Debt Relief for Nicaragua: Breaking out of the poverty trap

October 1998

This paper represents the views of: Grupo de Propositivo de Cabildeo (GPC, in Nicaragua), Oxfam International, the European Network on Debt and Development (Eurodad),
Sudewind (Germany), Centre for Democratic Education (USA), Ibis (Denmark),
Nicaragua Solidarity Campaign (UK) and was prepared by Oxfam International
with inputs from these organisations.

Oxfam International

Contents

Executive Summary

Nicaragua is Latin America's poorest country, with some of the worst indicators for human welfare. It also has the world's highest level of per capita debt, at around US$1,300 per capita, and one of the highest ratios of debt to GDP. Even though Nicaragua consistently fails to service its debt in full, actual debt repayments are two and a half times spending in health and education *combined*. This diversion of resources is taking place in a situation characterised by extreme poverty, for example:

- **Over half of the population live below the poverty line**
- **Two fifths of poor children are malnourished**
- **Three quarters of the poor live in rural areas, and half of these are extremely poor, unable to meet their daily food needs**

Poverty translates into chronic problems in health and education. Infant and maternal mortality is high, with the maternal mortality rate over three times higher in rural areas than the national average. Almost two fifths of the population do not have access to safe drinking water, and almost three quarters of the population are without sanitation services. Although gross enrolment in primary school is high, Nicaragua has the lowest primary school completion rate in the region and more than a third of poor children do not even have access to textbooks.

These abysmal human development indicators reveal problems that are further compounded by the pressures placed on the economy and government resource base by the extremely large foreign debt. In 1997, over half of government revenue went into servicing the US$6 billion debt. The effects on social sector spending have been disastrous, with per capita spending in the social sector now at levels lower than in the 1980s.

In 1997 spending on debt servicing was:

- **Over half of government revenue**
- **Two and a half times recurrent health and education expenditure *combined*, and 11 times recurrent spending on primary health care**

Social investments have been 'crowded out' by diverting limited government revenues to foreign creditors. The effect has been to exclude the poor from the benefits of growth. At the same time growth has suffered since the poor, over half of the population, are denied access to the social and economic infrastructure through which they can participate more effectively and more equitably in economic life. The barriers to growth and poverty reduction caused by debt have grave consequences now, and will continue to do so into the future.

Debt reduction is vitally needed to help Nicaragua break out of the poverty trap. The dimensions of the debt problem speak for themselves:

- **The ratio of debt stock to exports is 689 per cent or over three times the lower limit set under the Heavily Indebted Poor Country (HIPC) initiative.**

- **The debt service ratio is 51 per cent for debt service due, compared to the HIPC range of 20-25 per cent.**

- **Net Present Value (NPV) debt stock to revenue is 934 per cent, compared to the 280 per cent sustainability threshold under HIPC.**

These hard facts underline the damaging impact of debt on Nicaragua's economic reform efforts and investments in the social sector. However, HIPC itself will do little to address these problems.

Debt relief prospects under the Heavily Indebted Poor Country (HIPC) initiative

While Nicaragua is eligible for debt relief under HIPC, on the basis of the debt sustainability criteria, the country may not actually receive any debt relief under HIPC until the year 2002 or later. According to the August 1998 IMF/World Bank review of HIPC, fewer than a quarter of HIPC countries will actually receive HIPC relief before the year 2000. At the same time, if Nicaragua receives HIPC debt relief in 2002, the debt relief provided will not be enough to reduce the debt to a sustainable level, because the debt sustainability thresholds in HIPC are inappropriate. As for many other HIPC countries, the framework delivers too little debt relief, too late. This is for a number of reasons:

- **Timeframe.**

Nicaragua might not receive HIPC relief until 2002 or later. Because HIPC countries must undergo two successive IMF programmes, lasting a total of six years. This time period can be reduced if the IMF agrees that performance under the Enhanced Structural Adjustment Facility (ESAF) has been strong enough. In Nicaragua's case, performance under ESAF has been interrupted. A strict interpretation would mean that the Decision Point[1] for Nicaragua would be delayed until 2001, three years after signing of the present ESAF in March 1998. While we acknowledge that ESAF has been interrupted, the overall reform programme has been strong, if not the equivalent of 'shock treatment', and Nicaragua's track record should be interpreted more flexibly. It appears that this has been agreed, and in the August 1998 IMF/World Bank paper which reviewed the progress of HIPC, Nicaragua's earliest Decision Point has been proposed to be set at 1999. However, Nicaragua will then have to undergo another three-year ESAF programme before actually receiving debt relief under HIPC.

- **Other problems with ESAF.**

The case for flexible interpretation of Nicaragua's track record is also rooted in recent findings concerning the efficacy of ESAF. Recent external and internal reviews of ESAF, have observed that almost three-quarters of ESAF agreements are delayed or not completed, mainly due to policy disagreements between the government partner and the IMF. Delays in HIPC implementation therefore will be inevitable. The IMF itself has noted that for such programmes to be implemented consistently, governments must own the programmes, and be in a position to build consensus within government, and beyond. The Reviews have also recommended that such programmes must pay better attention to the effects of policies on the poor and vulnerable, and to integrate appropriate compensatory actions at the outset.

- **Inappropriate debt sustainability thresholds.**

[1] The Decision Point is the point at which it is decided whether a country will receive debt relief under HIPC, and by how much.

The World Bank and the IMF acknowledge that debt sustainability ratios are extremely difficult to define, and that the present ratios were derived using a 'rule of thumb'.[2] The ratios were derived mainly from Latin American experience of the 1980s, and relate to better developed economies, with more extensive levels of infrastructure, higher income levels and generally better social indicators. They are not valid or appropriate for the nature of Nicaragua and of other HIPC countries, which generally have extremely weak and vulnerable economies, often highly dependent on primary commodity exports. We propose more appropriate indicators in the ranges of: 150-200% NPV debt stock to exports; 15-20% debt servicing to exports and 200% NPV debt stock to revenue.

- **Cost of HIPC.**

Because of concerns with the cost of HIPC, creditors are trying to limit its benefits. A shorter time frame and lower debt sustainability thresholds could make the cost of debt relief for Nicaragua much higher. Deeper and earlier debt relief for Nicaragua and other countries will receive considerable opposition on purely on the grounds of cost. Once again, this undermines the ability of the HIPC framework to reach its potential as an exit for poor countries to reach debt sustainability. The human development needs of such countries as Nicaragua demand extraordinary measures and efforts for debt relief, and cannot be left to debates on cost grounds alone. **The total projected cost of HIPC is $8.2 billion, this is less than the $11 billion Europeans spend annually on ice cream or the $17 billion Europeans and Americans spend annually on pet food[3].**

This *Paper* presents the case for Nicaragua receiving earlier and deeper debt relief based on a more flexible interpretation of its track record. Credit should be given for the achievements of the past, and the timetable for debt relief should be accelerated.

Breaking out of the poverty trap: a human development window

We support a proposal made by Oxfam International to accelerate HIPC, by developing a 'human development window' within the initiative. Under this approach, if Nicaragua agreed to commit 85-100% of debt relief resources to poverty reduction initiatives, the country would be given improved incentives in the form of even deeper debt relief by a Completion Point of March 2000, one year from the proposed Decision Point. This approach could be a major opportunity to re-energise HIPC, and contribute to achieving the targets set at various UN summits, and recently incorporated by the OECD as 2015 targets for reducing poverty and improving health and education. **In Nicaragua's case, through this approach, HIPC can become an important additional tool for achieving human development.**

For illustrative purposes we look at the potential human development benefits to Nicaragua if debt service was reduced to 10% of exports under the 'human development window' in HIPC. We have calculated that over US$500 million could be made available between 2000 and 2002, if Nicaragua was to receive relief at a March Completion Point, which we propose. The finance that could be made available has then been compared with broad government development plans, contained in 'Preparing for the next Millennium', submitted to the Consultative Group in early 1998, and with UNICEF unit costings for social sector provision. The results are striking, with this finance, Nicaragua could, for instance:

- **provide free universal primary education each year**

---

[2] see Claessens *et al* "Analytical aspects of Debt Problems", in Z.Iqbal and R.Kanbur, *External Finance for Low Income Countries*, IMF, Washington DC, 1997, pp27-33.
[3] *Human Development Report 1998*, UNDP, New York NY, 1998, pp 37.

- **construct 1,500 pre-school classrooms, and rehabilitate 500 schools**

- **improve the primary level completion rate to from 34% to 70%**

- **improve access to primary health services for 1.2 million poor people**

- **improve water supplies to 600,000 people in rural areas**

- **provide complete sanitation coverage to the rural population**

For such achievements to be made, it is vital that action is taken quickly. We propose the following measures:

- **Government and creditors should commit themselves to the implementation of a 'Debt for Human Development Window' within HIPC.**

- **Government, donors and civil society should work together to develop agreed national development plans within a Poverty Action Framework, and mechanisms for converting debt relief into human development within these plans, from now until late 1999.**

- **A Debt Sustainability Analysis (DSA) should be carried out in early 1999, before the March 1999 Decision Point, and that civil society are involved.**

- **Nicaragua should receive deeper debt relief, via the 'Human Development Window', at a Completion Point of March 2000.**

- **A committee of government, donors and civil society representatives should oversee the implementation of the Poverty Action Framework, and the use of debt relief resources. Civil society should also be able to help government monitor the use to which future lending is put, to ensure that the country does not become seriously indebted again, and to ensure that lending is used for productive purposes.**

This approach could be an opportunity to develop a new partnership between Nicaragua and its creditors. Such a partnership is very similar to that recently proposed in the World Bank discussion paper[4]. This paper proposes a range of approaches to improve ownership and success of national development strategies. Some of these approaches include: that governments should develop strategies with civil society and the private sector; that support is sought for these strategies and partners identified; that donors should be involved in the design of strategies to help with quality and future collaboration, and that donors should then agree to fund aspects of the programme. This kind of approach is compatible with the 'debt for human development window' for improving HIPC.

The 'human development window' approach for Nicaragua could become an important catalyst in a range of ways. Firstly, this is an opportunity to accelerate the flagging HIPC initiative, without re-negotiating the framework, through developing a system of incentives by developing a window for countries which are serious about poverty reduction. Secondly, this is an opportunity for Nicaragua to use the additional resources from debt relief, coupled with other instruments such as a strong policy environment, investment, and aid and lending support, to make progress on achieving the UN human development targets agreed at a range of UN summits. Thirdly, for creditor governments it is an opportunity for them to

[4] *Partnerships for Development: From Vision to Action*, World Bank, Washington DC, Sept. 23, 1998.

make progress on 2015 targets that they have adopted in the OECD document, *Shaping the 21st Century*. Debt relief for Nicaragua, linked to human development targets, could help to strengthen the linkage between growth and poverty reduction and higher levels of human development. This could be a real chance for Nicaragua to break out of the poverty trap.

Introduction

Nicaragua is Latin America's poorest country, with some of the worst indicators for human welfare. It also has the highest level of per capita debt, at around US$1,300, and one of the highest levels of debt in proportion to GDP[5] in the world. Even though Nicaragua consistently fails to service its debt in full, actual debt servicing is two and a half times its spending on health and education combined. According to the World Bank, using evidence from the most recent surveys in 1993, one fifth of the population live in extreme poverty, unable to meet even basic food requirements.

- Over half of the population live below the poverty line.
- Two fifths of poor children are malnourished.
- Three quarters of the poor live in rural areas, and half of these are extremely poor, unable to meet their daily food needs.

Health levels are low in Nicaragua, and infant and maternal mortality is high, with maternal mortality indicators over three times worse in rural areas than the national average (see Table 2 for welfare indicators). Nearly two fifths of the population lack access to safe drinking water, and almost three quarters are without sanitation services. Although gross enrolment rates in primary school are high, Nicaragua has the lowest primary school completion rate in the region, and more than one third of poor children do not even have access to textbooks.

In Nicaragua poverty has a female face, and women bear the brunt of poverty in many ways. With the growth of home-based informal activities, demands have risen for women's labour. In addition, women must cope with the needs of high numbers of dependent children, declining access to basic services, and a heavy workload in collecting water and fire-wood. Child labour is a serious problem within poor families; it affects children's mental and physical health, as well as their educational development.

The problems suggested by these abysmal human-development indicators are further compounded by the pressures placed on the economy and government resource-base by the extremely large foreign debt. In 1997, over a half of government revenue was spent on servicing the US$6 billion debt. The effects on social-sector spending have been disastrous: per capita spending in this sector is now lower than in the 1980s.

In 1997 spending on debt servicing was:

- Over half of government revenue
- Two and a half times recurrent health and education expenditure *combined*, and 11 times recurrent spending on Primary Health care

Social investments have been 'crowded out' by diverting limited government revenues to debt servicing obligations to foreign creditors. One effect has been to exclude the poor from the benefits of growth. At the same time, growth has suffered since the poor, (over half of the population) are unable to contribute to it. The barriers to growth and poverty reduction created by debt have grave consequences for social and economic development. Although Nicaragua and a range of creditors have made important progress in reducing Nicaragua's debt burden from over US$11 billion in 1994 to its current level of US$6.1 billion,

[5] According to the IMF, Net Present Value (NPV) of debt as a percentage of GDP was 206 in 1996, exceeded only by Sao Tome and Principe among countries included in the Heavily Indebted Poor Countries (HIPC) initiative.

debt will remain unsustainable until 2002, which is the earliest date when it could receive debt relief under the Heavily Indebted Poor Country initiative (HIPC).

- Looking ahead over the next few years, Nicaragua's debt servicing will average around US$280m a year, continuing to absorb more than twice the health and education budgets combined.

Even if Nicaragua receives relief under the HIPC initiative, there will be serious difficulties in reducing the debt to levels compatible with the human development needs of Nicaragua, due to failings in the HIPC framework.

Nicaragua's difficulties reflect problems in the design and implementation of HIPC. Under existing rules, Nicaragua will have to go through two successive IMF programmes before receiving debt relief under HIPC. The first arrangement under the Enhanced Structural Adjustment Facility (ESAF) for Nicaragua broke down after one year in 1995, and the second ESAF was signed only early this year. Current rules demand three years of compliance with an ESAF programme before reaching a Decision Point, when eligibility for HIPC relief is agreed on. This is then followed by three more years before the Completion Point is reached, at which time HIPC debt relief would be provided (see Table 4 for details). In exceptional cases, this last three-year period may be reduced if the country can demonstrate a strong previous track record. If Nicaragua is not treated more favourably by creditors, then it may reach the Completion Point and receive HIPC relief as late as 2002, or even later if there are interruptions in the implementation of the ESAF programme.

It is possible that, with efforts on the part of Nicaragua's creditors and the Nicaraguan government, this time frame could be reduced, and the size of debt relief increased. We,[6] along with non-governmental organisations (NGOs) throughout the world, have argued that the time frame for HIPC implementation should be reduced to three years, and that the sustainability thresholds should be lowered so that they are relevant for HIPC countries. At the same time, the problem of debt could become an opportunity for poverty reduction, helping to meet internationally agreed targets, if debt relief incentives were introduced for countries committed to implementing plans for poverty reduction. *With a new Millennium approaching, HIPC may be on the verge of failure, with fewer than a quarter of countries actually receiving debt relief before 2000, unless greater steps are taken to ensure that more countries become eligible for deeper and earlier debt relief.* In Nicaragua's case we recommend the following course of action:

- **Government and creditors should commit themselves to the implementation of a 'Debt for Human Development Window' within HIPC.**

- **Government, donors and civil society should work together to develop agreed national development plans within a Poverty Action Framework, and mechanisms for converting debt relief into human development within these plans, from now until late 1999.**

- **A Debt Sustainability Analysis (DSA) should be carried out in early 1999, before the March 1999 Decision Point, and that civil society are involved.**

- **Nicaragua should receive deeper debt relief, via the 'Human Development Window', at a Completion Point of March 2000.**

[6] This paper represents the views of: Grupo de Propositivo de Cabildeo (GPC, in Nicaragua), Oxfam International, the European Network on Debt and Development (Eurodad), Sudewind (Germany), Centre for Democratic Education (USA), Ibis (Denmark), Nicaragua Solidarity Campaign (UK), and was prepared by Oxfam International with inputs from these organisations.

- **A committee of government, donors and civil society representatives should oversee the implementation of the Poverty Action Framework, and the use of debt relief resources. Civil society should also be able to help government monitor the use to which future lending is put, to ensure that the country does not become seriously indebted again, and to ensure that lending is used for productive purposes.**

Nicaragua's debt

Growth of the debt

Nicaragua's debt problems intensified during the 1980s. As in other heavily indebted and poor countries, external problems such as falling commodity prices, rising oil prices, and high interest rates interacted with economic mismanagement and excessive borrowing. Nicaragua's situation was worsened by armed conflict in large parts of the country.

In 1979 the revolutionary Sandinista government inherited from the Somoza regime US$1.6 billion of debt, low national savings, and a country debilitated by years of civil war. During the 11 years of Sandinista rule, significant advances were made in meeting the basic needs of the population, and in rapidly raising health and education standards. Ultimately, however, these policies were financed through increased borrowing, which led to an expanding and unsustainable public sector and serious indebtedness. The exchange rate was overvalued, and inflation rose, to reach 36,000 per cent in 1988. The government faced serious balance of payments problems and rising debt. These difficulties were further compounded by the US-led economic embargo and international isolation, and the US-supported war of the 1980s. This war was both costly and destructive, and leading to greatly increased defence expenditure. The government initially responded to these external and internal problems by discontinuing debt service, assuming a massive debt with the USSR, and increasing money supply. The situation worsened, and the Sandinista government eventually introduced a stabilisation package which included devaluation, increases in interest rates, and restrictions on credit and public spending. The recession caused GDP to decline by 13 per cent and further undermined worsening social indicators.

In 1990, the new Chamorro government inherited a debt stock of US$10.7 billion, 40 per cent of which was arrears. By 1994, this debt had reached a peak of US$11.7 billion. Nicaragua at that time had the highest debt per capita and highest ratio of debt to GDP of any country in the world.[7]

Recent debt-relief measures

Following a series of negotiations, Nicaragua has benefited from recent reductions in debt stock, although debt servicing has remained at unacceptably high levels. The government first went to the Paris Club[8] for relief in December 1991, and then for a second time in March 1995. In April 1998, following agreement of a new ESAF, Nicaragua was granted Naples Terms[9] for the rescheduling of its debt flows. During these three rounds of Paris Club discussions up to 1998, a total debt reduction worth around US$800 million was obtained, the bulk of this being reduction in debts to the former German Democratic Republic,

[7] Per capita debt was US$2,786, and total debt was 6.5 times the size of GDP.
[8] The Paris Club is an informal group of creditors, mainly from industrial countries, which has met on a regular basis in Paris since 1956.
[9] Naples Terms for debt reduction were agreed by the Paris Club in December 1994, and are applied on a case-by-case basis, where countries can receive reduction of eligible external debt of up to 67% in net present value terms.

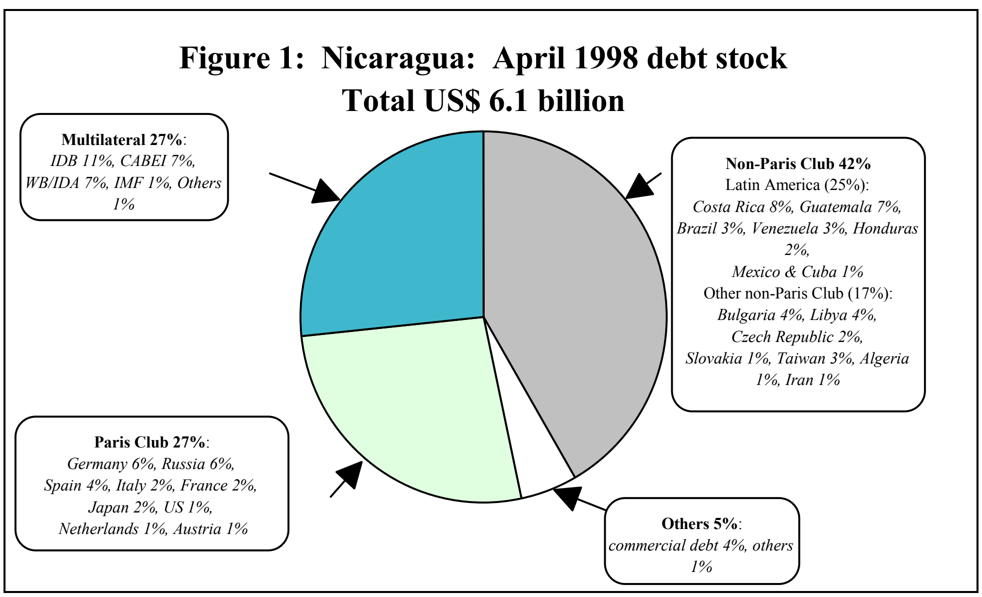
granted by the German government.

Outside the Paris Club, successive negotiations have led to a reduction in debt of almost US$6 billion. The largest of these were agreements with Russia and Mexico in 1996, when Russia wrote off just over US$3 billion of debt owed to it by Nicaragua, and Mexico wrote off just over US$1 billion, representing in both cases a reduction in debt stock of over 90 per cent. Other concessions were given by the governments and central banks of Venezuela, Honduras, El Salvador, Argentina, and the Czech Republic. With support from the World Bank, the Inter-American Development Bank (IDB), and other donors, a relatively successful commercial debt buy-back operation was undertaken, with US$1.1 billion bought back (around 83 per cent of the total offered) at a rate of eight cents on the dollar. In 1997, a debt of US$540 million owed to the Central American Bank of Economic Integration (CABEI) was rescheduled and reduced by 18 per cent, some US$100 million.

These negotiations have reduced Nicaragua's debt burden from six times GDP at the end of 1993, to three times GDP at the end of 1997.

Debt profile

Despite these various measures, Nicaragua's debt stood at US$6.1 billion[10] in April 1998, with a third still in arrears. In per capita terms this comes to around US$1,300 owed to foreign creditors by every Nicaraguan. The bulk of this debt is bilateral, with just over a quarter owed to multilateral institutions, mainly the IDB, the Central American Bank of Economic Integration (CABEI) and IDA (International Development Association) debt to the World Bank. Of the bilateral debt, over a quarter is owed to the Paris Club with Germany, Russia and Spain being the largest creditors. Another 40 per cent is owed to a large number of non-Paris Club creditors, with Costa Rica, Guatemala, Brazil, Venezuela, Bulgaria and Libya being the largest. There is a small amount of outstanding commercial debt. Figure 1 summarises the distribution of Nicaragua's debt stock.



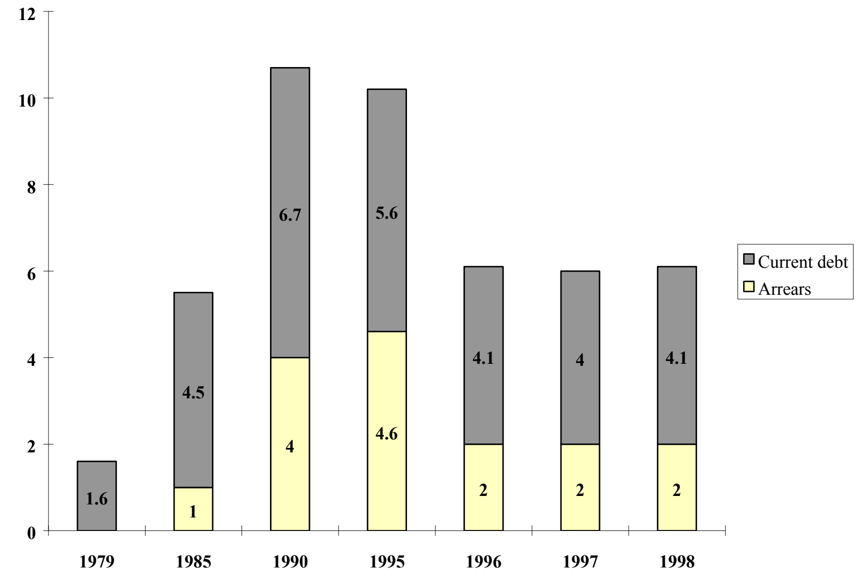
Source: Central Bank, 1998

---

[10] Unless described otherwise, debt is nominal or 'face value', not net present value – see footnote 12 for description of NPV.

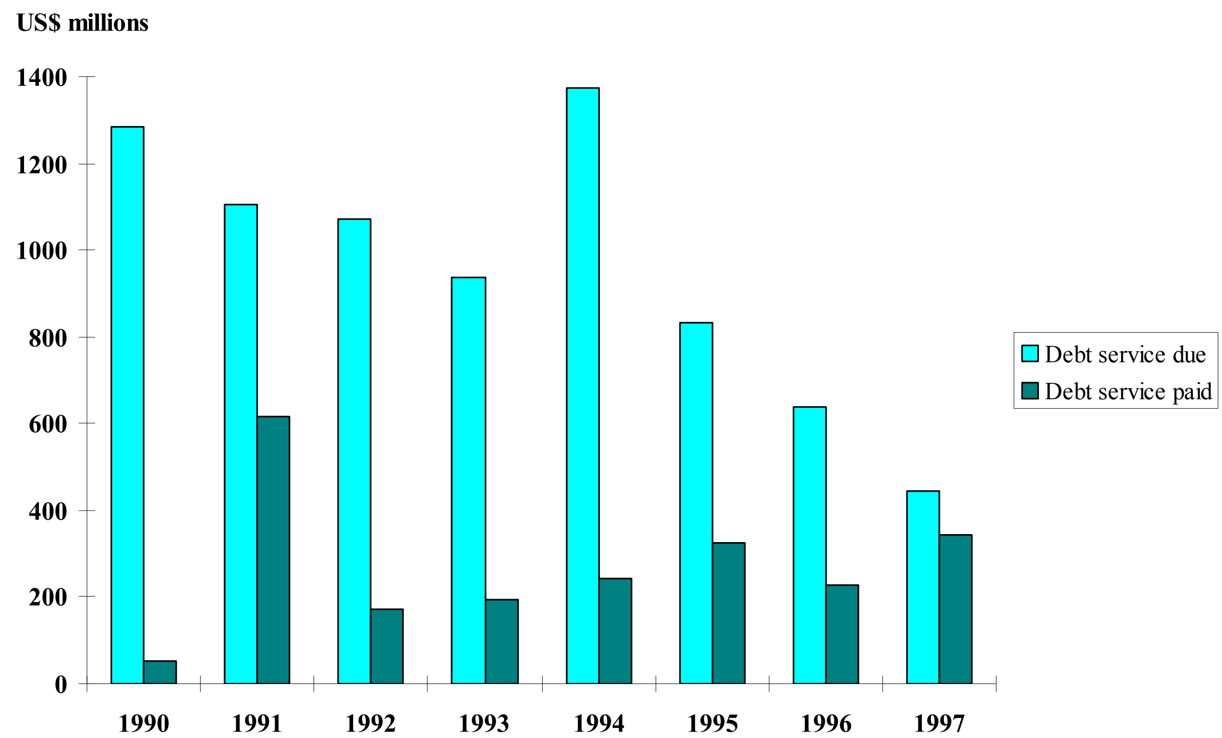
Like almost all of the HIPC countries, the Nicaraguan government has been unable to meet its repayment obligations. According to the Central Bank, scheduled debt service in 1997 was US$443 million. Following rescheduling this was reduced to US$343 million, and final payments were US$264 million, because agreements were not reached with some non-Paris Club creditors. From 1991 to 1997, Nicaragua has paid on average only one third of debt servicing due, despite going to the Paris Club twice, and despite reductions in the debt stock and servicing mentioned above. Arrears stand at one third of debt stock, and in 1995 were almost half of the total debt stock, reinforcing the problem of unsustainable debt servicing. Existing debt relief measures appear inadequate to deal with the scale of the problem, as can be seen from Figures 2 and 3, and Nicaragua's debt remains at unsustainable levels.

Figure 2: Growth of Nicaragua's external debt



Source: Central Bank, 1998

Figure 3: Nicaragua: external debt service (1990-1997)



Source: Central Bank, 1998

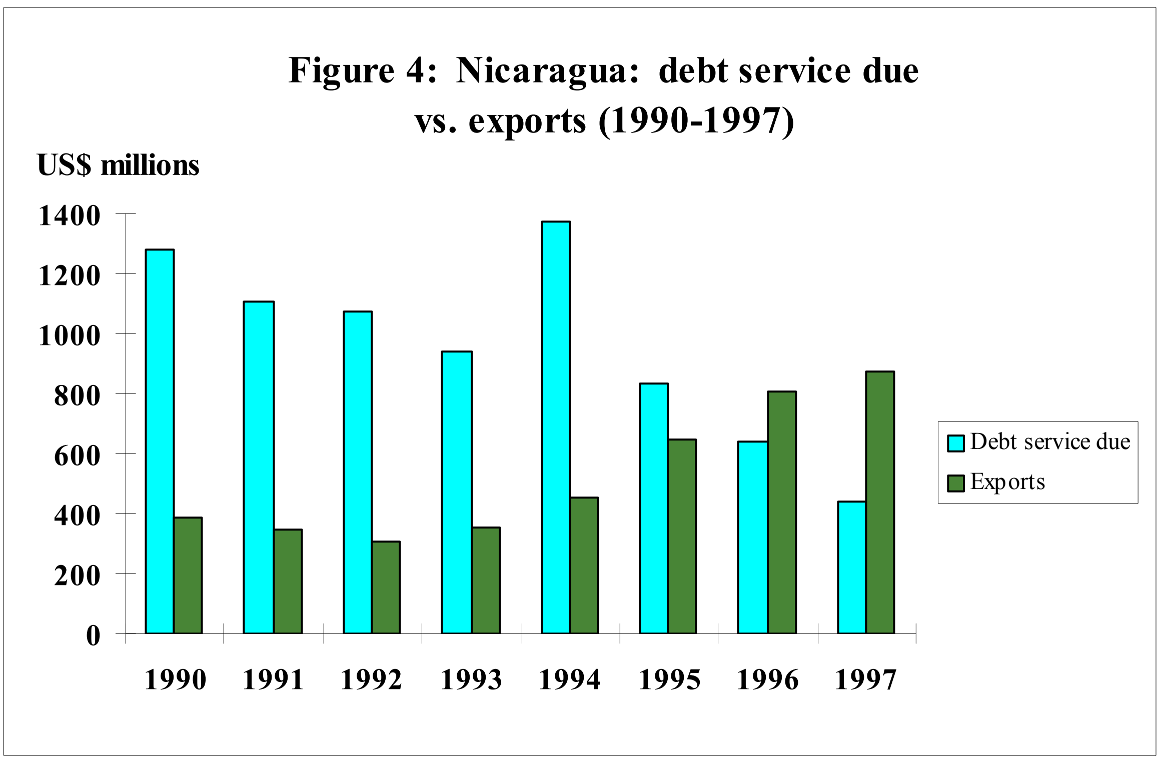
Debt servicing

Debt-service projections by the IMF show repayments averaging around US$ 278 million per annum for the next five years. These calculations may be an underestimation, since they assume that other commercial and non-Paris Club creditors agree terms comparable to the recent Paris Club Naples Terms treatment of debt service flows, and also that the Paris Club provides a stock of debt reduction of 67 per cent at the end of 2000. The Fund's predictions are optimistic, since Nicaragua will also have to undertake a series of highly complex and difficult discussions with a wide range of non-Paris Club bilateral creditors, and with unpredictable outcomes. Some of these creditors face economic problems themselves, such as Honduras and Guatemala. Honduras is itself deeply indebted and allocates over half of its revenue to servicing its debt. Any stock of debt reduction by the Paris Club would also require compliance with conditions under the new ESAF arrangement. There are also other possibilities for dealing with bilateral debt. One member of the Alliance has offered proposals to the German government to review whether ex-GDR debt can be converted into Official Development Assistance (ODA), and also to investigate whether some debt can be converted into credit programmes for development.

Table 1: Nicaragua: external debt indicators (end-1997)			
	US$m		
Total debt stock	6,001	Total debt/exports	689%
Contracted debt service	443	Contracted debt service/exports	51%
Debt service after rescheduling	343	Actual debt service/exports	39%
Actual debt service	264	Contracted debt service/revenue	87%
Ordinary revenue	512	Actual debt service/revenue	67%
Exports	871	Net present value debt to GDP	237%

Source: Central Bank of Nicaragua

At the same time, another commercial debt-buy-back operation will have to be negotiated and donors sought for funding. This operation could be more difficult to manage than the previous one, since much of the remainder of this debt is with companies that did not participate in the first buy-back operation. This would be a buy-back of around US$200 million remaining from the IDA funded 1995 operation, and would cost around US$16 million, according to the Central Bank. The government is involved in legal disputes concerning this debt, and the particular problem of commercial credit highlights the problem of ensuring 'comparable' treatment of debt by all creditors as part of the HIPC framework.



Source: Central Bank, 1998

Debt Service Due/Exports: 1990: 328% 1991: 316% 1992: 346% 1993: 264% 1994: 303% 1995: 130% 1996: 79% - Note that HIPC sustainability threshold is 20-25%

Scheduled debt servicing in 1992 was over three and a half times the size of exports, and in that year growth was actually declining. Debt servicing was later reduced to half of exports in 1997, following debt reduction negotiations. However, between 1994 and 1997 debt servicing absorbed on average over half of government revenue. Fiscal pressures such as these have reduced the government's ability to make the economic and social investments required to improve growth and reduce poverty.

In the future it appears that the situation will improve only marginally. Projections of the ratio of debt service to exports carried out by the IMF average at over 21 per cent for the next five years. Using a lower growth scenario, the ratio increases to 22 per cent, according to IMF figures. In both cases this is above the 20 per cent lower limit of sustainability criteria set within the HIPC framework. The Nicaraguan government will continue to face serious fiscal pressures.

Even with Naples Terms flow reductions for all bilateral creditors, and Paris Club Naples Terms stock of debt reduction in 2000, Nicaragua will face similar constraints, where debt servicing from 1998 to 2002 will continue to absorb 50 per cent of government revenue. Nicaragua's position is untenable without huge amounts of foreign aid, a large portion of which is recycled as debt re-payments to the same countries and institutions that provided the aid.

Recycling aid

Since 1990 Nicaragua has been supported by massive amounts of foreign aid. Between 1990 and 1995, it received over US$3.9 billion, and by 1997 this had reached nearly US$5 billion.

- aid between 1990 and 1995 represented almost US$1,000 per capita.

- in the last five years, aid has been equivalent to 22 per cent of GDP.

Initially most of the aid was used to pay off arrears to international financial institutions, and later to balance of payments support for the stabilisation programme. For the five years from 1990, half of the aid was used for financial-sector support. The remainder went into reconstruction efforts, including demobilisation of the military and Contra forces, including re-settlement of refugees; some 21 per cent went into productive areas such as agriculture and manufacturing, 12 per cent into economic infrastructure, and 14% into the social sector. Two thirds of the aid came from bilateral sources, and one third from multilateral sources, with over half given as grants and the remainder as loans. In all, Nicaragua has received aid worth an average of 22 per cent of GDP in the last five years. This position is extremely precarious, and even though exports have been growing, imports have also risen, and the current account balance was negative at over US$500 million in 1997, more than a quarter of GDP. Only enormous aid flows allow Nicaragua to maintain its slow development path.

However, more than one third of aid has gone into paying off debt - another example of the failure of existing debt relief measures to address Nicaragua's problems.

- of every $3 provided to Nicaragua in aid, $1 is recycled in the form of debt repayments.

While aid has helped to service debt, and to support Nicaragua's development, this aid is also declining and current trends are likely to continue. Aid flows in 1996 and 1997 were almost US$500 million and US$400 million respectively. Donor pledges at the Consultative Group meeting were US$1.8bn over the next three years, and actual allocations may be less than these pledges. Nicaragua has been highly dependent on aid, both to fund reconstruction and development efforts, and to assist in servicing the debt. However, declining aid flows will further constrain Nicaragua's ability to service debt, and to promote national development efforts. In the light of this trend, debt relief becomes even more vital as a source of additional resources for poverty reduction and growth.

Debt sustainability

The external debt of poor countries affects their national development in many ways, with both economic and social consequences, which are further compounded by generally poor economic performance. Even with concessional flows of finance and as described above, current debt relief mechanisms, the external debt service payments of Nicaragua remain unsustainably high. Links between economic performance and the debt burden can be observed in the impact on investment found due to the 'debt overhang' and 'crowding out' effects. There is reduced access to international financial markets, and the instability created by a large stock of debt. The 'debt overhang' discourages investment and constrains growth, while at the same time high levels of debt servicing reduce public investment. It has recently been argued[11] that a high debt burden also encourages capital flight, through creating risks of devaluation, increases in taxation, and thus the desire to protect the 'real' value of financial assets. Capital flight in turn reduces domestic savings and investment, thus reducing growth, the tax base and debt servicing capacity. The diversion of foreign exchange to debt servicing also limits import capacity, competitiveness and investment, and thus growth. In Nicaragua this has important consequences for the rural sector.

At the same time, aid is diverted from poverty reduction priorities into debt repayments, and in addition to this, government debt servicing diverts resources from vitally needed investment in the social sector and poverty reduction measures. For Nicaragua debt affects all of these areas, and these pressures have led the government to seek additional support from donors to assist with the fiscal pressures caused by debt servicing.

Interim arrangements

Half of Nicaragua's government revenue is absorbed by debt servicing, which reduces the availability of finance for addressing social sector needs, while at the same time budget constraints threaten debt servicing for priority creditors, particularly the multilateral institutions. These pressures have led government to develop two interim proposals for assistance from donors, to assist the country until it receives HIPC debt relief. The first is a tentative proposal from the Central Bank for a multilateral debt fund, and the second is a concrete proposal discussed at the Consultative Group meeting for a Supplementary Social Fund. The two proposals are not consistent with each other, the one from the Central Bank being concerned only with debt servicing, and the other being concerned with social sector issues, yet both ask for additional interim resources to cover the fiscal problems caused by debt servicing.

Multilateral Debt Fund

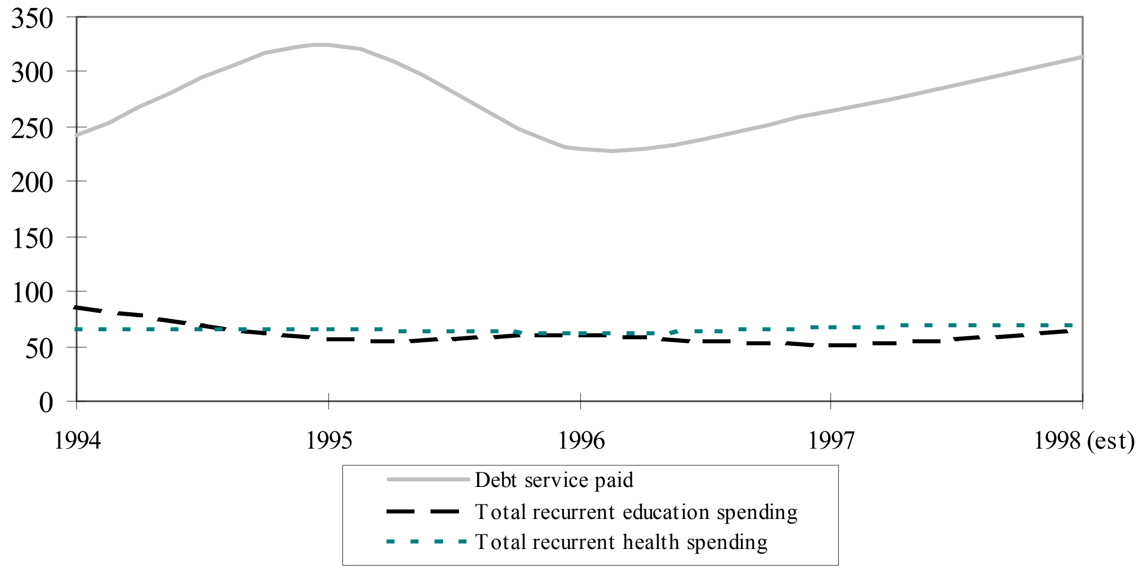
For Nicaragua to receive continued donor support, it must ensure that the debt of priority creditors – the Paris Club and the multilateral institutions, such as the IMF, IDB, and World Bank - is being serviced. These demands place enormous pressures on the budget, which must at the same time address many other priorities, particularly in the social sectors. The Central Bank has tentatively proposed the creation of a multilateral debt fund into which donors would pay, and which would then augment government debt servicing allocations. It is proposed that Nicaragua should meet multilateral debt servicing obligations to a value equivalent to 20 per cent of exports, and that debt-servicing finance above that should be paid from the multilateral debt fund.

[11] See Elbadawi *et al* 'Debt overhang and economic growth in sub-Saharan Africa', in Z.Iqbal and R.Kanbur, *External Finance for Low Income Countries*, IMF, Washington DC, 1997, pp49-76, and David Woodward 'Debt sustainability and the debt overhang in heavily indebted poor countries: some comments on the IMF's view' in EURODAD, *World Credit Tables*, 1996, pp29-43.

Supplementary Social Fund

To combat the effects of high debt servicing on an overstretched government budget, the Nicaraguan government, at the Consultative Group meeting in early 1998, made a proposal for donors to support a Supplementary Social Fund (SSF). The recently agreed ESAF has allowed donors to support additional recurrent spending in the social sector, over and above the agreed 'fixed' allocations and expenditures made by government. The implications are that donors will add to government recurrent spending in the social sector. The intention of government is that this additional donor support to the social sector will allow social sector spending to increase from present levels back up to 1994 levels, and to maintain these levels until 2001. Eventually the government of Nicaragua hopes that HIPC debt relief may release sufficient resources to bridge this funding gap. As can be seen from Figure 5, debt servicing has been consistently two-three times higher than the total of expenditures on health and education.

Figure 5: Nicaragua: debt service paid and recurrent health and education spending



The government is requesting US$128 million under the SSF between now and 2001, when it hopes to qualify for HIPC, and when it hopes that further debt relief may become available. The plan covers support to primary education, including school decentralisation, incentives to promote retention of teachers and students, and provision of school packs to poor students. In health, support will go to drug supplies and immunisation, training and equipment for maternal and child health care, and maintenance of facilities. One further area of spending is the provision of nutrition and basic health care to children below the age of five, including rationalising the social safety net programme.

If social spending is maintained at current levels and with current projections, many thousands of children will lose their right to education and to improvements in the quality of basic education. At the same time, many mothers and children will lose their lives or suffer unnecessarily due to inadequacies in health-care provision and nutritional support. Donors' support for the social sector is vital. However, the existing plans for the SSF have not been discussed in great depth with representatives of civil society, and donors are hesitant to support a plan which is fairly limited in scope, which may not be the most effective form of social sector support, and one where it may be difficult to ensure accountability.

- **The alliance urges the Nicaraguan Government to collaborate with donors and civil society to**

improve this plan and to seek support for it as an interim arrangement.

In effect, donors are being asked to support basic social sector expenditures, because government must service debt instead. Social sector spending is being 'crowded out' by debt servicing.

Crowding out social investment

Nicaragua has gone through major transitions in the past decade. In the mid-1980s education and health indicators rapidly improved. The government placed a very high priority on social expenditure, and education and health services were provided free of charge. Education spending rose from 2.4 per cent of GDP in the late 1970s to 5 per cent in the 1980s, while health spending increased from 1.6 per cent of GDP to 5 per cent in the same period. However, spending declined in the late 1980s, due to the effects of the economic embargo and the war, the consequent decline in GDP, and constraints placed on the budget by over-expansion of the public sector. Yet major achievements were made. A major literacy drive reduced illiteracy from 66 per cent to 13 per cent (although levels have now risen), one of the lowest illiteracy rates in Latin America, winning Nicaragua a UNESCO prize. At the same time, near-universal primary school enrolment was achieved, secondary school enrolments increased significantly, and gender-linked disparities were reduced at both levels. Increasing prioritisation of primary and secondary health-care led to a rapid decline in infant mortality, from 120 in the mid-1970s to 60 deaths per 1,000 live births in the mid-1980s.

Table 2: Nicaragua: Welfare data

	Year	Nicaragua	Latin America & Caribbean
Population (est. million)	1997	4.7	-
GDP/capita (US$)	1995	380	1540
Debt/capita (US$)	1997	1,300	-
Population in poverty (Rural population in poverty)	1995	50% (76%)	- -
Population unable to meet basic food needs	1995	20%	-
Life expectancy (years)	1995	67	69
Infant mortality /1,000 births	1996	48	38
Under five mortality/1,000 births	1996	57	36
Mortality rate for lactating mothers/1,000 births	1996	44	30
Children not reaching 5th grade	1996	46%	31%
Adult literacy	1995	66%	76%
Population without access to safe water (Rural population without water)	1996	39% (80%)	18%
Population without sanitation services	1995	68%	39%

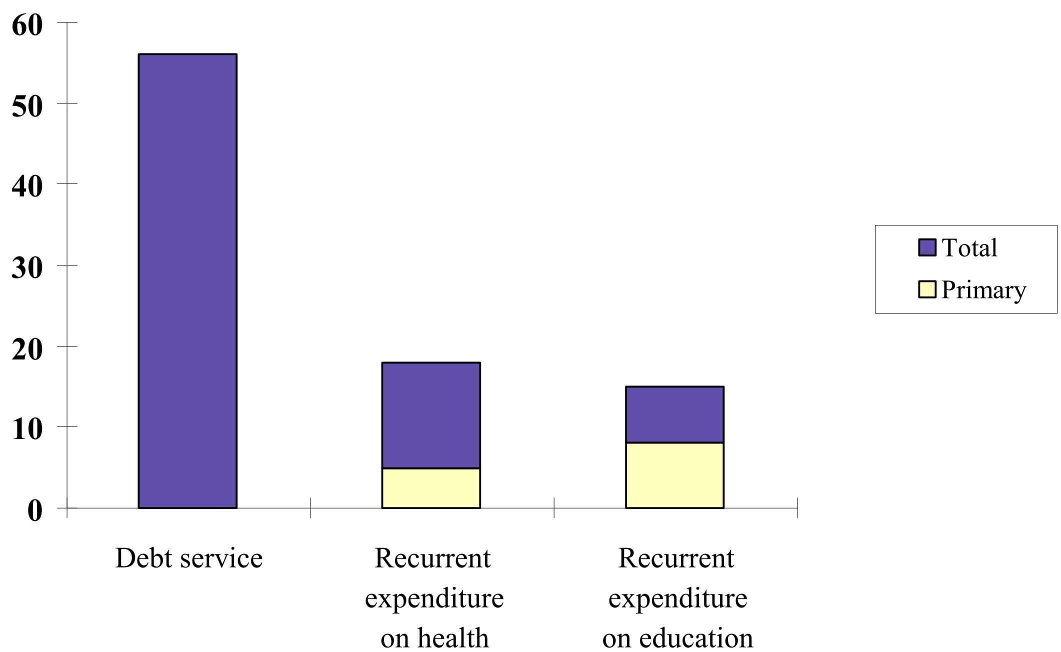
Source: UNDP Nicaragua – Human Development Report, 1998, Nicaragua in the World Context

Overall, however, many of these social sector gains have been lost in recent years, due to the contraction in the economy from the late 1980s, the rapid pace of reform and subsequent social consequences, including increased costs of social services to the poor, and due to the extraordinary burden that debt has placed on government budgets. From the late 1980s, the Sandinista government introduced measures to stabilise the economy, and these measures included major cuts in public spending, including the loss of over 10,000 jobs. Such action reduced inflation to a limited extent. The Chamorro government greatly deepened and extended these measures, and at the same time received huge amounts of donor support. Public spending was further constrained, with major job losses, and reductions in health and education spending. As a proportion of GDP, spending on education dropped by 25 per cent between 1990 and 1995. It appears that in recent years poverty has grown, and a survey of poverty carried out by an NGO, FIDEG, in 1996 estimated that 66 per cent of the population were living below the poverty line (an increase from 50 per cent in the 1993 government surveys), and that those living in extreme poverty had risen to almost 40 per cent.

Per capita spending on health and education has declined from peaks in the mid-1980s. In health, for instance, annual per capita expenditure reached US$40 on average in the second half of the decade, and dropped to just over US$11 in 1997. The World Bank recommends spending of more than US$17 per capita for a country like Nicaragua; in fact the government target is around US$19 per capita.

As debt service continues to escalate, government has reduced recurrent spending on health and education has increased debt service payments. Government recurrent expenditure per pupil in primary education declined to US$34 in 1996, from US$43 in 1993. Since 1993, overall recurrent education spending per student has been reduced by almost one quarter, and health spending has dropped by one tenth in the same period. However, actual per capita debt servicing for 1997 was almost US$60.

Figure 6: Nicaragua: per capita debt service, education and health spending, 1997



Debt-relief prospects under the HIPC initiative

While Nicaragua can make short term requests for donors to provide aid to mitigate the effects of debt servicing on social expenditures, Nicaragua's debt relief prospects are bleak. During the period of major transition and economic reform from 1990, and where per capita GDP even reduced by 8% between 1990-93, debt servicing grew from US$52 million in 1990 to US$264 million in 1997. GDP per capita fell by 8 per cent between 1990-1993. GDP growth is now at around 5 per cent, but scheduled debt servicing has grown over 500 per cent from 1990 to 1997.

Over the next few years, debt servicing will average around US$280m, continuing to absorb more than twice the health and education budgets combined. Such diversions of government resources are unsustainable, and, although this is recognised within the HIPC framework, debt relief prospects in the near future are poor, and Nicaragua may have to wait until 2002 for substantial debt relief.

The HIPC framework

The HIPC framework made significant progress in debt relief measures when it was introduced in 1996. For the first time, a comprehensive and integrated framework was developed, which for the first time extended to multilateral creditors. At the same time, the HIPC initiative provided a basis for reducing debt obligations to match a country's ability to pay, and was supposed to provide a 'once and for all' exit from debt problems. However, there were a number of failings in the proposal, and Nicaragua, like many other HIPC countries, is deeply affected by these failings.

The first problem is with the level of debt relief provided, which depends on the definition of debt sustainability thresholds. For Nicaragua these thresholds are set too high for the Government to be able to support sustainable human development. The second problem is that Nicaragua may have to wait for two successive IMF programmes to be completed. Even with the positive interpretation of Nicaragua's performance shown in the IMF/World Bank review of HIPC in August 1998, this could mean waiting four years before receiving debt relief under HIPC in 2002. This delay may be reduced, however, depending on how creditors judge Nicaragua's present and future performance. The final problem relates to the cost to the creditors of providing HIPC debt relief to Nicaragua, and the implications of this for real relief granted to Nicaragua.

Debt-sustainability thresholds

The HIPC framework established three main criteria for assessing debt sustainability. The first assesses the level of net present value (NPV)[12] debt stock against exports. The second assesses the ratio of debt servicing to the size of exports. The third assesses the ratio of NPV debt to revenue. If a country's debt stock or servicing falls above these thresholds at the end of the six year period, then the country will become eligible for HIPC debt relief. For Nicaragua these thresholds are shown in Table 3.

Table 3: Nicaragua: HIPC sustainability thresholds (end-1997)

	Actual	HIPC Thresholds
NPV debt/exports	601%	200-250%
Debt service/exports	40%	20-25%

[12] The Net Present Value (NPV) of debt is the sum of all future debt-service obligations (interest and principle) on existing debt, discounted at the market interest rate. Whenever the interest rate on a loan is lower than the market rate, the resulting NPV of debt is smaller than its face value, with the difference reflecting the grant element of the loan. IDA loans, due to their low interest rate (¾ per cent), long grace period (10 years) and repayment periods (40 years) have approximately a 67 per cent grant element. ESAF loans from the IMF, due to their shorter grace period and repayment period (5 and 10 years respectively), have a 33 per cent grant element only.

NPV debt/revenue	926%	280%

Source: World Bank

Notwithstanding the fact that Nicaragua's debt is far in excess of these thresholds, we, and many NGOs and religious bodies, have been arguing for some time that the existing ratios within the HIPC framework are seriously flawed. The World Bank and the IMF acknowledge that debt sustainability ratios are extremely difficult to define, and that the present ratios were derived as a 'rule of thumb'.[13] The ratios were derived mainly from Latin American experience of the 1980s, they relate to better developed economies, with greater levels of infrastructure, higher income levels, and generally higher social indicators. They are not valid or appropriate to the nature of HIPC countries, which generally have extremely weak economies, often highly dependent on primary commodity exports, which in turn are vulnerable to shock. Such countries have poor and under-developed infrastructure, a fragile policy environment, and extremely low human development indicators. The thresholds developed for HIPC bring debt servicing levels down to those already being paid, and serve to minimise the cost of HIPC to the creditors. At the same time, the development of these unrealistic thresholds has enormous consequences for sustainable human development, as well as for reducing growth prospects for the future.

Alternative indicators have been proposed by Oxfam International in the following ranges:

- **150-200 per cent NPV debt stock to exports**
- **15-20 per cent debt servicing to exports**
- **200 per cent NPV debt stock to revenue**

However, even using existing HIPC thresholds, Nicaragua's debt position is unsustainable within the HIPC group of countries.

While debt sustainability indicators express the severity of Nicaragua's debt position, and other concerns highlight aid dependency issues, this vulnerability is worsened by the lengthy time frame within which Nicaragua may receive relief. At the same time, the social costs of indebtedness are further exacerbated by this lengthy delay .

Nicaragua's track record on compliance with ESAF

For a country to receive HIPC relief, it must complete two IMF programmes, over a period of up to six years. Table 4 shows how the process might affect Nicaragua.

Table 4: Nicaragua: A possible scenario for the HIPC Initiative

First stage **1998-1999** (credit can be given for already established track records)	Normally takes three years	Signs ESAF agreement **(March 1998)**. According to the recent IMF/World Bank Review of HIPC (August 1998), credit is being given to Nicaragua for performance, and the earliest timing of Decision Point for Nicaragua has been set as 1999
		Receives Paris Club Naples terms, 67 per cent debt service flow rescheduling – agreed in April 1998

[13] See Claessens *et al* 'Analytical aspects of Debt Problems', in Z.Iqbal and R.Kanbur, *External Finance for Low Income Countries*, IMF, Washington DC, 1997, pp27-33

		Other bilateral and commercial creditors agree similar or better terms
		Multilateral institutions continue to provide adjustment support, under concessional terms, to prevent future build-up of debt-service problems
		Nicaragua establishes first three-year track record of good performance (to be eligible to receive Paris Club stock of debt operation under Naples Terms)
Decision Point (1999) If Nicaragua is judged harshly, the Decision Point could extend to up 2001, three years from signing the current ESAF in 1998		Nicaragua should be eligible. Receives Paris Club Naples Terms, 67% eligible debt-stock reduction (on pre cut-off date debt). IMF/World Bank Boards review eligibility under HIPC by carrying out a Debt Sustainability Analysis (DSA) with government to see if further debt relief is required, and, if so, defining debt-sustainability ranges. The DSA can be done at an earlier date if required.
Second Stage (can be shortened for countries that already have sustained performance)	4th - 6th year	Paris Club reschedules debt-service flows with up to 80 per cent reduction and commits to 80 per cent reduction of eligible debt stock at Completion Point
		Other bilateral and commercial creditors agree similar or better terms
		Donors and multilateral institutions provide enhanced support through interim measures
		Nicaragua establishes second track record of good performance
Completion Point (2002) (earlier or later, depending on performance)		Paris Club provides up to 80% reduction of eligible debt stock
		Multilateral institutions provide reduction in their claims proportional to that provided by the Paris Club
		All creditors take co-ordinated action, if necessary, to provide sufficient assistance to reduce Nicaragua's remaining debt to a sustainable level on the basis of proportional burden sharing

Source: Interpretations based on an IMF framework, also using information from the IMF/World Bank paper 'The Initiative for Heavily Indebted Poor Countries – Review and Outlook', August 1998.

One of the key concerns for Nicaragua is the question of when it may receive debt relief under HIPC. The worst-case scenario is that Nicaragua may have to wait until the year 2002. The problem that Nicaragua faces is that, although major reforms have been carried out since the late 1980s, it has a broken track record with the IMF. Briefly summarised the record is as follows:

- *December 1991:* Nicaragua went to the Paris Club for the first time.
- *April 1994:* Nicaragua signed the first ESAF agreement with the IMF.
- *September 1995:* following failure to meet taxation targets, this programme failed and moved into a

'bridge plan'.

- *September 1996:* 'bridge plan' suspended following failure to meet targets in taxation and savings, partly due to pressures in the run up to elections.

- *March 1998:* ESAF II was signed under the new Alemán administration. It contains a wide range of extremely challenging targets.

The interpretation of this track record, and the delays to debt relief which this may imply, will have a huge impact on the size of future debt relief, and serious consequences for poor people. Policy performance is important, but what should be relevant in the case of Nicaragua is Nicaragua's overall performance.

While debt relief is a vital ingredient for growth and poverty reduction in Nicaragua, it is not the only necessary ingredient. Another important ingredient is sound economic management. Unfortunately, compliance with ESAF alone is used as a measure of Nicaragua's policy performance. What should be more relevant is the *overall* reform programme in Nicaragua, and o*verall* performance, rather than judgements made purely on achievement of ESAF targets. Nicaragua has been undertaking substantial and deep economic reforms from the early 1990s, equivalent to a massive 'shock treatment'. Major and difficult reforms have been implemented, in areas such as inflation, taxation, privatisation, public sector restructuring and job reductions, and demobilisation in the army. These have largely been achieved with relative success, in a difficult environment, even though there has been slippage in the implementation of ESAF over the past years.

From 1991 the Chamorro administration implemented far-reaching measures to reduce inflation, which fell from 13,000 per cent in 1990 to 20 per cent in 1993. Following IMF recommendations, the córdoba was devalued by 80 per cent, massive cuts were made in public spending, leading to large-scale job losses. Further reforms were undertaken in taxation, to improve efficiency and widen the tax base. Despite delays, these reforms have now been introduced.

At the end of the 1980s war, defence expenditure was also greatly reduced from US$182 million in 1989 to US$32 million in 1996, mainly through substantial cuts made to the size of the army. Demobilisation has meant that the army has diminished in size from 80,000 to 17,000. This has, however, not been an easy process, and problems with negotiations and settlement packages, particularly in land allocation, for both ex-army and ex-contra soldiers, led to a period of continued insecurity. Yet despite this, demobilisation plans were carried through.

Strong privatisation efforts have also taken place, and virtually all productive state firms, more than 340, have been sold off, with subsequent redundancies. The public sector is undergoing major reform. New legislation has been passed to reform commerce, finance, taxation and labour relations. The loss-making national bank, BANADES, has been dismantled, and the state telephone company, ENITEL, will be privatised (with a portion of proceeds directed to social sector spending). However, such changes have had serious consequences in the labour market. Although unemployment rates for men and women are roughly equal, and recorded unemployment has declined from 23 per cent in 1993 to 14 per cent in 1997, unemployment is mainly an urban phenomenon, underemployment, especially in rural areas, has risen to 32 per cent. At the same time, the purchasing power of average salaries has declined to a level below the cost of living. There have also been serious environmental consequences and other effects on Nicaragua's natural resources, associated with rapid privatisation and the promotion of investment, and diminished state regulation and control.

In areas of other reforms, more recently a new property rights law was passed through the National Assembly, to assist in resolving pending claims and to speed up the issue of property titles. This has been a highly contentious law, and yet eventually, following complex negotiations, it received broad cross-party support. Overall, massive reforms have been undertaken to shift the country from a centrally planned economy to a market economy.

There have been some economic benefits during this reform period, and during 1996/7, real GDP rose by 4.8 per cent after a long period of decline; domestic investment rose from 18 per cent in 1992 to 29 per cent in 1996/7, and national savings increased from a negative 18 per cent of GDP to 4.7 per cent of GDP in the same period. Inflation was further reduced, reaching 7 per cent in 1997. These are major achievements for any country recovering from civil war, not just economically, but also socially and politically. Nicaraguan society remains highly polarised, and yet these reforms have been undertaken in a relatively peaceful atmosphere, an incredible achievement given Nicaragua's history.

The case for flexible interpretation of Nicaragua's track record is also rooted in recent hard facts concerning the efficacy of ESAF. Recent external and internal reviews of ESAF, directed by the IMF, have observed that almost three quarters of ESAF agreements are delayed or not completed, mainly due to policy disagreements between the government partner and the IMF. Recommendations by the IMF for subsequent improvements noted that, for such programmes to be implemented consistently, governments must own the programmes, and must also be able to build consensus within and beyond official circles. Recently the Nicaraguan government has publicly released the ESAF 'letter of intent' and is promoting a public discussion of ESAF. Such processes require time, and also flexibility on the part of the IMF, to ensure that policies are appropriate for each country's different circumstances, and are negotiated with some flexibility to allow for governmental views and approaches. At the same time, the reviews were recommended that such programmes should pay closer attention to the effects of policies on the poor and vulnerable, and to integrate appropriate compensatory actions at the outset. For instance, this may include increased social service provision as the best way to target the poor, who are frequently not well integrated into the national economy. Difficulties with the ESAF programmes in Nicaragua are no exception to these findings, and yet even so major reforms have been made, although at high social cost. Nicaragua deserves more tolerance, especially in the light of the high levels of poverty and the heavy burden of debt.

Recent progress of other countries through HIPC is not encouraging for Nicaragua. Uganda, a country which had a ten year track record of strong progress under adjustment, had to wait one year between Decision Point and Completion Point, when a more flexible interpretation of HIPC criteria could have led to immediate relief. Mozambique, a nation also recovering from conflict, will have to wait two years between Decision and Completion Points until it can receive relief under HIPC, yet performance has been sustained and strong under adjustment – even with post-conflict pressures. Flexible interpretation of Nicaragua's track record will allow Nicaragua to address economic and human development needs, with additional resources gained through earlier debt relief.

We recommend that Nicaragua should reach the Decision Point by March 1999, one year from the signing of the second ESAF, and should reach the Completion Point by March 2000.

This can be justified on the country's past and present performance. The pursuit of sound economic policies and prudent borrowing should be rewarded by positive interpretation of the time-frame under HIPC rules. There is, however, another key constraint which militates against a reduction of the existing time frame for entry into HIPC, and against reducing the sustainability thresholds: this is the cost to creditors of such debt relief.

The cost of HIPC

The progress of Bolivia and Mozambique through their Decision Points in HIPC has highlighted problems within the present approaches, and the cost to creditors of debt relief through HIPC. In Bolivia's case, the debt-to-exports ratio was finally defined as sustainable at a very high level of 225 per cent, beyond the World Bank and IMF recommendation of 215 per cent. This extraordinary step was made because of the unwillingness of the Inter-American Development Bank to cover the costs of debt relief it would have had to provide, if the threshold was lower. In Mozambique, negotiations took over a year to reach decisions on burden sharing between creditors, beyond the 80 per cent net present value threshold, and even then agreement almost collapsed because a few creditors failed to support a full burden sharing approach. Only extraordinary efforts by some creditors and the World Bank managed to ensure that necessary financing was achieved.

Another area affecting the level of debt relief provided is in the estimation of export projections. The size of exports predicted for a country when it reaches Completion Point will affect the debt relief provided, since the ratios of debt service to exports and debt stock to exports alter, depending on the size of exports. Frequently over-optimistic export projections have been used to reduce the size of debt relief, and it is only recently that the IMF agreed to look at more realistic averages for the previous three years' export growth, rather than basing calculations on just the previous year.

In Nicaragua's case, it is very likely that for debt sustainability to be reached, all creditors will have to provide relief above the 80 per cent threshold, and this will involve exceptional action from bilaterals and multilaterals alike. In particular, the multilaterals face a range of financing problems. The effects of the East Asia crisis, higher lending to Eastern Europe, the Russian crisis, and growing problems in Brazil and elsewhere have overextended, and may continue to over-extend, both the World Bank and the IMF. At the same time, support to HIPC from the World Bank is funded by net income, and over recent years income flows have been seriously declining, the effects worsened by growing demands, and pressure to maintain reserves. The World Bank will face serious constraints in supporting sustainable debt relief for poor countries over the next few years.

Other important multilaterals affect Nicaragua's position. The Inter-American Development Bank holds seven per cent of Nicaragua's debt stock, and this bank has a very weak 'soft' lending arm with which to cover debt relief financing. The IDB's behaviour over Bolivia will not give Nicaragua great hope that appropriate debt relief will be provided by the IDB. The Central American Bank of Economic Integration (CABEI) also holds seven per cent of stock. The recent CABEI rescheduling deal has been already been defined as a 'down payment' on HIPC, and, given its over-extended lending to both Nicaragua and Honduras, it is unlikely that the bank will be able to provide much in the way of concessional relief without major support from regional members. Questions must also be asked about the appropriateness of non-concessional CABEI lending to HIPC countries such as Nicaragua and Honduras.

One solution to these problems, put forward by some of the leading industrialised nations, and consistently rejected the IMF, is the possibility of using sales from IMF gold reserves to finance debt relief through HIPC. Aside from the benefits this would have for many heavily indebted and poor countries, such an approach for Nicaragua could ensure that assistance is provided to the IDB and CABEI, and wider than this, would ensure that sufficient financing was available for discussions on debt to be based on an analysis of debt sustainability, rather than on complex ways to reduce the cost to creditors.

A human development window: debt relief for poverty reduction

While a positive interpretation of the HIPC framework, as recommended earlier, may allow Nicaragua to receive debt relief earlier than may be the case at this time, this would still result in delays of almost two years before the country went through HIPC. However, the sustainability thresholds within HIPC would still leave Nicaragua with serious problems in debt servicing. Even with donor support to the Supplementary Social Fund or to a possible Multilateral Debt Relief Fund, the burden of debt servicing on the budget will remain extremely high, with continuous costs in terms of social expenditures and constrained national investment. **To overcome this problem, we support Oxfam International's proposal for an additional measure: the creation of a debt-for-human development window, under which, if the government is willing to allocate 85-100 per cent of the savings from debt to poverty reduction initiatives, Nicaragua will be given improved incentives in the form of even deeper debt relief by March 2000.**

Such a proposal would not mean that creditors would need to renegotiate HIPC. The adoption of the 'fiscal window', to address the concerns of Côte d'Ivoire, in the HIPC framework, and more recently the development of a window for post-conflict countries show that reform and innovation are possible without re-negotiation of the entire initiative. Nor would a 'human development window' in HIPC be another layer of conditionality which will delay implementation. Rather, the aim is to create an incentive structure for the Nicaraguan government, which, if willing to utilise debt relief in the interests of the poor, will be given incentives to do so. At present, conditionality is geared towards penalising poor performance in relation to narrowly defined macro-economic targets, often set with insufficient regard for their impact on the poor.

Our primary concern is to identify practical ways of linking accelerated and improved implementation of the HIPC initiative to national and international development targets.

These targets have been agreed by the government of Nicaragua at international conferences during this decade. These include the World Conference on Education for All (Thailand, 1990), the World Summit for Children (New York, 1990), Population Summit (Cairo, 1994), World Summit on Social Development (Copenhagen, 1995), the IVth World Conference on Women (Beijing, 1995), and Habitat II (Istanbul, 1996). All of these commitments have been reiterated by the Nicaraguan government in its 1998 development strategy 'Preparing for the Next Millennium'.

At an international level, targets have been consolidated by the OECD in its document *Shaping the 21st Century*. They include:

- reducing by half the numbers of all those living in extreme poverty before 2015;
- universal primary education before 2015;
- eliminating gender-linked disparities in primary and secondary education before 2015;
- reduction by two-thirds of infants and under-5 child mortality, and two-thirds maternal deaths before 2015;
- providing access through the primary health care system to reproductive health services for all appropriate ages before 2015;
- implementing national strategies for sustainable development by 2005, keep to ensure current trends in

the loss of environmental resources are effectively reversed at both national and global levels before 2015.

The Nicaraguan government has been making attempts to support and prioritise social expenditures during the present period, planning to do so until substantial debt relief is received through HIPC. The 'human development window' approach is a mechanism which builds on what is already, to some extent, underway in Nicaragua. Looking at other countries which have gone through HIPC, there are lessons to be learned for instance, from the government of Uganda's Poverty Action Fund. This fund has been developed as part of a wider strategy for channelling savings from debt relief into poverty reduction, with a high level of participation from civil society, and with rigorous monitoring. Over a two-year period, the Ugandan government worked with donors and civil society to develop a National Poverty Eradication Action Plan. The government then committed itself to allocating debt relief resources into a Poverty Action Fund which would support this plan, and to doing this transparently, with an open invitation to donors and representatives of civil society to monitor allocations and expenditures. At this time, debt relief resources of up to US$40 million a year are being channelled into the Poverty Action Fund to support primary education, health care, water supply, agricultural extension, and rural feeder roads. This approach provides a model for what could be achieved under a reformed HIPC - and we strongly urge creditors and the Nicaraguan government to study the Ugandan case in this light.

Given resource constraints in Nicaragua, one of the most effective ways of channelling additional resources into effective public spending would be through debt relief incentives. Such incentives would operate by rewarding the government for entering into genuine poverty reduction partnerships, with earlier and deeper reductions in debt stock and debt servicing demands. This would be done through a new **Debt for Human Development Window** in HIPC, in which the debt sustainability thresholds would be lowered as follows:

- **to 10-15 per cent for debt servicing;**
- **to 100-150 per cent for NPV debt stock/exports;**
- **to 150-170 per cent for NPV debt stock/revenue.**

The window would be open to the government only if it was willing to commit 85-100 per cent of savings on debt into identified poverty reduction initiatives. Such initiatives to promote equitable and sustainable human development could include small-scale infrastructural projects, such as rural feeder road construction, rural credit, as well as basic social sector initiatives. Although the Nicaraguan government could still enter HIPC through the conventional route, it would not be eligible for the additional debt relief provided through the Debt for Human Development Window without making additional commitments to poverty reduction.

Recognising the exceptional nature of debt relief being proposed, strict eligibility requirements would have to be enforced. These would be linked to commitments on poverty reduction, rather than to the more narrowly defined economic conditionalities in the IMF programmes.

In order to qualify for the Human Development Window, the government would be required to develop a coherent **Poverty Action Framework (PAF),** for converting savings on debt into poverty reduction initiatives. Drawn up in consultation with major donors and with the full participation of civil society, the PAF would serve as a contract between creditor and debtor government. To allow sufficient time in Nicaragua for planning activities with all actors to take place, the plan would be submitted some time after the Decision Point in the HIPC framework, possibly by late 1999. There is growing recognition of the importance of improving partnerships in the development process, such that national development plans can be initiated by government, and their evolution and development carried out with all stakeholders – civil society, the private sector, and international partners. This process builds national capacity, promotes consensus, and increases ownership and thus support for the development process. The PAF would achieve the following ends:

- consolidate existing sectoral planning strategies and other poverty reduction initiatives, identifying the financing gaps which would emerge were these to be geared towards attainment of the 2015 targets (summarised in the OECD document);

- indicate how savings from debt will be allocated *as additional resources* (i.e. over and above existing and projected allocations) between different sectors;

- make clear commitments to transparency and accountability, including the independent auditing of expenditures, quarterly reporting on all releases to PAF-supported activities, publication of operational details, and detailed reporting to legislative bodies, donors, and civil-society organisations;

- provide for regular consultation with civil society and donors to evaluate performance in reducing poverty and identifying policy problems.

This could mean that Nicaragua could receive enhanced HIPC relief through improved sustainability thresholds by early 2000.

It should be stressed that entry to HIPC through the Debt for Human Development Window would provide *additional benefits*. In other words, Nicaragua would remain eligible for debt relief through HIPC if the government chose not to make these additional commitments on poverty reduction, but they would lose the incremental savings offered by the new facility.

One potential problem which might arise in implementation is that of non-performance, or the failure of the government to deliver on the financing pledges made under the Poverty Action Framework *after* having received debt relief through the 'human development window'. Where such failures were a consequence of unavoidable fiscal problems related to adverse circumstances - such as the recent effects of El Niño or a collapse in export prices - the arrangement could be rolled over by mutual consent. However, where policy failure on the part of government is the cause of non-performance, penalties would be required to avert problems of moral hazard. These should be transparent and agreed in advance as part of the contractual arrangement between creditors and the Nicaraguan government.

In our view, the most effective approach would be to establish a linkage between aid and debt relief, with any shortfalls in public spending under the Poverty Action Framework matched by reductions, on a dollar-for-dollar basis, in aid disbursements during the following financial years. These reductions could be applied up to a ceiling equivalent to the amount of additional debt relief provided by the 'human development window'.

The Nicaraguan government has developed broad policies and plans for national development, within the ESAF framework. The government's main objective is stated as 'to fight poverty and to reduce unemployment, in a context of financial stability and sustainable growth'. Plans cover governance, financial reform, and social sector issues. The main engine for growth is intended to be rural development, which at the same time is intended as a way of ensuring that the poor, who make up the majority of the rural sector, participate in this growth. To this end government has developed governance objectives, including modernising the executive branch, consolidating the rule of law, plans to increase the participation of civil society, decentralisation plans, and prioritisation of poverty reduction through investment in the rural sector.

Consultation with civil society on the development of these plans has been fairly minimal, yet civil society has much to offer**. We call on the government to implement a process of national consultation with civil society, to develop better informed and gender inclusive long-term development plans, which are based on a greater consensus**. Such plans must prioritise the rural sector, given that it is the main locus of poverty and also the engine for growth.

Given the polarisation present in Nicaraguan society, and the threat of unrest caused by continuing poverty, mechanisms must be developed to bring all actors together to work on addressing commonly held concerns about the level and depth of poverty in Nicaragua.

The process could be as follows: the Nicaraguan government would commit itself to debt relief for human development, and this would be initiated with donors in late 1998, in full consultation with civil society. In line with our earlier recommendations on the HIPC time frame, Nicaragua could reach a Decision Point in March 1999, at which time a Debt Sustainability Analysis (DSA) could be carried out by government, the IMF, and the World Bank. Representatives from civil society could also be involved. Debt sustainability criteria could be reduced in line with the human development approach, and civil society may be able to help with this analysis. During this analysis, mechanisms for converting debt relief into human development could also be developed by all actors involved. National development plans could be defined with donors and civil society during a one-year process up to late 1999. Nicaragua could then reach the Completion Point in March 2000 with enhanced debt relief under a 'human development window'. In summary:

- **Government and creditors should commit themselves to the implementation of a 'Debt for Human Development Window' within HIPC.**

- **Government, donors and civil society should work together to develop agreed national development plans within a Poverty Action Framework, and mechanisms for converting debt relief into human development within these plans, from now until late 1999.**

- **A Debt Sustainability Analysis (DSA) should be carried out in early 1999, before the March 1999 Decision Point, and that civil society are involved.**

- **Nicaragua should receive deeper debt relief, via the 'Human Development Window', at a Completion Point of March 2000.**

- **A committee of government, donors and civil society representatives should oversee the implementation of the Poverty Action Framework, and the use of debt relief resources. Civil society should also be able to help government monitor the use to which future lending is put, to ensure that the country does not become seriously indebted again, and to ensure that lending is used for productive purposes.**

Potential savings for poverty reduction

Detailed calculations would need to be carried out to determine potential benefits from the 'human development window' approach. For illustrative purposes, using debt service and export data from the IMF, preliminary estimates from the Alliance show that savings could average over US$178 million each year from 2000 to 2004. Also for illustrative purposes, when these savings are compared with the government development plan 'Preparing for the Next Millennium', all of the plan could be realised, using only 60 per cent of debt-relief resources released through the human-development window. If we also use unit costs calculated by UNICEF, even more can be achieved.

In summary, savings from reduced debt servicing could achieve the following:

- provide free universal primary education each year
- rehabilitate 500 schools
- construct 1,500 pre-school classrooms
- improve the quality of teacher training for 1,000 Atlantic Coast teachers
- improve the primary level completion rate to from 34 per cent to 70 per cent
- rehabilitate 550 health posts and 30 hospitals
- improve the working environment of 1,500 health personnel
- improve access to primary health services for 1.2 million poor people
- increase the service range for water supply from 30 per cent to 50 per cent would benefit 600,000 people in rural areas.
- provide complete sanitation coverage to the rural population

For illustrative purposes, we have used one improved HIPC threshold, the debt service to export ratio, and we have calculated the savings from debt servicing if servicing was reduced to 10 per cent of exports. It should be noted that this is only one approach for calculating linkages between debt relief and human development.

Table 5: Savings if the ratio of debt service to exports was reduced to 10%

	1999	2000	2001	2002	2003	2004
Debt service (US$ millions)	244	254	310	355	358	360
Exports (US$ millions)	1,195	1,291	1,387	1,489	1,585	1,706
Debt service if debt service/exports at 15% (US$ millions)	179	194	208	223	234	256
Debt service if debt service/exports at 10% (US$ millions)	120	129	139	149	158	171
Savings: Debt service savings at 10% debt service/exports ratio (US$ millions)	**124**	**125**	**171**	**206**	**200**	**189**
Average savings over 5 years from 2000 to 2004 are at US$178 million per year						

Source: IMF for debt and export figures

The broad plans developed by the Nicaraguan government and presented at the Consultative Group meeting in April 1998 have costed social-sector initiatives for the next three to five years at a total of

US$290 million. See Table 6.

Table 6: social sector costs in 'Preparing for the Next Millennium', April 1998		
		US$ millions
Planning	Social-sector policy co-ordination unit	10
Education	Infrastructure rehabilitation	40
	Increasing primary-school retention	22
	Improving capacity and equity	10
	Sub -Total	**72**
Public health	Infrastructure rehabilitation and others	24
	Hospital administration modernisation, rehabilitation, and	36
	equipment maintenance plan	50
	Strengthen public health services	**110**
	Sub-Total	
Social infrastructure	Expansion of access to water and sanitation in rural areas	40
	Housing for low-income families	33
	Housing in rural areas	10
	Energy provision to poor neighbourhoods in Managua	15
	Sub-Total	**98**
	TOTAL	**290**

Source: Government presentation to Consultative Group, April 1998.

These proposals by government are one approach to addressing poverty in Nicaragua, and they address only some social sector areas, and not the national development path in itself. At the same time, these programmes have been fully discussed with relevant civil society organisations. However, for illustrative purposes, it is possible to compare what can be achieved in these plans with the resources available from savings in debt servicing.
These programmes aim to improve social-policy planning and monitoring, which would be vital to ensure that government policies are correctly addressing poverty reduction. Basic education provision is to be strengthened by improving the quality and relevance of primary education, improving the quality of education infrastructure (pre-primary school, primary and secondary) and improving student and teacher incentives. More than 500 schools could be rehabilitated, and desks and chairs provided to more than 1,500 schools. At this time, the average length of primary education in Nicaragua is four years, and only 1.6 years in rural areas. The programme will address problems of retention and also repetition. The capacity and equity programme costed above is intended not only to address management aspects, but will also prioritise the neglected Atlantic Coast region.

In health, considerable investments could be made in modernising the system and in retaining the provision of a free basic package of health services. Modernisation is planned to take place by rehabilitation and expansion of 160 health posts, and the re-equipping of 550 others. Thirty hospitals could be rehabilitated. The reorganisation and rehabilitation area, including training of staff, is intended to enable an integrated PHC programme to be implemented, affecting some 1.2 million poor people. The infrastructure programmes aim to improve water provision to more than 600,000 people, and implement some small housing and power projects. The plans are very much broad sketches of what may be possible, and have not been discussed in depth with donors or with civil society, however, they are indications of what may be possible if resources are made available. **These programmes could be successfully completed within three years, using almost 60 per cent of the debt savings generated in the first three years.**

Using UNICEF unit costs for social sector expenditure it is possible to calculate interventions in a range of areas. In Nicaragua, sanitation coverage is extremely poor with 69% of the population having no access to appropriate sanitation. At an average cost of US$55 per latrine for a family of six, provision of universal coverage would cost almost US$30 million. Improved sanitation would make major inroads into reducing illnesses such as diarrhoea. In education, according to UNICEF calculations, the unit cost of primary schooling per child per year is US$75, and the number of primary school students is around 780,000. Free universal primary education would cost around US$60 million to achieve per year.

If these areas were addressed, in addition to existing government plans, free universal primary education could be achieved on an annual basis, and complete sanitation coverage in rural areas could be achieved using 100 per cent of the debt savings generated in the first three years.

The 'human development window approach' for Nicaragua could become an important catalyst in a range of ways. Firstly, this is an opportunity to accelerate the flagging HIPC initiative, without re-negotiating the framework, through developing a system of incentives by developing a window for countries which are serious about poverty reduction. Secondly, this is an opportunity for Nicaragua to use the additional resources from debt relief, coupled with other instruments such as a strong policy environment, investment and aid and lending support, to make progress on achieving the UN human development targets agreed at a range of UN summits. Thirdly, for creditor governments it is an opportunity for them to make progress on 2015 targets that they have adopted in the OECD document, *Shaping the 21st Century.* Debt relief for Nicaragua, linked to human development targets, could help to strengthen the linkage between growth and poverty reduction and higher levels of human development.

Members of Grupo Propositivo de Cabildeo e incidencia (GPC)

ORGANISMO	TELEFONO	FAX	E-MAIL
FADCANIC Ray Hooker Orval Delgado	270-1921 270-0536	270-1921	*fadca@ibw.com.ni*
UNAG Daniel Nuñez Alvaro Fiallos	266-2077 266-3511	266-2433	rriiunag@ibw.com.ni
FENACOOP Ariel Bucardo María Briones	278-7037	278-7041	
CISAS María Zúniga Ana Quiróz	266-1662	266-2237	cisas@ibw.com.ni
FONGs Ana Quiróz	266-1662	266-2237	idem
CEPAD Gilberto Aguirre Darwin López	266-4869 266-5216	266-8255 266-4236	cepad@ibw.com.ni
FACS Edwin Zablah Carlos Benavente	277-4773	267-5670	Facs@facs.org.ni cbenag@ibw.com.ni
C. HUMBOLDT Amado Ordoñez	249-2903	249-2903	humboldt@ibw.com.ni
CRIES Orestes Papi Ricardo Zambrana	222-5137 222-5217	268-1565	zambrana@nicarao.apc.org.ni
APP Sharon Hostetler	265-1774	265-1933	wfpnica@ibw.com.ni
Facilitamiento - Facilitator Cirilo Otero Jardines de Veracruz D-20, Managua, Nicaragua	289 7630	289 7630	gpcnic@*ibw.com.ni*

European and US NGOs

EURODAD 10 Square Ambiorix B-1040 Brussels Belgium	Sudewind Lindenstrasse 58-60 53721 Siegborg Germany	Centre for Democratic Education 8403 Colesville Road Suite 720, Silver Spring Maryland 20910-3368 USA
Nicaragua Solidarity Campaign c/o Red Rose Club 129 Seven Sisters Road London, N7 7QG, UK	Ibis Norrebrogade 68B 2200 Copenhagen N Denmark	

Oxfam International is a network of eleven aid agencies that work in 120 countries throughout the developing world: Oxfam America, Oxfam in Belgium, Oxfam Canada, Community Aid Abroad (Australia), Oxfam Hong Kong, Intermon (Spain), Netherlands Organization for International Development Cooperation (NOVIB), Oxfam New Zealand, Oxfam Quebec and Oxfam United Kingdom and Ireland. Please call or write to any of the agencies for further information.

Oxfam International Advocacy Office
1511 K Street NW, Suite 640
Washington, DC 20005
1.202.783.3331 (ph)
1.202.783.5547 (fax)
oxfamintdc@igc.apc.org

Oxfam America
26 West St.
Boston, MA 02111-1206
1.617.482.1211 (ph)
1.617.728.2595 (fax)
oxfamusa@igc.apc.org

Oxfam in Belgium
39 rue du Conseil
1050 Bruxelles
Belgum
32.2.512.9990 (ph)
32.2.514.2813 (fax)
oxfamsol@ngonet.be

Oxfam Canada
Suite 300-294 Albert St.
Ottawa, Ontario
Canada K1P 6E6
1.613.237.5236 (ph)
1.613.237.0524 (fax)
oxfam@web.net

Community Aid Abroad
National & Victorian Offices
156 George St. (Corner Webb Street)
Fitzroy, Victoria
Australia 3065
61.3.9289.9444 (ph)
61.3.9419.5318 (fax)
enquire@caa.org.au

Oxfam Hong Kong
9/F, Breakthrough Centre
191 Woosung Street
Jordan, Kowloon
Hong Kong
852.2520.2525 (ph)
852.2789.9545 (fax)
info@oxfam.org.hk

Oxfam Great Britain
274 Banbury Road
Oxford
England OX2 7DZ
44.1865.311.311 (ph)
44.1865.312.600 (fax)
oxfamoxfam.org.uk

Oxfam New Zealand
P.O. Box 68-357
Newton
Auckland 1032, New Zealand
64.9.358.1480 (ph)
64.9.358.1481 (fax)
oxfam@oxfam.org.nz

Intermon
Roger de Lluria 15
08010
Barcelona, Spain
34.3.482.0700 (ph)
34.3.482.0707 (fax)
intermon@intermon.org

Oxfam in Ireland
19 Clanwilliam Terrace
Dublin 2, Ireland
661-8544 (ph)
661-8568 (fax)
oxfamie@indigo.ie

Netherlands Organization for International Development
Cooperation (NOVIB)
PO Box 30919
2500 GX
The Hague, The Netherlands
31.70.342.1621 (ph)
31.70.361.4461 (fax)

Oxfam Quebec
2330 rue Notre-Dame Quest
Bureau 200
Montreal, Quebec
Canada H3J 2Y2
1.514.937.1614 (ph)
1.514.937.9452 (fax)
oxfamprg@videotron.net (programmes and projects)
oxfamdg@videotron.net (other departments)