MISSION CONCLUDING STATEMENT

Nicaragua: Staff Concluding Statement of the 2019 Article IV Mission

November 20, 2019

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

This statement summarizes the preliminary findings and recommendations of the mission that visited Managua during October 29-November 12 in the context of the 2019 Article IV consultation. The mission is grateful to the authorities for the constructive dialogue and hospitality.

Context and recent economic developments

1. Social unrest in April 2018 and its aftermath have caused an abrupt economic contraction. Real GDP fell by 3.8 percent in 2018 as road blockades and impairments to infrastructure caused supply disruptions, while sharply weaker consumer and investor confidence resulted in bank deposit outflows and decreased private investment. The tourism, construction, and retail sectors were particularly affected. In 2019, the economy is projected to shrink by 5.7 percent. The contraction is due to the deterioration in confidence and international sanctions, which aggravated financial constraints and reduced investment, employment, and social indicators. Inflation is projected at 6.4 percent by end-2019 (as compared to 3.9 percent in 2018), which reflects the transient effect of tax measures adopted earlier this year.

2. The economic contraction resulted in an external current account surplus in 2018 and 2019H1. Steady growth in remittances, exports, and a drop in imports—due to lower disposable income—caused an improvement in the current account. The stronger current account was more than fully offset by capital outflows (FDI and private portfolio flows). In recent months, however, capital outflows have decelerated, and banks improved their liquidity positions. Overall, net international reserves (NIR) are expected to increase by US$ 171 million in 2019 (in 2018 NIR reached US$ 1,146 million, down US$ 656 million from the 2017 level).

3. Strong buffers and the authorities' determined macroeconomic policy response to the very difficult circumstances helped avoid a downward economic and financial spiral.

4. The Consolidated Public Sector (CPS) position in 2018 deteriorated to a deficit of 3.9 percent of GDP but is expected to improve significantly in 2019. In response to the difficult situation posed by the 2018 events when tax collection plummeted, the pension system depleted its reserves and external financing dwindled, in 2019, the government adopted revenue-enhancing measures and reduced capital expenditure to reverse the deterioration in the fiscal balance. Overall the CPS deficit is estimated at 2.2 percent of GDP in 2019.

5. In response to the challenging macroeconomic situation, monetary and financial sector policies eased during 2018-19. In 2018, a combination of efforts by banks to enhance their liquidity buffers (through attracting new external financing and accelerating loan collection) and of the authorities by introducing repos, reducing reserve requirements, and phasing-in regulatory provisioning helped the financial sector and borrowers to adjust to the new environment. The economic downturn and loan recalls have nevertheless imposed a heavy toll on bank asset quality and profitability. In recent months, however, the outflow of bank deposits appears to have bottomed out and flows of new non-performing and restructured loans have largely been contained (broadly, the nominal amount of these assets, after including *"aliviados,"* seems to have stabilized in 2019.Q3). Through end-September 2019, the officially reported NPL ratio was 3.8 percent, while a broader measure of borrowers experiencing some sort of distress accounts for 18 percent of total loans. The declared level of liquidity (45 percent of total deposits) and solvency (almost 22 percent of risk-weighted assets, more than twice the minimum capital requirement ratio) through September 2019 suggest the banking system holds good cushions to withstand decreased confidence and economic growth.

Outlook and policy recommendations

6. The main challenge for 2020 and beyond is to stay on course to preserve macroeconomic and financial stability. Restoring confidence and external financing flows is critical to avoid a further contraction in credit and jobs, which would continue to hold back investment and consumption, implying a significant headwind to economic activity. As a result, real GDP growth is expected to contract by a more moderate 1.2 percent in 2020 before gradually recovering to a low level of growth over the medium term. Policies to restore private sector confidence and prevent the occurrence of negative feedback loops related to credit contraction are essential to promote economic recovery and reverse the increase in poverty. Addressing medium-term fiscal challenges and undertaking structural reforms — which are unavoidable to safeguard fiscal sustainability— require obtaining broad public support. Indeed, satisfactorily addressing the challenges could significantly raise medium-term growth performance.

7. Given the tight financing envelope, fiscal policy should address fiscal sustainability while minimizing adverse impacts on economic activity and social outcomes. Based on the implementation of the announced fiscal and pension measures and assuming no additional measures are taken, the available financing in 2020 would allow fiscal policy to begin offsetting some of the underlying headwinds to economic activity—a reversal relative to 2018-19. The authorities, as mandated by law, are currently evaluating how growth-friendly the recently enacted tax reform is. Against this background, rebalancing the composition of fiscal spending becomes a priority to generate medium-term output growth prospects. Curbing expenditures on goods and services and especially transfers to state-owned enterprises will allow increased spending on social programs, social safety nets, and public investment, which would lead to more equitable and sustainable growth.

8. Restoring business confidence and addressing supply-side bottlenecks are key elements to promote sustainable economic growth. Policies to bring back private sector confidence, including a frank evaluation of the impact of recent measures, are essential to promote economic recovery and offset an increase in poverty. Over the near term, strengthening government institutions in the areas of contract enforcement and the efficiency of the legal framework in settling disputes, protection of property rights, investor protection, registering property, and resolving insolvencies could significantly improve the country’s competitiveness. In the medium term, Nicaragua needs to continue efforts to improve infrastructure, invest in human capital, address labor skills bottlenecks, and upgrade technological readiness, all of which would contribute to enhancing the economy’s competitiveness and growth potential.

9. The international reserve coverage should be increased. The country characteristics of Nicaragua (crawling peg exchange rate regime, a high degree of dollarization, and volatile terms of trade and FDI flows) suggest that increasing the reserve coverage to a range between 5 to 10 months of imports—compared to the projected level of 4.6 months at end-2019—is advisable to contain risks. The real exchange rate is assessed to be moderately stronger than warranted by fundamentals (by about 7 percent). Over the medium-term, Nicaragua’s weak external position should be improved by enhancing competitiveness through structural reforms to boost productivity growth while keeping inflation low.

10. Strengthening further actions to enhance the timely identification and provisioning of distressed assets should be a matter of priority. As borrowers (performing and restructured) adjust their operations to the new and lower level of economic activity, additional loan quality deterioration needs to be avoided. Ongoing efforts by the bank superintendence to verify in-situ banks' proper loan classification and provisioning by assessing with a forward-looking approach the borrower's repayment capacity are critical. Supervisory work on credit risk could be enhanced by expanding the scope of loan-inspections handled by the bank superintendence and requiring banks (according to a well-defined criteria) to conduct semi-annual independent asset quality and collateral valuation reviews to support the bank superintendence's work, and by introducing regulatory incentives for banks to monitor closely the foreign exchange position of their large non-exporter borrowers (as they account for not less than 50 percent of total foreign currency- denominated loans). To offset potential additional provisioning requirements, banks should be able to use the cushion provided by their reported higher capitalization ratios through September 2019. Enhancing crisis preparedness, reforming the legal framework to facilitate debt-workouts, and strengthening the financial safety net would protect the financial system against downside risks.

11. The authorities' efforts to address the recommendations of the 2017 Financial Action Task Force (FATF) Mutual Evaluation Report are necessary to protect the integrity of financial transactions and mitigate the exposure to illicit flows. Ongoing concerns over Nicaragua's AML/CFT framework could negatively affect the financial sector, increase pressures over correspondent banking relations, and more generally deteriorate the business climate. To avoid being identified by the Financial Action Task Force as a jurisdiction with strategic AML/CFT deficiencies, Nicaragua will need to show that significant progress has been achieved to address the shortcomings highlighted in its Mutual Evaluation Report. Since July 2018, Nicaragua has made overarching reforms to the legal framework, notably, by adopting a new AML/CFT law and a new law for the Financial Intelligence Unit. Implementation efforts are underway and could be strengthened by: (i) updating Nicaragua's ML/TF National Risk Assessment; (ii) registering and building capacity for new reporting entities to effectively report suspicious transactions; (iii) implementing risk-based supervision and sanctioning non-compliance; (iv) collecting and facilitating access to beneficial ownership information.

12. Nicaragua needs to achieve greater transparency of the fiscal accounts to be able to assess better and manage fiscal risks. An efficient fiscal risk management policy requires a comprehensive vision of the government's liabilities and commitments, identification of key fiscal risks and their potential cost, the definition of early warning mechanisms, and measures for mitigation of fiscal risks, including the adoption of budgetary tools for such purposes. To provide an accurate view of the overall fiscal position, the authorities should publish financial statements—including all financial assets and liabilities, cash flows, expenditures, and financing of all the NFPS components. The efforts to include the statistics for all state-owned enterprises (SOEs), decentralized entities, and municipalities should be strengthened. The mission recommends establishing a fiscal risk unit to prepare risk assessments, including on the revenue losses from tax expenditures, to be reviewed by the Economic Cabinet before the budget bundle is submitted to the National Assembly. Strengthening SOEs financial governance is also a priority and will reinforce overall fiscal risk management.

13. Addressing anti-corruption policy weaknesses could advance competitiveness and growth. Improving the understanding of corruption risks among public officials and private agents, updating related policies and strategies, and enhancing dialogue and institutional coordination for increased prevention, investigation, and prosecution of cases would help to fight corruption. Also, international good practices suggest the need to strengthen the existing asset declaration regime for high-level public officials as well as further efforts targeted at politically exposed persons. Contract enforcement and the efficiency of the legal dispute settlement framework, enforcement of property rights, investor protection, registering property, and resolving bankruptcies continue to be a priority. Stronger anti-corruption measures would help collect more tax revenues, improve resource allocation, upgrade fiscal risk management, and provide better quality and quantity of social and physical infrastructure.

14. Past progress in widening and disseminating economic statistics needs to be preserved. Further efforts are needed to improve source data in the real sector, particularly for tourism, manufacturing, and retail; incorporate the results of the household survey in the national accounts; harmonize public sector debt with external sector debt data; monitor assets and liabilities of public enterprises; and improve coverage of FDI statistics. The mission, nevertheless, welcomes the authorities' intentions to continue building on the Fund's technical assistance to improve the quality and consistency of statistics. The mission recommends resuming the timely publication of data, which is critical to business confidence and policy credibility.

Nicaragua: Selected Economic Indicators, 2015-21

	2015	2016	2017	2018		2019	2020	2021
				Pre-Crisis	Prel.	Projections		
Output	(Annual percentage change)							
GDP growth	4.8	4.6	4.7	4.7	-3.8	-5.7	-1.2	0.0

GDP (nominal, US$ mill.)	12,757	13,286	13,844	14,581	13,118	12,431	12,421	12,600
Prices								
GDP deflator	7.6	4.6	4.5	5.9	3.4	5.4	5.0	4.5
Consumer price inflation (period avg.)	4.0	3.5	3.9	5.9	5.0	5.4	5.0	4.5
Consumer price inflation (end of period)	3.1	3.1	5.7	6.0	3.9	6.4	5.0	4.5
Exchange rate								
Period average (Cordobas per US$)	27.3	28.6	30.1	…	31.6	…	…	…
End of period (Cordobas per US$)	27.9	29.3	30.8	…	32.3	…	…	…
Real effective exchange rate								
Fiscal Sector				(Percent of GDP)				
Consolidated public sector balance	-2.1	-2.5	-2.3	-3.3	-3.9	-2.2	-3.1	-3.7
Revenue (Incl. grants)	27.4	28.7	29.2	28.6	28.0	30.8	30.1	30.1
Expenditure	29.5	31.2	31.5	31.9	31.9	33.0	33.2	33.8
of which: Central Gov. balance 1/	-1.3	-1.1	-0.9	-0.9	-3.2	-0.8	-1.5	-2.3

Revenue	17.7	18.5	18.7	18.4	17.4	19.6	18.7	18.7
Expenditure	19.0	19.6	19.6	19.3	20.6	20.3	20.2	21.0
Money and financial	(Annual percentage change)							
Broad money	19.5	9.4	11.7	9.7	-18.7	-6.3	3.7	4.5
Credit to the private sector	23.5	17.5	16.0	15.5	-8.7	-7.8	0.6	3.0
Net domestic assets of the banking sys.	19.2	11.0	8.8	14.6	-7.7	-1.6	3.9	3.2
External sector	(Percent of GDP, unless otherwise indicated)							
Current account	-9.0	-6.6	-4.9	-8.9	0.6	1.5	1.2	0.8
of which: oil imports	6.1	5.2	6.4	8.4	7.6	7.6	7.2	7.1
Capital and financial account	14.7	9.0	9.6	8.2	-1.4	-2.5	-1.4	-0.5
of which: FDI	7.1	6.3	5.1	5.6	2.2	2.6	2.6	2.7
Gross international reserves (US$ mill.)2/	2,353	2,296	2,593	2,137	2,080	1,937	1,906	1,941
In months of imports excl. maquila	4.8	4.1	5.3	3.5	4.8	4.6	4.5	4.5
Net international reserves (US$ mill.)3/	1,601	1,506	1,802	1,592	1,146	1,320	1,392	1,471
Public sector debt 4/	40.7	41.7	44.2	42.7	47.8	51.7	54.0	56.4

MEDIA RELATIONS

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Domestic public debt	9.1	9.5	9.4	9.0	9.9	10.9	12.2	13.3
External Public Debt	31.7	32.2	34.8	33.7	38.1	41.8	43.1	44.2
Private sector external debt 5/	44.8	44.6	43.1	35.4	43.6	43.0	40.9	38.5

Sources: National authorities; World Bank; and IMF staff calculations and estimates.

1/ Central government deficit and INSS revenue in 2018 include a 1.2 percent of GDP for repayment of INSS historical debt. Similar transfers are projected in 2019-24

2/ Excludes the Deposit Guarantee Fund for Financial Institutions (FOGADE).

3/ Excludes resources from the Deposit Guarantee Fund for Financial Institutions (FOGADE), and reserve requirements for FX deposits.

4/ Assumes that HIPC-equivalent terms were applied to the outstanding debt to non-Paris Club bilaterals. Does not include SDR allocations. From 2016 onwards includes preliminary data on the domestic debt of SOEs and municipalities. Prior to 2016, the stock of domestic debt of SOEs and municipalities is based on the capitalization of flows.

5/ Includes short-term commercial debt.

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