NICARAGUA

THE IMF AND FINANCIAL SECTOR REFORM IN NICARAGUA

EXECUTIVE SUMMARY

In the 1990s, in the wake of a devastating war, Nicaragua was compelled to restructure its financial system, re-establish links with sources of multilateral finance, and operate under precarious conditions of political and social turmoil. The economic stabilization and adjustment programs implemented by President Violeta Barrios de Chamorro in the early 1990s, and more recently by President Arnoldo Aleman, is a version of the standard prescription applied by the IMF in over 60 countries in the South.

Nicaragua began program of a stabilization and adjustment program in 1990. Initially financed by USAID, the IMF took the lead in designing and implementing the program with a Stand-by Agreement in 1991. Two agreements under the Enhanced Structural Adjustment Facility have been signed, the first in 1994 and the second in 1998.

Although in theory the IMF prescriptions are intended to achieve stabilization and restart growth in indebted countries with serious structural problems, in practice these programs serve mainly to ensure that the countries under "treatment" comply with their foreign-debt obligations. Hence, much of the foreign aid upon which Nicaragua remained highly dependent -- between 1991 and 1995, foreign assistance represented an annual average of 29.9 percent of GDP -- "leaked" abroad as interest payments and amortization of foreign debt. While the trade balance has shown some signs of improvement in recent years, the deficit has actually grown since 1990. More foreign assistance has translated into more imports without economic recovery, so that the trade deficit reached 35 percent of GDP in 1997, thus contributing to the debt burden.

After several years of economic depression, the economy began to grow again in 1994, but there has been no noticeable improvement in the standard of living of the Nicaraguan people. As of late 1996, 71 percent of Nicaraguans lived in poverty, infant mortality stood at 58 per 1,000 live births, and 26 percent of children under five years of age suffered from malnutrition. As of 1997, 14 percent of the population was unemployed, with an additional 13 percent underemployed.

The financial-reform process carried out under the adjustment program has been especially controversial. Interest rates have risen to very high levels, and the new institutional structure favors short-term credit for speculative purposes rather than longer-

term investments for productive purposes. Agricultural and industrial-production groups that have been displaced by or subordinated to financial groups do not have many opportunities, especially medium-sized and small-scale producers. In Nicaragua, the large industrialists linked to the governing elite enjoy sufficient tariff protection and fiscal support to make their operations extremely profitable. The remaining sectors simply do not receive benefits or are in a disadvantaged situation.

As a result, the boom that took place in private finance and in certain extractive activities -- with high short-term profitability and minimal investment -- contrast with the stagnation of domestic production and the generalized deterioration in the conditions of that production.

While the money supply has slowly grown since 1991, the amount of money in circulation has decreased. The composition of the money supply has changed significantly, so that much more of it is now concentrated in short-term deposits at high interest rates, particularly dollar-denominated deposits. Private banks now control 66 percent of the assets in the financial system. While deposits grew at an annual rate of 41.8 percent between 1992 and 1995, gross investment as a percentage of GDP increased at an average rate of just 10.8 percent. Even that limited growth occurred primarily in the public sector and was mainly financed by foreign assistance.

Not only was the process of financial deregulation in Nicaragua not linked to a development strategy, it also failed to establish a competitive financial structure. Many barriers to the establishment of new financial institutions continue to exist. Under these circumstances, interest rates have remained high not just because of perceived business risks, but also because of the oligopolistic structure of the banking system. This has further limited productive investment.

THE IMF AND FINANCIAL-SECTOR REFORM IN NICARAGUA

by Oscar Neira, CRIES

I. Introduction

In the 1990s, in the wake of a devastating war, Nicaragua was compelled to restructure its financial system, re-establish links with sources of multilateral finance, and operate under precarious conditions of political and social turmoil. The economic stabilization and adjustment programs implemented by President Violeta Barrios de Chamorro in the early 1990s, and more recently by President Arnoldo Aleman, is a version of the standard prescription applied by the IMF in over 60 countries in the South.

The plan is applied in an unvarying sequence. The first phase is designed to achieve stabilization and fiscal surplus at any cost. After stabilization is achieved, structural reforms begin; these consist of a package of trade and economic liberalization, deregulation of markets and privatization of state-owned enterprises. Finally, efforts are made to attract investment in order to pass from stabilization to growth. There are often policy overlaps among these phases.

The program carried out by the Chamorro Administration fell into this pattern. The first measures were carried out under a 1991 Stand-by Arrangement. The first stage of reforms consisted primarily of administrative measures in public-sector operations, such as: improvements in public organization and administration; the setting of utility fees, taxes and tariffs; privatization; and the restructuring of the financial system and the allocation of credit. An Enhanced Structural Adjustment Facility (ESAF) loan was to be the bridge between the first and second phases, with the government hoping to carry out the second phase between 1993 and 1995 and then move on to the third phase in 1995 and 1996.

While the reforms made up to 1992 constituted a good starting point for further reforms -- the money supply had been stabilized and channels of foreign financial resources had been reopened -- the subsequent adjustment program has failed to establish the basis for sustained financial stability. Hence, the much acclaimed monetary stability has actually been full of ups and downs. The government has been unable to maintain the value of the cordoba, the local currency. In 1993, the government began to utilize a system of mini-devaluations that each year threatened to accelerate. This has been met with a significant dollarization of prices so as to operate with values considered stable by the public. Under this dollarized system, the risk involved in making productive investments has led to financial savings being hoarded rather than being used for productive purposes.

As a result, the boom that took place in private finance and in certain extractive activities -- with high short-term profitability and minimal investment -- contrast with the stagnation of domestic production and the generalized deterioration in the conditions of that production.

Although in theory the IMF prescriptions are intended to achieve stabilization and restart growth in indebted countries with serious structural problems, in practice these programs serve mainly to ensure that the countries under "treatment" comply with their foreign debt obligations. Hence, much of the foreign aid upon which Nicaragua remained highly dependent -- between 1991 and 1995, foreign assistance represented an annual average of 29.9 percent of GDP -- "leaked" abroad as interest payments and amortization of foreign debt. During the first half of the decade, an annual average of 12 percent of GDP flowed back out of the country. Despite these payments, by the end of 1995 the country carried the highest level of foreign debt as a percentage of GDP in the world, so that, for every dollar produced, five dollars were owed in foreign debt.

While the trade balance has shown some signs of improvement in recent years, the deficit has actually grown since 1990. More foreign assistance has translated into more imports without economic recovery, so that the trade deficit reached 35 percent of GDP in 1997, thus contributing to the debt burden.

A central result of the adjustment process in Nicaragua has been that any progress made in increasing domestic savings has been nullified by transfers abroad to repay an onerous prioritized foreign debt, making sustainable recovery virtually impossible. Despite several rounds of debt forgiveness by creditor nations, both the stock of debt and the flow of debt payments continue to create pressures far beyond the country's payment capacity.

Meanwhile, social conditions have continued to deteriorate under the country's stabilization and adjustment programs. According to a June 1994 report by the United Nations Development Programme (UNDP), 74.8 percent of Nicaraguan families lived in poverty, with 43.6 percent in extreme poverty or indigence. Total unemployment (official unemployment plus underemployment) reached 60 percent of the economically active population, affecting principally youth and women.

The adjustment program has also undermined the process of democratization in Nicaragua. The crystalization of a paternalistic, highly discretionary and corrupt state, combined with poor performance in terms of economic growth and social services, has impaired the consolidation of democracy. The balance of power reached and sustained among powerful interest groups has generated a situation in which economic policies become irrational and damaging. In fact, the structural changes that would be needed to achieve sustained growth are blocked by those implementing the IMF- and World Bank-dictated adjustment program. This coalition of "new capital" and factions of the old capital, under IMF guidance, has created a situation in which the discretionary and despotic use of power has created insecurity around property and civil rights, thus inhibiting investment. In fact, investment and imports of supplies and capital goods continue to be depressed, further contributing to low levels of production.

Key Elements of IMF Adjustment Programs in Nicaragua

Date	Agreement	Amount	Key policies
9/91	Stand-by Arrangement	US$58.4 million	* Interest-rate deregulation * Unification of legal reserve requirements * Privatization * Restriction of domestic credit * Reduction in government spending and

			deficit * Increase Central Bank reserves
6/94	ESAF	US$173 million	* Cuts in government spending * Cuts in public-sector employment * Improvements in tax collection * Restriction of credit * Resolution of property-rights issues * Privatization * Reduction of state-owned bank operating costs * Improvement in loan recoveries * Labor-market flexibility
3/98	ESAF	US$136 million	* Cuts in government spending * Increases in taxes and fees * Cuts in public-sector employment * Restriction of credit * Elimination of targeted credit * Closing of BANADES (National Development Bank) * Privatization of state-owned enterprises * Improvement of quality of social spending

Sources: Adolfo José; Acevedo Vogl, Nicaragua y el FMI: el pozo sin fondo del ajuste, Latino Editores and CRIES, 1993; IMF Survey, 25 July 1994, p. 244-5; 1998 Letter of Intent

The financial-reform process carried out under the adjustment program has been especially controversial. Interest rates have risen to very high levels, and the new institutional structure favors short-term credit for speculative purposes rather than longer-term investments for productive purposes. Agricultural and industrial-production groups that have been displaced by or subordinated to financial groups do not have many opportunities, especially medium-sized and small-scale producers. In Nicaragua, the large industrialists linked to the governing elite enjoy sufficient tariff protection and fiscal support to make their operations extremely profitable. The remaining sectors simply do not receive benefits or are in a disadvantaged situation.

As the financial has been detached from the real, and since the production of goods and jobs do not matter, social exclusion is the correlate of productive destructuring. Strengthened as they are, financial groups have broken their alliances with broad sectors of medium-sized and small businesses. With the concentration of political power in the Nicaraguan oligarchy, further polarization of income has occurred in the country. Without change to a progressive kind of "grassroots" development, the traditional style of development "from above" was maintained, and this partial adjustment has created more barriers than opportunities for profound structural change in Nicaragua.

II. Overview: Conflicting Evaluations of the Financial-Sector Reforms

It is striking how differently Nicaraguan producers and government officials view the financial-reform process. Agricultural producers insist that interest rates are very high and that the restriction of credit is very severe. Public dissatisfaction with the management of monetary policy was especially high during late 1995 and 1996 when all monetary-policy efforts focused on recuperation of the overdue loan portfolio. This put great pressure on a broad range of delinquent small-scale farmers and medium-scale businesses, as well as on the state banking system's payment capacity. This monetary-policy focus was prompted by the government's lack of compliance in the first quarter of 1995 with some of the monetary programming goals contained in the ESAF agreement with the IMF. The Fund then imposed new conditionalities designed to realign the program, measures that resulted in the imposition of partial solutions to the problem of the overdue loans.[(1)]

The government has insisted that these perceptions on the cost and scarcity of credit are unfounded. In real terms, major monetary aggregates (M3/GDP) have experienced persistent growth. Similarly, the total credit supply has grown in real terms. While real interest rates are high, this is not seen as a problem.[(2)] Instead the government and its creditors in the international financial institutions maintain that many of the existing problems are associated with the lack of deepening of the financial reform, especially measures related to privatization of the state banking system infrastructure, while avoiding a major restructuring of the system. They believe that reducing the size of the state banking system would facilitate the entry of private banks to provide credit to the agricultural and industrial sectors, sectors in which the state banks have a good deal of their current portfolio.[(3)]

While the public perception is based on an incomplete picture of the current financial-reform process, it does reflect truths that are obscured in the more aggregated presentations used by official sources. Although it is true that total real liquidity (M3/GDP) has grown substantially since 1991, this growth has occurred mainly in deposits indexed in local and foreign currencies. That is to say, the orientation of monetary policy has favored short-term financial investments or "unearned income" over the receipt of "earned income". This increase in total liquidity has occurred along with an important change in the composition of liquid real assets, so that the weight of cash and demand deposits in the economy have become less significant, and high-powered money (primarily bank reserves) has remained constant since the 1991 stabilization.

The narrowness of the financial reform, which was centered on simple compliance with the IFI conditionalities, without any vision of how to put the country back on the path to development, has led to a vicious circle of stabilization without sustained growth. In addition, inflows of foreign assistance are decreasing, making the stabilization that has been achieved quite vulnerable. This has been timidly recognized by the Inter-American Development Bank (IDB) in its 1996 Country Paper and by the government in a recent report to the Consultative Group of the Paris Club.[(4)]

In general, there is no automatic relationship between economic deregulation and improvements in the economy's efficiency. This is particularly true in countries such as Nicaragua that are experiencing complex processes of institutional and economic transformation. The elimination of public regulation over a series of economic activities in the absence of an adequate rule of law and of consolidated market structures, will only increase economic wastefulness and the system's basic irrationality. In this sense, the Nicaraguan case could offer important lessons for other countries, especially in the realm of financial deregulation.

In Nicaragua, not only was the process of financial deregulation not linked to a development strategy, it failed to establish a competitive financial structure. Under these circumstances, interest rates reached very high levels, as much due to general factors derived from the country's risk position as from the oligopolistic structure of the banking market. This has made the recovery of loans difficult and has inhibited productive investment.

III. Financial Reform in Nicaragua

A. Background

Under the Somoza regime, external price shocks were neutralized through control of the money supply. In fact, the money supply was virtually passive, adjusting itself nearly automatically to foreign-exchange flows entering the country. Under these conditions, total credit was determined by flows from the real economy and changes in the demand for money by the public. The economic policy was oriented by the monetary focus on the balance of payments.

Financial intermediation was structured in blocs that tightly integrated financing with business activities. This system favored a dualistic form of growth, since the majority of small-scale producers, mainly agricultural producers, were ineligible for financing because of institutional restrictions. But beyond that, the belief that small-scale producers were not profitable had a strong influence on policymakers, and therefore credit served more as a subsidy used for political or social reasons than for economic reasons. Credit from the national development bank was intended to assist producers not covered by private financial groups and was conditioned on their utilization of a technological package designed to make them profitable in the future.

In the 1980s, the Sandinista government attempted to control and direct the economy to make the state the center of economic accumulation.[(5)] Private banks were nationalized and the new state banking system redistributed subsidies to state-owned enterprises prioritized by government policy. In contrast to the other socialist experiences, in which finances played a residual role in controlling the economy, under the Sandinista mixed-economy scheme finance came to be the favored tool of the redistributive fiscal policy.[(6)] Consequently, the financial system lost all sense of efficiency and competitiveness, as its activities were focused on redistributing local currency and foreign exchange in order to achieve the goals prioritized by the state-centered development scheme.

During this period, the principal instruments utilized were the rationing of foreign exchange and the political allocation of credit. Central Bank credit and that of the other state banks was granted without restrictions on producers, but this did not have the expected effects on real production.[(7)] Allocating credit for political rather than economic purposes left a distinct culture of managed credit and created the perception that credit was a kind of obligatory subsidy to disadvantaged sectors.

B. External Conditionality and Financial Reform

The process of reinsertion of the Nicaraguan economy into the U.S. sphere of domination, as well as its reintroduction to traditional financing channels and to the tutelage of the international financial institutions, took place quickly under the Barrios de Chamorro Administration (1990-1996). The key factor that permitted the normalization of relations with the international financial institutions (IFIs) was the first renegotiation of the country's foreign debt in April 1990, which concluded with Nicaragua's official recognition of its accumulated debt and its commitment to repay it. At that time, the foreign debt had reached a total of US$12.693 billion.

As indicated in a 1997 Ministry of Foreign Assistance report, the bulk of the debt originated from the accumulation of penalties on overdue loans made to the Sandinista government by its allies in the then-socialist-bloc countries. Although the Sandinista government recognized the debt inherited from the Somoza dictatorship, especially that contracted with the IMF, this was not the majority of its debt. Up to 1985, the Sandinista government honored and paid off its debts with the Fund. The purpose of those actions was to maintain formal relations with the IMF, but the government was not interested in receiving new loans because of the conditionality that would be attached to them. At the peak of the Reagan era, the United States' bellicose foreign policy had great influence in eliminating loans to Nicaragua.[(8)] Because of that, starting in 1985 there were practically no relations between the Fund and the Sandinista government.

The 1990 change in government, however, did not mean that the U.S. government granted preferential treatment to Nicaragua. The "support" provided by the United States was initially channeled through USAID and then placed under the strict tutelage of the IMF, while any pardoning of the foreign debt was avoided.

The Barrios de Chamorro Administration had no choice but to accept the IMF's policy prescriptions in order to gain access to foreign resources. Given the fact that the economy was in a situation of extreme illiquidity and decapitalization, her Administration's bargaining power in negotiations was very weak. Without ample foreign support and with serious domestic conflicts, its acceptance of the external conditionality was seen as a last resort in a sea of political uncertainty.

Early in 1990, the Barrios de Chamorro Administration implemented a process of financial deregulation in response to the IMF mandates. That program re-established the role of private banks and redefined the role of the state commercial banks and the Central Bank. For that to occur, the government was forced to stretch the meaning of the existing Constitution, particularly the part referring to the role of the State Bank monopoly and its orientation toward development. The very opening of the private banks was achieved through a legal artifice, since the existing Constitution only granted those functions to the state.

In addition to authorizing the opening of private banks and financial institutions, the law creating the Superintendence of Banks and other Financial Institutions was approved and the Central Bank Code was reformed, as was the law creating the Nicaraguan Investment Fund (FNI). New reforms to general bank laws were also introduced. The process of financial reconstruction reflected the change from a centralized financial system regulated by the state to one oriented toward market forces. New institutions were created while still maintaining much of the old financial structure, so that the state banks, in order to be competitive, had to be restructured at a high cost.

In any case, the Central Bank and the state banks were curtailed and their roles redefined. Likewise, the state currency-exchange agencies were eliminated and preference was given to the development of a stock market and companies that could accept deposits. The Insurance Law was approved in 1995. This ended the state monopoly on insurance, permitting the entry of private firms.

C. Elements of the New Financial Policy

In general, monetary policy in the early 1990s focused almost exclusively on stabilization. The financial system was transformed, first as a result of conditions imposed by USAID in its September 1990 "Stabilization and Recovery Program II" program and later through conditions imposed by the Fund. In September 1991, with the signing of the Stand-by Arrangement with the Fund, the Central Bank began to shed its role of lender of first resort. It was reoriented to become a lender of last resort, focused on controlling inflation and maintaining the exchange rate, as well as monitoring the strengthening of finances and supporting the economic growth process. In short, a financial strategy oriented toward a decentralized market economy started to take form.

Between 1992 and 1994, the Central Bank substantially diminished its interventionist role in the financial system. Direct financing to the banking system through the discount window was drastically reduced, and free-market policies were implemented through the deregulation of active and passive interest rates and the establishment of very short-term lines of credit, which were mainly limited to resolving the commercial banks' liquidity problems. Likewise, within the program of re-activation and modernization of the banking system, the issuance of bonds by the Central Bank and commercial banks was authorized.

Monetary policy was narrowly adjusted to achieve the objective of controlling inflation, as was required by IMF conditionality. Initially, this meant maintaining a fixed exchange rate and, starting in 1993, sustaining the rate of mini-devaluations. With the signing of the ESAF in June 1994, it came to imply a marked conservatism in the management of the money supply, strictly controlling the expansion of the monetary base to maintain a very low inflation rate. But it also opened the possibility of an eventual conflict between two fundamental policy goals -- control of inflation and the maintenance of the exchange rate.

1) Deregulation of interest rates

Between 1980 and 1990, interest rates were fixed each month by the Central Bank, with negative real interest rates predominating. This affected the credit market, creating a high demand for credit. The period was also characterized by the existence of interest rates on savings that were higher than those for loans, which led to financial losses for the banks. According to Irving [1985], the purpose of this policy was to garner financial resources from businesses and households in order to sustain the establishment of the state as the center of accumulation.

Starting in May 1990, the Central Bank began to set interest rates annually instead of monthly, establishing a level of active (lending) rates higher than passive (savings) rates in order to eliminate the banking system's losses. In September 1991, in accordance with the Stand-by Arrangement with the IMF and the Commercial and Financial Adjustment Loan from the IDB, the Central Bank began a gradual process of deregulation of interest rates. Initially, the Central Bank fixed certain interest rates, with the rest determined by the market. This policy was intended to maintain a positive rate that would encourage savings at the same time that the supply of credit in the economy had become a determinant tool.

In 1992, the semi-free system of interest rates was continued for passive rates, while active rates were totally liberalized. Starting in 1993, interest rates were freely determined by the market. This policy was endorsed in the June 1994 ESAF and, as this was a three-year agreement, continued in force until the end of the Barrios de Chamorro Administration in January 1997. Interest rates were therefore determined by the banking market, and the Central Bank interest rate continued to be anchored to the banking rate.

2) The legal reserve requirement

During the 1980s, up to the implementation of the 1991 stabilization program, the legal reserve requirement served to amass resources from households and businesses in order to finance public-sector spending. Moreover, all deposits in dollars were held in the Central Bank in order to manage the foreign-exchange crisis, and many local-currency deposits were transferred to the Central Bank, applying high reserve rates, which amounted to a scheme of forced taxation of the financial system.

Under the Barrios de Chamorro Administration, starting in May 1990, the Central Bank began a process of adjustment of reserve rates. By April 1995, the legal reserve for local-currency deposits was set at 15 percent. This measure was accompanied by an expansion of the eligible deposits, to deposits greater than one year in both currencies.

3) The opening of free-market operations

The Central Bank did not introduce open-market operations as a tool to control liquidity until 1995. When this tool did appear, it did so in a short-term financial market that was unfamiliar with these operations. In fact, in spite of five years of financial reform, the financial markets were still very rudimentary, with only an incipient stock market.

The Central Bank initiated open-market operations through the use of auctions, whose attraction consisted of the fact that buyers of the government bonds set their own interest rates.[(9)] Nevertheless, this mechanism did not significantly reduce liquidity in accordance with monetary goals. This obliged the Central Bank to change the nature of the open-market operations, offering high interest rates, instead of large quantities of bonds.

By the end of 1995, the results of the open-market operations carried out through the Negotiable Certificates of Investment (CENIs) grew to 57.2 million cordobas, 13 million cordobas more than programmed for that year. Of the total placed in the CENIs, 68.8 percent was granted at 360-day terms at a discount of 20 percent, 23.6 percent was placed at 28-day terms at a 15.5 percent discount, and 5.9 percent was placed at 91- , 60- and 192-day terms. These results surpassed the monetary program's expectations, reflecting the confidence shown by the private sector in these Central Bank securities.

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4) Central Bank credit policy

Throughout the period from 1990 to 1996, the Central Bank's credit policy went through considerable transformations in order to adjust it to the economy's market orientation, as well as the IMF and World Bank cross conditionality. The Central Bank was reoriented to make it a lender of last resort for the financial system. This conversion process was not easy, particularly given the different institutional actors, such as the banks, the government and the public enterprises, which had previously received credit directly from the monetary authority.

Starting in 1991, the Central Bank's credit policy was delineated more narrowly to meet the objectives of the stabilization program. The resurgence of the private banking system created conditions that led to the Bank's main clients to direct their credit demands to the private financial system. During 1991 and 1992, Bank policy was directed mainly to facilitate short-term resources to commercial banks. In 1993, the Central Bank's credit policy moved toward more restrictive credit management; there would not be any monetary expansion from this source beyond loans repaid to the Central Bank.

In 1994, the Central Bank introduced major changes in short-term credit policy as a product of conditionalities in the new ESAF agreement. The principal modifications consisted of the liberalization of interest rates and the application of a requirement that the value of accounts in local currency be maintained. The Bank's policy on credit extension to the government underwent extreme changes, as it changed from an expansive to a restrictive policy in accordance with the terms of the ESAF. The Bank's credit policy in 1995 and 1996 continued under the programming directives of the ESAF. In this regard, the measures adopted pointed toward the Central Bank's exiting the credit market, to the point that it truly became a lender of last resort.

IV. Impact of the Financial Reforms

A. Macroeconomic Effects

The financial reforms eliminated much of the extensive financial regulation that had been established during the 1980s. As interest rates were deregulated, they reached real positive, and then very high, rates. A dramatic substitution of financial assets like savings and term-deposit accounts, as well as in dollar deposits and financial investments for more liquid assets to the holding meant that, between December 1992 and December 1995, the real increase in savings and term deposits in inflation-indexed cordobas, plus deposits in foreign currency, totalled 186.4 percent. Private-sector deposits in both state and private commercial banks increased spectacularly. Inflation-indexed deposits in corbodas in the private banking system grew 121.5 percent in real terms. At the same time, total private-sector deposits in cordobas in commercial banks (including the state banks) grew 44.1 percent in real terms.

Another key characteristic of these deposits is that almost 50 percent of them are in short-term holdings at terms no greater than one year. This indicates that, in spite of the price stabilization, there is apprehension about its permanence. This has led to a persistent "dollarization" of the economy. And, given the high yields of financial investments, as much in the private sector as in the autonomous public entities, people have preferred to channel financial savings toward indexed or dollarized deposits. But the fact that these deposits are short term keeps the financial savings from that source from being utilized for investment loans for terms greater than one year.

The proof that the high levels of financial savings have not flowed toward investment is *that, while these deposits expanded at an annual rate of 41.8 percent between 1992 and 1995, gross investment as a percentage of GDP increased at an average rate of just 10.8 percent. Moreover, this growth in investment has mainly occurred in the public sector, which has been financed principally by foreign assistance, with the subsequent deterioration in the economy's external position. In spite of the fact that since 1992 there has been a noticeable improvement in public-sector non-financial savings, the lack of participation by the private sector in the process of financial accumulation has played a major role in the failure of domestic savings to show signs of recovery until 1995.*

On balance, in spite of its speed and its coordination with other reform processes, financial deregulation has not lead to the required levels of financial intermediation nor has it automatically brought efficiency or growth to the economic system. The building of a new institutional structure parallel to the financial reform was not only slow in developing, it has also been quite deficient and has lacked any unifying purpose. This problem was in good part the result of a lack of a clear vision on how to proceed, as suggested by the fact that the formulation of the Barrios de Chamorro Administration's development strategy was very late and so immature that it was never implemented.(10)

Supporting a simplistic laissez-faire economic scheme in a context of massive poverty and insufficient economic growth was a recipe for negligence by the public sector regarding the challenges confronting the country. Even in a market-oriented scheme, the role of the public sector is key to supporting the consolidation of market structures or to simulate their creation when they do not exist.

The state that emerged during the Barrios de Chamorro Administration functioned under a paternalistic logic that helped determine the orientation of policy. That is to say, it was tightly linked to the particular interests of the governing elite, who have an oligarchic tradition. The financial and commercial oligarchy could, under this political arrangement, assert its interests within a voracious process of accumulation of wealth, arising as much from accumulation of the assets of the privatized state-owned enterprises as from unfair competition in the use of the state apparatus.(11)

In many countries that are undergoing financial liberalization the tendency has been that financial capital supports policies that permit unrestricted capital mobility, although it does not necessarily support policies that permit free mobility of production and services. High capital mobility dooms countries that lack capital either to financial suffocation or else to the maintenance of very high real interest rates, as well as a flexible exchange policy. The rising cost of capital has a number of effects, but, above all, it makes investment difficult and ends up depressing the level of economic activity, strangling the adjustment process on the threshold of stabilization, as Nicaragua experienced during the Barrios de Chamorro Administration.

Moreover, financial liberalization created limits in the effectiveness of traditional economic policies, such as devaluation of the currency to obtain an exchange rate *favorable to exports and the maintenance of positive but low real interest rates. The decisions of international financiers, stock-market movements and decisions of large transnational companies greatly interfere with national abilities to regulate monetary, exchange, and capital-movement policies.*

B. Consequences for Private- and State-Bank Lending

At the beginning of 1996, the banking system as a whole controlled assets equivalent to 45.5 percent of GDP. Some 66 percent of total financial-sector assets belonged to the private banks and the rest to the state banks. The net credit portfolio was equal to 32.3 percent of GDP in 1996, of which a little more than half was credit from private banks. Private banks held some 55 percent of total deposits. Deposits denominated in foreign currency made up 47 percent of total deposits.

With regard to the type of loan portfolio, private banks controlled a major share of personal and commercial credit (46 percent) and industrial credit (30 percent). These three activities constituted three-fourths of the total private-bank portfolio. The fourth share in order of importance was the agricultural sector with nine percent and livestock in fifth place with a six-percent share; other credits made up the remaining nine percent of the portfolio.

It is noteworthy that only 15 percent of the total private-bank portfolio was concentrated in the agricultural/livestock sector, as it reflects the lack of penetration and positive disposition that these institutions have on and toward the sector. This low level of participation equally reflects the problems of land ownership, the lack of security in the countryside, and the high levels of arrears in the state-banking system.

The state banks, meanwhile, were lending the equivalent of 15.8 percent of GDP, with 74 percent of the portfolio concentrated in the farming sector and only 11 percent financing a combination of commercial and personal activities. It is evident that this loan structure is the opposite of private banks and that the state banks have essentially been financing the farming sector in Nicaragua.

Bank Portfolio by Targeted Recipient Sector

Type of credit	Private	State	Total
Personal	11.5%	2.5%	7.1%
Commercial	34.0%	7.8%	21.2%
Industrial	30.4%	10.1%	20.5%
Agricultural	9.0%	44.6%	26.4%
Livestock	5.9%	29.2%	17.3%

Others	9.2%	5.8%	7.6%
Total	100.0%	100.0%	100.0%
Total (cordobas)	2804.7 m.	2681.4 m.	5486.1 m.

Source: Based on Superintendencia de Bancos data, March 1996.

The differences in loan periods are also substantial. Credit granted by private banks is mostly short term. Credit disbursed with terms of up to six months makes up 33 percent of the portfolio, and that between six and 12 months is 26 percent; that is to say that 59 percent of the credit that private banks extended in 1996 were loans of one year or less. Medium- and long-term loans -- those over 18 months -- made up just 29 percent of the total private loan portfolio. In contrast, state-bank credits were for the most part medium and long term in duration -- 58 percent of the total portfolio is on terms of more than 18 months.

Breakdown of Bank Portfolio by Loan Periods			
Loan Period	Private	State	Total
Up to 6 months	32.9%	17.6%	25.4%
7-12 months	26.5%	17.9%	22.2%
13-18 months	11.7%	7.2%	9.5%
Over 18 months	29.0%	57.3%	42.9%
Total	100.0%	100.0%	100.0%

Source: Based on Superintendencia de Bancos data, March 1996

Both the private and the state banks, instead of granting credit to small and medium-sized producers, have preferred to work with large producers. As indicated below, 89.2 percent of private bank clients received just 15.7 percent of total loans, while 2.8 percent have taken 64 percent of the credits granted. As for the state banking system, represented in this case by the National Development Bank (BANADES) and the Nicaraguan Bank of Industry and Commerce (BANIC), 53 percent of the loans went to just three percent of those institutions' borrowers.

Breakdown of the Bank Portfolio by Amounts (percent of total)						
	Private Bank		State Bank		Total	
Stratum	Clients	Amount	Clients	Amount	Clients	Amount
Up to 100	89.2%	15.7%	85.6%	16.1%	87.0%	15.9%
101.1 to 500	8.0%	20.3%	11.4%	30.6%	10.1%	26.7%
Over 500.1	2.8%	64.0%	3.0%	53.4%	2.9%	57.4%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Total[a]	16,680	1,327	25,666	2,192	42,346	3,519
[a] Number of Clients and Thousands of Córdobas						

Source: Based on Superintendencia de Bancos data, March 1996

C. Policy Bias against Production

The restriction of credit has not been uniform. In general, credit for production has been very restricted, even though financial resources are relatively abundant. The paradox is clear. Simply stated, the entire system of incentives and profitability is oriented toward commercial and short-term activities, penalizing producers.

The financial reform has contributed to making access to credit more difficult in two very concrete ways. First, the cost of the credit, at 24 - 28 percent (as of September 1998), is very high. Second, credit policy has become much less flexible. This is basically due to the Central Bank's role as lender of last resort and the decapitalization of the state development banks and their diminished capacity to support production.

Other factors associated with the financial reform, as indicated above, have also played a role in the establishment of a financial intermediation structure that is not fully competitive. The financial market in Nicaragua continues to be essentially an oligopoly led by a state banking system in arrears. There are still many administrative barriers to the free entry of new intermediaries in the financial sector, which limit the supply of credit and maintain the commercial-banking sector's profits.

The private banks' lack of dynamism -- due to the state banks' preferential demand for credit, the lack of adequate internal resources or long-term deposits, the excessive system of guarantees given the current national situation, and risk aversion -- led to the rationing of credit to those projects that, in the judgment of the banks, are truly profitable. This has concentrated the private banks' loan portfolio in short-term personal, commercial and industrial loans.

At the same time, the current problem of monetary policy has been focused on meeting the goals set by the IMF's ESAF program for net international reserves. Since September 1995, policy has been adjusted to meet very restrictive domestic-credit targets, so that the main sources of financing lie in increases in loan recoveries and charges made by the banks and not in the granting of credit by the Central Bank to the financial system. The greater dependency on loan recuperation to finance short-term credit has been crucial in the change in the structure of credit, i.e., the tendency toward lending to commerce and industry in which the rates of very short-term recuperation are very high. In 1996, agricultural and cattle credit represented, in real terms, less than half of the real credit granted in 1991, while commercial credit was 65 percent higher than in 1991.

D. <u>Impact on Productive Activity</u>

There exists a marked bias in the financial system, both state and private, toward financial investments -- "sheltered assets" -- which is supported by the relatively high level of foreign assistance. This orientation in the use of deposits serve to create new wealth as the growth in the financial realm of the economy does not have any real correlation with production.

After GDP declined an average of 3.7 percent annually from 1984 through 89, it might be considered a sign of success that it did not continue to fall at the beginning of this decade, particularly since a decline was averted in an atmosphere of severe economic adjustment and structural reform. The economy continued to be essentially stagnant until 1994. Production grew 3.3 percent that year and subsequently 4.5 percent in 1995 and 1996, and then by five percent in 1997. Although production has increased at rates above the rate of population growth in recent years, which at more than three percent is the highest in Central America, there has been no noticeable improvement in Nicaraguans' standard of living.

The recovery experienced between 1994 and 1997 was based in large measure on the recovery of agriculture and its effects on such sectors as agroindustry, commerce, transport and communications, as well as electrical energy. Agriculture grew at rates of 16 percent in 1994, 7.2 percent in 1995, 10.1 percent in 1996, and 97 percent in 1997.. This expansion was based on the increase in traditional export crops, especially coffee, which grew at an average annual rate of 18 percent from 1994 to 1997, and sugarcane, which grew at a rate of 14 percent during this period. In the case of coffee production, the growth rate was influenced by excellent international prices.

In the case of sugarcane, success was due to the high levels of protection that this industry enjoyed, as well as the fiscal support obtained under the Barrios de Chamorro Administration. In both cases, producers' own revenues made it possible to sustain financing for these activities that did not depend on credit from the state development banks.

Nicaragua: Real GDP 1991-1996 (Rates of annual percentage growth)

Sectors	1991	1992	1993	1994	1995	1996	1997
Real GDP	**-0.2%**	**0.4%**	**-0.4%**	**3.3%**	**4.3%**	**4.5%**	**5.0%**
Primary Activity	**-3.9%**	**3.1%**	**1.8%**	**10.8%**	**5.0%**	**6.6%**	**8.5%**
Agriculture	-5.0%	-0.5%	-6.2%	16.1%	7.2%	10.1%	9.7%
Cattle	-3.5%	8.8%	12.1%	-0.5%	-4.2%	1.0%	5.9%
Fishing	45.4%	26.4%	62.7%	55.8%	49.2%	2.1%	10.3%
Forestry	1.0%	1.2%	1.0%	1.5%	2.6%	2.8%	3.2%
Secondary Activity	**4.5%**	**-3.3%**	**0.3%**	**2.7%**	**5.5%**	**5.3%**	**4.8%**
Industry	6.4%	-5.1%	0.0%	1.0%	2.8%	2.4%	3.1%
Construction	-8.1%	8.3%	1.5%	17.8%	17.5%	16.6%	9.0%
Mining	-1.4%	17.1%	2.7%	-10.1%	30.3%	31.0%	23.0%
Terciary Activity	**-0.7%**	**1.2%**	**-1.8%**	**-0.1%**	**3.3%**	**2.9%**	**3.1%**
Commerce	4.9%	1.4%	-2.3%	1.6%	5.1%	5.0%	5.2%
General govt.	-12.5%	0.1%	-1.7%	-5.6%	-1.8%	-4.0%	-5.0%
Transport	4.9%	1.4%	-4.0%	-0.3%	5.1%	4.6%	5.2%
Banking/insurance	-1.9%	0.0%	-1.4%	1.4%	3.3%	3.6%	4.2%
Energy and water	0.3%	3.1%	1.4%	3.4%	5.9%	5.9%	6.0%
Property	0.8%	0.6%	0.5%	0.5%	3.3%	3.5%	4.0%
Other services	4.3%	2.5%	-1.7%	2.9%	4.1%	4.2%	4.4%

Source: Banco Central de Nicaragua (BCN), 1997

In the agro-export sector, where credit was scarce, there were severe declines or stagnation, however, particularly in the production of sesame and peanuts. Meanwhile, cultivation of basic grains grew at a rate of three percent between 1994 and 1997. In the case of maize and beans, this growth was based mainly on the reactivation of croplands abandoned during the war[12] and encouraged by the expansion in direct credit granted outside the financial system through rural development programs.[13]

In sectors where business-type producers operate, such as irrigated rice and industrial sorghum, the credit restrictions have contributed to a slow growth of production of 1.5 percent and -2.2 percent, respectively between 1994 and 1997. At the same time, cattle butchering and live cattle exports, however, actually decreased slightly during the period, so that production in the sector fell by 1.5 percent. Among the factors that led to this outcome are the decline in international prices for beef, the lack of investment and problems of arrears on long-term loans to the sector.

Finally, fishing activity grew by an average of 29 percent due to the abundance of investments in that sector. To a large degree, the growth experienced since 1994 in a number of sectors, including fishing and forestry, is based on the extraction and depreciation of the country's ecological wealth more than on the production of goods. Actual investments in these sectors have low capital requirements and are highly profitable because of good international prices.

E. Falling Living Standards

The maintenance of exchange-rate and price stability has fostered recovery in certain sectors, such as agriculture, fishing, industry, construction and mining. Although production increased at rates similar to population increases between 1994 and 1996, there has been no appreciable change in Nicaraguans' living standards, however. In spite of the price stability, the economic reforms have been insufficient to achieve the levels of growth required in a sustained manner. The insufficiency and partiality of the reforms is due to the fact that there was no significant advance in a process of productive conversion that would permit improvements in the country's competitiveness at a regional or international level.

The modest reactivation of production has been strongest in export sectors, with a notable increase in the share of non-traditional products. The volume of exports increased an average of ten percent a year between 1990 and 1996. Import volumes increased seven percent during this period due to, among other things, the process of economic reactivation itself. This meant that the trade deficit held steady at an average of 34 percent of GDP. In 1997, the trade deficit had risen to US$668 million, much higher than that registered in 1990.

The concentration of income in exporters, combined with the high annual rate of population growth (estimated at around three percent), has neutralized the possibilities of improvement in Nicaraguans' living standards. In fact, by the end of 1996, 71 percent of Nicaraguans lived in poverty; infant mortality was 58 per 1,000 live births; 26 percent of the population under five years old suffered from the effects of malnutrition; food consumption, in terms of calories, was 37 percent lower than the level recommended for the country; and 25 percent of the population was considered illiterate.

The open-unemployment rate rose considerably under the adjustment program. It increased to 22 percent in 1993 and then fell to 14 percent in 1997, thanks to the mitigating function of the reactivation of production. The combined rate of un and underemployment has grown to 27 percent of the economically active population, however. Wages, in national terms, have covered around 120 percent of the cost of a basic consumption basket since March 1991, and no change is foreseen in the near future.

Up to now, the country's development strategy has overprotected the urban population and subsidized sectors of the economy that consume considerable quantities of foreign exchange. This has undermined the agricultural sector, in spite of the fact that it generates 34 percent of Nicaragua's GDP, 65 percent of exports and over 40 percent of employment.

V. Reorientation of Economic-Reform Policy

A new set of economic reforms is required to consolidate the gains from the reactivation process that the Nicaraguan economy experienced between 1994 and 1997. In agricultural countries with a prolonged period of economic decline, such as Nicaragua, sustainable development can only be achieved through the strengthening, reactivation and restructuring of the agricultural sector's productive activity.

Within an alternative scheme, it is important to begin from the obvious point that access to credit does not resolve everything. However, its scarcity in the development of productive activities not only undermines production but also prevents producers from forming their own capital for investing. Changing the current situation is not easy, but some actions could be taken in the short term while market-oriented, standardized mechanisms that would enable productive activities to become profitable are found and consolidated. The final objective should be to achieve a true adjustment of the financial market so that a competitive structure of financial services is achieved that facilitates the process of real productive investment. But, in order to arrive at that point, actions must be taken in the short term to make productive activities profitable.

First, fiscal tools and credit policy should be utilized to substantially reduce the cost of credit. While reducing interest rates through market mechanisms is by nature a structural policy, lowering the cost of credit can be achieved through short-term actions. These could include the elimination of certain taxes on credit transactions and the establishment of lines of credit for the duration of the agricultural cycle based on a credit ceiling established on a case-by-case basis. The establishment of a system that permits agricultural clients to operate something like a revolving line of credit would reduce the incidence of borrowers having to pay to establish credit two or three times per cycle.

In addition, much of the red tape involved in the utilization of credit must be eliminated. This is especially true in the case of letters of exchange granted to businesses importing agricultural supplies. This mechanism hinders producers from obtaining inputs at the lowest possible cost, as they must purchase at prices that are relatively high in the Central American context. The elimination of this practice would significantly reduce farmers' costs of production.[(14)]

A rapid level of recuperation of overdue loans of over 100 million cordobas must be achieved. Just eight percent of debtors are in this category, but they are responsible for nearly 80 percent of the overdue loan portfolio. A restructuring policy that provides equal treatment of all debtors would truly benefit the large debtors as well as those without collateral.

Another action would be to develop and strengthen the private and non-traditional financial institutions in such a way that they can absorb resources and financing for rural activities until a true system of rural financial institutions is organized. This implies a greater opening of the financial market and neutral treatment for private formal and nonconventional institutions.

Many of the proposed actions are not only feasible, but relatively easy to carry out, as long as there is sufficient political will. What is important is that there be a clear objective in the financial policy, in general, and particularly in credit policy, to support and complement the process of recovery of growth, efficiency and equity in the economy. Without this clarity of purpose, to continue pigeonholed in a process of partial and ill-proportioned adjustments rather than achieving the strengthening of a market-oriented economy, will only facilitate the actions of financial oligarchies to establish costly roadblocks to development.

Endnotes

1. Avendaño, 1996.

2. Lächler, 1995)

3. Revilla, 1996

4. Gobierno De Nicaragua, 1996a

5. Irving, 1985

6. Mas, 1994

7. Enriquez y Spalding, 1989

8. Stahler-Sholk, 1989

9. Banco Central, 1995

10. Gobierno De Nicaragua, 1995

11. Neira, 1996

12. Neira and Renzi, 1995

13. Rose, 1997

14. Rodríguez, 1996

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