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**Honduras:** Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

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## Letter of Intent

April 29, 2015

Ms. Christine Lagarde  
Managing Director  
International Monetary Fund  
Washington, DC 20431

Dear Ms. Lagarde,

The implementation of our program is off to a strong start. Honduras' macroeconomic performance strengthened substantially in 2014, supported by our economic program and aided by more favorable external conditions. Economic growth increased, inflation declined, and the external position strengthened. Fiscal consolidation advanced strongly, with a large reduction in the central government and combined public sector deficits. Against this background, all program quantitative targets set for the first review were met, generally with ample margins. At the same time, all but one of the structural benchmarks were observed, as explained in more detail in the attached MEFP supplement.

Notwithstanding the strong start of the program, we are aware that, as set out in the November 2014 Memorandum of Economic and Financial Policies (MEFP), continued efforts are required to bolster macroeconomic stability and enhance the conditions for sustainable inclusive economic growth. We remain fully committed to these objectives and to the policies contained in the MEFP. The attached MEFP supplement discusses program implementation so far and the main elements, including some revisions, of our economic program for 2015.

Strengthening the fiscal position—including the finances of public enterprises—and the external sector, moving forward with structural reforms to boost competitiveness and growth, while protecting low-income group, remain our priorities for 2015. To attain these goals, we will adhere to the November 2014 MEFP and the policies set forth in the attached supplement to the MEFP. This supplement discusses in more detail the performance under the program and update the polices to meet our program objectives focusing on (i) improving the fiscal position, including tight control in the wage bill and capital spending; (ii) restoring financial sustainability of the state-owned electricity company (ENEE) and of the telecommunication company (Hondutel); (iii) strengthening tax administration; (iv) expanding our social protection system in a fiscally sustainable manner; and (v) advancing with our structural reform program to boost competitiveness by establishing strong foundations for robust and sustainable growth.

Based on the performance under the program so far and our commitment to continued program implementation, including its proposed revisions, we request the completion of the first review under the SBA/SCF arrangements. We plan to continue treating the arrangements as precautionary.

We remain confident that the policies set forth in the November 2014 MEFP and in the attached supplement are adequate for a successful implementation of the program. However, the government stands ready to take additional measures that may be required. The government will consult with the Fund on the adoption of such measures and in advance of revisions to the policies contained in the MEFP and the attached supplement of the MEFP, in accordance with Fund's policies on such consultation. The government will also continue to provide relevant information to monitor performance and reviews of the program on a timely basis.

We authorize the IMF to publish this Letter of Intent, its attachments and the related staff report.

Sincerely yours,

/s/

Marlon Tábor Muñoz  
President, Central Bank of Honduras

/s/

Wilfredo Rafael Cerrato Rodriguez  
Minister of Finance

Attachments

- I. Memorandum of Economic and Financial Policies
- II. Technical Memorandum of Understanding

## Attachment I. Memorandum of Economic and Financial Policies for 2015–17

1. **Honduras has made significant progress to bolster macroeconomic stability.** Since taking office in January 2014, the new administration embarked on a sound home-grown economic program, supported later by the December approval of a Stand-By Arrangement (SBA) and an arrangement under the Standby Credit Facility (SCF). Strong program implementation allowed for an overperformance on the fiscal targets owing to higher revenue, strict spending controls, and adjustments to electricity tariffs, while structural reforms were broadly on track (table 1 and 2). Despite the strong fiscal consolidation, social spending directed to the most vulnerable was protected.
2. **We remain fully committed to the objectives set forth in the November 2014 Memorandum of Economic and Financial Policies (MEFP).** These reforms will be complemented with policies described in this supplementary MEFP to ensure program's goals remain within reach. These includes (i) continuing the fiscal consolidation, including tight control on the wage bill and rationalization of capital spending, with a view to improving efficiency and productivity in the delivery of public services; (ii) regaining financial sustainability of the public-owned electricity company (ENEE) and the telecommunication company (Hondutel); (iii) strengthening tax administration; (iv) expanding our social protection system in a fiscally sustainable manner; (v) and advancing with the structural reforms program to boost competitiveness and strengthen the foundations for robust and sustainable growth.

### I. Macroeconomic Developments, Program Implementation and Outlook

3. **Economic activity strengthened in 2014.** Real GDP growth is estimated to have risen to 3.1 percent (3 percent under the program and 2.8 percent in 2013), reflecting mainly an increase in private investment, as confidence rebounded and more than offset the dampening effects of fiscal consolidation. For 2015, GDP growth is expected to rise to 3.3 percent (3 percent in the program), reflecting mainly higher incomes from lower international oil prices and the recovery of the US economy.
4. **Inflation has declined over the last year.** Inflation dropped to 5.8 percent (6.5 projected in the program) in 2014, owing to lower fuel prices. In 2015, inflation is projected to decline further to 4¾ percent (5.8 percent in the program), driven by the decline in domestic fuels prices and the fading of one-off effects from the fiscal measures implemented in early 2014 (particularly the increase in the VAT rate). Inflation stood at 3.7 percent in March 2015.
5. **The external position has strengthened.** The external current account deficit is estimated at about 7.4 percent of GDP in 2014 (7.8 projected in the program), 2 percent below the 2013 deficit of 9.5 percent of GDP. This improvement reflects the strong fiscal consolidation, improvement in the terms of trade, and strong growth of remittances. The improved current account and steady capital inflows allowed for an NIR accumulation of about US\$260 million in 2014, comfortably exceeding

program projections. The external position is expected to strengthen further in 2015, with the current account deficit projected to narrow to 6½ percent of GDP (7.1 percent of GDP in the program), driven mainly by lower spending on fuel imports. This would allow a further strengthening of international reserve buffers (see paragraph 18), bringing the projected reserve coverage to 4.5 months of imports (3.8 months of imports in the program).

6. **Fiscal consolidation targets were met with ample margins (Table 1).** In 2014, the combined public sector (CPS) deficit declined to 4.3 percent of GDP (5.9 percent of GDP projected in the program), driven mainly by a smaller wage bill and cuts in goods and services, and, to a lesser extent, lower capital spending and an improvement in the balance of public enterprises. The fiscal improvement was evenly split between the central government and the rest of the public sector. The smaller wage bill compared to the program projection reflects positions not filled at the central government level and a reduction of redundant positions at the rest of the public sector level, mainly in Honduran Social Security Institute (IHSS) municipalities, and other public entities.

7. **End-December 2014 quantitative targets for ENEE were also met,** including the continuous target of no arrears accumulation. The ENEE deficit declined as programmed to 1.3 percent of GDP in 2014 (from 1.8 percent in 2013), on the back of strict spending controls, lower energy costs, and tariff adjustments implemented during the last quarter in 2014.

8. **Monetary policy evolved in line with program objectives.** In 2014, credit growth expanded by about 10 percent, restrained by active efforts from the central bank to mop up liquidity. In addition, the deceleration of banks' credit in foreign currency contributed to reduce somewhat the increasing risks in the banking system from unhedged borrowers (we plan to implement a set of measures to further reduce this risk, see paragraph 22). In February and March 2015, the monetary policy rate was reduced by a total of 50 basis points to 6.5 percent (implying a real rate of about 2 percent, based on expected inflation) in response to a drop in inflation rates and an improvement in external conditions, and ongoing excess capacity as output remains below its potential level. The pace of currency depreciation was adjusted in recent months as envisaged in the program and in line with requirements to support external competitiveness.

9. **December 2014 and March 2015 structural benchmarks were mostly met (Table 2).** In December, we have enacted reforms to strengthen the PPP-framework to reduce fiscal risks, including repealing legislation that provided for the issuance of debt guarantees to private firms involved in PPP projects. We also completed a census of public employees, which has registered all public servants in a centralized system that is almost fully integrated with the automated payroll system. Our next task in this area is to conduct an audit to match assignments with job descriptions, with the objective of eliminating redundant positions and reduce further the wage bill. In the area of public enterprises, through March, we took measures to reduce the wage bill of ENEE by about 0.16 percent of GDP in 2015 excluding severance payments via reductions in its workforce. We plan to continue the workforce reduction process and complete it by August to achieve our goal of lowering ENEE's wage bill by about ¼ percent of GDP during this year, as specified in the structural benchmark. We have also prepared a plan to improve the finances of the state telecommunications

company (HONDUTEL), whose full-fledged implementation is expected to begin in October 2105 (see paragraph 20).

## II. Fiscal Policy

### A. Fiscal Program for 2015

10. **Our 2015 fiscal program will focus on further reducing the CPS deficit and strengthening the finances of ENEE.** The revised fiscal program targets central government and combined CPS deficits of 3.8 and 2.7 percent of GDP, respectively, somewhat lower than in the original program. The 2015 fiscal adjustment, measured by the primary balance of the CPS, is projected at about 2¼ percent of GDP, with primary spending projected to decline by about 1¼ percent of GDP. Expenditure reduction will concentrate at the central government level, and focus on further declines in the wage bill. At the same time, the operational balance of public enterprises would rise by about 1 percent of GDP, mainly on the back of measures already adopted in the electricity sector (e.g., tariff revision to better reflect the energy cost structure, reduction of redundancies at ENEE) and stricter discipline and efficiency gains by other public enterprises.

### B. Revenue

11. **Tax revenue.** Tax revenue is expected to improve slightly in 2015 relative to the program, by about 0.2 percent of GDP, owing to more vigorous economic activity arising from lower oil prices. On the legal challenge to the advance payment on the income tax adopted in late 2013, we continue to feel confident that the court will uphold the tax. In the unlikely event that the tax is not upheld, we will reduce spending accordingly to protect our fiscal program's targets.

12. **Tax administration.** Progress continues to be made on improving the administrative capacity of the tax agency (DEI) in order to support tax revenue growth. We are in the process of strengthening the Large Taxpayers Unit (LTU) with more and better trained staff (Structural benchmark, September 2015). We are concentrating our efforts to audit a group of 39 "mega" taxpayers, which account for about 40 percent of tax revenue. We have also created a special division at the LTU to deal with transfer pricing. At the same time, as envisaged in our program, we have established a business process mapping (BPM), strengthened control process for fuel imports, and are in the process of streamlining operations in the tax intelligence and risk analysis unit and strengthening the post clearance and risk management department. We plan to start the process of strengthening the quality of DEI staff, which will involve hiring specialized personnel and elimination of redundant positions.

### C. Spending

13. **Wage bill.** We reaffirm our commitment to keep the nominal wages stable at the central government (including in the health and education sectors) in 2015. We have made significant advances in different initiatives to control further the payroll. The census of all public employees was completed in December 2014 (structural benchmark). Currently, all wage payments are executed

through our integrated financial management information system (SIAFI) that is linked to the system that manages public employment (SIREP). This link would allow us to identify and close irregular positions. In addition, consistent with the 2015 budget law, we will cancel at least 60 percent of all unfilled posts existing at the start of year at the central government and decentralized institutions. For the rest of 2015, with the assistance of the World Bank, we will conduct a review to match functional operations of occupations with job assignments, and those positions identified as redundant will be closed by end-2015.

14. **Capital spending.** Following the recommendations of a committee created to review our investment program, we will continue to rationalize public investment, including rescheduling non-priority investment programs. This rationalization process would allow raising efficiency and contributing to lowering financing needs while still providing adequate support to long-run economic growth.

15. **Financing.** Our baseline plan envisages placing bonds in global markets to help finance the 2015 budget. However, we are considering the possibility of issuing in the domestic market instead, in order to take advantage of improving domestic financial conditions along with reducing foreign currency risks. We will make a decision on this in the coming months. Our priority is to keep our program fully financed. Therefore, should securing this financing from domestic prove difficult, we will tap external markets, which we are confident will remain open to Honduras—likely on improved conditions—given our strong program implementation.

16. **Domestic debt management.** We plan to launch a market-friendly plan to improve the domestic debt profile in the first half of 2015. The plan involves the exchange of bonds maturing in 2016–18 (when sizeable amortizations will become due) with new bonds that will carry longer maturities. Participation by creditors (local banks and public pension funds) will be voluntary, and the operation will be neutral in net present value terms. The implementation of this plan will allow us to spread better the government's gross financing needs over the medium term while providing debt holders with a standardized debt instrument. The latter may also help to facilitate improved liquidity management in the inter-bank money market—an important step to strengthen the transmission channel of monetary policy—and the development of a yield curve in local currency.

17. **Domestic arrears.** The audit of all domestic arrears, estimated at about 3 percent of GDP at end-2104, is ongoing, including in central government and public enterprises. We are focusing the audit on claims that have proper documentation (verification notes, also called F-01 in the Honduran government accounts) as irregular claims cannot be paid under Honduran legislation. Owing to some delays in the procurement process of the accounting firm mandated to do the audit, we request to postpone completion of the corresponding structural benchmark (original set for June 2015) to September 2015, still in the time for the second program review. Once the audit is finalized, we will decide on the best way to clear all validated claims, including the use of securities, during 2015 as envisaged in the November 2014 MEFP.

## D. Public Enterprises

18. **We will continue to strengthen the finances of key public enterprises.** The operational balances of ENEE and HONDUTEL improved last year reflecting adjustment to tariffs and higher operational margins in the former case and increased efficiency and payroll reductions in the latter. We are confident that our 2015 plans for ENEE (revising tariffs to reflect variations in costs, elimination of redundant personnel, and reduction in non-technical losses), and Hondutel (overhaul of the business model, suppression of redundant posts) are the right steps to strengthen the finances of these companies and reduce the burden on the public finances. This would contribute to generating additional fiscal space to expand social programs and protect high-priority capital projects and raising overall efficiency in the economy.

### ENEE

#### 19. **We plan to meet ENEE's 2015 quantitative targets on the basis of the following policies:**

- *Wage bill reduction.* Our program envisages a reduction in the payroll of about ¼ percent of GDP in 2015 (excluding severance payment estimated at about 0.2 percent of GDP). As mentioned above (paragraph 9), to achieve this goal, we plan to further reduce ENEE's personnel by August. We expect to complete the whole downsizing process, including paying corresponding severance costs, by November. With the measure expected to be broadly financially neutral in 2015 after severance payments are accounted for, its full impact on ENEE's wage bill will start to be seen in 2016.
- *Electricity tariff adjustments* in 2014-15 have been consistent with our objective to recover financial sustainability of ENEE. To protect operational margins, ENEE will continue to revise tariffs to reflect variations in fuels costs until the new Regulatory Committee for the Electrical Energy (CREE) is fully functioning. Once CREE is fully working, tariffs will be revised on a quarterly basis to reflect overall cost changes, as mandated by the new electricity sector law.
- *Reduction in non-technical losses.* As envisaged in the November 2014 MEFP, we plan to reduce non-technical losses ((estimated at about 20 percent in end 2014) by about 2 percentage points in 2015. To this end, until a new private operator takes charge of the ENEE, the following plan to reduce losses will be put in place: (i) complete the installation of smart meters (a process started in 2014), aiming to monitor about 65 percent of consumption by June 2015; (ii) disconnect the electricity provision to customers with unpaid bills and enforce legal prosecution of those committing fraud; and (iii) finalize databases to identify theft comparing the physical electricity distribution with the billing system. In addition, as part of a program agreed with the World Bank,<sup>1</sup> we are implementing an action

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<sup>1</sup> The Power Sector Efficiency Enhancement Project (PROMEF).



plan that includes improving the measurement of losses, closely monitoring technical losses via the distribution network's optimization system, installing special (high-voltage) meters for large users to make electricity theft more difficult, changing damaged meters, and putting in place a commercial management system for new costumers. Our fiscal program provides for the ENEE investment required for this loss reduction plan.

### **Hondutel**

20. **We have prepared a plan to restore the financial sustainability of Hondutel (structural benchmark, March 2015).** This plan includes an overhaul of its previous business model, including reducing its cost structure and attracting a strategic investor to open new line of businesses (internet and mobile services) to underserved areas. The process to select the strategic partner is expected to start in April 2015, and the partnership to start operating by October 2015. Meanwhile, as part of the cost reduction plan, Hondutel will continue downsizing its payroll to fit the personnel needs of the new business model while unloading unnecessary assets.

## **III. Monetary, Exchange Rate, and Financial Sector Polices**

21. **Monetary policy will remain focused on price stability and protecting the external position.** We are aiming to further lower inflation to 4¾ percent during 2015. Taking advantage of the favorable external position, we propose to revise up our targets for accumulation of net international reserves (NIR) to about US\$2,730 million by end-December 2015 (increasing reserve coverage to 4½ months of imports, up from 3.8 months in the original program). Accordingly, we will revise the net domestic assets target to be consistent with a prudent expansion of bank credit to the private sector to support the growth objectives of the government (Table 1). That said, should inflation begin to rise and external reserves target becomes at risk, we stand ready to tighten monetary policy, as appropriate

22. **We will continue to improve the operational framework for conducting monetary policy.** The BCH has continued to move in this direction by: (i) improving liquidity forecasting and liquidity management on a daily basis; (ii) improving market-based repo operations for liquidity management; (iii) increasing the signaling content of the TPM; and (iv) starting the phasing out of banks' use of government bonds to meet a portion of reserve requirements, with the aim of eliminating this practice during the program period. The BCH has not issued any new authorizations to allow government bonds to be held as reserve requirements.

23. **Our exchange rate policy will continue to be consistent with the objective of safeguarding competitiveness and strengthening the external position.** With the view to gradually moving to a more flexible exchange rate arrangement over the medium term, we will request IMF technical assistance to help us with the preparation of an operational plan for the gradual removal of foreign exchange surrender requirements (structural benchmark, December 2015). This plan will also include the regulations needed to ensure a proper functioning and development of the foreign exchange market.

24. **Recapitalization of the central bank.** In December 2014, we started implementing a multi-year plan to recapitalize the central bank (adopted by congress in May 2014) through non-negotiable bonds bearing a positive real interest rate. As scheduled, the first issuance took place in December 2014 for L. 3,058 million, with a coupon of 6 percent for the first year and 8 percent afterward. The recapitalization program comprises four additional annual issuances of L. 3,000 million at an 8 percent coupon (the next issuance is scheduled for December 2015). We anticipate that the central bank would be able to reach a positive level of capital by the early 2020s.

25. **We are taking measures to reduce risks in the financial sector.** We are aware that foreign-currency borrowing by unhedged agents remains a risk in the banking system. Based on recommendations of recent IMF technical assistance, we plan to increase, for lending to unhedged agents, the risk-weighted capital asset ratios to 150 percent for mortgage loans where debt-to-collateral ratio exceeds 80 percent and to 200 percent for consumer loans (including credit cards). This increase will be implemented gradually during 2015-17, with the process starting by mid-2015. At the same time, we plan to closely monitor and assess risks on banks' foreign currency funding and introduce additional corrective measures, if needed. We will also improve data provision on foreign-currency operations. As envisaged in the November 2014 MEFP, we are in the process of strengthening pension funds' investment policies and governance in line with best international practices to safeguard pension fund resources while achieving adequate returns. We expect to complete this process during the third quarter of 2015.

26. **We resumed publication of the financial stability report in April 2015.** This report will allow us to monitor more closely developments in the financial sector and improve transparency of their operations. Congress has also approved new legislation on AML/CFT to bring it in line with the 2012 FATF standard.

27. **The update of the safeguards assessment of the BCH has been completed.** In keeping with its recommendations, we are committed to reforming the central bank law, with the aim of strengthening the central bank's governance and operational autonomy. We plan to bring the necessary amendments to a vote in congress by December 2015. We will also strengthen financial reporting by taking steps to move to IFRS during the period of the program.

#### IV. Structural Reforms

28. **Implementing the new PPP framework.** A new fiscal unit in charge of assessing fiscal risks within the Finance Ministry was created, following the amendment of the PPP framework law in compliance with the December 2014 structural benchmarks. Assistance from the IADB and the Millennium Challenge Account is being sought to further strengthen the capacity of the staff attached to this unit so it can properly estimate contingent risks stemming from PPP projects. Once the unit has achieved this capacity, we will resume the process of approval and development of new PPP projects. In the meantime, we will continue moving forward with the implementation of our portfolio of existing projects that has already been approved by congress, subject to the requisite favorable assessment by the Finance Ministry. We will continue implementing the international

accounting standard (IPSAS32) to record PPP operations in the fiscal accounts as stated in our 2015 budget law.

29. **Energy sector.** We have revised our strategy to engage a private operator to strengthen the financial conditions of ENEE. This new strategy includes hiring a management company (for up to 5 years) that will focus on reducing non-technical losses, maintaining and upgrading the distribution network, and streamlining costs. These steps are needed to open the way to find a permanent long-term strategic investor. We launched the bidding process in March 2015, and plan to appoint an operator in charge of reducing nontechnical losses by August 2015. In the mean time, ENEE will continue to implement its action plan (see paragraph 19) to lower losses.

30. **Medium-term fiscal framework** (structural benchmark, June 2015). Based on previous CAPTAC TA and supported by the Millennium Challenge Corporation, we are on track to develop a plan for the implementation of a medium-term fiscal framework. Our goal is to use this framework in the preparation of the 2017 budget.

31. **Framework law for social protection.** We are aiming at widening the social protection system, including unemployment protection and a new framework to provide health services, while moving gradually to a universal health and pension coverage supported by multi-pillar systems. As set out in the November 2014 MEFP, we are assessing the fiscal costs of these initiatives to ensure they can be accommodated within our fiscal targets and that the reform is fiscally sustainable on an intertemporal basis. At the same time, we are working on the design of complementary, specific legislation (particularly the social security law, governing the IHSS, and the law on public health care). We will bring the new framework legislation on social protection to a vote in congress only when (i) it has been ensured that it is consistent with our fiscal program targets and intertemporal fiscal sustainability; and (ii) the details of the complementary, specific legislation have been worked out.

32. **IHSS reform.** The November 2014 MEFP envisaged submitting the IHSS reform legislation to congress by March and its approval by June 2015. The IHSS is expected to play a central role in the proposed new social protection system and it is crucial that its reform fully takes into account the cost and financing implications of the new framework legislation. To give adequate time for the preparation of the both reforms, we request moving congressional submission of the legislation reforming the IHSS to September 2015 (structural benchmark), and its approval to December 2015 (structural benchmark).

### **Program Monitoring**

33. **Program Monitoring.** The program will be subject to semi-annual reviews, and will be monitored through performance criteria, indicative targets, and structural benchmarks, as set out in tables 1 and 2.

**Table 1. Honduras: Performance Criteria 1/**

(Cumulative flows; millions of Lempiras, unless specified)

	2014			2015			
	Prel.	Dec		End-Jun.		End-Dec.	
	End-Jun.	Prel.	Prog.	Program	Rev. prog.	Program	Rev. prog.
<b>QUANTITATIVE PERFORMANCE CRITERIA</b>							
<b>Fiscal targets 2/</b>							
Overall balance of the combined public sector (floor)	-2,642	-16,670	-23,931	-5,256	-2,600	-14,283	-11,700
Overall balance of the central government (floor)	-4,365	-18,001	-22,252	-6,870	-4,470	-17,873	-16,900
Overall balance of ENEE (floor) 3/	-2,155	-5,511	-5,521	-1,491	-1,249	-3,353	-1,648
<b>Public debt targets 4/</b>							
Contracting and guaranteeing of new non-concessional loans (continuous ceiling, in million US\$)	...	55	600	600	...	600	...
Accumulation of new arrears by ENEE (continuous ceiling)	...	0	0	0	...	0	...
Accumulation of new external arrears (continuous ceiling, in million US\$)	0	0	0	0	...	0	...
<b>Monetary targets</b>							
Net international reserves of the Central Bank (floor, in million US\$)	2,362	2,475	2,271	2,390	2,594	2,411	2,730
Stock of net domestic assets of the central bank (ceiling) 5/	-28,900	-26,857	-22,017	-27,001	-30,922	-22,454	-28,625
<b>Indicative targets 2/</b>							
Wage bill of the central government (ceiling)	17,945	37,251	38,049	18,850	18,600	39,248	38,456
Social spending (floor)	2,496	9,950	7,078	2,384	2,384	7,333	9,000
Operating revenue-to-spending ratio of ENEE (floor)	...	0.86	0.85	0.97	0.98	0.97	1.03

1/ Definitions as specified in the Technical Memorandum of Understanding.

2/ Cumulative starting in January of the correspondent year.

3/ Excluding government transfers.

4/ Cumulative starting in December 2014. Targets on non-concessional debt and external arrears are for the combined public sector.

5/ Using the program exchange rate of L21.1066 = 1US\$.

**Table 2. Honduras: Structural Benchmarks 2014–15**

Measure	Target Date	Status
Adjust average electricity tariffs by 2.5 percent during 2015 to reflect past cost increases; further adjust tariffs to incorporate current changes in costs.	Continuous	Met
Approval of legislation to strengthen the PPP framework	December 2014	Met
Repeal legislation allowing the issuance of government guarantees for debt contracted by private companies involved in PPP projects	December 2014	Met
Conduct a census of public employees, with the aim of identifying and cancelling redundant positions during 2015	December 2014	Met
Take actions sufficient to achieve savings in ENEE's wage bill as indicated in paragraph 11 of the November 2014 MEFP.	March 2015	Not met. Mostly implemented <sup>1</sup>
In consultation with staff, prepare a plan to address the financial difficulties of HONDUTEL	March 2015	Met
Present a program for developing a medium-term fiscal framework with a clear fiscal anchor and fiscal policy targets	June 2015	In progress
Submit to congress legislation to reform the Social Security Institute (IHSS) to strengthen its actuarial position and improve its governance	September 2015 <sup>2</sup>	In progress
Complete an audit of public sector arrears, with a view to clearing them	September 2015 <sup>3</sup>	In progress
Strengthen the Large Taxpayer Unit with adequate staff levels	September 2015	In progress
Present to congress a 2016 budget bill consistent with the program targets for central government and CPS deficits	September 2015	
Present a plan for a gradual removal of foreign exchange surrender requirements	December 2015	
Approval of the law reforming the IHSS	December 2015 <sup>4</sup>	
<sup>1</sup> See paragraph 9 for details. <sup>2</sup> The original date was March 2015. <sup>3</sup> The original date was June 2015. <sup>4</sup> The original date was June 2015.		

## Attachment II. Technical Memorandum of Understanding

1. This memorandum sets out technical understandings between the Honduran authorities and the Fund staff for monitoring of the economic program agreed for the period November 2014–November 2017. It defines the concepts used to assess observance of quantitative performance criteria, structural benchmarks, and indicative targets specified in Tables 1 and 2 of the Memorandum of Economic and Financial Policies (MEFP). It also specifies the frequency of the data to be provided to the Fund to monitor the developments under the program.

### A. Program Assumptions

2. For program monitoring purposes, unless otherwise indicated, U.S. dollar denominated components of the balance sheet of the Central Bank of Honduras will be valued at the exchange rate of L21.1066/US\$ exchange rate at end-August 2014. Amounts denominated in other currencies will be converted for program purposes into U.S. dollar amounts using the cross-rates as of end-August 2014 published on the IMF website <http://www.imf.org>, including US\$/EUR = 1.3188, JPY/US\$ = 103.71, CHF/US\$ = 0.9145, CAD/US\$ = 1.0858, SDR/US\$ = 0.6586.

### B. Fiscal Targets

3. Unless otherwise specified, the definitions of all fiscal variables contained in this Technical Memorandum of Understanding are based on the IMF's 2001 Manual on Government Finance Statistics.

4. **The deficit of the combined public sector (CPS)** will be measured from the financing side (i.e., "below the line"), and will correspond to the net borrowing of the CPS, from both external and domestic sources, excluding payment of domestic arrears accumulated until December 2013. The CPS comprises the nonfinancial public sector (NFPS) and the operating result (quasi-fiscal balance) of the central bank. The NFPS covers the central government, local governments and decentralized agencies, the social security institute (IHSS), the public pension funds (INJUPEMP, INPREMA, and IPM), all decentralized agencies and funds, and non-financial public enterprises.

5. **The deficit of the central government** will also be measured from the financing side, excluding payment of domestic arrears accumulated until December 2013. For program purposes, the central government corresponds to the concept of central administration used by the authorities and includes the executive, judicial, and legislative branches.

6. **The current primary expenditure of the central government** is defined as total current expenditure less interest payments.

7. **The central government wage bill** is defined as all central government wages and salaries, including severance payments, plus employer social security and pension contributions;

other remunerations (such as bonus payments and in-kind compensations) are also included in the definition.

8. **Social spending** is measured at the central government level and defined as the programs and projects with social content that are financed with domestic resources, debt relief, grants and loans (see Table B).
9. **The overall balance of ENEE** will be measured from the financing side. For program purposes, it will be defined excluding subsidies in the form of current transfers) from the central government to the company.
10. **The operating margin of ENEE** will be defined as the ratio of operating revenue to operating expenditure. Operating revenue will be defined as current revenue excluding interest earnings and subsidies in the form of current transfers from the central government. Operating expenditure will be defined as total expenditure excluding interest payments and capital spending.
11. **The operating balance of public enterprises** is defined as the difference between operating revenue and operating expenditure of the enterprises.
12. **Net domestic financing of the CPS** will be measured as the operating result of the central bank and the change (relative to end-December 2013) in the stocks of: (1) outstanding indebtedness of the NFPS (direct bank credit plus bank holdings of public sector bonds less deposits) to the domestic financial system (central bank, commercial banks, and other financial institutions); (2) outstanding public sector bonds held outside the financial system; (3) repatriation of deposits held abroad; and (4) outstanding suppliers' credit and floating debt (un-cashed and undelivered checks, and unpaid invoices and orders) of the central government, and unpaid orders of the rest of the NFPS. For the purposes of the program, domestic financial system is defined as comprising all depository institutions, according to the Monetary and Financial Statistics Manual (MFSM) definition.
13. **Discrepancies.** The authorities will undertake periodic reconciliations to minimize discrepancies between above-the-line and below-the-line financing data. As needed, such reconciliations must be carried out prior to completion of the program reviews.
14. **Adjustor.** If tax revenues net of legally-mandated transfers to the *Vida Mejor* and security trust funds were to exceed those projected under the program for 2015, at least 50 percent of the excess revenue will be saved and the residual will be allocated as counterpart to social and/or capital projects (Paragraph 8, Table B).

### C. Monetary Targets

15. **Net International Reserves (NIR) of the central bank (program definition).** For program purposes, the NIR of the central bank will be measured as gross international reserves that are readily available minus (i) short-term reserve liabilities (including purchases and credits from the Fund), as described in the international reserves table prepared by the central bank according to the MFSM; (ii) foreign assets that are counterpart of foreign currency deposits of financial institutions at the central bank and of any other liability of the central bank with residents that is payable in foreign currency; (iii) the transfer to the central bank of foreign currency deposits held abroad by all public entities, including HONDUTEL, INJUPEMP, and IHSS. Readily available reserves also exclude those assets that are pledged or otherwise encumbered, including but not limited to reserve assets used as collateral or guarantee for a third-party external liability. NIR will be valued at program accounting exchange rates.

16. **Net domestic assets (NDA) of the central bank** will be measured as the difference between currency issue and NIR, both measured on the basis of end-of-period data.

17. **Adjustors.** Starting in 2014, the target floor on NIR will be adjusted downwards by up to US\$100 million for the shortfall of programmed external disbursements to the budget (including from sovereign bond placements).<sup>2</sup> In case of an excess during the program period, the target floor on NIR will be adjusted upwards by the full such amount. External disbursements to the budget (including sovereign bond placements) are expected to total about US\$290 million in 2015. For 2015, the end-year target floor on NIR will also be adjusted downwards (upwards) by about US\$9 million (US\$4.5 million for the end-June target) for every US dollar that the price of oil exceeds (falls below) the oil price projected in the program. For program purposes, the relevant oil price is the WEO's average petroleum spot price (APSP). The program projects an APSP of US\$58.14 for 2015.

### D. External Targets

18. **External debt.** For program purposes, the definition of debt is the one set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to External Debt (Executive Board's Decision No. 6230-(79/140), as amended by Decision No 14416-(09/91, effective December 1, 2009). This definition applies also to commitments contracted or guaranteed for which value has not been received, and to private debt for which official guarantees have been extended and which, therefore, constitute a contingent liability of the public sector. Excluded from this definition are normal import-related credits, defined as liabilities that arise from the direct extension, during the normal course of trading, of credit from a supplier to a purchaser—that is, when payment of goods and services is made at a time that differs from the time when

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<sup>2</sup> In the program, any adjustment to the NIR target will be mirrored by an equal adjustment in the opposite direction to the target ceiling on net domestic assets of the central bank.



ownership of the underlying goods or services changes. Normal import credit arrangements covered by this exclusion are self-liquidating; they contain pre-specified limits on the amounts involved and the times at which payments must be made; they do not involve the issuance of securities. For the purpose of the program, external debt is defined on the basis of residency.

19. **Debt definition.** The definition of debt set forth in No. 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements reads as follows:

(a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lesser retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property.

(b) Under the definition of debt set out in point (a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt give rise to new debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

20. **Definition of public debt.** For the purpose of the program, public sector debt is defined as the debt of the CPS excluding the debt of local governments.

21. For purpose of the program, the guarantee of a debt arises from any explicit legal obligation of the general government or any other agency acting on behalf of the general government to service such a debt in the event of nonpayment by the recipient (involving payments in cash or in kind), or from any implicit legal or contractual obligation to finance partially or in full any shortfall incurred by the debtor.

22. **Concessional** will be calculated using a unified discount rate of 5 percent and taking into account all details of the loan agreement, including maturity, grace period, payment schedule, upfront commission, and management fees. The grant element of loans can be calculated using the concessional calculator available at the IMF web site <http://www.imf.org>.<sup>3</sup> For program purposes, a debt is **concessional** if it includes a grant element of at least 35 percent, calculated as follows: the grant element of a debt is the difference between the present value (PV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The PV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt. The discount rate used for this purpose is 5 percent.

23. **Borrowing on non-concessional terms.** For the purposes of the program, this continuous ceiling applies to the contracting or guaranteeing of nonconcessional external debt by the CPS or any other agencies on its behalf.<sup>4</sup> Debt denominated in currencies other than the U.S. dollar shall be converted to the U.S. dollars using program assumptions on bilateral exchange rates. The continuous ceiling applies not only to debt as defined above, but also to commitments contracted or guaranteed for which value has not been received. This ceiling will be adjusted downwards by the amount of programmed disbursements that change into concessional resources.

24. **Exclusions.** Excluded from the non-concessional external debt continuous ceiling are: (i) debts classified as international reserve liabilities of the Central Bank, (ii) debts to restructure, refinance, or prepay existing debts, (iii) use of Fund resources (iv) short-term import financing (with a maturity of less than one year), and (v) central bank instruments placed in the domestic market held by nonresidents.

25. **Stock of external debt arrears.** For the purpose of the program's continuous ceiling, external debt service arrears are defined as overdue debt service arising in respect of obligations incurred directly or guaranteed by the public sector, except on debt subject to rescheduling or restructuring, as indicated by the respective creditors. The CPS will accumulate no external debt arrears during the program period.

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<sup>3</sup> Currently available at <http://www.imf.org/external/np/pdr/conc/calculator/default.aspx>.

<sup>4</sup> This includes short-term external debt (with an original maturity of up to and including one year) and non-concessional medium- and long-term debt with original maturities of more than one year.

## E. Energy Sector

26. **Arrears of ENEE** are defined as overdue payments of ENEE to private and public entities. During the program period, no new arrears to the private sector will be accumulated, excluding technical delays stemming from the payment process. Technical delays are defined as the maximum period allowed for the payment of suppliers' and/or contractors' invoices to ENEE without incurring arrears, in line with the law on public contracts (Decree 74-2001). This period extends up to 45 days, starting from submission of appropriate documents for payment.

## F. Monitoring and Reporting Requirements

27. **The information required to monitor the compliance with quantitative and structural benchmarks** specified in the MEFP will be supplied to the Fund at least monthly (electronically, to the extent possible) and within 45 days of the end of the previous month (unless otherwise noted) according to the sources detailed in the next paragraph.

28. **The ceilings on the deficit of the central government and of the CPS** will be monitored below-the-line on the basis of the monthly reports *Financiamiento de la Administración Central* and *Financiamiento del Sector Público Combinado*, respectively, prepared by the central bank, which contain:

- **Net external financing** of the central government and the NFPS, respectively, with detailed information on disbursements, amortizations, exceptional financing, zero coupon bonds, and accumulation of arrears. This information will be prepared by the central bank and reconciled with the Ministry of Finance.
- **Net domestic financing** of the central government and the NFPS, respectively, with detailed information on: (1) net domestic financing from the central bank and the rest of the financial system to the central government and the NFPS, as contained in the *Balance diario*; (2) net placement of bonds (including stabilization bonds) by the central government and the NFPS outside the financial system, as reported by the central bank with data from the Public Credit Directorate of the Ministry of Finance; (3) change in foreign currency deposits held abroad by the central government and the NFPS; and (4) change in the outstanding stock of suppliers' credit and floating debt of the central government, as reported by the Treasury, and the rest of the NFPS as reported by the central bank. To monitor the net domestic financing to the CPS, the central bank will provide the Fund with detailed data on a cash basis on the operating revenue and expenditure of the central bank.

29. **The ceilings on the wage bill of the central government** will be monitored monthly on the basis of the Ministry of Finance report: *Sueldos y salarios de la administracion central*.

30. To complement the monitoring of fiscal performance, a breakdown of tax revenue by type of tax will also be provided monthly.

31. **Social spending (Table B)** will be monitored quarterly on the basis of financial reports provided by the Ministry of Finance.
32. **The overall balance of ENEE** and its non-accumulation of arrears will be monitored monthly on the basis of financial reports provided by the Ministry of Finance.
33. **The floor on NIR and the ceiling on NDA of the central bank** will be monitored on the basis of information produced by the central bank, in accordance with the new presentation of the MFSM. This information will be provided within two weeks of the end of the previous month.
34. **The ceilings on the contracting of non-concessional external debt and on the non-accumulation of external payments arrears** will be monitored with information provided by the Ministry of Finance. The accounting of non-reschedulable external debt-service arrears by creditor (if any), with detailed explanations, will be transmitted by the Ministry of Finance on a monthly basis within four weeks of the end of each month. Moreover, a loan-by loan accounting of all new loans contracted or guaranteed by the public sector, including detailed information on the amounts, currencies, and terms and conditions, as well as relevant supporting materials, will be transmitted by the central bank on a quarterly basis within four weeks of the end of each quarter.
35. **Implementation of structural measures in the program** will be monitored monthly based on information provided by the central bank, the Ministry of Finance, and the Banking and Securities Commission.

Table A. Data to Be Reported to the IMF

Item	Periodicity
<b>I. Fiscal Data</b>	
<b>Net external financing:</b> detailed information on disbursements, amortizations, exceptional financing, zero coupon bond, and accumulation of arrears.	Monthly, within 45 days of the end of each month.
<b>Net domestic financing</b> of the central government and the NFPS: detailed information on (1) net domestic financing from the central bank and the rest of the financial system to the central government and the NFPS, (2) net placement of bonds by the central government and the NFPS outside the financial system, (3) change in foreign currency deposits held abroad by the central government and the NFPS; and (4) change in the outstanding stock of suppliers' credit and floating debt of the central government, as reported by the Treasury, and the rest of the NFPS as reported by the central bank.	Monthly, within 45 days of the end of each month.
<b>Monitoring of net domestic financing to the central government</b> will require that the central bank provide the Fund with detailed data on a cash basis on the operating revenue and expenditure of the central bank.	Monthly, within 45 days of the end of each month.
<b>Monitoring of net domestic financing to the CPS</b> will require that the central bank provide the Fund with detailed data on a cash basis on the operating revenue and expenditure of the central bank.	Monthly, within 45 days of the end of each month.
Overall balance of ENEE and arrears (if any, with detailed explanations)	Monthly, within 45 days of the end of each month.
Wage bill of the central government.	Monthly, within 45 days of the end of each month.
Breakdown of tax revenue by type of tax	Monthly, within 45 days of the end of each month.
Social spending	Quarterly, within 45 days of the end of each quarter.

Detailed information on:	
Revenues and expenditures of the central government.	Monthly, within 45 days of the end of each month.
Revenues and expenditures of the NFPS, including the operating balance of public enterprises.	Quarterly, within 45 days of the end of each month.
Revenues and expenditures of ENEE.	Monthly, within 45 days of the end of each month.
<b>II. Monetary Data</b>	
Detailed information on the Central Bank balance sheet, including Net International Reserves and Net Domestic Assets.	Monthly, within 2 weeks of the end of each month.
Detailed information on domestic liabilities of the central bank payable in foreign currency, including change in foreign currency deposits of public enterprises in the central bank.	Monthly, within 2 weeks of the end of each month.
<b>III. External Debt</b>	
Loan-by loan accounting of all new loans contracted or guaranteed by the public sector, including detailed information on the amounts, currencies, and terms and conditions, as well as relevant supporting materials	Quarterly, within four weeks of the end of each quarter.
The accounting of arrears on external debt-service by creditor (if any), with detailed explanations.	Monthly, within four weeks of the end of each month.
<b>IV. Additional Data</b>	
Balance of Payments statistics	Quarterly, within three months of the end of each quarter.

Table B. Main Social Programs

Description
<b><i>Bono Diez Mil and Vida Mejor Programs</i></b>
<i>Bono Diez Mil</i>
<i>Vida Mejor</i>
<b>Other social investment expenditures and programs</b>
<p>Honduran Social Investment Fund (FHIS)</p> <p>Community Education Program (PROHECO)</p> <p>Family allowances program (PRAF)</p> <p>Healthy schools program (Free school meals)</p> <p>Free tuition</p> <p>Social work scholarships</p> <p>Transportation education bond</p> <p>Social aid to persons</p> <p>Patronatos Aldeas y Caserios, NGOs</p> <p>Academic excellence scholarships</p> <p>Various scholarships</p> <p>Other scholarships and programs</p>

## Honduras—Supplementary Letter of Intent First Reviews Under the Stand-By Arrangement and the Standby Credit Facility

September 3, 2015

Ms. Christine Lagarde  
Managing Director  
International Monetary Fund  
Washington, DC 20431

Dear Ms. Lagarde,

*This letter supplements the Letter of Intent (LOI) for the first reviews under the SBA/SCF arrangement of April 29, 2015.*

In May, Congress approved a framework social protection law (SPL) that would provide a multi-pillar scheme for expanding coverage of healthcare, pensions and existing social programs. This law will be complemented with specific legislation to reform the Honduran Social Security Institute (IHSS) and the public health law. We will implement the provisions of the SPL gradually to keep costs within the program targets and minimize pressures on the public finances. The law's additional costs during the program period will be contained to be consistent with the fiscal targets envisaged in our program. We will also continue to improve the targeting of our social safety net to help contain the cost of the new law. At the same time, consistent with the provisions of the SPL, we are prepared to reduce, eliminate or phase out existing tax exemptions to help cover the long run costs of the law and maintain a low and sustainable fiscal deficit.

Following revelations of corruption at the IHSS during the previous administration, our government has moved towards a stronger stance against corruption in Honduras. We have responded quickly to these revelations by ordering a full investigation of the events, while calling for a broad and unconditional national dialogue on corruption. We have also proposed five concrete measures to address corruption: the creation of a unit of supervision and support against corruption and impunity at the Public Prosecutor's Office; a similar unit for the council of the judiciary and the courts inspectorate; a special new unit for the security of judges, prosecutors, their families and judicial installations; a new monitoring entity for the justice system; and a new system of business integrity. We are confident that these measures will prove effective in combating corruption. In addition, as set out in the November 2014 LOI, we also plan to strengthen the governance of IHSS on the basis of legal reforms. This will build on measures already taken to strengthen procurement practices and process at the institution, following the replacement of its management team in 2014.

Macroeconomic performance remains in line with the program targets, we have met all the end-June performance criteria (PC) and indicative targets and no longer request modification of the



end-June 2015 PCs as previously requested, (See Table 1). We have developed a medium-term fiscal framework (the June structural benchmark called for a presentation of plan for developing it), which we intend to use in the preparation of the 2016 budget (originally planned to use for the 2017 budget). At the same time, we have established the new electricity sector regulator, which will become operational over the coming months.

We authorize the Fund to publish this letter and the associated staff report supplement.

Very truly yours,

/s/  
Marlon Tábor Muñoz  
Chief Economic Cabinet

/s/  
Wilfredo Rafael Cerrato Rodríguez  
Minister of Finance

/s/  
Manuel de Jesus Bautista Flores  
President of the Central Bank

**Table 1. Honduras: Performance Criteria 1/**  
(Cumulative flows; millions of Lempiras, unless specified)

	2015				2015	
	End-Jun.			Status	End-Dec.	
	Program	Adjusted	Actual		Program	Rev. prog.
<b>Fiscal targets 2/</b>						
Overall balance of the combined public sector (floor)	-5,256	-3,345	3,461	✓	-14,283	-11,700
Overall balance of the central government (floor)	-6,870	-4,959	-707	✓	-17,873	-16,900
Overall balance of ENEE (floor) 3/	-1,491	...	-395	✓	-3,353	-1,648
<b>Public debt targets 4/</b>						
Contracting and guaranteeing of new non-concessional loans (continuous ceiling, in million US\$)	600	...	80	✓	600	...
Accumulation of new arrears by ENEE (continuous ceiling)	0	...	0	✓	0	...
Accumulation of new external arrears (continuous ceiling, in million US\$)	0	...	0	✓	0	...
<b>Monetary targets</b>						
Net international reserves of the Central Bank (floor, in million US\$)	2,390	2,406	2,848	✓	2,411	2,730
Stock of net domestic assets of the central bank (ceiling)	-27,001	-27,345	-38,706	✓	-22,454	-28,625
<b>Indicative targets 2/</b>						
Wage bill of the central government (ceiling)	18,850	...	18,459	✓	39,248	38,456
Social spending (floor)	2,384	...	3,985	✓	7,333	9,000
Operating revenue-to-spending ratio of ENEE (floor)	0.97	...	1.04	✓	0.97	1.03

Source: Honduran authorities and fund staff estimates.

1/ Definitions as specified in the Technical Memorandum of Understanding.

2/ Cumulative starting in January of the correspondent year.

3/ Excluding government transfers.

4/ Cumulative starting in December 2014. Targets on non-concessional debt and external arrears are for the combined public sector.