

**Sticks as Carrots:
Open Market Operations and Internal Debt in Nicaragua**

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I. Introduction

The launch of the Poverty Reduction Growth Facility (PRGF) for highly indebted poor countries in 1999 was announced as a change not only in policy, but also in culture at the International Monetary Fund (IMF). For the first time, poverty reduction was placed on the agenda as an objective of structural reform.

Like its predecessor reform packages, the PRGF continues to prioritize macroeconomic growth as a means for reducing poverty. The central pillar of this approach remains the shift from state-led to market-led economies, through financial deregulation. Policies to establish ‘market discipline’ give the market responsibility for directing resources to their most efficient uses.

A primary component to market discipline is the phasing out of direct monetary instruments – such as directing credit or credit ceilings – and adoption of indirect instruments. The most commonly used indirect instruments are Open Market Operations (OMOs) involving the purchase or sale of financial instruments – usually bonds or treasury bills - by the Central Bank.

With the appropriate conditions, OMOs can provide needed financing to reduce government deficits without increasing the foreign debt. They can contribute to Central Bank autonomy and allow for increased flexibility in responding to shocks.

But where financial institutions are weak or mismanaged, the use of OMOs can actually work against poverty reduction by facilitating the exchange of high levels of foreign debt for an unsustainable public debt. In these cases, the substitution of domestic creditors for international creditors relieves the IMF of debt reduction responsibilities without lightening the overall debt burden in any meaningful sense.

This paper challenges the IMF's view of OMOs as 'pro-poor' policy instruments, drawing on the experience of the world's most highly indebted country per capita, Nicaragua. I begin by examining the practice of OMOs within the framework of market discipline, and outline some common critiques. I then turn to the case of Nicaragua and detail its recent experience with OMOs to finance the government deficit. In the Nicaraguan case, the IMF's carrot (debt relief) and stick (market discipline) approach replaced external debt with an internal debt that now represents one of the largest obstacles to tackling poverty. I conclude by discussing the social impacts of the failed OMOs and drawing lessons for policy.

II. OMOs – Advantages and Limitations

OMOs fit within the framework of market discipline, loosely defined as “internal and external governance structures in the absence of government intervention.”¹ This reliance on the market to maintain stability depends directly on the existence of a stable financial system, including solid institutional underpinnings, which allow the market to function efficiently.

The IMF sees the shift away from government intervention toward market-led financial system as pro-poor policy reform. The Fund actively promotes reform of the financial system in most HIPC's, as a means to generate macroeconomic growth, which will in turn provide resources for poverty reduction. Most PRSPs include commitments to deregulate financial markets, allow market-based determination of interest rates, promote auctions of treasury bills and a secondary market of government debt instruments,

¹ Andrew Crockett, “Market Discipline and Financial Stability,” Bank for International Settlements, speech at the Banks and Systemic Risk Conference, Bank of England, London, 23-25 May 2001, www.bis.org.

introduce new financial instruments, deregulation of entry into the banking sector and establish a stock exchange. These commitments may also include increased supervision of the banking system and central bank independence.²

The IMF's practice of promoting the use of OMOs within the context of market discipline rests on three primary arguments:³

First, government issuance of bonds as a means of financing a budget deficit is preferable to external borrowing, because it does not add to the foreign debt. Public debt is usually payable in local currency, whereas external debt must be repaid in US dollars. OMOs are also preferable to government borrowing from the Central Bank, which adds money to the economy and can result in higher inflation and decreasing reserves.

Second, promoting an open market allows the Central Bank more effective control over the money supply, allowing it to buy bonds to increase liquidity and sell them to decrease liquidity. Indirect operations are more flexible than direct instruments, such as credit ceilings, which tend to be set quarterly and are thus less effective in responding to sudden shocks. In addition, the ability to issue and purchase bonds facilitates greater Central Bank independence of the government.

Third, the IMF argues that shifting to indirect instruments is a pro-poor policy because offering government bonds, which tend to be low-risk, encourages "access to safer assets... incentives to save, and access to credit markets."⁴ If done in moderation, issuance of bonds can boost the economy by giving businesses and households access to

² Based on a review of PRSPs for Cape Verde, Central African Republic, Chad, Ethiopia, Gambia, Guinea, Guinea-Bissau, Lesotho, Madagascar, Mali, Mauritania, Mozambique, Rwanda and Sierra Leone. From UNCTAD, "From Adjustment to Poverty Reduction: What is New?" United Nations, New York, September 2002, 38.

³ These arguments are outlined in the IMF's *The Adoption of Indirect Instruments of Monetary Policy*, (Washington: IMF, 1995).

⁴ International Monetary Fund, "PRSP Sourcebook Chapter 6," IMF, April 2001, 22.

credit. OMOs offer a safe asset to the financial sector so that it can diversify and assume more risk, thus allowing this sector more access to credit. For households, government bonds offer a low-risk investment and a source of collateral.

However there are limitations to the use of OMOs, especially where financial markets are weak. First and foremost, the use of market discipline to stabilize an economy assumes a legal and institutional framework that is generally lacking in less developed countries. Without these solid underpinnings, OMOs are more likely to be mismanaged and to contribute to greater indebtedness.

Second, OMOs can be – and often are – overdone. Issuing government bonds can only continue as long as the market sustains an appetite for these bonds. Decreasing market demand raises the interest rates the government must offer, adding to the debt burden. The cases of Argentina and Russia demonstrate the dangers of selling too many bonds to private creditors.

Third, where financial markets and institutional frameworks are weak, the chances for mismanagement of OMOs are high. Measures need to be in place to ensure diversification both of creditors and maturities. OMOs tend to involve very short-term bonds - with three to six months maturity. A small number of creditors holding bonds maturing at the same time could provoke a run on the currency and cause substantial damage to a financial system.

Similarly, good sequencing of reforms is essential. For example, liberalizing interest rates without first establishing a sustainable fiscal position or establishing regulatory institutions to oversee the process can contribute to unequal concentration of wealth. Likewise, issuing government bonds without measures to ensure transparency or

specified limits on acceptable levels of debt can exacerbate existing problems of corruption and unsustainable debt.

Fourth, a market-based strategy of issuing bonds to domestic creditors as a “pro-poor” means of reallocating resources is unrealistic in poor countries. This rationale regards households and businesses as potential savers. In much of the developing world where the poor survive on \$1 or less a day, household savings are negative. Indeed the experience of many developing countries shows that financial market liberalization has actually decreased the access of the poor to financial resources.⁵

Overall, the shift from central bank financing to market-based financing through auctioning of government bonds and the adoption of market-based interest rates can increase the vulnerability of poor economies to external shocks. Indeed, as the United Nations has pointed out, financial deregulation constituted a key factor in precipitating the economic crises of the late 1990s in middle income countries.⁶ In African economies, these policies resulted in accumulation of domestic debt with harsh consequences for income distribution.⁷ The financing of public deficits with government bonds where financial markets are weak tends to lead to high and volatile interest rates. In turn, the accumulation of domestic debt at high interest rates increases the debt burden on the budget and leads to Ponzi financing, so that future payments can only be met with more loans. The end result is an unsustainable debt burden, which strains the already-strapped public budgets of poor countries.⁸

⁵ UNCTAD, Trade and Development Report 1998, United Nations, New York 1998.

⁶ UNCTAD 1998, *Op. Cit.*, 8.

⁷ UNCTAD, Trade and Development Report 1997, United Nations, New York, 1997.

⁸ UNCTAD 2002, *Op. Cit.*, 29.

III. A Bad Swap: the Case of Nicaragua

Nicaragua is the world's most highly indebted country per capita, and generally regarded to be the second poorest in the Western hemisphere, after Haiti. Since 1990 the country has implemented a series of reforms mandated by the IMF as part of its debt restructuring process. These reforms have allowed the government to meet debt service obligations, and receive some debt relief. After two Enhanced Structural Adjustment Facility (ESAF) agreements during the 1990s, Nicaragua became eligible for the HIPC initiative in 2000. The IMF and World Bank approved Nicaragua for the "decision point" of HIPC the following year.

At the "decision point" of the HIPC program, Nicaragua qualified for interim relief on some bilateral debt. From 1997-03 it received roughly \$2 billion in external debt relief, through donations from the World Bank, the Inter-American Development Bank, and other multilateral organizations.⁹ After reaching the "completion point" of the initiative in January 2004, Nicaragua should receive some additional relief.

At the same time, Nicaragua's internal debt has ballooned to \$4.12 billion, or 1.6 times the GDP for 2002. Most of this is short-term, non-negotiable debt. Of this, roughly \$2.7 billion is owed by the government to the Central Bank, and the remaining \$1.47 billion is owed to the domestic private sector.¹⁰

The government's debt to the public sector includes Central Bank bonds as writedowns on the portfolios of the state banking sector, Central Bank operational losses and exchange rate losses, external debt service and compensation bonds held by the

⁹ Nestor Avendaño, "Nicaragua: Debt Relief/HIPC vs. Poverty," Quaker Peace and Social Witness, London, England, 2003, 1.

¹⁰ Avendaño 2003, *Op. Cit.* 1.

Central Bank. This debt is mostly held in long-term bonds at very concessional interest rates.

The public debt to the domestic private sector represents a much bigger drain on the budget. This debt is prioritized over the debt to the Central Bank, and is financed primarily with tax revenue. The public debt to the private sector has several illicit sources, including unjust property confiscations during the Sandinista years, failed OMOs by the Central Bank (for a loss of \$280 million over the past six years) and government bailouts of private bank failures in the late 1990s. The last two of these are particularly problematic, as they were carried out under IMF and World Bank tutelage.

In 2000, the IMF, the World Bank and the IADB cut off aid to Nicaragua, due to corruption charges against the Alemán government. The Alemán administration had used government funds to cover the costs of a series of fraudulent bank failures in the late 1990s. The subsequent cutting of aid from the IFIs blocked important resources to Nicaragua, as it relies on external financing for one third of government spending.¹¹

In 2001 Nicaragua felt the effects of a global economic downturn and falling commodity prices. The upcoming elections also adversely affected the economy as investors waited to see whether the pro-market candidate Enrique Bolaños or former leftist Sandinista leader Daniel Ortega would win the presidency.¹²

The government found itself in urgent need of resources to compensate the Central Bank for the money it had used to bail out the fraudulent banks in the late 1990s and to finance its growing public expenditures, especially election-related costs. Excess liquidity in the system threatened to trigger inflation, but Nicaragua's crawling exchange

¹¹ Nicaraguan Central Bank website, 2004, www.bcn.gob.ni

¹² Nicaraguan Central Bank, 2001 Annual Report, Managua, 2001, 6. From the website: www.bcn.gob.ni

rate peg eliminated the option of devaluing the currency. As a result, international reserves fell by \$171 million instead of the planned \$38 million set forth in the monetary program.¹³

In the lead-up to the 2001 elections, the Central Bank attempted to raise money by selling dollarized bonds on the world market. These bonds, called Negotiable Investment Certificates (CENIs by their Spanish acronym) were originally priced at 15 percent interest rates. International investors were not interested, given the high country risk before election day. The day after the election of Enrique Bolaños, when country risk – and with it, the interest rates on bonds – should have dropped, these bonds sold at 22 percent interest with a two-year payback period. Most of these bonds (some estimate up to 60 percent)¹⁴ were bought by a handful of shareholders of Nicaragua’s two largest private banks: Banpro and Bancentro.

Dealing with the Debt: IMF and Government Responses

At the end of 2002, the Nicaraguan government debt owed to domestic bondholders stood at \$369 million, or 134 percent of the Central Bank’s international reserves.¹⁵ Added to this is the cost of the bank failures, nearly \$530 million.¹⁶

In its 2003 Country Assistance Strategy for Nicaragua, the World Bank recognized the public debt as a “major source of macroeconomic vulnerability,” one which “threatens to undo the debt reduction benefits projected from the HIPC initiative.” The IMF also identified the large public debt as a source of instability and a threat to the

¹³ Ibid.

¹⁴ Avendaño, Nestor, interview with the author, Managua, 20 January 2004.

¹⁵ Avendaño 2003, *Op. Cit.* 20.

¹⁶ Ibid.

other macroeconomic goals of the PRGF program in its fourth review of Nicaragua's PRGF in 2004:

“Even after completion of debt relief under the HIPC initiative, Nicaragua's public debt will remain large. Fiscal consolidation will, therefore, need to continue for medium-term debt sustainability to be achieved.”¹⁷

Under more recent agreements with the IMF, the Nicaraguan government has taken steps toward curbing the rising public debt. A draft law has been submitted to Congress setting limits on the external and internal indebtedness of the government sector. This includes the establishment of a centralized process for contracting public debt.¹⁸

The Nicaraguan government also committed to renegotiating the internal debt with the domestic private sector on more favorable terms. At the end of 2003 the government was able to renegotiate the terms of bonds held by two large bondholders to restructure \$320 million in debt falling due in 2003-04. Of this, \$280 million in debt was refinanced to fall due over 10 years at 8.4 percent interest. The remaining \$40 million, which originally fell due in December 2003, will be paid over three years at 7.4 percent interest.¹⁹ The original interest rates were between 8-21 percent.

In addition, the Nicaraguan government took steps toward reform of the tax system to generate revenue for internal debt payments. The first phase of the planned tax

¹⁷ IMF, “Nicaragua: Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility,” IMF Country Report No. 04/71, March 2004, 5.

¹⁸ IMF 2004, *Op. Cit.*, 14.

¹⁹ IMF 2004, *Op Cit.*, 9.

reform has been implemented, with the goal of raising the tax burden by one percent of GDP annually. As part of its 2003-05 PRGF agreement with the IMF, Nicaragua instituted a tax reform, and collected 24 percent more tax income in 2003 than 2002. A new tax code, submitted to Congress last fall, should be approved this year. But although these steps toward sustainability are encouraging, they do not ameliorate the social consequences of the internal debt burden.

Social Impacts

The mismanagement of OMOs in Nicaragua has brought adverse social impacts that directly question the seriousness of the IMF goal of poverty reduction. During the 1990s, the diversion of resources toward external sectors and the domestic private sector had already weakened social capital. By 1998, debt payments consumed two-thirds of the government budget, more than two and a half times health and education spending combined and 11 times the amount spent on basic health services.²⁰ Nor did the slight gains in economic growth reach the majority - per capita GDP fell by 3.8 percent from 1980-89 and by 0.6 percent from 1990-99²¹

Interim relief under HIPC has brought a significant reduction in Nicaragua's external debt, but not enough to reverse the social damage. After over a decade of adjustment policies, Nicaragua's per capita debt has fallen from \$1,400 in the 1990s to an

²⁰ Oxfam, "Debt Relief for Nicaragua: Breaking out of the Poverty Trap," Policy Paper, Oxford, 1998.

²¹ Mark Weisbrot, David Rosnick, "Another Lost Decade?" Center for Economic and Policy Research, 13 November 2003.

expected \$450 when it completes HIPC in 2004.²² Still, all this makes little difference in a country where the per capita income is a mere \$370.²³

In this context, the application of OMOs had four adverse social impacts:

1. *Internal debt payments drain scarce resources for poverty reduction programs.* In 2003, 37 percent of total government spending went toward internal and external debt obligations, while 35 percent went to poverty reduction programs.²⁴ Last year, payments to domestic creditors consumed 85 percent of tax income²⁵ that could have been used to fund social programs. Even more worrisome is the fact that in 2002 and 2003, internal debt payments consumed roughly 70 percent and 60 percent of the resources freed up under HIPC debt relief, respectively (see table 2 for details).²⁶ This directly contradicts the mandate of HIPC established under the Cologne Terms of 1999, in which Paris Club creditors stipulated that funds freed up by debt relief under HIPC would be used exclusively to fund poverty reduction programs. Thus even the ‘carrot’ of debt relief becomes the ‘stick’ of further resource drains.

Indeed, spending on poverty reduction has not increased significantly even with debt relief. In 2003 the government spent just 15.8 percent of GDP on programs to reduce poverty, only a slight increase from 14 percent in 1997.²⁷ In some sectors, especially health care, spending levels have declined as a percentage of GDP and in per capita

²² Nestor Avendaño, based on analysis of Nicaraguan Central Bank figures, interview with the author.

²³ World Bank, *The Little Green Data Book*, 2003.

²⁴ Avendaño 2003, *Op. Cit.* 17.

²⁵ Avendaño 2003, *Op. Cit.* 1.

²⁶ Gobierno de Nicaragua, Secretaría de Coordinación y Estrategia, “Estrategia Reforzada de Crecimiento Económico y Reducción de la Pobreza, Segundo Informe de Avance,” Managua, Nicaragua, Octubre 2003. p. 32.

²⁷ World Bank (2002), “Strengthened Growth and Poverty Reduction Strategy (SGPRS): First Progress Report,” Nov. 2002.

terms. In 1999, directly after Hurricane Mitch, a rise in international aid boosted social spending to 19 percent of GDP, what the World Bank called “unsustainable levels.”²⁸ In 2002 per capita spending on health was \$23.20 and fell to \$21.08 in 2003. The overall health budget fell from \$125.8 million in 2002 to \$121 million in 2003. Spending as a percentage of GDP decreased by three percentage points from 2001 to 2003, and remains the lowest in Central America.²⁹

2. Rather than increasing access to credit, the application of OMOs further concentrated wealth in Nicaragua. Since over half of the auctioned bonds ended up in the hands of two major creditors, the general population saw little benefit from their sale. Already, Nicaragua is one of the world’s most unequal countries, comparable only with Swaziland, Brazil and Sierra Leone:³⁰ Approximately 63 percent of national income goes to the richest 20 percent of the population, while only three percent goes to the poorest 20 percent.³¹ Channeling resources where they are most needed – housing for low-income populations, loans to start-up enterprises – will require a more direct strategy than OMOs can offer.

3. Reliance on tax revenue to finance the public debt overburdens the poorest sectors. Given Nicaragua’s skewed income distribution and regressive tax structure, the increased tax burden falls heaviest on the poor. In 2002, over 80 percent of the taxes collected by

²⁸World Bank, “Strengthened Growth and Poverty Reduction Strategy (SGPRS): First Progress Report,” Nov. 2002.

²⁹ Quirós Viquéz, Ana (2003) “Nicaragua: Salud en la Estrategia de la Reducción de la Pobreza,” Centro de Información y Servicios de Asesoría en Salud,” Managua.

³⁰ United Nations Development Program, *Human Development Report 2002*, New York.

³¹ World Bank, *World Development Indicators 2003*, Washington DC, 2003.

the government were indirect taxes, including a hefty 15 percent sales tax. The tax burden was 25 percent in 2003 – that is, for every *córdoba* of production the government took 25 *centavos* in taxes.³² In addition, the tax reform took effect during a recession – a measure that is irresponsible and borders on immoral in a country where 82 percent of the population earns less than \$1 a day.

Very little has been done to address problems of tax evasion and avoidance by the higher-income strata of the population and the business sector. In its 2004 review, the IMF recognized that results from attempted tax reform have been less than satisfactory. In particular, the corporate minimum income tax has failed to deliver the expected revenue. Some firms reported lower assets than in previous years to avoid increasing taxes. Other corporations have sued the government on the new tax, mainly on procedural grounds. In the meantime these firms are delaying payment until the suits are settled, which could take several months.³³

4. *Nicaragua continues to rely on external financing for poverty reduction programs.* The diversion of resources toward domestic creditors means Nicaragua must rely even more on external financing for its poverty reduction programs. Already, 65 percent of the government's poverty reduction strategy is financed with external resources, mostly loans on concessional terms and donations tied to specific programs.³⁴ Without the burden of the internal debt, Nicaragua's budget would not be in deficit at all.

³² Nestor Avendaño, *Op. Cit.*, 16.

³³ IMF 2004, *Op. Cit.* 11.

IV. Conclusions

The use of OMOs in Nicaragua without securing the necessary preconditions for proper management simply resulted in the exchange of an unsustainable external debt for an equally unmanageable internal debt. This in turn undermines the goal of poverty reduction and leaves Nicaragua extremely vulnerable to sudden macro shocks, such as a fall in commodity prices. A sharp drop in coffee prices in 1999 led to a drop in reserves from the equivalent of 3.3 months of imports in 1999 and 2000 to 2.3 months in 2002.³⁵ Such a shock puts Nicaragua's capacity to pay its debt in jeopardy.

One key lesson from the Nicaraguan experience is that sequencing matters. Only after the mismanagement of public borrowing nearly eclipsed the heavy external debt burden was the government encouraged to design a policy to contain the public debt. While the law on external and internal debt currently in Congress is a welcome step forward, it surely should have been a prerequisite for the conduction of OMOs, to ensure that borrowing was kept in check.

Similarly, the pursuit of transparent negotiations regarding the public debt is welcome, but long overdue. The original terms for the bonds sold by the government to private creditors were not made public until the problem of the internal debt entered the national debate. Current reforms emphasize transparency and provide technical assistance for monitoring, but these too should have been in place before.

More important, the Nicaragua case demonstrates serious market failures in relying on indirect monetary instruments to direct resources where they are most needed and can be most efficient. A more sustainable, pro-poor strategy might include more

³⁴ Avendaño 2003, *Op. Cit.* 17.

³⁵ Nestor Avendaño, *Op. Cit.*

government intervention to direct credit toward infrastructure projects, or credit for housing or small businesses. These policies should accompany the current tax restructuring process – another welcome yet long overdue reform. In addition, more could be done to address tax evasion by the wealthy and corporate groups in Nicaragua, so as to redistribute the debt service burden more equally and alleviate poverty.

That these mismanaged OMOs were carried out under IMF tutelage is especially worrisome, given its stated goal of poverty reduction. Above all, the IMF should be working to ensure Nicaragua's adherence to the Cologne terms, under which resources from interim HIPC relief are channeled toward poverty reduction programs, rather than pursuing policies that ultimately drain the government budget. By shifting its creditor responsibilities to the domestic private sector, the IMF has set up additional obstacles to the achievement of its own stated goals. The result is a cruel catch-22 for Nicaragua, a policy where carrots are disguised as sticks that hit hardest at the most vulnerable.

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