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Central Intelligence Agency

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Nicaragua: The Economy and Sanctions

Summary

The Nicaraguan economy has deteriorated markedly since the 1979 revolution. Anti-private sector policies, combined with financial mismanagement and rising defense costs have depressed economic activity, constrained exports, and forced the regime to ignore its international creditors. The regime has recently adopted a series of reform programs in an effort to alleviate the economic deterioration, but hyperinflation, poor infrastructure, and continued serious foreign exchange constraints will continue to limit progress. [redacted] 25X1

Circumventing US economic sanctions has caused trade disruptions and diversion of financial and managerial resources which have exacerbated the economic deterioration. We estimate that through the end of last year the US trade embargo against Nicaragua cost about $115 million in lost export earnings, more expensive imports, and middlemen fees. Indirect costs also have been significant, but are harder to quantify. Shortages of US-produced spare parts, machinery and other inputs have stunted production and contributed to inflationary pressures. [redacted] 25X1

This typescript was prepared by the Nicaragua Branch, Middle America Cuba Division, Office of African and Latin American Analysis. Comments and queries are welcome and may be directed to the Chief, Middle American-Cuba Division, ALA, [redacted] 25X1
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The Nicaraguan economy remains marginally vulnerable to further tightening of the US embargo. The 30 or so US companies operating in Nicaragua continue to provide important services to the economy from oil refining and distribution to computer software. At the same time, expenditures from US travellers and remittances from support groups and relatives in the United States probably provide as much as $25 million annually in scarce foreign exchange. 25X1

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General Economic Situation

The Nicaraguan economy has fallen to record depths since it began its post-Somoza decline in 1981, primarily because the regime has put political considerations ahead of economic ones. In real terms, overall economic activity has fallen more than one-third below pre-revolutionary levels.[1] Per capita income is roughly half its 1977 level despite a nearly four-fold increase in economic aid since 1979. Inflation, which began spiraling in 1985, climbed to an annual rate of 16,500 percent earlier this year. Not surprisingly, exports have declined to about one third of that registered during the last years of the Somoza era. 25X1

In our judgment, economic policies driven primarily by political concerns are responsible for the steady deterioration of the economy. Specific policies contributing to the decline include:

- <u>The regime's seizure of much of the economy from the private sector.</u> Blatant and capricious anti-business acts --including the uncompensated seizure of productive farms and businesses--has led to massive capital flight, driven many of the economic elite out of the country, and alienated the rest. The remaining private farms and businesses have deteriorated from lack of investment, and business leaders say that many landowners and manufacturers stay in Nicaragua only to protect their assets while hoping for a change in the government.

- <u>Tight bureaucratic controls that have choked production.</u> For example, until recently, private farmers had to have their crop plans approved before planting; buy all their seeds, fertilizers, and insecticides from the government; hire labor from Sandinista unions at fixed wages; and sell their produce to the state at artificially low prices.

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[1] See economic indicators in Figures 1 through 4 at the end of the text. 25X1

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While low prices provide party members with inexpensive food and other consumer goods, this practice inevitably has resulted in shortages of goods for the general population.

- Sandinista financial mismanagement that has impeded production, driven up the public sector deficit, and fed inflation. Subsidized interest rates to state farms and businesses as well as party loyalists have inflicted losses on the State-owned banking system. These borrowers often have used the funds to buy luxury items instead of investment goods while private farmers and businessmen have been denied funds to purchase needed inputs.

- Rapidly rising defense costs, especially since 1983, that have siphoned off an increasing share of scarce resources. The military now consumes 65 percent of the central government's budget and has been a major contributor in driving the non-financial public sector deficit from 6 percent of GDP in 1979 to over 50 percent last year. 25X1

The depressed domestic output has had a major impact on Nicaragua's international accounts. Declining exports have driven the trade balance from a $52 million surplus in 1978 to an average annual deficit of more than $500 million during the past three years.[2] With debt service added to the trade deficit, the amount of assistance required to cover Managua's annual foreign obligations has risen from nearly zero in 1979 to more than $1.3 billion last year--equivalent to more than half of the country's annual GDP. 25X1

While many official creditors have responded generously to Sandinista calls for debt reschedulings, loans, and credits, foreign assistance has not increased fast enough to meet Managua's import and financial needs. Last year, imports were 25 percent lower than 1981 levels in current dollars, worsening consumer shortages, particularly in the cities. As a result, since 1981 the Sandinistas have been increasingly inclined to ignore their debt obligations, alienating commercial banks, multilateral organizations, and many bilateral Western lenders in the process.[3] The regime has sought to make up for the loss of Western aid with assistance from the Soviet Bloc. Soviet Bloc aid, however, has been mostly technical assistance and low quality goods rather than production-enhancing investment funds and capital goods previously

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[2] See table 1.

[3] See the Nicaraguan foreign profile in table 2.

supplied by the West. By 1986, moreover, Moscow was beginning to demand some payment for its assistance and started to question Managua's constant requests for more aid, charging that much of the aid already provided was being wasted. 25X1

Attempts at Economic Reform

The gap between falling production and the ever-increasing need for foreign assistance forced the regime to slow its policy of expanding state control and adopt some economic reform measures in mid-1987. These measures--including indexing salaries to inflation and easing some price and distribution controls--failed to revive the economy, however, because the underlying causes of the economic crisis were not addressed. By early 1988, shortages of oil and other imports were crippling production and soaring inflation was destroying Nicaragua's currency and undermining the Sandinistas' hold on the economy. Moreover, Managua's insistence on maintaining price, wage, and exchange rate controls--even in the face of additional reforms announced in February--further undercut production. 25X1

In our view, the threat of further economic deterioration led the regime to back away from total control of the economy further last month. Managua eliminated many wage and price controls, implemented an 85 percent devaluation of the cordoba against the dollar, increased credit to farmers with political ties to the regime, and indexed interest rates and the exchange rate to inflation. The regime, however, made it clear that such measures did not mean that the Sandinistas were renouncing Marxist-Leninism. In a speech announcing the measures, Ortega admitted that the reforms are a tactical necessity to protect the revolution. He threatened to "bury" the private sector if it fails to increase production and investment. The regime recently carried through on this threat by expropriating several properties including the country's largest privately-owned sugar refinery. 25X1

Outlook for the Coming Year

Numerous constraints, however, will keep production increases modest at best, despite the government's reform efforts.

- Inflation--which we believe will not be substantially reduced unless defense spending is slashed--poses the greatest challenge. If the higher rates brought on by the reforms are sustained beyond a few months, productivity will suffer because more of the economy will slip into the less efficient black market system, and the currency will again be in jeopardy of losing its transaction value.

- Output also will be limited by the government's insolvency and increasingly dilapidated infrastructure.

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- Should the regime retain or tighten export controls it could negate many of the reforms' potential benefits. 25X1

Faced with discontent within the party, the Sandinistas could backtrack on the reforms. Minor concessions to party loyalists--including increased credit for state farms and cooperatives--could easily fail to buy their backing, forcing the Sandinistas to choose between rescinding some of the measures or losing political support. Nearly all groups within the party will likely want to dump those reforms that have taken away their access to cheap hard currency, gutted education, health and other social programs, and forced state-controlled farms and businesses to compete more equally with private producers. 25X1

Finally, poor relations with the United States and other traditional lenders and the domestic business sector make it unlikely that the Sandinistas will be able to revitalize the economy any time soon, in our judgment. Managua is unlikely to attract the billions of dollars in investment needed to bring the Nicaraguan economy back to pre-revolution production levels. The renewal of expropriations this week and Ortega's venomous attacks on the private sector during a speech last month almost certainly means that businessmen will remain reluctant to risk major investments. Furthermore, the Soviets, while interested in maintaining the Sandinistas in power by providing oil and vital foodstuffs, have shown no signs that they are willing to invest heavily in the rebuilding of Nicaragua. 25X1

Impact of Current US Sanctions

Trade disruptions and the diversion of financial and managerial resources to circumvent US economic sanctions--imposed in May 1985--have put additional pressure on the Nicaraguan economy. We calculate that through the end of 1987 the US measures have directly cost Managua $115 million--over and above the $320 million decline that had been experienced since the 1979 revolution--because of the loss of access to US markets, higher freight costs for exports and imports and new middlemen fees to circumvent the embargo. 25X1

On the export side, we estimate that direct sanction-related losses have cost the Sandinistas $70 million in net foreign exchange losses since the embargo was announced. Of this amount, $20 million was lost during the last seven months of 1985, $28 million during 1986, and $22 million last year.[4] In our view, major losses have occurred in the following areas:

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[4] See table 3.

- We estimate that net hard currency earnings from beef exports have fallen some $24 million since May 1985 because of the embargo. Efforts to find alternate markets in Canada and elsewhere have been mostly unsuccessful, according to Embassy [redacted] 25X1

- Loss of the US sugar market has cost Managua about $15 million. Since the Sandinistas lost the US sugar quota, they have had to sell largely on the glutted world market at less than one-third the subsidized US price.

- Net foreign exchange earnings from banana exports have fallen by another $15 million since the embargo was implemented. While new sales to West European customers have taken up some of the slack, [redacted] 25X1 higher transportation costs and product deterioration during the longer shipping time have sharply cut profit margins. 25X1

- During the same timeframe, net foreign exchange losses from lower passenger and cargo revenue and higher prices for maintenance and spare parts have cost Aeronica--the state airline--about $6 million, according to official Nicaraguan estimates [redacted] The Sandinistas have been able to limit Aeronica losses somewhat by selling Nicaraguan tours out of US travel agencies and rescheduling some flights through Mexico, Honduras, and Costa Rica. 25X1

- Despite success, on Managua's part, in redirecting seafood and tobacco exports, we estimate that sanctions have cut Nicaragua's net foreign exchange earnings by $9 million. [redacted] 25X1

On the import side, we estimate direct foreign exchange expenses from higher prices and new middlemen fees to regain access to priority US-sanctioned goods have cost the Sandinistas about $45 million, including $14 million in 1985, $16 million in 1986, and $15 million in 1987. [redacted] 25X1 the Sandinistas are only gradually reducing their dependency on US goods. [redacted] 25X1 25X1 while the Sandinistas have found some new suppliers for much of the foodstuffs and raw materials formerly provided by US sources, they have not done nearly as well replacing imports of US-built machinery, agrochemicals, and spare parts. While costs of regaining access to priority US-sanctioned goods varies considerably, [redacted] an average 25X1

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additional 25-percent markup to obtain these goods through third-country US subsidiaries or by using front companies to procure the items in the United States. As a result we estimate that from May 1985 through last year:

- The Sandinistas have paid an extra $34 million to buy priority US-manufactured spare parts, machinery, and chemicals because of embargo-circumvention surcharges.

- Managua has paid an extra $11 million to retain access to raw materials and semi-finished and consumer goods. [redacted] 25X1

While the Sandinistas have made some progress in reducing their reliance on imported US goods and services, we estimate that it will be years before they can work their way completely free of dependency on US supplies. [redacted] 25X1 at least half of Nicaragua's existing capital stock (plants, factories, machinery, and equipment) is still dependent on US spare parts and equipment despite the longstanding Sandinista policy of cutting economic ties to the United States.

The indirect costs of the embargo to the economy are much more difficult to quantify. [redacted] the 25X1 embargo has required substantial bureaucratic attention, which has further strained Managua's ability to address critical domestic economic issues and development projects. Moreover, where the Sandinistas have been able to find replacement imports for US goods in either the West or the Soviet Bloc and thus avoid the costs of circumvention, [redacted] the shortage of 25X1 adequate replacement parts for US-made plants and machinery continues to stunt production in a wide range of activities. For example, the domestic commercial fishing fleet has been virtually disabled by lack of spare parts, although Managua has limited foreign exchange losses by leasing some of its fishing grounds to Cuba and to private fishermen in Costa Rica and Honduras. The Sandinistas have also had to eliminate jobs in banana field operations and in government-owned meat-packing plants because of lower foreign trade demand, according to Embassy [redacted] 25X1 reporting. In the aggregate, we believe these factors have played a substantial role in dampening economic activity, increasing consumer and producer shortages, and accelerating triple-digit inflation rates. [redacted] 25X1

<u>Remaining Vulnerabilities</u>

Tightening US economic sanctions could further reduce Managua's access to US goods, technology and financing at the margin. We calculate, for example, that restricting economic aid on financial remittances from US persons to official and private Nicaraguan recipients could cut Managua's foreign exchange receipts

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[redacted]

by as much as $20 million per year, or about 10 percent of 1988 estimated export earnings. In addition, limiting travel to Nicaragua by Sandinista support groups and other US tourists probably would shave off another $5 million in earnings. [redacted] 25X1

Prohibiting US citizens and businesses from providing direct investments or technical, financial, or related services could also hurt Managua's efforts to minimize the impact of existing sanctions. While the exact dollar value of such activities is difficult to calculate, it would affect areas ranging from access to computer software to refining of oil products.[5] From the standpoint of in-country operations, only a few of the 31 US businesses remaining in Nicaragua employ US citizens. According to US business press, most of these companies have not been able to remit more than token earnings to owners and, in many cases, are staying in country only to protect investments. In some cases, those assets are significant; for example, Exxon's assets were valued at close to $100 million in early 1987, according to press sources.[6] [redacted] 25X1

Sandinista hard currency earnings could be further cut by restricting their access to third-country US subsidiaries or tightening regulations on the import of Nicaraguan products currently allowed to enter the United States following minimal processing in third countries. While either of these steps could result in legal challenges, neither would result in substantial financial costs to third countries, and both would hurt Managua somewhat. Even so, some third countries would be likely to fight the steps for political reasons in support of Nicaraguan extraterritoriality claims. [redacted] 25X1

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[5] See table 4 for a listing of US companies doing business in Nicaragua.

[6] Exxon sold two distribution centers to the Nicaraguan government in mid-1987 which would reduce figure somewhat.

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Figure 1

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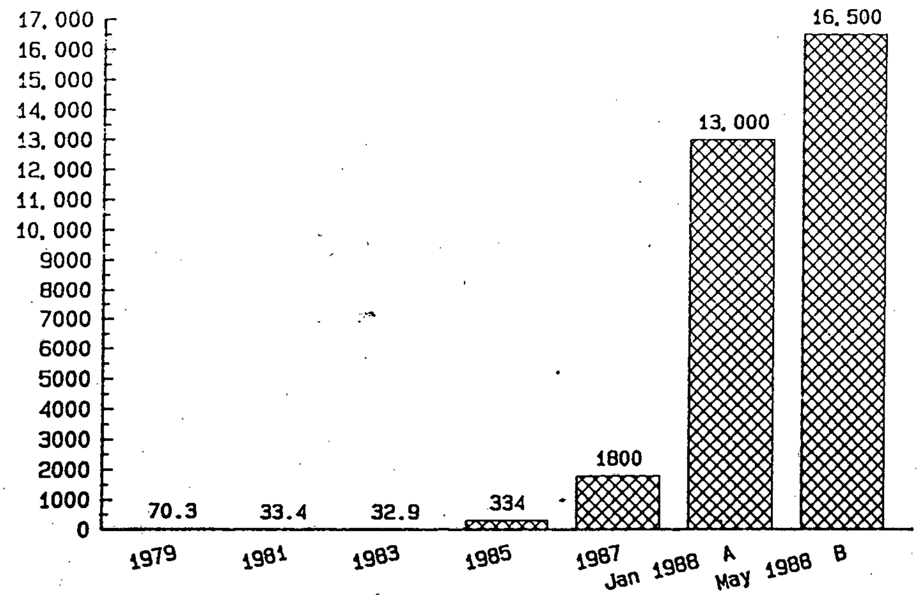
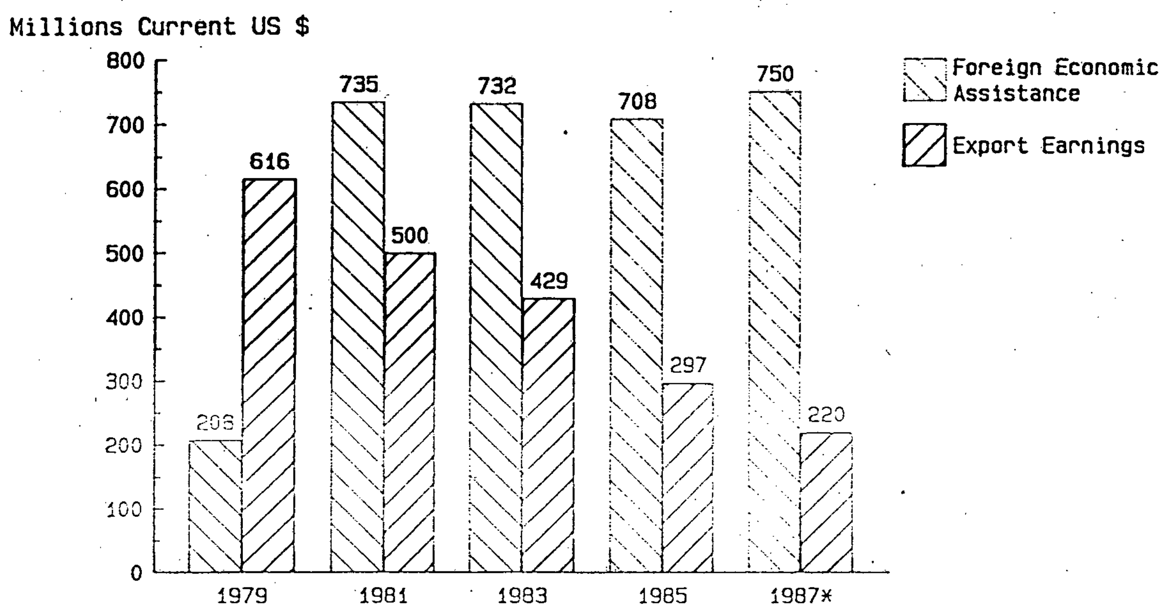
NICARAGUA: Economic Indicators, 1979-1988
Consumer Price Inflation
(Percent)



A: Annual rate during quarter ending in January
B: Annual rate during quarter ending in May

Export Earnings and Foreign Economic Assistance



*1987 Estimated

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Figure 2

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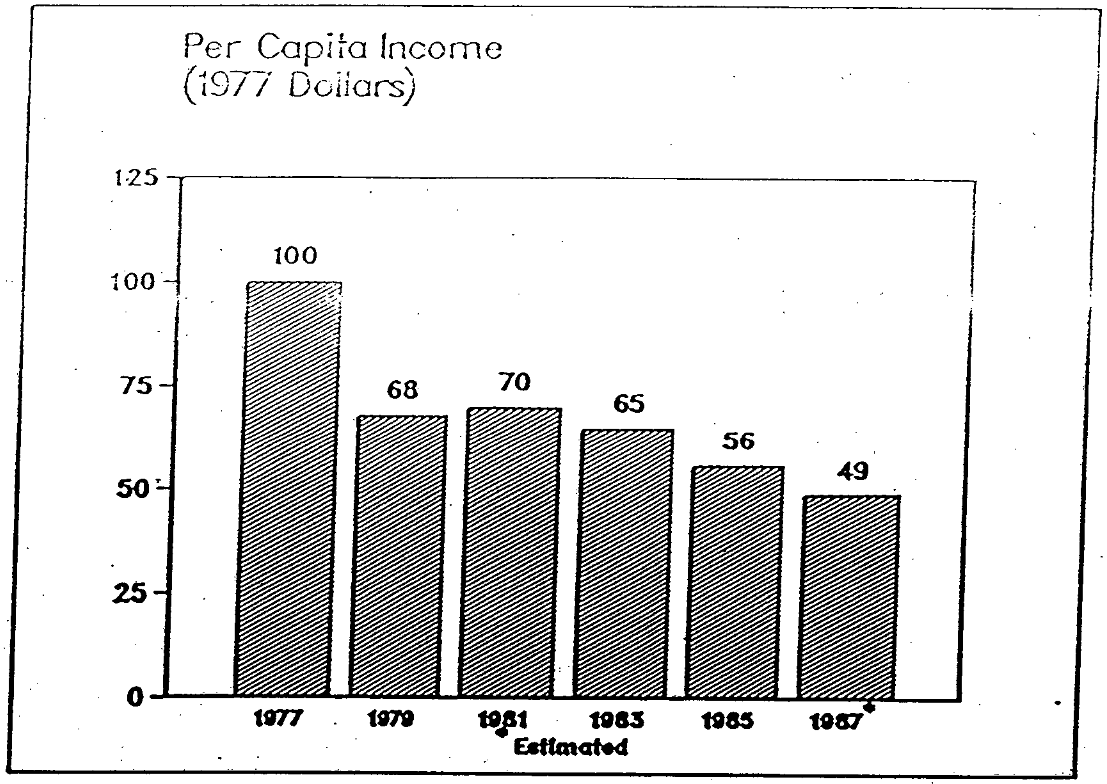
NICARAGUA: ECONOMIC INDICATORS, 1979–1987



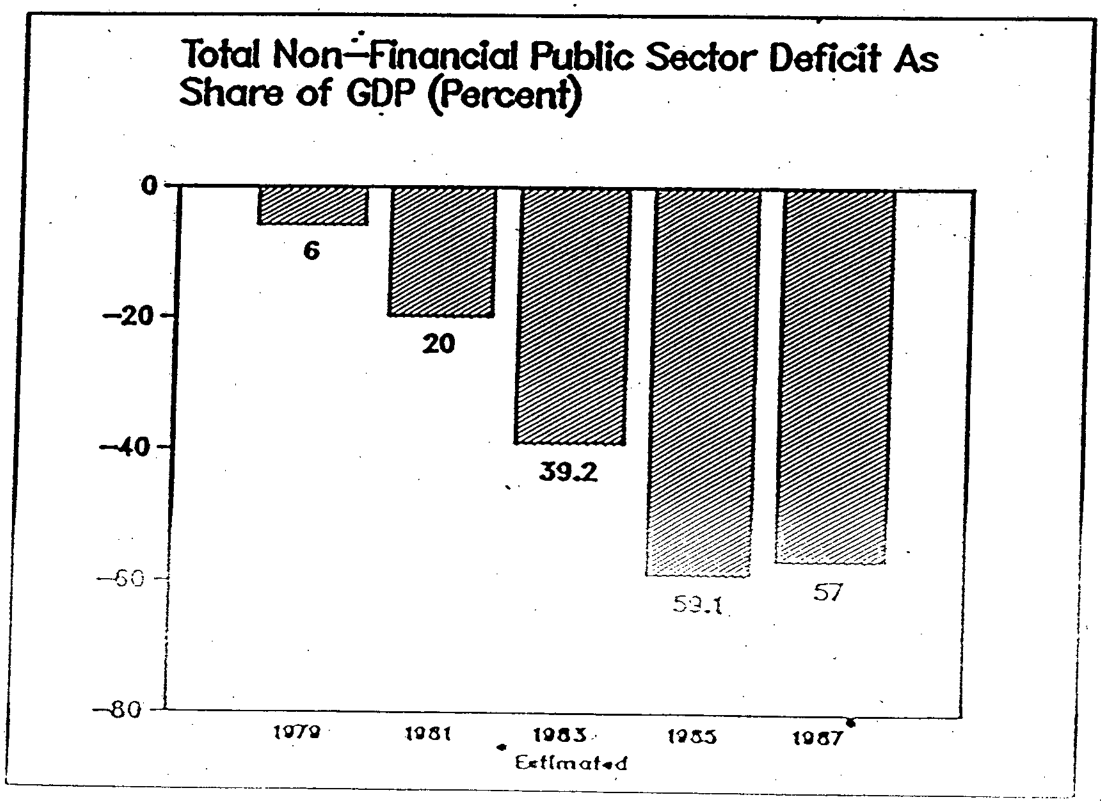


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Figure 3

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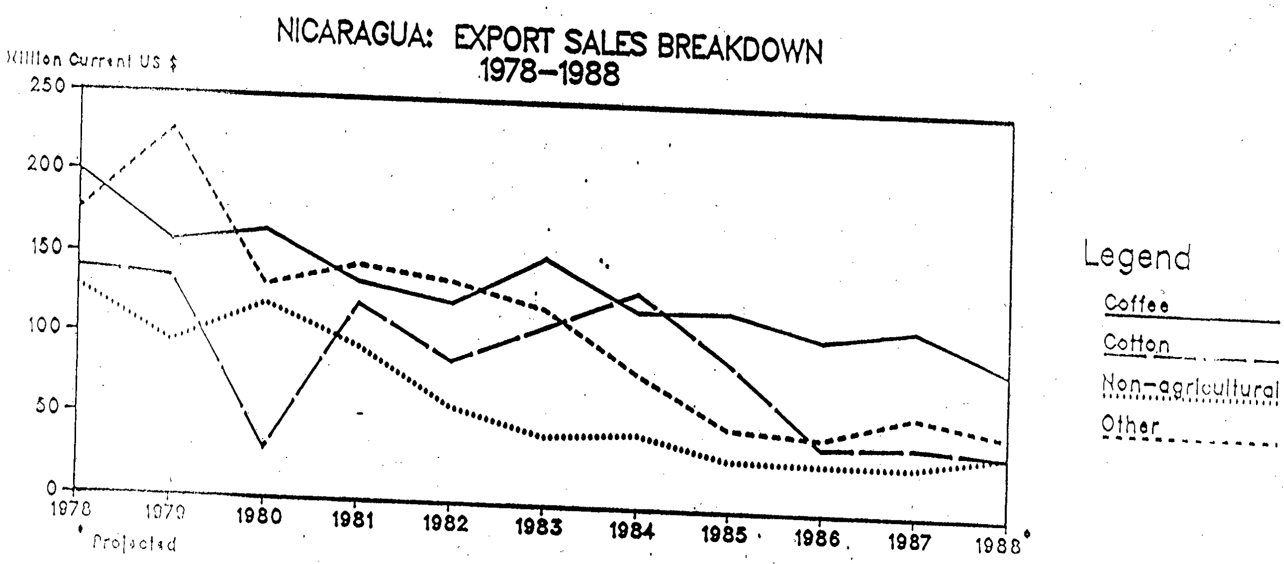

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988*
Coffee	200	158	166	136	124	154	122	123	107	115	90
Cotton	141	136	30	122	87	110	134	91	41	43	39
Non-agricultural	130	95	121	95	59	43	46	32	31	31	40
Other	175	227	133	147	138	122	83	51	47	62	51

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Figure 4

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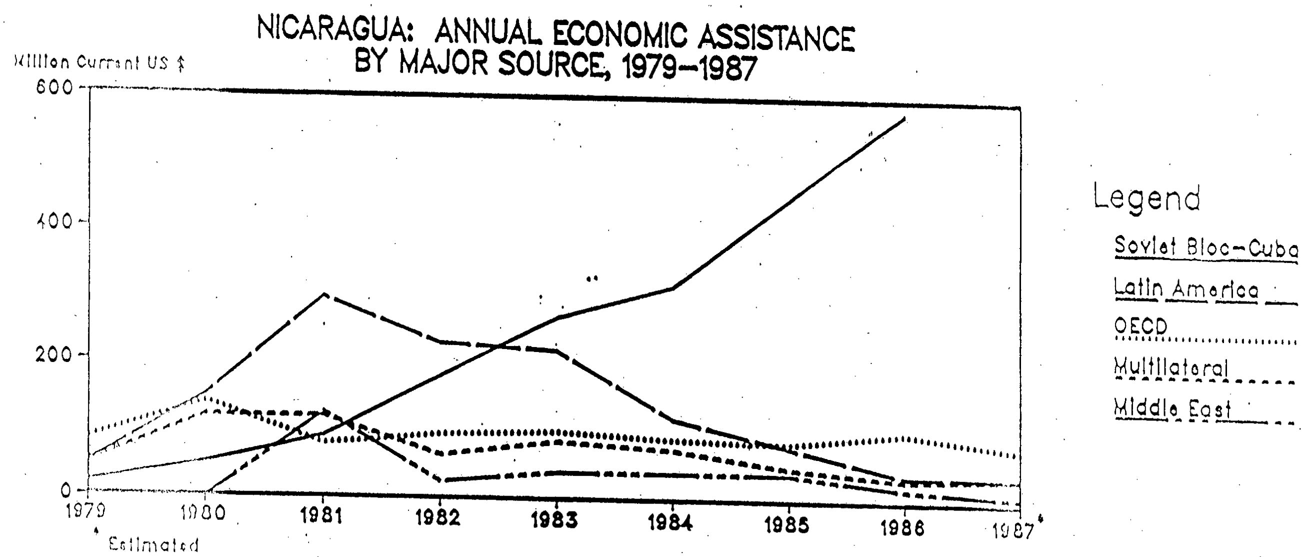

	1979	1980	1981	1982	1983	1984	1985	1986	1987
Soviet Bloc–Cuba	20	50	90	180	270	320	450	580	535
Latin America	50	150	300	230	220	120	80	40	40
OECD	85	140	80	95	100	90	86	103	80
Multilateral	50	120	120	65	86	75	50	35	40
Middle East	0	0	125	25	40	40	40	20	10

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Table 1

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Nicaragua: Balance of Payments, 1979-1987

(Millions US Dollars)

	1979	1980	1981	1982	1983	1984	1985	1986	1987
CURRENT ACCOUNT	180	-392	-563	-515	-565	-666	-856	-764	-879
Trade Balance	227	-353	-422	-318	-349	-414	-545	-519	-479
Exports, f.o.b.	616	450	500	406	429	386	297	226	251
Imports, f.o.b.	-389	-803	-922	-724	-778	-800	-842	-745	-730
Net Services and Transfers	-47	-39	-141	-197	-216	-252	-311	-245	-400
CAPITAL ACCOUNT	-120	190	583	296	363	460	630	-139	135
Official disbursements	115	371	424	455	375	416	598	625	560
Debt amortization due	-117	-130	-97	-113	-341	-166	-192	-690	-500
Rescheduled debt*	138	135	92	27	418	247	154	74	125
Other capital and errors and omissions	-256	-186	164	-73	-89	-37	70	-148	-50
OVERALL BALANCE	60	-202	20	-219	-202	-206	-226	-903	-744
Increase in arrears			37	78	254	202	4	827	669
Net change in reserves	60	-202	57	-141	52	-4	-222	-76	-75

*Includes conversion of Central Bank short-term liabilities from previous arrears into medium-term debt

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Table 2

Nicaragua: Debt Profile*

(million US $)

	1986	1987
Total	5720	5845
Medium Long-term	5344	5650
Official	4000	4275
Multilateral	772	830
Bilateral	3228	3445
Private	1344	1375
Financial market	1310	1345
of which:		
US banks	59	23
Suppliers	33	30
Short-term	376	195
of which:		
US banks	7	20

*Does not include arrears

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Table 3

Nicaragua: Direct Costs of Sanctions

(million US $)

	1985[a]	1986	1987
Total export and import lossess	**34**	**44**	**37**
Export Losses	20	28	22
Beef	5	9	10
Sugar	7	4	4
Bananas	3	8	4
Aeronica	2	3	2
Seafood	2	3	1
Tobacco	1	1	1
Import losses	14	16	15
Machinery and chemicals	10	12	
Other	4	4	

[a]Embargo phased in beginning 7 May 1985; costs are estimated net foreign exchange losses.

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TABLE 4

US INVESTMENT IN NICARAGUA*

COMPANY (US PARENT)	US INVESTMENT	ACTIVITY
Aceitera Corona (United Brands)	80%	Manufacturer-cooking oil
Acumuladores Centro-americanos (Exide Corp.)	25%	Manufacturer-electric accumulators and plates
Cia. Petrolera Chevron (Chevron Corp.)	100%	Sale and distribution of petroleum refined products
Citizen Standard Life Insurance (same US name)	100%	Collection of insurance premiums
Citibank (Citicorp)	na	Banking
Electroquimica Pennwalt (same US name)	40%	Manufacturer-chemical products
Empaques Multiwall Ultra-fort (St. Regis Paper)	51.7%	Manufacturer-multicap bags
Esso Standard Oil (Exxon)	100%	Refining and marketing of fuels and lubricants
Hercules de Centroamerica (Hercules)	60%	Manufacturer-insecticides
Hotel Intercontinental (same US name)	21.15%	Hotel
Hotel Ticomo (na)	100%	Hotel
IBM World Trade Corp. (same US name)	100%	Rent and sale of computer equipment
Industria Ceramica (American Standard)	50%	Manufacturer-toilet accessories
Industrias Gemina (General Mills)	50%	Manufacturer-flour and sub-products
Industrias Nabisco Cristal (Nabisco Brands)	60%	Manufacturer-cookies and crackers

*Mid-1987

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Kativo de Nicaragua (H. B. Fuller)	100%	Manufacturer-paints
Kem Centroamericana (Kem Manufacturing)	100%	Sale of chemical products
Mercadeo Industrial (H. B. Fuller)	na	na
Polymer (United Brands)	100%	Manufacturer-domestic and industrial plastic products
Sabores Cosco de C.A. (Cosco International)	100%	Manufacturer-food flavorings and essences
Texaco Caribbean (Texaco)	100%	Sale of petroleum sub-products
Tropigas de Nicaragua (Transway International)	50%	Sale of propane and butane gas
United Marketing (same US name)	100%	Buy and sell food products
Xerox de Nicaragua (Xerox)	100%	Sale and rent of Xerox equipment
Ahlers (na)	license	Manufacturer-hygiene products
Armando Mendoza Yescas & Asociados (na)	representative	Consulting and auditing services
Budget Rent-a-Car (same US name)	license	Car rental
Targa Sasso Rent-a-Car (Avis)	license	Car rental
Price Waterhouse (na)	100%	Consulting and auditing services
Monsanto Agricola de Nicaragua (na)	representative	na
Bristol Myers de C.A.	representative	na

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