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Nicaragua: Economic Impact of the US Aid Freeze [redacted]

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Summary

The suspension of $104 million in US aid has halted Nicaragua's economic growth this year and reduces expectations for future performance. The loss of US aid has forced the government to slash spending, boost taxes, and tighten domestic credits. While these measures have slowed growth, they have not headed off a foreign exchange crisis. If the full amount of US aid remains frozen, in our judgment, a devaluation of the cordoba will be required in the next few months, and Managua will find it impossible to meet IMF targets at yearend. In addition, anti-US sentiment may grow in some quarters. Release of half the aid would allow the government to finish 1992 without further belt-tightening, although IMF-mandated goals would still be difficult to reach. Full disbursement would boost investor confidence, allow Managua to meet its IMF targets, and permit some economic growth next year. [redacted]

This memorandum was prepared by [redacted] Office of African and Latin American Analysis. Comments and queries are welcome and may be directed to Chief, [redacted] ALA, on [redacted]

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Nicaragua began the year with high hopes for economic progress. Private and government economists had forecast 3-to 5-percent real economic growth, which would have made 1992 the first year of economic expansion since 1983. In addition, the Chamorro administration, in its proudest economic achievement, held inflation to an annual rate of 2 percent for the first half of 1992, in contrast to 13,000 percent in 1990. Although structural reforms had lagged, particularly in the state banking sector and in privatizing state enterprises, Managua's economic stabilization program appeared on track.[1] [redacted]

The suspension of $104 million in US aid in May, however, disrupted the government's plans. The US package represents almost 28 percent of Managua's budget of $370 million for 1992. In response, the Chamorro administration has been forced to cut spending sharply, raise taxes, and grapple with growing pressures on the balance of payments. As a result, public investment has plummeted, and we judge the Nicaraguan economy will experience no growth this year. [redacted]

> **The US Aid Freeze in Perspective**
>
> The suspension of US aid has further strained an already-weak economy; even without the freeze, the Nicaraguan economy had poor prospects for long-term growth. Nicaragua has the highest per capita debt in the world and the lowest per capita GDP in Latin America. The Chamorro administration inherited almost no foreign reserves, an infrastructure devastated by years of mismanagement and war, and a tangle of property ownership questions. Yet, after two years in power, the administration has made no headway in establishing a stable property regime or in contending with Sandinista-dominated and statist-oriented labor unions that cloud the business climate. Production of tradeable goods has stagnated; export earnings this year of about $280 million will be nearly identical to 1988 levels, leaving reserve levels totally dependent on outside largesse. Finally, consistency and stability in economic policy could fall victim to problems between Chamorro and the National Assembly in the next few months. [redacted]

Managua Tightens Its Belt

In light of the loss of US aid, the Nicaraguan government has taken a number of steps designed to avoid missing critical IMF targets, which would jeopardize next year's IMF aid program and debt reduction talks.[2] It has sharply cut spending in both the public and private sectors; [redacted] Much of the reduction is from the budgets of state enterprises, which account for more than 20 percent of GDP. In addition, the government has tightened credit to the private sector--particularly to agriculture, which has received only half the funding it received last year. [redacted]

Managua also has acted to increase revenues. President Chamorro announced in late September that the value-added tax, which had been cut to 10 percent in February, would be restored to its previous level of 15 percent. Moreover, Finance Minister Pereira has said publicly that water and electricity hikes are being considered. The government

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1 See Annex A for selected economic indicators. [redacted]
2 See Annex B for compliance with IMF targets.

calculates that these measures will bring in an additional $40 million this year [redacted]

Finally, the administration, despite labor opposition, is moving ahead with its privatization program as a means of trimming expenses and boosting revenue. Press reports indicate state rail and bus companies probably will be offered for sale shortly. [redacted]

Even after taking these actions, Managua was able to meet IMF targets in September only because the IMF showed leniency in measuring compliance with its guidelines. Meeting the targets allowed Managua access to a small amount of IMF funds and preserved the government's eligibility for other bilateral and multilateral assistance programs. [redacted]

Balance of Payments Crunch Looming

Despite the measures already taken, pressure on the balance of payments is worsening. [redacted] Liquid reserves are sufficient to cover only three weeks of imports. Managua is planning to reprogram $50 million of project aid from non-US donors into balance of payments support to ease the crunch. In addition, the gap between the official and black-market exchange rates jumped to 10 percent by mid-October. The government is spreading stories of US counterfeit currency appearing in the country in an effort to discourage Nicaraguans from buying dollars. [redacted]

Both exports and imports are falling this year. We calculate that exports will drop from $300 million to about $280 million, mostly due to the credit crunch and shortages of imported agricultural inputs that have squeezed agricultural production. Cotton production has been hit particularly hard, and next year's coffee harvest will suffer if the credit shortage continues. We estimate that imports this year will drop by $50 million from earlier projections to about $630 million.[3] [redacted]

The following table provides our projections of what Nicaragua's balance of payments would have been if the US aid had been disbursed on schedule and what it will be without US aid:

Balance of Payments Projections, 1992
(in millions)

	Aid Disbursed as Scheduled	Assuming No Aid
Current Account	-$550 million	-$520 million
Exports	$300 million	$280 million
Imports	-$680 million	-$630 million
Net Services/transfers	-$170 million	-$170 million
Capital Account (including aid)	$525 million	$425 million
Change in Reserves	-$25 million	-$95 million

[3] Even if aid were resumed immediately, we believe at least 60 days would be required to fill new import orders. [redacted]

Efforts to find alternative sources of foreign funding have been only partially successful. President Chamorro's trip to northern Europe in October netted about $38 million in additional aid for this year--some of it merely brought forward from next year's account. Substantial additional contributions this year are unlikely. [redacted]

What Next For Managua?

The Chamorro administration's policy options and economic prospects are evaluated below under three scenarios:

-- A continued withholding of all US aid.
-- The release of $50 million.
-- The release of the entire $100 million.

In each case, we assume that Nicaragua will continue to place high priority on meeting IMF-mandated targets.[4] [redacted]

US aid remains frozen. To stave off a foreign exchange crisis, Managua would be forced to tighten monetary and fiscal policies further and almost certainly would be forced to devalue the *cordoba*. [redacted] While these measures would slow the drop in foreign exchange reserves, they run the risk of fueling inflation and undermining agricultural production and exports next year. Despite these measures, the Chamorro administration would have to hope for more leniency from the IMF, since meeting some December targets would be all but impossible without substantial, unexpected aid from other sources. [redacted]

Half of the US package is disbursed. A devaluation would still be necessary, in our view, but probably could be postponed into next year. Although additional fiscal belt-tightening would be required, there would be less impact on workers in state enterprises. Restrictions on credit could be eased, and financial constraints on agricultural production next year would not be as steep. Compliance with most IMF targets in December would be within reach, although Managua still would probably be unable to amass adequate international reserves. [redacted]

The entire US aid package is released. A devaluation could be postponed through next year unless other factors continued to limit export growth. Managua would be able to resume public investment to stimulate the economy. Credit to the agricultural sector would be liberalized, and exports would probably rebound. The likely lifting of import restrictions would boost private investment slightly, with some positive effect on economic growth. The government probably would have little trouble meeting IMF guidelines but might keep recent tax increases in effect anyway. [redacted]

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[4] See Annex C for a matrix of the three scenarios. Abandoning IMF targets would provide short-term payoffs but would quickly drain reserves, jeopardize international aid, and rekindle inflation. Although Sandinista Party chief Daniel Ortega in August proposed an alternative economic plan--calling for revaluing the *cordoba* and lowering taxes--and [redacted] Managua is considering more expansionary policies, we see no indication that the Chamorro administration would consider a radical departure from the current program. [redacted]

No matter what the decision on aid, Managua will continue to face serious economic challenges. Private sector confidence is still shaky because of slow movement on property reform, and investment is likely to remain inadequate even if all US aid is disbursed. Under any of the three scenarios, economic growth for 1992 will remain flat and inflation will jump--perhaps to as much as 10 percent--for the year, due to the tax hikes and import restrictions already in place.

Implications for the United States

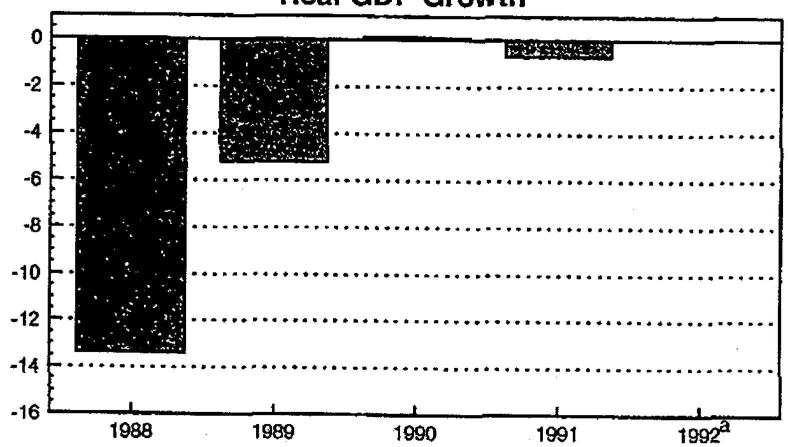
Although the suspension of US aid has had some beneficial results--such as encouraging more rapid progress on the privatization of state enterprises--its impact on the economy has been overwhelmingly negative. By undermining investment and export production, it has contributed to delaying economic recovery, and its effects will be felt for years. Managua is unlikely to get sustained economic growth started in the near term without substantial financial assistance from the United States or other foreign donors.

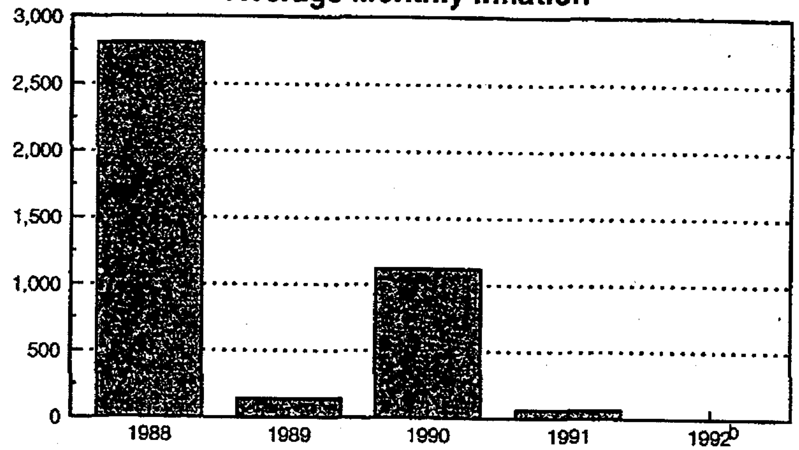
Continued economic stagnation is likely to fuel public restiveness and could further undercut the effectiveness of the Chamorro administration. Public protests over the recent tax hikes suggest political pressures will mushroom if the government takes additional austerity measures. A devaluation of the *cordoba* would raise import prices, erode real wages, and provide a convenient rallying point for critics of the Chamorro administration. The opposition, led by National Assembly President Cesar, is certain to exploit the government's difficulties at every opportunity.

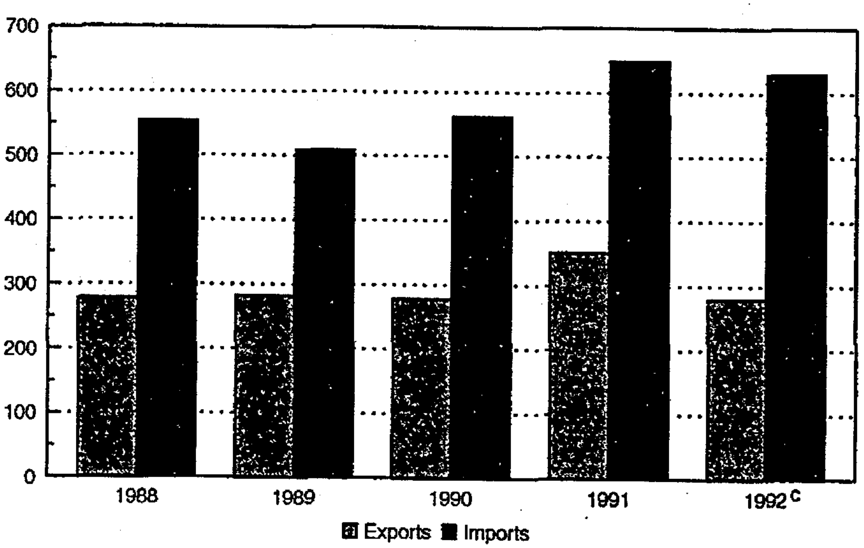
A prolonged suspension of aid could fan anti-US sentiment within the government, the Army, and the public at large. Many agricultural producers, for example, almost certainly will grumble about Washington's policies if they are unable to obtain credit for spring planting, and workers may blame the aid freeze for job layoffs at state enterprises. For his part, Sandinista Party chief Daniel Ortega will continue his accusations of US indifference to the suffering of the Nicaraguan people.

Annex A

Nicaragua: Selected Economic Indicators, 1988-92







[a] CIA Estimate (0)
[b] CIA Estimate (0.1)
[c] Estimates based on 1st quarter data
Source: IMF trade data

Annex B

IMF TARGETS *

TARGET	SEPTEMBER	DECEMBER	COMMENT
1. Ceiling on total government expenditure	1,335	1,930	No compliance problem.
2. Limit on net domestic credits to nonfinancial public sector	-615	-760	No compliance problem.
3. Ceiling on net domestic central bank assets	-141	-95	Made target in September; likely to miss in December unless US aid is released.
4. Net international reserves	$122	$123.5	Made target in September; likely to miss in December unless US aid is released.
5. Limits on contracting external credits by Public Sector and Central Bank	n/a	$40	No compliance problem.

* Millions of cordobas. $ sign indicates millions of dollars.

NOTE: September targets were met when IMF relaxed compliance criteria. Without at least $50 million in US aid, December compliance will be far short on both net domestic assets and international reserves. [redacted]

This table is classified [redacted]

Aid Effects Matrix

	Effects on GDP Growth	Balance of Payments	Fiscal Policy
Continued Aid Freeze	• Will probably be flat this year. • Growth in GDP unlikely in 1993 because of continued spending cuts, tax hikes, and restricted imports.	• Imports would shrink and 1992 current account deficit will narrow; overall deficit widens, however. • Exports next year would fall because of continuing agricultural credit cutbacks. • Potential noncompliance with IMF in December would threaten official loan disbursements and debt servicing deals. • Devaluation would provide export incentives but probably would not close the trade gap for many years to come. • Foreign exchange controls likely.	• Continued tightening to try to meet IMF targets and to help hold off a devaluation. • Further state spending cutbacks likely. • Further banking reforms unlikely.
$50 Million Disbursement	• Would be flat this year, with some growth likely next year. • Possible credit easing and state investment spending would lead to modest growth next year.	• No change in this year's deficit. • The trade gap could increase somewhat in 1993, because of less severe import restrictions. • Postponing devaluation would mean export prices would not affect trade until late in the year.	• Only minor changes to the policies already implemented. • Some easing in spending possible next year. • No further tax hikes likely in the near term.
Full Disbursement	• No effect on GDP this year. • Hikes in state spending and no import restrictions would likely lead to 3-4 percent growth next year.	• Import restrictions would be eased immediately, which would widen the trade gap next year. • Exports would rise modestly next year with agricultural credit easing. • Official loan disbursements would resume, thereby facilitating debt restructuring talks.	• State investment spending would rise and flexibility in dealing with the most politically troublesome tax increases -- such as electricity hikes -- would be possible.