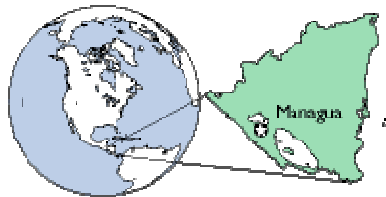


COUNTRY REVIEW

Nicaragua



26 October 2009

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EULER HERMES COUNTRY RISK GRADE: D

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- A functioning democracy.
- Qualified for full HIPC Initiative and MDRI debt relief and an IMF PRGF programme is in place.

Weaknesses

- Left-leaning government with potential to tilt towards radical populism and international re-alignment.
- Weak political institutions, low per capita GDP and poor long-term growth record.
- Policymaking hampered by complex political situation.
- High dependence on primary commodities and vulnerability to natural disasters.
- Relatively high public debt even after debt relief.
- Wide current account deficit and low net FDI coverage.

Key Risks

- **Recession**
- **Exchange rate**

Country Risk Assessment

Ratings	Nicaragua		Median Grade D	Jamaica	Peers	
	Latest	Previous			Vietnam	Barbados
Systemic Political Risk:	P3-	P3-	P3-	P2-	P3+	P2+
Systemic Economic Risk:	E6	E6	E6	E6	E6	E6
ME rating:	ME6	ME6	ME6	ME6	ME6	ME5
<i>Structure</i>	4.7	5.7	6.0	5.7	6.0	5.0
<i>Policy</i>	5.6	4.8	5.6	5.8	6.0	3.2
<i>Solvency</i>	5.2	6.0	4.5	5.8	4.3	2.8
<i>External Liquidity</i>	5.6	4.8	4.6	6.0	5.3	6.0
SBE rating:	SBE5	SBE4	SBE5	SBE4	SBE5	SBE3
COUNTRY GRADE:	D	D	D	D	D	C

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Managua
Population:	5.67 mn (2008)
GDP:	USD 6365 mn (2008)
Currency:	Cordoba (NIO)
Form of state:	Republic
Head of government:	President Daniel Ortega
Next elections:	2011 (Presidential & Legislative)

Major Industries (% of GDP at market prices, 2008)

Agriculture, forestry & fishing	18.1%
Mining	1.2%
Manufacturing	18.0%
Utilities & construction	9.0%
Services	53.6%

Global Assumptions

	2009	2010
Real GDP grth (% yr/yr) *	-3.9	0.9
Inflation (% , av) *	-0.1	1.3
Dated Brent (USD/b)	61	72
* Major economies		

Main Exports (% of total, 2008)

Free Trade zone	43.6%
Coffee	10.5%
Beef	8.0%
Fish & Seafood	3.9%
Sugar	1.9%

Main Imports (% of total, 2008)

Consumer goods	29.0%
Fuels & lubricants	23.1%
Intermediate goods	28.3%
Capital goods	19.5%
Other	0.2%

Lead Export Markets (% of total exports, 2007)

US	31.7%
El Salvador	14.0%
Honduras	9.2%
Costa Rica	7.2%

Lead Import Markets (% of total imports, 2007)

US	22.5%
Mexico	13.5%
Costa Rica	8.4%
Venezuela	6.4%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	5,295	5,690	6,365	5,868	5,941
Population (mn)	5.53	5.60	5.67	5.74	5.81
GDP per capita (USD)	958	1,016	1,123	1,022	1,022
Real GDP growth (% yr/yr)	3.9	3.2	3.2	-3.5	2.3
Inflation (% , eop)	9.4	16.9	13.8	0.3	4.0
Fiscal balance (% of GDP)	0.7	1.3	-0.7	-5.1	-3.5
Current account balance (% of GDP)	-13.4	-17.6	-23.2	-12.0	-15.0
External debt/GDP (%)	102	80	70	79	81
External debt/Exports of goods & services (%)	159	120	108	120	120
Interest payments/Exports of goods & services (%)	2	3	2	2	2
Foreign exchange reserves (USD mn)	922	1,103	1,141	1,370	1,250
Import cover (months)	2.8	2.8	2.5	3.7	3.1
Exchange rate assumption, NIO:USD (av)	17.57	18.45	19.37	20.34	21.36
f: CRU central forecast					

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

A functioning democracy has been in place since the end of the 1980s, during which time there have been orderly transfers of power between administrations and different presidents. The latest presidential elections in November 2006 were won by the FSLN (Sandinista) candidate Daniel Ortega, former president (1986-90) and leader of the radical left revolutionary Sandinista government that overthrew the 20 year Somoza dictatorship in 1979—a remarkable comeback, having lost presidential elections in 2000, 1996 and 1990.

Under Ortega Nicaragua has become a member of the radical-left axis in the region, including membership of ALBA, (the Bolivarian Alternative for the Americas) though this has also facilitated financial support from Venezuela, including Petrocaribe, which subsidises oil imports. However, at the same time the government has negotiated a PRGF programme with the IMF. In part this reflects the fact that, unlike Venezuela, Ecuador and Bolivia, Nicaragua lacks large energy resources and, as a result, is heavily dependent on external financing, which requires the government to steer a more centrist course. Performance under the PRGF has been uneven, but a preliminary staff agreement on the second and third review has recently been agreed, though it is pending adequate progress on the budget. The Sandinista government is also constrained as it lacks a majority in congress with which to push through major legislation (good or bad). This inhibits radical excess but could also slow implementation of the tax measures under discussion to curb the fiscal deficit as required by the PRGF. However, there is a long-standing institutional power sharing agreement between the Sandinista's and the PLC (constitutional liberal party), led by former president Roberto Aleman. Nicaragua is also a member of DR-CAFTA.

A key issue is President Ortega's attempts to change the constitution in order to end, among other things, term limits, which would allow him to stand again in the next elections due by November 2011. This, along with the establishment of citizen's councils, has similarities with developments among the radical left elsewhere. Having been frustrated in congress, Ortega's latest move is to obtain a legal ruling from the Supreme Court repealing the ban on consecutive and more than two terms in place since the constitution was revised in 1995. Reportedly this was done without consultation with opposition linked members of the politicised Supreme Court. The ruling means that Ortega no longer needs to obtain a 60% approval in congress and the backing of public referendum to stand for re-election. Much may still depend on horse trading with Aleman, but there is potential for instability. Were Ortega to secure another term, or if, possibly, his wife were to succeed him, the radical left agenda would probably gather pace as it as elsewhere.

Relations with neighbouring Honduras will remain strained over the removal of President Zelaya, who is seen as an ally of the radical left, but outright military action is unlikely. Relations with the US and EU are also strained, partly because of alleged irregularities in the 2008 municipal elections but also because of the leftward drift. This will reduce budgetary support.

Economic Stability

The economy is vulnerable to the vagaries of both commodity prices and natural disasters (agriculture still accounts for 18% of GDP and manufacturing 18%) and is relatively energy intensive. Growth performance has been weak with annual average growth of real per capita GDP of 1.6% in the past ten years, leaving Nicaragua in the low income group of economies (World Bank classifications).

Real GDP grew by an annual average 4% in 2003-08, but there was a marked slowdown in Q1 2009 followed by a sharp contraction in Q2 in the wake of the global financial crisis and recession. Consumer spending has been hit by lower commodity prices and a fall in workers remittances (which are the equivalent of 13% of GDP) and investment has the additional uncertainty of a radical left leadership as well as the external environment. Government investment is constrained by delays in official financing from abroad. Overall we expect GDP to contract by 3.5% in 2009, followed by modest growth of 2% in 2010, as US demand recovers.

The non-financial public sector fiscal balance (including external grants) was in small deficit (-0.7% of GDP) in 2008, after two years of small surpluses. Data for the first seven months of 2009, however, point to a large deficit having emerged, probably in excess of 5% of GDP, as revenues have fallen, while expenditure has continued to increase, though public investment has slowed, partly a reflection of lower official aid inflows so far in 2009. The preliminary staff agreement with the IMF on the PRGF second and third review is contingent on progress on budget adjustment. A key element of this is the tax changes that the government are proposing/discussing with various sectors, but which are likely to

encounter opposition. Nonetheless, it seems likely that some of the deficit reduction measures will be implemented and the PRGF will probably remain in place. There is also a small quasi-fiscal deficit of the central bank of around 1% of GDP. The increased deficit in 2009-10 will raise the public debt-GDP ratio to a very high 85%.

Monetary policy is geared to increasing net international reserves within a crawling peg exchange rate regime. There was a fall in international bank lending in the global crisis, but exposure through portfolio flows and directly to "toxic" assets was very limited. Overall FX reserve loss was limited, though monetary growth has fallen rapidly, as the central bank has issued short term USD denominated debt to maintain reserves. Broad money grew by around 1% yr/yr in August compared with 18-20% yr/yr at the latest peak and real domestic credit growth has been negative for some time. Inflation has also fallen rapidly. The headline CPI in August fell by 0.1% yr/yr, compared with latest peak inflation of 23.9% yr/yr in August 2008, though underlying inflation persists in low single digits. We expect inflation to be close to zero at end-2009 and to rise to 5% by end-2009. Interest rates have only recently begun to fall, but recent additions to FX reserves (via the IMF's SDR issue) should assist a more expansionary monetary policy (assuming that official external financing can be maintained, which is not assured). The exchange rate crawl has been set at 5% for some time and is likely to be maintained at this pace. The exchange rate is not strongly overvalued.

The chronic trade deficit widened steadily to 34% of GDP in 2008, but as domestic demand has fallen imports have slumped, more than offsetting the fall in exports as global demand and commodity prices fell. Remittances have also fallen in 2009 (in contrast to strong growth in recent years). Nonetheless the current account deficit should narrow to 12% of GDP in 2009 from 23.2% in 2008, before widening slightly to 15% in 2010. Net FDI inflows are set to fall in 2009 and may cover less than 25% of the current account deficit in 2009-10. External financing requirements will have to be met almost entirely from official sources. This depends on maintaining the PRGF and a balance politically between the centre- and radical-left as far as traditional donors are concerned, though Venezuela continues to provide support. How much support is available from this source, however, will depend on oil prices and there is a clear risk that political developments could disrupt the overall official flows on which a sustainable balance of payments depends.

Having qualified for full debt relief under the HIPC and MDR initiative, the external debt stock had fallen to 70% of GDP and 107% of exports of goods and services at end-2008 (from 155% and almost 400% respectively in 2001) but both will rise in 2009-10, to 80% and 120% respectively. However, as much of the debt is owed to the official sector and is on concessional terms, interest payments as a proportion of exports of goods and services are only 2%.

Structural Business Environment

The Structural Business Environment is well below average in our assessment.

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Charts

