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NICARAGUA

PROGRAM TO IMPROVE PRODUCTIVITY IN NICARAGUA II

(NI-L1096)

LOAN PROPOSAL

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ABBREVIATIONS

BCN	Central Bank of Nicaragua
BFP	Banco de Fomento de la Producción [Production Development Bank]
BRM	Bank Resolution Mechanism
CONAMI	Comisión Nacional de MicroFinanzas [National Microfinance Commission]
IAAC	Inter-American Accreditation Cooperation
IMF	International Monetary Fund
MEFCCA	Ministry of Family, Community, Cooperative, and Associative Economy
MHCP	Ministry of Finance
MIFIC	Ministry of Development, Industry, and Trade
OECD	Organization for Economic Cooperation and Development
ONA	National Accreditation Office
PBL	Policy–based loan
PCU	Program Coordination Unit
PNDH	Plan Nacional de Desarrollo Humano [National Human Development Plan]
ProCompetencia	National Institute for the Promotion of Competition
RAAN	Atlántico Norte Autonomous Area
RAAS	Atlántico Sur Autonomous Area
RDI	Research, development, and innovation
SIBOIF	Superintendency of Banks and Other Financial Institutions
SMEs	Small and medium-sized enterprises
TFP	Total Factor Productivity
VUCEN	Ventanilla Única de Comercio Exterior de Nicaragua [Nicaragua’s One-Stop Window for Foreign Trade]
VUIs	Ventanillas Únicas de Inversión [One-Stop Windows for Investment]
WEF	World Economic Forum

PROJECT SUMMARY

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(NI-L1096)

<table>
<tr><th colspan="6">Financial Terms and Conditions</th></tr>
<tr><td colspan="3">Borrower: Republic of Nicaragua</td><td></td><td>OC</td><td>FSO</td></tr>
<tr><td colspan="3" rowspan="2">Executing agency: Ministry of Finance</td><td>Amortization period:</td><td>30 years</td><td>40 years</td></tr>
<tr><td>Grace period:</td><td>5.5 years</td><td>40 years</td></tr>
<tr><td>Source</td><td>Amount (US$)</td><td>%</td><td>Disbursement period:</td><td>1 year</td><td>1 year</td></tr>
<tr><td>IDB: Ordinary Capital (OC)</td><td>39,000,000</td><td>60</td><td>Inspection and supervision fee:</td><td>[a]</td><td>N/A</td></tr>
<tr><td>IDB: Fund for Special Operations (FSO)</td><td>26,000,000</td><td>40</td><td>Interest rate:</td><td>SCF-Fixed[b]</td><td>0.25</td></tr>
<tr><td rowspan="2">Total</td><td rowspan="2">65,000,000</td><td rowspan="2">100</td><td>Currency of approval:</td><td>U.S. dollars</td><td>U.S. dollars</td></tr>
<tr><td>Credit fee:</td><td>[a]</td><td>N/A</td></tr>
</table>

<table>
<tr><th colspan="7">Project at a glance</th></tr>
<tr><td colspan="7">Project objective/description: The general objective of the program is to improve productivity in Nicaragua. This objective will be achieved through the execution of a productivity improvement program that has four specific objectives: (i) maintaining a stable macroeconomic environment consistent with the program objectives; (ii) strengthening financial regulation so as to improve access to financing for companies and production-oriented projects; (iii) enhancing the business climate and competition; and (iv) strengthening institutions for productive development.

This is the second of two consecutive operations, technically linked but financed separately, under the modality of a programmatic policy-based loan.</td></tr>
<tr><td colspan="7">Special contractual conditions precedent to the single disbursement of the loan proceeds: The disbursement of the proceeds of the Bank's loan will be contingent upon the borrower's fulfillment, to the Bank's satisfaction, of the policy reform commitments, which are described in the program components and are included in the Policy Matrix (Annex II), as well as fulfillment of the other conditions set forth in the loan contract (paragraph 3.2).</td></tr>
<tr><td colspan="7">Exceptions to Bank policies: None.</td></tr>
<tr><th colspan="7">Strategic Alignment</th></tr>
<tr><td>Challenges:[c]</td><td>SI</td><td>☐</td><td>PI</td><td>☑</td><td>EI</td><td>☑</td></tr>
<tr><td>Crosscutting themes:[d]</td><td>GD</td><td>☐</td><td>CC</td><td>☐</td><td>IC</td><td>☑</td></tr>
</table>

[a] The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with applicable policies.

[b] The borrower will pay interest on the outstanding balances of this portion of the Ordinary Capital at a LIBOR-based rate. When the outstanding balance reaches 25% of the net approved amount or US$3 million, whichever is greater, the base rate will be set on that balance.

[c] SI (Social Inclusion and Equality), PI (Productivity and Innovation), and EI (Economic Integration).

[d] GD (Gender Equality and Diversity); CC (Climate Change and Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. PROJECT DESCRIPTION AND RESULTS MONITORING

A. Background, problem to be addressed, and rationale

1.1 **Background.** This project is the second in a series of two programmatic policy-based loans (PBLs) aimed at improving productivity. This series of programmatic loans originated in 2014 (loan 3177/BL-NI) and was agreed upon with the Government of Nicaragua to provide support for a set of structural measures intended to improve the productivity of the Nicaraguan economy as a whole.

1.2 Specifically, this operation supports policy reforms with the concrete objectives of strengthening financial regulation to eliminate structural barriers that affect the ability of companies to access financing, enhancing the business climate and competition, and strengthening the institutions that promote productive development. These objectives are similar to those in programmatic loan 3177/BL-NI approved in 2014, which established the program's main legal and institutional reforms. That loan was disbursed the same year, as its conditions precedent had been met. This second program consolidates the policy reforms, which have made significant progress to date: (i) improvement of financial regulation, particularly in terms of the regulation and supervision of microfinance institutions and financial transparency; (ii) technological and operational improvements in the Banco de Fomento de la Producción [Production Development Bank] (BFP) as a public tool for supporting the competitiveness of key sectors in the country; (iii) simplification of foreign trade and company registration processes; (iv) the country's competitiveness and consumer protection framework; and (v) restructuring of the key institutions involved in productive development. The second operation accounts for 16% of the country's external financing needs for 2016, which are estimated to total US$406.25 million.[1]

1.3 **Macroeconomic context.** In recent years, Nicaragua has been able to maintain a solid, stable macroeconomic position, which should continue in the short and medium term. Economic growth has been sustained, averaging 4.8% over the last five years, reaching 4.9% at the end of 2015. The fiscal deficit of the nonfinancial public sector is moderate at 1.6% of GDP in 2015; public debt, as a percentage of GDP, is sustainable and has been declining, from 49.1% in 2014 to 48.1% in 2015. Inflation continued its downward trend, closing the year at 3.05%. The current account deficit fell to 7.8% of GDP (2015 estimate), compared to its historical levels exceeding 10% of GDP. General and extreme poverty levels dropped significantly, to 29.6% and 8.3% in 2014, compared to 42.5% and 14.6% in 2009, respectively. Recently, the International Monetary Fund (IMF) concluded the 2015 Article IV consultation, noting a positive economic performance in 2015 and a favorable medium-term outlook. This was reflected in the country's sovereign risk rankings in 2015,[2] highlighting the positive economic growth trend, a prudent fiscal policy, low crime rates, and partnerships between the government and the private sector. The main vulnerabilities are related to the international environment, particularly the financial slowdown of the country's main trading partners, the volatility of oil and commodities prices, and adverse climate conditions. The IMF also stressed the need

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[1] Financing needs are calculated as a deficit after contributions from the central government and amortization of public debt (external and internal). The source of this data is the Medium-Term Budget Framework 2016-2019, published by the Ministry of Finance.

[2] For the first time ever, Fitch Ratings and Standard and Poor's gave the country a credit rating (B+, with stable outlook). Other countries with the same rating include El Salvador, Angola, Uganda, and Armenia.

to make improvements in the following areas: (i) supervision and regulation of the financial system, in order to increase the productive sector's access to financing without affecting macroeconomic stability; and (ii) competitiveness of the productive sector, to diversify exports and reduce the economy's vulnerability to external shocks.[3]

1.4 **Productive context.** The country's economic structure is based on small, low-productivity companies, most of which are informal and coexist with large companies, primarily in the agroexport sector.[4] In Nicaragua, micro, small, and medium-sized enterprises (MSMEs) represent more than 90% of the business universe, contribute close 40% of GDP, and generate approximately 60% of jobs.[5] The low level of productivity of smaller companies reduces their integration into value chains, particularly the more productive chains geared to the external market, where technological requirements are greater. At the same time, for companies that are downstream in the chain, this situation limits the possibility of having efficient local suppliers. Moreover, when smaller companies are able to access the value chains, their poor performance may affect the performance of the entire chain. Indeed, data from the World Economic Forum (WEF)[6] show that in Nicaragua the integration of companies into the value chain and the very competitiveness of those chains are low compared to levels in other countries in Latin America and the Caribbean. If local supplier quality and quantity indicators are taken into account, Nicaragua ranks 129th in the world, only ahead of Haiti with respect to Latin American and Caribbean countries. In terms of the depth of the value chains, Nicaragua ranks 128th in the world, behind all countries in Latin America and the Caribbean. These figures are not insignificant, considering the preponderance of value chains in the modern economy. Numerous studies show that the value chain is the way in which productive activity is organized and competes at the domestic and international level.[7] Therefore, making progress in the productivity of relatively smaller companies is an important factor in improving access and the productivity and competitiveness of value chains and the Nicaraguan economy.

1.5 Within value chains, the importance of agricultural chains should be underscored, given the country's productive structure. The agricultural sector plays a leading role in the Nicaraguan economy, accounting for around 18.5% of GDP,[8] 60% of jobs, and 75% of exports. However, a substantial percentage of the companies that participate—or could participate—in these chains suffer from low uptake of technology and little investment in fixed assets, among other factors, which hinders the efficient performance of these chains and progress toward links with greater value added.[9] Nicaragua participates in the primary links of the agricultural chains, mainly as a supplier of commodities. The high percentage of agricultural products in

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[3] IMF Article IV, 2016.

[4] IMF Article IV, 2012.

[5] Central Bank of Nicaragua, "Microfinance and Small and Medium-Sized Enterprises in Nicaragua," Working Documents, 021, 2012.

[6] WEF, Global Competitiveness Report 2015-2016.

[7] See for example *OECD, Moving up the value chain: staying competitive in the global economy, 2007; Brewer, P. and T. Speh, "Using the Balance Scorecard to Measure Supply Chain Performance." Journal of Business Logistics 21(1):75-94, 2000.*

[8] Compared to 14% for industry and 53% for services (Central Bank of Nicaragua, 2014).

[9] See loan 3042/BL-NI for more information on agricultural value chains in Nicaragua.

Nicaragua's exports and the poor quality of these exports,[10] together with low technological and innovation capacities in the country (see paragraph 1.19), are reflected in the limited complexity of the productive structure, which in turn limits economic growth.[11] In 2014, Nicaragua ranked 96th out of 124 on the Economic Complexity Index, which is worse than the previous year, and is only ahead of Ecuador, Bolivia, and Venezuela in Latin America and the Caribbean.

1.6 **The productivity problem.** With a per capita GDP of US$1,904.7 in 2014,[12] Nicaragua was the second least developed country in the region, after Haiti. Promoting growth is key to improving living standards and continuing to reduce poverty in the country. In this regard, improving the total factor productivity (TFP) of the Nicaraguan economy plays an essential role. Numerous studies report on the key importance of productivity for economic growth.[13] These studies show that differences between the economic growth levels of different countries and regions can fundamentally be explained by their different levels of productivity. In Nicaragua, since the early 1990s, the contribution of TFP to growth has been negative (an annual average of -0.3%),[14] and growth has been based primarily on increases in labor input. In order to boost sustained economic growth in the country, the Government of Nicaragua has undertaken a structural reform agenda to improve the country's productivity, expand the productive capacities of enterprises, and strengthen all value chains that make up the Nicaraguan economy. The promotion of value chains is in line with the dual objective of: (i) improving the productivity of Nicaraguan companies by integrating them into these chains;[15] and (ii) moving toward segments with greater value added in the chains, which will in turn lead to greater economic growth.

1.7 **Reform priorities.** In keeping with the diagnostic assessments[16] and recommendations of multilateral organizations,[17] the first operation identified three reform areas for increasing productivity in the country: (i) stability, access, and efficiency in financial intermediation; (ii) business climate and competition; and (iii) institutions and policies for productive development. This operation continues the support provided to the Government of Nicaragua in the identified reforms, which are fully consistent with the country's National Human Development Plan (PNDH) 2012-2016. The progress made in the first operation as well as the reforms included in the second operation in each of the three reform areas are presented below.

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[10] IMF Article IV, 2016.

[11] Measured in terms of the diversity of exported products and the number of countries that export the same products (see *Hausmann, R. et al., The Atlas of Economic Complexity*, *Center for International Diversity, Harvard University, 2013*).

[12] Central Bank of Nicaragua, "Nicaragua in Numbers," 2014.

[13] For a review of the literature, see "Support to SMEs, Financial Access/Supervision Sector Framework Document," IDB, 2014.

[14] Johnson, C. (2013), "*Potential Output and Output Gap in Central America, Panama and Dominican Republic," IMF Working Paper*, WP/13/145.

[15] Recent studies demonstrate the relationship between a company's participation in the value chain and its level of productivity (See *UNCTAD, "World Investment Report. Global Value Chains: Investment and Trade for Development," 2013*).

[16] See Agosín et al. (2009). *Nicaragua: Remembrance of the growth past,* Chapter 7 in Agosín et al., *Growing Pains. Binding constraints to productive investment in Latin America*. See also Swiston, A. and L. Barrot (2012), *"The Role of Structural Reforms in Raising Economic Growth in Central America," IMF Working Paper*, WP/11/248.

[17] IMF Article IV, 2012.

1. Strengthening financial regulation to improve productivity

1.8 The level of development of financial systems has a significant effect on productivity because it: (i) seeks to better allocate the capital factor toward projects yielding better returns; and (ii) reduces the impact of volatility and macroeconomic shocks.[18] Data from 2014 show an increase in financial depth in Nicaragua: that year, domestic lending to the private sector as a percentage of GDP was around 34%, compared to an average of 29% for the period 2011-2013.[19] Because of this improvement, access to financing fell from first among the biggest obstacles to the performance of activities, as reported by the private sector, to fifth place, behind areas such as infrastructure and job training.[20] The reforms implemented in the first operation were aimed at improving the productive sector's access to financing, while at the same time maintaining the stability of the financial system through improvements in regulation and supervision. The second operation continues with this line of reforms, focusing on the following areas: (i) improving micro and macroprudential regulation; (ii) improving financial transparency and developing a new framework to promote long-term financing; (iii) improving the collateral system; and (iv) improving the efficiency and operations of Public Development Banking.

1.9 **Improving micro and macroprudential regulation.** Effective supervision of the financial system is essential for avoiding crises, the effects of which undermine the confidence of financial sector agents, limiting the expansion of the deposit base, the potential growth of intermediation, and the availability of medium- and long-term financing.[21] The importance of financial regulation is also indicated in the analyses evaluating the effects of structural reforms on the growth of productivity in Central America[22] and in developing countries,[23] which emphasize financial regulation and supervision as one of the factors with the greatest impact on economic growth and productivity in lower-middle income countries. To strengthen this area, the first operation envisaged reforms in macro and microprudential regulation.

1.10 At the macroprudential level, two reforms were adopted to improve the ability to manage the risks affecting the Nicaraguan financial system as a whole. First, basic principles were defined for the operation of an organization aimed at analyzing and reporting on actions intended to regulate the entire financial system, particularly systemically important financial institutions. Coordination between the entity responsible for prudential regulation, the Superintendency of Banks and Other

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[18] See Cavallo, E. et al. (2013), *"The Role of Relative Price Volatility in the Efficiency of Investment Allocation," Journal of International Money and Finance* 33, 1-18.

[19] Data from *Global Development Finance Indicators*. This increase is explained by the increase in the demand for financing, primarily for consumption and services, together with the improvement in lending indicators, which provided incentives for providing financing (Fitch, 2014).

[20] Access to financing was indicated as the primary obstacle to doing business in the country by the World Economic Forum (2013), "Global Competitiveness Report." However, for the MSME segment, access to financing continues to be the primary obstacle to doing business. The results of the surveys conducted by the Consejo Superior de la Empresa Privada [High Council for Private Enterprise] (COSEP, 2015) show that 51% of these enterprises state that they have problems obtaining credit, and 82% say they use their own resources as their main source of financing.

[21] For example, nearly half of the differential between the region and the most advanced economies and other developing regions is due to the effects that the banking crisis had on financial intermediation in terms of higher spreads and risk aversion. See de la Torre, A. et al. (2012), Financial Development in Latin America and the Caribbean, Washington, D.C.: World Bank.

[22] See Swiston, A. and L. Barrot, (2012), op cit.

[23] See Norris, D. et al. (2013), *"Reforms and Distance to Frontier," IMF Discussion Note, Technical Appendix.*

Financial Institutions (SIBOIF), and the entity responsible for monetary policy, the Central Bank of Nicaragua (BCN), is a fundamental tool of macroprudential policy. This policy is in turn based on the information collected by both institutions, which are also the main recipients of the reports and stress tests conducted with that information. Second, a Bank Resolution Mechanism (BRM) was defined, establishing the responsibilities of the various regulatory agencies in terms of intervention, resolution, and liquidation, the coverage target for the FOGADE reserve fund [Deposit Guarantee Fund], and procedures and timeframes in the event of the takeover of an institution. The second operation will consolidate these reforms through: (i) the operational startup of the Financial Stability Committee; and (ii) the operational startup of the BRM.

1.11 At the microprudential level, the SIBOIF was strengthened in the area of risk-based regulation and supervision, with the approval of the regulatory framework for risk management to be used by financial institutions. In addition, the Comisión Nacional de MicroFinanzas [National Microfinance Commission] (CONAMI) approved regulations in the area of credit risk, registration, and internal and external audits. This helped improve the risk regulation and supervision of each financial institution, and move forward in ensuring compliance with the Basel I and II principles. In the second operation, progress will be made with this line of reforms through: (i) the development and implementation of a risk-based supervision manual by SIBOIF and CONAMI; (ii) the use of international financial accounting standards in banking institutions; (iii) the entry into force of liquidity risk and leverage ratio regulations for banking institutions; (iv) reform of credit risk regulations and issuance of technological risk regulations by CONAMI; and (v) the implementation of a single accounts manual adapted to microfinance by CONAMI, to standardize information from microfinance institutions.

1.12 **Improving transparency and developing new financial instruments.** Prior to the first operation, Nicaragua had one of the highest levels of banking concentration in the region (in 2012, the assets of the five largest banks represented 95% of total system assets, a figure much higher than the average for the region and for low-income countries, at 78% and 87%, respectively). By 2015, these levels had fallen to 79%, which is about average for Latin America.[24] In 2014, interest rate spreads remained very high: 12.5%, compared to the regional average of 6.8%. In order to increase efficiency and competition in the banking system, a series of reforms were identified in the first operation to increase consumer protection and promote greater transparency, as well as financing mechanisms representing alternatives to bank loans. Along these lines, financial transparency rules were approved that establish the type and deadlines for information to be delivered by financial institutions to their clients, along with procedures for complaints and unfair terms in the banking and microfinance sectors. In addition, exchange invoices were regulated to promote factoring as a supplier financing instrument, defining the procedure, timeframes, and responsibilities for its use. Thus, the country already has an approved legal framework to offer financing through factoring, giving SMEs additional liquid assets that can be used to enhance their financing. The second operation will consolidate these reforms through an evaluation of competition in the financial system conducted by SIBOIF in order to identify new policy measures to continue to promote competition and consumer protection, as well as the entry into effect of the law on public-private partnerships, which, in line with international standards, promotes

[24] IMF Article IV, 2016.

long-term financing in the country through new financing structures based on risk management shared by the public and private sectors.

1.13 **Improving the operation of public banking.** Nicaragua has a public development bank, the Banco de Fomento de la Producción [Production Development Bank] (BFP) that began operating in 2010 with the mandate to provide financing to the productive sectors, supplementing the activities of the commercial banking system[25] where market failures create credit rationing problems for the productive sectors. These sectors notably include those in rural, primarily agricultural areas, where the risk and costs of financial intermediation are higher, limiting the ability of small and medium-sized producers to increase the volume and quality of their output and thus integrate into chains with greater value added.[26] The first operation identified the need to help the BFP strengthen its institutional framework, internal efficiency, and risk management and business development capacities. To this end, the following events took place: (i) SIBOIF approval of regulations requiring the evaluation and classification of BFP assets, eligibility criteria for borrowers, and procedures for the management of internal risks; and (ii) approval of BFP's internal rules in the area of process management, including the assessment and management of lending and recovery, and strengthening technological capabilities for process management. These reforms helped improve the BFP's administrative efficiency (administrative expenses over total revenues) by 12 percentage points between 2012 and the last quarter of 2015 (from 33% to 21%). Furthermore, in order to have a greater impact in the country's productive sectors, in 2015 the BFP was converted to a joint venture authorized to issue shares so as to include private partners. The second operation will consolidate these reforms by making procedural[27] and technological[28] improvements in the BFP and formulating a strategic plan for the BFP that defines medium-term priority action areas and instruments.

1.14 **Improving creditor protection and the collateral system.** Creditor protection is a central element for access to financing.[29] Nicaragua falls below the regional average in terms of protecting the legal rights of creditors and borrowers.[30] Although it has a better performance than other countries in the region in terms of the potential for

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[25] The BFP is the heir to the important work done by Financiera Nicaragüense de Inversiones [Nicaraguan investment fund] (FNI) and Fondo de Crédito Rural [rural credit fund] (FCR), which were created in the 1990s.

[26] See Coon, J, A. Campion, and M. Wenner, 2010. *Financing Agricultural Value Chain in Central America*. Technical Note IDB-TN-146.

[27] Including: (i) reengineering of the credit process; (ii) reengineering of the trust process; (iii) changes in disbursement modalities (through commercial banks) and digital payment receipt applications; (iv) definition of the loan pay-off process; (v) definition of the process for safeguarding assets, collateral, and legal documents; (vi) improvements to streamline payment processes (electronic platforms); (vii) changes in organizational structure based on the BFP strategy; and (viii) automation of processes.

[28] Including: (i) upgrades of portfolio, collateral, and loan modules (new banking core); (ii) control and administration of trust projects for group lending; (iii) creation of a guarantor module (trusts); (iv) official approval of management reports; (v) automation of SIBOIF and Validator regulatory reports; (vi) defining the parameters of loan payment plans and operational processes; (vii) automation of loan contracts; (viii) implementation of e-commerce platform; and (ix) implementation of the new website.

[29] For a review of the effects of creditor protection on access to finance, see Djankov, S. et al. (2008), *"Debt enforcement around the world," Journal of Political Economy* 116 (6), 1105-1149.

[30] According to data from *Doing Business*, in 2016 Nicaragua ranked 150th in the world in the area "Resolving Insolvency," scoring 4 out of 10 on the indicator, well below the countries with the best performance in Latin America and the Caribbean (Colombia and Mexico, which scored 7.2 and 5.8 points, respectively) and the regional average of 4.9.

using or recovering collateral in cases of default, its position in international rankings has significantly worsened in recent years.[31] The absence of a flexible system for recovering and utilizing collateral causes the collateral required by the banks to be excessively high,[32] making access to credit enormously difficult, particularly for new companies, companies in more innovative sectors that are not very dependent on physical capital, or companies in sectors with property records problems (the agricultural sector, for example). These reforms are also highly complementary to the business climate reforms described in the next section, particularly in the area of property records and commercial reforms. To improve creditor protection, the first operation promoted the establishment of a preliminary draft law on secured transactions, based on consensus with the private sector and following the principles and practices defined by the international standards of the Model Inter-American Law on Secured Transactions, approved in connection with the Inter-American Specialized Conference on International Private Law (CIDIP) of the Organization of American States (OAS). The objective of the second operation is to consolidate this reform through the entry into effect of the law on secured transactions.

2. Enhancing the business climate and competition

1.15 **Business climate, competition, and productivity.** The business climate is a key variable for improving productivity and lowering transaction costs in company operations and throughout the value chains, as well as for improving the integration of companies in such chains.[33] The significant interplay among reforms to improve the business climate suggests that an organized reform incorporating various measures intended to strengthen the country's business climate as a whole will have greater impact.[34] Recent evaluations of structural business climate reforms show highly significant effects on productivity and growth.[35] Key issues such as simplification of the regulatory burden, promotion of competition, and strengthening of consumer protection were addressed in the first operation. The results of these reforms helped improve the country's performance indicators in these areas. For example, Nicaragua moved up seven places in the global ranking of ease of doing business (World Bank's *Doing Business* 2015 report).[36] This report highlighted improvements in starting a business (20 positions), trading across borders (3 positions), and enforcing contracts (1 position). The second operation continues this line of reforms as follows: (i) regulatory improvement and simplification of

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[31] According to data from *Doing Business* for 2016, contract performance in Nicaragua takes 519 days, below countries such as Costa Rica (852 days), Panama (686 days), and Colombia (1,288 days). However, between 2013 and 2016 Nicaragua declined even further on this indicator, increasing from 409 days in 2013 to 519 days in 2016.

[32] According to data from *Enterprise Surveys*, companies report that the collateral required averages nearly 250% of the face value of the loan, much higher not only than the average in low income countries (231%), but also the average for the developing countries in the region and other Central American countries such as Honduras, El Salvador, and Guatemala.

[33] Arias-Ortiz, E. et al. (2013), "Productivity in Services: Does the Business Climate Matter? New Evidence from LAC Microdata." Mimeo, Washington, D.C.: Inter-American Development Bank.

[34] See for example Love, I. and L. Klapper, (2010), "The Effect of the Business Environment on New Firm Registration," World Bank Working Paper.

[35] These effects are quantitatively important. The results show that business climate reforms may lead to increases in output and TFP, ranging from 20% to 58% and from 7% to 19%, respectively. See Norris, D. et al. (2013), op cit.

[36] *Doing Business* measures how easy it is to do business in a country based on existing regulations. This index is prepared from observations of 11 areas affecting the operation of a company, starting with its creation.

procedures; and (ii) strengthening governance of regulations in the area of competition and consumer protection.

1.16 **Regulatory improvement and simplification of procedures.** The excessive regulatory burden entails an unnecessary cost for companies, discouraging them from entering the formal domestic and international markets, making their operations more costly, and hindering their participation in value chains. In order to reduce this burden, certain measures were adopted in the first operation in order to: (i) improve the procedures for the creation and operation of companies by introducing a plan to reduce the time and procedures involved in registering companies, through the creation of a single registration document and one-stop windows for investment (known by their Spanish-language acronym, VUI) in seven municipios, in order to simplify registration, formalization, and technical assistance procedures; and (ii) simplify and automate foreign trade procedures through the execution of interagency agreements to facilitate the operation of Nicaragua's One-Stop Window for Foreign Trade (VUCEN). The second operation will include measures to continue simplification processes in the areas of registering property, paying taxes, and trading across borders; the startup of operations of VUIs in the seven municipios and the startup of operations of the VUCEN, thereby simplifying, coordinating, and automating foreign trade procedures so as to increase integration into global value chains.

1.17 **Improving competition and consumer protection.** Increased competition promotes incentives for the growth of more productive companies, as well as more efficient business management.[37] The regulatory framework for competition in Nicaragua is relatively young: the Competition Law in Nicaragua was enacted in 2006 and the relevant authority (ProCompetencia) began operations in 2009,[38] and the country has made significant efforts to develop the effectiveness of its antitrust policy and the extent of market dominance of large business groups.[39] The first operation focused on: (i) institutional strengthening of ProCompetencia through separation of its investigation and enforcement roles; and (ii) approval of a consumer protection law to better enable users to file complaints and change utility companies and increase the transparency of company information regarding their products and services. Despite the progress made in this area, it is important to continue on the path of reforms in the sector, in order to raise the level of competition in Nicaragua's domestic market. For example, according to international indicators, the country ranks 119th out of 144 in the extent of market dominance and 108th out of 144 in the effectiveness of antitrust policies (the WEF's Global Competitiveness Report 2014-2015). The second operation plans to continue supporting the country in terms of strengthening the institutional capacity of ProCompetencia, particularly through the introduction of a human resources policy and training in the analysis and

[37] Empirical evidence on the relationship between competitiveness and productivity in Holmes, T. and J. Schmitz, (2010), "Competition and Productivity. A Review of Evidence," Federal Reserve Bank of Minneapolis.

[38] ProCompetencia has monitored the competitive practices that it addressed between 2009 and 2014, i.e., 56 cases of major significance including 28 involving unfair competition, 10 on price-fixing, and 7 involving mergers. In terms of support for MSEs, it has conducted training throughout the country on the economy and competition laws, and has actively researched obstacles and extent of exclusion from the market experienced by these smaller enterprises.

[39] Since 2006, Nicaragua has improved its rankings in the WEF's indicators of effectiveness of antitrust policy and extent of market dominance, moving from 116th and 112th place in 2006, to 100th in both indicators in 2013.

development of sector competition indicators, following the best practices established by the Organization for Economic Cooperation and Development (OECD).

3. Strengthening institutions for productive development

1.18 Increasing productivity requires the existence of efficient institutions capable of developing policies to: (i) identify the market failures impeding efficient allocation of the economy's resources to the most productive companies and projects; and (ii) design, implement, and evaluate effective public policies to remedy those failures.[40] Nicaragua has made progress toward creating an institutional framework to promote different areas related to productive development. An essential step in this regard was the creation of ProNicaragua in 2002 as a project of the United Nations Development Programme (UNDP) intended to boost the socioeconomic transformation of Nicaragua by promoting investments and exports. This organization has successfully helped design and execute productive transformation policies in the country.[41] The first operation in the series implemented actions to build the technical capacities of public institutions to carry out projects intended to promote productive transformation and effectively coordinate public and private sector entities. The second operation continues the reforms in the areas identified in the first operation, i.e.: (i) organizational and strategic development of productive development policies; (ii) strengthening institutions engaged in promoting exports and attracting investment; and (iii) improving science and technology institutions and policies.

1.19 **Organizational and strategic development of productive development policies.** In productive development, the needs of companies and value chains involve subject areas that draw upon a large number of government agencies with different areas of jurisdiction, calling for a high level of coordination and planning, supported by an effective organizational structure and strong technical capabilities.[42] To move forward in that direction, the program's first operation focused on the functional reform of the country's principal agencies responsible for supporting small and medium-sized enterprises (SMEs)—the Ministry of Family, Community, Cooperative, and Associative Economy (MEFCCA) and the Ministry of Development, Industry, and Trade (MIFIC)—in order to prevent duplication of effort, clarify roles, improve coordination, increase coverage, and improve specialization.[43] However, various studies[44] confirm the need to also strengthen these institutions' results-based management capacities and their ability to evaluate projects. The

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[40] For a review of the literature and empirical evidence regarding the relationship between productivity and institutions, see IDB (2010) op cit; IDB (2014), *Sound Policies and Institutions for Productive Transformation,* Macmillan for Washington, D.C.: Inter-American Development Bank, forthcoming.

[41] In 2012 ProNicaragua won the Global Investment Promotion Best Practices (GIPBP) prize awarded by the World Bank.

[42] Ibid.

[43] Since the MEFCCA's creation in 2013, the business promotion and development functions of the General Directorate of Micro, Small, and Medium-Sized Family Enterprise have not been aligned with the corresponding functions at the MIFIC. This reform seeks to organize the institutional framework for SMEs in the country by concentrating SME activities at the MIFIC.

[44] International Fund for Agricultural Development, Inclusion of Small-Scale Producers in Value Chains and Market Access Project, 2014; and the Swiss Agency for Development and Cooperation in Central America, Value Chain Management Manual, 2013.

second operation calls for the institutional strengthening of the MIFIC and MEFCCA in the area of management and evaluation of productive development projects.

1.20 **Strengthening institutions engaged in promoting exports and attracting investment.** Increased foreign direct investment in the country and increased activity of domestic companies in international value chains foster technology transfer, adoption of technical standards, and dissemination of good practices in production.[45] An institutional framework that helps attract investment and promote exports is essential. The first program focused on strengthening ProNicaragua through: (i) the development of its institutional anchorage in government as an autonomous agency; (ii) the functional and organizational distinction between activities to promote exports and activities to attract investments; and (iii) opening offices in the Atlántico Sur Autonomous Area (RAAS) and Atlántico Norte Autonomous Region (RAAN), to help attract investment to those two regions.[46] The second operation envisages the entry into effect of the institutional reform of ProNicaragua, which consolidates it as an independent agency to promote exports and imports, and the entry into effect of strategic plans to attract investment in RAAN and RAAS.

1.21 **Improving science and technology institutions and policies.** Essential conditions for improved enterprise productivity include investment in research, development, and innovation (RDI). There is ample evidence that promoting RDI helps to improve enterprise productivity.[47] The public sector plays a fundamental role in providing such services, given the existence of significant market failures.[48] In Nicaragua, investment in RDI amounts to 0.05% of GDP, below the average in Latin America (0.68%) and the average for OECD countries (2.28%).[49] This program supports the efforts by the Nicaraguan government to promote RDI and coordinate institutions in the national innovation system. Along these lines, the first operation implemented the following reforms: (i) creation of the Comisión de Investigaciones Científicas Prioritarias Nacionales [National Priority Scientific Research Commission] (CPN), to identify priority research needs to accelerate the education and training of the human capital required to develop science, technology, innovation, and entrepreneurship. The CPN has worked to identify areas of knowledge that are essential for executing projects considered by the government

[45] Baltabaev, B. (2014), "Foreign direct investment and total factor productivity growth: new macro-evidence", The World Economy 37(2), 311-334.

[46] ProNicaragua has already decentralized its activities and determined the procedures, costs, and coordination necessary for its offices to operate. The initial estimates based on the cost-benefit analysis performed by ProNicaragua are positive, given that opening these offices will help to attract investment that is currently nonexistent, with expected benefits greater than the cost to operate the offices.

[47] The evidence shows that investments in innovation explain up to 75% of the differences in productivity growth rates, after taking externalities into account (Griliches, 1979). In this regard, Lederman and Maloney (2003) calculated that the social return on innovation is quite high for countries in Latin America. The authors observed an average return of around 60% in middle-income countries such as Mexico and Chile, and for relatively poor countries like Nicaragua. Some estimates show an average return of nearly 100%.

[48] The principal market failures are: (i) existence of public goods; (ii) problems of information asymmetry; and (iii) transaction costs. See Rivas, G. (2010), "How and when to intervene. Criteria to guide interventions to support productive development," Technical Note, Washington, D.C.: Inter-American Development Bank.

[49] For a detailed analysis of the institutional aspect of RDI in Nicaragua and its impact on the country's ability to innovate, see Solís, G. et al. (2012). "Innovación inclusiva y desarrollo tecnológico en Nicaragua" [Inclusive innovation and technological development in Nicaragua], Technical Note, Washington, D.C.: Inter-American Development Bank.

as having very high priority; (ii) strengthening of the national quality system[50] based on the creation of 11 metrology units at the subnational level;[51] and (iii) attention to areas of noncompliance for purposes of recognition of the National Accreditation Office (ONA) by the Inter-American Accreditation Cooperation (IAAC). The second operation envisages the development of a science, technology, innovation, and entrepreneurship strategy to promote priority sectors by creating a Fondo de Impulso a la Innovación [Innovation Promotion Fund],[52] as well as making the resulting adjustments in the metrology units set up at municipal government offices based on a prior assessment, and completing the international recognition of the ONA. The second operation also includes measures intended to strengthen the export and growth capacity of livestock value chains by improving their traceability, a key concern for marketing high quality products, and therefore, incorporating them into more productive international value chains.

1.22 **Government priorities.** The program objective is consistent with the National Human Development Plan (PNDH) 2012-2016 of the Government of Nicaragua, which includes increased productivity as one of its pillars, in order to generate greater economic growth with more social benefits for the poorest populations and reduce inequality. Within its lines of action, the plan recognizes the importance of an institutional and regulatory framework in such areas as financing of production, competition, and simplification of administrative procedures. The PNDH's recognition of the importance of these issues supports the sustainability of the policy reform actions under this program.

1.23 **Strategic alignment.** Although the program is not directly aligned with a specific strategic objective of the IDB Country Strategy with Nicaragua (2012-2017) (document GN-2683), it does contribute to the dialogue on value chains established in the strategy. It is consistent with the Update to the Institutional Strategy 2010-2020 (document AB-3008) and is aligned with the following development challenges: (i) Productivity and Innovation (PI), by improving access to financing for projects that increase the productivity of SMEs in Nicaragua; and (ii) Economic Integration (EI), by strengthening the institutions engaged in promoting exports, integration in global value chains, and attracting investments. Although the program logically presents institutional reform measures that affect a wide range of sectors, it is also aligned with the dialogue on strengthening value chains since it calls for specific actions to

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[50] The system is headed by the MIFIC, which serves as the agency that enforces laws related to quality and has standardization, metrology, and accreditation functions. Quality refers to the characteristics a product, service, or process must have in order to meet customer requirements and expectations, in accordance with established rules and standards.

[51] The 11 municipal metrology units expanded metrology capacities in the territories where the value chains originate, which increased their productive potential. Statistics on the services offered can be found in the Report on the verification of weights and measures of the municipal metrology units.

[52] The Innovation Promotion Fund creates instruments to support innovation, science, technology, and entrepreneurship activities, and will be executed by CONICYT to increase prizes for innovation and prizes that promote activities in the productive sector. The fund will operate through public requests for proposals. The maximum amounts, eligibility criteria, priority areas, and other relevant details will be determined when the pubic requests are launched. The priority sectors are those specified in the National Science, Technology, and Innovation Plan: health, environment and natural resources, energy, agriculture and agroindustry, and information and communication technologies. These sectors were selected based on their potential and alignment with the National Human Development Plan. One of the strategic programs of this plan is science, technology, innovation, and entrepreneurship for the transformation of Nicaragua.

build the capacities of specific sectors and value chains.[53] The program is also aligned with the crosscutting theme of Institutional Capacity and Rule of Law (IC), since it includes institutional reforms aimed at improving the efficiency and capacity of Nicaraguan institutions. Lastly, it is consistent with: (i) the Sector Strategy: Institutions for Growth and Social Welfare (document GN-2587-2); (ii) the Support to SMEs and Financial Access/Supervision Sector Framework Document (document GN-2768-3), which highlights the importance of having appropriate regulatory and institutional frameworks to promote access to financing for the productive sector, thereby raising their level of productivity; and (iii) the Innovation, Science, and Technology Sector Framework Document (document GN-2791-3), which indicates the need to improve the regulatory and institutional framework in order to increase the level of investment in innovation by Latin American and Caribbean countries, thereby helping to make the economy more productive.

1.24 **The Bank's experience and lessons learned.** The program is consistent with the work carried out in the country in the area of: (i) financing for productive development with the BFP (loan 3042/BL-NI), which seeks to improve the inclusion of agricultural producers in value chains in Nicaragua, through greater access to financing; (ii) support for trade facilitation and border integration (loan 3484/BL-NI); and (iii) technical assistance operations to strengthen the financial, science and technology, productive, and foreign trade sectors (operations ATN/OC-12240-RG; ATN/SF-12516-NI; ATN/TI-12253-NI; ATN/FI-12368-NI; ATN/OC-13103-NI; ATN/OC-13105-NI; ATN/KF-13331-NI; ATN/OC-13337-NI; ATN/OC-14201-NI; ATN/OC-14488-NI). The program incorporates the lessons learned by the Bank in the design of policy-based loans, particularly loan 3177/BL-NI, in terms of the importance of: (i) the proper sequencing of reforms; (ii) interest on the part of the country's authorities in promoting a reform agenda and ownership of such reforms; and (iii) support for reforms through technical assistance actions. These lessons have been incorporated into the program design.

1.25 **Coordination with other donors.** The project team has identified activities of other agencies that complement this operation. They include: (i) the European Commission's "Programme to Support Improvement of the Business and Investment Climate in Nicaragua;" (ii) the World Bank's project on "Modernization and Harmonization of the Commercial Regulatory Framework in Nicaragua;" and (iii) the Swiss Agency for Development and Cooperation's project on "Strengthening Institutions and Capacities in the Area of Competition and Consumer Protection Policies," in conjunction with the United Nations Conference on Trade and Development (UNCTAD).

B. Objectives, components, and cost

1.26 **Objectives.** The general objective of the program is to improve productivity in Nicaragua. This objective will be achieved through the execution of a productivity improvement program that has four specific objectives: (i) maintaining a stable macroeconomic environment consistent with the program objectives; (ii) strengthening financial regulation to improve access to finance for companies and production-oriented projects; (iii) enhancing the business climate and

[53] For example, the following measures: (i) measures intended to incorporate analysis and support for value chains in the strategic plans of public development banks; (ii) actions to improve the competitiveness of agricultural and livestock value chains; and (iii) the formulation of action plans and strategies for regional value chains and specific areas in the country, such as regions along the Atlantic where value chains are especially weak in terms of infrastructure and technical capacities.

competition; and (iv) strengthening the institutional framework for productive development.

1.27 **Beneficiaries.** The program's reforms are crosscutting and seek to overcome restrictions on the effective functioning of markets. Given this objective and the broad nature of the reforms, this program is expected to benefit the country's businesses in general.[54] As a result of these reforms, the program is expected to help build capacity in the companies so as to improve their inclusion in domestic and global value chains.

1.28 The program will be executed by means of policy conditions organized in four components. It is expected that they will be fulfilled prior to the operation's presentation to the Board. This includes additional reforms that were not initially included, but are considered essential for achieving the program's objective, especially in the area of strengthening the country's strategic value chains. For more details, see the Comparative matrix and rationale for changes in the second operation. The components and policy conditions are as follows:

1.29 **Component I. Macroeconomic stability.** The objective of this component is to ensure a macroeconomic context that is consistent with the program objectives and Policy Letter guidelines, as set out in the Policy Matrix (Annex II).

1.30 **Component II. Strengthening financial regulation to improve productivity.** The following policy objectives are included in this component: (i) improvement of macroprudential regulation; (ii) improvements in microprudential regulation and supervision; (iii) improvements in transparency and the development of new instruments providing access to financing for productive development; (iv) improvement in the efficiency and functioning of public development banks; and (v) improvements in creditor protection and the collateral system. To achieve these objectives, the operation includes the following reforms: (i) startup of operations of the Financial Stability Committee comprised of SIBOIF and the Central Bank for macroprudential supervision purposes, with the mandate to improve information sharing and the detection of indicators that identify systemic risks; (ii) startup of operations of the Bank Resolution Mechanism (BRM); (iii) development and implementation of a risk-based supervision manual by SIBOIF and CONAMI; (iv) application of regionally harmonized international accounting standards in banking institutions; (v) entry into effect of liquidity risk and leverage ratio regulations; (vi) reform of credit risk regulations and issuance of technological risk regulations by CONAMI; (vii) implementation of a single accounts manual adapted to microfinance by CONAMI, which standardizes information from microfinance institutions; (viii) report on the evaluation of competition in the financial system by SIBOIF; (ix) entry into effect of the Public-Private Partnerships Law, following international best practices; (x) implementation of procedural and technological

[54] A more detailed analysis indicates that the effect may be greater on those enterprise segments that will benefit most directly from the program's measures, notably SMEs, especially those with greater growth potential, which are more affected by the restrictions addressed by the program. SMEs have much less access to banks for financing their investments than large companies do (18% and 43%, respectively) and have to provide a much higher percentage of collateral in order to obtain financing (240% and 200%, respectively). In addition, these differentials are greater than the regional average and the average for lower-middle income countries (World Bank, 2010, *Enterprise Surveys*). Thus, reforms designed to improve the stability of the financial system and the operation of collateral registries such as those considered in this program can be expected to be more beneficial to those companies for which these restrictions are more relevant, such as SMEs.

improvements at the BFP; (xi) formulation of a strategic plan for the BFP, defining the tools and priority areas of medium-term action; and (xii) entry into effect of the law on secured transactions. In turn, this operation calls for the implementation of liquidity risk and leverage ratio regulations, which was not initially included at the beginning of the programmatic series, and is intended to consolidate the progress the country has made in financial regulation.

1.31 **Component III. Enhancing the business climate and competition.** This component relates to the following policy objectives: (i) regulatory improvement and simplification of procedures; and (ii) strengthening of the governance of regulations in the area of competition and consumer protection. To achieve these objectives, this operation includes the following reforms: (i) improvements in the simplification of procedures involving licenses and permits, as measured in the *Doing Business* report in the areas of registering property, starting a business, simplifying the payment of taxes, and trading across borders; (ii) startup of operations of one-stop windows for investment (VUIs) in seven municipios; (iii) startup of operations the one-stop window for foreign trade (VUCEN), thereby simplifying, coordinating, and automating procedures for foreign trade;[55] (iv) development of sector indicators on competition, following the best practices established by the OECD; (v) introduction of a human resources policy and training for ProCompetencia staff; and (vi) analysis of barriers to competition in the tourism, dairy, and lumber sectors. Although it was not initially included, this last action was added in order to carry out actions to improve the competition of the country's strategic productive chains.

1.32 **Component IV. Strengthening institutions for productive development.** This component relates to the following policy objectives: (i) implementing the strategic plan for productive development; (ii) strengthening institutions engaged in promoting exports and attracting investment; and (iii) improving science and technology institutions and policies. To achieve these objectives, this operation includes the following reforms: (i) institutional strengthening of the MIFIC and MEFCCA in the area of the management and evaluation of productive development projects;[56] (ii) entry into effect of the institutional reform of ProNicaragua by creating it as a government agency; (iii) entry into effect of the strategic plans to attract investment in the RAAN and RAAS in order to geographically diversify the destination of foreign investments; (iv) development of a science, technology, innovation, and entrepreneurship strategy to promote priority sectors, through the creation of an Innovation Promotion Fund; (v) making adjustments in the metrology units set up at municipal government offices, based on a prior assessment; (vi) completion of the international recognition of the ONA; and (vii) implementation of a beef production segregation system by the Instituto de Protección y Sanidad Agropecuaria [Institute of Agricultural Protection and Health] (IPSA) aimed at improving livestock traceability. In the dialogue with the country's authorities, the last condition was added to this second operation in the programmatic series due to its particular importance in terms of enhancing the program objective, since it is a measure that is highly capable of guaranteeing the quality of products in the country's livestock

[55] The initial phase of VUCEN implementation will be for public institutions and a pilot group of companies. Then, after making any necessary adjustments based on the first phase, the services offered by VUCENs will be expanded to all companies in the country.

[56] In terms of the MIFIC, this includes improvements in project management procedures and project evaluation methodologies. For MEFCCA, it includes the creation of the project unit and the implementation of a project evaluation methodology.

value chains, thereby improving their ability to be included in international value chains and enhancing their growth potential.

C. Key results indicators

1.33 The key indicators for measuring achievement of the program's general impact will be the contribution of the reforms to GDP growth. GDP growth is expected to be greater with the reforms included in the program compared to scenarios where there are no reforms. The specific objectives of the program will be measured using the following indicators: (i) credit to the private sector as a percentage of GDP; (ii) the strength of the legal rights index; (iii) ease of registering property; (iv) ease of trading across borders; (v) effectiveness of anti-monopoly laws; (vi) ability to innovate; and (vii) investment in science and technology as a percentage of GDP. For more details, see the program's Results Matrix.

D. Economic analysis

1.34 The Economic Analysis of the Program is based on the impact of the program's reforms on GDP growth in the medium term. A simulation analysis projected the estimated effects of the reforms in the financial and business climate area, based on the econometric work of Swiston and Barrot (2012). These results are derived from a regression model in a cross-sectional panel that estimates growth equations, using the generalized method of moments (GMM). The central projection assumes that the reforms will partially close the gap identified in the aforementioned Swiston and Barrot document. In addition, the effects of the reforms are sensitized to the level of costs, growth rates with no reforms, level of effectiveness of the reforms, and the previous scenarios as a whole. Following the Bank standard, the effects of the reforms were discounted at a real rate of 12%, yielding a net present value of the program of US$228.7 million.

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instrument

2.1 This is the second of two consecutive operations, which are technically linked but financed separately under the modality of a programmatic policy-based loan (PBL), to facilitate a fluid policy dialogue between the country and the Bank and allow the timeframes necessary to implement the reforms. The second operation is for an amount of US$65 million. The scale of this operation is warranted due to the country's fiscal resource needs, but has no direct relationship to the costs associated with the program reforms, pursuant to Policy-based Loans: Guidelines for Preparation and Implementation (document CS-3633-1, paragraph 3.27(b)). The country's projected external financing requirements for 2016 are US$406.25 million. This operation will account for 16% of those requirements.

B. Environmental and social risks

2.2 This operation does not require classification under Directive B.13 of the Bank's Environment and Safeguards Compliance Policy (document GN-2208-20 and Operational Policy OP-703). The proposed reforms will not have any negative environmental or social impacts.

C. Sustainability and other program risks

2.3 **Program risk.** The development risk, due to general weaknesses in infrastructure and human capital not addressed by the program that could interfere with the increase in productivity, is medium. However, there is political consensus in the country with regard to the needs in these areas, and improvement projects are under way, including those with Bank support (through the following technical assistance operations: ATN/OC-12240-RG; ATN/SF-12516-NI; ATN/TI-12253-NI; ATN/FI-12368-NI; ATN/OC-13103-NI; ATN/OC-13105-NI; ATN/KF-13331-NI; ATN/OC-13337-NI; ATN/OC-14201-NI; ATN/OC-14488-NI). The Bank will monitor the country's position in the international rankings and attend the multisector coordination meetings held by the executing agency with the relevant agencies. In addition, a request is currently being processed to provide technical cooperation support (NI-T1203) for the government institutions and agencies directly involved in the implementation of the policy reforms agreed upon with the government, and are included in the program's Policy Matrix. The remaining risks are low.

2.4 **Sustainability of the reforms.** This second operation completes the programmatic series that began in 2014. The initiated reforms set the country on a path of sustainable institutional change for the following reasons: (i) the government has made significant investments in terms of human and financial resources and time to develop the regulations envisaged by the program; (ii) the proposed regulatory changes have been adapted to the requirements of diverse interest groups, so as to prevent blockage or paralysis; and (iii) there has been significant technical assistance coordinated by multilateral organizations in the principal legislative reforms which not does not end in this second operation, but will also support the relevant subsequent actions required to properly assimilate the institutional change being promoted.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 The executing agency will be the Ministry of Finance (MHCP), which will appoint the Program Coordination Unit (PCU) responsible for coordinating the entities involved in the execution and delivery of the work plans and semiannual status reports in compliance with the Policy Matrix. The PCU will be the Program Coordination Unit of the MHCP, in conjunction with the relevant government agencies. The key institutions for program design and implementation include the BCN, SIBOIF, CONAMI, BFP, MIFIC, ProCompetencia, ProNicaragua, and MEFCCA. The PCU will periodically monitor the reforms included in the Policy Matrix with these agencies, in order to prepare and send to the IDB semiannual reports on the progress made in fulfillment of the conditions established in the program.

3.2 **Special contractual conditions precedent to the single disbursement of the loan proceeds.** The disbursement of the proceeds of the Bank's loan will be contingent upon the borrower's fulfillment, to the Bank's satisfaction, of the policy reform commitments, which are described in the program components and are included in the Policy Matrix (Annex II), as well as fulfillment of the other conditions set forth in the loan contract**.**

B. Summary of arrangements for monitoring results

3.3 Program implementation will be monitored by the PCU, which will periodically monitor the reforms included in the Policy Matrix, in order to prepare and send to the Bank semiannual reports on the progress made in fulfillment of the conditions established in the program. The borrower and the Bank will hold regular meetings to review fulfillment of the conditions required by the program. At the end of the program, the Bank will prepare a project completion report and an ex post evaluation. Details on the specific objectives and means of verification can be found in the Monitoring and Evaluation Plan. To evaluate the program, the operation recommends the calibration of a computed general equilibrium model for the financial component (Model of Dabla-Norris et al., 2014). It should be noted that the feasibility of this calibration was confirmed through existing exercises for Nicaragua demonstrating its viability, and the availability of data required to recalibrate the model with 2019/20 values was confirmed with the World Bank.

IV. POLICY LETTER

4.1 The Policy Matrix for the proposed program is in line with the Policy Letter issued by the Government of Nicaragua, which reaffirms the government's commitment to implement the activities agreed upon with the Bank.

Development Effectiveness Matrix			
Summary			
I. Strategic Alignment			
1. IDB Strategic Development Objectives	Aligned		
Development Challenges & Cross-cutting Themes	-Productivity and Innovation -Economic Integration -Institutional Capacity and the Rule of Law		
Regional Context Indicators			
Country Development Results Indicators			
2. Country Strategy Development Objectives	Aligned		
Country Strategy Results Matrix			
Country Program Results Matrix	GN-2849	The intervention is included in the 2016 Operational Program.	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)			
II. Development Outcomes - Evaluability	Evaluable	Weight	Maximum Score
	8.5		10
3. Evidence-based Assessment & Solution	9.2	33.33%	10
3.1 Program Diagnosis	3.0		
3.2 Proposed Interventions or Solutions	3.6		
3.3 Results Matrix Quality	2.6		
4. Ex ante Economic Analysis	10.0	33.33%	10
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis	2.5		
4.2 Identified and Quantified Benefits	2.0		
4.3 Identified and Quantified Costs	2.0		
4.4 Reasonable Assumptions	2.0		
4.5 Sensitivity Analysis	1.5		
5. Monitoring and Evaluation	6.2	33.33%	10
5.1 Monitoring Mechanisms	1.3		
5.2 Evaluation Plan	5.0		
III. Risks & Mitigation Monitoring Matrix			
Overall risks rate = magnitude of risks*likelihood	Low		
Identified risks have been rated for magnitude and likelihood	Yes		
Mitigation measures have been identified for major risks			
Mitigation measures have indicators for tracking their implementation			
Environmental & social risk classification	B.13		
IV. IDB´s Role - Additionality			
The project relies on the use of country systems			
Fiduciary (VPC/FMP Criteria)			
Non-Fiduciary			
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:			
Gender Equality			
Labor			
Environment			
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project			
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan			

Note: (*) Indicates contribution to the corresponding CRF's Country Development Results Indicator.

The Program for Improving Productivity in Nicaragua II (NI-L1096), for a total amount of US$ 65 million, is the second operation of a programmatic series of two policy based loans. The objective of the operation is to improve productivity in Nicaragua, through four components: (i) maintaining a stable macroeconomic environment, (ii) strengthening financial regulation for improved access to finance, (iii) improvements in the business climate and competitiveness, and (iv) strengthening the institutional framework for supporting productive development.

The diagnosis is clear and it documents the causes of a negative contribution of total factor productivity (TFP) to the growth of Nicaragua. The diagnosis is also well articulated with the proposed solutions. Indicators in the Results Matrix that are subjective should have been replaced with more reliable indicators.

This second operation maintains the validation of the methodology used for the General Economic Analysis (GEA) during the first operation of the series. Nevertheless, the standards for the estimation of costs and benefits have been improving over time, and the analysis presented in more recent operations is based on general equilibrium models. The monitoring and evaluation plan is adequate for this type of operation and it is comparable to that of similar operations.

The overall risk of the operation is low. Nevertheless, clear mitigation measures should have been established, as well as SMART indicators for the only risk classified as medium, which is related to deficiencies in infrastructure and human capital.

POLICY MATRIX

POLICY OBJECTIVES	AGREEMENTS FIRST OPERATION	AGREEMENTS SECOND OPERATION
Component I: Macroeconomic stability		
Maintaining a stable macroeconomic environment consistent with the program objectives.	Maintain a macroeconomic policy framework consistent with the program objectives.	Maintain a macroeconomic policy framework consistent with the program objectives.
Component II: Strengthening financial regulation to improve productivity		
Improving macroprudential regulation	Establishment of basic principles for the operation of the Financial Stability Committee (FSC), following international best practices. Establishment of basic principles for handling the resolution of financial institutions.	Startup of operations of the Financial Stability Committee. Implementation of the manual for the resolution of financial institutions.
Improving microprudential regulation and supervision	Approval of the regulatory framework for risk management by financial institutions. Approval of rules of the National Microfinance Commission (CONAMI) for regulation and promotion of microfinance intermediary financial institutions, including rules for credit risk management, registration, internal and external audits, and transparency.	Development and introduction of a risk-based supervision manual by SIBOIF and CONAMI. Application of regionally harmonized international accounting standards in banking institutions. Reform of credit risk regulations and issuance of technological risk regulations by CONAMI. Implementation of a single accounts manual adapted to microfinance by CONAMI, standardizing information from microfinance institutions. Entry into effect of liquidity risk and leverage ratio regulations, in accordance with the Basel III principles.
Improving transparency and developing new instruments for access to financing for productive development	Approval of financial transparency rules, including the type and deadlines for the information to be delivered by financial institutions to their clients, the complaints procedure, and unfair terms. Regulations implementing the Exchange Invoice Law.	Preparation and approval of a report evaluating competition in the financial system by SIBOIF. Entry into effect of the Public-Private Partnerships Law, following international best practices.

POLICY OBJECTIVES	AGREEMENTS FIRST OPERATION	AGREEMENTS SECOND OPERATION
Improving the efficiency and operation of public development banking	Reform of the institutional and management framework for the Banco de Fomento de la Producción (BFP), particularly: • Specification of the evaluation and classification of BFP assets by SIBOIF. • Improvements in BFP process management, including assessment and management of lending and recovery. • Strengthening of technological capabilities for process management.	Implementation of procedural and technological improvements at the BFP. Formulation of a strategic plan for the BFP that defines medium-term instruments and priority action areas.
Improving protection for creditors and the collateral system	Preliminary draft law on secured transactions, based on consensus with the private sector.	Entry into effect of the law on secured transactions.
Component III: Enhancing the business climate and competition		
Regulatory improvement and simplification of procedures	Simplification of business registration procedures through a single registration document that incorporates the municipal license, the taxpayer master file (RUC), and the permit from the Nicaraguan Social Security Institute (INSS). Creation of One-Stop Windows for Investment (VUIs) in seven municipios, in order to simplify procedures for registration, formalization, and technical assistance for investment. Execution of interagency agreements to facilitate exports through Nicaragua's One-Stop Window for Foreign Trade (VUCEN).	Improvements in the simplification of procedures for licenses and permits, as measured in the *Doing Business* report in the areas of registering property, starting a business, simplifying the payment of taxes, and trading across borders. VUIs up and running in seven municipios. VUCEN up and running, for the simplification, coordination, and automation of foreign trade processes.
Strengthening the governance of regulations in the area of competition and consumer protection	Institutional separation of the investigation and enforcement roles of the National Institute for the Promotion of Competition (ProCompetencia). Passage by the National Assembly of the Consumer Protection Law, which defines the basic rights of consumers and institutions and mechanisms to ensure their enforcement, following international best practices.	Development of sector competition indicators, following the best practices established by the OECD. Introduction of a human resources policy and training for ProCompetencia staff. Analysis of barriers to competition in the tourism, dairy, and lumber sectors.

POLICY OBJECTIVES	AGREEMENTS FIRST OPERATION	AGREEMENTS SECOND OPERATION
Component IV: Strengthening institutions for productive development		
Implementing the strategic plan for productive development	Improvement of the institutional structure for productive development through: • Functional reform of the agencies responsible for productive development (MEFCCA and MIFIC), to prevent duplication of effort, increase coverage, and improve specialization.	Institutional strengthening of the MIFIC and MEFCCA in the management and evaluation of productive development projects.
Strengthening institutions engaged in promoting exports and attracting investment	Institutional development of ProNicaragua to promote more competitive exports and investments through: • Creation of ProNicaragua as an autonomous government agency. • Functional and organizational distinction between activities to promote exports and activities to attract investments. • Opening offices in the Atlántico Sur Autonomous Region (RAAS) and Atlántico Norte Autonomous Region (RAAN).	Entry into effect of the institutional reform of ProNicaragua by creating it as a government agency. Entry into effect of the strategic plans to attract investment in the RAAN and RAAS, in order to geographically diversify the destination of foreign investments.
Improving science and technology institutions and policies	Creation of the National Priority Scientific Research Commission (CPN), to promote the development of science, technology, innovation, and entrepreneurship, as part of the National Human Development Plan. Creation of 11 metrology units at the subnational level, focused on dimensions of mass and volume. Attention to areas of noncompliance for purposes of international recognition of the National Accreditation Office (ONA) by the Inter-American Accreditation Cooperation (IIAC)	Development of a science, technology, innovation, and entrepreneurship strategy to promote priority sectors, through the creation of an Innovation Promotion Fund. Make adjustments in the metrology units set up at municipal government offices, based on a prior assessment. Completion of the international recognition of the ONA. Implementation of a beef production segregation system by the Institute of Agricultural Protection and Health (IPSA) in order to improve the traceability of livestock.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-___/16

Nicaragua. Loan ____/BL-NI to the Republic of Nicaragua
Program to Improve Productivity in Nicaragua II

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Nicaragua, as Borrower, for the purpose of granting it a financing to cooperate in the execution of the Program to Improve Productivity in Nicaragua II. Such financing will be for the amount of up to US$39,000,000 from the resources of the Single Currency Facility of the Bank's Ordinary Capital, corresponds to a parallel loan within the framework of the multilateral debt relief and concessional finance reform of the Bank, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on __ _________ 2016)

LEG/SGO/CID/IDBDOCS#40705098
NI-L1096

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(Adopted on __ _________ 2016)

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