Rabobank

Country report **NICARAGUA**

Summary

Benefitting from large foreign direct investments into its maquila- and mining sectors, Nicaragua's economy continues to recover strongly from its 2009 recession, posting 4.7% economic growth last year. Provided substantial Venezuelan financial support continues in the coming years, economic growth is expected to remain in strong, as the Sandinista government continues to pursue business-friendly policies. Meanwhile, following President Daniel Ortega's landslide victory in the allegedly fraudulent 2011 general elections, the quality of Nicaragua's democratic institutions comes under increasing pressure. While this has led to cut-backs in financial support from various Western donor countries, the impact on Nicaragua's weak balance of payments has been limited by ongoing Venezuelan assistance. Yet, given considerably uncertainties about the continuation of these payments if Venezuelan President Chávez were to leave office, maintaining workable relations with Western countries remains imperative.

Things to watch:

- Continuity of aid flows, especially in case of a leadership change in Venezuela
- Deterioration of democratic institutions
- Balance of payments weakness

Author: **Fabian Briegel**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-64053
F.Briegel@rn.rabobank.nl

Nicaragua

National facts		
Type of government	Republic	
Capital	Managua	
Surface area (thousand sq km)	130	
Population (millions)	6.6	
Main languages	Spanish (98%)	
	Miskito (2%)	
Main religions	Roman Catholic (59%)	
	Protestant (23%)	
	Other (3%)	
Head of State (president)	Daniel Ortega	
Head of Government (president)	Danial Ortega	
Monetary unit	córdobas (NIO)	
Economy		**2011**
Economic size	*bn USD*	*% world total*
Nominal GDP	7	0.01
Nominal GDP at PPP	21	0.03
Export value of goods and services	4	0.02
IMF quotum (in mln SDR)	130	0.06
Economic structure		*5-year av.*
Real GDP growth	4.7	2.7
Agriculture (% of GDP)	17	17
Industry (% of GDP)	26	26
Services (% of GDP)	57	57
Standards of living	*USD*	*% world av.*
Nominal GDP per head	1070	11
Nominal GDP per head at PPP	3166	27
Real GDP per head	863	11

Social and governance indicators	rank / total
Human Development Index (rank)	129 / 187
Ease of doing business (rank)	118 / 183
Economic freedom index (rank)	101 / 179
Corruption perceptions index (rank)	134 / 183
Press freedom index (rank)	72 / 178
Gini index (income distribution)	52.3
Population below $1.25 per day (PPP)	11.9%

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
US	60	US	22
Canada	8	Venezuela	15
El Salvador	5	China	9
Venezuela	2	Costa Rica	9

Main export products (%)	2010
Manufactured products	51
Agricultural products	31
Minerals	11
Fishing produce	6
Main import products (%)	2010
Consumer goods	38
Intermediate goods	23
Oil & derivatives	20
Capital goods	18
Openness of the economy	2011
Export value of G&S (% of GDP)	62
Import value of G&S (% of GDP)	93
Inward FDI (% of GDP)	13.4

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

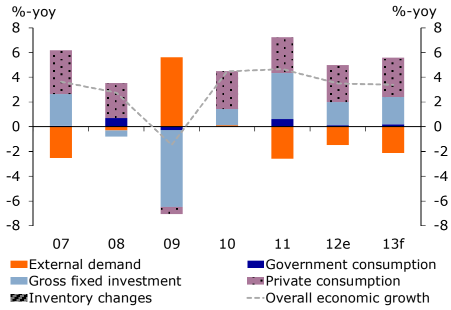
Economic structure and growth

Nicaragua is a small open economy in Central America with a nominal GDP of USD 7bn and a population of 6.6mln inhabitants. With a nominal GDP per capita at PPP of USD 3,166 in 2011, about 27% of the world average, Nicaragua is the poorest country in Central America. 20 years after the end of Nicaragua's civil war between its left-wing Sandinista government and the US-sponsored Contras, the local economy is prospering again. However, the country remains heavily dependent on bilateral and multilateral assistance, as well as inflows of remittances from Nicaraguans living in the US and Costa Rica. In spite of incumbent Sandinista-president Daniel Ortega's staunch anti-American rhetoric, the US and the EU have continued to be providers of concessionary financing so far, and the country has repeatedly relied on IMF Extended Credit Facilities. Yet, given Nicaragua's membership in the Venezuela-led Alternativa Bolivariana de las Americas (ALBA), a regional alliance of left-wing Latin American governments, Venezuela has become the country's most important source of external assistance since the election of Sandinista-president Daniel Ortega in 2006. While individual Western countries' annual financial support usually amounts to less than USD100mln, Venezuelan annual financial support reached levels of about USD 500mln in recent years. As these payments are directly related to President Hugo Chávez's personal interest in supporting leftist Latin American leaders, a continuation of Venezuelan financial largesse remains tied to the fate of the Venezuelan president, however. Nicaragua's economy is still dominated by the agricultural sector, which accounted for 17% of GDP last year. While the production of coffee and beef dominate agricultural output, the country also produces bananas, sugar, cotton, corn and rice. Nicaragua's manufacturing sector generates about a quarter of national output. Benefitting from preferential access to the US market under the Dominican Republic-Central American Free Trade Agreement (DR-CAFTA), the local maquila-sector specializes in the production of textiles and apparel, while other manufacturing mostly centers around the processing of agricultural produce, like beef and coffee. Nicaragua's relatively small mining sector mainly focuses on the extraction of gold and silver. In recent years, Nicaragua's tourism sector has gained some ground.

Nicaragua's exports reflect its economic structure. Manufactured products, mainly textiles and apparel, account for half of all exports in 2010. Agricultural and mining exports accounted for about 30% and 10% of total exports, respectively. Nicaragua mainly imports consumer goods, intermediate goods for its maquila sector, as well as oil and fuels. As hydrocarbon imports account for about a fifth of all imports, the local economy is highly exposed to changes in hydrocarbon prices, though Nicaragua's participation in the Venezuela-led Petrocaribe oil-trading scheme has dampened this risk in recent years. About 60% of Nicaragua's exports are destined for the US, while US-imports account for about a-fifth of total imports. Largely owing to oil imports from Venezuela, the South American country has become Nicaragua's second-most important import partner.

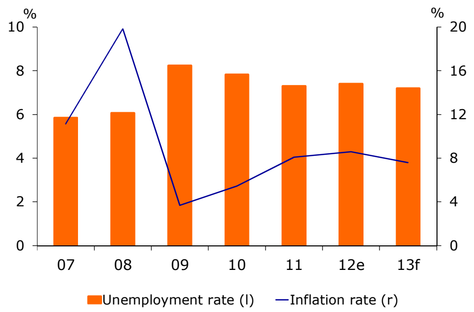
Nicaragua's banking sector is well-capitalized, while banks' liquidity remains ample. In March 2011, the sector-wide capital adequacy ratio stood at about 12%, while available liquidity stood at almost 200% of the required minimum level on the back of recent strong growth in deposits. Reflecting Nicaragua's positive economic developments, non-performing loans amounted to a limited three percent of total loans outstanding, while real loan growth re-entered positive territory. Since about 70% of all deposits are held in USD, the local banking system remains exposed to abrupt movements in the country's exchange rate.

Figure 1: Economic growth



Source: EIU

Figure 2: Unemployment and inflation



Source: EIU

Following a 4.5% expansion in 2010, Nicaragua's economic growth strengthened to 4.7% last year. As foreign direct investment almost doubled with respect to the previous year on the back of the Sandinista-government's business-friendly policies, low wages, relative public safety, and considerable Venezuelan financial support, gross fixed investment replaced private consumption as the main growth driver last year. Still, rising consumer spending remained an important pillar of economic growth, as firming remittances inflows and falling unemployment supported the release of pent-up consumer demand. Reflecting a rather sluggish economic recovery in the US, Nicaragua's most important trade partner and source of remittances, economic growth is expected to slow down to about 3.5% in both 2012 and 2013.

Given Nicaragua's heavy dependence on economic developments in the US, oil price fluctuations and foreign aid, in particular, the risks to the outlook are heavily tilted to the downside. As ongoing tensions in the Middle-East could lead to a renewed spike in oil prices despite the current global economic downturn, Nicaragua might face a strongly rising oil import bill this year that could bring with it balance of payments difficulties and depress domestic demand. Even worse, the outlook for foreign financial support has worsened considerably. While President Ortega's 2011 re-election bodes well for a continuation of his business-friendly policies, the concurrent deterioration of Nicaragua's democratic standards will likely lead to reduced financial support from the US and several European countries. Still, given that Western financial assistance is dwarfed by Venezuelan support (about 8% of Nicaraguan GDP each year), this year's Venezuelan presidential elections and the health of President Hugo Chávez are major determinants of Nicaragua's economic fate. Even though Nicaragua's authorities estimate that a complete payment stop would lower annual economic growth by up to 3%, the economic and social consequences would likely be manifold. Venezuela finances various social projects and reduces balance-of-payments pressures through the provision of cheap oil under its Petrocaribe oil trading scheme.

Political and social situation

Nicaragua is currently governed by president Daniel Ortega of the left-wing Frente Sandinista de Liberación Nacional (FSLN). Mr. Ortega, who overthrew the authoritarian Somoza regime as the founder and head of the FSLN in 1979, returned to power in 2006 when he won the relatively uncontested legislative and presidential elections, receiving 38% of the votes. Due to the lack of an absolute majority in Congress, Mr. Ortega has relied on the support of the right-wing Partido Liberal Constitucional (PLC) in Congress during his presidential term. He has been confirmed in office last year, as the FSLN won the allegedly fraudulent presidential and legislative elections in a landslide and the party's cozy relationship with the country's Supreme Electoral Council (CSE) and Supreme Court of Justice (CSJ) helped the president in circumventing a constitutional ban on consecutive presidential terms. The elections provided the FSLN with a whopping 63 out of 93 seats in Congress and consequently, Mr. Ortega no longer needs the support of the right-wing PLC. Furthermore, the FSLN's dominant position enables the government to conduct constitutional changes without the consent of the country's strongly diminished opposition.

Even though Mr. Ortega's dependence on the PLC certainly contributed to the implementation of sound economic policies and the adherence to the conditions imposed under an IMF Extended Credit Facility, the fact that the FSLN no longer needs PLC-support in Congress should not lead to major policy changes. While Mr. Ortega's pronounced left-leaning and anti-American rhetoric suggests otherwise, actual policies have been rather pragmatic. Given the ongoing need for multilateral assistance and the considerable uncertainty surrounding the future of generous Venezuelan financial assistance if Hugo Chávez were to leave office, we expect that the Sandinista government will refrain from drastic policy changes in order to maintain a workable relationship with Western donor countries, the US in particular.

Notwithstanding limited concessions to Western demands, the Sandinista's election victory will likely lead to a further deterioration of democratic standards and a further infiltration of Nicaragua's weak public institutions by Sandinista party members. Also, given the FSLN's absolute majority, changes to the current limit on the number of presidential terms cannot be excluded. In its current form, Nicaragua's constitution forbids both two consecutive and non-consecutive presidential terms. As Mr. Ortega has been in office from 1979 to 1990 and from 2006 onwards, he had actually been barred from last year's elections already and he would consequently benefit from a constitutional change in order to remain in office beyond the following elections. Yet, given his age (he is 66 years old) and the expected negative reaction of Western donor countries and regional trade partners, we do not expect the Sandinistas to take this step and thereby deviate from their current pragmatic policy course. We rather expect that President Ortega will try to promote his wife Rosario Murillo as his successor and legitimize her presidency during the next elections, which would spark fewer foreign protests.

Owing to the Sandinista's firming grip on the state's various institutions and lingering allegations of outright fraud during last year's presidential elections, political instability will likely persist in the near future despite President Ortega's popularity. Rampant corruption and the perception that mainly Sandinista-party members benefit from Nicaragua's recent economic success might also add to political instability. Especially ahead of this year's municipal election, at times fatal local outbursts of violence cannot be excluded. Still, provided that Venezuelan financial support, particularly for social programmes, continues, broad political stability should be maintained.

Similar to other Central American countries, drug-related crime is on the rise in Nicaragua and confronts the local law enforcement authorities with rising challenges. While its homicide rate of 13 murders per 100,000 inhabitants is relatively low and compares very favourably with neighboring Honduras (82 homicides per 100,000 inhabitants), drug-related violence in the sparsely populated and controlled Caribbean regions is on the rise. Being aware of the importance of relative public safety in order to attract foreign direct investment, the Ortega administration intends to strengthen its law enforcement capacities. Supported by foreign donations, Nicaragua's comparatively strong and reliable security forces should stand a better chance at keeping drug-related violence at bay than many of its regional peers. However, increasing public distrust in the authorities amid mounting control of the police force by the Sandinistas could undermine its effectiveness.

Nicaragua's external relations reflect President Ortega's rather pragmatic policy approach. In spite of his staunch anti-American rhetoric, his government strives to maintain workable relations with the US and other Western countries, as a complete cessation of bilateral relations would bring with it substantial cuts in bilateral and multilateral assistance. Recent changes to the election laws in response to US criticism and the appointment of a new US ambassador to Nicaragua seem to confirm this. Notwithstanding, reflecting the Sandinista's left-leaning political ideology and consequent generous financial support, Nicaragua continues to entertain cordial relations with Venezuela and other members of his Alternativa Bolivariana de las Americas (ALBA). Nicaragua also has relatively cordial relations with Iran, to which it still owes about USD 200mln that had been provided during President Ortega's first presidency. Nicaragua's relations with neighboring Costa Rica remain tense, as both countries are still involved in a judicial conflict over the shared riverine border.

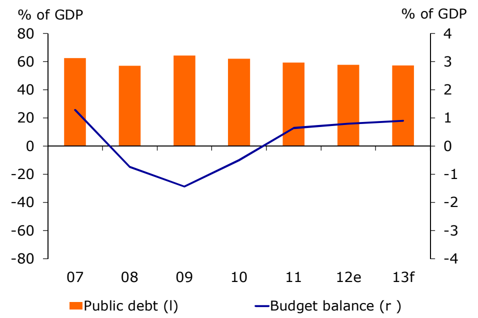
Economic policy

Despite President Ortega's strong left-leaning rhetoric that is reminiscent of Venezuelan leader Hugo Chávez, Nicaragua's economic policies have generally been sound in recent years and have put the country on a more sustainable economic growth path. Besides being limited in policy scope by the conditions set under an IMF Extended Credit Facility, Nicaragua's participation in the Dominican Republic-Central American Free Trade Agreement (DR-CAFTA) obliges the country to conduct market-oriented policies that promote foreign trade and investment. Going forward, we do not expect the Ortega-administration to deviate from these policies, given recent successes in attracting foreign direct investments and President Ortega's cordial relationships with foreign and

domestic businessmen. The substantial Venezuelan financial aid that Nicaragua has received so far in response to closer diplomatic ties have not led to marked economic policy changes.
The current administration's economic policy aims to improve macroeconomic fundamentals in order to ensure strong economic growth, while putting government finances on a more solid footing. Given widespread poverty, maintaining elevated levels of pro-poor spending receives particular attention. A new regulatory framework for microfinance institutions has been put in place and the administration announced that it would embark on pension reform. Government efforts also aim at reducing Nicaragua's heavy dependence on oil imports by promoting investment in renewable energy, predominantly hydro-electric power stations and biomass, while membership in Venezuela's Petrocaribe oil trading scheme brings with it price discounts on oil imports.

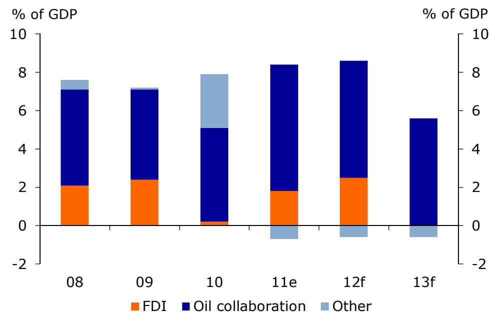
In an attempt to broaden Nicaragua's income sources, the Ortega administration recently revived the decades-old idea of building a canal through Nicaragua to link the Atlantic and Pacific Ocean. In order to underline its commitment to this alternative to the Panama Canal, new legislation to this end has been passed and high-ranking government official have tried to attract funding in Europe. Going forward, it remains to be seen whether the project will receive the substantial amounts of needed financing, as ongoing juridical battles with Costa Rica over the shared riverine border bring with it considerable uncertainty for investors. Moreover, China, according to the Costa Rican government, does not seem to be interested in the projected.

Figure 3: Public finances



Source: EIU

Figure 4: Venezuelan financial support



Source: IMF

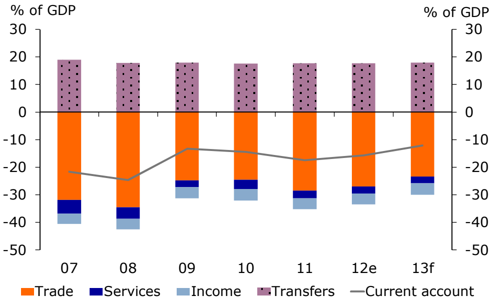
Following the expiration of the IMF's Extended Credit Facility in early 2012, Nicaragua will likely apply for a continuation of IMF support this year in order to gain access to multilateral financing. In accordance with the IMF's program, recent tax reforms have increased revenues, while improvements in tax administration have delivered efficiency gains. Consequently, the budget balance after grants improved from a deficit of 0.5% of GDP in 2010 to a small surplus 0.6% of GDP last year. Assuming economic growth of about 3.5% in the coming years, the surplus after grants is expected to improve to about 1% of GDP, which would still imply a deficit before grants of about 2% of GDP though.

Driven by strong economic growth and budget surpluses, Nicaragua's relatively high public debt decreased from 62% of DGP in 2010 to 59% of GDP last year. Provided foreign financial support and economic growth remain stable, Nicaragua's public debt level is expected to decrease to 57% of GDP in 2013. Given Nicaragua's participation in a third Poverty Reduction and Growth Facility related to the IMF's Extended Credit Facility, the country could once more become eligible for debt relief in line with the IMF/World Bank Heavily Indebted Poor Countries initiative. Monetary policy is conducted by the Banco Central de Nicaragua, which strives to maintain price stability, uphold the crawling peg of the córdoba with respect to the US dollar, and ensure the functioning of the payments system. Subject to the crawling peg, currently set at 5% p.a., the central bank targets both foreign reserves levels and inflation. While monetary policy is conducted in line with the government's economic program, the central bank's policy objectives generally take precedence. However, the recent replacement of the director of the central bank could lead to reduced central bank independence. Owing to a high pass-through of global oil prices, headline inflation came in at 8.1% in 2011. Driven by a double-digit increase in the minimum wage and a possible increase in oil prices, it is expected to increase to about 8.6% this year.

Balance of Payments and External Position

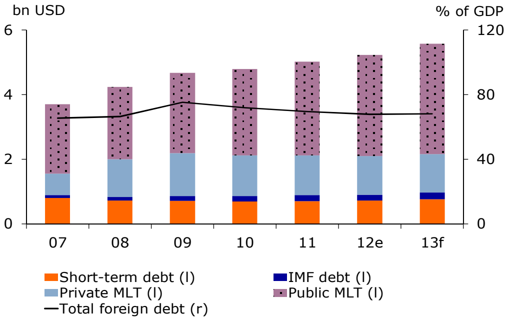
Nicaragua's large structural current account deficit deteriorated markedly last year, when it increased from 14.5% of GDP in 2010 to 17.4%. While the transfers account surplus, mainly family remittances from Nicaraguans living in the US and Costa Rica and foreign grants, remained rather constant in GDP terms, the considerable trade balance deficit increased as rising exports were more than compensated by higher imports following a pick-up in domestic demand and higher global oil prices. For 2012 and 2013, driven by an improving trade balance deficit, the current account deficit is expected to improve to a still sizeable 16% and 12% of GDP, respectively.

Chart 5: Current Account



Source: EIU

Chart 6:External debt



Source: EIU

With about 70% of the current account deficit being covered by foreign direct investment flows, access to multilateral funding will remain imperative for the Nicaraguan government. While the country's recent positive performance under the IMF's extended credit facility bodes well in this respect, the decision by various Western donor countries to cut back on financial support illustrates that external support is not warranted. With Venezuelan ALBA-related inflows amounting to an estimated 8% and 5% of GDP in 2012 and 2013, respectively, additional risks to Nicaragua's balance of payments might arise from an abrupt end of these payments. Given the ongoing uncertainty about the future of the Venezuelan Chávez-led government due to President Chávez's cancer, the relevance of this risk has increased considerably.

Still, Nicaragua's relatively favorable debt structure and level of foreign exchange reserves should assist in bridging funding gaps until multilateral support can be called upon. As about half of Nicaragua's debt is public and predominantly owed to multilateral institutions, a certain degree of leniency in times of payment difficulties can be expected. Moreover, short-term debt only amounts to about 17% of total external debt. However, since Nicaragua's foreign exchange reserves are expected to cover only about 3 months of imports and 89% of debt service payments, the country faces elevated risks of balance-of-payments issues in the near future, which underlines the need for continued access to bilateral and multilateral emergency funds.

Nicaragua

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	3.6	2.8	-1.5	4.5	4.7	3.5	3.4
Consumer prices (average % change pa)	11.1	19.8	3.7	5.5	8.1	8.6	7.6
Current account balance (% of GDP)	-21.6	-24.6	-13.3	-14.5	-17.4	-15.7	-12.1
Total foreign exchange reserves (mln USD)	1103	1141	1573	1799	1892	1900	1950
Economic growth							
GDP (% real change pa)	3.6	2.8	-1.5	4.5	4.7	3.5	3.4
Gross fixed investment (% real change pa)	10.7	-1.8	-25.2	7.1	19.5	8.5	9.5
Private consumption (real % change pa)	4.2	3.4	-0.7	3.6	3.4	3.6	3.8
Government consumption (% real change pa)	0.9	8.9	-3.2	-0.2	7.6	1.4	2.0
Exports of G&S (% real change pa)	8.3	11.9	3.5	14.1	6.0	5.8	4.2
Imports of G&S (% real change pa)	10.9	8.5	-7.8	10.6	9.5	7.1	6.8
Economic policy							
Budget balance (% of GDP)	1.3	-0.7	-1.4	-0.5	0.6	0.8	0.9
Public debt (% of GDP)	62	57	64	62	59	58	57
M2 growth (% change pa)	18	8	10	25	9	14	16
Consumer prices (average % change pa)	11.1	19.8	3.7	5.5	8.1	8.6	7.6
Exchange rate LCU to USD (average)	18.4	19.4	20.3	21.4	22.4	23.6	24.7
Recorded unemployment (%)	5.9	6.1	8.2	7.8	7.3	7.4	7.2
Balance of payments (mln USD)							
Current account balance	-1224	-1570	-828	-963	-1259	-1210	-990
Trade balance	-1803	-2201	-1540	-1636	-2055	-2080	-1920
Export value of goods	2186	2530	2390	3157	3941	4320	4930
Import value of goods	3989	4731	3929	4792	5996	6400	6850
Services balance	-283	-269	-148	-222	-199	-190	-200
Income balance	-212	-240	-259	-278	-287	-310	-340
Transfer balance	1075	1140	1118	1173	1282	1370	1470
Net direct investment flows	382	626	434	508	968	850	800
Net portfolio investment flows	0	0	0	0	0	0	0
Net debt flows	797	583	413	149	28	90	300
Other capital flows (negative is flight)	226	399	413	532	356	280	-60
Change in international reserves	181	38	432	226	93	10	50
External position (mln USD)							
Total foreign debt	3701	4233	4672	4787	5012	5220	5570
Short-term debt	803	719	716	697	703	720	770
Total debt service due, incl. short-term debt	2048	2173	2185	2189	2281	2120	2130
Total foreign exchange reserves	1103	1141	1573	1799	1892	1900	1950
International investment position	-7085	-7921	-8718	-9291	-10866	n.a.	n.a.
Total assets	1710	1974	2680	3322	3635	n.a.	n.a.
Total liabilities	8794	9895	11398	12614	14502	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-31.8	-34.5	-24.8	-24.6	-28.5	-27.0	-23.4
Current account balance (% of GDP)	-21.6	-24.6	-13.3	-14.5	-17.4	-15.7	-12.1
Inward FDI (% of GDP)	6.7	9.8	7.0	7.6	13.4	11.0	9.8
Foreign debt (% of GDP)	65	66	75	72	69	68	68
Foreign debt (% of XGSIT)	101	102	117	100	87	82	78
International investment position (% of GDP)	-125.1	-124.3	-140.3	-139.5	-150.6	n.a.	n.a.
Debt service ratio (% of XGSIT)	56	52	54	46	39	33	30
Interest service ratio incl. arrears (% of XGSIT)	15	14	15	12	10	8	8
FX-reserves import cover (months)	2.8	2.5	4.1	3.9	3.4	3.2	3.0
FX-reserves debt service cover (%)	54	53	72	82	83	89	92
Liquidity ratio	78	75	93	98	96	102	105

Source: EIU