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Abstract

Despite generous debt reduction under the HIPC initiative, Nicaragua is not growing at the rate required to alleviate poverty. This paper outlines Nicaragua's vulnerability to external changes and its inability to compete in the global market. Nicaragua suffers from severe structural problems; it has a very poorly diversified industrial structure, and its trading performance is correspondingly weak, relying on basic agricultural exports that have suffered stagnant or declining prices on international markets. Nicaragua is a clear example of an HIPC country that has achieved the criteria to enter into the HIPC initiative but is struggling to maintain sustainable economic development while trying to achieve poverty reduction.

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1. Introduction

Although there is a general consensus among economists that economic growth is good for the poor, the debate continues on whether economic growth is sufficient for poverty reduction. While the benefits of globalization are widely recognized, there has been a failure to obtain economic development in poor countries and a rapid increase in the poverty rate. Overall, the poverty rate in the developing world is higher than in the early 1970s. Specifically, 54 countries are poorer now than in 1990, 21 countries have a larger proportion of people going hungry, 14 countries experience more children dying before the age of five, and 12 countries have shrinking primary school enrolments; in 34 countries, life expectancy has fallen (UNDP,2003, p.3).

Poverty is no longer an issue specific to the developing world. By accentuating the great divide between rich and poor, the potential to create an unstable and dangerous world increases. The international community is considering poverty as a major challenge for economic development (World Bank, 2005). As a consequence, two distinguished initiatives were launched from different multilateral institutions. In 1996, the International Monetary Fund (IMF) and World Bank launched the Heavily Indebted Poor Countries (HIPC) initiative in an attempt to eliminate unsustainable debt in the world's poorest, most heavily indebted countries. In September 2000, the United Nations met at the Millennium Summit and agreed to work together to fight extreme poverty and to promote human dignity and equality. The Millennium Development Goals (MDGs) was the name given to a far-reaching and ambitious programme of 8 goals[1], which binds governments, international institutions and the business community.

[1] Goal 1: Eradicate extreme poverty and hunger
Goal 2: Achieve universal primary education
Goal 3: Promote gender equality and empower women

The International Monetary Fund (IMF) and World Bank are trying to establish new strategies for economic growth linked with poverty. During the 1990s, these institutions created a number of instruments, technically known as ‘facilities’. The Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF), recently replaced by the Poverty Reduction Strategy Paper (PRSP) have been designed to assist developing countries. The PRSPs are a very substantial set of economic, social and political reforms with carefully worked out objectives, policies and targets to foster economic growth and poverty reduction in an HIPC country. In 2005, 28 out of the 41 applicant countries have qualified for debt relief under the HIPC initiative and have been embracing the IMF and World Bank reforms (IMF, 2005a).

The economic, political and social transformation of Nicaragua since the early 1990s has led to the emergence of a market economy based on openness and competition. With the structural economic reforms, the restoration of democracy and the re-establishment of peace, important progress on the economic and political fronts has been achieved. During the 1990s, the Nicaraguan economy grew steadily at an average rate of 4.5 percent. Despite this growth, the United Nations Human Development Report for 2003 identified Nicaragua as the country with the highest percentage of people living below the poverty line. Some 82.3 percent of the Nicaraguan population lived on less than one dollar a day and 92.3 percent on less than two dollars a day. These trends do not indicate a synergy between economic growth and poverty reduction.

Goal 4: Reduce child mortality
Goal 5: Improve maternal health
Goal 6: Combat HIV/AIDS, malaria and other diseases
Goal 7: Ensure environmental sustainability
Goal 8: Develop a global partnership for development

Nicaragua is facing difficulties to compete in the global market, to maintain its good economic performance and to attract foreign investment. Nicaragua suffers from severe structural problems and geographic vulnerability to natural disasters, which impede sustainable economic growth and foreign investment. The economic and social performance has also resulted from almost 50 years of dictatorial rule and the plundering of the nation's resources by the Somoza regime. Thereafter, the Sandinista's revolution and the counter-revolution, with international economic embargoes and financial blockades, brought the economy to its knees. As a result of these and other adverse circumstances, Nicaragua faces high poverty, high illiteracy and a precarious infrastructure making it an unattractive location for foreign investment. To understand Nicaragua's structural problems, which impede sustainable economic growth, foreign investment and the development of its people, it is necessary to examine economic and social indicators.

2. The Debate on Poverty, Debt and Economic Growth

During the 1990s, the increase of poverty and the unsustainable debts of many poor countries dominated the debate on development. Poverty, debt and economic growth are inseparable issues; debt-overhang hinders economic growth and impedes poverty reduction (Berensmann, 2004 pp321-30). The debate on poverty and debt has been intense in recent years, highlighting three main mechanisms in which debt-overhang hinders economic growth in poor countries. One of these mechanisms is governmental budget constraints. Most developing economies experience structural deficit in their commercial position, thereby generating insufficient budget revenue[2] to match debt-service requirements. The only available policy answer is to increase

[2] Payment capacity for government external debt basically depends on budget revenue.

taxes and/or contract social spending (Adam and Bevan, 2005 pp.571-97). This negatively impacts domestic effective demand and the provision of effective social services, ultimately resulting in the economy being stuck in low growth equilibrium. Secondly, debt burdens can also affect economic growth through the external account (fear of exchange and trade related crises) (Serieux, 2001 pp.309-11). Finally, debt overhang also carries negative monetary effects, as it increases the probability that governments will engage in inflationary financing and/or currency depreciation because of excess demands for foreign currency created by debt-servicing needs (Yasushi, 2005 pp.1-46).

The launch of the HIPC initiative and the Millennium Development Goals has consolidated the approach to support poor countries towards economic development; however, the assumption that economic growth reduces poverty has been misleading in the application of appropriate economic policies in low-income countries. This assumption is based on the rejection of the well-known Kuznets hypothesis (see Kuznets, 1955, pp.1-28). The Kuznets hypothesis postulated that growth and inequality are correlated in a U-shaped curve, in which inequality will increase in the initial phases of economic growth, and then inequality will worsen, but will improve when countries reach middle income status. The Kuznets model has been extensively applied in a large body of research since its publication. In recent years, Kuznets' hypothesis has been rejected by a number of empirical studies (Ravallion, 1995; Deinihger and Squire, 1998; Bruno, Ravallion and Squire, 1998; Dollar and Kraay, 2001), demonstrating that economic growth has not much of an impact on inequality. As a result, a new paradigm based on the work of Dollar and Kraay (2001), which suggest that economic growth is good for the poor, has emerged. Dollar and Kraay investigated the income of 80 poor countries over a period of 40 years. They claim that the average income of the poor rises proportionately with economic growth, and in general, economic growth benefits the poor as well as those with wealth (Dollar and Kraay, *2001* pp.1-32).

In recent years, the debate continues on whether economic growth is a sufficient condition for poverty reduction. The increasing body of literature about the relationship between economic growth and poverty reduction claims that poverty reduction depends on different factors. It is suggested in a number of studies that income inequality is an important factor that hampers human development and poverty reduction (Morley, 1998; Chen and Ravallion, 2000). Some empirical studies have found a negative correlation between economic growth and inequality (Bernabou, 1996) while other research concludes that there is a positive and significant correlation between economic growth and inequality (Forbes, 2000 pp. 869-87).

There is a general consensus among economists that debt hampers economic growth, that income inequality has negative effects on human development, and that economic growth is good for the poor. Little has been said on the importance of structural weaknesses in low-income countries that hamper economic growth and poverty reduction in the present economic system. The relative failure of the HIPC initiative in achieving sustainable development has underlined the fact that debt is just part of the hindrance faced in a country's efforts to reduce poverty.

Beyond appropriate domestic policies, it is clear that reinforced global financial cooperation is needed to address structural problems that are hindering economic growth. Nicaragua requires more public and private investment, and industrial restructuring will also be important to generate a more diversified and higher value-added set of industries that can compete on world markets. It is also clear that without extra funding, poor countries would not achieve poverty reduction. The G7 proposal of February 2005 should be the beginning of addressing the problem of HIPC countries. The petition to the IMF and World Bank to concede 100 percent debt relief for HIPC indicates a step in the right direction.

3. The HIPC Initiative and Nicaragua

The unsustainable debt of many poor countries and the increase of poverty in the past twenty years have led to a broad and critical debate about the costs and benefits of globalization. Several aspects of the agenda for crisis prevention and crisis resolution were discussed at international level during the 1990s. Of these, two issues were identified as most important: first, the guarantee of international financial stability and, secondly, progress in the reduction of poverty in the world's poorest countries.

3.1. The HIPC Initiative

In September 1996, the IMF and the World Bank launched the Heavily Indebted Poor Countries debt initiative in an effort to tackle the problem of unsustainable debt in the world's poorest most heavily indebted countries. The idea behind this initiative was to establish an exclusive debt relief package seeking to reduce debt stocks to sustainable levels. In September 1999, the HIPC initiative was modified, reviewed and amended. One of the most important improvements was the thresholds of debt sustainability (see Box 1). The Enhanced HIPC initiative allowed seven additional countries (Benin, Central African Republic, Ghana, Honduras, Lao People's Democratic Republic, Senegal and Togo) to qualify for debt relief under the HIPC. Other improvements were the substitution of the Cologne terms for the Naples terms[3] and the possibility of debt relief 'front loading', stating that a proportion of debt relief be delivered at the decision point.

Box 1: The Debt Sustainability Analysis

The Debt Sustainability Analysis (DSA) is determined by three ratios:

	Original HIPC(1996)	**Enhanced HIPC(1999)**
Foreign debt to export ratio	200-250	150
Foreign debt to GDP ratio	280	250
Foreign debt service to export ratio	20	15

Under the enhanced HIPC, for example, debt is considered unsustainable when foreign debt to export ratio exceeds a fixed ratio of 150 percent, foreign debt to GDP ratio goes over 250 percent, and foreign debt service to export ratio surpass 15 per cent. The boards of the IMF and World Bank then determine the country's eligibility. At this stage all creditors compromise debt relief, which is estimated on the basis of the country's economic stability.

A typical HIPC country has very low per capita income; certain other characteristics are also common among the HIPC countries such as low human development, extremely high debt stock and scheduled debt-repayment, and a long history of adjustment attempts. Sachs (1999) describes the HIPC countries as the poorest of the poor, marked by a combination of extreme poverty and financial insolvency.

3.2. Nicaragua and the HIPC Initiative

[3] In December 1994, Paris Club creditors decided to enhanced terms on the debt of the poorest countries. These terms were named "Naples terms" which were review in September 1999. Under these terms, the poorest and most indebted countries could be eligible to 67 per cent external debt reduction. The Naples terms are intended to act as an "exit mechanism" the debt-stock reductions will be grated on the understanding that the debtor country does not return to the Paris Club for further rescheduling.

During the 1990s Nicaragua became the world's most heavily indebted country on a per capita basis, reaching its highest levels in 1994, when its foreign debt climbed to the staggering figure of US$11.695 billion (see Table 1). Every Nicaraguan shouldered an external debt of US$2,600 – over eight times the average income per head. This appalling financial performance resulted from the plundering of the nation's resources by the Somoza regime. When Somoza left the country, foreign debt had reached US$ 1.6 billion (Black, 1981, p.202). Thereafter, the counter-revolutionary war and financial embargo made it difficult for the Sandinistas to comply with international financial organisations. Although the Sandinistas tried to renegotiate external debt, much of the financial resources that came from outside where directed to finance military operations. During the 1980s external debt grew steadily from the accumulation of arrears and loans; however, foreign loans continued to flow during the 1990s when Nicaragua received four large loans from the IMF.

With the launch of the HIPC initiative, several creditors including non-Paris Club creditors were open to renegotiate or forgive debt to Nicaragua. In 1996 Russia, Mexico and the Czech Republic provided debt reduction of 92 percent of net present value (NPV). In 1997, a rescheduling agreement with the Central American Bank for Economic Integration involved forgiveness of US$104 million (Castro-Monge, 2001, p.424). At the end of 1996, total external debt amounted to US$ 6.09 million (see Table 1). In December of 2000, the IMF and World Bank estimated that Nicaragua has been relieved of 72 percent of its total external debt, a figure of US$6.5 billion.

Table 1: Balance of Public External Debt per Creditor (millions US$)

Concepts	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 (a)
Multilaterals	1,286.8	1,087.6	1,243.0	1,291.2	1,472.0	1,587.2	1,681.8	1,657.1	1,897.2	2,170.4	2,260.2	2,343.4	2,563.5	2,616.2
IDB	433.5	406.9	464.7	474.7	554.0	644.1	706.0	737.1	826.8	896.5	923.1	999.0	1,100.5	1,115.8
CAB	340.3	362.6	394.8	424.3	467.6	493.1	502.7	442.0	447.0	448.1	442.4	421.4	390.8	388.3
IBRD	304.0	79.1	68.7	56.1	45.4	36.0	27.6	16.2	14.7	9.4	4.6	0.0	0.0	0.0
IDA	61.9	110.9	184.0	207.9	255.0	272.8	323.0	362.3	487.9	596.7	653.3	688.5	812.4	844.3
OPEC	37.9	38.3	40.6	40.9	37.8	36.1	33.0	32.7	27.9	23.0	21.5	21.8	24.2	29.2
IFAD	23.7	25.0	24.8	19.8	20.2	20.5	18.7	18.5	21.1	21.9	23.9	26.1	29.4	29.7
Others	85.5	64.8	65.4	67.5	92.0	84.6	70.8	48.3	71.8	174.8	191.4	186.6	206.2	208.9
Bilaterals	7,221.8	7,199.6	7,548.1	7,726.9	8,325.2	8,271.8	4,044.5	4,027.0	4,115.0	4,084.1	4,123.8	3,740.4	3,555.3	3,591.3
Club of Paris	1,172.9	890.4	1,458.0	1,355.8	1,647.7	1,329.3	1,327.9	1,199.4	1,600.9	1,489.6	1,493.3	1,480.1	1,638.3	1,666.9
Central America	714.8	779.7	818.5	855.9	886.2	940.6	979.5	998.7	1,051.6	1,119.2	1,194.0	691.3	706.4	709.2
Ex-Socialist	3,249.0	3,533.7	3,732.6	3,880.1	4,093.2	4,261.7	1,065.3	824.6	743.2	479.8	473.1	454.8	220.2	220.9
Latin America	1,435.2	1,291.0	1,327.2	1,390.2	1,444.9	1,451.4	387.1	469.5	428.4	376.4	264.1	252.7	105.3	105.6
Others	649.9	704.8	211.8	244.9	253.2	288.8	284.7	534.8	290.9	619.1	699.3	861.5	885.1	888.7
Commercial Banks	1,843.7	1,711.8	1,711.6	1,739.9	1,727.6	269.5	272.4	234.1	246.3	246.3	234.6	242.8	206.8	204.9
Suppliers and others	363.1	313.5	289.5	229.3	170.2	119.9	95.6	82.8	28.6	52.9	41.3	47.6	37.0	37.1
TOTAL	10,715.40	10,312.50	10,792.20	10,987.30	11,695.00	10,248.40	6,094.30	6,001.00	6,287.10	6,548.90	6,659.90	6,374.20	6,362.60	6,449.50

Source: Central Bank of Nicaragua, Department of External Affairs, 2003.

In January 2004, after six years of continued negotiations, the IMF and World Bank boards accepted Nicaragua into the HIPC initiative. The debt-reduction under the enhanced HIPC initiative provided debt relief of US$4.5 billion or equivalent to US$3.3 billion in NPV to be delivered from 2001 until 2023. As a result, external debt was reduced from 300 percent of current GDP to about 70 percent, requiring between 15-20 percent of exports to finance debt service payments. Of the total Nicaraguan debt relief, the World Bank Group contributed US$382.6 million in debt service relief, which is equivalent to US$190.9 million in NPV. The IMF will grant debt relief of US$106.5 million, equivalent to US$82.2 million in NPV, on payments that are due from 2002 to 2009. The remaining amount of debt relief will be covered by other multilateral and bilateral organisations.

3.2.1 Stages of the HIPC Initiative in Nicaragua

The qualification of a highly indebted poor country for debt relief is not automatic. The financial assistance under the HIPC initiative is subjected to satisfactory macroeconomic performance based on economic policies of the IMF and World Bank, while debt sustainability is subjected to three ratios (see Box 1). Nicaragua's external debt position was assessed with reference to the DSA ratios. The ratio of foreign debt to exports was 650 percent, foreign debt to GDP ratio was 355 percent and accumulation of principal and interest arrears accounted for 36 percent (Esquivel, F. Larrain, and J. Sachs, 1998). Notwithstanding the fact that Nicaragua's debt was far in excess of the DSA ratios, the country's journey to reach the completion point has been long and tedious.

Stage 1: Decision Point

Soon after the launch of the HIPC in 1996, the Nicaraguan government signed a second Enhanced Structural Adjustment Facility with the IMF. This new economic programme, which lasted two years, graded Nicaragua with 'good economic performance' and recognised its potential to submit an application for the initiative. In April 1998, the Paris Club awarded Nicaragua debt service flow reschedules under the Naples' terms. Other bilateral and commercial creditors agreed to provide their share of relief required under the enhanced HIPC initiative.

At this stage Nicaragua established three-year track records of good economic performance based on the Poverty Reduction Strategy Paper (PRSP) and had to demonstrate the capability to sensibly use the Poverty Reduction and Growth Facility (PRGF) granted by the IMF. After an assessment of its macro-stabilization efforts, in September 1999, the IMF and World Bank declared Nicaragua eligible as a Heavily Indebted Poor Country. At that time, Nicaragua was paying between 40 and 45 percent of the total value of its exports in debt service. That year the country owed about US$2.17 billion to multilateral organisations, US$4.08 billion to bilateral organisations and US$234.3 million to commercial banks, bringing the total amount of external debt to just over US$6 billion, or three times the country's Gross Domestic Product.

The IMF and World Bank formally approved its eligibility and committed to deliver the debt relief required to reach debt sustainability – provided policy reforms remained on track over the following years. If this is done, the country reaches the 'completion point', where the international community provides 'irrevocable' debt relief. For Nicaragua, the decision point was scheduled for December 1999, but Nicaragua did not achieve its completion until the end of 2002 due to the failure of achieving PRSP targets in good governance and zero tolerance on corruption. These failures were also compounded by internal debt problems and the losses of international reserves.

In 2002 and 2003 the government faced great challenges in reducing the fiscal deficit, increasing public sector savings and overcoming the crisis of international reserves. Nevertheless, the economy provided a positive outlook for the evaluation of the PRSP. In November 2003, the efforts of the government paid off, gaining favour from the international community. The approval of tax reform, the regimen of communal property for indigenous people, the Social Housing Fund, the penal procedure code and the measures adopted to fight corruption were all favourable to the evaluation of the PRSP in 2003.

Stage 2: Completion Point

During this stage the international financial institutions grant interim debt relief, provided the country stays on track with the economic program of the IMF and World Bank. In January 2004, the IMF and World Bank agreed that Nicaragua had taken the necessary steps to reach its completion point under the enhanced HIPC Initiative. Nicaragua was the 10th country that has qualified to obtain external debt relief after Bolivia, Burkina Faso, Guyana, Mauritania, Mali, Mozambique, Tanzania and Uganda.

The amount of cash relief has been calculated by the IMF and World Bank methodology as the difference between the amount of the average service before and after HIPC relief. Total HIPC relief is estimated between the difference of the average service effectively paid during the period 1992-1998 and service to be paid after HIPC relief. The average service amount is estimated at US$216.6 million, which is the average service of 1992-1998 paid with domestic resources. For example, the amount of debt relief for 2001 is the difference between the average service during the period 1992-1998 (US$216.6 million) and service after HIPC relief, that is, US$153.3 million (see Table 2). Total HIPC relief in 2001 accounted for US$ 99.4 million and was directed to finance the balance of payments (US$36.1) and poverty spending (US$63.3 million).

HIPC relief for poverty spending is the debt relief of multilateral and bilateral creditors. For example, in 2001 debt relief from multilateral creditors amounted to US$48.1 million and bilateral creditors contributed US$15.2 million. HIPC relief has been divided into two accounts: capital expenditure and current account. The latter is dedicated to finance additional health programmes, rural development, technology transfer programmes and a decentralisation programme; while the former is mainly dedicated to programmes that aim to improve water and sanitation and rural development programmes.

Table 2: Allocation of Debt Relief

	2001	2002	2003	2004	2001	2002	2003	2004
	Millions of Dollars				*Percentage of GDP*			
1. Average service 1992-1998	216.6	216.6	216.6	216.6	5.4	5.4	5.3	5.1
2. Service after HIPC relief	153.3	158.0	115.7	91.1	3.8	3.9	2.8	2.1
3. Relief cash (1-2)	63.3	58.6	100.9	125.5	1.6	1.5	2.5	2.9
4. Total HIPC relief	99.4	239.0	241.4	232.4	2.5	6.0	5.9	5.4
5. HIPC relief for Balance of Payments	36.1	168.2	141.0	106.9	0.9	4.2	3.4	2.5
6. HIPC relief for Poverty Spending	**63.3**	**70.8**	**100.9**	**125.5**	**1.6**	**1.8**	**2.5**	**2.9**
Multilateral	48.1	70.8	76.0	80.3	1.2	1.8	1.9	1.9
Bilateral	15.2	0.0	24.9	45.2	0.4	0.0	0.6	1.1
HIPC relief for current expenditure	49.9	47.9	67.0	83.4	1.3	1.2	1.6	2.0
HIPC relief for capital expenditure	13.4	22.9	33.9	42.1	0.3	0.6	0.8	1.0
7. HIPC relief allocation	**63.3**	**70.8**	**100.9**	**125.5**	**1.6**	**1.8**	**2.5**	**2.9**
Primary Rural healthcare	-	1.5	1.3		-	0	0	
Social Safety Net	0.7	0.8	0.7		0	0	0	
Social Services	57.5	58.3	80.2		1.4	1.5	2	
Education	37.8	38.2	52.3		0.9	1	1.3	
Health	14.4	12.3	20.1		0.4	0.3	0.5	
Water and Sanitation	2	1.2	2		0.1	0	0	
Housing	1	0.5	0.4		0	0	0	
Municipal Infrastructure	2.2	6	5.3		0.1	0.1	0.1	
Protection of vunerable groups	3.4	5.8	6.8		0.1	0.2	0.2	
Social Investment Fund	1.6	4	4		0	0.1	0.1	
Development of the Atlantic Coast	0.1	0.2	0.2		0	0.1	0	
Implementation of ERCERP	0	0.1	0.6		-	0	0	
Support for production	0	0.2	7.3		-	0	0.2	

Source: Government of Nicaragua, Second SGPRS Progress Report 2003. Table 8

In 2001 cash relief amounted to US$63.3 million and was allocated to 9 programmes: primary care, social safety net, social services, protection of vulnerable groups, social investment fund, development of the Atlantic coast, implementation of the National Poverty Reduction Strategy (ERCERP) and support for production. Among these programmes, social services, which is subdivided into education, health, water and sanitation, housing and municipal infrastructure, received the highest proportion of cash relief (see Table 2). It is important to note that HIPC debt relief for poverty spending accounted for only 1.6 percent of the GDP in 2001, 1.8 in 2002, 2.5 in 2003 and 2.9 in 2004.

3.2.2. Poverty Reduction Strategic Papers (PRSP)

The PRSP programme is a carefully designed set of policies and targets that pay explicit attention to a country's specific situation and to its growth and poverty reduction priorities. The

PRSP programmes are designed by the Government of the applicant country and are reviewed by the Executive Boards of the IMF and the World Bank. The PRGF programs have three distinctive features:

a. Economic reforms are based on liberalization, deregulation and privatization of their economy, while macroeconomic stabilization uses monetary and fiscal policies. During the preparation of the PRSP, stabilization policies and restructuring programmes are devised and budgeted in a more flexible manner, given the individual situation of the country concerned, and with a more explicit focus on the impact of the policies on the poorest and most vulnerable communities.
b. Social reforms are based on a Poverty Alleviation Plan that the Governments of the applicant country are required to elaborate. A key feature o the PRSP is to increase national ownership. The idea behind this is that the participation of civil society in the poverty-reduction plan will generate discussions on the macroeconomic framework and policies underlying PRGF (IMF, 2005b). The plan should also consider reduction of inequality and increasing consumption for vulnerable groups.
c. The IMF and World Bank base their financial support on the condition that reforms ensuring ‘good governance’ are undertaken. The term good governance includes fighting corruption, transparency in the administration of public funds, citizens’ participation and effective rule of law. Corruption is a high priority in the list of good governance, as it remains a serious economic, financial and political problem both nationally and internationally.

Based on implementation of the PRSP, and in addition to their entry into the HIPC program, successful countries also have access to the IMF's Poverty Reduction and Growth Facility (PGRF) program, which offers low interest loans for low income countries. The PRGF allows eligible countries to borrow up to a maximum of 140 percent of their IMF quota over a three-year period, with the interest rate set at 0.5 percent, and with semi-annual repayments commencing in five and a half years and ending 10 years after of the disbursement of the funds. The IMF states that the expected average access to the PRGF programme for first-time users is 90 percent of their quota, and this declines to 65 percent of the quota for second time users.

4. Economic Growth and Poverty in Nicaragua

Since 1990, Nicaragua has witnessed extraordinary economic, social and political changes. The new structural reforms marked the transition from a central planning to a market-based economy in Nicaragua. Monetary and fiscal policies were implemented in order to promote economic growth in an environment of stable prices and exchange rates. Opening domestic markets to foreign trade and investment were also important measures that allowed the Nicaraguan economy to participate in the global market.

Social and political reforms took place during the mid-1990s. With the launch of the Heavily Indebted Poor Country (HIPC) initiative in 1996, Nicaragua had the opportunity to qualify for debt relief. Under this initiative, the IMF and World Bank demanded from each applicant country further reforms to the economy and also to the social and political sectors. After a long and tedious process of reforms, in January 2004, Nicaragua was formally accepted for debt relief under the HIPC initiative.

4.1. Economic Performance

Nicaragua made significant strides in restructuring its economy and providing an environment for the operation of market forces. In 1992, the economy gained stability and by 1994 the economy recorded a growth of 3.3 percent of the GDP. Nevertheless, a number of challenges and failures accompanied the successes of the Nicaraguan economic reforms. Trade and current accounts were highly negative and there was a failure in attracting long-term investment, creating jobs, and reducing poverty. Nicaragua suffers from severe structural problems and geographic vulnerability to natural disasters, which impede sustainable economic growth and foreign investment. Nicaragua has a poorly diversified industrial structure, and a weak trade performance, relying on raw material exports that have suffered declining prices on international markets.

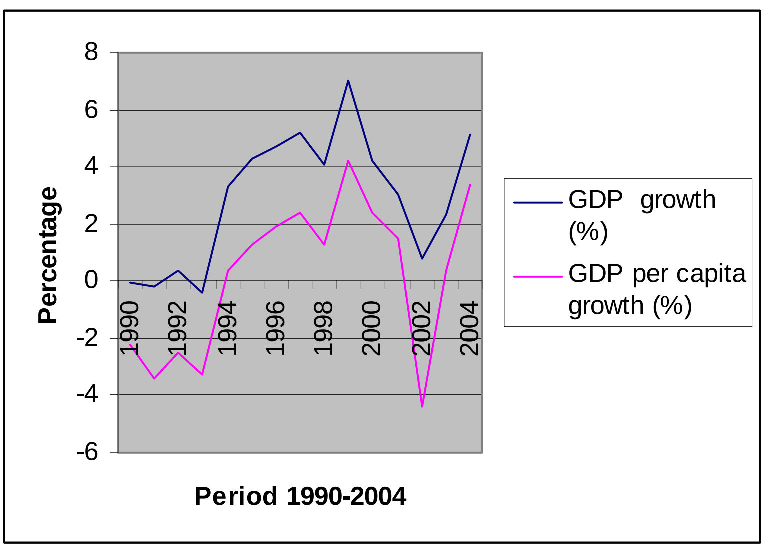
4.1.1 Growth of GDP and GDP per capita

Economic growth has been uneven during the first years of economic reforms as the economy faced a multitude of global and domestic economic and political challenges. The economy started to show positive growth during 1994 (3.3 percent). Further progress on macroeconomic stabilization allowed the economy to keep on growing. During the period 1994-2001, the average annual GDP growth was 4.5 percent; however, in 2002, the economy of Nicaragua started to show a decline. Real GDP fell to 0.8 percent. In 2003, GDP grew at an average rate of 2.3 percent. This outcome has been heavily influenced by the drop of coffee prices and other major agro-export products on international markets. The crises exposed the fundamental policy failures and structural imbalances in the economy.

Economic recovery consolidated during 2004, but not enough to suggest a real recovery for per capita income. Per capita income or GDP per capita is the most important economic yardstick to measure public welfare. Per capita income means division of the nation's revenues versus total population and indicates the average share of wealth for each Nicaraguan. The immediate effect of the decelerating Nicaraguan economy has been the reduction of per capita income. The GDP per capita, during the first four years of the economic reforms was negative. During 1994-2001, the GDP per capita has grown at a modest rate of 1.9 percent. In 2002, GDP per capita was reduced to a negative rate of -4.4 percent. In other words, the per capita income of a Nicaraguan citizen in 2002 has reduced more than five times compared to 2001.

Figure 1

Growth of GDP and GDP per capita



Source: Banco Central de Nicaragua, Datos Estadisticos 1990-2004.

4.1.2 Inflation and Exchange Rates

Important indicators of Nicaragua macroeconomic stability have been a low inflation rate, low devaluation rates and steadiness of the exchange rates. Monetary measures were used to bring stability to an economy that experienced a high rate of inflation during the 1980s. In 1990, the first year of economic reforms, inflation increased by 13,490.4 percent. A major cause of this increase was price liberalisation. By 1991 the annual rate had declined to 865.6 percent, still a very high figure. In 1992 the rate of inflation had improved to an impressive average rate of 3.5 percent. Although monetary measures were bringing economic stability, from 1993-2003, trends in annual inflation rates fluctuated from 19.5 percent in 1993 to 3.9 in 2002.

Devaluation of the national currency and liberalisation of the rate of exchange were important mechanisms within the monetary policies. With the introduction of a new currency *el Cordoba de Oro* that rated 1:1 to US$ in 1990, nominal devaluation reached 6,957.5 percent, while the exchange rate reached 3,000 percent. In 1991, devaluation continued to be high at a rate of 939.6; however, exchange rates reached a low rate of five percent. These drastic changes in the nominal devaluation and nominal exchange rate during the first two years of reforms reflected overall macroeconomic instability. Since 1992, *el Cordoba de Oro* maintained itself within a band of 5 to 15.55 per US$1 in 2003.

Table 3 Nicaragua: Inflation and Exchange Rates

Inflation and exchange rates	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Inflation	13,490.30	865.6	3.5	19.5	12,4	11.1	12.1	7.3	18.5	7.2	9.9	4.8	3.9	6.5
Rate of nominal devaluation	6,957.5	939.6	0.0	27.0	12.0	12.0	12.0	12.0	12.0	10.0	6.0	6.0	6.0	6.0
Nominal exchange rate	3,000.00	5.00	5.00	6.40	7.10	7.97	8.92	9.99	11.19	12.32	13.06	13.84	14.67	15.55

Source: Central Bank of Nicaragua, Economic Indicators 2004.

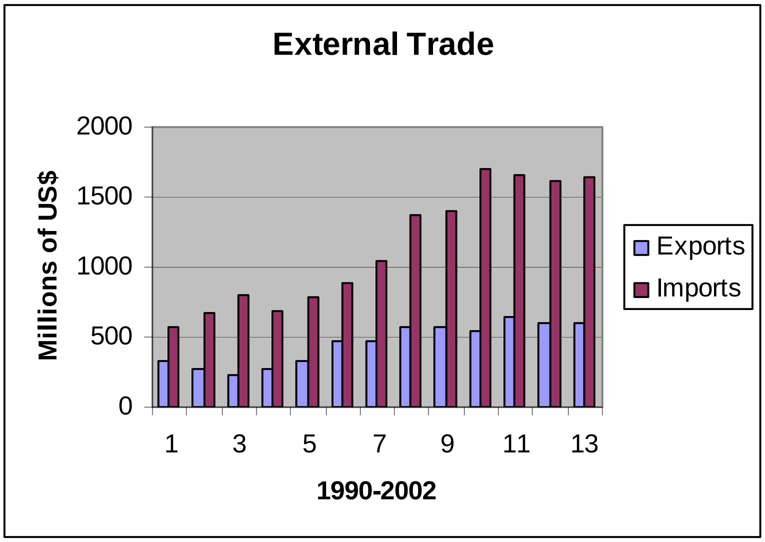
4.1.3 External Sector

Nicaragua has been suffering from persistent trade and current account deficits since before the 1990s. With the liberalization of the economy, imported products and services have flooded the local market. External trade imbalances have been significant, increasing from US$ 242 million in 1990 to US$1,040 in 2002. In 1990, exports accounted for US$330.5 million while imports accounted for US$ 572.3 million. By 2002, exports accounted for US$596.3 million and imports 1636.40 million.

The Nicaraguan external sector is highly dependent on agricultural production. Most exports are primary in nature and low value added commodities; 87 per cent of Nicaragua's exports are primary products, 13 per cent are manufacture, and three per cent are high technology (UNDP, 2003 p.288). Traditional and non-traditional exports include coffee, cotton, sesame, sugar, molasses, beef, seafood, bananas, gold, silver and manufactures. During the period 2000-2003, coffee, sugar, beef, seafood and non-traditional agriculture accounted for 64 per cent of all of Nicaragua's exports. Many of these have experienced declining prices on world markets, and this has contributed to declining trade performance. The balance of payments continues to be negative, in which imports account for nearly double of the Nicaraguan exports.

Figure 2

Nicaragua: Exports and Imports



Source: Banco Central de Nicaragua, Datos Estadisticos 1990-2002.

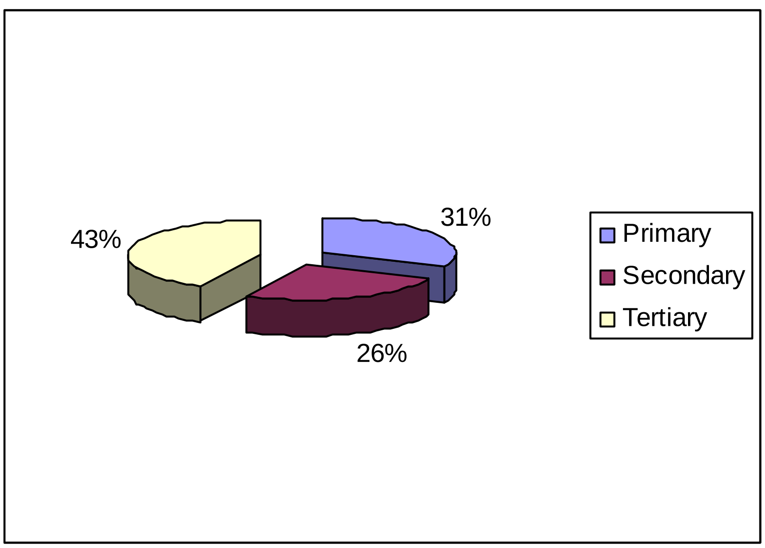
4.1.4 The Labour Force and Industrial Structures

Literacy and education levels among the Nicaraguan population (5.1 million inhabitants) are relatively low. In 2001, about 81 percent of the Nicaraguan people were enrolled in primary education, and only 48 percent reached fifth grade. Some 36 percent of the Nicaraguan population has enrolled in secondary level and 31 in tertiary education (UNDP, 2003 p. 272). In 2004, the labour force amounted to over 1.97 million people with a median age of 20.4 years; 30 per cent of the labour force were employed in agriculture, 24 percent in trade, 12 percent in manufacturing, 20.5 percent in social services, 4 percent in central government and 6 percent in the other sectors of the economy (Government of Nicaragua–INE, 2004, p 3).

The Nicaraguan industrial sector is very narrow and undiversified. In the most recent period of 2000-2003, 31 per cent of the economy's overall production is in the primary sector (agriculture, cattle, fishing, forestry and mining), of which 89 per cent is in basic agriculture and cattle. The secondary sector (manufactures and construction) accounts for 27 per cent of the economy's overall production, and it is dominated (73 per cent) by low value-added manufactures from primary produce. The tertiary sector (trade, general government, transport and communication, banking and insurance, electricity and water, housing, and other services) accounts for the remaining 42 per cent of the economy's total production, and over half of this is general government, and wholesale and retail trade. The picture that emerges is of a very basic economic structure that is not geared to competing successfully in value-added international markets.

Figure 3

Nicaragua's Industrial Structure
2000-2002



Source: Banco Central de Nicaragua, Datos Estadisticos 1990-2002.

4.2. Current Poverty in Nicaragua

The most common measures of poverty used today at global and national levels are those introduced by the World Bank. For global aggregation and comparisons, the World Bank focuses on income and consumption, defining the international poverty line as US$1 a day according to 1993 Purchasing Power Parity (PPP)[4]. The Living Standards Measurement Study (LSMS) survey was introduced in 1980, and nowadays is used by most developing countries as a tool of poverty assessment at the national level. The LSMS uses surveys to investigate in detail different dimensions of household well-being, including consumption, income savings, employment, health, education, fertility, nutrition, housing and migration.

4.2.1 Global Aggregation and Comparison

According to the United Nations Human Development Report for 2003, Nicaragua was identified as the country with the highest proportion of people living below the poverty line. Some basic statistics are as follows:

- 82 percent of the Nicaraguan population live on less than US$1 dollar a day, and 94.5 percent live on less than US$2 day,
- 2.3 percent of the national income is shared by the poorest 20 percent,
- 30 percent of the population are undernourished,
- Nicaragua has 52.2 percent of the poverty gap[5], the highest among all nations.

[4] Purchasing Power Parity (PPP) is a method of measuring the number of units of a country's currency required to buy the same products and services in the domestic market that US$1 would buy in any other market. Because goods and services may cost more in one country than in another, PPP allows us to make more accurate comparisons of standards of living across countries.

[5] Poverty gap is defined as the percentage increase in consumption needed to reach the poverty line.

4.2.2 Living Standards Measurement Study (LSMS)

The LSMS survey has been used by the Nicaraguan government to assess poverty at the national level. The survey collects data that can be used to assess household welfare and to evaluate the effect of various government policies on the living conditions of the population. The survey consists of four different questionnaires: a) household questionnaire, which focuses on consumption and income, as welfare is measured by expenditure on consumption; b) community questionnaire, records the location and quality of health services and schools available in the area, the condition of roads, the sources of fuel and water, the accessibility of electricity, means of communication and agricultural conditions and practices; c) price questionnaire records the everyday price rises experienced by individuals and, d) special facility questionnaire, obtains detailed information needed on schools or health clinics.

The Nicaraguan LSMS 2001 included modules on housing, health, education, economic activity, fertility, household enterprises, household expenditures, agricultural activities, and credit/savings. The survey identifies characteristics of the poor in Nicaragua:

- Little or no education. Widespread poverty continues to be persistent, especially amongst those with little or no education. The poor and extremely poor have only 2.3–3.1 years of education. The unemployed and people working in the informal sector are large in this category. The informal sector comprises 66 to 85 percent of those employed and little or no education is a common denominator in the informal sector (Pisani, 2003 p.117).

- Rural poor. The most affected are the rural areas where two out of three people live in conditions of absolute poverty. The poor live mainly in the central region and Atlantic coast, relying on agriculture. Only 67 percent of the rural population have access to safe water, 47 percent have access to electricity and 94 percent use firewood for cooking. Matagalpa and Jinotega have recently been incorporated in this category. These two regions are the most affected by the economic crisis caused by low coffee prices on the international market.
- Large households. Poor households have more than seven members in the family. About half of the country's women have little information on family planning and face high reproductive risks.
- Most of those living in poverty are women and children. About 27 percent of poor children and 36 percent of extremely poor children suffer from chronic malnutrition. About half of the female population are either poor or extremely poor. While poor women are more likely to suffer from anaemia, poor children suffer from stunt growth. 20 percent of children are under height for their age (UNDP, 2004, p.162).
- Human development gaps in urban and rural areas are evident. Michael Passini (2003) found education to be the key determinant in sectoral participation and earning ability. Those with higher levels of education were most likely to be employed in the formal sector and those with lower education are found in the informal work sector. The best location to engage with education is urban Nicaragua. In Managua, for example, only 2 out of 10 people remain extremely poor; while on the Atlantic coast and the rural Pacific region the vast majority live in extreme poverty.

In the last ten years, health indicators have improved but challenges remain. The under-five mortality rate was 43 per 1,000 live births in 2001, which is low compared with the rate obtained by developing countries (90) and the least developed countries (160). Compared to Latin America's average rate (34), Nicaragua's rate of child mortality remains high. The rate of immunisation against measles for one-year-olds is 99 percent, a good achievement compared with the rate obtained by developing countries (69 percent) and middle income countries (UNDP, 2003, p.198-338).

Nicaragua's maternal mortality ratio is 250 per 100,000 live births, higher than the Latin American average (188) but lower compared to developing countries (463). In Nicaragua, 65 percent of births are attended by skilled professionals, while Latin America has obtained the average rate of 82 percent. According to the Nicaraguan government (Government of Nicaragua, 2000, p.8), to obtain health care, extremely poor families have to travel three times the distance, and spend three times as much, as non-poor households. About 30 percent of extremely poor women receive no prenatal care. Most poor women have no access to information on family planning.

Nicaragua is one of the countries with the highest malnutrition rates in Latin America. Malnutrition afflicts 37 percent of poor children, and adult malnutrition has worsened since 1993; the majority of the rural population in Nicaragua has serious vitamin A deficiency. Anaemia is common among children, students and adult women. About 30 percent of children have vitamin A deficiency and anaemia, and 30 percent of women are affected by anaemia caused by deficient consumption and increased absorption or losses not compensated by food (FAO, 2001 p.4). Malnutrition stunts growth, impairs the mind, and consigns its sufferers to the likelihood of poverty and an early death.

4.2.3 Inequality Rate

The Latin America and the Caribbean is the region with the highest inequality rate in the world (0.51) that varies from a high of 0.59 in Brazil to a low of 0.43 in Uruguay. The Gini coefficient is a statistical measure of inequality (zero indicates perfect income equality, while a one would imply that all wealth is concentrated in a single person). The Nicaraguan Gini coefficient is 0.56; this is in the top quartile of the world's countries for income inequality. The wealthiest 10 percent of the country receive 45 percent of total income of the country, while the poorest 40 percent receive only 10 percent (Government of Nicaragua, 2003 p.36).

5. Structural Weakness in Nicaragua

The strategies of the IMF and World Bank for poverty reduction are anchored in economic growth based on trade liberalisation, privatisation and macro-stabilization programmes. It appears that in the case of Nicaragua, failure to attain ample poverty reduction is linked to the failure of maintaining good economic performance. Despite of the generous debt relief through the HIPC initiative, HIPC countries have failed to create a synergy between debt and poverty reduction (Serieux, 2001 pp.305-41). The relative failure of the HIPC initiative in achieving sustainable development in Nicaragua, underlines that debt is just part of the hindrance faced by low-income countries in their efforts to reduce endemic poverty. Beyond appropriate domestic policies, it is clear that these countries need to address structural problems that are hindering economic growth hence poverty reduction. Poor countries require more public and private investment, and industrial restructuring is important to generate a more diversified and higher value-added set of industries that can compete on world markets.

The free market economy works on the basis of openness and competition. Openness makes the markets more efficient as capital has freedom to move across countries. It has also been acknowledged that the initial benefits of competition in a free market will be the specialization of the economy, elimination of inefficient producers, best allocation of resources, reduction of prices, increase of the quality of products and services and, finally, better quality of life for individuals (Friedman, 1962, p.12). Highly industrialized countries have done well under this model, as they are competitive in the global market. For Nicaragua, however, there are three main limitations under the free market economic model that are important to consider.

- First, Nicaragua is unable to compete in the global market because of its small and weak economy. Today, international trade has been a very important instrument of economic growth. An increase in exports facilitates an increase in production in most industries, and growth in imports supports the fulfilment of the domestic demand for consumer and investment products. In the case of Nicaragua, with a weak industrial structure, openness has resulted in a negative balance of trade and an export sector highly dependent on primary products which have created a vulnerable economy. The oversupply of coffee in the international market, for instance, has caused a drop in coffee prices, damaging the Nicaraguan economy. As a consequence, poverty has increased in many regions dedicated to the production of coffee (World Bank, 2005).
- Second, lack of investment in human capital is another important limitation on economic development in Nicaragua. Privatization and deregulation in Nicaragua have drastically reduced the provision of health services and education (Pasani, 2003). Several empirical analyses attempting to explain cross-country income differences have established that

human capital is an explanatory variable for economic growth in the country (Rivera and Currais, 2004; Rodriguez-Pose and Fratesi, 2004; Bloom, Canning, and Sevilla, 2004; Boucekkine, de la Croix and Licandro, 2002; Fayissa and El-Kaissy, 1999; Corvers, 1997). It must be emphasised that education and health are important elements in human development. Good health has a positive, statistically significant effect on economic growth and contributes to other development objectives (Bloom, D. Canning, and D. Sevilla, 2004 pp.1-13). Other research studies have highlighted education and training as important variables in attracting investment in today's competitive world (Oman, 2000).

- Finally, Nicaragua has been unable to attract quality foreign investment. In the era of globalization, foreign direct investment (FDI) is regarded as an essential factor in the development of the economy (World Bank, 2004). It is conceded that FDI has the potential to generate employment, enhance exports and contribute to long-term economic development. Unlike other Latin American countries, little investment in labour intensive activities has taken place in Nicaragua. In 2003, Latin American countries had managed to export an average rate of 49 per cent of manufactured products and 15 percent of high technology. Nicaragua exported only 13 percent of manufactured goods and 3 percent of high technology; although with the free zone system, the manufacturing sectors have been more dynamic in the last two years. Even low-income countries have managed to export an average rate of 52 percent manufactured products and 7 per cent of high technology (UNDP, 2003, p.288).

The overall attractiveness of a country as a potential market site for FDI depends on balancing benefits, costs, and risks associated with doing business in that country. Although long-standing determinants of foreign investment, such as natural resources, remain important in the assessment of foreign investors, new factors, such as education and training, infrastructure, poverty, illiteracy and unemployment carry much weight in assessments by foreign investors. High rates of poverty and unemployment produce social instability. In the case of Nicaragua, inadequate access to education has created large pools of unskilled workers (Economist, 2003). Investors prefer to invest their capital in low-risk locations. High rates of poverty, unemployment and illiteracy cause high-risks for FDI.

There are a number of factors that have restricted investment in Nicaragua:

a. Security risk. Although levels of organised crime in Nicaragua are lower than in neighbouring countries, high poverty rates and poor law enforcement make crime a growing problem.
b. Labour market risk. Low levels of educational attainment and training qualifications have weakened Nicaraguan labour. There is a shortage of a skilled labour force.
c. Legal and regulatory risk. The judiciary is inefficient and tends to be highly politicised. This means that contractual agreements are often not respected and protection of property rights is limited.
d. Corruption. While reducing corruption has been a priority for the government of President Enrique Bolanos (leading to the imprisonment of former president, Arnoldo Aleman), high levels of graft persist at all levels of society.
e. Infrastructure risk. Nicaragua has a very precarious infrastructure, which has deteriorated further in the wake of Hurricane Mitch in 1998.

6. The Way Forward and Conclusions

Despite steady economic growth since 1994, Nicaragua's economic performance has not been sufficient to reduce poverty. Furthermore, its economic polices are not oriented towards the poor. Since 1990, Nicaragua has begun to implement policies of structural adjustment with the aim of reviving its economy. Macroeconomic stability was obtained, but this gain was accompanied by a significant increase of poverty. The economic reforms based on the market economy have rationalized economic resources, regulated prices and reduced public expenditure. These were translated into a fall in national consumption, a rise in unemployment and a drop in real wages for the skilled and unskilled (Pisani, 2003).

Tackling poverty requires economic growth (Dollar and Kraay, 2001) and generating investment is an important factor of growth. In the era of globalization, foreign direct investment (FDI) is regarded as an essential factor in the development of the economy. It is conceded that FDI has the potential to generate employment, enhance exports, and contribute to long-term economic development (World Bank, 2004). More recently, the importance of spillovers of FDI has been considered a powerful prospect to encourage foreign investment, as FDI seems to bring into a host economy knowledge, managerial skills, marketing strategies, and distribution and production networks that benefit the domestic economy (Blomström, 2001). Therefore, creating a better climate for FDI has become a central component in the economic development of most countries, including the HIPC countries.

At present, a prominent characteristic of the trends of FDI is that the bulk of the foreign investment inflows going towards the developing countries have been directed only to a limited number of countries. Poor countries are finding it difficult to attract FDI (Addison and Heshmati, 2003). Creating a better climate for FDI includes a long list of factors. Recent literature focused on this topic identifies institutional features as the new and significant determinants of FDI. Institutional features include the degree of political stability, government intervention in the economy, trade openness, property rights legislation, red tape, and the profit tax system.

Recent analytical work addressing the issue of incentives for attracting FDI highlight corruption as an important deterrent to it (Oman, 2000). Education and training are also new and important factors in the list of determinants of FDI in developing countries. Numerous studies (Borensztein, 1994; Noorbakhsh, 200; M.Blomström, 2001; Zhang, 2001; Addison and Heshmati, 2003) have identified education and training as vital determinants of FDI in the new global economy. Blomström (2001) points out that in order to create the strongest potential market site for FDI, governments of developing countries must focus on education and training. By improving education and thereby enhancing human capital, export-oriented FDI is encouraged, helping to maintain macroeconomic stability (Zhang, 2001).

Making FDI an instrument of economic growth goes beyond making a country an attractive market site for investment. Making FDI an instrument of economic growth requires setting long-term economic development goals in the light of national priorities. FDI will only generate a positive contribution to economic growth when the necessary conditions for economic development are implemented and the domestic economy is ready to absorb spillovers (Willem te Velde, 2001). Due to limited domestic savings, governments of poor countries are unable to invest and/or encourage investment. Therefore, financial cooperation from developed countries through private investment, technical assistance and advisory work are required. Investment should be directed to increase the developmental impact on local communities, including local businesses, health, education and infrastructure. The international community should also make expertise available to local business and provide business development services for local companies.

The most important areas to focus on in order to reduce poverty and promote human development in Nicaragua are policies that will strengthen the economy and adequately address human development. Policy priorities for sustainable economic growth and poverty reduction should include:

a. Labour-intensive investment. Job creation is an important strategy to consider, as labour is the main asset of the poor.
b. Investment in health and education. Education and training are key factors in obtaining equality, economic modernization and international competitiveness. Investment in education, health and nutrition is vital for the reduction of poverty and the promotion of economic growth. Although social services in Nicaragua have improved, the poorest of the poor need to have more access to these basic services. Three quarters of the population remain without access to improved water and sanitation (UNDP, 2003). Inequality in access to health and education services continues to prevail in the country.
c. Export diversification. This should be implemented to make production more competitive on the international market, where coffee, cotton and sugar prices remain vulnerable.
d. Profound industrial re-structuring. The country's future prosperity necessitates significant industrial restructuring to generate a more diversified and higher value-added

set of industries that can compete on world markets. This will, in turn, necessitate more international investment and the government will need to address these factors in order to promote foreign investment, create jobs and improve infrastructure.

e. The creation of a competent, professional and independent public bureaucracy. This will support a strategy to attract FDI. The role of the public sector in developing pro-poor programmes is vital in most developing countries.

Efficient economic policies are needed in the HIPC countries to obtain economic development and reduce poverty; yet, for low income countries, good economic policies are not enough. Developed countries should help to alleviate extreme poverty by dismantling obstacles to exports from the HIPC countries. The international community must cultivate long-term relationships that will protect long-term investment, including capital assets.

Acceptance for debt relief under HIPC has not been enough to strengthen the Nicaraguan economy, nor has it permitted greater investment. The government of Nicaragua together with the IMF and World Bank need to establish an effective and efficient link between poverty and debt relief and work in partnership with other governments and the domestic business community. With a very poorly diversified industrial structure and a weak external sector, the conclusion is clear that Nicaragua's future prosperity necessitates significant industrial restructuring to generate a more diversified and higher value-added set of industries that can compete on world markets. This will in turn necessitate more international investment and the government will need in order to take further steps to promote foreign investment, create jobs and improve infrastructure.

In Nicaragua, high poverty rates have caused social unrest and the increasing rate of crime has turned the country into an unattractive location for foreign investment. These social factors have not only caused serious difficulties in the establishment of a sustained economy but also in the development of democracy. Poverty causes insecurity, and extreme inequality has been shown to impose significant security costs on the advantaged. The world’s richest countries could effectively reduce their security costs by doing more to alleviate extreme poverty. The international community should build up long-term relationships that will protect long-term investment, not just as a moral duty but also out of self-interest.

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