

**INTERNATIONAL DEVELOPMENT ASSOCIATION AND  
INTERNATIONAL MONETARY FUND**

NICARAGUA

**Joint Staff Assessment of the Poverty Reduction Strategy Paper  
Second Progress Report**

Prepared by the Staffs of the International Development Association and  
the International Monetary Fund

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1. **The second annual Poverty Reduction Strategy Paper<sup>1</sup> (PRSP) Progress Report of the Government of Nicaragua presents a complete review and analysis of the government's implementation of the PRSP to date, and lays out the government's intentions to update the strategy during 2004.** This Progress Report (henceforth the Report) presents the results in implementation during the second year of the PRSP presented to the Boards of the IMF and IDA on September 19, 2001 and September 25, 2001, respectively. The Report incorporated inputs from government, civil society, and the donor community. It addresses seven key areas: (i) revision of the medium-term macroeconomic framework; (ii) progress in poverty reduction; (iii) implementation of policies and programs under the four pillars and three cross-cutting themes of the PRSP;<sup>2</sup> (iv) progress in targets and intermediate indicators, selected on the basis of the Millennium Development Goals (MDGs); (v) enhancement of public expenditure management instruments; (vi) impact analysis; and (vii) rationale and plans for updating the PRSP. Donors expressed strong support for the PRSP process at the Consultative Group (CG) meeting in October 2003. The government and stakeholders also expressed their continued commitment to the process.

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<sup>1</sup> *Estrategia Reforzada de Crecimiento Económico y Reducción de Pobreza*, Government of Nicaragua, July 2001.

<sup>2</sup> The four pillars are: (i) broad-based economic growth and structural reform; (ii) investment in human capital; (iii) better protection of vulnerable groups; and (iv) institutional strengthening and good governance. Three cross-cutting themes address the country's ecological vulnerability, social inequality, and the need for greater decentralization.

## I. OVERALL ASSESSMENT OF THE REPORT

2. **The Report presents a balanced assessment of achievements and challenges encountered in implementing the poverty reduction strategy in Nicaragua.** It examines progress in meeting PRSP targets and intermediate indicators during the second year of implementation of the strategy, and broadens the analysis of poverty reduction. The Report continues to emphasize links between the PRSP and MDGs, identifies remaining challenges, particularly where performance may have fallen short of the desired outcome, and notes the relevance of monitoring intermediate indicators to ensure steady progress. It presents the findings of two Poverty and Social Impact Analyses (PSIAs) of the recent tax reforms and the prospective education reforms that Nicaragua is contemplating under the Education For All—Fast Track Initiative (EFA). While recognizing that advances have been made in fiscal decentralization, the Report acknowledges that substantial work is needed to complete the legal framework and norms and to devolve responsibilities.

3. **The Report details government-led efforts to improve donor coordination** mainly through two workshops seeking agreement on mechanisms to realign donor assistance toward achieving development objectives contained in the strategy and to improve impact and cost-effectiveness of programs.<sup>3</sup> It details progress in establishing sector-based coordinating boards as mandated by a presidential decree in February 2003, and a global coordinating board established in June 2003 after the second workshop.

4. **The Report incorporates inputs from government, civil society, and bilateral and multilateral donors.** Report preparation under the leadership of the Secretariat of Coordination and Strategy of the Presidency (SECEP) was a joint effort with the Ministry of Finance (MHCP) and the Central Bank of Nicaragua (BCN). Line ministries and government agencies also participated, particularly those responsible for monitoring the PRSP and MDGs, such as the Ministry of Health (MINSAL), the Ministry of Education (MECD) and the Nicaraguan Water and Sewerage Company (ENACAL). The Report was discussed with the National Commission for Economic and Social Planning (CONPES) in mid-October 2003, which is the primary channel at the national level for formal consultations with civil society on economic and social policy, including PRSP preparation.<sup>4</sup> Donors were consulted at the CG meeting.

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<sup>3</sup> Detailed information is contained in the document “Coordination of the Cooperation for Development” at <http://srec.cancilleria.gob.ni/publicaciones/publicaciones6.shtm>.

<sup>4</sup> CONPES, created to advise the President on the formulation and evaluation of social and economic programs, brings together representatives of political parties, the business community, labor unions, churches, universities, and a network of national NGOs. It was given the added responsibility of liaising with civil society and other stakeholders to provide feedback for the preparation of the PRSP and to build ownership for the poverty reduction strategy.

## II. PROGRESS IN IMPLEMENTATION OF THE POVERTY REDUCTION STRATEGY

### A. Medium-Term Macroeconomic Framework

5. **The current government has succeeded in reorienting economic policies after a series of shocks and an initial weak policy response.** Real GDP growth fell from its 1999 peak due to a weakening of fiscal and monetary policies (2000–01), a banking crisis (2000–01), and the deterioration in the external environment (1999–2002). However, the government that took office in 2002 moved quickly to address the large imbalances by implementing corrective fiscal and monetary policies.<sup>5</sup> As result of these policies, the economy has stabilized, growth has started to recover moderately, inflation remains under control, and the external position has strengthened.

6. **Revised real GDP growth targets are feasible with sustained prudent macroeconomic policies and institutional reforms.** While near-term growth projections have been trimmed somewhat, reflecting recent trends, over the medium term, growth is expected to converge toward potential output growth, estimated to be about 5 percent (Table 1). The PRSP underscores the importance of macroeconomic stability based on prudent policies and the role of the private sector as the main engine of growth. It also highlights the objective of broad-based economic growth that promotes employment and rural development. To this end, the authorities intend to increase investment in human capital, improve protection of vulnerable groups, and strengthen institutions and governance.<sup>6</sup>

Table 1. Nicaragua: Medium-Term Macroeconomic Framework

	Prel.	Projections					
	2002	2003	2004	2005	2006	2007	2008
		(Annual percentage change)					
GDP at constant prices	1.0	2.3	3.7	3.8	4.2	4.6	4.8
Consumer prices (period average)	5.3	6.2	6.0	4.5	3.9	3.1	2.2
		(In percent of GDP)					
Combined public sector balance before grants	-10.5	-8.4	-6.8	-6.3	-6.6	-5.4	-4.7
Combined public sector balance after grants	-5.5	-3.2	-3.8	-3.0	-3.2	-1.8	-0.9
Investment	32.1	31.5	31.0	30.8	29.9	30.9	30.3
Private sector	25.3	24.2	22.7	22.6	21.7	22.6	22.1
Public sector	6.8	7.3	8.2	8.3	8.2	8.2	8.2
National savings	10.7	13.6	15.1	16.1	16.5	18.4	18.6
External savings	21.4	17.9	15.8	14.7	13.4	12.5	11.7
Memo item							
Debt service ratio, after HIPC relief 1/	16.9	12.4	9.5	10.6	12.0	12.0	10.9

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

1/ In percent of three-year average of exports of goods and nonfactor services.

<sup>5</sup> Measures included two rounds of tax reform, restraint in nonessential spending, the sale of intervened banks' assets, and the restructuring of domestic debt.

<sup>6</sup> The recommendations of the public expenditure commission, which was created in July 2003, should help strengthen the government's development strategy. Key recommendations include improving financial management, through creation of a unified registry of public investment, and better monitoring of all public spending. Progress in implementation of the recommendations of this commission should be incorporated into the next PRSP progress report.

7. **The medium-term macroeconomic framework centers on sustained prudent fiscal and monetary policies.** The fiscal strategy focuses on reducing the overall deficit through continued efforts to improve revenue administration and rationalize expenditures. The combined public sector (CPS) deficit after grants is projected to fall from 3.2 percent of GDP in 2003 to 0.9 percent in 2008. The government plans to improve tax collections and streamline public spending. Financing needs, including those stemming from rising public investment, could be met by grants from bilaterals and could qualify for highly concessional financing from multilaterals with a view to ensuring debt sustainability. Monetary policy will remain guided by the objectives of maintaining low inflation and reducing domestic debt, while strengthening the central bank reserve position. Lowering the stock of dollar-indexed and dollar-denominated domestic debt of the BCN is also critical to reduce vulnerabilities and to support commercial bank lending to the private sector.

8. **Further analysis on the sources of growth and how best to reduce vulnerabilities would be useful.** In the National Development Plan (NDP), which was presented in draft form in October 2003, the authorities elaborated the first pillar of the PRSP—broad-based economic growth and structural reform. However, the analysis in the PRSP could be strengthened by evaluating in more detail the sources of growth as well as the greatest risks to the targeted growth profile. In addition, the report would benefit from a discussion of ways to improve the economy's resilience to external shocks and on the economic structure revealed by the revised national accounts.

9. **The PRSP could include a more detailed description of the actions being implemented to strengthen the financial system.** Despite the progress achieved so far, the prudential and supervisory framework of the financial sector needs to be strengthened further—the authorities are addressing this challenge. Government policies that merit support include granting legal protection to banking supervisors, introducing consolidated supervision, and modifying the legal framework in line with international best practices. Nicaragua's participation in the Financial Sector Assessment Program (FSAP) will help identify financial sector vulnerabilities and reform needs.

## **B. Poverty Reduction**

10. **The authorities made good progress in reducing poverty during 1993–2001,** but new data are not available to assess the impact of more recent policies stemming from the PRSP. The share of the total population living in poverty fell from 50 percent in 1993 to 46 percent in 2001, while that in extreme poverty declined from 19 percent to 15 percent over the same period. Two nationwide surveys in 2001—the Living Standards Measurement Survey (LSMS) and the Demographic and Health Survey (DHS)—extended the database derived from the LSMS carried out in 1993, 1998, and 1999, and the DHS in 1998.<sup>7</sup> Living Standards Measurement Survey (INEC) has been fully engaged

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<sup>7</sup> New LSMS and DHS surveys are expected in 2005.

in the analysis of poverty and living conditions. INEC has deepened the systematic analysis of poverty by regions and by examining distributional issues for income and consumption. Notwithstanding the above progress, recent external and domestic shocks have dampened growth and contributed to a fall in GDP per capita. More needs to be done to recover lost ground and to work toward meeting the MDGs.

### **C. Implementation of Policies and Programs**

11. **The pursuit of fiscal discipline to restore macroeconomic stability has dominated the second year of strategy implementation.** Upon taking office in January 2002, the new authorities faced major macroeconomic imbalances that needed to be addressed urgently. The authorities rose to the challenge with the adoption of corrective stabilization and structural adjustment measures that led to an agreement with the IMF on a three-year PRGF-supported program in December 2002. This program, which is essential for the successful implementation of the strategy, remains on track.

12. **Effective implementation of the strategy continues to require establishing operational links with PRSP goals, as recommended by the IDA and IMF staffs in the previous assessment.** Line ministries and government agencies responsible for implementing the strategy need to translate intermediate indicators into specific actions and measurable outputs with detailed timelines and funding allocation commitments. Most agencies have planning departments working on improved criteria to select high-impact and cost-effective programs aligned with intermediate indicators established in the strategy. However, the current process of elaboration of the national budget uses administrative categories and past allocations as main guiding principles. Administrative and financial departments have a leading role in elaborating annual budgets, while planning departments are still weak and have little influence in advancing toward a more strategic approach to the national budget. Consequently, this is a critical missing link for sectoral budgets to respond to sectoral policies and priorities.

13. **Nicaragua has an opportunity to enhance its economic prospects by participating actively in the Central America Free Trade Agreement (CAFTA).** Trading relations with the country's major trading partner, the United States, could be liberalized significantly under CAFTA. This trade agreement is expected to: (i) boost exports by making permanent and expanding the Caribbean Basin Initiative trade preferences currently enjoyed by Nicaraguan exporters, (ii) improve the investment climate and thus attract new national and foreign investment, and (iii) consolidate the Central American Common Market trading block. Nicaragua also faces important challenges in the implementation of CAFTA, including the need to cushion the potential impact on a few sensitive protected activities (mainly traditional agricultural activities) and ensuring that the gains from freer trade benefit the majority of the population. The Ministry of the Economy (MIFIC) with Bank technical and financial support is completing a study on CAFTA's challenges and opportunities for Nicaragua's agricultural sectors, including evaluating the effects on potential winners and losers and alternative policy responses. The staffs recommend incorporating the findings of the

study in the next PRSP progress report. Another important topic in relation to CAFTA is its potential impact on public finances. Although the authorities believe that Nicaragua's generally low levels of external tariffs, and the expected gradual reduction of tariffs over a period of up to 15 years, should result in a minimal fiscal impact, nonetheless IDA and IMF staffs suggest a more in-depth analysis of this area once listings and schedules are publicly available and also incorporating the analysis in the next PRSP progress report.

#### **D. Targets and Intermediate Indicators**

14. **Less than half of the PRSP's monitorable goals<sup>8</sup> were met during the second year of implementation.** The Report attributes this disappointing performance mostly to lower economic growth than originally envisaged. However, better success in achieving PRSP targets will also require strengthening work at the sectoral levels, particularly in prioritizing actions and allocating resources accordingly. This, together with accelerating progress in institutional reforms in the social sectors, are key challenges for meeting PRSP targets.

15. **Despite past gains in poverty reduction, achieving the targeted reduction in extreme poverty by 2015 would require a minimum 2 percent annual growth in real per capita GDP.** An even faster pace would be required to achieve many other PRSP/MDG goals. Fertility rates continue to be high, progress in education is mixed, productive infrastructure has been virtually stagnant since the early 1990s, basic water and sewerage infrastructure has progressed very modestly, and diarrhea and upper respiratory infections for children under five show little progress since the early 1990s. Moreover, most health sector goals were not met during the second year of implementation of the strategy. Although the Report identifies contributing factors for the less-than-satisfactory performance, and suggests some remedial actions, the quality of public health expenditures needs to improve by consolidating the large number of overlapping projects into programs that focus on the country's core health priorities. MDGs and other long-term goals that may possibly be achieved are those related to extreme poverty, under-five mortality, access to water, and access to sanitation.<sup>9</sup> Targets for universal primary enrollment, maternal mortality, and infant mortality are not likely to be reached. Also, access to reproductive healthcare services, chronic malnutrition, and illiteracy are not likely to be met. Among all MDGs and PRSP long-term goals, infant mortality, diarrhea and acute respiratory infection, access to reproductive healthcare services, access to water, access to sanitation, and illiteracy are worrisome. The most important country-specific factors associated with PRSP/MDGs in Nicaragua include: female literacy, institutional births, access to safe water, electricity, home and land titling, sanitation,

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<sup>8</sup> Progress in several key PRSP goals linked to MDGs (i.e., poverty reduction and infant and child mortality) is monitored for 2001, but not for 2002 or 2003, because these indicators are measured by LSMS and DHS surveys only every three to four years.

<sup>9</sup> World Bank (2003) Nicaragua Poverty Assessment Report No. 26128-NI.

roads, and vaccination. In particular, access to safe water is relevant for three key goals for children under five: mortality, malnutrition, and diarrhea.

### **E. Public Sector Management**

16. **The authorities have developed an expenditure-tracking mechanism that adequately monitors the use of budgetary savings resulting from the interim relief under the Heavily Indebted Poor Countries (HIPC) Initiative.** This mechanism is broadly in accordance with the proposals set out in Appendix III of the Decision Point Document (EBS/00/259). The proposals in that appendix identify the Supplementary Social Fund (FSS) as the entity responsible for monitoring the use of HIPC debt relief and indicate that the use of those funds will be reflected in the central government budget, which is to identify the government's total poverty-related outlays.<sup>10</sup> Under the current tracking system, the BCN calculates the total budgetary savings from HIPC debt relief for each year. This information is incorporated into the central government budget, which also identifies all central government expenditures and transfers associated with the poverty-reducing programs identified in the PRSP, as well as all other external and internal sources of financing for those programs. With this information, which is publicly available, it has been possible to verify an increase in external resources, including HIPC debt relief, dedicated to poverty-reducing activities, with no decline in domestic resources allocated to similar activities. As described in the HIPC completion point document, the authorities have met satisfactorily the targets for poverty spending as a share of GDP.

17. **Significant improvements have taken place in public sector management.** In particular, progress toward greater accountability and transparency include: (i) the implementation of the Integrated Financial and Administrative Management System (SIGFA) across the central government; (ii) the operation of a single account in the treasury; (iii) making the national budget and its execution available online; and (iv) government-led action plans with specific instruments, timelines, and commitments to be supported by the Bank under the Poverty Reduction Strategy Credit (PRSC). Nonetheless, there are some areas that need continued cooperation, assistance, and technical support, which the Bank intends to support through a Public Sector Modernization Technical Assistance Credit (PSMTAC), expected to be presented to its Board in March 2004.

18. **Program prioritization needs to be improved urgently, and intermediate indicators developed to help measure progress and enhance resource efficiency.**

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<sup>10</sup>The "*Reglamento Operativo FSS-HIPC*" approved by the FSS Coordinating Council in September 2002 envisaged a budgetary treatment of the FSS that is different from its current treatment and that would have complicated the budget presentation. The authorities revised the FSS operating regulations in November 2003 to conform to the current budget treatment of the FSS, which IDA considers adequate. The revised regulations were approved by the FSS Coordinating Council.

Program prioritization, old and new, needs further improvement alongside the preparation of the first multi-year budget expected in 2005. Participatory planning at the local level is still only just getting started. Local stakeholders have been involved in elaborating municipal plans, but mostly through uncoordinated efforts by way of separate programs, mainly the Emergency Social Investment Fund, (FISE), the Program for Supporting Implementation of the Strategy (PAI), and the Program for Supporting Monitoring of the Strategy (PASE). A PRSC prior action will help address this problem by supporting the definition of institutional responsibilities at the municipal and central government levels. In addition, INIFOM has initiated work to produce its first corporate annual operating plan for 2004,<sup>11</sup> and signed a coordination agreement with FISE.

19. **A comprehensive system for monitoring poverty indicators and for program evaluation has yet to be implemented.** A consultancy for designing a National System to Monitor Poverty Indicators (SINASIP) was commissioned by SECEP in 2001 and financed by the IDB, but the system still is not operational. A Statistical Technical Committee has been established to support monitoring.<sup>12</sup> Short-term actions to be taken, and detailed in the Report, include establishing a web page and implementing SINASIP at the departmental levels. This should contribute to the formulation, execution, and monitoring of PRSP programs, projects, and indicators at the departmental and local levels. The staffs attach particular importance to creating a well-functioning poverty monitoring system. They regard it as a core responsibility of SECEP, and encourage the government to move promptly from the planning to the implementation stage. INEC and the line ministries have made significant advances in statistical and administrative data collection. However, further efforts are needed to use the information selectively, incorporating it into policy making and program evaluation. Advances in monitoring at the local level include on-going collaboration between INIFOM and SECEP, supported by PAI, in providing a monitoring toolkit to municipal governments attached to the Municipal Investment Plans (PIM).

## F. Impact Analysis

20. **PSIAs were carried out on tax reform and basic education.** Two areas of reform with important economic, social, and political impact were selected for PSIA work: the Law of Fiscal Equity and the Education For All—Fast Track Initiative. The Report incorporates these PSIA results. The ministries of finance and education have incorporated PSIA findings into their action plans for strengthening revenue administration to ensure achievement of equity gains from the tax reform. They will also design mechanisms to encourage more poor children to take advantage of EFA. The

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<sup>11</sup> Supported by the Bank's Municipal Development Project, Danish International Development Agency (DANIDA), Finland, German Agency for Technical Cooperation (GTZ), Spanish Agency for International Cooperation (AECI), European Union (EU), IDB and United Nations Capital Development Fund (UNCDF)

<sup>12</sup> The commission includes MINSA, MECD, ENACAL, the Foreign Affairs Ministry (SREC), INEC, BCN, MHCP, and SECEP.

PSIA on tax reform determined the impact to be slightly progressive, both on vertical and horizontal equity grounds.<sup>13</sup> The largest redistributive impact of the Law of Fiscal Equity would come once it is fully implemented and complemented by progressive public spending. Thus, improvements in tax administration to reduce tax evasion and increase revenue collection will be key to the distributive gains of the reform.<sup>14</sup> The work was coordinated by MHCP, with participation of members of the tax reform commission established for designing the reform, and with Bank technical and financial support. Civil society members of the commission participated in this PSIA beginning from the definition of terms of reference, discussion of the methodology, and presentation of preliminary and final results.

21. **The PSIA work on the EFA indicates the need to consider both supply and demand constraints.** Projections of the number of enrolled children with and without EFA would be almost the same by 2015; about a thirty percent increase. However, efficiency gains (reduced repetition and drop-out rates) under EFA mean that a greater proportion of the children attending the system would be of the appropriate age. Increased enrollment in primary education creates the need to obtain additional funding, as stated in the EFA document, in order to both increase coverage and improve quality. For the poor to take advantage of this initiative, ways need to be found to address high direct costs of schooling plus the opportunity cost of labor of working children. Almost one-third of rural boys in Nicaragua are engaged in child labor, and there is almost a one-to-one correspondence between work and nonattendance to school for boys and girls alike. The PSIA work on basic education was jointly coordinated by MECD and the World Bank, which also provided technical and financial support.

22. **Two other PSIA's have been initiated.** One on the public investment program in coordination with SNIP, and another on decentralization in coordination with INIFOM and the Nicaraguan Association of Municipalities (AMUNIC) to be cofinanced by the Bank and GTZ. KfW is studying the possibility of financing a PSIA in the water and sewerage sector.

### G. Rationale and Plans for Updating the PRSP

23. **Sustained broad-based growth will be critical in advancing PRSP targets, including poverty reduction.** Modest progress has been made in reducing poverty and meeting MDGs. More substantial progress will require an acceleration of income growth, as well as improvements in education and health. Vulnerability to natural disasters and

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<sup>13</sup> Vertical equity implies that those with greater ability to pay taxes should contribute a larger proportion of their income or wealth in taxes. Horizontal equity implies those with equal ability to pay taxes should pay the same proportion in taxes.

<sup>14</sup> Paragraph 7 of the Supplementary Memorandum of Economic and Financial Policies provides additional information on the actions being planned by the authorities to strengthen tax administration.

terms-of-trade shocks have slowed development. Policy slippages, particularly in 2001–02, further exacerbated the situation, which coupled with the highest population growth rates in the region resulted in negative real GDP per capita growth. The first pillar of the PRSP—broad-based economic growth and structural reform—had already been identified by IMF/IDA staff as being in need of reinforcement in the last JSA. To strengthen the first pillar, the government has prepared a draft National Development Plan (NDP), for which it is seeking support from the international community.

24. **The authorities are planning to update the PRSP in 2004 by drawing on the NDP, which places special emphasis on accelerating growth.** The lessons of two years of implementing the PRSP (prepared in 2001) indicate that the PRSP needs to place more emphasis on growth in order to reach its poverty-reducing goals. Experience has shown the need for improved costing of PRSP targets, increased emphasis on export growth, detailed plans on judicial reform and decentralization, higher-quality public spending, and an improved alignment of the PRSP with the budget and the PRGF. To these ends, the authorities are planning a workshop in early 2004, with broad-based participation, including multilateral organizations.

## H. Consultation

25. **PRSP implementation efforts have broadened participation, and some increase in local level involvement has been achieved.** A presidential decree issued in March 2002 entailed a dual reform of CONPES, eliminating government representation, with the intention of strengthening the independence and autonomy of civil society, and incorporating women, youth, autonomous regions, and media representatives. Another presidential decree in October 2002 reformed the selection process of CONPES members. A short list for presidential selection, with the possibility of being re-elected, is to be formally presented by CONPES before initiating its annual session. Although the decrees signaled the new authorities' endorsement of CONPES and allowed for broader participation by incorporating new stakeholders and increasing the rotation of its members, the government tends to use this national forum only occasionally and the initial effect of the revised selection process has meant a delay in initiating sessions for most of the first half of 2003. At the national level, CONPES can continue to serve as an active forum for dialogue between government and civil society, but the authorities would need to hold sessions regularly and CONPES would need to build links with local actors, such as the municipal councils. The consultation of the draft NDP showed an important degree of ownership from the government, including consultations with CONPES and focused on seeking agreement with local actors on ways to improve the consistency of local demands with the available supply of projects. This has been a significant step forward in building ownership of the strategy at the local level. However, consultation at the local level still needs to be carried out more regularly. Formalization, through legislation currently being drafted and discussed, is needed to achieve systematic participation at the local level and will be key to ensuring successful implementation of the strategy.

## I. Risks to the Strategy

26. **The staffs consider that the strategy continues to be subject to several important political, institutional, and economic risks.**

- The implementation of the PRSP faces significant political risks given the lack of a stable majority in the national assembly, which has often delayed decision-making and policy implementation.
- Important institutional risks to program implementation are posed by weaknesses in the courts and the comptroller's office. The absence of a well-functioning judicial system undermines private sector confidence and limits the impact of efforts to reduce poverty through faster growth.
- Nicaragua remains vulnerable to natural disasters (*El Niño, hurricanes, earthquakes*) and to terms of trade shocks (*further coffee price declines, oil price increases*).
- The economy still faces significant vulnerabilities in its public finances (including a high deficit and public debt stock), a weak banking sector, and widespread dollarization.
- There are also risks associated with the potential fiscal burden of the recently approved Municipal Law "Ley de Transferencias Presupuestarias a los Municipios de Nicaragua," pension reform, and civil service reform. To ensure that these reforms do not worsen the medium-term fiscal outlook, fiscal decentralization must include the transfer of expenditure responsibilities as well as the resources to finance them. In addition, the government will need to rationalize its expenditures to make room for the costs of pension and civil service reform.
- Given the risks to the baseline fiscal strategy, including from potential political difficulties in fully implementing all of the government's expenditure-rationalization and revenue-enhancing measures, as well as the uncertain yield from these complex reforms, it is important for the government to develop fiscal contingency plans.

27. **These risks are not evaluated by the Report.** The staffs recognize that these risks have been analyzed to some extent by the draft NDP. However, the preparation of action plans to mitigate and/or avoid them is still at an early stage. Thus, the staffs recommend that the authorities prepare and implement action plans to mitigate these risks and increase the likelihood of attaining PRSP/MDG goals.

### III. CONCLUSION

28. **The Report presents a coherent medium-term macroeconomic framework and credible efforts toward implementing the poverty reduction strategy.** However, higher economic growth than currently projected will be necessary to reach most MDGs set for 2015. The staffs caution that although the economic outlook appears favorable, there are important risks and vulnerabilities, stemming from the fragile political environment, external risks, high public debt, large fiscal deficit, and potential fiscal instability. These risks underscore the need for continued prudent macroeconomic policies, complemented by structural reforms to raise the competitiveness of the economy. Sustained macroeconomic stability and broad-based economic growth continue to be key elements for achieving policy objectives and strategy targets.

29. **The staffs consider that important progress has been made in the implementation of the PRSP.** Progress has been made in several areas cited in the joint staff assessment of the first annual progress report of the PRSP, namely in: (i) improving macroeconomic stability and reducing the fiscal deficit through a combination of revenue and expenditure measures, while simultaneously achieving the poverty-reducing spending targets agreed in the program, (ii) pursuing government-led efforts to realign donor assistance to support the PRSP, (iii) formulating specific actions to implement the first pillar of the strategy for broad-based growth and structural reform, (iv) elaborating two full PSAs on the tax reform and the education-for-all initiative, and (v) initiating solid steps toward improving accountability and transparency in fiscal and public financial management systems and laying out immediate public actions to be supported under the PRSP. Five main areas are in need of further work: (i) strengthening the judicial system, (ii) updating the PRSP to strengthen the first pillar of the PRSP—broad-based economic growth and structural reform, (iii) improving program prioritization, especially in the public investment portfolio, by consolidating project registries, and applying impact and cost-effectiveness criteria, (iv) increasing participation in implementation and monitoring of the strategy, in particular within line ministries and at the local level, and (v) implementing the national system of monitoring indicators.

30. **The staffs of the Bank and Fund consider that the country's efforts toward implementation of the strategy provide sufficient evidence of its continuing commitment to poverty reduction,** and therefore the strategy continues to provide a credible framework for Bank and Fund concessional assistance and for reaching the completion point under the Enhanced HIPC Initiative. The staffs recommend that the respective Executive Directors of the World Bank and the IMF reach the same conclusion.

### Abbreviations and Acronyms

AMUNIC	Nicaraguan Association of Municipalities
BCN	Central Bank of Nicaragua
CAFTA	Central American Free Trade Area
CG	Consultative Group
CONPES	National Commission for Economic and Social Planning
CPS	Combined Public Sector
DHS	Demographic and Health Survey
EFA	Education For All – Fast Track Initiative
ENACAL	Nicaraguan Water and Sewerage Company
FISE	Emergency Social Investment Fund
FSAP	Financial Sector Assessment Program
FSS	Social Supplementary Fund
GTZ	German Agency for Technical Cooperation
HIPC	Heavily Indebted Poor Countries
INEC	Living Standards Measurement Survey
INIFOM	Nicaraguan Institute of Municipal Development
LSMS	Living Standards Measurement Survey
MDGs	Millennium Development Goals
MECD	Ministry of Education
MHCP	Ministry of Finance
MIFIC	Ministry of the Economy
MINSA	Ministry of Health
NDP	National Development Plan
PAI	Program for Supporting Implementation of the Strategy
PASE	Program for Supporting Monitoring of the Strategy
PIM	Municipal Investment Plans
PRSC	Poverty Reduction Strategy Credit
PRSP	Poverty Reduction Strategy Paper
PSIA	Poverty and Social Impact Analysis
PSMTAC	Public Sector Modernization Technical Assistance Credit
SECEP	Secretariat of Coordination and Strategy of the Presidency
SIGFA	Integrated Financial and Administrative Management System
SINASIP	National System to Monitor Poverty Indicators
SNIP	National System of Public Investment