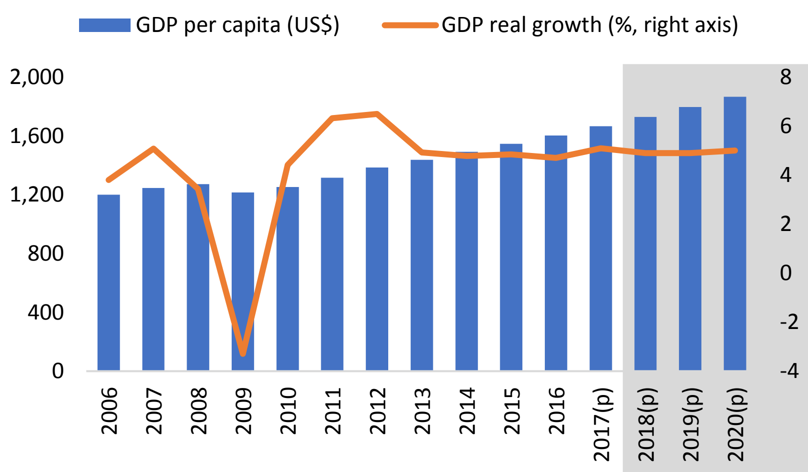
Development Challenges in Nicaragua

Priscilla Gutiérrez and André Martínez

Medium-Term Economic and Social Trends

Nicaragua has experienced dynamic economic growth in recent years, averaging 4.9% from 2013 to 2017, compared to a regional average of 0.9% for Latin America and the Caribbean (LAC). This growth has been supported by favorable external sector conditions and macroeconomic policies that have preserved fiscal, monetary and financial stability. Poverty and inequality in Nicaragua have also declined.

Figure 1. GDP Per Capita and GDP Growth



(p) Projected

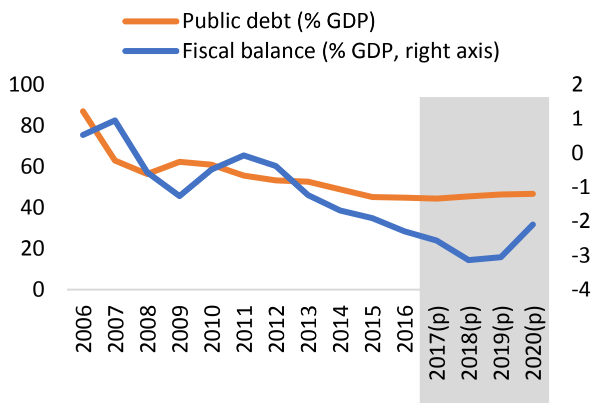
Source: Banco Central de Nicaragua and Ministerio de Hacienda y Crédito Público.

Economic performance has benefited from the external sector, particularly exports, remittances and foreign direct investment (FDI). In the last five years, goods and services exports growth, which averaged 4.4% yearly, has contributed more than a third of GDP growth. In the same period, remittances accounted for 9.6% of the GDP, and they have supported domestic consumption. FDI, moreover, represented 6.5% of GDP and covered 85% of the current account deficit. This deficit has significantly narrowed, hitting a four-decade minimum of 5.2% of GDP in 2017, mainly because of the increase in goods exports. Nonetheless, the external position has significant room for improvement, as external financial liabilities are 314% higher than external financial assets.

The country has a relatively strong macroeconomic position. The deficit of the consolidated public sector (CPS) represented 1.9% of GDP on average in 2013-2017. This figure, however, rose from 1.2% to a level of 2.6% projected in 2017, due to election-related spending in 2016-2017 and an expansion of public investment. Moderate deficits, robust economic growth and stability in the exchange rate have allowed public debt to decline in the last five years from 52.7% to 47% of GDP. The crawling peg exchange rate

regime has additionally been an anchor for inflation and supported international reserves accumulation. Inflation averaged 4.8% in the last five years, with rates of 3.1% in both 2015 and 2016. In 2017, however, inflation rose to 5.7% as a result of pressures on non-core inflation, particularly food and utilities. Credit to the private sector has shown a strong performance, as it has increased 14.3% yearly and represented around 35% of GDP on average during the 2013-2017 period. Moreover, no risks are perceived in the financial sector because overdue loans averaged only 0.9% of the credit portfolio in that period.

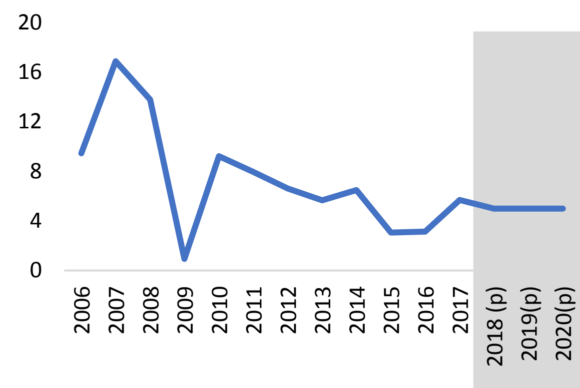
Figure 2. Public Debt and Fiscal Balance



(p) Projected

Source: Banco Central de Nicaragua and Ministerio de Hacienda y Crédito Público.

Figure 3. Inflation



(p) Projected

Source: Banco Central de Nicaragua and Ministerio de Hacienda y Crédito Público.

Recent economic growth has been accompanied by improvements in social indicators. GDP per capita shows an upward trend, going from US$1,438 in 2013 to US$1,667 in 2017. The overall poverty rate, using the income approach, fell from 44.5% in 2005 to 35.5% in 2014, while extreme poverty decreased from 20.4% to 15.0%. Furthermore, income inequality has declined. Between 2005 and 2014, the Gini coefficient decreased from 0.52 to 0.48, closer to the Latin American average. Likewise, health and education indicators have improved. Life expectancy at birth increased from 72.2 years in 2006 to 75.0 in 2015, and the gross enrollment ratio at the primary level has gone from 99 to 107% in the same period. Nevertheless, despite the country's positive economic growth, the reduction of poverty is still lower than in the region as a whole. Moreover, the country also exhibits large territorial disparities, as rural areas and the Caribbean regions display considerably higher levels of poverty than cities and the Pacific Coast, respectively. The unemployment rate has remained moderate, at an average of 5.6% between 2013 and 2017, but the informality rate is one of the highest in the region, around 75% of total employment.

Medium-Term Economic and Social Outlook

Strong macroeconomic performance is expected to continue in the medium term. For the next three years, economic growth is expected to be higher than the estimated potential rate of 4.5%. The fiscal deficit of the CPS is projected to widen from 2.6% to 3.1% of GDP in the next two years, due to projected expansion of public investment; the government is not expected to start a fiscal consolidation until 2020. Public debt is

expected to increase slightly, to 46% of GDP in 2019, but without compromising sustainability. Inflation is expected to be in the range between 5% and 6%. While the current account deficit is projected to remain at historically low levels, below 6.0% of GDP in the next two years, credit to the private sector is expected to continue growing rapidly at a 9.1% rate in 2018.

The macroeconomic environment is expected to be favorable to sustaining improvements in social indicators. GDP per capita is anticipated to reach US$1,866 in 2020, a 12.0% percent increase over 2017. The expected evolution of macroeconomic variables and GDP per capita may contribute to a continuation of the decline in poverty and inequality, the accumulation of human capital and the maintenance of a low unemployment rate.

Risk Factors

The economic outlook faces both external and internal risks. The first external risk is the potential approval of the NICA Act in the United States, which would restrict financing from international financial institutions to the Nicaraguan government; this could in turn put pressure on public finances and external accounts. Second, changes in the commercial and migratory policy of the United States, Nicaragua's main trading partner, could affect the level of remittances, capital flows and trade. Third, further increases in the interest rate of the Federal Reserve of the United States could impact the cost of both public and private financing and FDI. Finally, other exogenous risks include potential volatility in commodities prices and the possibility of natural disasters. The country additionally faces internal risks such as the financial sustainability of the Nicaraguan Social Security System and private debt incurred as a result of previous Venezuelan cooperation.

Development Challenges

The main development challenge of Nicaragua is to increase productivity to promote increasingly inclusive growth and improve welfare. The country should therefore make progress in the following three areas.

- **Strengthening human capital.** Despite advances in several health and education indicators, it is essential to focus the country's efforts on strengthening human capital in the short and medium term. In regard to health indicators, the infant mortality rate is still 25% higher than the LAC average, and the teenage pregnancy rate is among the highest in the region. Moreover, only 30% of the rural population has access to potable water. Concerning education, Nicaraguan students achieved one of the lowest scores on the Third Regional Comparative and Explanatory Study (TERCE), a standardized test administered in the LAC region. The reduction of disparities observed across the country (rural vs. urban areas and Pacific vs. Caribbean Coast) also remains a priority. A higher level of human capital will contribute to greater productivity and inclusive economic growth in the future.

- **Fostering productive opportunities and capabilities.** Although there have been significant improvements in infrastructure, there are still gaps to close in areas such as roads, ports, logistics and energy that separate Nicaragua from the region's average performance and have a negative effect on the country's competitiveness. For instance, the road density index is 184.34 km/1,000 km^2,

while the regional average is 397.59 km/1,000 km². In addition, the country's lack of port infrastructure on the Caribbean Coast makes the cost of transportation expensive. Moreover, Nicaragua's electricity prices are the second highest in Central America. These gaps, along with a production structure concentrated in low-value aggregated goods, limit the productive potential of the country and restrict productive opportunities for most of the population. The high level of labor informality is also a challenge to address, as it likewise affects productivity.

- **Improvement of the Institutional Framework.** The country's institutional environment is lagging behind the LAC average, representing a challenge for the business climate and investment. According to the World Economic Forum (2017), the Global Competitiveness Index ranks Nicaragua 93rd among 137 countries in 2017-2018. Therefore, it becomes necessary to redouble efforts to strengthen regulatory and legal frameworks to allow efficient development of different economic sectors, attract higher investment inflows, and create certainty in the economic decisions of households, firms and investors.

Conclusion

Continuation of sound macroeconomic policies can help Nicaragua face contingencies if economic risks become realities. Macroeconomic stability in recent years has fostered economic growth, inflows of foreign direct investment and the implementation of important development projects. The authorities can go further in building fiscal buffers by rationalizing subsidies, as the government is already doing in the electricity sector, and eliminating tax exemptions. Although further efforts to foster investment can still be undertaken, solid FDI shows that Nicaragua is already an attractive destination for investment.

Additionally, increasing capital spending aimed at strategic sectors, such as health, expansion of basic services and productive infrastructure, could impact future economic performance and the accumulation of human capital. Recent experience indicates that infrastructure and other projects have increased potential GDP, and this trend is expected to continue. However, the rising cost of international financing is a risk that should be addressed so that the expansion of infrastructure and increase in provision of public goods can continue. The country must therefore diversify its sources of financing and take advantage of other mechanisms such as public-private partnership (PPPs). Strengthening Nicaragua's institutional framework may also generate more confidence in the economy and thus create the conditions for further investment.

References

World Economic Forum. 2017. *The Global Competitiveness Report 2017–2018*. Geneva, Switzerland: World Economic Forum.