* High, Substantial, Modest, Negligible.

Efficacy: The extent to which the project's objectives were achieved, or expected to be achieved, taking into account their relative importance. *Possible ratings* High, Substantial, Modest, Negligible

Efficiency: The extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and benefits at least cost compared to alternatives. *Possible ratings:* High, Substantial, Modest, Negligible. This rating is not generally applied to adjustment operations.

Sustainability: The resilience to risk of net benefits flows over time. *Possible ratings:* Highly Likely, Likely, Unlikely, Highly Unlikely, Not Evaluable.

Institutional Development Impact: The extent to which a project improves the ability of a country or region to make more efficient, equitable and sustainable use of its human, financial, and natural resources through: (a) better definition, stability, transparency, enforceability, and predictability of institutional arrangements and/or (b) better alignment of the mission and capacity of an organization with its mandate, which derives from these institutional arrangements. Institutional Development Impact includes both intended and unintended effects of a project. *Possible ratings:* High, Substantial, Modest, Negligible.

Outcome: The extent to which the project's major relevant objectives were achieved, or are expected to be achieved, efficiently. *Possible ratings.* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Bank Performance: The extent to which services provided by the Bank ensured quality at entry and supported implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of the project). *Possible ratings:* Highly Satisfactory, Satisfactory, Unsatisfactory, Highly Unsatisfactory.

Borrower Performance: The extent to which the borrower assumed ownership and responsibility to ensure quality of preparation and implementation, and complied with covenants and agreements, towards the achievement of development objectives and sustainability. Possible ratings· Highly Satisfactory, Satisfactory, Unsatisfactory, Highly Unsatisfactory.

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This report was prepared by Georges Cahuzac (Consultant) who assessed the projects in January–March 2002 and by Jorge García-García (Task Manager) who finished the report. Norma Namisato provided administrative support.

Principal Ratings

Economic Recovery Credit (Credit 2302-NI)

	ES*	PPAR
Outcome	Mod. Unsat.	Satisfactory
Sustainability	Uncertain	Likely
Institutional Development Impact	Negligible	Substantial
Bank Performance	Marg. Sat.	Satisfactory
Borrower Performance	Satisfactory	Satisfactory

* The Evaluation Summary (ES) is an intermediate OED product that seeks to independently verify the findings of the ICR.

Key Staff Responsible

Project	*Task Manager/Leader*	*Division Chief/ Sector Director*	*Country Director*
Appraisal	Baran Tuncer	Marco Voljc	Rainer Steckhan
Completion	Ivan Rivera	Robert Lacey	Edilberto Segura

Principal Ratings

Second Economic Recovery Credit (Credit 2631-NI)

	*ES**	*PPAR*
Outcome	Mod. Sat.	Satisfactory
Sustainability	Uncertain	Likely
Institutional Development Impact	Modest	Substantial
Bank Performance	Satisfactory	Satisfactory
Borrower Performance	Satisfactory	Satisfactory

* The Evaluation Summary (ES) is an intermediate OED product that seeks to independently verify the findings of the Implementation Completion Report (ICR), a self-evaluation by the responsible operational division of the Bank.

Key Staff Responsible

Project	*Task Manager/Leader*	*Division Chief/ Sector Director*	*Country Director*
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Preface

This is a Project Performance Assessment Report (PPAR) for Nicaragua Economic Recovery Credits I and II. The projects supported economic stabilization and economic reforms aimed at arresting the decline of GDP, reviving growth, achieving price stability, establishing conditions for private sector development and helping Nicaragua adjust to lower levels of foreign aid. The projects were financed through IDA credit 2302-NI for US$110 million, approved on September 3, 1991 and closed on June 10, 1992; and IDA credit 2631-NI for US$60 million approved on May 27, 1994, and closed on June 30, 1996.

The findings of this assessment report are based on a review of President's Reports for the projects, legal documents, project files, related economic and sector work, IMF country reports, and discussions with Nicaraguan officials and the IMF and Bank Group staff.

The draft PPAR was sent to the Borrower, and its comments have been taken into account and reproduced in Annex F of the report.

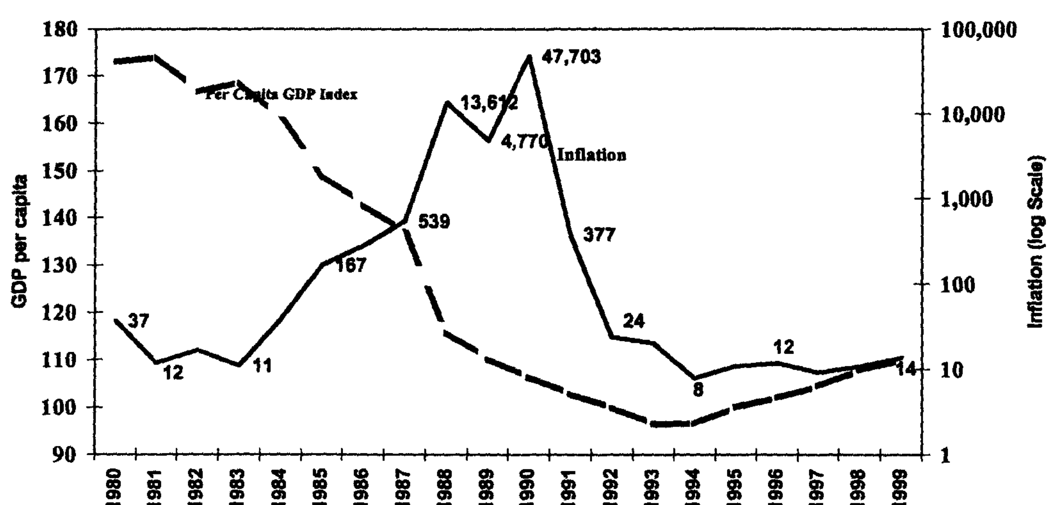
1. Introduction

1.1 OED selected two credits (Economic Recovery I and II) to evaluate the Bank's program of assistance for stabilization, adjustment and reform in Nicaragua, and to derive lessons for future assistance to other countries. The two adjustment operations supported economic reforms during the period 1991–1996.

The Sandinista Legacy

1.2 For eleven years (1979–1990) the Sandinista regime sought to organize the economy along socialist lines, while at the same time facing an armed struggle with groups that opposed the regime. The Sandinistas had nationalized most privately-owned firms and left a non-financial public sector that spent about 50 percent of GDP, of which state-owned companies accounted for 29 percent of GDP. Regulations drowned what remained of a private sector, and a land reform and an urban property redistribution program left a complex property rights problem. Foreign trade was heavily regulated, and state-trading companies did almost all the exporting and about half of import trade. By 1990 the basic institutions of a market economy were defunct and the economy was in tatters: prices rose at about 48,000 percent (see graph below), exports and GDP per capita were about 40 percent their level in the mid 1970s, the fiscal and current account deficits reached 29 and 36 percent of GDP and the external debt was six times the GDP. For the economy to revive, Nicaragua had to eliminate its macro-economic imbalances, reduce the external debt and shift from a command to a market economy. On the political front, Nicaragua had to build its democratic institutions.

Annual Inflation (percent) and Per Capita GDP (1995=100)



The Chamorro Administration: Reversing Sandinista Policies.

1.3 Violeta Chamorro, who took over the Presidency in April 1990, inherited a devastated economy, a polarized society and a large and inefficient state sector. Her administration tried to solve the problems inherited while making efforts to establish peace and build a national consensus to liberalize the economy. To reduce inflation, in May 1990 the Government introduced a second currency (the Córdoba Oro, to be used as a unit of account), pegged it to the US dollar, and tried to reduce the public sector deficit by reducing the wage bill and increasing taxes and the prices of public sector services. The measures failed to achieve their objectives that year, and economic decline and hyperinflation continued as the Government accumulated arrears and financed its deficit with money printed by the Central Bank.

1.4 The administration began to adjust the economy in 1991, under the umbrella of an IMF monitoring program concerted with IDA and IDB. The program set targets for the fiscal deficit and domestic credit expansion. Under the program the Government restrained public expenditures (among others through a program of voluntary retirement of public employees), increased tax collection and reduced the deficit to a level that foreign financial assistance could cover (see Table 1.1). Also, the Government devalued the Córdoba Oro by 400 percent, and, after increasing wages for public sector employees, it increased the prices of public services.

1.5 The Government also took steps to improve fiscal and financial management and to set the basis for structural change. Specifically, it

- completed processing voluntary employment reductions in the public sector (see Annex B);
- had, by the end of 1992, sold, liquidated or returned to their former owners 233 of the 351 firms under CORNAP (Junta General de Corporaciones Nacionales del Sector Público), the State-owned holding company in charge of divesting of state-enterprises (see Annex B);
- limited the role of state-owned trading companies, reduced import taxes and eliminated quantitative restrictions;
- obtained from the National Assembly the approval of a bill to set up a Superintendency for the financial sector, and submitted to Congress a banking and financial institutions law;
- began to restructure the State-owned banks (see Annex D), a sensitive decision that some in the Government questioned; it liquidated Banco Inmobiliario (BIN) and closed the Corporación Financiera de Nicaragua (CORFIN), a holding company that controlled the state banks; it also authorized the operation of three private banks, and adopted a mostly market-determined interest rate policy.

1.6 Political and constitutional crises hampered the adjustment and structural reforms during the implementation of the two economic recovery credits. Disagreements between the Sandinistas and the Government and within the governing party on whether to liberalize the economy made it difficult to decide what to do and when. The conflict slowed the restructuring of state banks because the Government and the Superintendency refused to be responsible for the privatization of Banco Nacional de Desarrollo (BANADES), as the Constitution and Banking laws had conflicting provisions on the matter. Political controversy around property rights and the conflict between the Government and the National Assembly, caused by the Assembly's decision to reduce the power of the Government to handle disputes over property rights, slowed down their solution.

1.7 Even with political consensus, the country lacked the capacity to carry out the changes required. The military conflict that preceded the Sandinistas' takeover of power produced a brain drain that reduced the managerial capabilities of the Government, a loss accentuated during the Sandinista administration. The Chamorro administration could hardly execute its March 1991 stabilization and adjustment program as originally planned. The technical assistance from donors and multilateral institutions could not make up for the country's lack of experience and know-how needed to manage such a program.

1.8 Private investors perceived the risk of doing business as high. The fragile political situation, the weak rule of law, the scant respect for property rights, and the disagreement over economic stabilization clouded the economic prospects. Such perceptions contributed to the weak response of the economy to the economic policies of the administration. Moreover, in 1992 and 1993 the political consensus within the governing party broke down, preventing the National Assembly from approving some of the legislation that supported the Government's stabilization and adjustment program. Rural violence spread, and strikes and demonstrations against restrictive economic policies helped to arrest attempts to introduce fiscal discipline and bring about structural change.

1.9 Despite the difficulties of imposing economic discipline and the risks perceived by the private sector, the economy improved slowly. By the end of 1993 inflation fell to 20 percent but, contrary to the expectations held when the stabilization program started, GDP stagnated, unemployment rose and the current account deficit stayed high, at some 50 percent of GDP (see Table 1.1). The outstanding external debt remained at about 600 percent of GDP. GDP per capita fell, and an IDA Poverty Profile found that in 1993 more than 50 percent of the population lived in poverty. After three years in government, the Chamorro administration realized that it had to reduce government expenditure further, privatize state-owned companies and rely on the private sector to ignite growth and stabilize the economy.

Table 1.1: Key Economic Indicators: 1990–1993

	1990	*1991*	*1992*	*1993*
GDP Growth (percent)	-0.1	-0.2	+0.4	-0.4
Inflation (percent)	7,485	2495	24	20
Unemployment rate (percent)	7.6	11.5	14.4	17.8
Non-financial public sector (NFPS) balance before grants (percent of GDP)	-33.2	-7.7	-8.4	-8.8
NFPS Revenue (percent of GDP)	18.3	25.0	28.6	29.6
NFPS Expenditures (percent of GDP)	51.5	32.7	37.1	38.3
Current Account Balance (percent of GDP)	-36	-49	-59	-48
External Debt (percent of GDP)	685	592	583	608

1.10 The administration sped changes in 1994, with reforms in the state, in the financial sector and, more profoundly, in the conditions of doing business by private sector agents. Most property disputes were reviewed, but the National Assembly added to the climate of uncertainty after approving a law that gave security of possession to the beneficiaries of agrarian and housing reforms during the Sandinista regime. The reforms of the state and the financial sector advanced: tax and fiscal regulations were made more transparent, the ceiling and floor on import duties and surcharges was reduced, and a new Labor Code gave employers more flexibility to hire and dismiss employees. Central government spending fell, but higher spending in the rest of the public sector still resulted in high public sector deficits (9 to 15 percent of GDP) and high levels of spending, 41 to 48 percent of GDP. The support of donors spared the government the need to finance the deficit with central bank credit. That support allowed Nicaragua to write off about 50 percent of its official debt, and to buy back part of its commercial debt; as a result, outstanding debt fell from 600 percent of GDP in 1994 to about 300 percent of GDP in 1997; the debt deals helped reduce the current account deficits by some 20 points of GDP, to 30 percent of GDP (see Table 2.1).

Table 2.1: Key Economic Indicators: 1994–1997

	1994	*1995*	*1996*	*1997*
Real GDP growth (percent)	+3.3	+4.3	+4.8	+5.1
Inflation (percent)	+7.8	+10.9	+11.6	+9.2
Unemployment rate (percent)	17.1	16.9	16.0	14.3
NFPS Balance (percent of GDP)	-13.8	-12.5	-15 4	-9.2
NFPS Revenue (percent of GDP)	29.6	29.3	31.6	34.4
NFPS Expenditure (percent of GDP)	44 90	40 6	47.5	43.9
Current Account Balance (percent of GDP)	-51.5	-36 1	-31.2	-30.3
External Debt (percent of GDP)	638	543	309	297

Source: Central Bank of Nicaragua, World Bank and IMF.

1.11 The policies carried out in 1994–97 improved economic conditions and the country's prospects (see Table 2.1). Total and per capita GDP grew, while unemployment declined. Inflation fell to about 10 percent per year, and the devaluation of the Córdoba (from 6 to 9 Córdobas per US dollar) led to a real depreciation and higher incentives for exporters. Tax incentives for exporters also helped to trigger the large increase in exports observed over the period. Except for government services, every sector began to recover. Notable in the recovery was manufacturing, which benefited from the free trade zones, programs for small and medium size companies, and a progressive flow of foreign investments. Exports of goods increased from 26 to 46 percent of GDP, and imports rose from 52 to 72 percent of GDP. Although the trade deficit remained high, 26 percent of

GDP, the large reduction in external debt helped reduce the deficit in current account from 52 to 30 percent of GDP. Despite the gains, Nicaragua still has much to do to improve the economic well being of its population. By 1997 per capita income was five percent higher than in 1990, but poverty and extreme poverty remained high, at about 50 and 25 percent of the population. After Haiti, Nicaragua has the lowest income per capita in Latin America, and its social indicators rank among the worst in the region.

1.12 Economic performance improved in 1998–2000, as the economy grew faster and inflation and unemployment continued falling (see Table 3.1). Hurricane Mitch caused large economic losses in 1998, but, with Nicaraguans' own resources and support of the donor community, investment increased sharply and the economy recovered quickly in 1999. The large transfers received permitted the Government to finance higher levels of investment and expenditure, but the Government kept its high level of expenditure in 2000 even after the assistance declined; the large expenditure also reflected large outlays related to municipal elections at the end of 2000. Triggered in part by wage increases, the cost of bank resolutions, and a large increase in capital outlays, government expenditure increased in 2001, increasing the combined public sector deficit after grants to about 14 percent of GDP. As a result, the rate of growth fell to about 3.3 percent and 1.0 percent in 2001 and 2002. After its inauguration in January 2002 the administration of President Bolaños reduced expenditures and increased taxes, cutting the deficit after grants to 9.2 percent of GDP. The administration intends to continue the fiscal adjustment in 2003-05 and, supported by an IMF poverty reduction growth facility program approved in December 2002, it expects to reach in 2005 a combined public sector deficit after grants of 3.3 percent of GDP.

Table 3.1: Key Economic Indicators: 1998–2001

	1998	*1999*	*2000*	*2001*	*2002 prel*
Real GDP growth (percent)	4.1	7.4	5.9	3.3	1.0
Inflation (percent)	13	11.2	7.4	7.4	6.0
Unemployment rate (percent)	13.2	10.7	9 9	10.5.	n.a.
NFPS balance before grants (percent of GDP)	-4.1	-14.1	-13.8	-19.0	-16.5
NFPS revenue (percent of GDP)	36 9	35.7	32.5	30.8.	n.a.
NFPS expenditure (percent of GDP)	41.1	49 7	46.4	49.8	n.a.
Current account balance (percent of GDP)	-37.1	-47.9	-38.3	-38.1	-28.0
External debt (percent of GDP)	296	289	278	250	250

Source Central Bank of Nicaragua; World Bank and IMF.

1.13 Over the past 12 years, new economic policies helped to stop economic decline and to lay the basis for faster growth. The political uncertainty of the early nineties prevented a quick response of the economy to the changes in economic policy introduced at the time, but as the uncertainty declined and the direction of economic policy was maintained, the economy started growing faster, and poverty and unemployment declined. The pace of growth faltered in 2001 and 2002, mainly as a result of economic policies, but the administration of President Bolaños expects that better governance and sound fiscal and financial policies will help to accelerate growth. If the administration succeeds, the beneficial impact of the changes supported by ERCI and ERCII will stand.

2. Objectives and Design

2.1 The two operations, part of IDA's assistance strategy, were complementary and supported stabilization, adjustment and structural reforms; they aimed at:

(i) Arresting the decline of GDP;

(ii) Reviving growth in a sustainable and equitable manner; and

(iii) Achieve lasting price stability.

2.2 The program focused on:

(i) Economic management: helping the Government, in coordination with the IMF, to address key fiscal and monetary policy issues;

(ii) Reform of the State: reducing public sector employment, privatizing government companies, and improving the management and institutional capacity of the public sector;

(iii) Financial sector reform: restructuring and closing state-banks, allowing private banks to operate, and establishing a system of supervision and prudential regulation; and

(iv) Private sector development: encouraging the Government to guarantee property rights, to conduct economic policy by rules rather than by discretion of the authorities, and to liberalize the trade regime and labor legislation.

2.3 Both credits had a broad agenda and a complex conditionality for the institutional capacity of the country. Table 4.1 shows the main groups of reforms supported by each credit. From 1994, IDA realized that the Government had to restore the confidence of the private sector for the country to achieve high growth rates, and to do so required it to focus its support on reorienting the role of the State, reducing barriers to private initiative, improving access to domestic financial institutions, and promoting a stable legal framework.

3. First Economic Recovery Credit (ERC-I)

3.1 The political, economic and social crisis prompted IDA, with the cooperation of IDB, to start preparing in January 1991 a long-term assistance strategy. By April 1991, IDA considered Nicaragua eligible for IDA credit, and by May 1991 donors and Nicaragua agreed on clearing Nicaragua's arrears to multilateral development banks. With the agreement in hand, the IMF approved in September 1991 a stand-by credit of US$55.7 million, to be disbursed over 18 months. After approval of the stand-by, IDA granted an Economic Recovery Credit (ERC-I) for US$110 million. The ERC-I

(September 1991–June 1992) was designed as a first step in support of a longer term structural adjustment program aimed at moving the economy from a command economy to a market based one. The financial package included US$132.5 million from IDB, a US$114 million co-financing from the Governments of Japan ($74 million), Germany ($35 million) and Switzerland ($5 million), and US$101 million equivalent from other bilateral donor agencies. In 1990 the U.S. Government had pledged more than US$500 million, of which it had already disbursed some US$300 million by September 1991.

3.2 ***Objectives.*** ERC-I aimed to support the Government's effort in arresting the ongoing decline in the economy, achieving price stability and reviving economic growth on a sustained basis. The credit supported four areas of the Government's economic program, detailed in the Letter of Development Policy. They were:

Table 4.1: Main Components of Economic Recovery Credits I and II

	ERC-I	**ERC-II**
I. Economic Management		
Economic Policy Formulation	(i) Create a stable macroeconomic environment, reducing Central Government non-interest current expenditures to less than US$325 million, and NFPS deficit to 3% of GDP, by 1992. (ii) Implement recommendations of joint Government/IDA public expenditure review.	Maintain supportive macro-economic framework: inflation to reach 10% in 1994 and single digit by 1996; public savings to increase by 2.3% of GDP in 1994, and 1 5% of GDP in 1995 and 1996.
Fiscal Policy	(I) Increase tax revenues removing income tax exemption, approving and satisfactorily implementing a program to phase out indirect tax exemptions including import tax (ii) Initiation of an action plan to improve tax administration with specific emphasis on income tax collection.	Maintain appropriate policy.
Monetary Policy	(I) Maintain tight credit policy and positive real interest rates. (ii) Eventual liberalization of interest rates.	
Exchange rate policy	Achieve full convertibility of Córdoba to create competitiveness in the trade sector.	Accumulation of international reserves to reach over 3 months of import by 1996.
II. Reform of the State		
Labor Mobility Program	(i) Demobilize military forces and militias and retire military officers (5,000). (ii) Stop hiring new employees in Central Government (iii) Introduce and complete voluntary employment reconversion program (target: 10,000 employees)	Design an implement an action plan in order to reduce employment by 13,500 positions during 1994–1996.

	ERC-I	ERC-II
Privatization	Adopt and implement action plan to divest of or complete preparation for divestiture of at least 90% of the enterprises still under CORNAP administration, by the end of 1993.	(i) Complete all the administrative steps needed for liquidation or transfer of ownership of the divested CORNAP and MCT enterprises, and two enterprises in the energy sector (ENIGAS and LUBNICA) (ii) Liquidate or bring to the point of sale some of PETRONIC's operations, especially the distribution of gasoline Satisfactory implementation of TELCOR privatization plan, and bringing to the point of sale a 40 percent share of TELCOR's telecommunications operations (ENITEL).
Public Sector Reform	(i) Start a study on public enterprise rationalization.	Preparation and satisfactory implementation of a three year Public Sector Reform Program and Action Plan, in line with the Governments' Policy Statement, including the restructuring of at least two major public institutions
	(ii) Strengthen tax administration through: operation of unit for large tax payers; issuance of decrees on sanctions applying to delayed payers and non-compliance; initiation of program on automated management control for personnel of Customs and Internal Revenue.	
III. Financial Sector Reform		
Improve Banking Sector Discipline	(i) Adoption of regulation for the implementation of the Law on Superintendency of Bank and start operations of the Superintendency (ii) Submission of a bill to the National Assembly on Banking and Financial Institutions.	(i) Implement agreed action plan to modify or introduce new prudential norms and to improve the functioning of the Superintendency. (ii) Enact decree, action plan, or draft law to increase penalties for non-compliance.
Improve financial information and accounting systems		(i) Design and implement a debtor management system. (ii) Implement a new chart of accounts.
Reform the state-owned banks	Adoption of an action program for their restructuring, carrying out the· (i) liquidation or merger of BIN with BANIC; (ii) dissolution of CORFIN; restructuring of BANIC, BANADES and BP.	Maintain policy of: (i) not recapitalizing state banks through new public sector funds or revaluation of non-financial assets, (ii) ensuring compliance with prudential norms and banking regulations; (iii) no pre-assigning of rediscounts from the Central Bank for specific activities.
Develop a private sector based financial system	Authorize the operation of three private commercial banks.	

	ERC-I	ERC-II
IV. Private Sector Development		
Improve guarantees of property rights		(i) Establish a program to review compliance with current administrative procedures to resolve conflicts over property (ii) Satisfactory implementation of the verification process. (iii) Commission and complete study to analyze financial mechanisms that increase attractiveness of compensation bonds, and implement recommendations in a satisfactory manner.
Reduce uncertainty by eliminating discretionality in the management of economic policy		Issue presidential decree establishing a policy disclosure for tax and fiscal measures, abrogating the powers of Ministries and Agencies to change rules and to create state-owned enterprises, and move these powers to the Office of the President.
Deregulate and reform domestic and foreign trade policy, and increase private sector participation in foreign trade	(i) Issue trade deregulation decree opening exports and imports trade to the private sector. (ii) Liberalize foreign exchange allocation mechanism, achieving full convertibility. (iii) Reduce nominal tariff protection to a range of 10–40% (iv) Eliminate selective consumption tax and stamp tax on imports by the end of 1993. (v) Design a price based mechanism to replace import quotas, and eliminate quantitative restrictions on food-grain imports. (vi) Eliminate most domestic price controls.	(i) Reduce nominal protection rate to 10%–37% except for fiscal industries. (ii) Present a time-bound tariff reduction program (iii) Complete preparation of action-plan to replace existing export promotion mechanism by a duty draw back system.
Promote greater labor productivity		Comply with agreement on labor policy as stated by Government. The Labor Code will give priority to free contracting and will guarantee the rescission, suspension or termination of contracts, despite the existence of collective bargaining agreements.

- *Macroeconomic policies.* The Government intended to carry out: (i) a fiscal policy that would maintain the proper balance between revenues and expenditures and would avoid using Central Bank financing; (ii) a monetary policy that would encourage financial resource mobilization and improve the efficiency of resource allocation; and (iii) an exchange rate policy that would encourage the diversification of exports and help to maintain the competitiveness and profitability of the tradable sector.

- *Public sector.* The Government committed itself to: (i) reduce non-interest current expenditure to US$338 million and US$315 million in FY91 and FY92, and reduce it by nine percent in FY93; (ii) reduce public sector employment by 10,000 in FY92;
(iii) divest or prepare for privatization 90 percent or more of state-owned enterprises by the end of 1993; (iv) reform the customs and revenue services to increase revenues and improve the efficiency of the tax system.

- *Financial sector.* The Government intended to reduce the role of the public sector in financial intermediation activities, and to create the conditions for more participation by the private sector. Restructuring the state-owned banks (through closure and privatization) constituted the cornerstone of the program. Other actions and plans complemented the program. The Government decided to create a Superintendency of Banks, announced its intention to free deposit rates and abolish substantive controls on lending rates, and committed to draft and present to the National Assembly a Law of Banking and Financial Institutions.

- *Incentives for private sector development.* The strategy aimed at reducing the size of the state and eliminating obstacles to the functioning of internal and external markets. The Government expected that restraining government expenditure and closing and selling state-owned companies would produce a smaller government. It planned to improve the working of markets by: (i) abolishing state trading monopolies and quantitative restrictions on imports and exports; (ii) reducing the level and dispersion of import duties; (iii) eliminating support prices for agricultural products; (iv) abrogating the legal framework for price controls; (v) eliminating barriers to entry by the private sector into sugar production, banana for export and slaughter houses for exports; and (vi) lifting restrictions on foreign exchange trading until achieving full current account convertibility of the Córdoba by March 1992.

3.3 ***Relevance.*** ERC-I adopted relevant objectives and its comprehensive approach to solving the problems was necessary as called for by the scope and size of the crisis. Nicaragua needed fiscal and monetary discipline to stop inflation, to create the conditions for growth, and to reduce the public sector and the current account deficits. Lower fiscal deficits required improving tax management, removing tax exemptions, privatizing state enterprises and restructuring those remaining in government hands—including state-owned banks; it also implied demobilizing military forces and completing programs of voluntary retirement of public sector employees. Mobilizing domestic savings and increasing credit to the private sector required restructuring the state-owned banks and adopting prudential regulation and efficient supervision of financial institutions. The reforms were also needed to engage the private sector in developing the financial sector. An appropriate market environment for developing the private sector required freeing domestic prices, abolishing state monopolies, and reducing import tariffs and quantitative restrictions to imports and exports.

3.4 ***Implementation experience.*** The credit was closed in June 1992, nine months after its approval. Two reasons contributed to the fast disbursement. First, Nicaragua's execution of an IMF stand-by had helped to improve fiscal and monetary policies. Second, a technical assistance program helped the Government to start the reforms; the substantial technical assistance would have been more effective if donors and the Government had coordinated their efforts better.

3.5 ***Outcome.*** The Government met all the conditions of the credit, but its outcome fell below the optimistic expectations of IDA and the Borrower. In fact, despite the actions taken, the economy stagnated because political instability continued, the Government wavered in its efforts to reform the public sector and was slow in solving property rights problems, and after the credit was disbursed it backslid in some areas, especially in the financial sector. The PPAR rates the ERC-I outcome as satisfactory, higher than OED's Evaluation Memorandum. The PPAR rates outcome higher because the actions taken constituted a first, fundamental, step to turn the economy around. Had these steps not been taken, the economy would have performed worse than it did, and reforms in later years would have been more difficult to carry out. Without ERC-I Nicaragua would not have had access to international credits, the arrears could not have been cleared and it would have been deprived of the financial and technical assistance of the donor community. ERC-I established the conditions for good management of economic policy and, after the political uncertainty faded away, for faster growth.

3.6 ***Macroeconomic policies.*** The public finances improved over their pre-standby and pre-credit situation, but throughout the execution of the credit they remained unchanged. The consolidated public sector deficit fell from 29 percent of GDP in 1990 to about 7.7 percent and 8.4 percent of GDP in 1991 and 1992. Public sector revenues increased from 18 percent of GDP in 1990 to 25 and 29 percent of GDP in 1991 and 1992, higher than originally expected. Expenditures fell from 52 percent of GDP in 1990 to 34 percent of GDP in 1991, but increased to 37 percent of GDP in 1992, rather than falling to the agreed 32.6 percent. Avoiding financing from the Central Bank helped bring inflation down, from 7,485 percent in 1990 to 24 percent in 1992. The Government cut 8,000 jobs from its payroll, privatized 161 of 351 enterprises, reducing their share in GDP from 30 to 20 percent, and carried out some of the recommendations of IDA'S public expenditures study (see Annex B).

3.7 ***Financial sector.*** The Central Bank carried out a tight monetary policy, controlling the growth of credit and monetary aggregates. The Government created a Banking Superintendency and submitted to the National Assembly a draft law to regulate financial institutions. It merged Banco Inmobiliario (BI) with Banco Nicaragüense de Industria y Comercio (BANIC), reduced the staff and networks of the remaining state-owned banks, and began plans to restructure BANIC, Banco Nacional de Desarrollo

(BANADES) and Banco Popular (BP).[1] It also authorized the operation of seven private commercial banks (five more than initially intended), but state banks continued dominating the market. The Government hesitated at giving more room to private financial entities because it: (a) lacked clarity on whether the Constitution mandated that the financial sector was solely state property; and (b) believed that state-owned banks would relieve the credit constraints for small borrowers in rural areas.

3.8 ***Private sector development.*** Incentives for private sector development were granted through deregulation and liberalization of domestic and external trade. On domestic trade it abolished state-trading monopolies, eliminated official price controls, and privatized state-trading activities. On external trade, it unified the exchange rate, brought import tariffs to within a range of 10–40 percent, eliminated most non-tariff barriers, and introduced in 1992 an export promotion mechanism that, to be more effective in achieving its goal, had to be simplified.

3.9 Despite the reforms, and contrary to expectations, growth did not take off. Real GDP fell 0.1 percent in 1991, increased 0.4 percent in 1992 and decreased 0.4 percent in 1993. Besides the negative impact of natural factors and volatile international coffee prices, the stagnation reflected the private sector's lack of confidence in the capacity of the Government to transform the structure of the economy. Private sector uncertainty arose from the unstable political climate, the slow pace in solving property rights disputes and the perceived indecisiveness of the Government in moving fast to establish a market-driven economy.

3.10 ***Sustainability.*** In July 1995, the PCR rated the sustainability of ERC-I results as dubious and OED rated it as *uncertain*. The political uncertainty and the weak administrative capacity of the central and local governments explained the ratings. In the mid-1990s the Government had not shown convincingly that it could maintain sound macroeconomic policies, reduce its dependence on foreign aid and continue the reforms started in 1991. Although still dependent on foreign lending to cover its external imbalances, the Chamorro and Alemán administrations have demonstrated their commitment to economic stability and to structural adjustment. The sound economic policies reduced inflation to about 10 percent and helped to increase annual growth rates to about 4.7 percent between 1994 and 2001. Today, ten years after they started, the reforms supported by the ERC-I are *likely* to be sustained and few question Nicaragua's adherence to the principles of a market-based economy.

3.11 ***Institutional development impact.*** The ERC-I identified the institutional weaknesses of the country, and supported better economic policies and some institution building. By promoting private sector development, economic stability and respect for property rights, the credit helped to take important steps in moving the economy from a centrally planned towards a market based system. OED's evaluation summary rated the ID impact of the credit as negligible. The credit was critical for the identification and

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[1] The Government notes that better coordination among the international financial institutions would have prevented them form imposing contradictory conditions. In the case of BANADESA, IDA asked for its closure while the IDB supported a program to continue its operations.

assessment of the institutional weaknesses of the country. Time has shown that the reforms supported by the credit have had a lasting impact on economic management and the development of institutions that encouraged growth and stability. The reforms also gave birth to a nascent respect for property rights and the rule of law. Based on the credit's long-term effects, the institutional development impact of the loan should be rated *substantial*.

3.12 ***IDA performance.*** IDA performance is not rated in the PCR. OED rated IDA performance at entry unsatisfactory and its performance for supervision satisfactory. This PPAR rates Bank performance as satisfactory. IDA helped the Government in preparing its program, define its policies and normalize relations with the international financial community but, at the time, it failed to properly assess the risks associated with the operation and to predict the outcomes of reforms. Also, IDA overestimated the potential impact of uncoordinated technical assistance on alleviating the shortcomings in the Government's capacity to implement the changes needed. Opening a resident mission in January 1992 constituted a major step for improving results and maintaining the dialogue with the authorities.

3.13 ***Borrower performance.*** The PPAR rates Borrower performance as satisfactory. Although the Government had few policy options and contributed little to the technical preparation of ERC-I, it should receive the credit for supporting the principles underlying the program proposed by IDA and for having implemented and met the conditionality in its entirety, despite the domestic controversy its execution raised.

4. Second Economic Recovery Credit (ERC-II)

4.1 The reforms ERC-I supported touched some of the most fundamental problems of the country, but they were insufficient to make the economy grow faster, recover and entice the private sector to invest and produce more. Aware that the program supported by ERC-I could only deal with part of the problems that plagued the economy, IDA began to prepare with the Government an operation to complement and expand on what ERC-I had achieved already. Political uncertainty delayed the preparation and negotiation of the credit, but on May 27, 1994, the Board approved the Economic Recovery Credit II for US$60 million and an IDA reflow of US$7.6 million. The financial package included US$37 million from Japan.

4.2 ***Objectives.*** The ERC-II supported the Government's structural adjustment program, and aimed at helping the country adjust to lower levels of foreign aid and establish conditions to revive the private sector. The ERC-II, processed in parallel with an IMF ESAF arrangement, supported fiscal measures to strengthen macro-economic stability.

4.3 The ERC-II sought to reduce the scope of government intervention in the economy, increase the efficiency of financial intermediation, and improve conditions for private sector development. Like ERC-I, ERC-II focused on (i) reform of the state; (ii) reform of the financial sector; and (iii) private sector development.

- For the reform of the state (see Annex B) the credit supported: (a) reducing public sector employment; (b) completing the divestiture of most of the companies under CORNAP, and extending it to utilities in oil, gas and telecommunications; and (c) implementing over 1994–1997 a program to decentralize government activities, to strengthen the Judicial and Legislative branches of the State, and to reform civil service, budget and expenditure management, and tax and customs administration.

- For the financial sector, the credit supported: (a) reforming the two largest state banks (BANADES and BANIC); (b) improving supervision of commercial banks and extending the government's oversight over FNI (the second-tier state-bank), INISER (the state insurance company) and the stock market.

- For private sector development the credit supported a program to: (a) strengthen procedures for solving conflicts in property rights and for making compensation bonds more attractive to their holders; (b) abrogate the powers of Ministries and Government agencies to change tax and fiscal policies, and to create new commercial enterprises; (c) reduce import tariffs up to a maximum of 37 percent and replace the current export promotion mechanism for a duty drawback system or a temporary admission regime; and (d) update labor market legislation according to principles set out in the "Letter of Labor Policy" (see Annex E).

4.4 ***Relevance.*** The objectives of ERC-II were consistent with those of ERC-I and relevant to address Nicaragua's economic problems. After the political disorder of 1994–95, the Government realized that it had to restore economic stability and increase public savings for the economy to grow and the central bank to gain international reserves. To achieve these goals, the government had to reduce its payroll, divest state-owned enterprises and prepare and execute a program to reform the public sector.

4.5 **Reordering the state** required keeping the rules of the game stable, reorganizing public sector organizations—to deliver services effectively—and administering the legal framework fairly. The changes were expected to improve the management of budget, tax and customs, thereby increasing revenues and reducing the public sector deficit. **Improving financial intermediation** required letting private banks enter the market and the Government and Central Bank to stop capitalizing and lending to state banks. A sound financial system also required proper economic incentives, good supervision, and enforcement of financial norms and regulations on all banks.

4.6 Economic uncertainty made the private sector reluctant to invest, and to allay its fears the Government had to: (i) protect property rights; and (b) set clear rules of the game by ending the discretionary changes of tax policies, applying incentives transparently, and clarifying labor market regulations.

4.7 The ERC-II dealt with some of the most serious problems in the country, and took into account the volatile political situation and the weak institutional and managerial capacity.

4.8 ***Implementation experience.*** Closed in June 1996, six months later than planned, ERC-II fell victim to the breakdown of the political consensus that occurred between late 1994 and the Fall of 1995, when the Executive and the National Assembly clashed. The National Assembly amended the Constitution and reduced the power of the Executive, triggering a constitutional crisis that ended in June 1995. The Executive, in turn, opposed the new Labor Code, a code that did not comply with the Labor Policy Letter agreed with IDA.

4.9 The political crisis diverted the Government's attention from economic matters, making it fail to meet the fiscal and monetary targets agreed in the ESAF; as a result, the IMF canceled the mid-review scheduled for early 1995. As the ESAF stumbled so did the ERC-II. The political impasse delayed the execution of the labor mobility program and the reforms in the public sector program. The clash made the divestiture of TELCOR, PETRONIC and the state banks more difficult because the National Assembly, in a conflict mood, had to approve the transfer of state assets to private parties.

4.10 The standstill led IDA to postpone disbursing the second tranche to February 1996, one year later, when the conditionality was fulfilled, a satisfactory macro-economic framework was in place, and the IMF's ESAF was back on track. The third tranche was disbursed in June 1996. Reform advanced in all sectors, notably in the development of the **private sector,** where the government went beyond project covenants. IDA's capacity to disburse later, when conditions were met, helped to implement the project successfully.

4.11 ***Outcome.*** ERC-II outcome is assessed as *satisfactory*, as in OED's Evaluation Memorandum, and lower than the ICR. ERC-II was relevant and succeeded in achieving most of its relevant objectives. The economy grew faster, inflation fell below 10 percent and unemployment fell from 17 percent in 1994 to 14 percent in 1997.

4.12 ***Main achievements.*** ERC-II met part of its goals for structural reforms. The *labor mobility* program met its objective of reducing public sector employment, which fell more than its target of 13,500 positions (about 8 percent of public sector employment). The *privatization program* achieved most of its objectives. The Government divested of 66 of CORNAP's 72 enterprises and 10 of the 17 companies of the Ministry of Construction and Transport, but did not complete the transfer of ownership for all. By the end of 1996 the Government still owned PETRONIC and TELCOR. The sale of TELCOR, transferred to ENITEL, a newly created agency set for privatization, was left to the new government.[2] Although it liquidated ENIGAS, it kept 75 percent of LUBNICA's assets. The Government deregulated the gasoline market, and proposed the full privatization of PETRONIC, an action that required legislative approval by the National Assembly. IDA accepted that full privatization was preferable to privatization of gasoline distribution but the Assembly approval would extend beyond the life of ERC-II. When the Government submitted to the Assembly a law for privatizing PETRONIC, IDA agreed to seek a waiver to this condition in March 1996.

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[2] The Government notes that the privatization process of CORNAP's enterprises was made at heavy costs to the public finances, with losses that still carry heavy burden for them.

4.13 The reform of the *financial system* fell short of plans. The strategy for containing the growth of state banks (keeping them under close monitoring, avoiding their recapitalization and subjecting them to prudential regulations) was partially executed, so BANADES and BANIC continued dominating the banking sector. Because BANADES and BANIC could not recover their loans they were exempted from complying with prudential norms. After deciding to downsize BANADES, sell a majority of BANIC to private parties, and transfer their non-performing assets to COBANICA, a new collection agency, the Government postponed their restructuring.

4.14 While failing with BANADES and BANIC, the Government managed to advance some reforms in other areas of the financial sector. The Government submitted to the Legislature a General Banking Law that aimed at strengthening the regulatory powers of the Superintendencia Bancaria y de Instituciones Financieras (SBIF).[3] SBIF approved new *prudential norms* in line with international standards, notably the capital adequacy requirements, and the Central Bank improved its management of monetary and exchange rate policies, by carrying out open-market operations and establishing an inter-bank foreign exchange market.

4.15 The Government also began to improve the climate for private sector development. It advanced in resolving *property rights* problems by: (a) reviewing more than 100,000 cases related to properties in the housing and rural sectors, solving the disputes in 82 percent of rural cases and 98 percent of housing cases; (b) increasing the returns on the 20-year bonds introduced in 1992 to compensate those whose property had been confiscated, making them negotiable and accepting that their holders use them to settle liabilities with the tax office and state enterprises (see Annex E). It also ratified a constitutional reform that allowed people linked to the Somoza regime to claim back confiscated properties, and signed a landmark law that secured property rights and constrained compensation to former owners.

4.16 Other actions reinforced those on property rights. The Government abrogated the discretionary powers of Ministries and agencies to modify taxes and economic regulations, concentrated those powers in the Presidency, and ordered changes to law and regulations to be published in the Official Gazette; the constitutional amendment of 1995 vested in the Assembly most of the powers until then held by the Executive on tax matters. It liberalized *foreign trade* and, except for eight industrial products, it reduced the maximum tariff to 35 percent, and in late 1997 the National Assembly decided to reduce to 10 percent the tariff ceiling by the end of 1999.Nicaragua is a member of the Central American Free Trade Area agreement, a group that will move to a customs union by January 1, 2004; then, the tariff for trade among members would be zero and the external tariff will consist of four groups of zero, five, 10 and 15 percent, representing 48, 27, 5 and 20 percent of tariff items. The reforms to the Labor Code, passed in October 1996 after two years of negotiations between the executive and the National Assembly, went beyond those agreed to in the Letter of Labor Policy.

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[3] The Government notes that financial liberalization and the opening of the capital account could be counterproductive without a strong superintendency of banks, and that privatizing a public monopoly while lacking an effective regulatory agency could lead to inefficient outcomes.

4.17 ***Sustainability.*** The reforms supported by ERC-II have stood well, and the PPAR, like the ICR, rates sustainability as *likely*, above OED's uncertain rating in 1998. With support from the international community, the administration of President Alemán continued the reforms started by the Chamorro administration. After Hurricane Mitch, the international community forgave some of the country's debt and postponed service payment, the IMF approved in 1998 a second three year ESAF, and IDA included the country in the group of highly indebted poor countries (HIPC). Entry into the HIPC scheme gave the country another chance to get more debt relief. IDA's ongoing Institutional Development Credit, Financial Sector Adjustment Credit, and an Economic Management TA credit have helped to consolidate the reforms of the state (privatization of ENITEL, Tax Reform Law) and of the financial system (privatization of BANADES and BANIC, and closure of Banco Popular [BP]). The credits supported the Government's efforts to bring competition to the insurance market, to reduce import tariffs and to offer guarantees to foreign investors. The administration of President Bolaños, who took over in January 2002, pledged to create conditions for private sector growth, and to combat corruption by reforming the Judiciary. His administration is discussing a new Poverty Reduction and Growth Facility agreement with the IMF, focusing on public sector reform to boost private sector confidence in the economy.

4.18 ***IDA performance.*** IDA performance is rated *satisfactory*, the same as the ICR and OED's evaluation memorandum. IDA moved quickly during identification and appraisal, benefiting from an active policy dialogue, and supported a relevant credit for the country. IDA also helped to attract co-financing and tried to ensure the consistency of the donors' technical assistance programs. IDA's assistance could have been more effective had it anticipated the problem of access to credit for small farmers, a problem that delayed the Government's decision to divest of the state-owned banks.

4.19 ***Borrower performance.*** Borrower performance is rated *satisfactory*. In spite of adverse political circumstances, the Borrower owned the strategy, maintained its commitment to the adjustment program, met most of the credit's covenants and did its best to keep the program on track. The country's weak institutions and the initial inexperience of the administration in planning and economic management contributed to the delays and problems in selling and restructuring state-owned enterprises.

4.20 ***Institutional development impact.*** ERC-II is considered as having a *substantial* institutional development impact.

5. Lessons

5.1 When the adjustment program requires deep economic changes, problems that need long-run solutions must be tackled early, under a global strategy whose rationale, constraints and benefits must be understood and accepted prior to approval of the credit. IDA and the Borrower should work to prepare the civil society for the changes needed and forthcoming, and whose benefits are not evident to the general public at first.

5.2 Under a fragile political environment and new democratic institutions, institutional capacity tends to be weak. IDA and the Borrower must address this problem early on, working with other donors and making the building of that capacity and the strengthening of institutions an integral part of the assistance program.

5.3 IDA must tone down its expectations of what reforms can achieve in a short time. IDA identified correctly the nature of the risks of failure, but it overestimated the response to the reforms supported by both credits. IDA and the Borrower assumed unrealistically that stabilization could be achieved in two years, and that an economic recovery based on private sector growth would occur in parallel.

5.4 An adjustment economic program that aims at private sector-led growth should focus from the beginning on developing and guaranteeing property rights, critical to restore confidence to private investors. ERC-I did not focus on the property rights issue and the desired response of the private sector did not materialize.

5.5 The structural reforms that Nicaragua required needed a medium- to long-term horizon, and they are served better with programmatic lending credits than with fast disbursing credits operating with a short-term horizon. Adopting a programmatic lending approach fits best with a multiyear phased support, where each operation needs to be self contained, and conditionality can be simpler and more specific.

Annex A

Basic Data Sheet

Nicaragua – Economic Recovery Credit (Credit 2302-NI)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	110	110	100
Credit amount	110	110	100

Cumulative Estimated and Actual Disbursements

	FY91	*FY92*
Appraisal estimate (US$M)	110	
Actual (US$M)	55	110
Actual cumulative as % of Credit	50	100

Project Dates

	Original Plan	*Revised Plan*
Initiating Memo	01/10/91	01/10/91
Preparation mission	01/15/91	01/15/91
FEPS/IM-OC	05/13/91	05/13/91
Depart appr.	06/06/91	06/06/91
Yellow cover	07/05/91	07/05/91
Documents to RVP	07/11/91	07/11/91
Start negotiations	07/23/91	07/23/91
Board approval	09/26/91	09/26/91
Signing date	12/31/91	12/31/91
Credit closing	06/30/92	12/31/92
PCR completion	12/15/93	03/31/94

Staff Inputs (staff weeks)

Stage of Project Cycle	*Actual Weeks*
Appraisal	22.7
Preparation	86.3
Negotiation	25.0
Supervision	45.9
Completion	10.0
Total	189.9

Mission Data

Stage of project cycle	*Date (mm/yr.)*	*No. of persons*	*Duration of mission (# of days)*
Preparation	01/91	7	2
Pre-appraisal	04/91	12	2
Appraisal	06/91	5	2
Negotiation	07/91	-	-
Supervision	12/91	1	2
	02/92	3	2
	04/92	3	1
	05/92	1	1
	06/92	2	2

Annex A

Other Project Data

Borrower/Executing Agency: Republic of Nicaragua

Related Bank Credits

Credit title	*Purpose*	*Year of approval*	*Status*	*Closing date*
ERC-II	Support the Government's structural adjustment program	1994	Completed	06/30/96
Institutional Development Credit	Improvement in delivery of public services and increasing public savings	1995	Completed	12/31/01

Annex A

Basic Data Sheet

Nicaragua – Second Economic Recovery Credit (Credit 2631-NI)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	60	61.7	103
Credit amount	60	61.7	103
Cofinancing	60	37.0	62

Cumulative Estimated and Actual Disbursements

	FY95	*FY96*
Appraisal estimate (US$M)	52.6	67.5
Actual (US$M)	31.0	61.7
Actual cumulative as % of Credit	59	91.4

Project Dates

	Original	*Actual*
Identification	01/15/93	01/15/93
Preparation	03/05/93	03/15/93
Appraisal	06/03/93	04/04/94
Negotiations	n.a.	07/23–25/94
Board Presentation	n.a.	06/21/94
Signing	n.a.	06/22/94
Effectiveness	n.a.	06/29/94
Credit Closing	12/31/95	06/30/96

Staff Inputs (staff weeks)

Stage of Project Cycle	*Actual*	
	Weeks	*US$*
Through Appraisal	68.9	185.1
Appraisal–Board	1.1	2.2
Board –Effectiveness	7.3	23 8
Supervision[1]	20.0	67.7
Completion	4.0	19.1
Total	101.3	297.9

[1] Task management of ERC-II was performed by the Bank's Resident Representative in Nicaragua. The 20 SW figure refers mainly to inputs of others, and likely understates the intensity of supervision.

Annex A

Mission Data

Stage of project cycle	Date (mm/yr.)	No. of persons	Duration of mission (# of days)	Specialized staff skills represented[2]	Performance rating[1]		Types of problems
					Implement. Status	Develop. objectives	
Through Appraisal	06/92	6	14	i (2), j, k, l			
	05/93	12	12	a, e, i (2), n, o, q, r, s,			
	07/93	3	5	t, u			
	03/94	9	9	c, i, m			
				a, b (2), e (2), i n, o, p			
Appraisal through Board approval	05/27/94						
Board approval through effectiveness					S	S	
Supervision	04/94	5	12.3	a, b, c, d, e	S	S	
	03/95	5		a, b, c, f, g	S	S	
	03/96	2		h, i	S	S	
Completion	12/96	2	2				

[1] Performance rating as shown in Supervision Form 590.
[2] Key to specialized staff skills:

a Lead Economist
b Financial Economist
c Banking Specialist
d Lawyer
f Public Sector Specialist
g Telecommunications Specialist
h Country Economist
i Economist
j Mining Specialist
k Energy Specialist
l Water and Sewerage Specialist
m Financial Sector Specialist
n Privatization Specialist
p Resident Representative
q Taxation, Public Enterp Natural Res.
r Property Rights Specialist
s Export Development Specialist
t Country Analyst
u Country Officer

Other Project Data

Borrower/Executing Agency: Republic of Nicaragua

Related Bank Credits

Credit title	Purpose	Year of approval	Status	Closing date
ERC-I	Support the Government's structural adjustment program	1991	Completed	12/31/92
Institutional Development Credit	Improvement in delivery of public services and increasing public savings	1995	Completed	12/31/01

Annex B

Reform of the State

Background

1. By 1990, Nicaragua's non-financial public sector (NFPS) was large and consisted of:

- **The General Government**, comprising the Central Government, the Social Security and Welfare Institute (INSSBI), and 143 municipalities;
- **Four public utility enterprises**: The Nicaraguan Energy Institute (INE), the Nicaraguan Institute for Water and Sewerage (INAA), the Telecommunications and Postal Services Company (TELCOR), and the Nicaraguan Urban Bus Company (ENABUS);
- **Other public utilities**, (11) subordinated to the four majors, including the State Oil Company (PETRONIC) a subsidiary of INE;
- A large number of **production companies** that were expropriated or created over the 1979–1990 period, and were either controlled by Ministries, notably the Ministry of Construction and Transportation (MCT) or by the National Corporation of Public Enterprises (CORNAP).

2. As a result of political pressures stemming from strong unionization public sector employment had swelled between 1979 and 1990. By the end of 1990 the number of public employees was about 219,000, fivefold its 1978 level. Out of 209,000 NFPS employees, about 109,000 were in the Central Government, and 91,300 in public companies, of which 78,000 came under CORNAP. Moreover, public sector salaries were high compared to the level of skills.

3. Consequently the resources used in public sector expenditures exceeded public sector revenue. Consolidated NFPS expenditures represented about 49 percent of GDP while NFPS revenue barely exceeded 19 percent of GDP. Moreover, the distribution of public expenditures between current and capital expenditures was not appropriate and by 1990 the NFPS only dedicated 2.1 percent of GDP to capital expenditures.

4. The fiscal adjustments required to bring progress toward a sustainable stabilization led the Government to: (i) reduce NFPS expenditures and increase its revenue; (ii) initiate medium-term public sector reforms; and (iii) undertake, under the Second Economic Recovery Credit, a major reform of the state based on the recommendations of studies, notably those of the 1992 Public Sector Expenditure Review.

5. Both Credits contributed to restoring some macroeconomic stability and to supporting the public sector reforms that addressed all the issues related to expenditures, revenue, and size of the State.

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Labor Reduction Program

6. The employment reduction program supported by ERC-I was a success. Despite implementation difficulties, during 1991–1992, public sector employment was reduced at least by 98,500 positions, to 120,200, mainly demobilizing armed forces (from 83,000 to 15,000) and offering an early retirement plan. Additionally, 13,200 positions were eliminated in 1993. During 1994–1996, ERC-II supported successfully the extension of the redeployment to the entire public sector under the Public Sector Mobility Program which reduced the number of public employees by 18,000 positions, surpassing the initial goal of 13,500.

Public Sector Employment
(Number of Employees at end of year)

	1990	1991	1992	1993	1994	1995	1996	1997	1999
Central Government	109,160	95,120	93,000	82,230	81,020	75,930	73,020	70,970	65,090
Public Enterprises	13,280	10,480	10,040	9,910	9,450	8,340	7,970	8,160	7,310
CORNAP	78,000	9,910	5,720	4,300	1,160	1,100	n/a	n/a	n/a
Banking Sector	9,920	6,550	5,060	4,100	4,120	3,810	2,960	2,020	1,690
Others	8,340	6,190	6,400	6,460	5,410	4,970	4,940	3,940	3,790
Total	218,700	128,250	120,220	107,000	101,160	94,150	88,890	85,090	77,880

Source . Central Bank of Nicaragua

As shown in the table, by the end of 1996, public sector employment had been cut by 31 percent over its level in 1991, the major downsizing having occurred at the enterprise level in CORNAP.

Privatization Program

7. The Government's strategy was to privatize companies of the *"Area de Propiedad del Pueblo"* (APP), but retain ownership of public utilities. The privatization of the APP enterprises was a major component for structural adjustment. Privatization involved the sale of companies legally owned by the Government, the return of confiscated companies to their legal owners, or liquidation. By divesting of these companies, the Government aimed to: (i) reduce the public-sector share in the economy; (ii) lower its administrative functions and management responsibilities; and (iii) earn additional revenue for the budget.

8. ERC-I helped to start-up the divestiture by helping CORNAP to: (i) complete, by March 1992, the divestiture of at least 75 companies out of which 25 were fully privatized while the remaining 50 were returned to their former owners or liquidated; and (ii) prepare for sale another 30 companies. Under ERC-I, the Government divested 233

of the 351 CORNAP enterprises. An additional 46 enterprises were privatized by May 1994.

9. However, the international business community showed little interest in bidding for CORNAP's assets and there was small capital repatriation connected with privatization. The income generated by the divestiture was small, because, in many cases, enterprises were returned to their previous owners and the operation included "buying-out" the collective bargaining agreement and compensating the fired workers.

10. ERC-II supported more ambitious targets that were partially achieved. Sixty-three of the remaining CORNAP enterprises were fully divested or closed and three others lost their public majority ownership, but six CORNAP companies remained under the control of the State. Regarding the public utility enterprises, the results were mixed. In the energy sector, ENIGAS was liquidated and workers were paid with the company's assets; twenty five percent of the oil company LUBNICA's capital was transferred to its workers and the remaining 75 percent to INE, in order to repay debts to PETRONIC. The Government's attempt to privatize PETRONIC by seeking the approval of the National Assembly failed. However, deregulation of the gasoline market occurred: by August 1995, private companies were in charge of the bulk of the distribution process and regulatory functions were vested in INE.

11. Moreover, 10 of the 17 original enterprises under the Ministry of Construction and Transport were privatized or liquidated, and the personnel and equipment of its remaining enterprises were reduced.

12. The major setback occurred with the privatization of TELCOR in the telecommunications sector. The privatization program was well advanced by the fourth quarter of 1994: nine bidding companies had been prequalified, TELCOR's regulatory powers had been transferred to ENITEL, the newly created agency to be privatized as service provider, and a new Telecommunications Law had been sent to the National Assembly. However, the Constitutional crisis that ensued interrupted the advance, which resumed in July 1995. The sale of ENITEL was advertised in January 1996, and a public call for bids was made before June 1996; with these steps IDA considered that the Government had complied with the conditionality of "making progress." Nevertheless, bid opening was postponed several times and the new Administration that took over in 1997 was left with the responsibility of privatizing ENITEL.

Public Sector Reforms

13. Increasing government revenue was part of the strategy for the stabilization program and to ensure the non-inflationary financing of public programs. Such effort required an improvement of tax administration and tax management.

14. ERC-I supported the initiation of an action plan with specific emphasis on: (i) the General Value Tax (GVT) and income tax collection; and (ii) the removal of income tax

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exemptions and the phasing out of indirect tax exemptions. It also contributed to organizational and procedural changes and to the strengthening of control and enforcement of tax regulations. Notably, tax declaration and payment procedures were simplified, corporate income tax unified and the number of brackets for personal income tax was reduced. Programs on an automated management control system and a computerized taxpayer identification system were also initiated.

15. ERC-II focused on the implementation of the recommendations of the 1992 Public Sector Expenditures Review. The conditionality associated with the operations resulted in the adoption, in October 1994, of a five-year Public Sector Reform and Action Plan, covering: (i) institutional restructuring; (ii) civil service reform; (iii) budgetary management; (iv) tax and customs administration; (v) decentralization; and (vi) strengthening of the Judicial and Legislative branches.

16. By 1996 the following actions had been taken:

- The creation of a Reform of the State Management Unit to design and coordinate the implementation of ERC-II.
- The completion of six Institutional Restructuring Agreements (ARIs) with four Ministries (Ministry of Construction and Transport; Ministry of Finance; Ministry of Natural Resources and Environment; Ministry of Economy and Development) as well as with the National Institute for Social Security.
- In MCT a planning division for economic infrastructure was established and an Integrated Management System (SIGFA) was installed in all Central Government ministries.

17. Moreover, (i) a multi-year modernization program of the Judicial System, including the construction of court houses and training for judges was implemented; and (ii) a new social security system was designed and implemented, with social welfare separated from pension and health insurance.

18. Supported by IDA sector credits, public sector reforms continued after ERC-II was closed. Notably, a reorganization of the Executive Branch occurred, as well as a reform of the pension system.

Annex C

Public Sector Expenditure Review

Main Recommendations

Background

1. The main purpose of the Public Expenditure Review was to assist the Government in improving the allocation of public resources and strengthening the institutions involved in financial management and project implementation.

2. Although the Government had taken steps to improve the fiscal balance, larger effort were required on the current expenditure side. Severe institutional and management problems magnified the difficulties resulting from the large size of the public sector. The system leading to expenditure decision was inadequate and deficient. Poor methods of planning and control were used by most ministries. The entire system of expenditure management and control need to be strengthened. Institutional weakness was particularly worrisome in the management of external aid.

Diagnosis and Strategy of Reform

3. The expenditure review identified six main problems: (i) institutional, procedural and processing problems of budgeting, investment planning and aid coordination; (ii) weak accounting function, leading to poor ex-post control and non-existing auditing; (iii) recurrent expenditure;
(iv) expenditure patterns (in particular in the social sectors) not reflecting government priorities;
(v) weak institutional and administrative capacity, both in the line ministries and in the public enterprise; and (vi) too large public investment program (PIP) for the Government's implementation capacity.

4. The Government could not tackle all the problems at once, and three phases were proposed to deal with them. The first should deal with recurrent expenditures to reduce the risks of destabilization from large budget deficits. The second phase would consist of: (i) a comprehensive reform of the civil service; (ii) rationalization of budget preparation; (iii) rationalization of project preparation; and (iv) reforms in the education, transport, energy and water sectors.

5. The actions to be implemented were the following:

Issues that need to be addressed most urgently

(a) *Reduce and restructure the Central Government current expenditures*: (i) reduce the wage bill while increasing wages for professionals; (ii) reduce expenditures in

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goods and services, while increasing allocations for operations and maintenance; and (iii) reduce expenditures for defense.

(b) *Strengthen and restructure budgetary management* by defining responsibilities for the core units which deal with budgetary practices and expenditure control, and establishing an accounting system.

(c) *Establish a new expenditure control mechanism* by: (i) revitalizing expenditure control by the Auditor General; and (ii) extending overall budgetary practices and expenditure control to the Ministries of Defense and Police and the item "Unforeseen Expenditures."

(d) *Improve the mechanism for coordination and control of external aid* by establishing an External Aid Coordination Committee that regulates the aid flows.

(e) *Establish a government-wide accounting system.* The proposed Budgeting and Accounting Units in each institution would be headed by a Ministry of Finance (MIFIN) appointed Accountant, and would bear key responsibility for bookkeeping and preparing year-end final accounts of the institutions. Each institution must submit its year-end final accounts to the Auditor General via MIFIN for legality and veracity clearance.

(f) *Prepare an implement a Technical Assistance program.* In order to expedite the above restructuring efforts, short-term three-pronged technical assistance needs to be provided to MIFIN consisting of: (i) training seminars for MIFIN staff on improved budget preparation, implementation and control issues, and some academic training abroad for Budget Directorate staff; (ii) technical assistance for the formulation of an overall government accounting system; and (iii) several short-term consultants in ex-post expenditure control, revision of the auditing mechanism by the Auditor General, and mid-term expenditure planning.

(g) *Reallocate funds toward primary health care* from curative to preventive care, and introduce a targeted fee system for both consultations and drugs, to improve efficiency and signal to users the cost of the different kinds of treatment. The funds collected should be allocated to primary health care.

(h) *Reallocate funds towards primary education* by: (i) reducing subsidies to higher education; (ii) developing cost-recovery options (in particular in higher education); (iii) charging universities for the use of public utilities; and (iv) reforming the retirement provisions of the "Ley de Carrera Docente" in line with Nicaraguan Institute of Social Security (INSSBI) national rules.

(i) *Produce a sectoral strategy in the agricultural sector*: Define the short and medium-term sectoral objectives, and the roles of the different institutions in meeting those objectives. A Committee should be set up to assist in the coordination of the overall sector policy.

Issues to be addressed subsequently

(a) *Establish* the *accountability of government institutions.* The Auditor General of the Republic should audit all government expenditures and institutions on behalf of the National Assembly as a superior organization and officially inform that body of its findings.

(b) *Improve the mechanism for preparing the Public Investment Program.* The Ministry of Economy and Development (MEDE) needs a clear mandate to: (i) coordinate the preparation of national and sectoral strategies, to be then translated into specific investment projects; and (ii) enforce agreed upon priorities and allocate domestic and external resources to the priority projects.

(c) *Strengthen institutional capacity for PIP elaboration* through technical assistance to the core ministries, the line ministries, and the public utility companies.

(d) *Restructure the civil service system and establish a sound salary scale* by: (i) establishing a separate Civil Service organization; (ii) setting up a system of establishments and payroll lists (iii) preparing position tables for each institution; and (iv) forbidding institutions to appoint staff without having a position authorized by MIFIN.

(e) *Reduce personnel in public enterprises.* INE, INAA and TELCOR should devise programs to reduce staffing levels to their revised functions.

(f) *Privatize or close* all firms producing goods that are now operating under the Ministries.

Final Phase

6. The final phase of the reforms includes an emphasis in reforming sectoral policies and strengthening sectoral institutions.

(a) *Reduce expenditures on the item "General Services"* by: (i) reducing the number of independent institutes; (ii) restructuring the urban transport subsidy; and (iii) reforming the Law earmarking funds for the University.

(b) *Reduce the size of central administration* after doing a study assessing where and by how much the ratio of service to administrative personnel should be increased.

(c) *Set up a preliminary model for mid-term expenditure planning* to establish consistency between revenues and expenditures as well as with expenditure priorities.

(d) *Ministry of Education (MED)* has to change teacher training, accreditation and reward alternatives.

(e) *Promote private sector investment in the energy sector* by: (i) creating an autonomous regulatory entity that promotes an efficient development and use of energy resources; and (ii) promoting private sector participation, particularly in power generation, distribution and commercialization.

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(f) *Improve operational and financial performance of the Nicaraguan Energy Institute (INE)* by: (i) reducing personnel; (ii) undertaking an effective power losses reduction program; and (iii) improving budgeting, auditing, control and managerial information systems.

(g) *Develop institutions for the rural water sector.* Plans should be elaborated in coordination with donors (that provide most of the services in rural areas): (i) to determine how their technical and financial assistance will be phased out and (ii) operations and maintenance handed over to municipal water companies, communities or private water companies.

(h) *Improve Nicaraguan Institute for Water and Sewage (INAA) and other sectoral institutions' management capacity* to execute and supervise more projects

Annex D

Financial Sector Reform

Background

1. By 1979, Nicaragua had one of the most advanced financial systems in Central America, with a combination of state, private national and foreign subsidiaries banks providing a wide range of financial services.

2. After taking power, the Sandinista Government: (i) eliminated private national institutions and nationalized all private commercial banks; (ii) transferred control of state-bank operations to a holding company which would evolve into the *Corporación Financiera de Nicaragua (CORFIN)*; and (iii) reduced the number of financial institutions to five:

- *Banco Nacional de Desarrollo (BANADES)* servicing the agriculture and livestock sector;
- *Banco Nicaragüense de Industria y Comercio (BANIC)* servicing industry and trade, largely oriented toward the urban sector;
- *Banco de Crédito Popular (BCP)* servicing the small scale sector;
- *Banco Inmobiliario (BIN)*, servicing the housing sector; and
- *Fondo Nicaragüense de Inversión (FNI)*.

3. The complete specialization of the five institutions and persistently negative real interest rates on loans reduced management incentives to improve the quality or efficiency of their operations. Myriad subsidies and the use of the banking system to pursue political objectives undermined the loan repayment culture. Bank managers rolled over poor and non-performing loans to maintain the flow of resources to targeted sectors and, periodically, the Government forgave or rescheduled overdue loans. All banks were highly dependent on Central Bank rediscount. Eighty-three percent of the growth in credit originated in the Central Bank and 96 percent of it was granted to the public.

4. Since the early 1980s, monetary policy was managed to provide inexpensive loans to the productive sector and finance the large borrowing requirements of the Government. Credit expansion resulted in accelerating inflation. Attempts to restrain its growth in 1988–1990 failed. In response to hyperinflation and the steady decline in the economy, the holdings of money and quasi-money fell from 55 percent of GDP at the end of 1988 to 27 percent by the end of 1989.

Financial Sector Reform

5. Starting in 1991, a number of steps were taken to reform the financial system and improve the efficiency of financial intermediation. By March 1991, a law was enacted that set forth the functions of the Superintendency of Banks and allowed private financial intermediaries to coexist with state-owned restitutions.

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6. The restructuring of the state-owned banks along with the cessation of Central Bank subsidies and discounts, and the promotion of an efficient private financial sector were the key elements of the reform program that both ERCs supported. Over the ERC-I implementation period, CORFIN was closed and BIN was liquidated. In June 1992, the restructuring of BANADES and BANIC was prepared as the Government wrote off and bought their non-performing loans, recapitalizing them indirectly. Both institutions were also submitted to the prudential norms issued by the Superintendency and had to undertake a major cost-reduction program, substantially reducing branches and staff. Over the ERC-II implementation period, the state banks were kept under close monitoring and not recapitalized; their non-performing assets were transferred to COBANICA, their loan growth submitted to ceilings and their network further downsized.

7. A legal and regulatory framework appropriate to private banking operations has been progressively established. Rules and standards to initiate operations were issued by October 1991. The Superintendency of Banks and other Financial Institutions (SBIF) strengthened guidelines on capital adequacy, loan concentration and assets evaluation, as well as penalties for non-compliance. A General Banking Law was also submitted to the National Assembly, which approved it in 1997. Finally, the insurance sector had been liberalized in July 1996, when the National Assembly passed a reform opening up the market to private competition.

8. The Central Bank Law approved in 1992 gave the monetary authority part of the autonomy it had lost. Stringent conditions were placed on Central Bank of Nicaragua (CBN) financing of both the Government and the financial system. Notably, credit lines to the State banks were discontinued. A mostly market-determined interest rate structure was gradually adopted, direct controls over the financial system were lifted and reserve requirements varied by category of deposits imposed. New monetary policy instruments were also introduced. The placement of negotiable investment certificates with maintenance of value (CENIS) for open market operations was initiated in 1995. An inter-bank foreign exchange market was established, exchange restrictions were phased out and the exchange rate was unified by early 1996.

9. The regulatory framework for the banking system is established and broadly appropriate, with two key laws: (i) the 1963 Law on Banks and Other Financial Institutions; and (ii) Law 125 of 1991 creating the SBIF. Other legal sources, sometimes contradictory and with vague definitions, give room for discretion in the application of norms and regulations

The Financial System After the Reform

10. The financial system structure has experienced a major transformation. Notably:

- The commercial state banking system is restricted to three institutions: BANADES, BANIC and BCP.

- Ten private banks were established and nine were operating by the end of 1996.
- Four private insurance companies were set up by banks and were competing with INISER, the state insurance institute.
- The stock exchange was operating but its activity was limited.

11. The bases for financial system supervision have been established. Even though mainly focused on banks, SBIF was empowered to: (i) supervise all institutions, including the Central Bank; (ii) establish regulations and norms for all institutions; and (iii) license new financial intermediaries. SBIF has a widespread jurisdiction over the state and private banking sector, the stock exchange, insurance companies, deposit warehouses and any other activity or institution that intermediates funds from the public (leasing, factoring, credit cards, funeral companies and pawn shops are included).

12. The system has gained depth as reflected by the rise in the ratio of liquid liabilities of financial intermediaries to GDP. The growth has been mainly in US dollar denominated deposits, whose share was close to 63 percent in 1997 compared to 29 percent in 1991. The allocation of financial resources has improved. The share of state banks in total private sector credit has declined with the transfer of their non-performing assets, nearly 40 percent of their portfolio, to a private collection agency, COBANICA, in 1996. State banks accounted for 21 percent of total assets, down from nearly 95 percent in 1991.

13. Despite the improvements in 1996, the financial system is still fragile. State banks (BANADES and BANIC) continue to control an important share of the sector, and their performance remains poor. BANADES was not fulfilling its mandate to serve small producers, its clientele had fallen, credit recoveries continued to be low and the annual operating costs were high. BANIC had similar problems and its portfolio was highly concentrated. *Private banks* have achieved substantial annual rates of return (15–35 percent), because of high intermediation margins and highly profitable investments in public bonds. Despite that each of the 12 banks remains small in terms of credit market share , which is reflected in high administrative costs. They are also undercapitalized, with an overall equity amounting to US$70 million in 1996, compared with US$500 million in El Salvador. Private banks were subject to a capital adequacy ratio of 8 percent, but the development bonds (BOFOS) they issued, and the Central Bank repurchased, contributed to a significant part of their capital. The *Managua Stock-Exchange* remains small. The main traded instruments are Central Bank and Government paper (CENIS and Compensation Bonds). As of 1996, the total volume of transactions in equities and bonds had reached US$320 million.

Annex E

Matrix of Policy Actions, Measures and Results Within the Two Economic Recovery Credits Over the Period 1991–1996

Objectives	Conditionality	Status/Results
I. Macro-economic Framework Ensure an appropriate and stable macroeconomic framework	1) Maintain a stable macroeconomic framework including fiscal deficit and domestic credit ceilings consistent with stabilization objectives. 2) Maintenance of exchange rate policy consistent with export competitiveness, which reflects changes in monetary indicators notably.	1) In 1991, Nicaragua initiated an economic adjustment program within a Stand-by Credit (September 1991–March 1993). Targets were partially met. 2) In April 1994, Nicaragua entered into an ESAF framework for a three-year period, but recurrent difficulties for meeting targets (fiscal) led to a Monitoring Program agreement in September 1995, and in September 1996, to ESAF suspension. 2) Done, with reservations.
	3) Satisfactory progress implementation through reduction of public expenditures, in military areas and increasing public revenues.	3) Done, with reservations.
	4) Action plan for carrying out recommendations of the study on public expenditures to be presented.	4) Done.
II. Reform of the State **A. Public Sector Labor Mobility** Achieve a permanent cost reduction to strengthen the fiscal balance through reduction in the labor force.	1) Demobilization of militia and military draftees by 35,000, as well as retiring of 5,000 military officers (1991).	1) During 1990–1993, public sector employment was reduced, by 183,000 positions to 107,000, through downsizing armed forces (83,000 to 15,000), privatization or closure of public enterprises (74,000 employees involved) and an early retirement plan.
	2) Introduction of an externally funded employment redeployment program to relocate 9,000 of 69,000 central	2) During 1994–1996, public sector employment was reduced by 10,300 positions. The target would be surpassed in 1999, as

Objectives	Conditionality	Status/Results
	government employees, (including 3,000 additional military personnel) to be completed for 8,000 personnel (in 1991).	14,000 positions were cancelled.
	3) Preparation of an action plan to extend redeployment to entire public sector, including CORNAP, initiating its implementation (1992) in order to reduce employment by 13,500 positions during 1994–1996.	
B. Privatization Program		
1) Promote more efficient resource allocation and lower fiscal burden through divestiture of state enterprises.	1) Established CORNAP and endowed it with responsibility for both managing and privatizing 351 state enterprises grouped in 22 corporations, while working out a strategy for divestiture, and adopting an action plan to privatize CORNAP (1991).	1) All but five of the companies under CORNAP were privatized, returned to their former owners, or liquidated, over the 1990/1995 period.
2) Improve the efficiency and service coverage by promoting private sector participation in the utilities sector, notably the telecommunications.	2) Complete the privatization of at least 25 companies through CORNAP; the devolution of their original owners, or the liquidation or the transfer to private sector of at least 50 companies through CORNAP (1992).	2) By the end of 1995 was completed the process of selling the assets of CONSULTRAN (MCT enterprise). A study on the privatization of another 7 firms under MCT was completed awaiting its implementation.
	3) At least 30 additional companies under CORNAP prepared for sale to private sector (1992).	3) As of December 1994, PETRONIC ceased to have a state-monopoly on distribution activities. Its organic law was then reformed (1995) to place it as a commercial company.
	4) Bring to the point of sale or closure enterprises under CORNAP and MCT(1994–1996)	4) Twenty-five percent of the capital of LUBNICA was transferred to its workers, the remaining 75% being transferred to INE, to repay debts to PETRONIC.
	5) Bring to the point of sale or liquidation some of the operations (gasoline distribution) of PETRONIC, while its regulatory functions are defined.	5) In 1995, Legislature approved laws to separate the regulatory and operational activities of the following public utilities:

Objectives	Conditionality	Status/Results
	6) Take steps for the sale of 40% of ENITEL shares, including the offer of a management contract for the winning bidder (1994–1996).	• Telecommunications (TELCOR, ENITEL) • Power (INE, ENEL) 6) In December 1995, a law created ENITEL to operate public telecommunications services, and authorized to sell up to 40% of its shares, as requested.
C. Tax System and Administration 1) Increase and maintain tax revenue to ensure objectives of stabilization and non/inflationary financing of medium/term government program. 2) Simplify and strengthen tax administration.	1) Removal of income tax exemptions and approval of a program to phase out indirect tax exemptions, including import tax exemptions (1991). 2) Adoption of a plan to improve tax administration with specific emphasis on GVT and income tax collections (1991), to be initiated immediately.	1) Corporate income taxes were unified, number of tax brackets for personal income taxes were reduced, the maximum marginal income tax was reduced in line with regional standards, and the VAT was raised from 10 to 15% (1990–1991). 2) The registry of the 10,000 largest tax contributors was updated and modernized (1990–1992). 3) Tax exemptions were reduced; public enterprises were subjected to taxation; income taxes applicable to agricultural and non-agricultural activities were unified; and coffee exporters were subjected to withholding tax (1993–1995).
D. Public Sector Reforms Create an efficient, smaller and modern public sector.	1) Prepare and begin implementing a 3-year plan in line with the Government's public sector reform policy statement covering: institutional restructuring, civil service reform, budgetary management, tax and customs administration, decentralization and strengthening of the Judicial and Legislative branches (1994–1996). 2) Create and initiate staffing of a Reform of the State Program Management Unit, which will design and coordinate the program (1994).	1) Conditionality was fulfilled. 2) Multi-year modernization program of the judicial system, including the construction of courthouses in most principal capital and training program for all judges was implemented, from 1992 to 1998.

Objectives	Conditionality	Status/Results
	3) Achieve satisfactory progress in its implementation, including the restructuring of at least 2 important public institutions.	3) Improved transparency and accountability in management of public finances through the adoption of an Integrated Management System (SIGFA) in central government ministries. 4) As of December 1996, six Institutional Restructuring Agreements (ARI) had been finalized (for MCT, MIFIN, MARENA, MEDE, INIFOM and INSS) and reforms started to be implemented, notably: (i) In MCT, a Planning Division for Economic Infrastructure was created; (ii) In INSS, a new social security system was designed and implemented (social welfare being separated from pension and health insurance).
III. Financial Sector Reform **A. Banking Sector Policy** Improve the allocation of resources and the efficiency of financial intermediation regulating banking activities, strengthening monetary control and developing a private sector based financial system.	1) Adoption of an action program for the restructuring of state owned banks and carrying out the: i) liquidation/merger of BIN with BANIC; ii) dissolution of CORFIN; iii) restructuring BNIC, BND and BP according to plans.	1) A policy of reducing the size of the state banking sector has been implemented within the framework of a state reform program agreed with IMF, World Bank and IDB. As of January 1997, the state banking sector included 3 institutions: BANADES, BANIC and BCP.
	2) Maintaining policy of : i) not recapitalizing state banks, through new public sector funds or revaluation of non-financial assets; ii) ensuring compliance with prudential norms and banking regulations; iii) no pre/assigning of rediscounts from the Central Bank for specific activities.	2) Non performing assets of BANADES and BANIC were transferred to COBANICA, a new collection agency (1996); ceiling was set on BANADES loans growth and its network downsized.
	3) Submission to Legislature of a bill on Banking and Financial Institutions, to be developed and implemented with technical assistance support.	3) A new law permitting the establishment of private banks and creating a Superintendency of Banks was approved (1991). Further on in 1995 and 1996, a new General Banking Law and a new Central Bank Law were approved.

Objectives	Conditionality	Status/Results
	4) Adoption of an interest rate policy close to the market.	4) Interest rate controls were progressively removed and directed credit was eliminated.
	5) Cessation of Central Bank subsidies and discounts except for agriculture and micro-enterprises.	5) Private banking has developed rapidly. Moreover, insurance market was opened up to private interests (1996).
	6) Issuance of licenses (3 at least) to start-up private financial institutions.	
B. Superintendency of Banks		
1) Establishment of a appropriate regulatory framework to be progressively strengthened.	1) Adoption of regulations for the implementation of the Superintendency Law and start-up of activities.	1) In May 1996, the Superintendency of Banks and other Financial Institutions (SBIF) approved new prudential norms on loan concentration, capital adequacy and assets evaluation, and reforms to exception to the norms.
2) Enforcement of prudential norms adopted by the Superintendency.	2) Increase penalties, create new prudential norms and improve the operations of the Superintendency of Banks, under an agreed action plan.	2) The new General Banking Law included the strengthening of the Superintendency.
3) Improve the financial information system and accounting systems.	3) Design and implement a debtor management system.	3) The system is operating with three tools: relevance analysis, balance information, loan amounts and provisions. The central risk system is tested, to maintain it current.
	4) Implement a new chart of accounts.	4) A new chart of accounts has been implemented since 1994, including all state and private banks.
IV. Private Sector Development Improve climate and incentives for private sector activity. **A. Property Rights** (ERC-II only) Resolve property rights disputes/ problems in order to improve security of land tenure.	1) Establish a program to review compliance with current procedures to resolve property conflicts.	1) Established a National Review Commission, an Office of Territorial Ordering and the Office of Quantification of compensation, during 1992–1993.
	2) Satisfactory implementation of the verification process.	2) As of 1996, the Office of Territorial Ordering had resolved 12, 117 cases (houses) equivalent to 98% of the total number of cases presented for review. With respect to rural sector, 82% of the 106,130 cases submitted were reviewed.

Objectives	Conditionality	Status/Results
		Progress was also made on 91% of the Agrarian Reform cases.
	3) Complete study on potential uses of the Compensation Bonds, with the objective of raising their value.	3) As of December 1996, 4501 resolutions were issued, covering 89% of the total claims presented to the Integrated System for Review of Property Claims. Since 1993, Compensation Bonds had been issued for an amount of C$3,933 million. Moreover, on the basis of the study a Law reduced the period of the Bonds from 20 to 15 years, their fixed interest rate was increased to reach 5% and the use of the bonds was extended, to cover tax payments notably. Late 1996, a redemption system was created allowing these.
B. Discretion in Economic Policy Promote a more stable and transparent policy environment, reducing ministerial discretion.	Issue a presidential decree establishing a policy disclosure for tax and fiscal matters, abrogating and elevating to the Presidency, the powers of Ministries and government agencies to change policies and to create state enterprises.	Two Presidential Decrees were issued in April 1994 enforcing publication of Decrees and Administrative Rulings in the Official Gazette, and abrogating the discretionary powers of Ministries.
C. Foreign Trade Reform and Deregulation Increase output and diversification of tradable goods by increasing private sector participation in trade. Promote export growth	1) Trade deregulation opening import and export trade to private sector. 2) Design a price-based mechanism to replace import quotas, and eliminate quantitative restrictions on food grain imports. 3) Reduce nominal protection rates to a range of 10%–37% (except for fiscal industries). 4) Foreign exchange allocation mechanisms liberalization. 5) Action plan to replace existing export promotion mechanisms by a duty drawback system. 6) Elimination of most domestic price controls.	1) State exporting and importing monopolies were eliminated (1991-1992). 2) A schedule for the reduction of nominal tariff ceilings was established (1994) and at the end of 1996 the ceiling was below 40%. 3) Price controls were eliminated on all products except public utilities (1991–1993).
D. Labor Market Reform Promote greater labor productivity	Comply with agreements on labor policy.	New Labor Code was promulgated in 1996.

Annex F

Comments Received from the Government

Banco Central de Nicaragua

PRESIDENCIA

Managua, April 14, 2003

Mr. R. Kyle Peters
Senior Manager
Country Evaluation and Regional Relations
Operations Evaluations Department
The World Bank
1818 H Street, NW
Washington, DC 20433
USA

Dear Mr. Peters:

Regarding your letter on March 24, 2003, on the reviews of the two Economic Recovery Credits to our country, we are enclosing the official comments of our Institution.

The process of evaluation stated on the draft of the Project Performance Assessment report (PPAR) of these credits we feel it should be useful in learning from past experience, not only for The World Bank, but also for the Nicaraguan authorities. These evaluations help us in analyzing and learning from our errors in order to better accomplish our tasks in the future.

Sincerely yours,

Mario B. Alonso Icabalceta
President

cc: Lic. Mario J. Flores, General Manager

Annex F

Comments on "Nicaragua – Economic Recovery Credits"

1. The document on Nicaragua presents a good summary on the events, achievements and failures associated not only to the two economic recovery credits but also on the outcomes following the disbursement period. However, as it has been seen in many other cases studied in the transition economies, there are more questions than answers.

2. In general, countries shifting from a command economy to a market oriented, experience highly complex policy decisions. In addition, IDA programs (jointly with IDB and IMF programs) encompass a whole set of policies that include complex design and planning problems and even more complex execution problems. The document seems to contain the observations that aid sometimes is insufficiently conditional, and at the same time, the conditions imposed are not always fully enforceable. Recent research studies are now focused on how the conditionalities and the international financial institutions (IFI) process of interaction with the borrowing countries affect their commitment to implement the reforms. The process should be made in such a way that there will be a strong "country ownership" of the reform program in order to restore and maintain a stable macroeconomic environment. This whole process, however, should have high coordination among the IFI's and other donors, that in the case of Nicaragua, it seems was very low and some times contradictory (World Bank asked for closing BANADES and IDB had a program for continuing its operations).

3. The programs were designed with a full set of policies that kept internal consistency but relied on an explicit sequencing of actions that not always correlated on time. For instance, financial liberalization and the opening of the capital account both could be counterproductive without a strong superintendence of banks, and Nicaragua is an example of this policy mistake. Privatizing a public monopoly while lacking an effective regulatory agency lead to higher prices and less overall efficiency.

4. The framework for economic growth envisioned in the document was very simple and full of generalities. It is useful to have had a clear understanding of the role played by allocative efficiency in prices that would lead to productive efficiency. The same could be said of liberalizing foreign trade, privatizing public enterprises, reducing state intervention, adding transparency, etc. Although these developments are important for any country they do not explain success or failure in the strategy for economic growth and sometimes can exert pressures on public finances. Even more, we could identify instance of conflicting objectives between stabilization and structural adjustment policies. For instance, in Nicaragua's case, the privatization process of the CORNAP's enterprises, was made at heavy costs, with losses that at the present means heavy burden for its public finances. Furthermore, several authors have observed that high labor-capital ratios (leading to low output-labor ratios) accompanied by population dynamics in the absence of externalities can lead to poverty traps, and market-friendly policies are not always a substitute for externalities.

5. There is some evidence that sound policies (trade openness, strong competition and higher transparency) are conducive to institutional growth, specially in the presence of strong external incentives (anchors), but it also seems that causality can be running in the other

direction, that is the strength and sustainability of policies depend on the quality of the institutional settings Successful market-based economies need institutions that (among others) will protect not only people's property rights but also a Judiciary that can uphold the rule of law and rein in corruption.

6 In this context, it should be further emphasized the need for institutional strengthening to be at the forefront of efforts to improve growth and reduce poverty. This is additional to provide appropriate regulation of product, factor and financial markets to counteract the sources or consequences of market failures, and to support macroeconomic stability. The main interrogation still remains, what might constitute an appropriate reform agenda for a country like Nicaragua, in terms of institutional design and reform strategies and priorities?

7. Finally, there are issues coming from the political economy of reform. The document should be more aware of how vested interests might undermine the reform process. With burdens unequally and unfairly shared, the losers and especially well-organized domestic interest groups can undermine the reform efforts, influencing authorities' political cost-benefit calculus and delaying the decision process. In Nicaragua, it was relevant the actions of these domestic groups in maintaining the political instability and slowing down the approval of required legislation and reforms to meet all the goals specially in the area of privatization and financial system programs.

IMAGING

Report No.: 25887
Type: PPAR